Questions and Answers – asset class treatment of residential property investment loans

What is the purpose of this consultation?

It is about helping to maintain the stability of our financial system by ensuring that banks classify their lending correctly and hold the appropriate level of capital backing for their loans.

The Reserve Bank is consulting on the asset class treatment of residential mortgage loans to property investors. We want feedback from banks and the property sector about options for a consistent definition of loans to property investors. Once we have settled on a definition, we propose to amend existing rules by requiring all locally incorporated banks to group residential property investment mortgage loans in a specific asset sub-class and hold appropriate regulatory capital for those exposures.

What are the options you're consulting on?

After feedback on earlier consultation last year, we have moved beyond our initial proposal to use a multiple-property count-based threshold to define loans to residential property investors. We propose three further options for defining the asset class treatment of residential mortgage loans to property investors. These options range from who occupies the property to the source of income used to service the loan.

The first option covers any property that is not owner-occupied – that is, any loan for a mortgaged residential property that isn't owner-occupied would be classified as a loan to a property investor. The second option is when loan servicing is primarily from rental income – that is, any loan that is serviced 50% or more by income generated from the mortgaged residential property would be classified as a loan to a property investor. And the third option is when loan servicing from any rental income – that is, any loan that is serviced from any level of income generated from the mortgaged residential property would be classified as a loan to a property investor. The Reserve Bank will settle on a final definition after consultation.

What's the purpose of this new asset class treatment?

The proposed new asset class treatment is designed to ensure that banks hold adequate capital for the risks they face from residential property investment lending. International evidence shows that default rates and loss rates experienced during sharp housing market downturns tend to be higher for residential property investment loans than for loans to owner-occupiers. The proposed new asset class rule will apply to all locally incorporated banks in New Zealand (not just the internal model banks, ie. the four major banks) adopting a consistent approach for loans to residential property investors.

For more background, see: **What's the background to this new rule?**

Why are you aiming rules at property investors?

Our rules apply to bank capital requirements not specifically to borrowers. One of the Reserve Bank's core functions is to help maintain financial stability, which we do in part by regulating banks. The change in our rules is proposed to better group loans with similar risk characteristics. Different types of lending require different amounts of capital backing. Lending for property investment has a different risk profile than lending to owner-occupiers, and banks therefore need to have a larger amount of capital for their investment property loans than they do for loans to owner occupiers.

Does the Reserve Bank want to limit the number of properties a person is allowed to own?

No. The Reserve Bank has no view on how many properties an individual should own, nor borrow against. Our interest is that banks are adequately capitalised for the risks they face.

Will this make residential property investment mortgage loans more expensive?

Pricing of loans is a matter for negotiation between borrowers and their banks, and is not regulated by the Reserve Bank. The proposed asset class rule may affect the amount of capital that the banks need to have as backing for some loans, which may affect pricing. However, each bank will implement the rules according to its own business practices and policies, including decisions on how to price loans.

Will the asset class rule apply in the case of lower value properties?

Yes. The proposed rule change will apply to property lending by banks irrespective of the value of the lending.

When do submissions close? Where do people send submissions?

The deadline for submissions is 7 April 2015. Specific details on where to send a submission are included in the consultation paper. There have been two rounds of consultation to date on other options and we expect this to be the final consultation on the matter.

When will the new asset class treatment take effect?

We propose that the new asset class classification for residential property investment loans takes effect from 1 July 2015.

Will this regulation be retrospective? If someone already has a mortgage loan they've used to buy an investment property, will the rules apply, or is it only for new loans?

The Reserve Bank is currently working on the technical detail of making the new rule work. As part of that, we are proposing a nine month transition period for existing lending. The Reserve Bank expects that after this transition period (ie. 1 April 2016) all lending to property investors will be classified correctly.

The property market is only hot in Auckland and Christchurch, so why are you penalising every region?

This is not about the state of the property market or penalising borrowers or regions. It is about helping to maintain the stability of our financial system by ensuring that banks classify their lending correctly and hold the appropriate level of capital backing for their loans.

How many loans to property investors do banks have?

It is still too early to say. The number of loans affected will depend on what definition of a residential property investor loan we finally settle upon after consultation.

How does this work in with the rule that limits high-LVR loans?

The proposed rule about loans to property investors is not related to restrictions on high-LVR lending.

The LVR rules are about making sure that banks limit their new lending in one part of the lending market (i.e. the part of the market where people have low deposits), while this proposed rule is about making sure that banks correctly classify loans to residential property investors.

Why not just impose a tax on property speculators?

A tax on property speculators:

1. Is a matter for IRD or the Treasury to advise upon, not the Reserve Bank.
2. Would do nothing to ensure that banks have adequate capital to back their loans.

Isn't this a macro-prudential policy change by the back door?

The current proposal is not a macro-prudential policy proposal, but having consistent asset class groupings used by all banks would help the Reserve Bank to implement targeted macro-prudential policies in future should that become necessary.

What's the background to this new rule?

The proposed new rule is designed to ensure that banks hold adequate capital for the potential risks that they face.

The Reserve Bank's capital adequacy rules group loans into five main categories, also called asset classes. They are: equity, banks, sovereign, corporate and retail. This system of asset classes groups together all the loans that have broadly similar risk characteristics and is more in line with international recommendations as issued by the Basel Committee on Banking Supervision.

Residential mortgage loans are a sub-category of the retail asset class. In New Zealand, all residential mortgage loans are currently grouped in the same asset class. But in the event of a severe downturn, loans to residential property investors behave differently than loans to owner-occupiers, i.e. they have a different risk profile. The relevant standard from the Basel Committee on Banking Supervision reserves the residential mortgage class mainly to owner-occupiers.

In our first consultation on this issue, in September 2013, the Reserve Bank proposed that internal model banks (i.e. the four major banks) using their own credit risk models to calculate regulatory capital should group loans to residential property investors in a separate sub-class than loans to owner-occupiers. We now propose that all locally incorporated banks (not just the four major banks) apply new capital adequacy rules for residential investment property.

Existing rules allow ambiguity about how loans are treated. The proposed new rule will ensure that when banks are calculating how much capital they must hold as a safety buffer, they will all treat loans to residential property investors the same.