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Dear Bernard,

Consultation on DTI proposal

This letter is my submission on the Reserve Bank's consultative document on the proposal to add some sort of serviceability restriction to the list of possible direct controls on banks that the Reserve Bank has government endorsement to use.

Overview

I am firmly against adding any sort of serviceability restriction (henceforward "DTI") to the list of possible controls. The Reserve Bank has failed to mount a convincing case, and has not demonstrated that it (or anyone) has the level of knowledge required for such restrictions to operate in a way likely to make New Zealanders as a whole better off. Such restrictions would appear to go well beyond the Reserve Bank's statutory mandate (contributing little or nothing to soundness and eroding the efficiency of the financial system), and a better cost-benefit analysis would in any case suggest that such controls would probably be welfare-detracting. Other instruments (such as capital requirements and associated risk weights) that do not impinge directly on the borrowing and lending options open to individuals and firms remain a superior way to manage any future risks to the soundness of the financial system. Serious microeconomic reform remains the best route to fix the serious housing affordability/land price problems.

As a reminder, the Reserve Bank has no statutory mandate to target house prices or the level (or growth rates) of credit in the New Zealand economy. It also has no "house purchaser or borrower protection" mandate. Restrictions of the sort proposed in the consultative document would represent serious regulatory over-reach.

The fact that a handful of advanced economies have deployed somewhat similar tools is little comfort or basis for support for the Reserve Bank's own proposals. Bad policy elsewhere isn't a good reason to adopt bad policy here. But more specifically, the interests of regulators themselves and of citizens are not necessarily, or naturally, well-aligned, a point that Reserve Bank material rarely if ever addresses. For example, the Reserve Bank makes much of the British and Irish DTI limits (which do not apply to investment properties, where the consultative document says the Reserve Bank would want to focus), but never addresses the institutional incentives facing regulators in those countries following the financial crises each experienced in 2008/09 (the typical regulator incentive in the wake of a crisis to overdo caution - and "to be seen to be doing something", in the regulator's own bureau-protection interests). On the flip side, neither in the current consultative document nor in past Reserve Bank material has the Bank seriously engaged with the experience of housing loan portfolios in floating exchange rate countries during the 2008/09 crisis. In countries like ours - including Australia, Canada, the UK, Norway, Sweden, as well as New Zealand - residential loan book emerged largely unscathed, despite big credit and housing booms in the prior years, and the subsequent nasty recession and, in most of these countries, a sustained period of surprisingly low income growth.

There has also been no evidence presented that banks have been systematically poor at making and managing portfolios of loans secured by residential mortgage, let alone that citizens should have any confidence in the ability of (and incentives on) regulators to do the job better. Anyone can suppress overall credit creation with tough enough controls, but to what end, at what cost, to whom? Controls of the sort now proposed, and the sorts of LVR restrictions already extensively used, seem to represent ill-targeted measures, based on an inadequate model of house and land prices. They temporarily paper over symptoms - house prices driven high by the failures of regulation elsewhere require high levels of credit - rather than address the structural causes of the housing market problems. And because they seem to be premised on a model that wrongly treats credit as a leading factor in the housing market problems, they also do little to address any (limited) financial stability risks. And in the process, they systematically favour some groups in society over others - the sorts of distributional choices that, if made at all, should be made only by elected politicians, not by an unelected official[1].

A reasonable starting proposition would be that in the 25 years prior to the imposition of LVR restrictions the New Zealand housing finance market had been efficient and well-functioning. Lenders lost little money, more borrowers could get better access to credit than in the earlier regulated decades, borrowers had no need to concern themselves with the changing details of Reserve Bank regulatory restrictions, there were no rewards to special interest group lobbying and rent-seeking, and competitive neutrality among different classes of lending institutions prevailed. Perhaps the Reserve Bank would disagree with that characterisation of the market, but if so then, in proposing still further extensions of its regulatory intervention powers, surely the onus should be on you to make your case, not simply to ignore the past, apparently successful, experience?

Specific points

Much of the first half of the consultative paper consists of a discussion of house prices and credit. No one disputes that house (and particularly urban land) prices in New Zealand are very high, but neither this paper nor other Reserve Bank work attempts a systematic analysis of the reasons why.

[1] A concern only heightened by the likelihood that the appointment of an acting Governor, to take office next month (and who the Bank has openly indicated will be dealing with this matter) is illegal (for reasons outlined here https://croakingcassandra.com/2017/04/24/whichever-is-less/)

It also pays little or no attention to the fact that real house prices in much of the country are no higher now than they were in 2007, at the peak of the last boom - a boom, and subsequent recession, successfully traversed by the financial system. Given that experience, how important can lower real interest rates - low for a reason - really be in the story? In fact, it also isn't pointed out that aggregate debt to income ratios are not much higher than they were in 2007 either - and certainly haven't increased at anything like the same rate.

Much of the discussion in the paper might make sense in an environment where unduly easy access to credit - say, access driven by regulatory initiatives - was a material factor in driving up house and land prices. But there is no such evidence that I'm aware of, and certainly none is presented. Mostly, housing credit growth is endogenous - higher house prices typically require a higher stock of credit to facilitate the gradual transition of the housing stock from older generations to younger generations. That makes it primarily a symptom of the other factors that have created the artificial scarcity in houses and urban land - notable land use restrictions (a topic never touched on in the paper, even though both main political parties now accept the perspective of many economists that it is a key part of the story) interacting with persistent population pressures (manifesting through high net immigration numbers). Your papers appear to have made no systematic attempt to disentangle the contribution of various factors driving house prices and to show when, and to what extent, a deterioration in credit standards has played an important role. Without that sort of analysis, a consultative paper like this simply isn't a good basis for robust public policy - it presumes a problem without demonstrating one, and simply doesn't tie its proposed tool to an in-depth analysis of the problem.

Similarly, the consultative document suggests a degree of Reserve Bank responsibility that Parliament has simply not assigned. There is no statutory mandate for the Reserve Bank to be targeting house prices. There is no statutory mandate for targeting credit or credit growth - for reasons, among other things, that we have little robust basis for knowing what levels or rates of growth are appropriate. The Bank's prudential powers are required to be exercised to promote the soundness and efficiency of the financial system. By contrast, monetary policy remains the tool assigned to - and best suited to - macroeconomic cyclical stabilisation. Thus, the claim that a DTI tool might useful in dampening some future recession actually isn't much of a gain at all, since monetary policy is able to react, and with it the exchange rate, to counter sustained demand shortfalls (and neither monetary policy nor prudential controls can do much about protracted slowdowns that reflect a structural decline in productivity growth).

The consultative document also repeats very unsubstantiated claims about the beneficial effects of the successive waves of LVR controls. As I have pointed out on previous occasions, while there is little doubt that the LVR controls have directly constrained the volume of high LVR residential lending, that in itself tells us nothing about any potential gains to financial stability. Without a careful analysis of how banks' capital has adjusted to the reduced volume of high LVR housing lending, or of what the banks have chosen to lend to instead of high LVR lending we simply don't know. Neither, it appears, does the Reserve Bank. The way risk-weighted capital requirements work, it is quite possible that banks are now holding a housing portfolio that, in itself, is a little less risky, and yet are holding quite a bit less capital against those risks. If so, LVR controls could have accentuated soundness risks, not eased them.

In his submission Ian Harrison of Tailrisk Economics has highlighted a number of concerns around the approach the Bank appears to be taking in thinking about essential expenditures in the context of a possible DTI restriction. I would echo those concerns.

Among your questions, you ask “do you agree that the current level of debt (relative to income) that some borrowers are able to borrow risk putting them under pressure, especially if interest rates rise. My responses would be (a) yes, (b) no, and (c) so what. “Yes” in the sense that of course any borrowing exposes the borrower to some risk if circumstances change unexpectedly, and all else equal the more the debt the greater the risk. But “no” in the sense that by far the greatest risk for continuing debt servicing on a residential mortgage loan is unemployment, rather than changes in interest rates, and yet there is no analysis of the unemployment experience presented in the paper at all. Your own past stress tests have, however, used unemployment shocks so severe that (as I have previously shown) they’ve never been exceeded in a modern floating exchange rate economy, and yet the soundness of the banks concerned was not impaired. The Reserve Bank is generally putting far too much weight on interest rate shocks as a risk to housing portfolios - because, it seems, that you are treating such shocks as exogenous events (which they hardly ever are in a country with its own currency) rather than as an endogenous response to the state of the economy. The sorts of large interest rate increases you worry about seem likely only in a climate of much stronger economic growth and associated pressures on price and wage inflation. Foreign funding shocks, for example, typically justify a cut in the OCR, not a translation into higher domestic borrowing costs. In addition, of course, they seem to pay little head to what sorts of interest rate buffers banks already use in setting their own lending standards.

Which brings me to the “so what” leg of the answer? Your question is posed in a micro way, and yet your statutory mandate is a macro (i.e. financial system as a whole) one. You do not have a borrower protection mandate, and should be focused on the risks to the overall health of banks, not on questions around whether individual borrowers might come under stress. Of course they might, but those who (say) found the servicing burden of higher interest rates impossible would also be likely to find it relatively easy to sell on their house to some other, less stressed, buyer. Economywide high unemployment for sustained periods - at the same time as sharp falls in house prices - remains the big risk on a housing portfolio, and you have tools as your disposal (monetary policy) to manage those unemployment risks. Individual borrower risks should be largely a matter for individual borrowers, and potential lenders.

The rent-seeking problem with direct controls (that I alluded to earlier) is again apparent in this consultative document. You will be aware that the initial LVR controls encompassed all residential housing lending. Subsequent intensive lobbying, from the building industry and associated government departments, saw the Bank carve-out lending for the construction of new dwellings. You propose that such lending would be exempt from a DTI restriction as well. But again, you appear not to engage with the evidence, and the pretty compelling logic, that in many cases lending for new dwellings will be materially more risky than that on existing dwellings. You have certainly never presented any evidence to the contrary, but rather appear to have got caught up in the politics of not wanting to appear to stand in the way of new housing supply. That is understandable in one sense, but the fact remains that many of nastiest housing finance crises abroad involved a considerable overhang of newly built properties, in new (often remote) neighbourhoods. You note that “feedback from the construction and banking industry on the exemptions for new construction provided under the LVR policy has generally been favourable”, but (a) that is hardly surprising, and (b) is not necessarily very encouraging. I find it somewhat disconcerting that you cite this favourably.

You have attempted to undertake a cost-benefit analysis of the proposed tool. I recognise that it is difficult to do so, in the absence of specific detailed design and in the absence of a specific set of circumstances in which you would envisage imposing such a restriction. Nonetheless, I appreciate the effort that has gone into the estimates, if for no other reason that writing the assumptions enablers commenters to better engage with, and critique the arguments you are making.

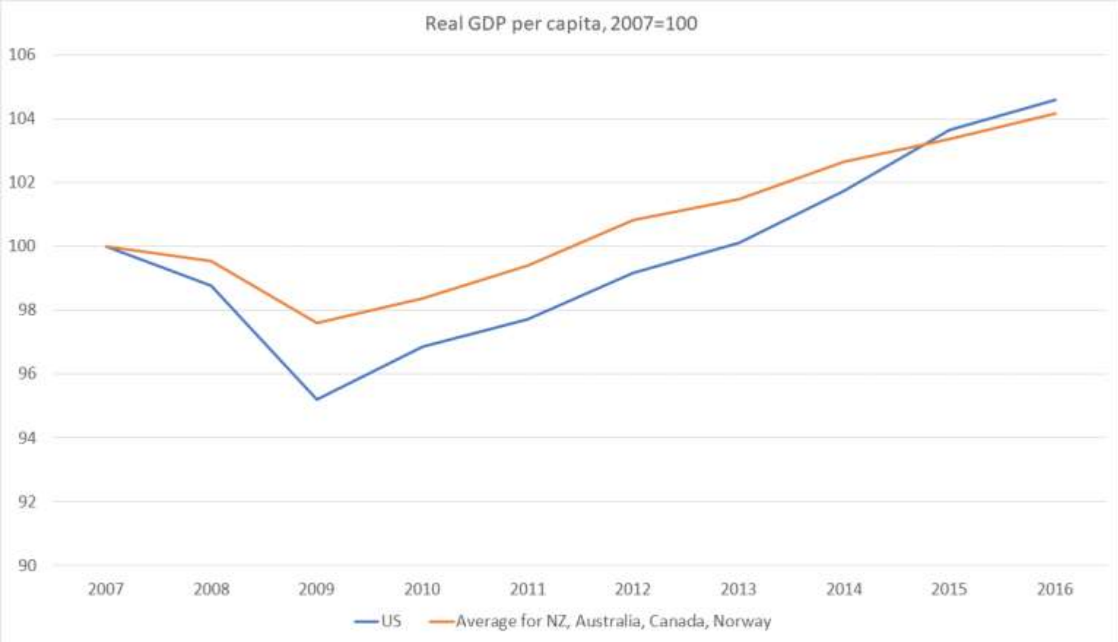
As I have noted elsewhere

> *In their cost-benefit analysis, the Reserve Bank assumes that a DTI type instrument can reduce – by a third – the risk of a financial crisis. And they assume that (a) financial crises are really expensive (lost GDP) and (b) that in addition to reducing the probability of a financial crises, a DTI instrument can reduce – by a quarter – the severity (again, lost GDP) of such a crisis. If all three assumptions aren't correct – if, say, a DTI instrument could reduce the probability but not the cost, or vice versa, or if a plausible crisis wasn't as costly as the Bank assumed – the expected net benefits shown in the paper would simply evaporate.*

In your consultative document, you never seem to engage directly with the assumption that a DTI instrument could reduce probability of a financial crisis - the only sort (as distinct from a pure “housing crisis”) you are mandated to worry about - by as much as a third. Frankly, it seems an ambitious assumption, with little or nothing to back it up. It isn't even clear what the relevant benchmark is. After all, as you note the stress tests suggest a pretty robust system with current lending standards and capital levels. Given how little you know about what difference a DTI limit might make, isn't it plausible that higher capital requirements could produce the same gains with (a) more certainty (since you know you'll have a larger buffer) and (b) fewer costs? In passing, I would add that interesting as the Schularick et al papers are, they are inevitably somewhat reduced form in their approach. Partly for that reason, they can't really offer much insight on the possible impact of policies in this area. Policy responses don't occur in a vacuum, and with the best will in the world polices are rarely imposed at exactly the right time.

On the question of the severity of financial crises, please treat my post here (https://croakingcassandra.com/2017/07/06/reserve-bank-dtis-and-the-cost-of-crises/) as a part of this submission. In that post, I pointed to one way of looking at the lost GDP cost of the US housing finance crisis of 2008/09.

> *This chart uses IMF WEO annual data. It shows real GDP per capita for the US normalised to 100 in 2007, the last year before the recession (and before the financial crisis itself intensified). And it shows the average for the four rising house price non-financial crisis countries on the same basis.*



> *Sure enough, the US recession was deeper than that in the average of these other four floating exchange rate countries which – despite the debt and run-up in house prices – avoided both housing busts and financial crises. But the cumulative gap between the two lines (ie adding up the differences across the nine years) is just under 10 per cent, which isn't even quite half of the "conservative" assumption the Reserve Bank is using.*

Was it a fair test?

> *If anything, I think the simple difference between the two lines errs towards overstating the costs of the US financial crisis. After all, the US ran into the effective lower bound on nominal interest rates. Standard Taylor-rule prescriptions would have had the Fed cut interest rates a lot more than the 500 basis points they did cut by (a nice chart I have in front of me from the Boston Fed illustrates that in the previous six easing cycles the Fed had cut by an average of more like 800 basis points). And the US went into the crisis with much less fiscal leeway than our fairly unindebted comparative sample.*

In addition, as you note in the consultative document, no one is suggesting that credit standards in New Zealand are remotely as low as they became in pre-crisis USA.

You may be inclined to respond to this analysis by pointing out that even the countries that didn't have housing or financial crises were affected by the economic recession in, for example, the United States. That is no doubt true, but the loss of demand from a sharp economic slowdown in a major trading partner is something that might a country for a year or so, but beyond that a country like New Zealand (or the others in the chart) could use domestic monetary policy, and the ability of the exchange rate to respond, to close the resulting output gap. There is no compelling to suppose that potential output in New Zealand was adversely affected by the US financial crisis.

Unfortunately (in this narrow respect), the sample of floating exchange rate advanced economies that have experienced domestic financial crises is very small. On the one hand, that is useful data in its own right - the probabilities of such events must be small, although of course the floating exchange rate period itself is only perhaps 40 years old. On the other hand, it means we have to be very cautious about drawing strong conclusions from what may be quite idiosyncratic experiences. Even in the United States, for example, it is well known that a chart of logged real GDP per capita suggests that the many earlier financial crises the US experience had little sustained impact on the performance of the real economy.

In passing, I would note that one cost that appears not to be mentioned is that in future housing booms, if these direct intervention tools are known to be in the arsenal, it is likely to affect incentives of potential borrowers in ways that aren't particularly helpful. Unsure what might trigger gubernatorial actions, and when, and concerned at being excluded by inevitably somewhat arbitrary direct controls, it would encourage people to seek to get in early - earlier perhaps than they might otherwise have bought.

My overall assessment of the cost-benefit analysis is that, at best, it is an example of "case not made".   At best, on your own other assumptions, the proposed policy tool looks likely to offer no net benefits. More probably, the net effect would be welfare-detracting.

Official Information Act request

Finally, I request copies of all submissions received by the Bank by the closing date for submissions.

Yours faithfully

Michael Reddell