Westpac New Zealand Limited

Submission to the Reserve Bank of New Zealand on the Consultation Paper: *Serviceability Restrictions as a Potential Macroprudential Tool in New Zealand*

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1. INTRODUCTION

1.1 This submission to the Reserve Bank of New Zealand (**RBNZ**) is made on behalf of Westpac New Zealand Limited (**Westpac**) in respect of the Consultation Paper: *Serviceability Restrictions as a Potential Macroprudential Tool in New Zealand* (**Consultation Paper**). Thank you for the opportunity to provide feedback on the Consultation Paper.

1.2 Westpac's contact for this submission is:

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2. KEY SUBMISSIONS

2.1 Westpac notes that the New Zealand Bankers Association (**NZBA**) will comment extensively on whether the Consultation Paper has sufficiently made the case to support the introduction of debt-to-income ratio (**DTI**) limits. We do not replicate that analysis and rather focus our submissions on the practicalities of implementing such limits. If DTI limits are to be introduced, it is important that the policy is clear and not overly complex so that it can be understood by both lenders and borrowers. The policy should include clear definitions so that it can be implemented consistently and efficiently across the industry.

2.2 With respect to timing, the Memorandum of Understanding between the RBNZ and the Finance Minister is due to be reviewed by May 2018. We assume that the review should include the effectiveness of the existing tools, and the governance arrangements around macroprudential policy. We consider that the decision about whether DTIs limits are added to the RBNZ's toolkit should be considered at that time rather than before it.

2.3 We also note that Responsible Lending Principles and conduct oversight have recently been introduced but have not had much time to bed in. Therefore it is difficult to assess their full effects. The addition of DTI limits to the macroprudential toolkit should be delayed until the impacts of this conduct regulation can be better assessed.

3. RESPONSE TO CONSULTATION QUESTIONS

Question 1: 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 We note that in isolation a DTI is not a suitable calculation for the assessment and approval of credit risk:

- There is no assessment of the likelihood of borrower adversity or any buffer for adversity.
- There is no allowance of the actual debt servicing requirements (which are a factor of debt repayment terms and interest rates).

Question 2: 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?

3.2 In isolation, interest rate rises are not a cause of increasing levels of default. The normal causes of mortgage default are an unanticipated reduction/loss of income and/or increase in other outgoings – usually as a result of changes to:

- Employment status or involvement;
- Health issues for the borrower or the borrower's family; and/or
- Relationship or marital breakdown.

The impacts of the above are generally material enough to adversely disrupt the borrower's position regardless of the servicing margin as assessed at loan approval.

3.3 The key mitigation of these adversities is the ability of the borrower to make choices that allow the impacts to be reduced, deferred or avoided. The key to choice is access to equity (as calculated by the loan-to-value ratio (**LVR**)). Making compensatory changes to income and/or outgoings sufficient to manage the adversity may be beyond the borrower's ability. The benefits of low LVRs are primarily for the borrower to avoid default (and thereby increased access to options such as refinance, renegotiation of loan terms or 'trade-down' of the asset). The lender's benefit in the reduction of loss given default, is secondary to this.

3.4 The chance of adversity arising, and the capacity of the borrower to absorb that adversity, are not visible in the DTI.

Question 3: 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?

3.5 We agree that a DTI measure can provide a very broad-brush indicator of income gearing but to do so needs to be implemented in a way that avoids risks of misinterpretation or complexity. The outputs of a DTI measure are similarly broad-brush and only a high-level basis for comparison across peers and over time – not as an absolute measure of underlying credit risk.

3.6 Individual banks must be able to continue to apply their own detailed servicing risk assessments and appetite in the context of the wider understanding of borrower and portfolio credit risk.

3.7 We are aware of the servicing assessment requirements that apply in Australia (to the parent bank) and are required to reflect those requirements in our policy setting – in particular the Australian Prudential Regulation Authority's guidance APG 223. This guidance includes elements such as: income haircuts; interest rate floors and buffers; and standardised living expenses allowances. The APG 223 guidance thereby allows for multiple layers of adversity and as a consequence results in a conservative initial servicing outcome in many cases – there is some cross-over between APG 223 compliance and apparently acceptable levels of DTI. However, the APG 223 guidance does not recognise the differing LVR regime in New Zealand and therefore the potential higher levels of adversity buffer that may give New Zealand borrowers. Therefore, we do not support the equivalent policy being developed by the RBNZ at this time.

Interest rates

3.8 We do not support using interest rates to target the housing market directly – a single policy tool cannot adequately serve multiple goals. However, there is no doubt that interest rates have a powerful impact on house prices (in both directions). We are sceptical of the idea that lower interest rates could be used to offset the growth-dampening effects of DTI limits, without offsetting the limits' house price dampening effects as well.

LVRs

3.9 DTIs and LVRs reflect different aspects of risk: DTIs affect probability of default, while LVRs affect loss given default. From the perspective of lenders, regulators should be indifferent as to which one they target, as reducing either will reduce lenders' exposure to losses. Therefore the argument for introducing DTI limits (in addition to LVRs) relies on reducing the harm to borrowers – ie, a view that default events are more harmful than falling into negative equity.

Alternative serviceability measures

3.10 A debt servicing to income limit would probably work in similar ways to a DTI limit. However, it could be undermined by a widespread shift to interest-only loans. It would therefore need to be accompanied by a limit on interest-only lending, which would then require a decision about how to set that limit (as the optimal amount of interest-only lending is not zero). Consequently, a debt serviceability requirement, although arguably more realistic, would be more complex to apply and would be more difficult for customers to understand.

Question 4: 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 The focus of the control is on the levels of Residential Mortgage related debt (and potentially more so the owner occupied debt). With this focus a very simple control could be developed. As drafted, there is a significant degree of complexity.

3.12 We understand that the intention behind this complexity is to reduce any risk of 'leakage' of income or debt to categories that may not be captured by the DTI control. Our concern is that these additional requirements add substantial levels of complexity to the collection and interpretation of data – as a consequence there is a risk of error or unintentional breach. We suggest that the risk of leakage could alternatively be dealt with in a similar way to that applied to LVR exemptions – specifically a principal of 'anti-avoidance' supported with a series of avoidance examples and guidance. In the case of LVRs, the requirement is essentially that debt provided for the purposes of funding residential property is captured in the control – such an approach would also work for DTIs.

3.13 Any regime of monitoring or a subsequent control needs to be simple to understand and interpret by lending personnel and by customers. The inputs into a DTI control are more variable and complex than for LVR. In our view, the complexity of the current LVR control is just within the boundaries of being workable and understandable across a multiple channel distribution business and a wide range of customers. We are concerned that, as drafted, the DTI proposal is too complex for implementation and the development of a consistent level of understanding and application.

3.14 The guidance provided for monitoring[1] includes a number of requirements that are technically challenging and will create substantial difficulty in implementation – to the point where there could be a compromise to the even-handedness of the control. A simplified approach will create a stronger basis for comparison across reporting banks and also over time.

3.15 We suggest the following simplifications:

Income Haircuts

Recommendation: Residential rental income to be assessed at 75% (as proposed), all other income category haircuts to be assumed as 0% (ie no discount haircuts applied).

Rationale:

- Each lender has a unique policy with regard to income haircuts – the use of net income after haircuts will distort the results given the different approaches.

[1] Collection Guide: Definitions, instructions and examples for completion of the survey – as of 14 June 2017.

- Non-rental income verification is often found by tracking deposits to an account. These (net after tax) deposits are recalculated to derive a proxy for Gross Income. Recalculating to allow for different income types (and haircuts) adds complexity. An acceptable period of deposit history may be used by the lender to mitigate need for the haircut at the outset (as part of each lender's risk appetite in this regard).

Student Loan Debt

Recommendation: Determine a single rule for the treatment of Student Loans to never include the amount as 'debt'.

Rationale:

- In most cases, Student Loan repayments have already been deducted at the point income is verified (as net income paid to account, then grossed up to just reflect income tax deductions – this results in understated Gross Income). Not reporting the Student Loan as debt in these cases is as proposed in the instructions.
- In cases where Student Loan repayments are not deducted at the point income is verified (such as when the income evidence is based on Gross Income), then the lender will take account any required Student Loan payments of these as an outgoing in any case. This process is the exception and not easy to identify in the data.
- In both cases above, the Student Loan repayment obligations are recognised within the Lender's servicing assessment and thereby impact on the overall qualification for debt – therefore the exclusion of Student Debt in all cases is the even handed approach.
- The quantum of Student Loan debt is generally of limited significance (overall <0.5% of total borrower debt at time of approval).

Self-employment or Business Income

Recommendation: Determine a single rule for the treatment of Self-employment or Business Income, to only ever allow the residual figure to be used (ie, after allowance for servicing of any business debt) and therefore not separately include any of the business related debt (or components such as interest) in the DTI assessment.

Rationale:

- The personal income that can be considered to cover any Residential Mortgage lending can only ever be the net available after all business obligations have been met – assessment using any other methodology is overly complex and could lead to distorted outcomes.
- Serviceability calculation processes for the assessment of credit risk in the case of business debt and residential mortgage debt are dealt with sequentially.
  - Step 1 – the business trading results are analysed to derive the level of residual business income to cover business debt servicing obligations – often in the form of interest or debt service coverage ratios. These ratios may in turn form part of the wider credit assessment and used for risk rating purposes.

  - Step 2 – the business income available after the assessment of debt servicing is then ‘allocated’ to the personal debts and this value becomes the ‘Gross Income’ starting point for the assessment of personal credit.

  This approach is simple and works well in most scenarios – in particular where there may be multiple shareholders and only a portion of business income is available to the applicant residential mortgage borrower.

Self-employment or Business Debt

Recommendation: Determine a single rule for the treatment of Self-employment or Business Debt, to always exclude it from the Debt total, regardless of security held or personal guarantee linkage.

Rationale:

- This approach fits with the suggested treatment of business income and allows the business assessment to be kept separate from the Residential Mortgage assessment.
- The suggestion to include the business debt in the DTI calculation, if it shares the same residential security and/or if there is a linking guarantee, is not workable. Below the Corporate level borrowers, virtually all business lending requires personal guarantee of the Shareholders (and then by implication the support of any security that may be held in the Shareholder’s name). The separation of the component of debt that may be covered by these arrangements (and inclusion in the Debt total for the purposes of DTI) would be very complex requiring a dynamic view of proportional security coverage and/or proportional business ownership). Such complexity is beyond system capability and beyond easy implementation by frontline lenders or justification to customers.

Non-residential Rental Income and Debt

Recommendation: Non-residential rental income (and therefore any related non-Residential Mortgage Lending, regardless of security held) should be excluded from calculations.

Rationale:

- The suggested application of the standard 25% haircut to non-residential rental income oversimplifies the risk assessment of rental income of this type. The 25% when applied to residential rental income makes sense in that this approach creates a ‘buffer’ for potential vacancy (that may arise from a week to week tenancy) and direct costs. In a non-residential rental situation the lending structure will more be adapted to match the underlying tenancy of the property with loan terms and income allowance reflecting the specific terms of the lease(s).
- Non-residential income is generally channelled through a business or related structure – and may be mixed in with other business activities. The separation of income from this source (and the related debt) is complex and difficult. Any material levels of debt reliant on this income source will not be provided as Residential Mortgage Lending with Business Loan products generally used (the value of Residential

Mortgage Lending limited by the value of Residential property in the first instance).

- The treatment of this income and debt in the same way as other Business income and debt (as outlined earlier) would avoid complexity.

Reliance on Gross Income calculations

Recommendation: Continue to allow the allowance calculation of Gross Income from evidenced Net Income (ie, not phase out this approach as suggested).

Rationale:

- The standard form of income evidence is by receipt of net income to a bank account. Credit risk assessment focuses on Net Income as the starting point, and evidence of regularly deposited net income is the most robust form of income verification.
- Calculations to derive a Gross Income figure from Net Income (ie, add back Personal Income Tax paid) are easily systemised and accurate.
- For many borrowers, evidence of Gross Income (such as a contract with a stated hourly rate) is of limited benefit in accurately determining the actual net income received in any recent periods which will depend for example on the number of actual hours worked – collecting this Gross Income evidence in addition to net income evidence is of no benefit.

Question 5: 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?

3.16 We agree with the speed limit approach – this allows a bank the ability to manage a range of allowable loans within its own risk appetite.

3.17 We suggest exemptions should be limited and easy to interpret – a similar set of exemptions to those available for LVR restrictions would be appropriate. The primary focus of exemptions should be to allow existing borrowers freedom to make their own banking choices (eg, portability and refinance exemptions should not be constrained by the borrower's historic DTI outcome) and to avoid any unintended disruption to the housing market (eg, a construction exemption). It is less evident that a "*very low value*" exemption is required. It appears to be counter-intuitive to the objective of avoiding borrower stress.

Question 6: Do you agree with our assessment of the impacts of a DTI policy 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?)

3.18 The construction exemption appears to play an important role in avoiding exacerbating the housing shortage even further. However, it is difficult to envisage any further broadening of the exemption that would have a significant impact on the housing shortage, given its scale.

Question 7: 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?

3.19 We do not have any comment on the RBNZ's cost benefit analysis as it will be the focus of the NZBA's submission.