

Grant Spencer: Investors adding to Auckland housing market risk policy

Speech by Mr Grant Spencer, Deputy Governor of the Reserve Bank of New Zealand, to The Northern Club, Auckland, 24 August 2015.

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Accompanying figures can be found at the end of the speech.

I am told that the Auckland housing market continues to be the hot topic of dinner conversation in Auckland. Auckland house prices have gone up by 24 percent over the past year. For prospective buyers, and especially first home buyers, this is not good news. Getting on the housing ladder has become a lot harder. Existing home owners on the other hand have seen their equity rise by 24 percent of the house value. For the Reserve Bank, we added this to the “What keeps you awake at night?” category some time ago. There are good reasons to think that the Auckland market poses an increasing threat to financial stability.

Today I want to tell you why we are concerned. A natural place to start is to ask what demand factors are driving Auckland house prices, and then to think about the supply response to those pressures. I will provide some new information on the composition of sales and, after describing the landscape, I will explain why we are concerned from a financial stability perspective. When something keeps you awake at night, it is good to do something about it. I will discuss the multi-faceted initiatives needed to address this problem, and the role that the Reserve Bank is playing. I will finish by updating you on where we are at with the investor LVR restrictions that we announced in May, including the recent public consultation on the policy and how the new policy will be implemented.

Strong demand is driving up prices

The main underlying cause of the housing shortage in Auckland is the continuing record net inflow of migrants, against a background of very low residential construction activity over many years. As seen in figure 1, the outflow of Kiwis has slowed over the past three years at the same time as the inflow of foreigners and returning Kiwis has accelerated. This has reflected the strength of the New Zealand economy as well as weakness in Australia and the broader global economy. While Auckland accounts for a third of the New Zealand economy, about half of the net inflow is coming in to Auckland.

In the year to June 2015, almost 50,000 permanent and long-term migrants arrived in Auckland, including New Zealand citizens returning from abroad. If these new residents have similar rates of home ownership and household sizes to existing residents, we estimate they could account for around one-third of the 30,000 Auckland house sales in the past year¹.

Interest rates are also an important factor influencing the demand for and pricing of housing, particularly long-term rates. Interest rates determine the cost of mortgage credit and therefore the amount of debt that can be sustained on any given level of household income. Figure 2 shows how low interest rates since the GFC have facilitated a significant increase in debt to income (DTI) ratios.

Interest rates also drive the discount rate used (implicitly or explicitly) by house purchasers in valuing the future stream of housing services. As seen in many countries around the world, low global interest rates post GFC have contributed to strong asset price growth, particularly in financial assets and in housing markets. This influence on house prices in New Zealand is reflected in the downward trend in rental yields (figure 3). While the sharper yield decline in

¹ This estimate is based on the assumption of around 3 people per dwelling and a home ownership rate of around 60 percent.

Auckland points to additional factors at play in the Auckland market, interest rates have been a key driver of demand, particularly investor demand.

It is useful to distinguish investor demand from owner occupier demand. While increased occupier demand, say due to population growth, adds to any underlying physical shortage of housing, higher investor demand affects the composition of rentals versus owner occupiers. However, investor demand can contribute significantly to house price pressures. If investors wish to expand their housing portfolios at a greater rate than the growth in demand for rental accommodation, this can push up prices even though the underlying housing shortage remains unchanged. Investor demand has become a growing factor in the Auckland market over the past year, and this has exacerbated price pressures arising from the underlying physical shortage.

Evidence of an increasing investor presence in the Auckland market is clear. Based on CoreLogic data, investors accounted for 41 percent of all Auckland market sales in June 2015, up 8 percentage points since late 2013. While some of this growth was at the expense of first-home buyers in early 2014, the more recent increase from late 2014 has been at the expense of “movers”. A similar pattern is seen in net investor purchases² (figure 4), which has also increased significantly, suggesting further declines in the Auckland home ownership rate.

Consistent with the increased share of investor sales, there has been a disproportionate expansion in mortgage credit to residential investors. The dollar value of new mortgage lending for all borrowers grew by 28 percent nationally, in the year to June 2015, reflecting increased house sales as well as higher average prices. Over the same period, new lending to investors increased nationally at a much greater rate of 40 percent. While some new lending represents “churn” as borrowers refinance existing loans and/or switch between banks, the sharp lift in new investor lending is consistent with greater investor participation in the housing market.

What do we know about these residential investors who have been expanding their presence in Auckland over the past year? First, their rising market share has primarily been driven by increasing purchases by small investors, with two to four properties, as opposed to investors with larger property portfolios. We have also seen a reduction in the share of investor cash sales in Auckland from over 25 percent in late 2013 to around 20 percent currently. This sort of profile – i.e. smaller investors who are reliant on credit – suggests that the new LVR restrictions on Auckland residential investors are likely to have an impact on overall demand. This is particularly so when we consider that over half of investor lending is currently being written at high LVRs – that is LVRs of over 70 percent.

Much has been said recently regarding the contribution of foreign investor purchases to price pressures in Auckland. Given that we do not have data on purchases by non-residents, it is not possible to make an accurate assessment of the extent to which such flows are adding to price pressures and also financing new housing construction. The role of non-resident investors in the Auckland market will become more apparent once the new requirements for purchasers to provide tax numbers are introduced in October.

The supply response

Currently, new dwellings are being built at a rate of around 8,300 per annum in Auckland. With roughly half of New Zealand’s net migration going to Auckland, this rate of construction may not be sufficient to prevent the existing shortage from rising beyond its current level of

² Net investor purchases are total purchases by investors less total sales by investors.

around 15 to 20 thousand dwellings.³ An increased rate of construction is needed. One positive change is that resources are increasingly being freed up in Canterbury as the residential rebuild tapers off. This should facilitate an increase in Auckland house building over the next couple of years. Our current forecasts, which are consistent with the Accord being met, suggest an annual construction rate of 8,700 in 2015, increasing to 11,000 by 2017.

High-rise apartment construction and other high-density options will be a crucial part of increasing construction and reducing the supply shortage. The need for increased densification has been recognised by the Auckland Council in recently proposed changes to the unitary plan, which will be finalised in mid-2016. It is also encouraging that the share of apartment consents in Auckland is rising, and is expected to increase further with several apartment projects currently in the planning stages. However, at 18 percent in the year to June, the apartment share of consents remains well below levels seen in the mid-2000s and significantly below what we see in other major centres. For example, apartments represent 39 percent of the total stock of dwellings in Sydney, compared to only 25 percent in Auckland.

Supply-side constraints remain a hindrance to faster rates of building. The key issues remain: a limited supply of land ready for building; restrictive planning processes, and a lack of coordinated planning in infrastructure development. Since the Housing Accords and Special Housing Areas Act 2013, there have been some encouraging developments, such as the proposed relaxation of density rules and initiatives to develop Crown land. However, more needs to be done and Special Housing Area building activity has remained very slow to date, with around 800 dwellings consented and 860 sections created in the 86 SHAs.

The recent draft report by the Productivity Commission points to some far-reaching changes needed to create a more responsive supply side. The Reserve Bank supports the draft findings of the inquiry and believes that the recommendations should be considered carefully. Recommendations that have the potential to improve the responsiveness of housing supply include the promotion of less restrictive planning rules and streamlined planning processes. For example, reviewing and relaxing rules in district plans, clarifying the RMA to include land use for housing as a priority, and ongoing RMA reform to streamline plan development. The Bank also supports measures that encourage the timely and coordinated provision of infrastructure to support new housing developments, and policies that reduce incentives for land banking.

Why are accelerating Auckland house prices a concern for stability?

House price inflation slowed significantly following the implementation of restrictions on high loan-to-value ratio (LVR) lending in October 2013. More recently, average national house price inflation has picked up, due almost entirely to significant renewed pressures in the Auckland market. The latest REINZ figures for July show Auckland house prices up 25 percent over the past year, compared to 3 percent for the rest of the country (figure 5). As a summary measure of excess demand, this points to the Auckland housing shortage getting worse, not better. In addition, the volume of house sales is picking up in other areas such as Waikato, Bay of Plenty and Northland, and this could translate into growing price pressures in those markets.

Looking at key house price ratios suggests an increasing degree of stretch in Auckland prices relative to sustainable levels. House price-to-income ratios have increased from around 6 to almost 9 in Auckland since 2012, a level seen in some of the world's most expensive cities – cities such as London, San Francisco and Sydney. For the rest of New

³ These estimates are broadly in line with estimates produced by the Auckland Council and Productivity Commission.

Zealand, the average price-to-income ratio is about half Auckland's level (figure 6). Similarly, rental yields have fallen materially in Auckland, and are currently at historic lows of below 3 percent. While low interest rates explain much of this downward trend, rental yields in the rest of New Zealand have remained well above Auckland yields (figure 3).

Auckland is increasingly being seen as a regional (Asia-Pacific) centre, and this no doubt accounts for a part of the stretch in price-to-income ratios. However, good long-run fundamentals do not make Auckland immune to a correction.

International evidence shows that the further house price-to-income ratios deviate from historical norms, the greater the potential for a sharp and damaging correction.⁴ In Auckland's case such a correction could be triggered by a range of domestic and external factors. The demand for housing would be reduced by a slowdown in the economy, which could result, for example, from continued weakness in export prices; or a drop off in the net inflow of migrants. Externally, if the current slowdown in China persists or accelerates then the flow of funds from that source could diminish. Or we could see an increase in the risk premium in New Zealand interest rates – either due to a global financial shock or due to a perceived increase in New Zealand specific risk. Indeed recently we saw an indication of this with Standard and Poor's reducing the stand-alone rating of the New Zealand banking system, citing heightened risk in Auckland housing as their primary concern.⁵

Interest rates internationally are at historic lows and well below rates seen in recent decades prior to the GFC. This reflects modest global growth, extraordinary monetary accommodation and weak inflationary pressures. It is not realistic to expect such low rates to remain the norm in the medium term, and the US Federal Reserve is likely to be raising rates in the coming months. Future interest rate increases, either because of a stronger domestic economy and higher CPI inflation, or because international long-term rates are higher, could have a marked impact on credit-based demand. New Zealand has high levels of household debt. On average, household debt is running at around 155 percent of household income and 30 percent of new borrowers are taking on mortgages at greater than 6 times income. At these ratios, it would not take much of an increase in interest rates to substantially erode mortgage affordability.

All of these factors could reduce housing demand and take pressure off house prices. The greater the investor component of demand, the greater the scope for the reduced demand to be amplified through weaker house prices as investors exit the market. Further, if at the same time an increased volume of new houses and apartments was starting to come on stream, then an excess supply situation could develop, causing prices to come back more sharply. We have seen this happen in regional housing markets in New Zealand. For example, house prices in Thames-Coromandel and Queenstown-Lakes saw relatively large falls in the wake of the 2008/09 recession, after experiencing relatively strong building activity during the 2000s. In other countries, excess housing supply has seriously exacerbated housing market downturns – as seen in Spain and Ireland during the GFC. If such a correction happened in the Auckland market, it would pose a significant threat to financial stability, something the Reserve Bank is mandated to preserve.

⁴ For example, following rapid increases to well above historical norms, Finland, Norway, and Sweden all experienced falls in house price-to-income ratios in excess of 30 percent in the late 1980s/early 1990s. Housing markets that were most over-valued prior to the global financial crisis on the basis of house price-to-income ratios also typically experienced larger than average house price falls.

⁵ While the stand-alone ratings of the 4 largest New Zealand banks were lowered, their full issuer ratings were unaffected due to ratings uplifts from assumed parental support. Issuer ratings were lowered on seven non-bank institutions.

What can we do about it?

In light of the financial stability risks inherent in the booming Auckland housing market – and the many contributing factors – the Reserve Bank has continued to promote a broad-based policy response, including both demand and supply-side policies.

On the demand side, we regard tax policy as an essential part of the solution, given the historical tax advantaged status of investor housing and the significant role being played by investors in the current Auckland market. The low level of Auckland rental yields (figure 3) suggests that expectations of capital gains and/or tax relief have been an important factor in investors' purchase decisions. We fully support measures announced as part of the Budget to reduce the tax-advantaged status of investor housing. The establishment of a two-year bright-line test for assessing trading gains from investment properties will bolster the effectiveness of the existing tax in this area. The requirement to provide tax identification details, and a proposed withholding tax on house sales by non-residents, will also aid enforceability.

I have talked about the important role of interest rates in the demand for and pricing of housing. Should the Bank therefore be using monetary policy to moderate the Auckland housing market? Our view, and that of the major central banks is: not if this requires monetary policy to deviate from its primary goal of achieving stability in the general level of prices. The Reserve Bank Act and the Policy Targets Agreement (PTA) state that monetary policy shall have regard to the efficiency and soundness of the financial system. However, in the current situation, with underlying inflation below target, falling export prices and weakening growth, it would not be appropriate to raise interest rates to dampen the Auckland housing market. Right now, that would push up the exchange rate, dampen growth and inflation and cause more problems than it solves.

We should also keep in mind that the long-term trend in real interest rates is ultimately determined by economic behaviour, such as saving and investment preferences, not central banks. This trend has clearly been downwards in recent years, both in New Zealand and globally. The current nexus of low CPI inflation, low interest rates and strong asset prices is reflective of the global economic environment. Many other countries are facing the same issues in housing markets and are looking to policies other than monetary policy, such as macro-prudential policy, to address the consequent risks around financial stability.

Macro-prudential policy

Macro-prudential policy is about using bank regulatory tools to address systemic risks that have the potential to damage the financial system, as well as having serious consequences for the domestic economy. A macro-prudential overlay will usually be applied on a temporary basis, for example during an upward asset price cycle, and be applied to all banks. The main aim of such policies is to help bolster the balance sheets of the banks so they can better withstand the impact of a potential credit or liquidity shock and continue to extend credit in support of economic activity. Macro-prudential policies can also help to reduce the strength of the financial cycle by slowing credit growth, e.g. by restricting the amount of credit being extended to the booming sector.

We will always be subject to economic and financial cycles. That is the historical reality. However, we can and should avoid the severe financial cycles that can cause major damage to the real economy – as we have seen internationally in the aftermath of the GFC. Our aim therefore is to reduce the amplifying effects seen in severe financial contractions by ensuring we have a very resilient banking system and also by directly moderating the credit cycle itself. Our on-going prudential requirements, together with macro-prudential overlays, aim to achieve that.

There is a point to clarify here around the stress testing that the Reserve Bank conducts on the banking system as part of our prudential oversight function. Sometimes commentators

incorrectly interpret the aim of macro-prudential policy as preventing bank insolvency. From a macro-prudential perspective, we may wish to bolster bank balance sheets beyond the point of avoiding insolvency. Stress tests help to inform our assessment of the adequacy of capital and liquidity buffers held by the banks. However, they are only one of the tools contributing to that assessment. In a downturn, banks will typically become risk averse and start to slow credit expansion in order to reduce the risk of breaching capital and liquidity ratios. In a severe downturn, faced with a rise in impaired loans and provisions, banks may start to contract credit which can quickly exacerbate the economic downturn. In this way, a financial downturn can have severe consequences for macro-financial stability well before the solvency of banks becomes threatened.

In 2014, the four largest New Zealand banks completed a stress testing exercise that featured a 40 percent decline in house prices in conjunction with a severe recession and rising unemployment. While this test suggested that banks would maintain capital ratios above minimum requirements, banks reported that they would need to cut credit exposures by around 10 percent (the equivalent of around \$30 billion) in order to restore capital buffers. Deleveraging of that nature would accentuate macroeconomic weakness, leading to greater declines in asset markets and larger loan losses for the banks. Such second round effects are not reflected in the stress test results. A key goal of macro-prudential policy is to ensure that the banking system has sufficient resilience to avoid such contractionary behaviour in a downturn.

The macro-prudential policy approach we have adopted has been centred on Loan to Value Ratios (LVRs). In October 2013, the Bank introduced a requirement that no more than 10 percent of any bank's new mortgage lending could be at LVRs over 80 percent. At the time, over 30 percent of new mortgages were being written at LVRs over 80 percent. Restricting the extent of high LVR lending has seen average LVRs in bank mortgage books gradually decline, with the proportion of high LVR mortgage loans on bank balance sheets falling from 21 percent to 14 percent. This has made bank balance sheets more resilient to a potential housing downturn (figure 7). At the same time, the reduction in high LVR lending helped to dampen credit growth and house price inflation over the following year.

Subsequently, from around September 2014, the Auckland market started to accelerate while house prices in the rest of the country continued to moderate. As mentioned earlier, we have identified credit-financed investor activity as an important contributor to the Auckland resurgence.

This raises concerns from a systemic risk perspective. Evidence from severe housing market downturns internationally show that loans to investors default more frequently at any given LVR during periods of market stress. Partly this is likely to reflect the fact that investors tend to take on more debt relative to income, so have less ability to absorb income shocks. The Reserve Bank has recently started collecting data on the debt to income (DTI) ratios of new borrowers (figure 8). Provisional data suggests that a much greater share of investors have high DTIs and that investor DTIs have been growing over the past year.

International evidence also suggests that investors play a strong role in amplifying property cycles. Investor participation tends to rise towards the peak of the property cycle and investors are more likely to sell properties when prices start to fall. Thus, property cycles are accentuated when there is a large investor presence in the market.

Our view is that banks need additional balance sheet buffers against residential investor lending, and that particular caution is required on investor lending in Auckland. The new LVR policy that we announced in May will require mortgages on Auckland⁶ investment properties to have LVRs of 70 percent or less. The aim of the policy is to strengthen the resilience of

⁶ Auckland is defined as the area of the Super City, extending from Rodney to Franklin.

banks against an Auckland housing downturn, and to moderate the cyclical role of the large residential investor segment of the market. While the speed limit on owner-occupied properties in Auckland will stay at 10 percent, the speed limit on high LVR mortgages outside Auckland will be relaxed from 10 percent to 15 percent. That easing reflects the low and steady rates of house price inflation in most other parts of the country, and our stated intention to begin removing LVR restrictions when they are no longer warranted. In recent months, there have been some signs of housing demand spilling out of Auckland, with house price growth starting to increase in Hamilton and Tauranga. If this strength persists, full removal of LVR restrictions outside of Auckland could be delayed. The Bank will continue to monitor housing market developments and modify its macro-prudential policies accordingly.

Implementing the new measures

The Reserve Bank undertook a public consultation on the proposed changes to LVR restrictions in June. As a result of the feedback received, some changes are being made to facilitate the implementation of the policy, but the substance of the policy remains intact. The details of the final policy are now available on the Bank's website. [www.rbnz.govt.nz/regulation and supervision/banks/consultations/Response-to-submissions-21-august.pdf](http://www.rbnz.govt.nz/regulation%20and%20supervision/banks/consultations/Response-to-submissions-21-august.pdf).

We announced our proposals for changes to the LVR policy in the *May Financial Stability Report* and began public consultation on 3 June. In response to the feedback received, we are making three main changes. First, a number of banks indicated they would not be able to formally meet the new restrictions by 1 October, given the need to make system changes. In response, the Reserve Bank is delaying implementation of the policy by one month to 1 November and providing all banks with an initial six month measurement period for meeting the restrictions. In making this change we are encouraged by the banks reporting that they are already curtailing lending to high-LVR Auckland investors ahead of the formal commencement of the policy.

Second, banks noted that the proposed 2 percent speed limit for high LVR investor lending was insufficient to accommodate special circumstances such as extra lending required to provide assistance to borrowers in hardship. In response we are adopting a higher speed limit of 5 percent on high LVR investor lending. This will provide banks with more scope to manage the existing pipeline of pre-approved lending. Based on our experience with the existing LVR speed limit, it is expected that the actual flow of high LVR lending to Auckland investors will settle well below 5 percent as banks adopt a buffer to ensure compliance.

Third, in light of feedback from the consultation, we have decided to introduce a new exemption category for lending for significant remedial construction work, such as for houses with weather tightness issues or requiring seismic strengthening. It would be undesirable to prevent banks from providing this lending, from both a financial stability and a broader efficiency perspective. To date, high LVR lending for such remedial work has counted against the existing speed limit.

In conjunction with the new LVR restrictions, and consistent with Basel guidelines, the banks will be required to establish a new asset class for all loans to residential property investors. Loans in this asset class will attract a higher risk weighting than owner occupied mortgages, requiring banks to hold more capital against them. For banks following the standardised approach to capital adequacy, the average risk weight for investor loans will increase by about 6 percentage points. For the larger banks, that will be developing new internal risk models, our expectation is that average risk weights on investor mortgages will increase by a similar amount.

Conclusion

The resurgence in Auckland house prices over the past year has made the Reserve Bank increasingly concerned about the risks to financial stability. It is certainly on our “what keeps us awake at night” list.

Auckland prices have risen a further 24 percent over the past year, stretching the price-to-income ratio for the region to 9. This is double the ratio for the rest of New Zealand and places Auckland among the world’s most expensive cities. New housing supply has been growing but nowhere near fast enough to make a dent in the existing housing shortage. In the meantime, net migration is at record levels and investors continue to expand their influence in the Auckland market.

The increasing investor presence, now accounting for 41 percent of Auckland house purchases, has been supported by rapid growth in new lending, with half of the new credit at LVR’s of over 70 percent. This trend is increasing the risk inherent in the Auckland market. The increasing investor presence is likely to amplify the housing cycle and worsen the potential damage from a downturn, both to the financial system and the broader economy.

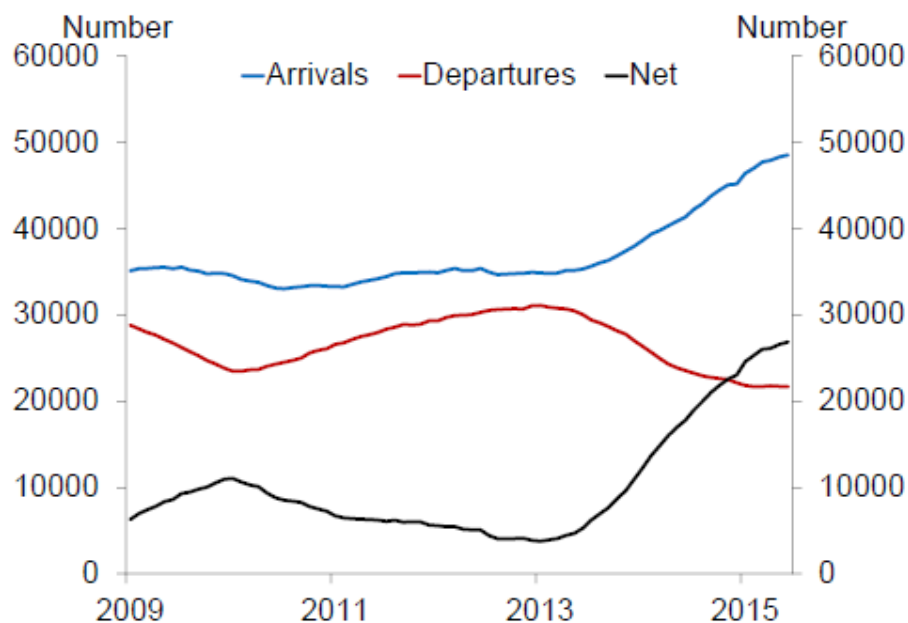
We recognise that low interest rates are contributing to housing demand pressures and this is a factor we take into consideration when setting monetary policy. However, the current weakness in export prices, economic activity and CPI inflation means that interest rate increases are likely to be off the table for some time.

Tax policy is also an important driver and we welcome the changes announced in the 2015 Budget, including the two year bright-line test, the proposed non-resident withholding tax and the requirement for tax numbers to be provided for investor house purchases.

Macro prudential policy can help to moderate the risks to the financial sector and broader economy associated with Auckland’s housing market. Modifications to the Reserve Bank’s LVR policy, announced in May, are targeted specifically at Auckland residential investors. The speed limit has been eased for the rest of the country where housing markets are not subject to the same pressures.

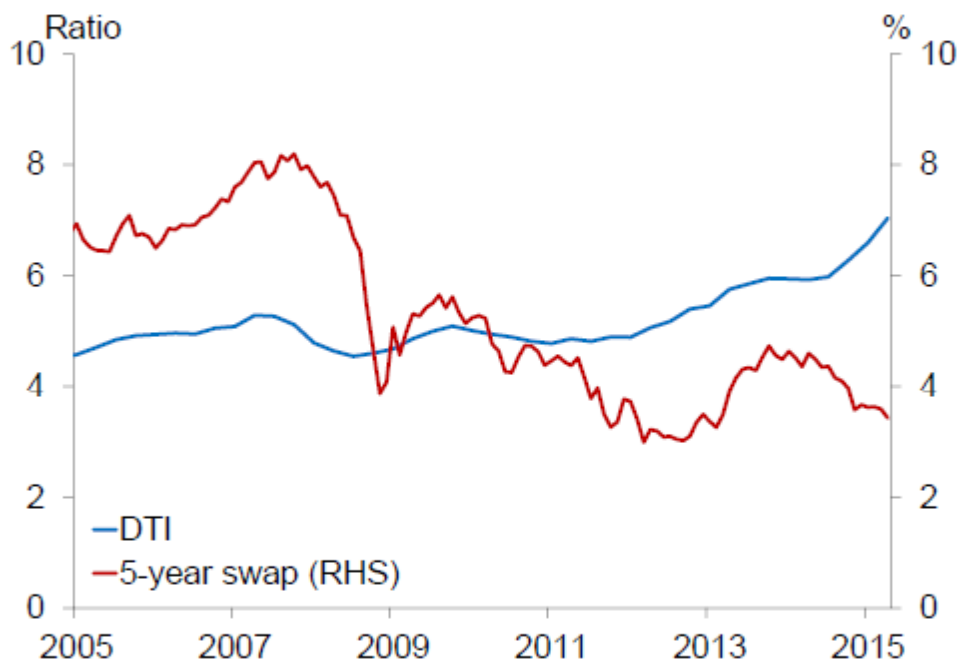
Our expectation is that investor LVRs will reduce financial system risk arising from this sector and assist in moderating the Auckland housing market cycle. However, macro-prudential policy is one of many factors aimed at reducing the imbalances in the Auckland housing market. Much more rapid progress in producing new housing is needed in order to get on top of this issue.

Figure 1
Auckland inward and outward migration



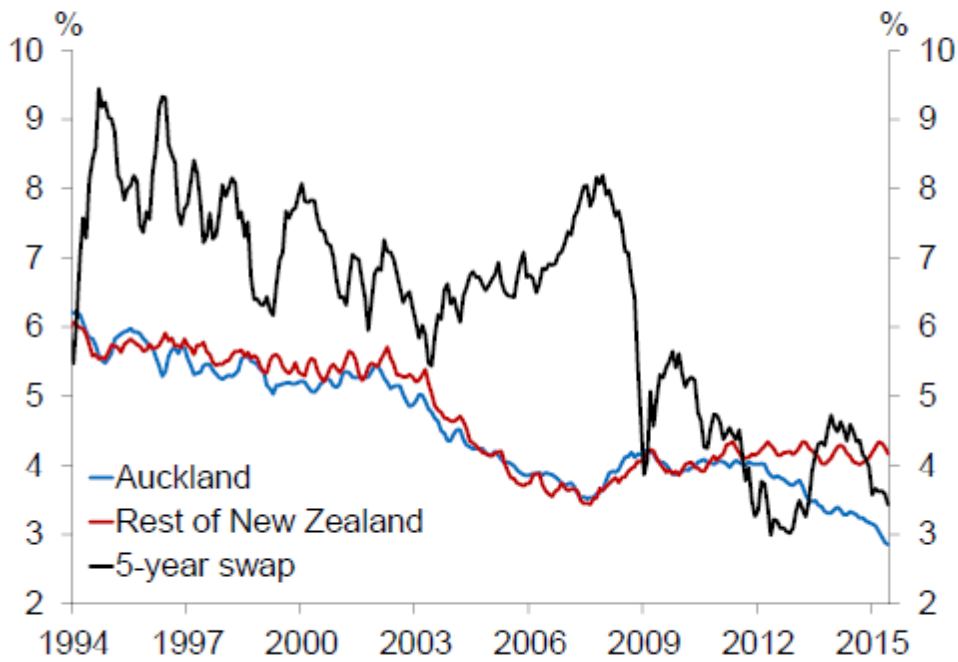
Source: Statistics New Zealand.

Figure 2
Representative Auckland buyer DTI and 5-year swap rate



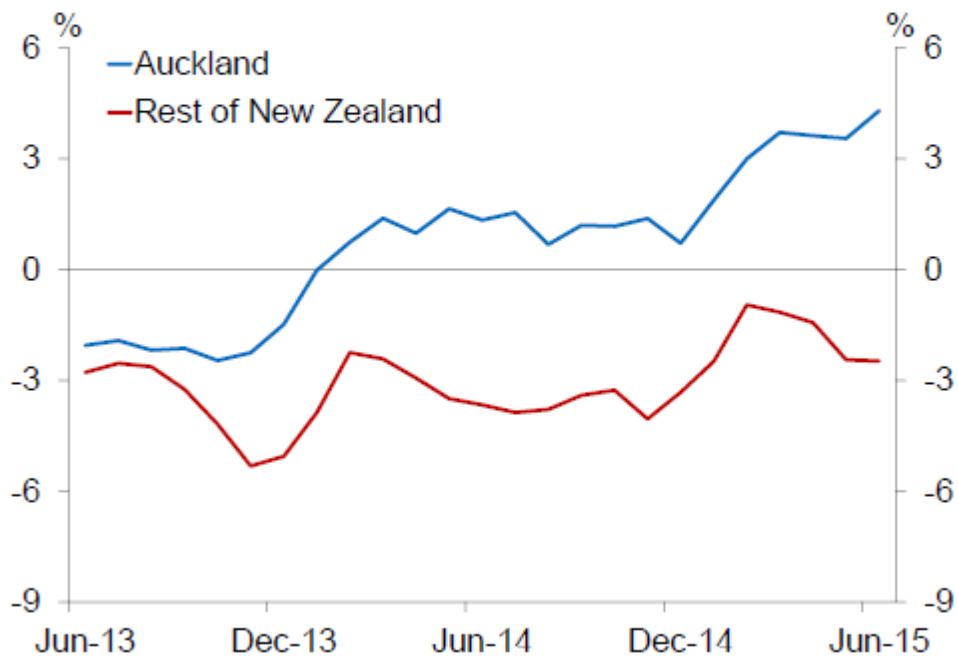
Source: QV, REINZ, Reuters, Statistics New Zealand.

Figure 3
Gross rental yields and 5-year swap rate



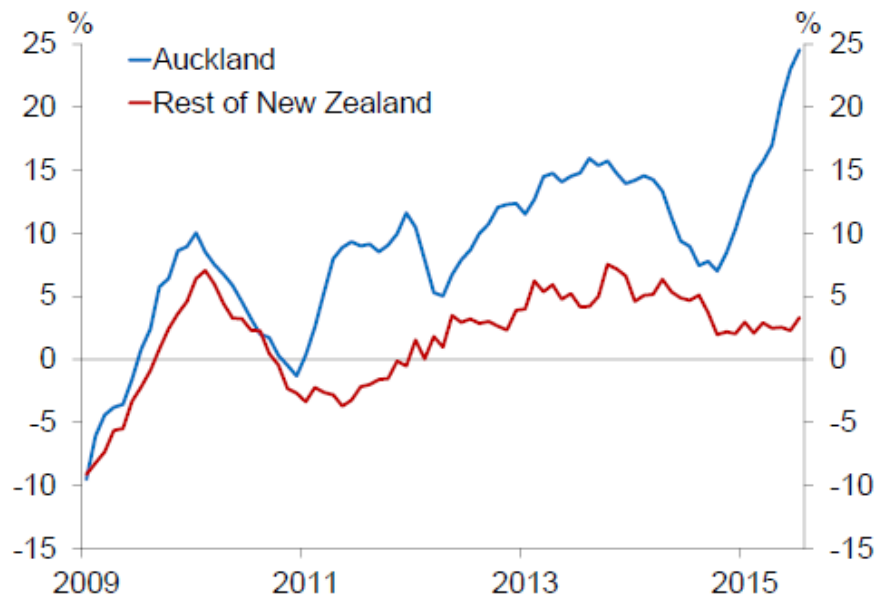
Source: MBIE, REINZ, QV.

Figure 4
Net investor purchases by region
(share of regional market sales, three-month moving average)



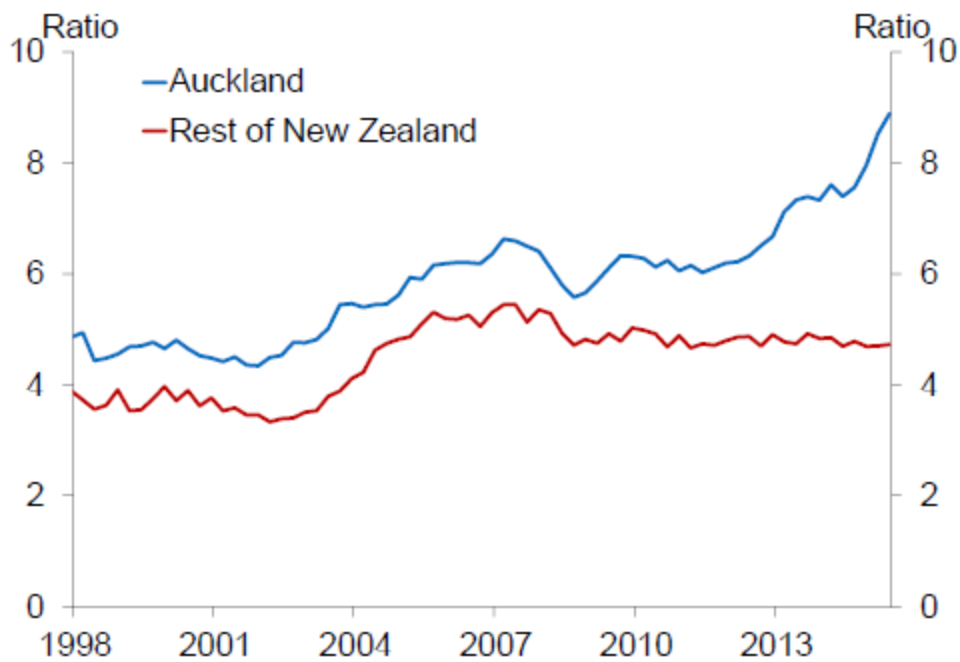
Source: CoreLogic NZ.

Figure 5
Annual house price inflation
(three-month moving average)



Source: REINZ, RBNZ estimates.

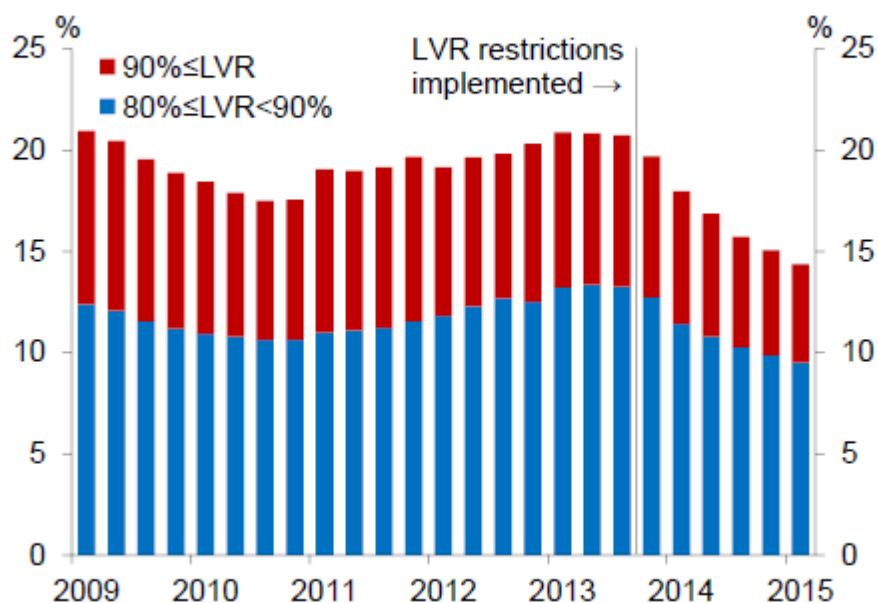
Figure 6
House price-to-income ratios



Source: REINZ, QV, Statistics New Zealand.

Figure 7

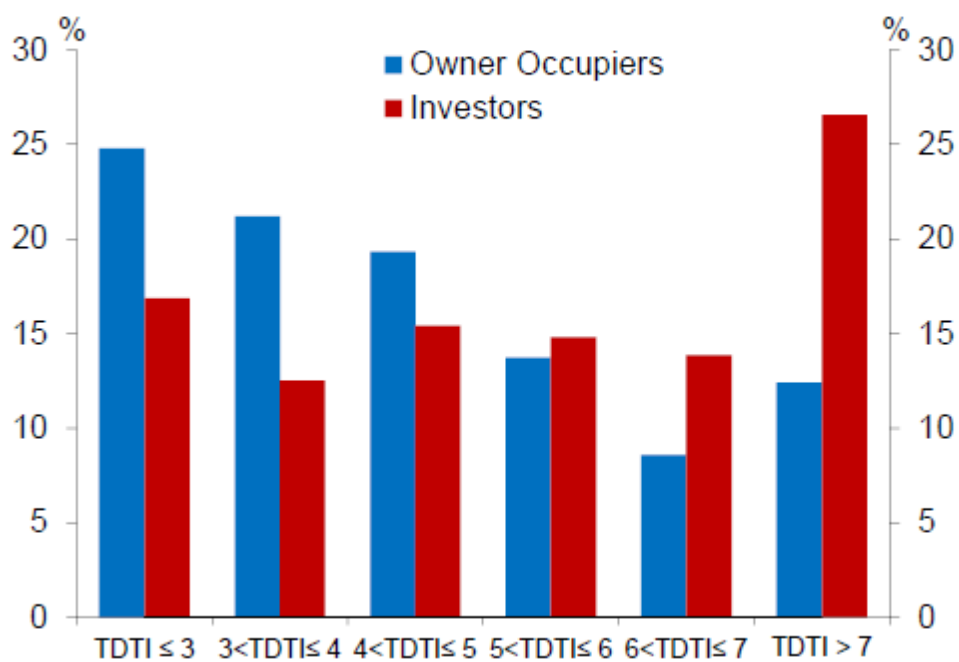
Portfolio share of high-LVR mortgages



Source: Registered banks' *Disclosure Statements*.

Figure 8

Total debt to income ratios of new borrowers



Source: RBNZ.