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Lessons for the RBNZ from the Bank of England's approach to financial stability

Just last week Mark Carney, the Governor of the Bank of England, tightened the rules on mortgage lending in the United Kingdom. Now loans set at more than 4.5 times income can make up only 15 percent of new mortgage lending. We like this approach to financial stability because it directly targets risk: can people afford to pay back their mortgage? In contrast, restrictions on the loan-to-value ratio (LVR) do this only indirectly.

The Bank of England's approach – a firebreak for mortgage lending

Mark Carney, the Governor of the Bank of England, wants to preserve financial stability. UK banks are creating more and more mortgage lending at high loan-to-income ratios. He fears a future where some families can't afford the debt-servicing costs of mortgages, default on their loans and cause a sharp economic contraction. For Carney, the Bank of England's problem is household indebtedness.

And Carney is clear what the problem is not: it is not the role of the Bank of England to control house prices. Nor is the policy designed to provide lower interest rates to help achieve monetary policy goals.

To protect against excessive lending in the future, the Bank of England is recommending restricting the share of loan-to-income (LTI) ratios above 4.5 times to less than 15 percent of new lending. Since the current share of new mortgage lending in excess of 4.5 times incomes is only 10 percent – well south of the restriction – the policy won't constrain current housing market activity. Instead, the restriction is a firebreak in the market, preventing lending getting out of hand.

Setting limits on income rather than the collateral of the loan (such as under the LVR approach) matches the Bank of England's problem: mortgage loans struck today that are not able to be serviced in the future. High LTIs speak directly to the ability to service mortgage debt. High LVRs tells us the mortgage is high but nothing about the ability to service that debt.

Loan-to-income ratios come with their own problems. Income needs to be defined and the appropriate LTI ratio for good times at the peak of economic cycle will not be the same as in bad times.

But the Bank of England is also going to ask mortgage lenders to test affordability of loan repayments under a buffer: can the loan be serviced if interest rates are three percentage points higher? That ensures some consistency on lending standards across the UK and makes for a very real test of affordability. Interest rates have seldom moved more than three percentage points in New Zealand where banks are relatively free to set their own lending standards.

The Bank of England has also signalled there is more to come on macro-prudential policy and is likely to move on capital requirements depending on the outcome of current research.

The Reserve Bank of New Zealand's approach

Back in August 2013, a combination of low interest rates, banks that were eager to lend again, a big recession that cleared out property developers, and tight council planning restrictions left Auckland with too few houses to meet demand. Prices had to rise and rose higher in Auckland than elsewhere in New Zealand. First-home buyers, thought to make up 40 percent of the market, were hurting.For the Reserve Bank of New Zealand, macro-prudential tools such as LVR restrictions hold the promise of cooling the

housing market without using interest rate hikes that hit fragile parts of the economy too. While the Reserve Bank's primary objective for macro-prudential tools is financial system stability, the Reserve Bank thinks coordinating policy across monetary and macro-prudential objectives is appropriate.

The Reserve Bank of New Zealand had a range of options. These included increasing bank capital and upping the risk weights on residential property. Ultimately, the Reserve Bank chose to use LVR restrictions before raising interest rates and announced a temporary cap on high LVR loans in August 2013.

From a prudential perspective, New Zealand's banks are well-capitalised. Non-performing loans peaked at just over one percent in the worst of the Global Financial Crisis. So *systemic* financial stability risks from high LVR lending (at 30 percent of new lending), must have been perceived to be high.

An impact with unintended consequences?

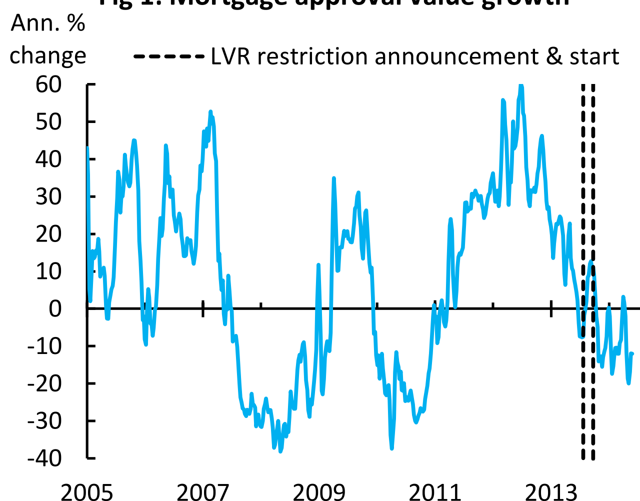
How did New Zealand's banks respond? Banks slashed high LVR lending not just to the cap of 10 percent of new lending but to a slim 4.3 percent – surprising the Reserve Bank of New Zealand.

Banks were threatened with losing their licence to trade if high LVR lending exceeded the cap. Each layer of decision-makers within the banks responded conservatively, adding buffers until the front line was left with a wafer thin rule of thumb on LVR lending. Growth in mortgage approvals continued to fall but Figure 1 shows the rate of increase eased before the announcement and implementation of LVR restrictions.

High LVR lending has shrunk to 5.3 percent of new lending. But the Reserve Bank's work suggests a banking system with LVR restrictions is not that much safer than a banking system without LVR restrictions.[1] In New Zealand, people just don't default that much.

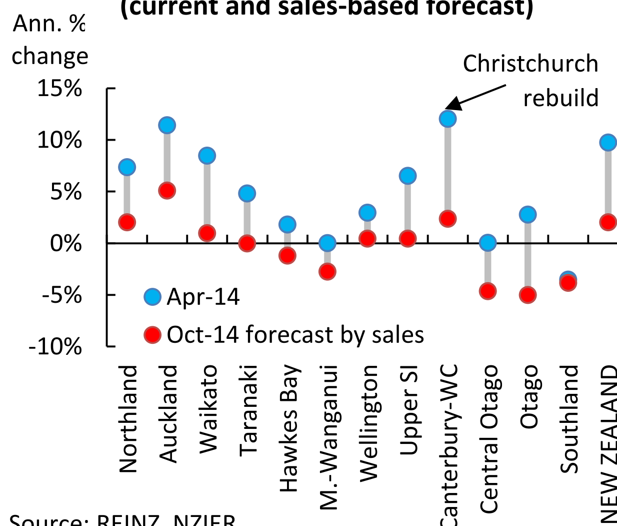
Nevertheless, many factors are slowing the housing market. Sales volumes have fallen sharply, continuing a trend from mid-2012. House sales lead prices by around six months – suggesting house prices will slow not just in Auckland, where prices have disconnected from fundamentals drivers, but in moderately valued provincial markets (see Figure 2), which were never a threat to financial and economic stability.

Fig 1: Mortgage approval value growth



Source: RBNZ, NZIER

Fig 2: Regional house price inflation (current and sales-based forecast)



Source: REINZ, NZIER

There were other unintended consequences. Banks started to compete more aggressively on price for traditional mortgages. Total lending has remained much the same as a result.

[1] Under a catastrophic scenario where house prices fall 40 percent, unemployment increases and interest rates increase 3.75 percentage points, LVR restrictions protect an additional 1 percent of mortgage lending from default compared to a world without LVR restrictions (see Bloor and McDonald, 2003 "Estimating the impacts of restrictions on high LVR lending", Analytical Note 2013/5, Reserve Bank of New Zealand).

First home buyers, who turn out to be only 19 percent of the market, have been hit hard. But property investors, who make up the bulk of property purchases, and who can access the equity in housing portfolios built up over long periods of time, were less affected. These investors are less likely to be at risk of defaulting than first home buyers since LVRs take aim at investors with low collateral, not low incomes. It turned out it was not highly-geared first-home buyers inflating the market, rather investors who have been affected by sentiment, but not policy.

Lessons from the Bank of England

The Bank of England has set up a reasonably targeted solution to a defined problem that they have communicated clearly.

Their LTI approach ties directly to the problem definition – mortgages that stretch the ability of households to service lending in the future. And the Bank of England appears to know their targets well – right now 5 percent of new mortgages are to first home buyers with a loan-to-income ratio north of 4.5. Knowing just who has stretched balance sheets and just who is being offered credit helps disentangle likely effects.

Their problem definition translates to a straight-forward KPI. Their new director of Financial Stability Spencer Dale says: "When people come to judge the success of this policy in, say, two years' time, do not judge us on what has happened to house prices, judge on whether we have controlled the levels of household indebtedness."

For the Reserve Bank of New Zealand, capping high LVR loans held the promise of reducing financial stability risks without the need to raise interest rates. But the problem definition could be clearer – what is the combination of financial and economic stability that is being targeted?

By definition, constraining riskier lending will improve financial stability. But the gains from LVR restrictions look limited and the economic impacts can be much different to those intended. It appears that much can be gained from studying closely the Bank of England's restrictions on LTI lending that are tied much more directly to financial stability risk.

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