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18 Bay Lair Grove
Island Bay
Wellington 6023

Bernard Hodgetts
Head, Macro Financial Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140
NEW ZEALAND

By email macroprudential@rbnz.govt.nz

Dear Bernard,

Consultation on the further extension of LVR restrictions

This letter is my submission on the Reserve Bank's consultative document on the publication of submissions.

I oppose the proposed extension of the LVR limits, as outlined in the consultation document. The proposal represent a step which would further undermine the efficiency of the financial system and (although it is not a direct statutory concern of the Reserve Bank) of the economy as a whole. And the proposed extensions of the restrictions rest on no more robust foundations than the previous two iterations of this policy (in the space of less than three years). Not only were the initial measures explicitly sold as "temporary", but by 2014 your own Deputy Governor was talking in terms of the possibility of lifting the restrictions. Instead, they have been progressively extended, based on no robust evidence and no convincing analytical model (if there were such a model, we wouldn't have seen the Bank lurch from one set of controls to the next in the way it has). The lack of any sort of serious cost-benefit analysis - a key element of robust policy design and assessment - and the complete absence of any numerical estimates, only accentuates the concerns about the Bank's latest proposal. We all know the limitations of cost-benefit analyses, and how officials can game the system, but at least when officials are required to put down and publish numerical estimates they provide something concrete against which others can evaluate the regulatory proposal concern. The Reserve Bank has, again, offered nothing.

I am also concerned that the very short consultation period suggests that the consultative process itself is little more than a sham. Your proposal is one under which the Governor - a single unelected official - would be exercising significant discretionary regulatory power, affecting (directly or indirectly) the financing plans of potentially tens of thousands of people. And yet only three weeks were allowed for submissions to be made, and the Bank has indicated that it envisages the new restrictions coming into effect only three weeks after that. That doesn't seem to leave much time for staff to collate, review and analyse the submissions, for discussion and internal debate to take place in light of the submissions, and for the Governor to take a final considered deliberative decision. The gap from final decision to when the new rule comes into legal effect seems likely to be very short indeed. That also doesn't seem like what we should expect to see in a robust policymaking process. These are private shareholders' businesses you are directly interfering with.

The three week consultative period - in contrast, say, to the nearly three months allowed for the recent consultation on publication of submissions - is also sadly at odds with the direction of reform indicated at the time the Bank announced the results of the regulatory stocktake last year. Perhaps there was some real substantive urgency on this occasion - as distinct from the simple impatience of a powerful policymaker - but the consultative document makes no attempt to explain quite what is so urgent. After all, this is the third attempt to get LVRs right.

Equally regrettable, and suggestive of the Governor having substantially prejudged the matter, was the statement that "we expect banks to observe the spirit of the new restrictions in the lead-up to the new policy taking effect". That might, perhaps, be a reasonable stance when the final decision has been made, to cover the brief period before the change takes legal effect. But this is a consultative document. If consultation means anything at all, it must mean that the Governor is open to reaching a different, or modified, decision in the light of the submissions. If so, why should banks be expected to adhere now to what (a) is not the law now, and (b) in the light of submissions, may never be the law? We are supposed to live under a system of government characterised by the rule of law, not the rule (or whims) of men (individual officials). How, one wonders, is the public to be assured that the Governor will be taking seriously the consultative process, and having serious regard to the material outlined, and the views expressed, in the submissions?

The Reserve Bank's various consultative documents on successive iterations of these controls display little consciousness of the way successful market economies work. For example, a stable and predictable regulatory framework lets private firms and individuals get on with planning their businesses, and their financing patterns. When the regulatory regime is as unstable as that around bank housing LVRs has become over the last three years, no one quite knows what environment they will be operating in, or how long this latest set of rules will last. It is a climate that encourages lobbying, rewards those with an ear to the ground around the Bank, rewards "connections" - none of that is a desirable feature of a functioning market economy. On the other hand, institutions that simply get on and build a prudently managed business, making their own assessments of opportunities and risks, looking for new opportunities that competitors may not yet have spotted, are penalised. And, as with most regulation, the growing complexity of the systems, and repeated revisiting and extensions, reward large existing players at the expense of newer smaller entities. Given the biases in our economic and political system towards large banks anyway - encapsulated in the "too big to fail" description, this new bias seems particularly regrettable.

The Bank's ever-more-extensive proposals also risk undermining the whole process of competitive innovation and discovery. For the previous 30 years of our liberalised financial system banks and other lenders were all free to lend pretty much to whomever they chose, based on their assessments of risk. They were free to manageand structure loan books as they each preferred and to discover, by experience, what worked and what did not, including which risks were best managed together and which were not. The Reserve Bank certainly had some reporting requirements in place, and the capital rules will no doubt also have influenced some bank choices in these areas. But those appear to be quite small constraints when compared with the requirements to classify loans pretty much as the Reserve Bank demands, and to restrict directly the ability of banks to individually make judgements about risk - both at a higher level (too much or too little housing exposure) but also at a much more fine-grained level that takes account of the individual circumstances of the potential borrower.

The Reserve Bank repeatedly forces the banks to spend considerable amounts - laughably described as "investments" in the consultation document, although I'm pretty confident the return on these "investments" is non-existent - on systems modifications. After a while, it simply becomes easier and cheaper to go along with what the Reserve Bank insists on, rather than doing things their own way. From a bureaucrat's perspective that standardisation is no doubt very attractive, but it isn't how successful market economies function - individual firms need the scope to innovate, to take risks in some are and not others, and to discover what works (what is a good risk) and what is not. None of us has the information in advance to know with certainty how credit should be allocated - it is revealed through the processes of competitive innovation. But there is no hint of this sort of process in any of the Bank's - very macro influenced - documents. And, of course, as we all know, any regulatory boundaries of these sorts invite gaming, such that the information reported is no longer as useful as it was before blanket prohibitions were put in place.

All these sorts of considerations helped shape the advice to governments from the Reserve Bank and the Treasury 30+ years ago, that led to the substantial deregulation of the New Zealand financial system, and a move away from a reliance on direct controls - whether in monetary policy or banking supervision - towards more indirect market-based tools. Neither in the current consultation document, nor in any of its predecessors, nor in other speeches or background material, has the Bank given any substantive basis for its apparent view that direct controls are now more appropriate and useful, that wise officials are better able to apply them well on a sustainable basis, than they were in the earlier decades. Without that sort of analysis it is difficult to have any confidence in what the Reserve Bank has been doing, or in the further extensions now proposed.

A good example of the problem with blanket controls is highlighted by the current proposed restrictions. The Reserve Bank makes a case that the investor finance restrictions should no longer apply only in Auckland. Given the existence of the tool, perhaps there is an arguable case for that stance. But there is no case made - or conceivably able to be made - for why, in effect, banks should be able to undertake no lending on rental properties in excess of a 60 per cent LVR in cities such as Gisborne, Wanganui, or Invercargill where nominal house prices have fallen over the last decade. In a deregulated system one might have expected private lenders themselves to become a bit more cautious about lending in, say, Auckland (although Reserve Bank documents rarely acknowledge banks' reassessments of their own risk appetites - except when the Reserve Bank disagrees with them). But there is no obvious reason why they should become so risk averse in those more stable provincial markets. No doubt, from preference they would continue to take considered risks in those regions, holding appropriate levels of capital in respect of the contribution of those loans to the overall risk of the portfolio. But by bureaucratic edict, with no supporting analysis or evidence, someone starting out in the rental property market in Wanganui will simply be unable to get a >60 per cent LVR loan from a bank. What public interest - what statutory goal for prudential policy --is served by such restrictions? We simply aren't told. In fact, I'm sure you know it is arbitrary and substantively unjustified too, but direct controls of this sort almost inevitably induce arbitrary and absurd outcomes. (Meanwhile, some of the riskiest possible housing loans - those related to the construction of new dwellings - remain totally exempt from the LVR limits - an exclusion that illustrates the returns to lobbying, rather than a careful assessment of risk across banks' loan books.)

As you will be aware, the Reserve Bank Act puts as much weight on the efficiency of the financial system as on its soundness when the Reserve Bank is exercising its prudential regulatory powers. Reasonable people can differ on whether that is how the law should best be worded, but the current wording is the law. Despite that, your consultative document gives very little attention to the efficiency aspects of the proposal (or those of the earlier waves of LVR controls), and when it does, it seems to misunderstand the notion of efficiency costs. For example, given the presence of LVR limits, borrowers' successful attempts to get around those controls and find, eg, non-bank lenders willing to meet their credit demand reduces efficiency costs, not increases them. The efficiency costs arise from the imposition of controls in the first place, and are larger the more effective those controls are in coming between willing borrowers and willing lenders. Inconvenience to regulators is not an efficiency cost - at least not until that day when central bank regulators are gifted with omniscience and perfect foresight.

Both in the current consultative document, and in other Bank material, much has been made of the alleged benefits from the LVR restrictions in reducing the riskiness of bank balance sheets. The Bank repeatedly cites evidence on the reduced volume of loans in the categories directly affected by the controls. And that is useful, but only goes so far. In particular, it does not look at all at the concentration of risk just beyond the regulated boundary (eg the proportion of owner-occupier loans with LVRS of 79.9 per cent is likely to be much higher than would be the case in a deregulated system, and there is little or no difference in the expected losses on such loans, and those of just over 80 per cent). As importantly, the Bank has not sought to offer insights on what the banks have done with the capital not being absorbed in these (now restricted) high LVR housing loans. How confident can we be, for example, that the risk has not simply shifted from one (currently high profile) form to another, less visible, set of risks?

Perhaps more importantly, none of the Reserve Bank's material ever seems to consider the extent to which banks already hold large amounts of capital in respect of high LVR loans. As the Reserve Bank has previously pointed out, and as bodies such as the IMF have confirmed, minimum risk weights on housing loans in New Zealand are among the very highest anywhere in the advanced world (and those minima are set according to the LVR of the loan). If the risk weights were set appropriately in the first place, then reducing the volume of high LVR lending may do nothing at all to reduce the risk of a threat to the soundness of the financial system. And if some of those risk weights actually erred on the conservative side, and if some of the very high LVR lending, has moved just outside the regulatory boundaries, it is not inconceivable that the LVR restrictions - which will have little sustained impact of house prices, as you yourselves recognise - could actually undermine (at the margin) the soundness of the financial system, and leave individual banks a bit more prone to distress in the event of a very large house prices and unemployment shock. Without some serious discussion of this sort of risk, and some description of how the Bank would envisage mitigating the risk, we cannot have any confidence that what you are proposing even makes sense on your own terms.

It is worth remembering that, by law, the Reserve Bank is required to exercise its power to promote the soundness and efficiency of the financial system. That isn't a suggestion, or simply one model. It is the law. You note (para 8 of your document) that you are "concerned that the risk of sharp fall in house prices poses a growing threat to the stability of the financial system". And yet, a few paragraphs later, you observe that "stress tests conducted by the Reserve Bank [involving very demanding shocks}…suggest that banks would remain solvent under stress scenarios involving a severe downturn in the housing market" (and, of course, those tests show not just that the banks remain solvent, but remain above regulatory minimum capital levels). You claim to worry about threats to financial stability, even though you have done severe stress tests that suggest no material threat to the soundness of the financial system. On that basis alone, further LVR controls are probably *ultra vires* – at very least, the represent regulatory over-reach. But the overall tone of your discussion suggests that what you are actually attempting to do is manage some wider set of macroeconomic outcomes - oblivious apparently to the potential of monetary policy and the exchange rate to offset economic downturns - rather than safeguarding the soundness of the financial system itself. But the soundness and efficiency of the financial system are your only statutory mandates. And since you have no good model for being to identify the probability of such an adverse event, or the impact of any Reserve Bank controls in reducing those risks, it looks a lot like flying blind - pursuing policymaker preferences and biases, rather than proposing policy based on robust research and sound models. That isn't a good basis for direct regulation of banks' lending decisions - actions that directly adversely affect a large number of firms and households.

In considering the empirical evidence that the Bank has advanced in support of this new wave of controls, it became apparent that the Bank seems to have shifted its ground, quietly dropping references to papers and arguments that were advanced in support of controls last year. And that the papers it now chooses to rely on - for support, perhaps, rather than illumination – prove much less than the Bank makes out.

It is striking, for example, that the Bank cites only two formal research papers to attempt to support its case that, all else equal, investor loans are riskier than those to owner-occupiers. Both were produced by a single central bank that had already decided on a policy of differentiating between owner-occupiers and investor loans. One of those papers, written up in the consultation document as reflecting UK experience, is in fact based on the experience of three (failed) Irish banks' UK operations - not perhaps a representative sample of exposures - in a four year window when the British economy was actually recovering. The consultative document cites decisions by the British and Irish authorities to differentiate regulatory restrictions as between investor loans and owner-occupier loans, but in fact in the British official paper the Bank references the UK authorities could cite, and apparently undertook, no independent research to demonstrate theclaimed greater riskiness of investor loans. Two papers from one central bank looking to backfill support for its own prior decisions hardly provides robust support for the sorts of controls the Reserve Bank is wanting to extend further here.

And it remains disconcerting, for example, that the Reserve Bank has made no attempt to systematically assess just how comparable even the limited amount of international data they had was in shedding light on the likely New Zealand experience. For example, under Irish law it is very difficult to evict someone in default on their mortgage. That isn't a feature of our law, but might be expected to influence defaults and recovery rates on owner-occupier loans in Ireland.

It also remains disconcerting that the Reserve Bank has apparently made no attempt to look at loan loss data from New Zealand over the last decade, to help shed light on this issue. It is quite true that New Zealand did not undergo an extremely severe shakeout in the last recession and aftermath. Nonetheless, the recession itself - in GDP per capita terms - was as severe as that in the United States, and the unemployment rose by almost 4 percentage points and has stayed quite high for a prolonged period (longer, for example, than in the UK). Corrections in our housing market after 2008 looked little different to those in the UK - the subject of one of the studies the Bank nonetheless cites. And - importantly for this exercise - in a variety of New Zealand centres nominal house prices fell substantially and stayed down for a prolonged period. Again, it is difficult to put much confidence in the Bank's assertions about the relative riskiness of different classes of home loans when (a) the international evidence is so thin, and generated by those with a specific agenda, and (b) when, despite repeated urging, the Reserve Bank has made no attempt to gather and apply any insights from New Zealand's own experience.

The Bank advances in support of its own regulatory proposals the proposition that the household debt to income ratio has now reached record highs. It was, however, telling that there was no chart to illustrate this point. As we all know, the debt to income ratio rose hugely from the early 1990s through to around 2008, and is barely higher now than it was in 2007/08. As you also know, much of the stock of housing debt is an endogenous response to higher house prices - younger generations gradually purchasing the now higher priced houses from older (less indebted) generations. There is little or no independent information in household debt itself, and perhaps especially not when the ratio to income has gone largely sideways for some years. The Bank adduces little evidence of a deterioration in lending standards to support its unease about household debt - perhaps not surprisingly, given the favourable results of the stress tests, and the waves of LVR restrictions already put in place over the last couple of years.

It also remains concerning how little attention the Reserve Bank gives to distributional issues in its analysis of the proposed restrictions. While distributional effects are not directly a required statutory consideration, it is usual for Regulatory Impact Statements to address such issues directly, and should be a good practice part of all policy development and appraisal. As with previous LVR controls, these restrictions are likely to fall most heavily on the relatively young and the relatively poor - and in a New Zealand context, that will typically mean disproportionately on Maori and Pacific populations. Direct controls prevent banks from pricing risk - instead they are simply prohibited from taking some risks. As you recognise, any impact on house price inflation is likely to be quite short-term in nature - and by squeezing out some marginal buyers what you will, in effect, do is to provide cheaper entry levels to cashed-up buyers, whether New Zealanders or foreign. Perhaps that has attractions to you from a financial stability perspective - but even then only if the capital requirements were not right in the first place - but it seems an inferior outcome relative to, say, a less distortionary policy of simply requiring higher capital to be held against housing exposures and allowing banks to get on with their own business - choosing who to lend to, and on what terms and conditions.

But distributional considerations may be nearer to the heart of this latest set of controls than the document suggests. There has to be at least a suspicion that what is actually going on is some covert "fiscal policy". Under the proposed new controls, banks will be able to lend up to 10 per cent of new lending to owner-occupiers at LVRs of above 80 per cent. And the Bank goes so far as to insert its own value judgements, arguing that banks should use even this quota to favour first home buyers. On the other hand, only 5 per cent of bank lending to residential property investors (at least the smaller ones caught directly by these controls) can be at an LVR of greater than 60 per cent - and even that 5 per cent is probably a practical near-zero (given headroom banks will require, and occasional special situations). There is simply no persuasive evidence that New Zealand loans to owner occupiers at 80 per cent LVR are **less** risky than loans to investors at LVRs of 60 per cent - but that is the assertion the proposed controls appear to rely on. It is hard to avoid a concern that what is actually going on is the Reserve Bank putting its hand on the scale to penalise people running residential rental businesses to explicitly favour first home buyers, regardless of the actual riskiness of the respective loans. Such a choice might - perhaps - be a legitimate one for an elected government but it certainly isn't one for an unelected bureaucrat with a statutory mandate concerned only with the soundness and efficiency of the financial system.

Conclusion

In conclusion, this policy proposal should not proceed. It is time for a rethink. The process itself has been rushed, there is a strong element of pre-determination about the Bank's language, and the timing suggest there is no intention of conducting a serious consultation.

In substance, the proposal if adopted will further undermine the efficiency of the financial system, while doing little or nothing to reduce any threats to financial stability (risks which, on your own stress tests are already very low). Indeed, there is a risk that such direct controls could increase, albeit modestly, the risk of serious financial system stresses because it will reduce the volume of capital held against bank mortgage books. Over time, the growing use of direct controls risks progressively undermining the willingness and ability of banks to do their credit risk assessments, and to compete with each other in doing so, rewarding going along with the Bank's assessment of risks, while gaming the rules at the margin wherever possible.

Since the Bank offers us no reason to think that its own assessment of credit risks - in the aggregate or at a more disaggregated level - is superior to that of the market, and since our banks actually came through a much larger housing and credit boom largely unscathed, there is little basis for us to prefer the Bank's judgement. And it has offered nothing to suggest how much its planned intervention might affect the probability or severity of any crisis.

Over-reliance on a very slender base of international evidence, and a failure to think hard about the distinctiveness of New Zealand (from, say, the Irish or US experience) or to make the attempt to gather and analyse New Zealand loss experiences should give citizens little reason to have any confidence in what the Bank is proposing, Even if investor loans were to prove slightly riskier, all else equal, than owner-occupier loans, the scale of the differentiation in the rules for the two types of lending suggests the Bank is driven at least as much by tilting the playing field against investors and in favour of first-home buyers as by its statutory responsibilities to use its powers in the interests of financial system soundness and efficiency. If so - and I hope there is nothing to that suspicion - it would have involved the Bank stepping well beyond its responsibilities (with little ability for citizens to hold it to account if it did so).

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

Yours faithfully

Michael Reddell