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

3rd August 2016

Head, Macro Financial Department
Reserve Bank of New Zealand
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Dear Sir,

**Re: Adjustments to restrictions on high-LVR residential mortgage lending**

This submission relates to the RBNZ consultation paper of July 2016 and is from the writer as an individual.

1. Writer context. I have, among numerous other things, 12 years previous retail/business banking experience at several main trading banks in NZ (1988-2000), 1 year general manager of manufacturing export business (formed JV with US company), 15 years finance broking/consulting experience concurrent with 14 years managing director of private property finance company. I am a first, second and third home buyer, own*/manage seven residential investment properties, two commercial investment properties, dozens of mortgage exposures (via own* finance company). I self-manage my family trust share portfolio (wholesale investor) NZX, ASX, FTSE, DOW etc. and have been a kiwisaver since its inception. I have a keen interest in the NZ economy and to a lesser extent, globally. I am fourth generation New Zealander and always pay substantial tax on time. My education ended at conclusion of sixth form. You could say I am highly experienced to provide a submission from a commercial experience perspective, less so from an economic theory perspective. My submission is out of concern for RBNZ performance for the benefit of New Zealand generally (macro). I serve to gain nothing financially as LVR's do not affect my investment situation, my portfolio is widely diverse. I disclose small holdings in ANZ, Westpac, NAB and numerous European bank stocks. I work alongside two residential mortgage brokers and have a keen understanding of the current mortgage market in New Zealand. My three children will soon be first home buyers.

2. Banks have had self-imposed LVR restrictions for as long as I can remember and the risk weighting towards residential mortgages has always been at the lowest risk end of the spectrum (perhaps rural lending was considered safer for some periods in early New Zealand history – certainly not now). It is reassuring to know 55% of bank exposure is to residential mortgages and increasing property values makes this all the better. RBNZ has imposed direct LVR restrictions of sorts since 2013 (micro-managed) – property values have increased more rapidly since. RBNZ imposed restrictions do not necessarily extrapolate to safer bank balance sheets if you apply RBNZ analysis that "house prices could fall very rapidly" because the very RBNZ policy to restrict LVR's may well have 'pumped' up values.

*in various legal entities including family trust and companies.

3. The major financial jolts in my lifetime (born 1967) are 1970's oil shock/rampant inflation, 1987 share-market severe devaluation and 2008 severe GFC (by far the most extreme). Our banks have performed incredibly well through each event. Residential mortgages have performed very well through each. I understand the Government guarantee was not called on by banks (but certainly helped confidence). RBNZ comments about "bubbles" and "downturns" and "corrections" is emotive journalist speak and not supported by the effect on banks (and New Zealand financial system stability) through the above mentioned major financial events. As a side issue, my experience is that the housing market plateaued from 2009 – late 2012 yet human behaviour dictated a thrift mentality in the face of uncertainty with contraction of 'wasteful' spending and increase in debt reduction. My banking experience suggests many people borrow jointly and direct all of one income towards housing repayments, the other to living costs. This in part explains bank resilience to major financial jolts. It is also the main reason for house prices constantly rising as a high proportion of net income (and probably all rental income) is directed into the housing market via mortgage payments, renovations, holiday homes, short stay letting etc.

4. RBNZ notes household debt at "record levels relative to incomes" (emotive speak). Households managed the 15%pa plus interest rates of the 1970's and 1980's and extreme inflation whilst income inflation lagged and yet the banking system held up. These interest rates and financial times were a greater test than any suggested imminent theoretical downturn or correction. Again, human behaviour (resilience, canniness, thrift) shone through. In my experience, it seems the income statistics RBNZ is using do not reflect reality of the real world net income of many mortgage borrowers. Family group income is the real test and is not to my knowledge a measured statistic. People have all sorts of incomes to support bank finance applications and these spread of income sources are not captured meaningfully in income statistics. If the current statistic is accurate, the financial system would be stressed right now – and it is not. A couple may have taxable salaries, rental income (and other investment income) via a company or trust that nets back to a low taxable income statistic. They may have family borders paying rent. Further, most bankers will talk of the 'mum and dad' bank being the biggest bank in the country. This mum and dad bank provides equity (first home deposit), debt servicing support, encouragement and financial assistance to enter the investment market. The mum and dad bank has, in many cases due to the passing of time, very high equity and high surplus income. For an example, Chinese culture operates thus and look at the spending power of the millions of Chinese. The focus of RBNZ, politicians and journalist should be on increasing incomes, not worrying about property prices.

5. I must comment on the term "correction" that RBNZ and economists (the latter are actually entertainers and marketers) use which implies there is an 'in-correct' situation. Don Brash and Gareth Morgan/Infometrics gave public speeches about this in the late 1990's suggesting baby boomers (another journalist emotive phrase) house values would crash as there was no one who could afford them. Those houses are now three times in value, carry little or no debt (in real terms) and said boomers are still earning surplus incomes – they form a big part of mum and dad bank.

6. The RBNZ LVR restrictions of recent past have not worked if the desire was to prevent a "severe correction" (extrapolate to financial instability) from accelerated property price rises suddenly dropping, as prices have risen faster since implementation of the current LVR restrictions. I expect those with equity and solid incomes have benefited financially, young

new entrants to property ownership have struggled and fringe regions of New Zealand have suffered financially. The banking system has actually built resilience because all the loans written since the GFC up to close of 2015 now have substantially lower LVR's due to far higher underlying security value, low interest rates and income growth. I think RBNZ is on the wrong tangent focusing on micro-managing bank LVR policy, and possible DTI policy. Both are already self-managed by internal bank credit policy.

7. I will comment now about development finance for new residential construction. THIS IS THE MAIN PROBLEM. Banks are very cautious and restrictive about such lending (self-imposed – not influenced at all by RBNZ) and rightly so in many instances as past write-offs confirm. The pre-GFC period was awash with development liquidity from non-bank financiers at the tail end risk spectrum and from main banks at the front lower risk end. RBNZ knows full well the losses suffered. It is this lending that threatens financial stability, not high LVR housing loans, whether owner occupied, investment or holiday home. For eight years New Zealand has had a severely restricted development finance market and that remains to this day with no relief in sight (of any scale). From 2008 to 2010 the market shrank rapidly and development sites devalued in many cases by 66%. Entrepreneurship has been severely dented with many developers un-bankable. This is the main reason New Zealand has under supply, not resource consent issues. The new unitary plan for Auckland will require hundreds of millions of development finance dollars which is still severely rationed. This means well healed long established developers will be the main players and their risk return on capital requirement will see prices rise further.

8. The other MAIN PROBLEM (but a very good one) is DESIRABILITY. The RBNZ 'Problem Definition' graph (consultation paper page 3) clearly shows Norway, Australia, Sweden, UK, Canada and New Zealand way out of kilter with other countries in house price (value)-to-income ratios. The obvious reason is desirability of these nations compared to others. The less obvious, as mentioned earlier, is that income statistics must also be out of kilter with other nation's data gathering. Income aside, desirability is New Zealand's biggest asset, always has been, but now is accelerating due to terror abroad, Brexit, D Trump (and all that means), commodities being so de-valued (job losses abroad), internet/cell phone instant spread of information globally and cheap air flight relatively. By global standards, the New Zealand lifestyle price (property value)-to-desirability measure remains in catch up to other well developed safe nations. Recent statistics for New Zealand immigration/kiwis returning home (there are 100,000's abroad), global bad news events and (my gut feel) is that property prices in New Zealand, especially the desirable cities/towns, are on a growth path to keep rising in double digits for many years ahead. This will bolster bank financial stability in ways not seen before. However, this could reverse quickly if New Zealand suffered a terror attack or disease outbreak. I expect there to be a reasonable lag time for foreigners to position themselves to a cashed up position to emigrate meaning the Brexit and D Trump (whether he wins or not, there is a groundswell in USA causing unrest) effect on New Zealand population growth is yet to be felt but could easily see net growth exceed 100,000 per annum (unless Government amends rules).

9. The RBNZ paper point 7. refers to interest rates "returning to more normal levels". The term 'more normal' is rather arbitrary. I understand banks use debt servicing test rates of 7%pa (or thereabouts) already, a self-imposed 'normal'. However, it may well be that 'normal' is now

5-6%pa (retail mortgage interest rate) for many years to come – take Japan stagnant economy as an example.

10. The RBNZ paper point 8. refers to bank losses in USA and Ireland post GFC. It seems RBNZ is comparing New Zealand with nations that had mortgage originators (brokers) running amuck and peddling white paper mortgages to every man and his dog (literally as I understand it). These billions were then dressed up as CDO's and sold into highly liquid main banks (and highly credit rated – RBNZ should be very weary of and place little value in rating agencies). New Zealand was largely immune from this. The MAIN LESSON, RBNZ keep an eye on New Zealand banks chasing fake mortgage deals to gain volume and out compete each other.

11. There are examples of high LVR lenders (some had 100% LVR products) in New Zealand now and recent past and I agree with RBNZ that these are small relative to overall debt market. They are worthy of analysis by RBNZ in how they assess credit risk to minimise possible losses as these companies are privately owned with shareholders who have a keen sense of personal wealth preservation. I contend that such analysis will show that high LVR loans, correctly credit assessed, show very low default – even through the GFC period.

12. RBNZ seems concerned about house price inflation and debt to income ratios and the possible negative effect on bank financial stability. I note some politicians (Green) are referring to 'income-to-value' instead of 'income-to-debt' which confuses the debate. Firstly, commodity devaluation in recent years and the flow on to agriculture lending both have a higher likelihood of destabilisation. Banks are hunkering down instead and farmers showing resilience, thrift, cunning etc. to retain their equity. It is these attributes in human phycology that also apply to the vast majority of residential mortgage borrowers and serve to ensure the bank system remains stable.

13. The RBNZ paper does not outline the total of bank debt assets held and percentage that are owner occupied/holiday homes, residential investment, and residential supporting business, and compare those statistics to dollar value in various categories being written. It seems that bank debt assets (residential mortgage categories) on balance sheet up to late 2014 are now low to very low LVR. It seems then that a small proportion are higher LVR. To have a destabilising effect, not only do property values have to drop substantially, banks would have to be performing 1,000's or mortgagee sales as well, and GFC experience suggests both scenarios unlikely.

14. A sector that is buoyant in New Zealand mortgage market is property investment sales companies that package up investment property purchased by amateur new entrant investors leveraging against high equity in existing property, and solid incomes. These companies mostly sell investors new houses to be built (exempt from RBNZ LVR rules) and provide mortgage broking and property management. The deals are usually inflated slightly on day one, supported by a valuation industry with +/- >10% variance. However, over time, these prove to be sound compulsory savings investments and quality bank clients. I am told that ANZ has immediately adopted a policy of 60% LVR to all residential investor lending, whether existing or new build. This surely is a disaster as it will cut back 'take out' finance for the new built homes developers seek to finance (with pre-sales that will shrink in volume).

15. Geographic spread of bank mortgages is a significant means to de-risking and therefore aiding stabilisation of the New Zealand financial system. Spread does have downside as some regions are poor lending propositions (remote Bay Of Plenty and West Coast as examples). However, the high proportion of Australian ownership of New Zealand bank equity and management control means New Zealand banks, from a financial stability perspective, are really trans-Tasman banks with vast spread of risk. RBNZ really needs to measure New Zealand housing mortgages in context of Australian housing mortgages which brings Auckland well into line on a risk mitigation basis.

16. RBNZ paper points 23 and 24 refer to borrower defaults and distressed sales along with bank resilience. Right now, if tested truly, a very high percentage of farm loans would be in technical default and if banks acted as their legal documents allow, the banks themselves would realise substantial loses and buyers at mortgagee sales would be limited to cashed-up buyers or those with very high equity. At this stage, banks are hunkering down in an effort to ride out low commodity prices rather than create a self-fulfilling situation. From the housing mortgage perspective as mentioned, this market has been sorely tested several times in the past and banks had no choice but to ride into self-fulfilling behaviours and yet, borrowers scrimped and saved and manoeuvred resourcefully to minimise the impact to themselves and thus demonstrate how stable the banking system is due to the high weighting of housing loans. NZ loan documents contain personal liability clauses meaning we do not walk away from debt like borrowers in USA or UK.

17. RBNZ paper point 25 again refers to loans written leading up to GFC and effects post GFC. These are of no use in comparing to the current financial position of New Zealand banks. Numerous USA housing loans up to and post GFC were absolute junk (and yet highly credit rated!). Again I say, RBNZ would be best looking at signs of banks investing in comparable junk – and high LVR housing loans approved under known current bank policies across New Zealand are not junk by any measure.

18. As a side note, RBNZ would do well to consider an alternative destabilising threat; that is past governors/chairs making public statements about house prices dropping 40% etc. and the aspersion that casts on current RBNZ personnel. I strongly suggest RBNZ distance itself very publicly from such past staff statements and ensure a media gag in employment contracts.

19. RBNZ paper point 28 refers to the possibility of RBNZ micro-managing bank debt servicing assessment by way of DTI's in future restrictions. My broker colleagues can confirm to RBNZ (and take you through the bank credit assessment training imposed by banks on accredited brokers) that banks already have self-imposed debt servicing restrictions that achieve the same outcome as a DTI unless the RBNZ is suggesting a DTI <4, which incidentally would see a contraction in bank balance sheets.

20. RBNZ point 29 refers to RBNZ continuing to investigate DTI limits and gather a lot more data around bank debt servicing analysis and it's relation to loan levels. That RBNZ does not already possess full thorough accurate data and working day knowledge of this critical area of bank lending (and bank stability) is surprising. It seems RBNZ would do well to rotate recent/current bank staff on to RBNZ staff or at least under contract to know exactly how bank lending is actually being assessed.

21. RBNZ paper point 30 refers to bank capital adequacy which was tweaked as I understand, post GFC and affected bank share prices, ROI etc. Bank margins have since fattened to compensate and the low interest rate environment makes bigger margins easier to achieve, not to mention a slight move into development finance which is far more lucrative. I am still of the view that banks operate on dangerously thin capital sums and this is an area RBNZ would be better focused on.

22. RBNZ point 31 seems to assume this consultation paper is a forgone conclusion. I will suggest alternatives which will need carefully thought media releases for RBNZ to change tact and maintain credibility. Please refrain from the "speed limit" jargon – sounds journalistic and 'amateur'. If anything, instead of LVR restrictions, place macro prudential 'rule' that of a bank's total loan assets, X% be restricted to residential investment category if you truly believe investment property lending is that much more risky that owner-occupier lending.

23. RBNZ point 33 refers to risks increasing since 2015 i.e. whilst LVR restrictions have been in place! It seems logical and obvious that further restrictions will increase risk further (if risk equals price rises – which in turn is assumed to mean imminent severe downturn. This is wayward thinking. You are right that banks self-imposed policy on debt servicing over-rules LVR policy due to lower yields. Banks are using interest cover of two times at actual rates which allows for substantial interest rate rise or substantial rental decreases through market forces or vacancy. RBNZ does not need to re-write bank policy.

24. RBNZ paper is not clear on existing lending and bank ratios as of 1 September 2016 (or right now as banks' are self-imposing their interpretation of RBNZ proposed changes immediately). I have direct post consultation paper release experience. E.g. an existing bank customer with own home, six rental properties all built new, two new builds to sell, other trading company income. Their investment property gearing LVR 72%. Interest cover two times. Home geared LVR25%. Borrower wishes to build four more new homes, keep two as investment, and sell two. Excellent result for producing more new homes. Unfortunately, bank (ANZ) adoption of RBNZ rules to reduce existing portfolio gearing to LVR60% immediately and gear up own home to LVR80%. Borrower wants to remove own home from exposure and will pull out of building the four new homes. RBNZ must at least leave existing bank portfolio un-meddled with – do not force borrowers to cease activity or supply will shrink and prices increase even faster. Bank measures must only collect data from loans written post 1st September 2016, especially bearing in mind that proposed restrictions are intended to be temporary. I contend that you will find that by 2018, based on same analysis as subject paper, RBNZ will need to go further to 40% LVR and then a new level of house values in NZ will have been artificially (but likely sustainably) created.

25. The above borrower example is an oft repeated story along with many borrowers with own home and one or two rentals. Borrowers structure their debt to repay their own home loan first (as interest not tax deductible) and prefer to have theoretical high gearing on rentals. Many are advised to move their own home to a debt free position in family trust (my house my castle etc.). These borrowers are the new development finance providers as they 'take out' the stock building companies and developers construct. Knee-capping the investor/buyer/quasi development funder to restrict borrowing as suggested will flow on to far less new builds. RBNZ has a problem defining what is new and what is no longer new. In my fresh example above, I would have though the bank should be adopting the 'new build'

exemption but they state the existing six houses are no longer new (true) and the two new builds to be built in borrower's construction company and then sold to investment company so will no longer be new. This is the lender behaviour RBNZ starts to create when micro managing bank policy.

26. RBNZ paper point 47 is possibly the key to plugging the development finance gap. There are a few dozen true high priced mezzanine financiers in NZ and all privately funded with some level of bank line against existing property stock. Then there is a band of non-bank lower priced mortgage lenders (Liberty, Resimac, Avanti, and Mortgage Trusts to name most) with a range of products. Seasoned property investors will, generally speaking, not touch these lenders due to price. Entrepreneurs', impaired credit borrowers, traders or those with keen sense of leverage will use these funders. I agree with RBNZ that in dollar terms, sums are low and of little consequence to financial stability overall.

27. RBNZ paper point 53 refers to table 2 and also is worded as if a "severe housing downturn" etc. <u>is going to happen</u>. The last immigration/net population growth increase (comparable to now) was in the 1950's through 60's. The only bank melt down I recall is BNZ in late 1980's for reasons completely separate to the housing market. United Building Society had issues but was acquired and finances stabilised. RBNZ needs to calm its language around house prices and face the real prospect of being completely wrong (as Brash and Morgan and others) as you may well yet observe New Zealand house prices pour on pace with value increase as world wealth shifts with increasing pace and flightiness. Restraining banks from participating actively in the buoyant years ahead with healthy self-imposed policies will likely have a counter effect.

<u>**Alternative RBNZ Macro Influence** (further consultation with banks needed to refine)</u>

1. Remove all micro-management LVR restrictions and revert to macro-prudential oversight. Add a bank policy monitoring division to RBNZ whereby bank credit assessment policies are to be overseen by RBNZ. Monitor bank lending approvals on a hindsight basis and impose fines where unjustified continual deviation from policy occurs.

2. Monitor bank lending categories and geographic spread and have a range of percentage spread per category, rather than a blunt/strict LVR limit as suggested in the RBNZ consultation paper. Link deviation from the optimum set percentages to each bank borrowing rate from RBNZ – i.e. the best way to influence bank credit behaviour is with financial sting.

3. Monitor bank retail lending that is approved on a formulaic basis, currently iPad based credit assessment metrics that are a recipe for abuse/manipulation and lending without bank staff thinking. RBNZ to overview the formulae and monitor any overriding by staff. Also to spot audit credit quality to look for systemic breaches.

4. Adjust bank capital ratio requirements relative to residential lending to investors as an indirect means to curtail the level of lending to that sector.