10 July 2015

18 Bay Lair Grove
Island Bay
Wellington 6023

Bernard Hodgetts
Head, Macro-Financial Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

(by email macroprudential@rbnz.govt.nz)

Dear Bernard,

Proposed restrictions on Auckland residential property investor finance

This letter represents my submission on the Governor's proposal to restrict to (practically) zero the ability of banks to lend secured on residential investment properties in Auckland, when the initial loan to value ratio would exceed 70 per cent.

As I have noted in various pieces of public commentary on this proposal, in such matters the Governor effectively acts as prosecutor, judge and jury in his own case. As such it is difficult to have any confidence in the consultative process - it is simply implausible that the single person actively and publicly proposing such restrictions can take a properly dispassionate and impartial approach to assessing submissions on the proposal. The proposed turnaround time, from the closing date for submissions to the release of the final policy position ("early August"), casts further doubt on the seriousness, and open-mindedness, with which the Bank (the Governor, as sole decision-maker) is approaching the consultative process on the substantive proposal (as distinct perhaps from the fine operational details). Confidence in the process is further undermined by the fact that no cost-benefit analysis has been provided for the proposal. We all know that cost-benefit analysis, in the right hands, can be generated to support any proposal, no matter how egregious, but proper cost-benefit analysis at least force the preparers to write down their assumptions, which enables them to be scrutinised, debated, and challenged.

All this means there is little incentive for members of the public to invest time and effort in making submissions to the Bank. Indeed, there is a risk that by submitting we might be taken as regarding the process as a legitimate one. Nonetheless, for the record, I do have some points that I wish to have recorded in respect of questions 1 to 4 of your consultative document. Many of my points have already been made in the following documents, which should be read as part of this submission. Each of them is available on my blog, www.croakingcassandra.com :

13 May 2015 "Yet another policy lurch" http://croakingcassandra.com/2015/05/13/

14 May 2015 "Some more thoughts on housing and the FSR" http://croakingcassandra.com/2015/05/14/

23 May 2015, "The Reserve Bank stands by its stress tests" http://croakingcassandra.com/2015/05/23/

4 June 2015, "The Reserve Bank's stress tests - again" http://croakingcassandra.com/2015/06/04/the-reserve-banks-stress-tests-again/

4 June 2015, "Yet more on stress tests" http://croakingcassandra.com/2015/06/04/

25 June 2015, My speech "Housing, financial stresses, and the regulatory role of the Reserve Bank", available at http://croakingcassandra.com/2015/06/26/housing-financial-stresses-and-the-regulatory-role-of-the-reserve-bank/

3 July 2015, "Brian Fallow covers my criticisms of the proposed new controls" http://croakingcassandra.com/2015/07/03/brian-fallow-covers-my-criticisms-of-the-proposed-new-controls/

My concerns about the substance of the proposal fall under five headings:

- The failure to demonstrate that the soundness of the financial system is jeopardised (this includes the failure to substantively engage with the results of the Bank's stress tests).
- The failure of the consultative document to deal remotely adequately, with the Bank's statutory obligation to use its powers to promote the efficiency of the financial system.
- The failure to demonstrate that the statutory goals the Bank is required to use its power to pursue can only, or are best, pursued with such a direct restriction.
- The lack of any sustained analysis (here or elsewhere in published Bank material) on the similarities and differences between New Zealand's situation and the situations of those advanced countries that have experienced financial crises primarily related to their domestic housing markets.
- The failure to engage with the uncertainty that the Bank (and all of us) inevitably face in making judgements around the housing market and associated financial risks, and the costs and consequences of being wrong.

The absence of any substantive discussion of the likely distributional consequences of such measures is also disconcerting. Distributional consequences are not something the Reserve Bank has ever been good at analysing. In many respects they were unimportant when the Bank's prudential powers were being exercised largely through indirect instruments (in particular, capital requirements) but they are much more important when the Bank is considering deploying direct controls. In particular, the combination of tight investor finance restrictions in Auckland and the continuing overall residential mortgage "speed limit" is likely to skew house purchases in Auckland to cashed-up buyers. In effect, to the extent that the restrictions "work" they will provide cheap entry levels. New Zealand first home buyers and prospective small business owners will be disadvantaged, in favour of (for example) non-resident foreign owners. At very least, it should be incumbent on the Bank to spell out the likely nature of these distributional effects.

Financial system soundness

I presume it is common ground that the primary responsibility of the Reserve Bank, in exercising its banking supervision powers, is to promote the soundness of the financial system. But it is also important to recognise that the injunction is to "promote" soundness, not ensure it, and the focus is on the "financial system", not just the banks which are being directly regulated.

It is also, I think, common ground, the bank capital ratios have increased materially since the recession of 2008/09. That results from a combination of regulatory initiatives and market expectations. Risk weights on riskier loans (including high LVR mortgage loans) have been increased, and capital has been increased as a share of risk-weighted assets. There is always room for further refinement of the models, and of estimates of required capital, but the Bank's last published work in the area, the regulatory impact material on the transition to Basle III, illustrated that at current levels of capital ratios the risks to the soundness of the banking system were very low. And that is, probably, as it should be.

The stress test results last year further reinforced that conclusion. Despite some very tough assumptions in the scenario - appropriately tough I might add – none of the banks tested was materially impaired. As the Bank itself noted, capital ratios dropped, but only because of the subsequent reweighting of the riskiness of the assets that were not impaired in the stress test scenario itself.

The Bank has also pointed out, in a recent issue of the *Bulletin,* that in past banking crises it is very rare for banking systems to get into serious trouble primarily on the basis on residential mortgage loan exposures.

And, of course, New Zealand banks came through the severe recession of 2008/09, in the aftermath of a huge and widespread asset price and credit boom, almost unscathed. No credible analysis has been presented, by the Bank or others, that the threats to the soundness of the financial system are now greater than they were in 2008. And yet the buffers against any such threat are already materially larger than they were then.

And yet the Bank is proposing new, more intrusive, restrictions on the ability of some residential property owners in Auckland to leverage their assets. But it is doing so without demonstrating any credible threat to the soundness of New Zealand's financial system.

In paragraph 23 of the consultative document, the Bank states that it believes the "stress test results would be worse if the exercise were carried out now". That is quite a weak statement, with no sense of anything "materially" or "substantially" worse. And the actual 2014 stress test results suggested an extremely robust system. If the 2014 results are misleading, the public is owed a more extensive and careful assessment of where and how they are likely to be wrong, including one that takes account of the continuing falls in real house prices in many parts of the country in the year since the stress tests were done.   In the meantime, the Governor's refusal to engage openly with the implications of the stress test results is disconcerting, since the stress tests are the most substantive analysis of risks the Bank has recently undertaken.

Somewhat relatedly, the Bank has not provided any evidence of a marked deterioration in lending standards, or that the absolute level of lending standards is now very low. This matters because the Bank's proposal implicitly says that banks are lending so irresponsibly that no bank can be trusted to make any (relatively) high LVR loans on residential investment properties anywhere in Auckland. Where is the evidence for this proposition? And, if it exists, how plausible is it that lending standards have fallen to such low levels only in this one sector of the overall lending market?   That wasn't the experience in financial systems that experienced systemic crises (eg the Nordics in the late 80s/early 1990s or the Ireland more recently).

Efficiency

The Reserve Bank is required to use its banking regulatory powers to promote the efficiency of the financial system. I think it is pretty well-recognised that the intention of Parliament, in including that provision in the 1989 Act, was to recognise that prudential regulatory controls, especially direct ones, might promote soundness but could also come at an efficiency cost. In other words, the efficiency provisions should be seen as a constraint on the degree, and type, of regulatory actions.

But, as far as I can tell, the consultative document does not substantively address the efficiency issues at all.   In paragraph 60, there is a bald statement that the proposal "is likely to encourage some Auckland investors to switch to purchasing property outside of the Auckland region", and then some mention in the following paragraph of the direct systems costs the controls will impose on the banks. But that is all. There appears to be no discussion at all, for example, of the likely diversion of finance away from banks to non-bank financiers (which will reduce the effectiveness of the restriction, but only by inducing borrowers to raise funds through - by evidence of revealed preference - less efficient entities). Those non-bank financiers may also be riskier entities.

More generally, the document gives us no basis for confidence that the Reserve Bank has the information or insights to enable it to make better decisions than the market on the allocation of credit (between housing and non housing loans, between investor finance and owner-occupiers, and between loans secured on Auckland property and loans secured on property in the rest of the country. A well-functioning financial system should enable credit to flow to those most able to pay for it (and who their lenders also consider able to pay for it). To substitute the judgement of an official for the market process seems to involve a considerable degree of hubris. If there is a case for this impairment of the financial system, it is not made in the consultative document.

In paragraph 61, the Bank concludes the "while this policy is likely to create some distortions, the Reserve Bank judges that these are not overly large when compared to the benefits of a material reduction in the probability of financial stress arising as a result of a severe housing downturn in the Auckland region"

But this is simply *ex cathedra* assertion, not backed by any analysis (presented in the consultative document or any other material the Bank has released). The consultative document provides no substantive analysis of the likely impact of the policy in reducing the chances (or extent) of financial stresses. The document reports some plausible estimates for the short-term impact on house prices, but (for example) how sensitive are the stress test results to such modest changes in house prices and credit stocks? And as the Bank has no idea when, or even if, a severe nominal house price correction will occur in Auckland, and yet the effects of such restrictions are largely temporary, how soon would the correction have to occur for any gains to be material?

Perhaps as importantly, what criteria is the Bank using to play down, as "not overly large" the distortions that will certainly (not just "likely") arise. What if high LVR investor lending gravitates off to the unregulated sector? What if banks, with unchanged profit targets, pursue other riskier lending prospects instead? What about the people wanting to start rental services businesses now, who might be unable to for several more years? And so on.

Other instruments

The Act requires the Bank to use its bank regulatory powers to promote the soundness and efficiency of the financial system. The combination of soundness and efficiency strongly implies an obligation to use the least distortionary instruments available to pursue the soundness objective. There is no evidence that has been done in this case. In paragraph 51, the Bank argues that the measures will "tend to promote the resilience of household balance sheets", but that is not a legitimate policy concern of the Reserve Bank. If Parliament had wanted to make it so, Parliament could have (and could now) amend the Act to substitute an alternative objective. The responsibility of the Bank is to promote the soundness of the financial system. Risk weights and required capital ratios seem much more attuned to that goal than direct restrictions on one particular pocket of lending. And yet there is no sign in the consultative document that the option of requiring higher capital ratios has been seriously considered to deal with any financial system soundness threat that the Bank can currently see emerging.

The Bank's case for higher risk weights on investor lending remains seriously unconvincing. It has not yet shown that the riskiness of investor property loans, made at the same stage of the cycle and with otherwise similar collateral and borrower characteristics, are riskier than loans on owner-occupied houses. But if one were to grant the Bank's view that they are riskier, the soundness goals might be as effectively pursued, with much less detrimental effect on the efficiency of the financial system, if the Bank has simply proposed further increases in risk weights on high LVR investor property loans.

Analysis of similarities and differences with other countries

The Reserve Bank has presented no serious analysis of the insights from the countries that have, and have not, experienced financial crisis associated with their housing markets. Bank documents tend to allude loosely to the recent experiences in the United States and Ireland (sometimes with references to the United Kingdom, although loan losses on UK residential mortgages through the recent crisis and recession were very low), but there is no detailed analysis of what causes those crises, or of why so many other countries (that also had rapid growth in credit and house prices) did not experience any severe financial system stresses.

The absence of such analysis gives us little reason to be confident in the judgements the Reserve Bank is taking now. If, for example, the Irish crisis arose primarily from the adoption of the euro and the distortion to pricing, demand for credit, and lending standards that come from systematically imposing a German interest rate on an economy that needed much higher interest rates, there may be few lessons for a floating exchange rate country like New Zealand (or Australia, Canada, and the United Kingdom). And if the US crisis, and associated heavy losses on housing loans, resulted largely from a huge deterioration in lending standards brought on in large part by the actions of regulatory agencies and Congress, again the lessons may be limited for us. Or, perhaps more specifically, they offer a very forceful lesson about the dangers of those sorts of well-intentioned political initiatives, and reason to be grateful that there is no sign of such initiatives in New Zealand.

The Bank's analysis seems to implicitly treat collapses in housing prices and financial crises as things that come out of the blue, as if a country happened simply to get a bad draw in a lottery, and other countries escaped that fate only by chance. A more plausible story is that lending standards matter hugely. They fell very sharply in the systems that experienced crises (notably Ireland and the US - but also the UK in respect of the offshore assets in particular). Lending standards also fell here in lead-up to 2007, but not enough to materially impair our banks. To date, the Reserve Bank has not presented any material to suggest that there has been a recent deterioration in lending standards, that lending standards are in any way imprudent, or that lending standards here in any way resemble those in countries that did face systemic financial crises.

Knowledge problems

Perhaps the Reserve Bank is correct in its assessment of the risks, and of the potential benefits (private or social - they differ) of its proposed restrictions. But the nature of life - and of anything to do with economics and asset prices, and public policy more generally - is uncertainty. The consultative documents evinces no sign that the Bank is aware of this uncertainty or of the limitations of its own knowledge (how often in the past, for example, it has been wrong about forthcoming corrections in housing prices). In particular, it shows no sign of having asked itself the question "what if we are wrong?" That should be one of the very first questions that any regulatory agency - particularly an unelected one with limited effective accountability- should be asking itself.

The Reserve Bank has previously indicated that, with hindsight, it would have imposed regulatory restrictions in respect of residential lending 10 years ago. And yet the major correction the Bank worries about has not happened in all that time. Had such controls been in place, the costs of distortions would have grown each year for no material gain for society. This is not just akin to an insurance premium - no ever wants to claim on a policy - since indirect measures (notably capital requirements) can provide the desired degree of resilience of the financial system, with fewer distortionary effects, and less ambitious knowledge requirements.

Had controls been in place over the last 10 years, many individuals would have had their aspiration to purchase homes, or start rental services businesses, postponed as a result of these regulatory provisions. Many people would be poorer as a result. And those costs would have fallen most heavily on the poorer and browner sections of our population. How can we have confidence that such restrictions would have been worthwhile? And how can we have such confidence now, especially when the case for these particular restrictions is based on quite threadbare analysis.

Conclusion

The restrictions proposed by the Reserve Bank do not pass the test of good policy. The problem definition is inadequate, the supporting analysis is weak, and the alignment between the measures proposed and the statutory provisions that govern the use of the Bank's regulatory powers is poor.

Reasonable people might differ on when policy tools should be deployed, but we should be able to disagree on the basis of much more extensive, robust, and well-documented background material than has been presented in this consultative document. At present, the evidence that we do have suggests that the New Zealand banking system is strong and highly resilient, with no sign that there has been any serious or disconcerting deterioration in lending standards. The Reserve Bank appears to be mistaking high house prices that result from real structural factors (land use restrictions and immigration policy), with those that results from a credit-led process. The latter might argue for much tougher prudential controls, though probably still less distortionary indirect ones. But there is simply no evidence at present of such a credit-led process. Yes, house purchases need to be financed, but that appears to be a largely passive facilitative process, which poses no materially enlarged threat to the soundness of the financial system.

Yours faithfully

Michael Reddell