

Submission

By



to the

Reserve Bank of New Zealand

on the

**Macro-prudential policy instruments and framework for
New Zealand : Consultation Paper**

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**MACRO-PRUDENTIAL POLICY INSTRUMENTS AND FRAMEWORK FOR
NEW ZEALAND: CONSULTATION PAPER
SUBMISSION BY BUSINESSNZ¹**

1.0 INTRODUCTION

- 1.1 BusinessNZ welcomes the opportunity to make a submission on the Reserve Bank of NZ *Macro-prudential policy instruments and framework for New Zealand Consultation Paper* (the “Consultation Paper”).
- 1.2 The Consultation Paper outlines four proposals for macro-prudential instruments designed to meet the objective of promoting greater financial system stability. The proposals are as follows:
1. A countercyclical capital buffer (CCB), which aims to provide the banking system with additional high quality capital in periods of credit downturn;
 2. Adjustments to the minimum core funding ratio (CFR), which require a greater use of ‘stable’ funding sources by banks;
 3. Adjustments to sectoral capital requirements (SCR) designed to target particular sectors in which risk is accumulating and posing a threat to the overall financial system; and
 4. Temporary restrictions on high-loan-to-value ratio (LVR) residential mortgage lending.
- 1.3 The consultation paper seeks submitters’ views on the latter three proposals, given that it is noted that the CCB framework has already been finalised and will be implemented from 1 January 2014.

Overarching views

- 1.4 BusinessNZ considers that sound macro-prudential 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.
- 1.5 The NZ financial system came through the Global Financial Crisis (GFC) 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 the collapse of a

¹ Background information on BusinessNZ is attached as Appendix 1.

number of finance companies, but overall, the financial system managed reasonably well.

- 1.6 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. For example, requiring greater financial stability may come at the significant cost of increasing the aggregate cost of capital.
- 1.7 Although risk reduction may be possible, beyond a certain point the marginal cost of taking action becomes progressively higher, while the potential returns reduce.
- 1.8 From an economic perspective, risk involves:
 - a. More resources, including time and money, for risk reduction; and
 - b. 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.
- 1.9 It is important for any changes to macro-prudential policy tools the Reserve Bank may make to reflect the above points, particularly where a proposed change may have an unintended impact, including an impact on economic efficiency or equity.
- 1.10 It is also important that any tools developed are 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. development contributions. It is important therefore that any tools developed address the real factors pushing up housing costs (and hence per se, risks associated with the housing market).
- 1.11 The Government has recently released a report² on residential land in Auckland which suggests that land available for development will fall well short of what is required to meet future demand. As well, a recent Ministry of Internal Affairs discussion paper on development

² Housing Affordability – Residential Land Available in Auckland – Ministry of Business, Innovation and Employment (28 February 2013).

contributions indicates an increase in the average development contribution charge nationally from \$3,000 to \$14,000 per section over the past decade, an increase of 360 per cent.

Recommendations

BusinessNZ **recommends** that:

The proposal to adopt restrictions on high loan-to-value ratio (LVR) residential mortgage lending does not proceed due to the potential for unintended consequences.

BusinessNZ **recommends** that:

If any of the proposals outlined in the consultation paper proceed, then it is fundamental that individuals, households, businesses and banks have adequate time to adjust to their implementation to ensure that any adverse impacts are minimised.

2.0 Section 1: Discussion on the Consultation Paper

- 2.1 While the consultation paper poses a number of questions, this submission deals with broad issues arising from the three proposed macro-prudential policy instruments outlined in the paper.
- 2.2 While not opposed per se to the implementation of the proposed tools, BusinessNZ has significant concerns in respect to, in particular, the proposed restrictions on high loan-to-value ratio (LVR) mortgage lending.
- 2.3 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.
- 2.4 Given that markets are generally faster at self-correcting than government intervention, 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.

- 2.5 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 – something which is not necessarily desirable.

1. Adjustments to the core funding ratio (CFR)

- 2.6 It is noted that the consultation paper states that from 1 January 2013, the minimum core funding ratio (CFR) has required banks to source at least 75 per cent of their funding from retail deposits, long-term wholesale funding or capital.
- 2.7 The consultation paper considers that if there is a significant deterioration in external funding market conditions, then it might be appropriate to make downward adjustments to the CFR. On the other hand, if global credit expansion is high, then it may be appropriate to increase the CFR.
- 2.8 While it is BusinessNZ understanding that banks were able to meet the obligations imposed by the CFR even before these were introduced, any adjustments to the CFR must be made in a timely fashion, well in advance of their introduction and clearly signalled to markets. This timeliness point applies in respect to the other proposals as well.
- 2.9 Markets inherently dislike risk, and in effect will build in a risk margin which will ultimately be reflected in the cost of credit facing households and businesses.
- 2.10 Unnecessary restrictions on the ability of banks to source funding, will, by definition, at least on the margins, impact on the cost of credit. There is no free lunch and reduced risk (for borrowers) will be traded off into potentially a higher cost of credit.

2. Sectoral capital requirements (SCR)

- 2.11 Adjustment to sectoral capital requirements would target particular sectors of the financial system where risk is accumulating and posing a threat to the stability of the system overall. Potentially this could apply

to housing and it is understood effectively already applies in respect to farm lending.³

- 2.12 Essentially, the proposed sectoral capital requirements adjustment would require banks to hold extra capital against exposure to a particular sector, the objective being to send a strong message to other banks and market participants about the riskiness of lending to that sector.
- 2.13 The net effect will likely be to increase the cost of capital to sectors considered to be posing a risk to the financial system.
- 2.14 Given that banks often have different market shares and specialise in lending to particular sectors, the potential implications for particular banks would need to be examined carefully to avoid any undue impact on both banks and the sectors they are lending to.
- 2.15 Along with the above concerns, and equally applicable to the other proposals outlined in the consultation paper, is when to introduce what is proposed?
- 2.16 Arguably, a reasonable amount of time is required in order to avoid undue disruption to banks, individuals and businesses, so that they can plan ahead with a reasonable degree of certainty knowing the rules are not going to change abruptly.

3. Restrictions on high-LVR housing lending

- 2.17 BusinessNZ is very concerned about this proposal, believing in some respects that it is entirely the wrong way to deal with what is largely a housing affordability problem.
- 2.18 There are a number of studies which suggest NZ housing is relatively high cost (compared with salaries/wage rates), with a number of reasons given for this situation. Land supply and development contributions were mentioned earlier in this submission.
- 2.19 There is no doubt that household debt (mainly in housing) is an issue but BusinessNZ would question whether adopting a LVR is an

³ See Rural Exposures under Basel II which came into effect in June 2011.

appropriate tool without unintended consequences and with no impact on economic efficiency and equity.

2.20 BusinessNZ's concerns with the proposal are expanded upon below:

- Adverse impact on particular groups
- LVR bears no relation to serviceability
- LVR bears 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

2.21 While it almost goes without saying 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 LVR, the benefits (if any) of this proposal might be widely dispersed but the costs will fall disproportionately on one group (in this case potentially lower income earners).

2.22 Given that there are, generally speaking, a number of benefits associated with home-ownership, restricting the ability of certain groups to enter the market without adequate cause is problematic.

LVR bears no relation to serviceability

2.23 Given the LVR bears no relationship to serviceability of loans, it is a crude and rather blunt instrument for assessing risk. Young couples, for example, may have a minimal deposit but relatively high earnings (currently) or potentially into the future, and hence would pose little if any risk to the financial system.

2.24 It could be argued that such couples should simply rent for another year or so and get a deposit together, but this represents an opportunity cost for many individuals.

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

- 2.26 An individual or family might have assets which they do not wish to cash-up (for a variety of reasons), so LVR will have little if any value in determining risk, apart from a generalised assumption that those individuals obtaining high LVR are inherently a “bad risk”.
- 2.27 In summary, the full picture of an individual’s net worth and earnings’ potential is probably much more relevant in determining risk than are LVRs.

LVR bears no relation to particular risks in particular areas

- 2.28 Putting aside the issue of aggregate risk, it is fair to say that New Zealand 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.
- 2.29 In general there is a relatively strong correlation between average income and house prices in most regions but it begs the question should a \$1 million house be treated the same as a \$100,000 house in respect to any proposed LVR?
- 2.30 To make a blanket judgment of risk across the country, irrespective of the particular market, is at best crude, and at worst, simply nonsense.
- 2.31 Notwithstanding the above, it is accepted that it would be nigh impossible to start making assumptions about particular regions and areas in respect to risk; this would simply have 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.

- 2.32 The introduction of LVR 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.

- 2.33 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.
- 2.34 It is understood that Canada currently has an LVR cap to restrict lending over 80 percent, but the cap does not apply to loans for first home buyers and only applies to loans provided by the banking sector and not by other lenders. This has aided faster growth in higher LVR lending in less regulated sectors of the economy and may not necessarily be considered desirable.
- 2.35 Rather than young people seeking finance through established channels, a Canadian-style cap could put added pressure on families, particularly perhaps elderly parents, to fund deposits required to meet the financial obligations imposed by the introduction of LVRs.

Impact on availability of small business finance

- 2.36 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

- 2.37 While it could be argued that the LVR will encourage people to save an appropriate amount of money in order to meet any LVR requirements, this could have unintended and adverse impacts on efficiency. Individuals may have to purchase 2 or even 3 houses before they can get what they want, simply because draconian rules prevent them from purchasing the house they want up-front.

BusinessNZ **recommends** that:

The proposal to adopt restrictions on high loan-to-value ratio (LVR) residential mortgage lending does not proceed due to its potential to have unintended consequences.

BusinessNZ **recommends** that:

If the proposals outlined in the consultation paper proceed, then it is fundamental that individuals, households, businesses and banks should have adequate time to adjust to their implementation to ensure that any adverse impacts are minimised.

APPENDIX 1

BACKGROUND INFORMATION ON BUSINESSNZ

BusinessNZ is New Zealand's largest business advocacy organisation.

Through its four founding member organisations – EMA Northern, BusinessCentral, Canterbury Employers' Chamber of Commerce (CECC), and the Otago-Southland Employers' Association (OSEA) – and 70 affiliated trade and industry associations, Business NZ represents 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.

In addition to advocacy on behalf of enterprise, BusinessNZ contributes to Governmental and tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development.