WESTPAC HOME TRUTHS

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Michael Gordon, Acting Chief Economist
+64 9 336 5670
michael.gordon@westpac.co.nz

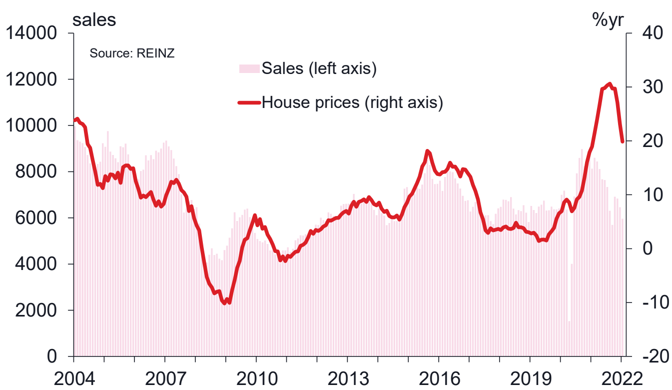
Life comes at you fast.

- There's now enough evidence to declare that the housing boom has ended, with prices turning downward in the last two months.
- We've long been saying that house prices can and would fall once we saw a meaningful rise in mortgage rates.
- That has now happened, with fixed-term rates now factoring in the prospect of a series of OCR hikes over the next couple of years.
- Changes to lending regulations will also have contributed to the slowdown to some degree.
- Their greatest impact is being felt right now while the changes are being bedded in, but we think their effects on house values will be less enduring.

The economist Rudi Dornbusch had a saying to the effect of: changes in the economy take longer than you'd expect, then they happen faster than you'd believe. That certainly seems to have been the case with the New Zealand housing market.

We've been predicting for some time that once mortgage rates rise from their lows, the housing boom would cool off and tip over into modest price declines. However, the timing of that price drop has always been fluid. At one point we expected it to begin in the early part of this year, later pushing that out until the middle of the year when it seemed that the market still had quite some momentum behind it.

REINZ house sales and prices



But now, we have enough evidence to show that the turnaround began in late 2021. The REINZ house price index fell by 0.9% in January, the second straight month of decline. As in December, the Auckland region led the drop in prices, but now the rest of the country has joined it as well. Prices are still up 20% on a year ago, reflecting the rapid price gains through much of 2021, but that measure is now coming down fast.

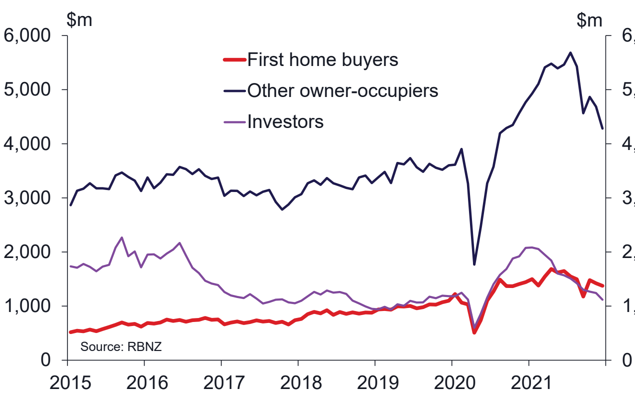
House sales have been steadily declining over much of the past year. But while that previously could have been described as a moderation in the Covid-era boom, we're now beyond that point, and sales are running below their pre-pandemic levels.

Property listings jumped higher in late 2021 as the Delta lockdown was eased. Combined with the slowdown in sales, that saw a lift in the stock of unsold homes for the first time in a while. This may prove to be short-lived though, particularly in Auckland, where recent data suggests that new listings have eased back again and the stock of homes for sale is stabilising. That's not surprising – in the absence of forced sellers, supply will tend to respond to demand. As potential sellers observe that auction clearance rates are falling and that sale prices aren't meeting expectations, some of them will choose to hold back.

Property listings (seasonally adjusted)

Reserve Bank data shows that new mortgage lending fell substantially in December. This is usually a low month for new loans anyway, but in seasonally adjusted terms we estimate that it was down by 9%. Lending to investors has been slowing since early 2021, when loan-to-value limits were reintroduced and the Government announced changes to the tax treatment for property investors. More recently, the slowdown has been concentrated among lending to existing property owners (including top-ups). First-home buyers have fared better so far, though lending is still down from its highs.

New mortgage lending (seasonally adjusted)



We should note that lending is a lagging indicator of the housing market. Loans are drawn down at settlement, which is typically about a month after the sale price is agreed, and can be several months after the lender gives pre-approval. The lending figures from January onwards are likely to shed more light on the latest trends.

We think the slowdown in the housing market reflects a combination of factors weighing on demand. (Housing supply, while an important issue in itself, doesn't seem like a plausible candidate for the speed of the turnaround in prices.) Not only have interest rates risen substantially, but the RBNZ further tightened its loan-to-value restrictions from November, and more prescriptive lending regulations under the Credit Contracts and Consumer Finance Act (CCCFA) came into effect from December.

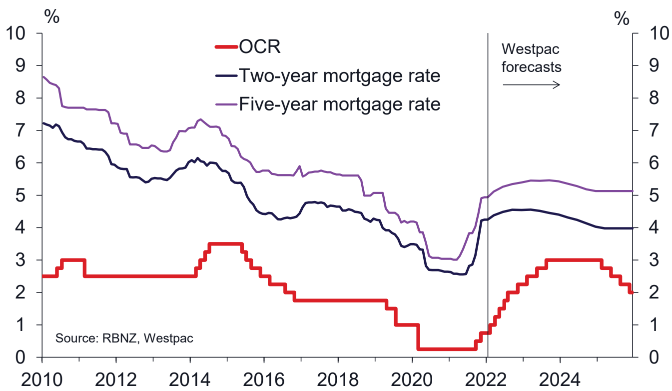
It's hard to separate out how much each factor has contributed to the slowdown. But the bigger question now is to what extent their effects will be enduring. In that respect, interest rates are the clear number one – mortgage rates aren't coming down again any time soon. LVR limits and the CCCFA will be having their greatest impact right now while the changes are being bedded down, but we think they're less likely to have an ongoing impact on prices.

Mortgage rates: We've long argued that interest rates are the single biggest driver of changes in house prices. And as the RBNZ has turned towards removing the monetary stimulus that was put in place during the Covid shock, we're now seeing house prices respond accordingly.

We need to be clear which interest rates we're talking about. Most mortgage lending in New Zealand is done at fixed rates, albeit for relatively short terms – typically one to two years, although some borrowers have been extending out for longer recently. Those fixed-term rates already embody the idea of an OCR rising from 0.75% today to around 3% over the next couple of years. So while the OCR cycle itself is still in its early stages, we'd argue that fixed-term mortgage rates are already closer to their peaks than their troughs for this cycle. That means the pressure on property values will be ongoing, but may not get much more intense than it is already.

Our 'fair value' approach suggests that at today's mortgage rates, the housing market has finally flipped into overvalued territory, but not hugely so. In our latest quarterly *Economic Overview* we forecast a cumulative price drop of around 10% between now and the end of 2024.

OCR and indicative mortgage rates

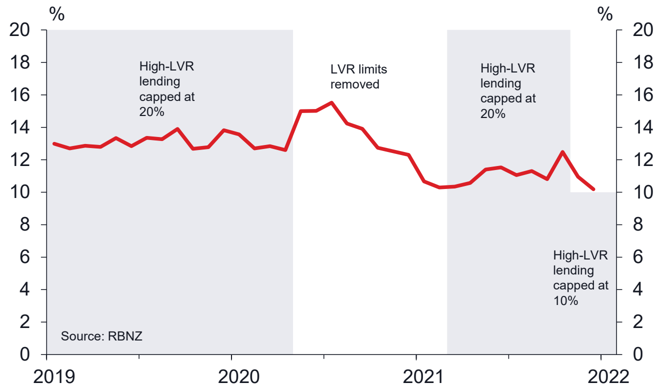


Loan-to-value ratios: After removing all restrictions on LVRs in the wake of the Covid shock, the RBNZ reintroduced them in March 2021 and successively tightened them over the course of the year. While the tightening initially focused on investors, it became apparent over time that homebuyers were also behind much of the heat in the housing market.

From November, loans with an LVR above 80% were limited to no more than 10% of new lending to owner-occupiers (previously 20%). On average, banks were already operating well within the 20% limit, so on the face of it this shouldn't have been too restrictive. However, while banks have cut back on new approvals for high-LVR loans, there is still a sizeable pipeline of pre-approvals that are being drawn down.

The RBNZ lending data helps to pinpoint the problem. Compliance with the new 10% limit will be determined on the three-month period ending January. The average share in the first two months was 10.6%, which suggests that banks would have had to hit the brakes hard in January to get under the limit. (The January lending figures will be published later this week.) Once the pipeline is under control, some high-LVR lending will resume in the coming months.

High-LVR loans as a share of owner-occupier lending



CCCFA: The latest changes to the CCCFA regulations, which came into effect in December, were aimed at better protecting consumers from harmful lending practices. Among other things, the new regulations are much more prescriptive about how lenders calculate income, recurring expenses, and the cash surplus remaining after loan repayments have been met. These rules cover the whole spectrum of consumer lending, from credit cards to car loans to mortgages.

The overall impact on the housing market is unclear. Some aspects of the changes could have an enduring impact, as lenders will have less scope to use their own discretion. But in other respects, the impact is likely to fade as the new requirements are bedded in. No doubt many borrowers have been caught unaware by the extra work required to demonstrate their creditworthiness. But once a loan is approved, the only ongoing requirement is to meet the repayments – no greater a task than it was before.

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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