Bank of New Zealand Response

Reserve Bank of New Zealand Consultation Paper:

Serviceability Restrictions as a Potential Macroprudential Tool in New Zealand

18 August 2017

Ref #7164504 v1.1

1.0 INTRODUCTION

1.1 This submission has been prepared by Bank of New Zealand (BNZ) in response to the Consultation Paper: "Serviceability Restrictions as a Potential Macroprudential Tool in New Zealand", released by the Reserve Bank of New Zealand (RBNZ) in June 2017.

1.2 BNZ welcomes this opportunity to provide a response to the Consultation Paper and acknowledges the industry engagement undertaken by RBNZ on this matter, including in relation to the debt to income reporting regime.

1.3 This submission contains commercially sensitive information, which is provided on the basis of strict confidentiality. A version of this submission, with the commercially sensitive information redacted, can be provided by BNZ to RBNZ for public release, if required.

2.0 EXECUTIVE SUMMARY

2.1 BNZ acknowledges the importance of RBNZ having a range of macro-prudential tools available to it to help it effectively manage risks when asset bubbles and other pressures might arise in the New Zealand financial system. BNZ has consistently supported this position from the time RBNZ began consulting on its macro-prudential tool kit options in 2013.

2.2 Consistent with BNZ's original submission, while the logic for having such tools available is robust, care must be taken in their deployment to ensure that the results of their use do not result in the outcomes that they are ultimately trying to avoid – a shock to the financial system. BNZ submits that this underlying principle remains valid in relation to the debt to income tool that is the subject of RBNZ's current consultation.

2.3 In particular, BNZ submits that the deployment of such a tool should only occur where there is a compelling case for its use (e.g. heightened credit growth and prolonged and highly elevated house price inflation), and where other moderating mechanisms have been given the opportunity to dampen asset price inflation. The significant rise in Auckland house prices since 2009 is arguably not due to excessive credit growth, but reflects a repricing of the housing stock to a new equilibrium Where other macro-prudential tools may be deployed that are targeted at the same sector risk, for example LVR restrictions, BNZ submits that there should be a segmented approach to the deployment of the tool that addresses the risk profile of home loan borrowers. Overlaying DTI restrictions for instance, on top of LVR restrictions without any segmentation, has the potential to significantly impact certain sectors of the home lending market who may otherwise be able to reasonably afford the lending e.g. some first home buyers may be at the start of their careers with capacity to manage discretionary spend and reasonable expectations of increases in income as their careers progress. While banks will necessarily include an assessment of serviceability (including some form of interest rate buffer) and the borrower's equity, these are separate considerations that go to the probability of a person being unable to meet repayments, and loss that might be suffered by the bank if they are unable to meet their contractual obligations. Whereas DTI and LVR are intended to address systemic risks.

2.4 In relation to the two main categories of home loan borrowers and the recommended selective targeting of macro-prudential tools:

(a) *Owner Occupiers*
BNZ submits that a DTI tool, if required, may be a preferable means of managing the risk of a collapse of any asset bubble associated with owner occupier lending. This owner occupier definition may include business related lending that is secured by a person's residential property. However, BNZ submits it should not include loans to third parties (such as a business in which the mortgagor is an investor) that is linked to the property by "an all monies" mortgage that secures a guarantee of the loan by the mortgagor, In the event of a default under a loan that is guaranteed, security over the third party's assets would most likely be exercised before making any demand on a guarantor. If demand is made on a guarantor, it is likely to be for the outstanding debt and not that the guarantor take over the servicing of the loan. Given an owner-occupier's income is typically the key lending repayment source, an increase in home loan interest rates may have a more immediate impact on serviceability. This would suggest that these borrowers are the segment who may be more specifically targeted with a DTI restriction to manage systemic risk.

(b) *Investors*:
BNZ submits that an LVR restriction, rather than a DTI tool, may be more appropriate for targeting credit growth associated with investor lending. The impact that the revised LVR restrictions had in late 2016 which more specifically targeted investor lending, would tend to support BNZ's view (though BNZ acknowledges other industry changes that occurred around this time, such as restrictions on the recognition of foreign income, and requirements to have a New Zealand tax number etc.). Investors are arguably more shielded from increases in interest rates (and associated serviceability pressures) given they typically have a large pool of potential renters to assist with mortgage servicing. It is notable that in the current economic cycle, that pool is expanding due to growing population, the failure to build sufficient new housing stock and the increase in the unaffordability of owning a home for many. In relation to complexity, collecting complete debt to income data on investors, particularly if spread over multiple institutions and varying sources, is likely to be extremely challenging for the industry. It may also give rise to issues of privacy and customer confidentiality, and specific legislative authority may be required to permit banks to exchange information.

2.5 BNZ submits that there has been a rapid increase in recent years in the industry's maturity as it relates to loan serviceability and associated risk management practices. While this has always been part of a prudent lender's assessment of borrower risk, recent changes such as RBNZ's DTI reporting requirements, consumer law changes (Credit Contracts and Consumer Finance Act 2003 (CCCFA) and Responsible Lending Code[1]), and best practice as defined by regulators in other jurisdictions (such as APRA's APG223 guidance), has meant that this has had an elevated profile in bank risk management frameworks. With industry maturity moving rapidly in this space, and the accuracy of DTI reporting due to be significantly improved by the end of 2017, BNZ urges caution on RBNZ's part, in assessing the shift in lender activity and the flow on effect that this will have in relation to the availability of credit and the impact on house price inflation, before making any decision on the design and deployment of any DTI tool.

[1] See section 9C(20(b) of the Credit Contracts and Consumer Finance Act 2003 and See Principle 5, Responsible Lending Code issued under the Credit Contracts and Consumer Finance Act 2003.

2.6 In relation banks' loan affordability obligations, it is also relevant to note further legislative and industry rules that address consumer lending outcomes, including the Code of Banking Practice which requires members to only lend if the information available to them leads them to believe the customer can service their loan[2]. Also, should events change and a customer become unreasonably able to meet their loan payment obligations, they can seek to have the terms of their loan changed so that they can meet them[3]. These rules operate as a fetter on the availability of credit, the impact of a change in circumstances on the outcome for a customer and significantly reduce the prospect of forced sales causing a collapse in asset values.

2.7 BNZ submits that the inclusion of any exemptions associated with the use of a DTI tool should be approached with caution by RBNZ. While there may be the need for some exemptions to avoid unintended consequences, they are typically very challenging to manage from an industry perspective and are likely to result in operational inefficiency. There would appear to be a prima facie case for some lending to be exempted however, such a bridging finance. Any move to accommodate exemptions should be done in close consultation with industry.

2.8 BNZ acknowledges that providing RBNZ with a DTI macroprudential tool would be consistent with the recent recommendations made by the IMF[4]***:***

> *Adding a debt-to-income cap to the macroprudential toolkit would enhance systemic resilience by limiting the risks from growing household indebtedness. Imposing additional loss-absorbency requirements for domestic systemic banks, and allowing an effective accountability of the RBNZ without jeopardizing the integrity and independence of its macroprudential decision-making process are also recommended*.

As a rule, BNZ sees merit in abiding by IMF recommendations. However, BNZ notes the IMF did not provide a view on the specific nature of a DTI tool, or when it should be invoked. BNZ submits that any DTI tool should be assessed against international best practice to draw on the experiences and learnings from those other jurisdictions.

2.9 BNZ notes that there are doubts over the effectiveness of DTI as a tool for controlling growth in house prices. A recent IMF Working Paper[5] found:

> *With the exception of Korea, none of the studies [of 6 countries] found that the macroprudential measures [LTV and DTI] were effective in reducing house price growth; this was especially so for countries that faced persistent housing demand and capital inflows.*
>
> *and*

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[2] See section 5.1 of the Code of Banking Practice. Note the Code is currently under review but the revised Code is not likely to change this obligation in a material way.

[3] See subpart 8 of the CCCFA

[4] IMF Country Report 17/110, New Zealand Financial Sector Assessment Program: financial System Stability Assessment. Page 6

[5] IMF Working Paper – LTV and DTI Limits – Going Granular WP/15/154, at pages 28 - 29. The same study found that stamp duty tied to house prices was a more effective at curbing house price inflation than macroprudential measures targeting housing loans. The reason for this was the stamp duties directly affected prices at the level of housing transactions and were not related to the origination of mortgage credit.

Summarizing, time series evidence from each country that dug deep into the measures show that LTV limits were effective in reducing loan-growth and improving debt-servicing performances of the borrowers. However, these measures were not effective in curbing house price growth, especially in countries that faced persistent capital flows. Targeting the tools towards the loan segment most at risk, like speculative properties, were more effective than aiming at overall credit or mortgage loans.

2.10 BNZ has read with interest the paper produced by tailrisk economics – The debt to income ration as a prudential tool: Response to the Reserve Bank of New Zealand Consultation Paper (August 2917). While BNZ does not necessarily agree with all opinions expressed in that paper, it does raise questions about the effectiveness of DTI tools and what might be their role in New Zealand. The paper underwrites BNZ's view that more research and consultation is required before any DTI tool is introduced.

2.11 BNZ notes the following in relation to the caution that should be applied in considering whether a DTI tool might be deployed:

(a) DTI is a relatively crude measure of loan servicing capacity. To get a comprehensive understanding of serviceability, other factors such as the borrowers living expenses, are critical in understanding the exposure that the borrower has to changes in interest rates. For this reason, BNZ submits RBNZ might wish to consider closer assessment of bank loan servicing calculations as a potential pre-cursor to the deployment of a DTI tool. It is likely these servicing calculations will be more accurate predictors of potential stress than DTI measures which are 'blunter' instruments. Through its prudential oversight activity, RBNZ may be able to achieve the intended outcomes, but via a process that is arguably more accurate and easier for banks to deploy. Matters such as consistency of definition, application across industry etc. may need to be addressed prior to this being an effective solution.

(b) As discussed with industry, the current DTI data limitations mean that reported DTI is almost certainly overstated (see below regarding the incomplete capture of all income information). Given the criticality of accurate data in defining both the need for such a tool to be deployed, as well as potential settings, BNZ submits that a DTI tool could not currently be deployed given the existing limitations. BNZ notes RBNZ's requirements on banks to have these data quality issues remediated by December 2017 – though it is important to recognise that the improvements in data capture will only apply to lending flow, rather than loans in the back book;

(c) Extensive consultation with industry and other stakeholders will be required to design a tool that is effective and that does not create significant unintended consequences (such as constraining the supply of credit for desirable purposes e.g. new housing), and in a worst case, cause a shock to the financial system. This would extend to the scope and nature of exemptions that would be included as part of the regime, as well as the targeted nature of the tool alongside other restrictions;

(d) In the interests of market certainty and clarity, RBNZ should issue a detailed description of the circumstances in which it sees the DTI tool might be invoked;

(e) In order to achieve a level playing field that does not asymmetrically weight higher risk lending into a smaller number of banks, the DTI policy rules would need to be clearly articulated and understood by industry, particularly in the case of more complex, multi-loan, multi-customer, lending.

(f) As noted above, the Australian owned banks are currently reviewing and amending lending practices to improve alignment to international best practice, such as APRA's APG 223 guidance. This is likely to result in changes being deployed in coming months that may further lessen the possible need for a DTI tool to be invoked.

2.12 BNZ supports RBNZ's intention to consult with industry again before introducing a DTI tool - this is highly desirable and a lesson learned from the earlier LVR restriction deployment. It is submitted that the presence of a DTI capability in the RBNZ toolkit, accompanied by accurate reporting and clarity on key indicators for when a tool might be deployed, is likely to result in modifications to lending activity being implemented by banks ahead of any tool being used. BNZ submits that this is likely to have the outcomes RBNZ is targeting, while also making it easier for banks to discharge their customer lending and prudential obligations.

3.0 BNZ SUBSTANTIVE SUBMISSIONS

Q1: *Do you have any comments on the evidence that high DTI borrowers are more susceptible to mortgage default and consumption stress? Are there other relevant studies, or other relevant channels through which a DTI policy would influence financial stability*?

3.1 NZ has not identified robust evidence that high DTI borrowers are more/or less susceptible to mortgage default. While logic infers this should be the case, there are factors that might mitigate against this, including:

- Owner occupiers may be prepared to make lifestyle sacrifices to meet mortgage commitments i.e. avoiding non-core expenses and deferring purchases in order to meet loan repayment obligations;
- DTI is measured at the point of loan application. Younger owner-occupiers are likely to subsequently experience increases in income;
- New Zealand borrowers have a strong propensity to favour certainty of exposure to interest rates over short term interest rate benefits – evidenced through the skew in fixed vs floating loans. In the local market, this provides a measure of resilience from extreme movements in interest rates – for a period at least. That timing point may be particularly relevant given it provides borrowers with a window in which to make lifestyle changes and exercise other options (such as selling a property) to mitigate the impacts of higher interest rates.
- Investors, who own multiple properties, have the benefit of diversified sources of income to meet their loan obligations and may have capacity to increase rents in a rising interest rate environment;

- Owner occupiers can take advantage of the hardship regime under the CCCFA, which allows a borrower to seek changes to the terms of their loan in certain circumstances; and
- The biggest risk to serviceability of investor loans is likely to be significant widespread levels of unemployment impacting tenants (noting this does not appear to be a significant risk at present as there are low levels of unemployment and high demand for rental properties because new builds have not kept pace with net population growth). More work is required to assess the potential significance of this risk, but BNZ submits, given the nature of the New Zealand economy, the employment risk factor is more likely to impact isolated pockets of housing rather than the nation's housing stock generally;

3.2 BNZ submits that care needs to be taken in extrapolating overseas experience in loan stress to the New Zealand environment and the use of macro-prudential tools – particularly given the fundamental differences between Loan to Income (LTI) ratio restrictions deployed in some European jurisdictions, and the more comprehensive DTI regime proposed by RBNZ.

Q2: *Do you agree that the current levels of debt (relative to income) that some borrowers are able to borrow risk putting them under pressure, especially if interest rates rise? Why are the DTIs achievable in New Zealand apparently higher than in other markets like the UK?*

3.3 BNZ submits that it is crucial to note that the question being asked is predicated on DTI reporting that is known to be inaccurate, and to almost certainly overstate the degree of high DTI lending in New Zealand. It is also important that like be compared with like, when making comparisons with other jurisdictions. As BNZ has privately discussed with RBNZ and through industry forums, this is certainly the case with its lending data, which has historically been captured with credit assessment outcomes in mind, and in particular, whether minimum debt servicing levels have been achieved. Where this is the case, further income information has not been recorded in BNZ's systems and is not therefore available for inclusion in DTI reporting.

3.4 There are a range of complex factors contributing to the reported high levels of debt to income, including:

- The extent to which debt and income are reported for more complex transactions. s9(2)(b)(ii) commercially sensitive [redacted]
- Limitations of existing data flow for subsequent reporting;
- Inconsistencies across the industry with reporting and definitions of debt and income; and
- Industry wide practice of only capturing and evidencing sufficient income required to meet the minimum servicing thresholds

3.5 Borrowers' ability to withstand significant increases in interest rates is untested in recent times in the market, though BNZ notes the extensive stress testing undertaken by banks at a portfolio level to understand overall risk profile. Stress testing results evidence the fact that housing portfolios are generally very resilient – this is particularly the case give the shift in LVR profile since RBNZ's restrictions were introduced. s9(2)(b)(ii) commercially sensitive [redacted] The recent dairy downturn is a good case in point, where customers were generally able to take cost out of their operations in response to falling dairy prices – the same would arguably be true of households and their expenditure. It is however difficult to predict how individual borrowers might respond. The usual reasons for experiencing hardship in servicing mortgage loans are major life events, such as loss of job or separation /divorce. As noted in the response to Q1 above, there are some existing mitigants - owner occupiers can take advantage of the hardship regime under CCCFA and investors currently have a wide pool of tenants to select from.

3.6 Although New Zealanders' financial literacy may generally be poor, they are relatively sophisticated in managing mortgage interest rate risk. This is particularly the case for investors. As noted above, New Zealanders are generally more comfortable locking in a higher fixed interest rates for an extended period, rather than seeking lower rates, but increased risk, associated with floating interest rates.

3.7 BNZ notes that, in respect of most common causes of negative shock to a borrowers' incomes (for example redundancy or loss of rental income), there are widely available personal insurance products that are designed to help manage these risks – these products may to some degree, mitigate the need to invoke a macroprudential tool.

Q3: *Do you agree with our assessment of other possible policies that are under the Reserve Bank's control, or do you think one or more of them could be preferable to DTI limits? Are there other policy options under the Reserve Bank's control that we haven't listed that could be relevant?*

3.8 If a DTI tool is to be implemented, BNZ recommends RBNZ consider matching appropriate tools to appropriate borrower-types. Specifically, BNZ recommends:

(a) *Owner-Occupiers*: apply a DTI tool only. Market feedback is that the current LVR speed limits are limiting the ability for new home buyers to gain entry to the market. By removing the initial deposit barrier to entry imposed under LVR, and instead taking an affordability assessment through a DTI control, this class of borrowers will still be restricted to an appropriate theoretical maximum to minimise risk to the banking system. BNZ submits it is a legitimate concern that an unintended consequence (of deploying both DTI and LVR tools) to Owner-Occupiers would, even further, shut key social groups out of the market. These possible unintended (and undesirable) social consequences need to be factored into the use of a DTI tool.

From a simplicity perspective, BNZ suggest the typical income and debt arrangements of Owner-Occupiers are more straight-forward, and easier to calculate/articulate, from a regulatory, bank and customer perspective.

BNZ submits that this definition would include lending for business purposes secured by business owner's the residential property. However, BNZ submits it should not include loans to third parties (such as a business in which the mortgagor is an investor) that is linked to the property by "an all monies" mortgage that secures a guarantee of the loan by the mortgagor, In the event of a default under a loan that is guaranteed, security over the third party's assets would most likely be exercised before making any demand on a guarantor. If demand is made on a guarantor, it is likely to be for the outstanding debt and not that the guarantor take over the servicing of the loan. BNZ also questions the utility of including unsecured debt (personal loans, credit cards etc.) in debt calculations as these tend to be fixed interest, relatively short term, and unlikely to result in defaults under mortgage loans.

Consideration should be given to whether a LTI tool might be a more appropriate restriction rather than a DTI tool. BNZ acknowledges that LTI provides a less comprehensive view of a borrower's overall circumstances, but there is a risk/complexity consideration in relation to the amount of information that is needed to manage the risk of an overheated housing market. An LTI may be sufficient for this purpose, and the collection of data may be much simpler (and compliance costs significantly lower).

(b) *Investors:* apply an LVR tool only. Collecting accurate debt to income data on investors, particularly if spread over multiple institutions and varying income sources, is likely to be extremely challenging for the industry. It may give rise to issues of privacy and customer confidentiality. Our impression is that specific legislative authority would be required to permit banks to exchange information. That aside, investors typically price their required level of rental income to cover loan repayment costs – and have this included within serviceability calculations. Depending on the duration of the lease, investors have flexibility to raise rents and to find new tenants who can pay higher rents. BNZ submits the underlying risk to the performance of an investment property is the rental market's ability to meet ongoing payments – ultimately an affordability issue is more likely to be caused by a material, systemic increase in unemployment than any other factor. An LVR speed limit, as is in place today, reduces the risk of this class of borrower excessively leveraging themselves across multiple properties, but allows investors to continue to contribute to new supply to the rental market.

3.9 BNZ submits that deploying both LVR and DTI restrictions at the same time would create a very complex system, where it would prove extremely challenging from both a regulator and bank perspective to determine which tool is having what effect. BNZ considers that it is important that RBNZ clearly communicate in what situations, LVR and DTI should be used separately, and when they should be used together (if at all).

3.10 BNZ submits the following in relation to the alternative policies discussed in the Consultation Paper:

(a) *Interest rates:* while low interest rates have undoubtedly been a factor in the increased levels of DTI, BNZ does not consider increasing interest rates (across the board) would be helpful. It would impact other areas of the economy, could increase the value of the NZD and compromise price stability objectives.

(b) *Capital requirements*: BNZ agrees with RBNZ that introducing macroprudential overlays, such as countercyclical capital buffers or a buffer specifically targeted at residential mortgages, might mitigate the risk of bank failure, but may not be effective at reducing the risk and potential impact of a housing downturn on households themselves.

(c) *Loan to value ratios*: Latest QV figures show the heat continues to come out of the housing market, particularly in Auckland, since the introduction of LVR and despite continuing high net migration and new housing builds being below required levels. BNZ agrees that the introduction of a DTI tool is not required now but sees that a DTI tool could potentially play a role in respect of borrowing by owner-occupiers as a replacement to LVR in appropriate circumstances.

(d) *More detailed prudential oversight*: The Australian owned banks have cognisance of guidance issued by APRA (APG 233). This guidance should mitigate the risk of high levels of DTI being a concern in the longer term. In the interests of efficiency, BNZ submits that any DTI tool introduced by RBNZ would be ideally consistent with APG223 definitions and guidance. Having a different set of home loan origination standards from those under the APG223 would create significant inefficiencies for New Zealand's largest banks

(e) *Alternative serviceability measures*: BNZ submits that the introduction of a debt servicing ratio (DSR) would be disproportionately constraining compared to DTI. BNZ submits that DTI allows customers more discretion as to how they spend their income than a prescriptive DSR would.

(f) *Capital adequacy measures*: BNZ considers that capital adequacy measures could be used as a tool to dampen down the risks to banks of an overheated housing market. RBNZ has already adjusted capital adequacy requirements with respect to investor lending, but there could be scope for further revision. While adjusting capital adequacy might strengthen the position of banks to withstand a housing shock, it may do little to prevent the ongoing build-up of pressures in the housing market, particularly where those pressures as acute.

(g) *Serviceability floors:* As noted above, another tool that could be considered by RBNZ is the setting of minimum interest rate floors/buffers (preferably aligned with APG223) for use in servicing calculations. These rates could be set relative to OCR or bank carded rates. For this tool to be effective and symmetrical across industry, RBNZ may need to be prescriptive about way serviceability is modelled.

Q4: *If a DTI policy was used, what would be the challenges and issues that could arise in the detailed rules and (for lenders and the Reserve Bank) monitoring compliance with the policy?*

3.11 BNZ notes the following challenges associated with the rules and compliance monitoring for DTI restrictions:

- Aligning LVR definitions and calculations across industry is challenging, and DTI is more complex, and alignment is likely to be harder to achieve – very specific guidance will be required from RBNZ;
- DTI restrictions may overlap with a bank's core serviceability calculations and credit policy settings. This may cause vary outcomes across that banks, and this inter-play is expected to cause even small differences being amplified into sizeable competitive advantages depending on a bank's interpretation;
- Investor income and related DTI calculations are a lot more complex to align across the industry than for owner occupiers. The same can be said for any

loan application where business income or self-employed income is required as an input. Some scenarios make it very hard to aggregate or de-aggregate borrowers and parties (just who should be included in the calculations or not, etc.) and pro-rating and disbursement of income can be tricky;

- Main bank ongoing alignment to APRA's APG 223 guidelines is expected to result in further changes to lending practices. Any DTI tool may create complexity for main banks, particularly where there is a conflict between DTI requirements (which will admittedly supersede all others), and competing regulatory requirements like APG223 – for this reason, BNZ submits any DTI tool needs to be carefully designed, in consultation with other regulatory authorities;
- A DTI restriction may drive further intensity of competition between the banks for customers having low DTI, low LVR or both – in the absence of well aligned capital outcomes across the banks, any housing related capital advantage that is held by a bank would again be amplified, particularly if a DTI restriction was overlaid on top of an LVR restriction. The RBNZ capital framework consultation ought to be conducted in a way that is specifically mindful of this outcome and the need for a level capital playing field.
- Certainty of outcome in the calculation of DTI is an absolute requirement and must not be open to different interpretations. The rules should not leave discretion open that banks could apply in different ways similar fact situations and thereby get different outcomes. For instance, leaving it up to each bank as to whether to treat student loans on either the servicing side, or the debt side, is not helpful;
- It is hard to factor in the qualitative aspects to some of the lending scenarios that do not meet normal servicing thresholds based on "in scope". For example, if servicing is above the DTI cap but the customer is due to receive an inheritance or guaranteed bonus payment in future that will enable them to pay down debt sufficiently to bring them below the cap. A scenario like this, if treated differently across the banks, will lead to competitive advantage;
- Finally, DTI data is only captured at the point of application. A borrower's situation can change rapidly, making the data of potentially limited use, other than to give a point in time assessment of overall risk associated with lending flow.

Q5: *Do you agree that a DTI policy (if implemented) should be broadly as described above (a speed limit, with similar exemptions to the LVR policy)? Are there other design options or additional exemptions (besides the suggestion described above for relatively inexpensive owner occupied homes) that would be worth considering?*

3.12 BNZ considers that a DTI type tool is more applicable to owner-occupiers than investors and the data required to be collected for the DTI calculation should be kept relatively simple. The inclusion of exemptions (including a speed limit and similar exemptions to LVR) would complicate how banks operationalise compliance DTI restriction compliance. For this reason, BNZ would prefer that any policy includes exemptions only where there is a compelling case. In particular, BNZ considers that a DTI tool that is confined to owner-occupiers would not require significant exemptions to give effect to the policy. It does not make a difference to affordability whether a mortgagor is buying a house under construction or an existing house, if the amount being borrowed is the same in each case. That said, BNZ submits that certain types of financing should be exempt, such as bridging loans.

Q6: *Do you agree with our assessment of the impacts of a DTI policy as described on the housing market – in particular, that it would not materially affect construction, and would if anything tend to increase the home ownership rate? Are there other potential consequences of the policy for the housing market that we have not discussed?)*

3.13 Prima facie, house construction would be boosted by a DTI restriction if, contrary to BNZ's submission, new builds are excluded from a DTI policy and some buyers seeking debt above the mandated maximum switch to a new build rather than buy an existing house. However, in New Zealand, especially in Auckland where the clear majority of affected borrowers will reside, construction is currently constrained due to many factors, including a shortage of both builders and property development finance.

3.14 If investor lending is not excluded from DTI restrictions, it is possible that home ownership rates will rise, as owner-occupiers face less competition for stock on sale. However, in Auckland, demand by investors is more structural and reflects the underlying growth in Auckland's population and economy as New Zealand's main point of contact with the rest of the world. This produces a high demand for investor-owned rental stock from new arrivals in the city and it is reasonable to expect, especially in a low interest rate environment, that investors will seek to profit by investing in the sector. A DTI restriction may merely slow the decline in the Auckland home ownership rate rather than reverse it.

3.15 BNZ submits that it is very difficult to model the potential impact on average rents.

3.16 Estimating the price impact of a DTI restriction is very difficult, particularly considering the proven inability for three decades of house price modelling in New Zealand to adequately forecast the way in which prices have in fact changed. RBNZ notes in its Consultation Paper that its macroeconomic model (NZSIM) is not designed to model macroprudential policy.

3.17 Further, house price inflation can occur in the absence of any change in the rate of home lending growth, and in fact with no growth at all. BNZ submits that the significant rise in Auckland house prices since 2009 is arguably not due to excessive credit growth, but reflects a repricing of the housing stock to a new equilibrium in reflection of factors including:

- Structurally lower borrowing costs on average;
- Accelerated population growth, reflecting a trend change in annual average net migration inflows;
- The role of technology in driving growth, causing people to live and work in large agglomerations, moving out of smaller locations;
- Higher demand from offshore investors, attracted to New Zealand housing by the absence of any purchase restrictions (beyond those imposed by Overseas Investment Act); and
- Inadequate land availability to satisfy demand.

3.18 BNZ notes RBNZ has not given any indication that it expects any unwinding of prices, only that there would be a temporary fall in prices of 2-5% below levels they would otherwise rise to during the growth period during which a DTI cap would be applied. After that period and removal of the DTI restriction, prices would recover to levels reflecting the long-term interaction between demand and supply factors.

3.19 Related to this, a 2015 IMF paper[6] looking at introduction of DTI tools and other measures in numerous countries noted that: "*LTVs and DTIs were effective in reducing loan-growth and improving debt-servicing performances of borrowers, but not always in curbing house price growth.*"

3.20 BNZ submits that RBNZ should consider signalling well ahead of time in a rising housing market that introduction of a DTI cap may be highly likely. This is because many investors make purchases and commit to leveraged developments in anticipation of more investor appetite and credit availability. Subjecting new investors to a DTI cap would risk a high rate of non-settlement of purchase contracts and may trigger a sudden wider price correction. The triggers for invoking a DTI restriction need to be clearly communicated and BNZ submits that loan applications/commitments that are completed before the "go live" date should be exempt.

Q7: *Please comment on the Reserve Bank's analysis of the potential costs and benefits of a DTI policy. Do you see other material costs or benefits, or have views about the magnitudes of the costs and benefits or the method used to derive them?*

3.21 The IMF paper referenced above notes that 36 countries have DTI restrictions, but only 10 have changed them since 2000. RBNZ's assumption in its modelling that the regime may only be applied for four years appears to be at odds with the practice followed in most countries which have them. BNZ submits that these and other lessons from overseas should be carefully considered before any restriction is deployed.

3.22 It is also notable that a 2015 Bank of Sweden paper[7] concludes in relation to the overall macro-economic effects: "...*we show that the effects of the debt-to-income limit on individual households vary based on a household's income, age group, region and the bank with which it does business. In the long run, the effects on the macroeconomy are limited.*"

4. Other Matters

4.1 In relation to house price inflation and pressures, BNZ notes United Kingdom and Ireland examples are regularly referred to in the consultation as potential precedents or frames of reference. Before considering the most appropriate policy option to apply, BNZ submits the following may also be considered:

- The scenarios in Ireland, the United Kingdom and United States were fuelled primarily by a combination of speculative practices and, the case of the UK, the Bank of England (BoE) base rate dropping from circa. 5.5% to 0.5% - fuelling the 'affordability of unaffordable houses' scenario. New Zealand on the other hand has a widely acknowledged supply/demand imbalance, caused by

[6] www.imf.org/external/pubs/ft/wp/2015/wp15154.pdf

[7] www.riksbank.se/Documents/Rapporter/.../2015/rap_ek_kom_nr8_150602_eng.pdf

net population growth (particularly from net migration) out stripping construction of new houses.

- The supply/demand imbalance in New Zealand is further exacerbated by record immigration. Looking at a long run data series, after recent and current experiences, we would need to go back to the 1870's to when immigration was last at current levels. At the core of the issue, New Zealand isn't well set up for these immigration volumes. It naturally creates an issue when you have an elastic population, but an inelastic housing market;
- New Zealand does not have the vacant housing developments that arose in both Ireland and the United States – there is no excess housing stock built on speculation, so by definition, there is not a bubble of speculative house building going on. In fact, there is no shortage of land available for housing development in Auckland, though planning and related issues may contribute to constraints. This is further compounded by an inadequate supply of development finance, skilled labour, and increase in construction costs. These factors are beyond RBNZ's direct influence. However, to the extent that the risk of another surge in house prices might re-emerge can be mitigated by increasing the rate of construction of new house, it is important that any measures taken by RBNZ do not constrain the construction of new houses.
- Other jurisdictions referenced in the Consultation Paper all had a period of significant credit growth relative to GDP growth which, in hindsight, were totally unsustainable.

5. Conclusion

5.1 BNZ is pleased to provide this submission and the information it contains. BNZ is available to discuss any issues raised.

5.2 Should the RBNZ have any questions in relation to this submission, please contact:

Paul Hay
Head of Regulatory Affairs

s9(2)(a) privacy [redacted]