Effects of LVR restrictions: an initial assessment

- Early signs of easing in housing demand, with the lower end of the housing market particularly affected.
- But effect on house prices muted, reflecting continued tightness in the housing market.
- Sharp decline in high-LVR mortgages as a proportion of banks' new lending means some success for financial stability.

An initial assessment of the impact of the high-LVR restrictions suggests they have had some success in reducing damage to the financial system in the event of a housing downturn but haven't materially reduced the probability of a house price overshoot that leaves the housing market vulnerable to a sharp downward correction. Housing demand has eased in recent months, but the impact on house prices has been muted. Nonetheless, there has been a noticeable shift in new lending patterns, with the sharp decline in high-LVR lending largely offset by an increase in lending to households with at least 20% deposit. Given the RBNZ had highlighted the risk high-LVR lending posed to banks' balance sheets in the event of a housing downturn, this change in the composition of new lending suggests the RBNZ will conclude some success in improving financial stability.

Overall, early evidence suggest the impact of the high-LVR restrictions on the housing market is at the low end of the RBNZ's estimates. We expect other factors will be the dominant influences on the housing market outlook. Rising interest rates and new housing construction remain the primary drivers for our expectations for slowing house price growth over the coming years. At the time of the introduction of the LVR restrictions, the RBNZ had acknowledged it expected the effects on the housing market would be modest, with the restrictions seen more as a complementary tool to use alongside monetary policy.

The muted impact of the restrictions on the housing market reinforce that interest rates are the most effective RBNZ tool for constraining the housing market – for either monetary policy or financial stability purposes. We continue to expect the RBNZ will increase the OCR by 25bp at the March meeting. Beyond this, we expect a fairly gradual tightening cycle, with the OCR expected to reach a peak of 4% by the end of 2015.

Sales data mixed over first few months

Greater than usual volatility around Christmas holiday period.

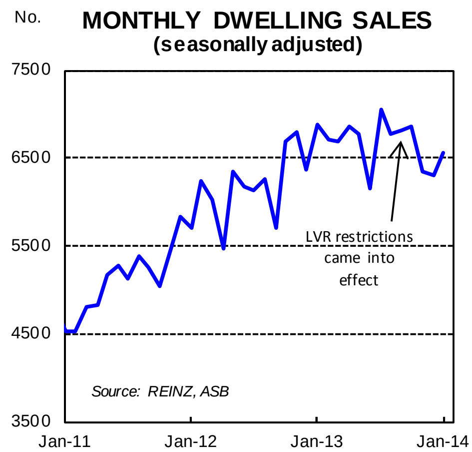
So far, we have housing market data for the first four months under the restrictions (October – January). It is worth pointing out straight away, though, that housing market data can be fairly volatile around the Christmas period and it is usual for some of the pressure in the market to ease during this period as activity drops off. The real test of the restrictions will be how strong the market is during the seasonal February/March upswing.

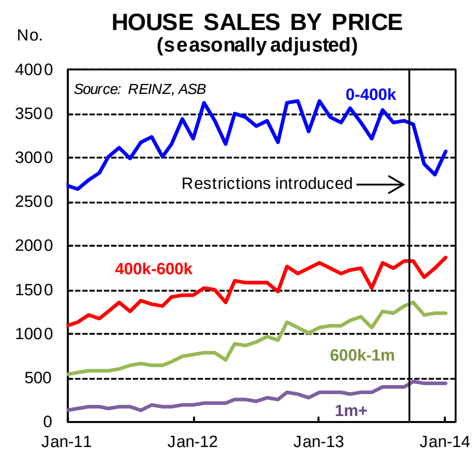
October to January data gives us early indication of effects of LVR restrictions.

Still, we can make some observations about what has been going on in the market over the first few months since the restrictions came into force – for instance, by seasonally adjusting sales data we can gain some insight into activity beyond the usual seasonal variations.

House sales fell over November and December.

The LVR restrictions certainly seem to have had an impact over late 2013, with housing market activity declining in November and December. In November, there was a 7.4% drop in sales nationally, and in December sales were another 0.5% lower. Lower sales numbers suggest that there was some reduction in demand following the introduction of the restrictions.





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Decline concentrated in lower end of market.

If overall demand has been dampened somewhat, have certain parts of the market been more affected than others? Sales data from both Barfoot and Thompson (for Auckland) and REINZ (all regions) show a much more pronounced drop-off in sales at the lower end of the market. Nationally, the number of sales under $400,000 was down 12% in Q4 from the previous quarter. Sales at the upper end of the market do not seem to have been greatly affected; sales between $600,000 and $1m were flat and sales over $1m actually rose by nearly 10% over the quarter.

But some rebound in January.

After the apparent cooling in activity late in 2013, January's data showed a significant rebound in sales volumes. Unsurprisingly, most of that recovery came at the lower end of the market. It may have been the case that buyers were simply more hesitant once the restrictions came into effect and decided to wait a month or two to see if there was a major shift in the market.

Supply also lower

Spike in new listings in October, but decline since then.

While demand looks to have been dampened somewhat over late 2013, the supply side of the market remains very tight. New listings looked to be rising over the middle of 2013, especially in the constrained Auckland market. Following the introduction of the restrictions, there was a surge in new listings in October but then sharp falls in November and December. Over Q4 as a whole, new listings were 6.5% lower in Auckland than in Q3, while national listings were down 1%.

Potential sellers may also be holding off.

We have already discussed the possibility that the new restrictions created hesitation amongst buyers, and it may well be the case that some sellers also decided to hold off for a month or two given a significant source of uncertainty. After very weak listings in December, new listings did edge back up slightly (in seasonally-adjusted terms) over January and February.

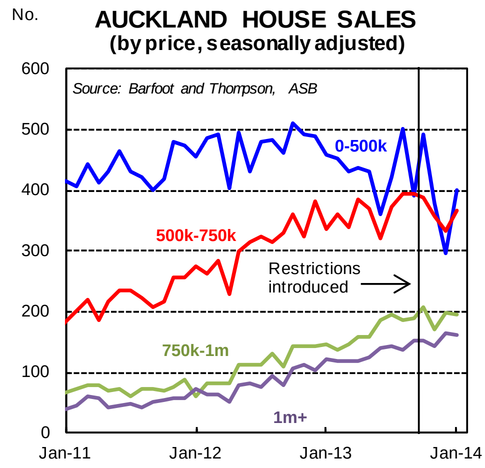
Housing market remains very tight.

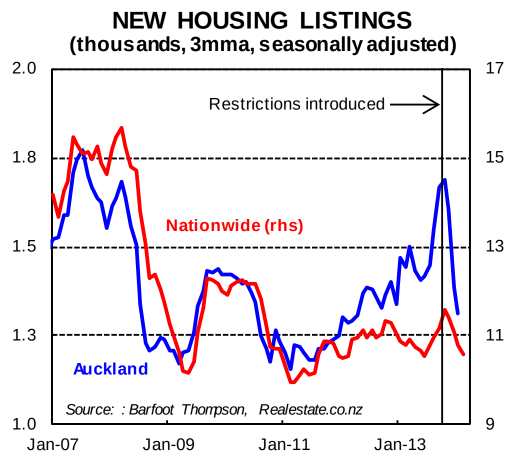
Still, overall supply remains at a very low level overall, particularly in the Auckland and Canterbury markets. As of February, total inventory (the number of homes on the market) was 7% below year-ago levels nationally, with Auckland housing inventory almost 15% below year-ago levels. Although there has been a small 2% increase in Canterbury housing inventory over the past year, its housing market remains very tight.

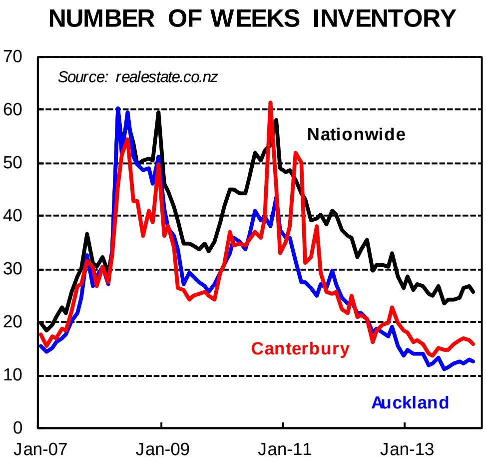
But suggestions price increases are slowing

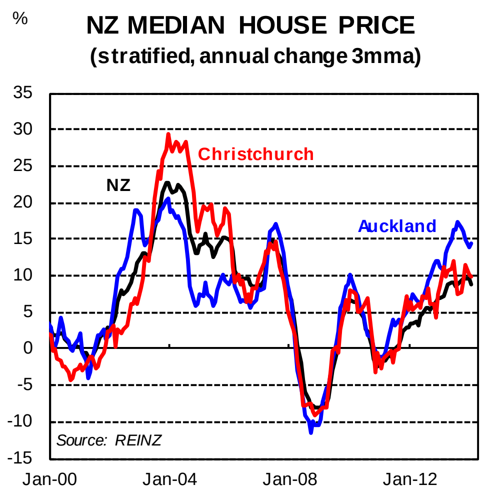
Signs of some cooling in housing market.

While there has been some volatility in the market, as usual, over the holiday period, the overall sense is that the market is cooling a little. The REINZ stratified house price index (taking a three-month average to look through volatility) suggests that price growth peaked at around 17% p.a. in Auckland in around August last year – prior to the announcement and implementation of the LVR restrictions. Since then the annual rate of





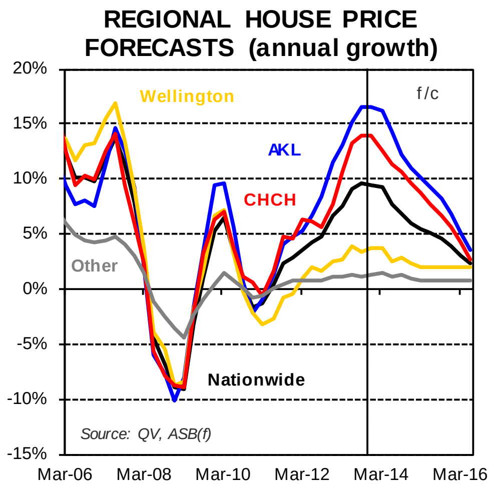


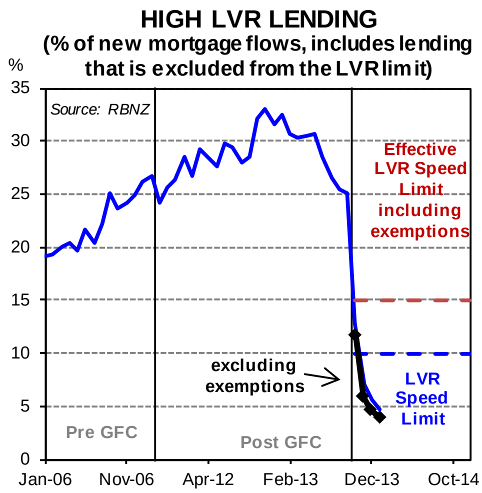


appreciation has eased to around 13%. Price growth at the national level looks to have peaked at around the same time, at around 10%. And once we seasonally adjust the index, January was the first month since April 2012 in which prices *decreased* at the national level – the index was down 0.3% from December.

We expect house price growth to moderate over coming year.

Indicators suggest that a gradual moderation in price growth will continue. The number of days it takes to sell a home is a good signpost of how 'tight' the market is and provides some indication of future price movements. The median of days to sell has increased (i.e. pressure is easing) at the national level and, even more noticeably, in the Auckland market. We expect house price inflation will ease over the coming year from the current annual growth rate of around 10% to around 6.5% by the end of the year. House-building activity is starting to pick up, particularly in Auckland and Canterbury where the housing shortages are most acute. Over 2013, just over 6,300 dwelling consents were issued in Auckland and 5,700 in Canterbury. This new supply of housing will help alleviate some of the supply pressures in the housing market, although we expect it will take several more years before the supply and demand imbalances in these regions are fully addressed. We also expect that as conservatism of potential sellers in the wake of the implementation of LVR restrictions wanes more houses will start to come onto the market.

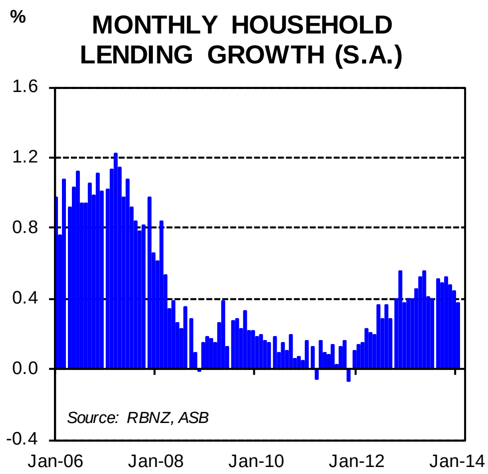




New lending impacted

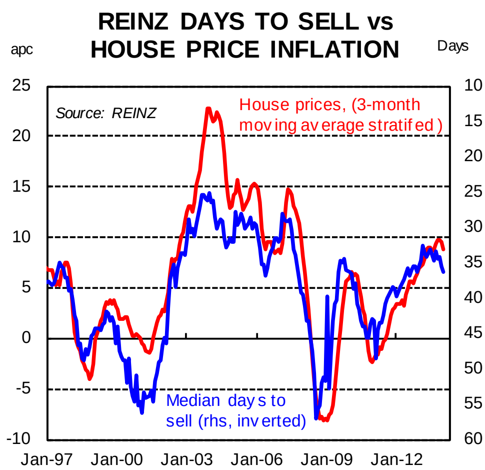
Sharp drop in banks' high-LVR lending as proportion of new lending positive for financial stability.

The effect of the LVR restrictions on financial stability is more marked. This is reflected in the sharp drop in banks' proportion of new mortgage lending with LVRs above 80%, from just over 25% in September to 3.8% (after exemptions) in January last year – well below the 10% limit imposed by the RBNZ. The slowing in this area of lending is likely to be greater than the RBNZ expected. To the extent the RBNZ has highlighted the risk high-LVR mortgages pose to banks' balance sheets in the event of a housing market downturn, the RBNZ will see the reduction in this proportion of mortgage lending as a positive development.

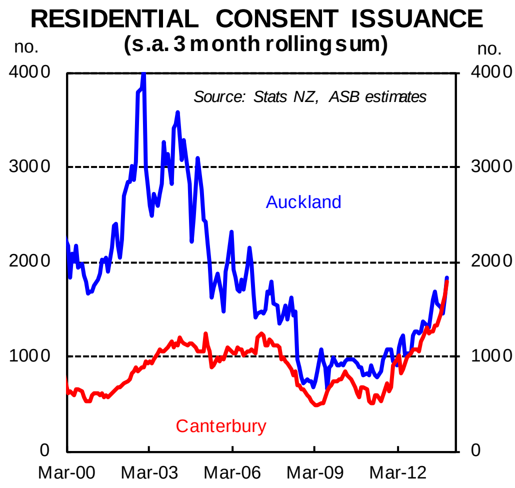


But little change in total mortgage lending growth.

While house sales volumes and new high-LVR lending dipped over the first few months of the restrictions, total net mortgage lending does not seem to have slowed dramatically. In seasonally-adjusted terms. Household lending has continued to grow at around 0.5% per month, a pace that has been sustained since early 2013. On an annual basis, household credit growth has stabilised at around 6%. So while fewer high-LVR mortgages are being written, total borrowing appears little affected and is tracking in line with house price growth. Mortgage rates generally became more competitive for low-LVR mortgages after the restrictions were announced, which may have



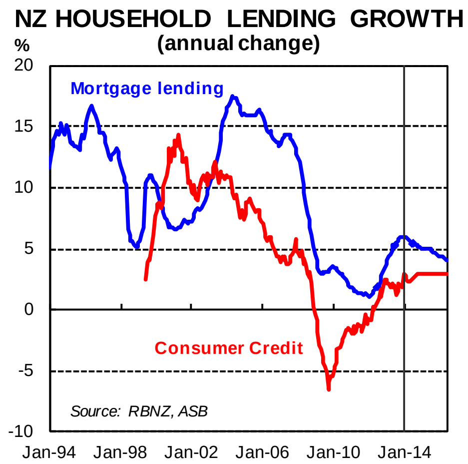
boosted demand amongst borrowers with substantial deposits. If anything, net mortgage lending growth has held up slightly better than we expected in the wake of the restrictions.



Implications for the housing market

Beyond the volatility, trend of easing in housing demand.

The greater volatility in housing market activity around the summer holiday season makes it hard to fully assess the effects of the LVR restrictions. The trend to date suggests an easing in housing demand since the implementation of the restrictions at the beginning of October, but against the background of a market that was showing signs of peaking. However, the effect on house prices is less clear, with signs potential sellers also held off putting their houses on the market initially after the restrictions first took effect given the uncertainty of the impact these restrictions may have on the housing market. The continued supply constraints are keeping upward pressure on house prices.

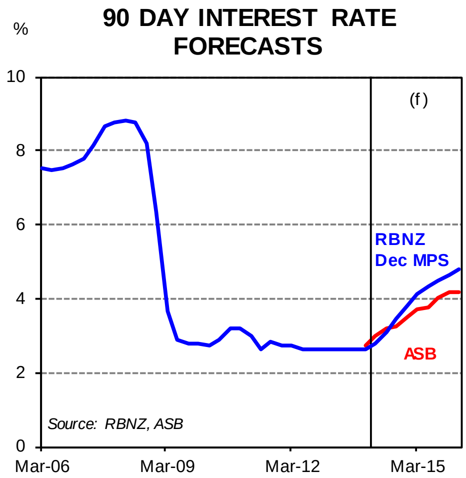


Effects on house prices muted.

For now, the dampening effect on house prices from the implementation of the LVR restrictions appears to be modest. Although it is difficult to ascertain the counterfactual of the housing market in the absence of the LVR restrictions, the fact that there has been little change to our house price forecasts following the LVR restrictions reinforces that any effects have been marginal.

Mortgage lending growth expected to ease.

We expect that as house price inflation eases, there will also be a gradual easing in mortgage lending growth over the coming years. We expect housing lending growth will ease to just over 5% by the end of this year from a peak of 6% in October 2013.



Implications for the RBNZ

LVR effects on housing market likely to be at the low end of RBNZ estimates.

At the time of the introduction of the LVR restrictions, the RBNZ undertook some analysis estimating the potential effects on house prices and housing credit growth. It estimated the LVR restrictions would likely reduce house price growth by 1-4 percentage points, and housing credit growth by 1-3 percentage points. In terms of the effects on monetary policy, the RBNZ has estimated it is equivalent to around a 30bp increase in the OCR. This indicates that the RBNZ already expected the effects of the LVR inflation on inflation to be modest. The RBNZ has noted that while the LVR restrictions could assist monetary policy, a lift in interest rates remains the most effective way of slowing housing demand.

The muted response to date of the housing market and credit growth suggests the impact is more likely to be at the lower end of the RBNZ's estimates. Other factors, such as rising interest rates and increased building will remain the dominant drivers of the housing market.

RBNZ will still be looking raise interest rates over the coming years.

The RBNZ has indicated in its recent communications that while it is still early days, it is fairly comfortable with the effects of the LVR restrictions so far. At the January OCR Review, theRBNZ noted the moderation in housing market activity. Nonetheless, the central bank has reiterated that it views an increase in interest rates as the most effective way to slow the housing market, with the LVR restrictions merely a complementary tool – and one with a very modest impact to date. The RBNZ has indicated it will be look to raise the OCR by around 2 percentage points over the next two years, with the pace of tightening dependent on the extent to which inflation pressures build in the NZ economy.

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