DRAFT

Submission by

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

to the

Reserve Bank of NZ (RBNZ)

on the

Enhancing the efficiency of macroprudential policy: activating DTIs and loosening LVRs Consultation Paper

March 2024

Section 1.0 Introduction

1.1 BusinessNZ[1] welcomes the opportunity to make a submission to the Reserve Bank of NZ on *Enhancing the efficiency of macroprudential policy: activating DTIs and loosening LVRs Consultation Paper* (the "Consultation Paper").

1.2 BusinessNZ notes that the Consultation Paper is proposing a package of changes to the Reserve Bank's macroprudential policies, namely:

- The activation and calibration of Debt-to-Income (DTI) restrictions on residential mortgage lending; and
- An easing in Loan-to-Value ratio (LVR) restrictions (subject to activating DTI restrictions).

1.3 The RBNZ proposes activating DTIs to allow banks to lend:

- 20% of their residential loans to owner-occupiers with a DTI greater than 6, and
- 20% of their residential loans to investors with a DTI greater than 7.

1.4 The RBNZ is also proposing easing the LVR settings at the same time as activating DTIs to allow banks to lend:

- 20% of owner-occupier lending to borrowers with an LVR greater than 80%, and
- 5% of investor lending to borrowers with an LVR greater than 70%.

1.5 The Consultation Paper outlines a number of questions (below) which BusinessNZ has provided responses to. It should be noted that the responses from BusinessNZ should be taken in the context that we do not believe there is a strong case for introducing DTI limits given banks already have significant commercial incentives to stress test loans and ensure that defaults on loans are minimised. DTI also disregards the many factors which a bank will consider when assessing the capacity of a borrower's creditworthiness. Stress tests of banks conducted by the RBNZ have repeatedly shown that banks are resilient to even severe house price shocks and sharp increases in the rate of unemployment.

1.6 It is also important to appreciate that any tools developed should be appropriate to deal with perceived risks associated with the financial system. For example, housing cost risks are largely a consequence of land supply and/or other regulatory factors which impact on cost e.g. authorised building materials. It is important therefore that any tools developed should address the real factors pushing up housing costs (and hence risks associated with the housing market).

[1] Background information on BusinessNZ is included as Appendix 1.

1.7 Geof Mortlock (Economic and Financial Consultant and ex-Reserve Bank senior employee) wrote succinctly in a recent article: "*The most appropriate policies to address residential property price concerns lie outside of the RBNZ's mandate. For example, appropriate policies are likely to focus on: (a) increasing the allocation of urban land zoned for residential construction; (b) strengthening the capacity of the building sector to build more properties; (c) relaxing unnecessary building code and consent requirements; and (d) reducing the level of immigration. None of these policy issues lie within the remit of the RBNZ.*"[2]

1.8 Notwithstanding the above, we take significant confidence from the proposed approach by the Reserve Bank that the DTI will have limited or no impact during "normal" times and will only really impact on the availability of debt during times of significant stress on house prices. It is noted that currently, banks are lending less than 10% of new loans to households with a DTI greater than six and investors with a DTI greater than seven. Secondly, given that the proposals will be introduced in what can be considered "normal" times, it will effectively have no immediate impact on the potential for individual and household to borrow, provided of course, that they meet regulatory requirements and lending restrictions that banks already require as part of normal commercial practice.

1.9 The remainder of this submission provides some overriding thoughts and concerns in respect to the proposals (Section 2.0) while Section 3.0 provides responses to the specific questions raised the Consultation Paper.

RECOMMENDATION

BusinessNZ **recommends** that:

Given the the lack of cost/benefit analysis of the proposals mooted in the Consultation Paper, and given the new Government's stated emphasis on improving the quality and efficiency of regulation, it would seem logical and desirable that the proposals are subject to a thorough cost/benefit analysis before proceeding further.

Section 2.0 Overarching Discussion

2.1 BusinessNZ considers that sound macroprudential policy is important to the entire economy, with minimising the risks to the banking system fundamental to the soundness of New Zealand's financial system.

[2] *Geof Mortlock argues Minister of Finance Nicola Willis should commission an independent review of the RBNZ's DTI policy coordinated by Treasury*. 30 January 2024 Interest.co.nz

2.2 The NZ financial system came through the recent Covid 19 crisis in reasonably good shape compared with many other countries, in no small part reflecting the soundness and quality of NZ's regulatory systems. Certainly, there was fall-out associated with significant quantitative easing (subsequent inflationary pressures and significant increases in Government debt), but overall, the financial system managed reasonably well.

2.3 Notwithstanding the financial system's reasonable performance, it is entirely appropriate for the Reserve Bank to look seriously at the soundness of its current prudential management systems to see if anything more can be done to manage risk successfully. But in doing so it should keep in mind that there is an optimal amount of resource which can be used in reducing risk, given that risk cannot be completely eliminated or if at all, not without great cost.

2.4 Although risk reduction may be possible, beyond a certain point the marginal cost of taking action becomes progressively higher, while the potential returns reduce.

2.5 From an economic perspective, risk involves:

- More resources, including time and money, for risk reduction; and
- Determining the desired level of risk - reconciling the increased cost with what must be given up, since by their actions individuals demonstrate a level of risk well short of zero.

2.6 It is important that any changes made to macroprudential policy tools should reflect the above points, particularly where a proposed change may have an unintended impact, including an impact on economic efficiency or equity.

2.7 It is also important that any tools developed should be appropriate to deal with perceived risks associated with the financial system. For example, housing cost risks are largely a consequence of land supply and/or other regulatory factors which impact on cost e.g. authorised building materials. It is important therefore that any tools developed should address the real factors pushing up housing costs (and hence per se, risks associated with the housing market).

2.8 While household debt in NZ is relatively high by international standards, housing ownership in NZ is amongst the highest in the world and the number of default loans and mortgagee sales does not appear to be an issue in NZ, let alone a significant issue.

2.9 Given that markets are generally faster at self-correction than government interventions, the onus of proof must be on government to prove beyond reasonable doubt that the benefits of intervention (of the type proposed) will exceed the costs, including any unintended costs consequent upon the regulation.

2.10 Given the proposed requirements are directed only to banks, it seems possible that other financial institutions will not be affected, a situation which can be considered inequitable and may encourage greater lending in less regulated sectors of the economy, which is not necessarily desirable.

2.11 Before addressing the specific questions on the Consultation Paper, it is briefly worth noting our general reluctance to support the activation of DTIs. Our concerns are particularly associated with the potential for unintended consequences, including, but not necessarily limited to, the following:

- Potentially adverse impact on particular groups
- DTIs are a blunt tool for assessing financial risk
- DTIs bear no relation to particular risks in particular areas
- Pressures to seek alternative capital via, loan sharks, family etc
- Impact on availability of small business finance
- Impact on efficiency if people undertake sub-optimal investments

Adverse impact on particular groups

2.12 While it almost a truism that the benefits of regulation must outweigh the costs in order for regulation to be justified, it is also important to analyse not only total costs and benefits (including potential unintended costs and/or benefits) but also where these expected costs and benefits might fall. For example, in the case of the DTIs, the benefits (if any) of this proposal might be widely dispersed but the costs will fall disproportionately on one group (lower income earners).

2.13 Given that there are a number of benefits associated with homeownership, restricting the ability of certain groups to enter the market without adequate cause is problematic.

DTIs are a blunt tool for assessing risk

2.14 As DTI settings may bear no relationship to serviceability of loans to specific individuals, they are a crude and rather blunt instrument for assessing risk. Delaying making an investment decision may impact adversely on specific individuals.

2.15 Banks already have strong commercial incentives to stress test loans and have incentives to ensure that defaults on loans are minimised. DTI disregard the many factors which a bank will consider when assessing the capacity of a borrower's creditworthiness. They are a very crude and blunt tool for assessing individual risk. Moreover, stress tests of banks conducted by the RBNZ have repeatedly shown that banks are resilient to even severe house price shocks and sharp increases in the rate of unemployment.

2.16 It could be argued that individuals with lower income levels impose a higher risk, but it is also an issue of determining lifetime earnings/consumption profiles and other assets which are arguably more important than DTIs.

2.17 An individual or family might have assets which they do not wish to cash up (for a variety of reasons), so DTI will have little if any value in determining risk, apart from a generalised assumption that those individuals obtaining high DTI loans are inherently a "bad risk."

2.18 In summary, the full picture of an individual's net worth and earnings potential is probably much more relevant in determining risk than are DTIs.

DTIs bear no relation to particular risks in particular areas

2.19 Putting aside the issue of aggregate risk, it is fair to say that NZ communities, towns and regions are not homogeneous in respect to risk. Some regions are in a relatively strong growth phase, while others are showing negligible growth. Indeed, some regions are showing strong population and employment growth with commensurate pressure on available housing; other regions are showing steady population decline, with limited if any real pressure on housing. Given this, it is not obvious that a $500,000 property should be assessed the same as a $3 million property in respect to DTIs, particularly, as noted above, banks have strong commercial incentives to manage risks given the potential for transaction costs and reputational damage should individuals default on loans.

2.20 To make a blanket judgment of risk across the country, irrespective of the particular market, is at best crude, and at worst, nonsense.

2.21 Notwithstanding the points above, it is accepted that it would be practicably impossible make valid assumptions about particular regions and areas in respect to risk; the assumptions made would create the same effect as treating everyone the same, regardless of income, age or other factors which might impinge on the ability to service a mortgage.

Pressures to seek alternative capital via, loan sharks, family etc.

2.22 The introduction of DTI restrictions (like LVRs) could have a number of unintended consequences, including encouraging individuals to seek deposits from other sources where the cost of capital is likely to be much higher. For example, rather than obtaining finance from a credible bank to secure a deposit, individuals might seek finance at much higher interest rates from less than reputable sources such as loan sharks, or put added pressure on family members to provide capital.

2.23 Given that it is likely that individuals will not want such loans recorded when they seek bank finance, the terms and conditions of such loans could well be harsher than might otherwise be the case.

Impact on availability of small business finance

2.24 Many small business owners use housing mortgage finance to partially fund business activities. They may do this for a number of reasons including, but not limited to, the fact that housing mortgage finance is generally less costly than business finance. By, in effect, restricting this source of finance, the ability of many small business ventures to get off the ground could be unnecessarily restricted.

Impact on efficiency if people undertake sub-optimal investments

2.25 While it could be argued that the DTI will encourage people to save an appropriate amount of money in order to meet any DTI requirements, this could have unintended and adverse impacts on efficiency. Individuals may have to purchase two or even three houses before they can get what they want, simply because draconian rules prevent them from purchasing the house they want up-front.

Section 3.0 Questions in the Consultation Paper

3.1 The Consultation Paper outlines a number of questions which BusinessNZ has provided responses to (below). It should be noted that the responses from BusinessNZ should be taken in context that we do not believe there is a strong case for introducing DTI limits given their questionability and bluntness as an effective risk management tool. However, we take significant confidence from the proposed approach by the Reserve Bank that the DTI will have limited or no impact during "normal" times and will only really impact on the availability of debt during times of significant stress on house prices. Secondly, given that the proposals will be introduced in what can be considered "normal" times, it will effectively have no immediate impact on the potential for individuals and households to borrow, provided of course, that they meet regulatory requirements and lending restrictions that banks already require as part of normal commercial practice.

Question 1:
Do you have any comments on the proposed approach to using the DTI restriction? That is: a) activating DTI restrictions at a setting which is binding during a boom but minimally binding at other times; b) activating the DTI restrictions as soon as practical; and c) applying the policy to both owner-occupiers and investors albeit not at the same level for both groups.

<u>BusinessNZ Response</u>

3.2 Given that the proposed DTI restrictions are likely to go ahead, BusinessNZ agrees with the concept of setting DTI restrictions at a level which is binding during a boom but has limited or no effect during normal times.

3.3 If DTIs are to be introduced, then it is appropriate to introduce them as soon as practically possible to ensure that current and future residential households and investors are minimally affected by the changes. It then allows adequate time for households and investors to adjust their behaviour if necessary without having to drastically change short-term plans.

3.4 BusinessNZ does not have strong views on applying the policy to both owner-occupiers and investors, albeit not at the same levels for both groups, but acknowledges the rationale for applying different levels as outlined in the Consultation Paper.

Question 2:
Do you see any major risks or issues with activating the DTI restriction in mid 2024?

<u>BusinessNZ Response</u>

3.5 No. However, it will be important that the Reserve Bank consults with banks in NZ to determine if there will be any potential unintended consequences to their operations which may call for a longer time period for any changes to be introduced.

Question 3:
Do you have any feedback on our proposed DTI calibration of:
• a DTI threshold of 6 with a speed limit of 20 percent for owner-occupiers; and,
• a DTI threshold of 7 with a speed limit of 20 percent for investors.

<u>BusinessNZ Response</u>

3.6 No specific comments although BusinessNZ would question the need for the DTI restrictions given that banks already have strong commercial incentives to stress test loans and minimise the impact of loan defaults because of the transaction costs and reputational risk of major defaults. Moreover, stress tests of banks conducted by the RBNZ have repeatedly shown that banks are resilient to even severe house price shocks and sharp increases in the rate of unemployment.

Question 4:
Do you have any comments on whether the proposed DTI calibration best achieves the policy objectives and approach of the policy?

BusinessNZ Response

3.7 See general comments for potential unintended consequences as outlined in paras 2.12 – 2.25.

Question 5:
Do you have any comments on our proposed initial regulatory measurement window of 6 months?

BusinessNZ Response

3.8 Again, as in response to Question 2, BusinessNZ would encourage the Reserve Bank to work closely with the banks and their representative organisation, the NZ Bankers Association, to ensure that the changes go smoothly with minimal disruption to any system changes that may be required.

Question 6:
Do you agree with our proposed LVR calibration of:
• a 20 percent limit on new lending to owner-occupiers with an LVR above 80 percent; and
• a 5 percent limit on new lending to investors with an LVR above 70 percent?

BusinessNZ Response

3.9 No specific comments.

Question 7:
Do you have any comments on our initial assessment of impacts?

BusinessNZ Response

3.10 The initial assessment appears to be sound. However, BusinessNZ would suggest that while the proposed changes to the LVRs and introduction of the DTI restrictions will be monitored by the Reserve Bank as to whether they are having the intended effect, BusinessNZ would be loath to suggest regular adjustments to the restrictions for fear of creating uncertainty for households and investors. Perhaps in this respect the Reserve Bank could outline a range of scenarios where the LVR and DTI limits would be changed to give some degree of certainty for those currently looking at buying property whether as owner-occupiers or as a residential property investor. In this respect, introducing the changes at a time when the impacts are likely to be minimal is probably a better option than waiting to see if borrowing levels become problematic and potentially a risk to the overall financial system.

<u>RECOMMENDATION</u>

BusinessNZ **<u>recommends</u>** that:

Given the the lack of cost/benefit analysis of the proposals mooted in the Consultation Paper, and given the new Government's stated emphasis on improving the quality and efficiency of regulation, it would seem logical and desirable that the proposals are subject to a thorough cost/benefit analysis before proceeding further.

Appendix One - Background information on BusinessNZ

The BusinessNZ Network is New Zealand's largest business organisation, representing:

- Business groups EMA, Business Central, Business Canterbury, and Business South
- BusinessNZ policy and advocacy services
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium-sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made - country of origin licensing organisation for NZ-made products, NZ-grown ingredients, and NZ-coded software services

The BusinessNZ Network is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

The BusinessNZ Network contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and Business at OECD (BIAC).

BusinessNZ Network