

13 April 2015

18 Bay Lair Grove
Island Bay
Wellington 6023

Cavan O'Connor-Close
Adviser, Financial Policy
Prudential Supervision Department
Reserve Bank of New Zealand

By email cavan.oconnor-close@rbnz.govt.nz

Dear Cavan,

Asset class treatment of residential property investment loans

I attach some comments on the Reserve Bank's consultation paper, dated 5 March 2015, on the asset class treatment of residential property investment loans in BS2A and BS2B. My comments are only on that part of the consultation document.

Yours sincerely

Michael Reddell

**Comments on Reserve Bank of New Zealand consultation paper (5 March 2015):
Housing review stage two: asset class treatment of residential property loans in BS2A and BS2B**

by Michael Reddell

www.croakingcassandra.com

13 April 2015

Introduction

The Reserve Bank's consultation document has an explicit strong presumption that mortgage on residential investment properties are materially more risky (has a higher probability of default, and/or higher loss given default) than loans on owner-occupied properties. But the evidence provided in support of the proposition, in a New Zealand context, is scant. There appears to be a strong element of pre-determination underpinning the paper (even allowing for earlier rounds of consultation, where nothing more robust was provided on the evidence and its applicability to New Zealand).

In particular, having relatively recently emerged from the biggest house price (and credit?) boom in modern New Zealand history, and a severe recession, with very low loan losses on banks' residential mortgage books (owner-occupied or investor), it is difficult to escape the impression that the highly detailed proposals being consulted on are more about an apparent desire by the Bank's Governor to introduce direct controls on bank lending to investor property owners than about any material overall weaknesses in the New Zealand bank capital framework. The recent stress test results, which provide a further considerable degree of confidence about the robustness of New Zealand bank balance sheets, tend to reinforce such a conclusion.

Such restrictions are unlikely to be in the public interest and might well be *ultra vires*. But a more careful assessment of the costs and benefits of such restrictions would be required before it would be safe to conclude that a clear delineation between owner-occupier and investor residential loans, of the sort proposed here, would be in the interests of anyone other than the Reserve Bank. Otherwise, this proposal may simply smooth the path towards bad policy initiatives - measures which could undermine the efficiency of the financial system, would probably do little for the soundness of the system, and which would further undermine the effective functioning of the housing market.

Policy rationale

The consultation document devotes two pages to the rationale for the proposal. It is not persuasive material. New Zealand has been recognised as having among the highest risk weights on residential mortgage loans of any advanced countries. Stress tests point to the resilience of the system in face of some fairly severe shocks. And as a recent Reserve Bank *Bulletin* has highlighted loans on residential mortgages have very rarely been central to any threats to financial system stability. And yet the tone of the document suggests that housing loans are somehow favourably treated within the capital framework. An example is the observation "both [IRB and standardised bank housing]

average risk weights are substantially lower than the risk weight on most corporate loans”, a point which seems to totally overlook the much lower level of collateral provided in respect of most corporate loans. The case may be able to be made that, all else equal, a loan to a New Zealand property investor is typically more risky than a loan to an owner-occupier, but it has not been made here. Citizens deserve more robust analysis of proposed policy initiatives. We can only hope that the Reserve Bank has more in-depth internal papers, and if so it would be useful for those to be released.

Apart from an unreferenced mention of a Fitch study, the evidence presented in the paper is mostly about Ireland - in effect, and doubly, a sample of one (one country, one specific crisis). It is striking that there are no data in the consultation paper on the experience in the United States in the recent downturn.

The small number of charts and tables presented are interesting, but on their own they do not convincingly make the case argued from them. For example, if investor property loans typically have a higher initial LVR than owner-occupier loans, it would not be surprising that default (and loss) rates on such investment property loans turned out higher than those on owner-occupier loans. But that may just reflect a difference in initial LVR, which should already be captured in banks’ internal models (and is captured to some extent in the rules for standardised banks). Moreover, if investor property loans were taken out later in the cycle than - otherwise equivalent - owner-occupier loans, they are also likely to have had higher default/loss rates. I am not sure on the situation in Ireland, but in the United Kingdom it certainly seemed to be the case that the small investor buy-to-let house purchases became much more important late in the cycle than they had previously been in the United Kingdom (or than they had been for a long time in New Zealand). But that might make any summary data on the United Kingdom (where in any case housing loan losses were very small, despite a severe and prolonged recession) much less enlightening for New Zealand, where small investor purchases of residential property have been an established feature of (a) the housing market and (b) the housing credit market, for many decades.

The paper focuses on the possibility of that investor property loans are, all else equal, higher risk. But even if such loans are, in fact, generally riskier - all other factors held equal - it was striking that there was no discussion in the paper as to whether risk weights on pure owner-occupier loans should be lowered? It would be interesting to know what evidence there is for the (implicit) view that overall capital requirements on New Zealand banks’ housing loans are now too low.

The consultation document gives some emphasis in the Basle documentation. In general, I do not think that New Zealand should put much weight on these considerations, or be defensive about departing from the guidelines. In this area, for example, it seems likely that the guidelines will have been heavily influenced by the form of the housing market in continental European countries. One of the features of the New Zealand tax system is that it is broadly neutral among various classes of possible investment property owners. That is so because of the ability of wage and salary earners to offset losses on operating investment property businesses against labour earnings - a highly desirable feature of the tax system, which treats investment properties as just another income-earning assets. By contrast, in many other countries, the inability to do such loss-offsetting against labour income skews holdings of rental properties into corporate vehicles. In addition, the general

absence of preferential tax treatment for institutional investors/retirement income vehicles, also makes individual purchasers competitive in the investment property market. As a result, outside Housing New Zealand and local government, we have very few very large residential landlords, and many very small ones. The picture is somewhat different in many other advanced countries. For large landlords in those countries it is much more natural to think of classing loans to finance residential investment properties with other forms of large scale business credit. In New Zealand, one would need more analysis of the specifics of the New Zealand market to reach such a conclusion. No such analysis has yet been presented by the Reserve Bank.

The consultation document asserts that “housing loans are a crucial area for maintaining financial stability in New Zealand”, but provides little evidence in support of the claim. Housing loans make up the largest share of bank balance sheets, but as a recent Reserve Bank *Bulletin* acknowledged, international research shows that housing loans have rarely played a central role in financial crises. This included some of the most severe post-war banking crises, those in the Nordic countries in the early 1990s. It is so even in Ireland (the favoured case study) where property development loans are at the heart of the recent crisis. The situation was somewhat different in the United States, but there a compelling case can be made that the marked deterioration in lending standards leading into the crisis was driven by government agencies and Congressional legislative initiatives. As noted earlier, it is not clear whether investor loans performed worse, all else held equal, during the recent US crisis, than owner-occupier loans, across the whole country and in with-recourse, and without-recourse states. If not, it might not be surprising, given that the regulatory demands pre-crisis had been focused on expanding owner-occupier lending. But that would simply reinforce the point that one cannot safely draw conclusions - applicable from one country to another, with quite different institutions and markets - that an investor property loan, with otherwise similar characteristics, will generally be more risky than a loan on an owner-occupied property.

The New Zealand banks and their Australian parents have had a good experience in housing lending for decades. The last significant loan losses on New Zealand residential mortgage lending were in the 1930s, and those were mostly not on the books of banks, and were as much a consequence of unexpected (policy-facilitated) deflation as of any particular weaknesses in the credit initiation process. The house price boom up to 2007 was the largest in modern history, and led to few credit losses. Given this backdrop, and the results of its own stress tests, it is difficult to know why the Reserve Bank is so focused on trying to draw bright lines between investor and owner-occupier loans - unless the tail (the desire for more controls, for which justification has not yet been presented) is wagging the dog. Such bright lines will inevitably impinge on some borrowers future options and choices, and yet it is not clear what the wider public policy gains is from reaching so directly into the details of banks' loan practices and classifications.

Better perhaps to require banks to have policies in place to take account of the potential different risk characteristics of loans that might have similar underlying collateral. Better perhaps - given that Modigliani-Miller propositions are likely to hold, at the margin, at current levels of bank capital - to rely on high overall capital requirements, rather than trying to reach beyond our knowledge, and the available data, to try to squeeze every residential mortgage loan into one or other of two regulator-defined boxes. Better perhaps to respect the fact that banks, and their shareholders, bear the first losses when things go wrong, and have a greater ability (and probably stronger incentives) to

appropriately differentiate risk than central bank regulatory officials do. The proposed approach seems driven by a desire for tidiness, and for additional intrusive controls on borrowers, rather than to reflect real risks to the New Zealand financial system, or the degree of complexity or variegation in the banks' residential loan books (and balance sheets more generally). They also appear to reflect a degree of certainty, and confidence, that the data, and international experience - to date, only lightly applied to New Zealand - do not yet seem to support.

13 April 2015