Intervening without understanding: The Reserve Bank and the housing market

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When I was young and exploring job opportunities, I spent a day at the Reserve Bank. The then deputy chief economist was explaining the attractions of working at the Bank - things other than just the heavily-subsidised house mortgages. But the one line I remember was when he stressed the involvement the Reserve Bank had in the housing market, and issues around mortgage financing.

That wasn't too surprising when one thinks about it. It was December 1982. We were coming towards the end of 40 years of pretty pervasive regulatory controls over so many aspects of the financial sector, including housing finance. The Reserve Bank was then a strong advocate in official circles for financial system deregulation, and allowing the market to take over the allocation of credit. It was - I thought then, and think now - on the side of the angels.

But in my first 20 or so years at the Reserve Bank housing was, at best, a very minor point of what we did. Within months, almost all the direct controls were stripped away. Institutions lent for housing if (a) they could fund themselves, and (b) if they could find (hopefully) creditworthy customers. It was their issue, not ours. Credit, generally, became more readily available. Interest rates trended back down, and banks typically became more willing to lend for longer terms. For an ordinary working person looking to buy a house, a very long repayment period will often make a lot of sense - just as a high initial LVR loan had always done.

And Parliament was careful to provide that whatever prudential powers the Reserve Bank did have were to be used not just to secure the soundness of the financial system, but also to promote the efficiency of that system.

There was a house price (and house credit) boom in the mid 1990s and the then Governor got interested in things that might be done to take the heat out of house prices. But there was never any suggestion of Reserve Bank controls impinging directly on borrowers.

House prices rose by 23 per cent in 2003. But even then it wasn't something the Bank worried too much about. The job Parliament had given us was (a) consumer price inflation, and (b) financial stability. Financial stability wasn't threatened.

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But after a couple of more years of house price inflation, the Minister commissioned the Bank and Treasury to identify possible measures that might take the heat out of the housing market without putting further upward pressure on interest rates and the exchange rate. We weren't that enthusiastic about any of the options - most of which would have required new legislation anyway – other than doing things that might improve supply (an issue we at RB didn't really understand much about). But there was no sustained appetite for direct Reserve Bank controls.

Bank regulation had long been pretty simple - standard "risk weights" used in calculating how much capital needed to be held against different types of loans. But about this time, the Basle II system was coming into play. Big banks were, in principle, to be allowed to use their own risk models to work out how risky different types of loans were, and hold capital accordingly. Banks regarded mortgage lending as very safe and wanted very low "risk weights" for residential mortgage lending. We pushed back, quite strongly, against that. But the focus wasn't really on trying to influence the flow, or composition, of new lending. That was a matter for banks and their customers. It was about making sure banks had enough capital if things went badly wrong - whether on housing exposures or other credits (e.g. dairy). Our role was about limiting damage.

Things began to change in the aftermath of the serious 2008/09 recession. Bad as it was, there was no banking crisis here, no threat to the soundness of the financial system. Banks' loan losses, such as they were, were concentrated in dairy.

But in the wake of the crises abroad, there was a great deal talk of new (so-called) macro-prudential instruments. The logic was that traditional bank supervisors looked at the risks of an individual bank's book, but didn't look or think much about how one bank's choices and risks could be exaggerated by the actions of other banks. That sounds fine, perhaps, in a country of 1000 banks. It never made much sense in New Zealand, where almost all the banking system risk was concentrated in four large banks, with quite similar balance sheets and risk profiles. Our Act has consistently told us to focus not on individual depositors, or individual banks, but on the financial system as a whole. And we consistently had. Banks also knew each other had similar risk profiles.

But the Reserve Bank did see a role for acting if it looked as though overall system risks might be getting particularly high. Largely, what we had in mind weren't the sorts of things that needed to affect customers very much, or very visibly, at all. There was the option of a temporarily higher required capital ratio, or temporarily higher risk weights on (say) housing or farm loans. Perhaps they might affect product pricing by a few basis points. Most likely they wouldn't affect behaviour much in boom times. After all, capital is easy and cheap to raise near the peaks of booms. We could look at bank funding - perhaps require banks to raise more long-term funding as the boom went on. But again, longer-term funding would be easy and cheap to raise in boom times. All these things would produce bigger buffers if things went wrong - assuming we got the timing right. In a speech on these matters given in May 2012, just before the end of the previous Governor's term, LVR limits were listed as an option, but were the last on the list of options. Hardly anyone internally regarded them as an attractive option.

But things changed dramatically after Graeme Wheeler became Governor in September 2012.

He'd lived in the United States from the late 1990s to 2012 and seemed determined that New Zealand should never go through the sort of wrenching crisis the United States had just gone through.

Thus far, so good. No one would wish that sort of crisis on their own country - or anyone else's for that matter.

As house prices picked up, Graeme was determined that "something must be done". And by "something", he didn't just mean "build bigger buffers", he meant taking action now, to rein in the risks banks were taking. And he was the single decisionmaker (by law). So very quickly it was "all systems go". Less than a year after Wheeler took office, the first new direct controls on banks - supposedly temporary - were announced.

In his speeches etc, there was a great deal of very general talk about sharp house price falls that had occurred in lots of countries at times (we'd had a big correction too in the late 1970s). It seemed that people were just expected to believe that, on the balance of probabilities, something nasty would happen here too before too long. And not just a fall in house prices - which should be of no direct concern of the Reserve Bank - but one that threatened to take down the banking system. If controls were disruptive, well really they were only protecting people from themselves.

Perhaps. But it wasn't the sort of standard of supporting analysis the Reserve Bank would accept in any other area of its responsibilities - the exchange rate being only the most obvious example.

Four years on we've had two new waves of LVR controls, with an arbitrary distinction now drawn between owner-occupiers and other residential property borrowers, and an even weirder distinction between loans for new-build purchases and loans for existing properties (the former are actually a lot risker than the latter). In addition, they now have a consultation paper out aiming to get the imprimatur of the Minister of Finance to use a debt-to-income ratio limit if, at some point down the track, the Governor thinks that would be a worthwhile control to impose. And, after decades, in which the focus was on treating all institutions equally, these controls apply only to people who finance through banks - typically the most efficient providers of retail credit. The housing finance system is becoming almost unrecognisable.

In recent decades the Reserve Bank has never been very good at is asking "what if we are wrong?" When private companies misread things, the shareholders lose money, the company loses market share, and usually before too long some corrective actions are put in place. But we have only one governments, only one central bank. There is no competition. And the people most directly affected by bad regulatory choices don't have exit options; most borrowers have to use banks, and banks themselves need to stay onside with the regulator, or the regulator can make things even worse for them in all sorts of little ways. Regulators - and political masters - often find it too easy to double-down: there isn't much incentive to admit mistakes and misjudgements. In fact, even the incentives to get things right - rather important when superimposing your judgement over that of people with decades of experience in taking and managing risk.

That makes it vital that regulatory agencies and government ministries follow very disciplined and transparent processes.

The Reserve Bank's processes have been consistently poor. They jump the formal hoops, putting out consultative documents and regulatory impact statements. But there is no independent review (even internally). And once the policy is in place, there is no searching independent critical self-scrutiny and review, just rather propagandistic claims designed to reinforce the Bank's prior view.

Here I want to highlight four important gaps; those:

- around other countries' experiences, and New Zealand's own past experiences,
- around their own stress tests of banks,
- around the impact on the efficiency of the financial system, and
- around the impact of the controls on the soundness of the financial system

You might suppose that before rushing off to adopt a whole new approach to housing finance regulation, premised on fears of financial crisis, the Reserve Bank would have produced some careful research on what had happened elsewhere and how it applies here.

But you would be wrong. Which is really quite extraordinary because:

- Several of the countries that had financial crises that appeared somewhat linked to housing (eg Ireland and Spain) were part of the euro-area, so didn't have their own monetary policy at all.
- Only a single country with a floating exchange rate had a housing-related financial crisis. The US is big and important country to be sure, but it is only one country. And it is a country well known for the heavy degree of government involvement in the housing finance market. But the Reserve Bank has produced no analysis of the competing interpretations of the US crisis, including those that emphasis the role of political and regulatory pressures in encouraging lenders to make poor quality loans to not-very-creditworthy people.
- And if one country with a floating exchange rate had a house price/housing credit boom, and then a nasty financial crisis, here are a few of those that had the boom but not the subsequent crisis: the UK, Australia, Canada, Norway, Sweden, and……New Zealand.

When six typically well-governed countries have one set of outcomes, and the remaining one - with a long history of a politicised, fragmented, banking system - had the other, perhaps there are idiosyncratic US factors at work? The Reserve Bank appears to have no basis for knowing.

What of New Zealand? In the run-up to the 2008/09 recession, we'd had one of the largest increases in house prices, and in aggregate debt/income ratios, in any advanced country. And our banks had been lending pretty freely on almost everything – housing, dairy, commercial property, and so on. In the simple models that tried to look across countries to identify future potential crises, New Zealand was near the top of the list of the vulnerable. And yet our banking system came through the post 2007 period unscathed. But not once has the Reserve Bank even attempted to address seriously the New Zealand experience. Assertions - or an eye turned deliberately away - simply substitute for analysis

Similarly, they've never once addressed findings by the researchers at the Norges Bank: mostly, banking system are brought down by business and, particularly property development lending. Housing loan losses typically aren't that important. That was the story in Ireland. Actually it was the story here in our last major domestic crises, that of the late 1980s. It isn't that surprising a result - after all, such credit is often either unsecured, or secured only on the project itself. If big new property developments financed near the end of boom go bad, they can easily be worthless. No tenants, no cashflow, no nothing. But the Reserve Bank ignores this too. Of course, the US experience in 2008/09 is something of an exception to the story, but in deciding whether it is a representative experience or an idiosyncratic one the evidence needs to be weighed carefully, and opened for scrutiny, not simply ignored.

The Reserve Bank also systematically ignores the results of its own stress tests. In these stress tests the Bank devises a, typically very demanding, macroeconomic scenario, and then gets the banks to apply that scenario to their loan books, at a pretty disaggregated level. Suffice to say, the results suggest that if house prices halve, and the unemployment rate rises to 13 per cent, no bank fails - based on loan books as they are at present. And so demanding is the test that there is no country like ours in modern times where the unemployment rate has risen from around 5 per cent to 13 per cent. With your own floating currency, the central bank can cut interest rates as much as is needed, and the exchange rate can fall sharply. It means we are very different than places like Ireland, Spain and Greece - where unemployment did skyrocket – or even than the US, where the exchange rate is less important, and often tends to rise in periods of crisis. The Reserve Bank will, reluctantly, acknowledge this point…..but then they barge ahead and impose new controls anyway.

As I've already noted, the Reserve Bank Act requires the Bank to use its prudential powers to promote not just the soundness of the financial system, but also the efficiency of that system. The Act also requires the Bank to publish reports enabling citizens and other stakeholders to evaluate how they are doing in this area. They don't.

Almost any measure to promote the soundness of the system is likely to come at some slight detriment to the efficiency of the system. But restrictions which directly impede the banks' preferred allocation of credit, and which favour non-banks over banks, go well beyond that. They impose the judgement of a single regulator - often a judgement plucked from the air - over the competitive discovery process of the market. But the Reserve Bank rarely, if ever, even acknowledges that these issues exist, let alone attempts to respond to them. If they are wrong, the lives and business plans of real people are disrupted unnecessarily. But what are the penalties on the Reserve Bank and its regulators?

You also won't even hear from the Bank about how controls fall unevenly on different groups. For example, LVR restrictions strongly favour the cashed-up buyer over the one needing debt. Since not even the Bank thinks their restrictions make very much difference to house prices beyond the short-term, that means temporarily cheaper entry levels for the middle-aged trading up, and for the fabled foreign buyers, at the expense of ordinary New Zealand individuals and couples starting out, who have to wait longer to buy. How is that just? Where is the Reserve Bank's mandate? How does it promote an efficient financial system? None of this has ever been openly analysed by the Reserve Bank. The young, the poor and the brown miss out, in favour of those who already have.

More recently, they've singled out investment property loans as particularly risky. Many of you might not like those restrictions, but these controls bear particularly heavily on people just starting out a rental services business. Investment property owners have become the subjects of opprobrium and disapproval. That's life. But the Reserve Bank has been giving aid and comfort to that mentality, feeding the flawed view that somehow purchasers of rental property have created the "housing crisis", rather than being a symptom of regulatory barriers that have made home ownership increasingly unaffordable to ordinary people.

There are no restrictions on borrowing secured on dairy land, but there are tough restrictions on borrowing on a residential rental property. There are no restrictions on property developments loans, but tough restrictions on financing a residential rental. Where is the systematic analysis of the case for those sorts of differences? There are none. These are arbitrary controls, but they are also pro-establishment controls, rewarding advantage, when well-functioning financial markets should be democratising, levelling, forces. Good portfolios of loans have a range of risks, adequately priced and provided for. With the restrictions in place now, and those proposed for down the track, we are further marginalising the riskier wanting access to credit. That might sound good to a risk-averse central bank, but the market - in fact life - is about taking risk, and about managing, pricing, and diversifying risk. It is what good banks do. And sadly, if the controls continue, we'll see a repeat of the 70s and 80s experience of credit provision being driven to the less-efficient, less stable, marginal providers. Again, to what social end?

Another big gap in the Reserve Bank's work in this area has been its analysis of the effects of the controls. In every speech and every FSR, we see the repeated claim that they have reduced the riskiness of the banking system. But again there isn't much there.

No doubt LVR controls have reduced the volume of high LVR bank housing loans outstanding. Direct controls almost bear down to some extent on the thing being controlled - be it drugs, pornography or whatever. But in making the claim that they have reduced systemic risk they never once address three related concerns:

- First, banks are required to hold more capital against higher risk loans than against lower risk loans. Reducing the volume of high risk lending will also reduce the volume of capital banks hold against the possibility of those loans going bad. If the risk weights were roughly right in the first place, the riskiness of the banking system doesn't change.
- Second, risks could have increased. Banks assign capital by placing loans in various risk buckets. An 80.1 per cent LVR loan might typically have a higher risk weight than a 79.9 per cent LVR loan, even though there is little difference in the riskiness of the two loans. If, as seems likely, lots of loans are now bunched just below the regulatory maxima - perhaps supported by family loans or other unregulated forms of credit - we might actually have less capital held against the typical loan now than would have been the case before the controls were put on, for no less effective risk. Perhaps there isn't much to the point, but we don't know, and there is no sign the Reserve Bank does either.
- The third concern is what the banks do with the capital they now aren't allowed, by regulatory fiat, to devote to high LVR housing lending. Bank shareholders presumably still want the same target rate of return on their equity in New Zealand banks. Either the freed-up capital is being returned to shareholders in high dividends - in which case it isn't providing a stronger buffer - or bank management will be looking for other, unregulated, exposures they can take on, at a faster rate than they otherwise would have. We don't know to what extent this has happened. Does the Reserve Bank?

And, of course, in imposing standard controls, and standard data reporting systems, they not only impose material upfront costs on banks (system changes) but, perhaps more importantly, they undermine a valuable part of how we learn about risk. Since no one knows with certainty quite where the boundaries should best be drawn, competition among banks in lending standards is also desirable. We - well, they - learn from their experiences, as they study the subsequent loan loss experiences. With everything standardised, and most of the choices made for them by a Reserve Bank with no incentives to get things right, banks will invest less in evaluating appropriate credit standards in the housing finance area. Society is poorer as a result.

But probably the biggest failure of all - and the one that should greatly concern citizens and those paid to hold banks to account - is that the Reserve Bank simply don't have a remotely adequate model of house/land prices. They've been anguishing about house prices for at least 15 years now. And constantly wrong. If they had a robust model of house prices, and housing finance, we could all scrutinise the details of it. Assuming it was robust, we might even be inclined to defer to it. But there is nothing of the sort.

The Bank seems to have an implicit, untested, model in which house prices are driven by some scattered, changing, mix of factors:

- Interest rates,
- Credit conditions,
- Immigration, and
- Lags in the rate of building

Thus, for years their story seems to have that in combination, the first three factors would drive up prices, and then as building "caught up" the market would be vulnerable to a very sharp correction. Consistent with that, they almost always forecast that house price inflation would shortly slow, and house price to income ratios would fall.

Unfortunately:

- They never seem to engage with the idea that interest rates are low (or high) for a reason, and the reasons will usually have to do with expected future income growth. Consistent with that, real house prices in much of the country are no higher now than they were when the OCR was 8.25 per cent a decade.
- They've never engaged in much systematic analysis of changing credit conditions. Thus, on most reckonings credit conditions were at their loosest in the years leading up to 2007, and yet there was no housing crisis then. More generally, there has been no evidence presented that high house prices are mostly a phenomenon of finance. If they were, perhaps finance-based restrictions might make sense. But they aren't.

Most importantly, they've never adequately engaged with economics of land, and the role that regulatory factors can play in driving the price of urban land - even on the periphery - a very long way from the price in the best alternative (agricultural use). Despite undertaking major interventions in the housing finance market, they've published no significant research in the area. Most experts - even both main political parties - now think land use regulation is a key part of the story. If so, then whatever happens to interest rates and credit conditions, there is nothing to take urban land values deeply and sustainably down again, unless the regulatory morass is unwound.

No doubt we'll still see cyclical fluctuations, and regional fluctuations - as in the 2008/09 recession. But those aren't sorts of falls central banks, with a financial stability focus on, need to worry about. It is the halving of house prices that bank regulators sit up and worry about. But there is no sign that the Reserve Bank has a good understanding of what might trigger such a crash.

In a similar vein, our Reserve Bank has never published any systematic analysis or research looking at, say, the differences in housing price outcomes between those regions in the US with tight land use restrictions and those without. It somehow assumes that prices will crash anyway, even with land use restrictions. And it has never identified any market in which a regulatory and infrastructure morass of the sort we have has been successfully undone. Relatedly, you will never see the Reserve Bank observe that in the most recent severe housing market shakeouts there was a material oversupply of houses in those countries. To the prospect of an oversupply of housing (and land) here, one can surely only say "if only".

Instead of a good rich model, and a nuanced understanding of the housing market, all we are given is the extreme reduced-form, of "what goes up, must come down again". Well, perhaps one day, but regulated prices can stay well out of line with unregulated fundamentals for a very long time - see second hand cars in NZ in the 1950s onwards, or New York taxi medallions.

Banks are prudent to have, and the Reserve Bank is prudent to require, sufficient capital to cope with a very nasty shakeout - eg a halving of house prices, and a doubling of unemployment. But a reasonable case for compelling them to hold big buffers requires much less knowledge than intervening directly - perhaps for decades - in banks' credit allocation choices, directly (and unpredictably – since they keep changing the rules) complicating potential borrowers' lives. We have good case for the former - the seriously unexpected can happen, and governments would be on the hook - but no more than a hunch for the latter.

So we've ended up with highly invasive direct controls which mean that, for the first time in decades, ordinary borrowers need to worry about what the government might regulate next, instead of being free simply to deal with their bank on the intrinsic merits of their own project, or their own servicing capacity. Years on, there are no published criteria indicating when these temporary measures might be lifted - if anything, we seemed to be headed deeper into a morass of financing controls. And all this has been done based on no good evidence whatever - whether about crises, about housing, or about the housing finance market, which had seemed to most involved to be working just fine. It is bad enough when they don't publish analysis. What is scarier is that the really don't seem to know. It is so far from being an acceptable standard that probably no one could have envisaged this happening even 10 years ago.

Conclusion

How did this sad state of affairs come to be?

Good systems of governance avoid putting very much power in one person's hands. But by law, the Governor could do all this on a whim. We don't run other state agencies or our court system that way.

We had a Board of the Reserve Bank that did nothing when the Governor they appointed started running off the rails.

We have banks that are scared to speak out, or take on the regulator.

We have a Parliament that isn't willing to do its job - holding to account the man, and institution, to whom they gave so much power.

Events matter too. Those crisis-ridden months of 2008/09 rightly prompted a "never let it happen here" mentality. But it was a knee-jerk reaction, with no analysis looking carefully at why it hadn't happened here. It seemed to provide an open field for enterprising interveners.

And then there were the NZ specific events: the huge and unexpected population surge, all amid governments (and oppositions) willing to do almost nothing to fix the underlying dysfunction in the housing and urban land supply market. "Someone needs to do something" was the mood. Well, the Reserve Bank was "someone" and LVR controls were "something". Never mind that they might have nothing to do with the underlying housing problem, and respond to financial stability problems that RB numbers suggest just don't exist.

Sadly, we've upped the returns to lobbying, and to keeping sweet with the regulator - incentives only accentuated by episodes like the Toplis affair. Evidence is that the Bank doesn't welcome debate, or challenge, or scrutiny, and could well try to take it out of your hide. That means even less serious scrutiny of the Bank than we might once have hoped for.

And so one thing piled on top of another, and a single person at the head of a once well-regarded body gets let loose to pursue his (questionably legal) whims, and mess up our well-functioning housing finance market, all while pontificating idly (without thoughtful background research or analysis) on a steadily worsening housing crisis. I'm sure he has good intentions - about saving us all from ourselves - but no mandate, no analysis or evidence, no accountability. Just whim.

Shortly, the one man will be off. And we - citizens, savers, actual and potential borrowers - will be left to live with the consequences. We can only hope that whoever takes up the role of Governor next year, does so with a quiet determination to begin unpicking the mess, allowing the market in finance to work properly - as it had been doing in recent decades - and building an institution known for the excellence of its analysis, operations and policy. Perhaps the new improved Bank may even be able to offer some compelling insights on the regulatory disaster that our housing market - in common with those in many other similar countries - has become.

But I'm not hopeful about any of this. Politicians seem not to care. And powerful officials typically rather like the degree of power they enjoy. Why take the risk, they might well say, of removing controls. Why not just trust us, we know what we are doing.