Withheld OIA s9(2)(a) [redacted]

August 8, 2016

Attention: Head, Macro Financial Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Email: macroprudential@rbnz.govt.nz

Dear Sir/Madam

I write on my own behalf, and do not represent any organisation, and seek your consideration of my comments on the Reserve Bank's consultation paper of July 2016.

My Interest in this matter

My interest in submitting is because I am a deposit holder in a banking institution in New Zealand and wish to see consideration of the interest of deposit holders in the Reserve Bank's analyses, deliberations, and actions. While the unusually low interests rates currently being imposed by the Reserve Bank are a concern[1], at this time when imprudent borrowing is very evident I am more concerned as to the risk that I am now exposed to in the context of New Zealand having an Open Banking Resolution (OBR) policy. The Reserve Bank states that OBR is a policy that places the cost of a bank failure primarily on the bank's shareholders and creditors (e.g. savings depositors). Consequently, this exposure of saving deposits to OBR means it is imperative that banking regulation should be of a particularly high standard and conservative.

Currently, it is evident by the credit-fueled increase in house prices that banking regulation settings in New Zealand are not currently adequate and consequently creditors (i.e. savings depositors) are unduly exposed to the risks of the current imprudent speculative borrowing in residential property.

General Comments on the July Paper

“Investor Lending” a misnomer

In its consultation paper the Reserve Bank has mischaracterised lending for purchase of rental properties as “*investor lending*” when that is obviously far from the case. Responsible

[1] It is now clear by observation, and by application of a personal financial-planning model, that reducing interest rates below a certain level (of about 5%) necessitates savers to disproportionately increase their savings rates, and consequently does not incentivise increased consumption but rather the reverse.

investment lending would entail debt servicing costs that can be supported by the yield of rental income (after allowing for maintenance, insurance, and rates etc). As outlined below, in the current market, lending above about 35% LVR is not “investor lending”. To allow borrowers to take on debt servicing costs beyond that limit is lending to support speculation for capital gain. Not only is such speculative borrowing putting the banks’ depositors at unacceptable risk of operation of the OBR mechanisms, but more inevitably the depositors with savings are exposed to the risk of very low or negative interest rates that the Reserve Bank will impose on savers to bail out speculators when the next financial crisis arrives.

Bank Disclosures little comfort to savings depositors

Depositors are assumed to be able to assess risk on the basis of the regulated requirements on banks to disclose their financial position.

However the banks do not disclose their biggest risk which is their lending standards and criteria. Also, their accounting rules allow considerable discretion in interpretation by bank accountants. There are clearly powerful incentives for banks to compete by taking greater risks, such competition being on the basis of having the weakest lending requirements. The “playbook” for profiting by risky lending was documented in the 1990s[2] and was again in evidence in the UK, Ireland and the USA in the last global financial crisis.

It is now more evident than ever that it is not sufficient for a savings depositor to assess risk by examining the financial statements of individual banks and their historical loan performance. Before a crisis, individual banks usually look sound and are difficult to separate from their peers, but when when a crisis occurs and depositors become concerned and move their money about, the weakest banks are quickly exposed. It is a mechanism of failure that is unpredictable even by regulators. Stress tests do not consider the rapid movement of money out of an unfortunate bank. In a crisis, seemingly sound banks can fail on a rumour. As Nassim Nicholas Taleb has observed: *“Banking is a very treacherous business because you don't realize it is risky until it is too late. It is like calm waters that deliver huge storms”*. Or as more colourfully stated by Warren Buffett "*Only when the tide goes out do you discover who's been swimming naked.*"

The unpredictable mechanisms and trajectories of banking crises, combined with the OBR policy now in place, means that savers with deposits at banks rely on sound macroprudential regulation. As part of sound macroprudential regulation it is imperative that banks are prevented from competing on the basis of increasing the risk of their lending (e.g. by having to work within strict DTI and LVR limits applied by regulation).

Inadequate LVR and DTI constraints is unjust

It is quite apparent by the Reserve Bank’s figures on lending that some borrowers are securing loans at high DTI levels (>4). The high levels of DTI accepted by a large proportion

[2] For instance “*The Best Way to Rob a Bank Is to Own One: How Corporate Executives and Politicians Looted the S&L Industry*” by William K. Black

of borrowers is disturbing from a creditor risk perspective[3], but it is also unjust. It is clear that young prudent prospective homebuyers are unable to compete in the purchase of homes by those imprudent borrowers who take on far too much much debt. This is unjust to those prudent young people seeking homes.

While they might not recognise it immediately, DTI limits will assist young prudent borrowers to acquire their homes at reasonable prices. Young buyers of similar incomes should only need compete on the levels of savings they have accrued and their credit record, and not be forced to compete on their willingness to be reckless borrowers.

It is clear that "investors" will continue to be treated more favourably than owner-occupiers even after implementation of the proposed LVR limits, despite their higher risk to creditors that has been clearly outlined in the Reserve Bank's paper. In paragraph 35 the Reserve Bank sets out a calculation that the DTI for an "investor" with a property earning a 6% yield, with a loan set at an LVR of 60%, would be 10. However, if the acceptable DTI limit is identified to be less than 7 (twice as high as the DTI limit of 3.5 regulated by the Central Bank of Ireland), then this suggests that where rental yields are only 4.7% or so, the appropriate LVR limit to treat investors on the same basis as owner-occupiers is less than 35%.

A similar conclusion can be drawn from Figure 7 of the Reserve Bank paper. For a loan to an "investor" to have the same risk of default as an owner-occupier at LVR of 80%, the LVR limit of the "investor"would need to be below 35%.

Comments on Questions 1 to 5 of the Consultation Paper

Q1: Comments on the problem definition for this policy.

The Reserve Bank states that house prices have increased since 2010 as a result of immigration, low interest rates, and sluggish housing supply. There is a clear omission here: - the influence of credit-fueled speculation on house prices enabled by weak regulation of lending. The unprecedented increase in house debt does not simply magnify the risks of the housing market, but is actually the major driver of the increase in house prices. There is now ample literature examining the self-reinforcing interactions between house prices and household debt. It should now be well understood that house price booms are associated with increased leverage and can be very destructive.

However, I take some comfort that Mr Spencer of the Reserve Bank has already acknowledged that a key driver of current extremes of the housing market is *easy credit* [4].

I have commented above that the proposed LVR limit for "investors" is too high at 60%. This proposed number of 60% seems to be derived in paragraph 41 on the basis of the following numbers:

[3] The consultation paper notes that around 30 percent of mortgage commitments extended at a ratio exceeding six times income, and 20 percent is above seven times income.
[4] http://www.rbnz.govt.nz/research-and-publications/speeches/2016/speech2016-07-07

- Rental yield of 6%;
- Expenses at 25% of rental income (1.5% of house value)
- Interest and principal repayments of 8 percent of the outstanding balance (assumed to be comprised of 5% for interest +3% capital repayment).

After adjusting for tax at the corporate rate of 28%, and a more typical rental yield of 4.7%, an interest rate of 5%, with expenses constant at 1.5% of house value, then the appropriate LVR limit would seem to be only 35% *[35% = (0.047 -0.015)/(0.05+0.03/(1-0.28))]*. To calculate the limit on a pre-tax basis would seem to be another, hopefully unintended, institutional bias in favour of "investors" over owner-occupiers.

Q2: Comments on the analysis of possible macro-prudential options or the rationale for the proposed LVR restrictions.

I support the proposed measures and the rationale for them, and seek that the Reserve Bank implements effective DTI and LVR limits as soon as practicable.

The IMF reports that "*Borrower-based policies such as limits on loan to value ratios and debt to income restrictions, and financial institutions-based policies, such as limits on leverage and dynamic provisioning, appear to be especially effective*".[5]

I would expect the Reserve Bank should want to adopt such tools as soon as possible.

In addition to DTI, LVR, and reinforcement of capital buffers, it seems open for the Reserve Bank to consider the adjustment of additional mechanism which has already proved effective: - the core funding ratio which is currently set to a minimum of 75%. It is evident that this ratio could be increased to 85% without any impact on well managed banks, and its increase will curtail more aggressive bank lenders while at the same time will likely also take the pressure off the NZD exchange rate.

Q3: Comments on the expected impact of the policy in increasing financial system resilience or dampening house price and credit growth.

The Reserve Bank notes that house price-to-income ratio is now the furthest from historical average than in almost any other OECD country. Had the tools of DTI and LVR limits been in place at the outset of the latest episode of credit-fueled house price speculation they would have prevented the many dangers now having to be addressed by the Reserve Bank. This suggests those limits should be mechanisms that are in place permanently, and should not be seen as temporary measures. Of course the parameters of such mechanism can be set as appropriate at the time, but those parameters should be able to be changed quickly as market circumstances change. The recent delays in instituting essential mechanisms is a concern, the mechanism should already have been in place.

[5] https://www.imf.org/external/pubs/ft/wp/2015/wp1561.pdf

The proposal for the lower LVR limits for "investors" is the very minimum the Reserve Bank should do. In addition the Reserve Bank needs to quickly impose meaningful DTI limits and require significant additional capital buffers as soon as it is able to do so. Given the current extremes of the housing market, the Reserve Bank would be negligent in its protection of savers if there were further delay in introducing all these macroprudential measures at meaningful settings.

Q4: Comments on possible unintended consequences from the policy.

Over-estimation of costs to "investors" versus benefits to other stakeholders

The discussion on the costs and benefits of the proposed LVR policy (e.g. Table 2) has no mention of the protection of bank creditors (particularly savers holding bank deposits). This omission would seem to indicate a lack of concern about the welfare of savers with deposits in banks. The bank creditors are vulnerable to OBR mechanisms and the Reserve Bank, having put OBR in place, has a duty to ensure that the chance of it being required is extremely low. With the evident imprudent lending currently being provided to "investors" the bank creditors are currently unduly exposed to this mechanism.

In the context of this omission it is disturbing that the Reserve Bank seemingly gives weight in its table summary to some concept of "*efficiency costs for investors delaying purchases*". There is no basis or evidence for this being a concern, and it seems to contradict the Reserve Bank's conclusion in paragraph 32 of the paper where the Reserve Bank states very credibly and, in my view, with considerable understatement that: *"From a wider efficiency perspective, the costs on an owner-occupier that cannot purchase for a period due to the LVR policy are likely to be greater than for an investor*."

Additionally, investors who are buying pre-existing housing add nothing to economic efficiency if they do so by excessive borrowing and outbidding prospective owner occupiers.

Moreover, it seems over-leveraged buyers of rental housing are likely to be causing inefficiencies because their scarce cash flow relative to loan servicing seems to prevent them from performing basic maintenance and providing minimal housing requirements such as insulation and dry habitation. The costs to society of inadequate and badly maintained rental housing is quite apparent and is obviously extremely high. The Reserve Bank should take such collateral costs into consideration in the further development of its policies.

Non-Bank Lending

The Reserve Bank assesses that there could be increased risk that non-regulated institutions engage in a material amount of high-LVR lending with implementation of lending constraints. However, while this should have been a concern prior to 2008, this should not now be a major concern to the Reserve Bank at this time given the implementation of the "Non-bank Deposit Takers Act 2013". Anecdotal commentary

suggests that lending quality from major banks is currently worse than that of non-bank lenders. If there is any issue in this area it should be dealt with directly and not by allowing the banks to continue to make high risk loans, particularly to “investors”.
Q5: Yes, the construction exemption is still appropriate.

Final Comments

In the context of OBR applying, LVR limits on lending and DTI limits on borrowing are essential for safeguarding the savings of bank depositors.

In addition, as Mr Spencer has said: “....*a DTI and LVR in combination would constrain credit growth and house price pressures on a more sustainable basis than would LVRs alone*”. I urge the Reserve Bank to apply these essential constraints as soon as practicable.

In addition I suggest:

- The LVR limit mechanism on lending should *not* be a temporary one, it should be a permanent mechanism with only the level of the LVR limit adjusted according to the circumstances of the time;
- The proposed DTI limits on borrowing should be applied as soon as practicable. Again, the DTI limit mechanism should be permanent and only the numerical value of the DTI limit varied according to market circumstances at the time;
- The proposed LVR limit on “investor lending” at 60% is still too high given the rental yield now prevailing across New Zealand cities and the risk of lending to investors. In the current market it should be less than 35%;
- The appropriate sectoral capital buffers should be significantly increased as soon as practicable;
- Consideration should be given to increasing the “core funding ratio” to 85%.

Thank you for the opportunity to make a submission. I trust the Reserve Bank will give due regard to safeguarding the interests of bank depositors in its future decisions and actions.

Yours faithfully

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