Tightening Loan-to-Value Ratio Restrictions

Submission to Reserve Bank of New Zealand

Michael Reddell

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1. This submission will be brief. It is quite clear from the consultation document that this is a Potemkin-village type of consultation, designed solely to give the appearance of consultation to jump through the bare minimum of legal hoops. This is evident in (a) the two-week period for submissions, (b) the less than two weeks the Bank says it will take before releasing its final decision, (c) the already-announced implementation date, (d) the Bank's stated expectation that banks will just apply the restrictions now anyway, and (e) the absence of any serious or rigorous cost-benefit analysis. However, there as there are significant flaws and omissions in your document - which appears to be more about spin than substance - and it is as well to put at least some of them on record.

2. Among the many problems with the document is the open acknowledgement that the current situation itself is not a financial system stability problem, and that the banking system now would be robust to even a substantial fall in house prices. Your worry, we are told, is some sustained continuation of recent lending patterns. But if so, why the urgency and absence of robust supporting analysis? Why the need for an "immediate response" (you claim LVR restrictions are "the most suitable tool for an immediate response")? The additional time it might have taken to produce a credible and transparent case for additional controls simply cannot, on your own reasoning, jeopardise the stability of the financial system. The internal evidence suggests that the Bank (the Governor, still the sole decisionmaker) simply wants more LVR controls for their own sake, or for purposes that are outside those Parliament has provided these powers for.

3. More substantively, there is no discussion at all in the consultation document of the Reserve Bank's capital requirements or the capital positions of the banks you are putting more controls on. As you will be well aware, the risk-adjusted capital ratios of New Zealand banks are high by international standards, and will be increased further – as a regulatory requirement - over the next few years. Capital is, and always should be, the key buffer against loans going bad, and we know that the New Zealand framework imposes relatively (by international standards) high capital requirements in respect of housing loans, including high LVR ones. It is simply unserious - or a desire to operate *ultra vires* – not to engage with the capital position of the banking system. That is especially so as your consultation document acknowledges that tighter LVR controls will impair the efficiency of the financial system. Given that acknowledged cost, there has to be a clear gain to financial system soundness (the other limb of your statutory goals/purposes) from any new regulatory impost, but your document makes no effort to quantify such a gain (reduced probability of failure), or to demonstrate that tighter LVR controls are the least-cost way to generate such a reduction. There is not, I think, even any attempt to engage with the "1 in 200 years" failure framework that the Bank dreamed up a few years ago to support the capital proposals it was then consulting on.

4. Your document makes much - far too much - of the potential implications of a reversal of the sharp rise in house prices over the past year or so. It does so in a tendentious and ungrounded way (including supported by a discussion of the housing market itself that seems to give no weight to the way land-use restrictions underpin the prices of house and land, no matter how many new houses come on the market in the next couple of years).

5. Thus, in paragraph 31 you claim that "a 20 per cent house price decline from the current level would still mean more than $4 billion of lending would be to borrowers in negative equity, and the majority of those impacted would be first-home buyers who borrowed in the last year". But what of it? First, $4 billion of loans is less than 2 per cent of the mortgage book of the banking system. Second, the actual negative equity in such a scenario is far far less than $4 billion (and some small proportion of banking system capital) - since little or no lending at anything like 100 per cent LVRs has taken place. And third, and perhaps most important, there is no sign that the Bank has made any attempt to look at risk across the whole mortgage book (let alone the entire loan book). It is no doubt true that a pullback in house prices from current levels would create some stress for some individual borrowers. On the other hand, for good or ill (and from a narrow financial stability perspective - only - it must be good) the rise in house prices over the last year has created a much bigger equity buffer for most existing borrowers. The document never betrays any sense that it is typically prudent for first-home buyers to borrow 80 or even 90 per cent of the value of a first home, or that direct controls on access to finance are one of the ways governments skew the market further towards the already-wealthy (noting, as the consultation document does, that LVR restrictions make little sustained difference to house prices, and so really just provide cheaper entry levels for other buyers).

6. The Bank's consultative document also attempts to make quite a bit of an argument that somehow LVR restrictions now can dampen the size of future "boom-and-bust cycles" in the economy, even going so far as to claim these incremental restrictions will improve the medium-term performance of the economy. But none of this argument engages with the (very healthy) capital position of the banking system and at times it seems internally contradictory. Thus, in paragraph 47 the Bank worries about dampening effects on consumption and economic activity from "increased serviceability stress" as a result of some future increase in interest rates, but never seems to recognise that the reason the monetary policy arm of the Bank would be raising interest rates is to dampen demand and inflationary pressures. If anything, the Bank's argument would seem to suggest that more high-LVR lending would, if anything, and in those circumstances **increase** the potency of monetary policy, and reduce the extent of any required OCR increases. More generally, the Bank continues to place a considerable reliance on claims about a significant housing wealth effect on consumption that appear inconsistent with New Zealand macroeconomic data over many decades, and which appear to over-emphasise existing homeowners while largely ignoring the loss of wealth/purchasing power for those who do not (yet) own a house.

7. The Bank notes that the extent of disintermediation as a result of LVR controls has been less, over the eight years the tool has now been used, than many had expected. That is certainly true, but actually suggests that the efficiency costs of the restrictions have been greater than had initially been expected. Fewer readily-visible alternative credit providers have developed or expanded, suggesting either that more potential purchasers have simply been

forced out of the market, or that much less visible credit provision (notably that within families, with no diversification risks) has taken its place. Absence of disintermediation may be attractive to a regulator, but it isn't obvious it is a good thing for the wider economy or society.

8. In conclusion, the Bank has simply not made any sort of compelling case for further tightening of LVR restrictions. At very least, such a case would have to involved a careful and documented cost-benefit analysis, that included engagement with the bank capital regulatory regime. There is no pressing financial stability risk, and so this proposal - in practice, these new rules – has the feel of action taken for the sake of action, perhaps to provide some cover for a government that fails to address the house price issue at source, or to fend off (misguided) critics of the Bank's LSAP monetary policy programme. That isn't a good or acceptable use of the powers of the state.

9. To the extent the initiative is about protecting borrowers from themselves - as your communications sometimes suggests - it may be nobly intended but is no part of the Bank's statutory responsibility (and thus not a legitimate basis for use of regulatory powers). Perhaps as importantly it seems to assume the current crop of central bankers and regulators knows more about the risks of house prices falling substantially and sustainably than (a) borrowers and their bankers (each with money on the lines) and (b) than their central banking predecessors over 30 years did (each Governor having at some point or other anguished about the risks of falls, even as central and local government policy continued to underpin the decades-long scandalous lift in real house prices). No evidence is advanced for either proposition.