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MEDIA COMMENT

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Commentary on new loan-to-value ratio restrictions

Victoria University of Wellington Chair in Public Finance Professor Norman Gemmell provides expert comment on the Reserve Bank lending restrictions.

Please feel free to use the quotes below or contact Norman Gemmell on 04-463 5843 or email *norman.gemmell@vuw.ac.nz*.

The introduction of the new loan-to-value ratio (LVR) restrictions by the Reserve Bank of New Zealand (RBNZ) this week has received much media commentary—both for and against. The idea (as with other monetary policy instruments such as interest rate rises), is to limit demand for house purchase to help stop unsustainable rises in house prices. As the recent global financial crisis revealed, especially in the United States, when house prices take a downward slump, people with high LVRs suffer most because their house is worth less than their mortgage. So the new LVR restrictions aim to limit demand (and unsustainable house price rises) specifically in a way that will limit the risk of new home buyers finding themselves in this vulnerable position.

Much speculation is surrounding the new policy and whether it will work or not—in reducing the risk of a future house price ‘bubble’. There is almost no past experience to call on to answer the question of how effective we can expect the new LVR restrictions to be. My best guess is that the policy will affect too few people, and in a particular segment of the housing market, to have much noticeable effect, but let’s hope that the officials at the RBNZ who have advocated the policy (and who have more expertise than me in this area) have convinced themselves to adopt it based on some evidence!

But the other big question is, even if successful, will it have other side effects that are good or bad? Here I am more worried for three reasons.

First, using a general rise in interest rates affects almost every borrower and in a similar way, whereas the LVR policy affects only a few, specific types of would-be borrowers. This makes it ripe for responses by borrowers that enable them to get around the policy. For example, first-time buyers who can’t find a 20% deposit, but who have parents who can extend their own mortgage and on-lend to their grown-up children will be in a more favourable position. Others less fortunate with their families’ economic fortunes will, however, be cut out. But expect credit constrained borrowers to explore plenty of ways around the new restrictions—and this could involve family personal loans at higher interest rates that make them more vulnerable to an economic downturn should it happen.

And therein lies the second problem—the policy is intended not to discriminate against lower income borrowers but these are precisely the ones likely to be less able to get around the restrictions. So the policy also discriminates against lower income households or families in a way that interest rate

policies don't. When interest rates rise, the banks can make a careful judgement on what they can afford to lend you, and what you can afford to borrow, based on your income prospects into the future, not on how much you've been able to save recently towards a deposit.

And thirdly, as some lenders have recently pointed out, ability to repay a mortgage is what really matters in regards to whether a borrower will be vulnerable to an economic downturn in future, not what percent of the house price they have borrowed. So, yes, a temporary house price downturn that leaves your house worth less than your mortgage is not nice. But as long as you still have the income to repay the mortgage you don't need to sell, and can wait for an upturn in house prices in future, as well as your repayments in the meantime reducing the loan value, to sort the issue out. The LVR restriction is only helpful for those who would have to sell their house in a crisis—perhaps because they become unemployed or need to move out. But these are also often the people whose borrowing would be already restricted when lending is based on their expected capacity to repay.

So, maybe we should hope that this new policy isn't too effective—that way it will have less of these distortionary effects that seem likely to accompany it.

Issued by Victoria University of Wellington Communications & Marketing. Haley Small, Assistant Communications Adviser, can be contacted by emailing haley.small@vuw.ac.nz or phoning (04) 463 5105 or 027 563 5105.

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