# The Treasury

## 2015 Loan-to-Value Ratios/Macroprudential Policy Information Release

## Release Document

## June 2015

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THE TREASURY
Kaitohutohu Kaupapa Rawa

**Treasury Report:** Treasury view on the RBNZ's proposed macroprudential settings

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| **Date:** | 30 April 2015 | **Report No:** | T2015/894 |
| | | **File Number:** | SH-11-4-3-7 |

## Action Sought

| | Action Sought | Deadline |
|---|---|---|
| Minister of Finance<br>(Hon Bill English) | Note that the Treasury requires further detail on the proposals and for the policy options to be considered as a package with the housing options before it can support the RBNZ's proposals on changes to macroprudential settings. | Friday 1 May |

## Contact for Telephone Discussion (if required)

| Name | Position | Telephone | | 1st Contact |
|---|---|---|---|---|
| Lucy Greig | Senior Analyst | 04 917 6085 (wk) | [1] | ✓ |
| James Beard | Manager, Financial Markets and International | 04 917 6161 (wk) | [1] | |

## Actions for the Minister's Office Staff (if required)

**Return** the signed report to Treasury.

**Enclosure**: No

**Treasury Report:** Treasury view on the RBNZ's proposed macroprudential settings

## Executive Summary

The Treasury supports the Reserve Bank's view that recent developments in the Auckland housing market could potentially pose a threat to financial stability over the medium term and although there may not be signs that a nasty correction may be imminent, there is cause for vigilance. Given the consequences of doing too little too late, we support the case for intervention at this stage on financial stability grounds on the basis of the available data.

However, in our view, the Reserve Bank has not made a strong enough case for the policy intervention chosen. Before we are comfortable with this policy option being published for consultation, we need to see a detailed examination of the evidence available, the analysis of the expected impacts on a range of variables, what other policies were considered and why the proposals were chosen.

Further, the Government's policy response to the developments in the housing market needs to consider the impact of the policy package as a whole – both in terms of the other tools that the Reserve Bank is considering, and the tools that are available to Ministers.

**Talking points you could raise with the Reserve Bank**

- You could note that there are gaps in the analysis as it stands in the paper. The Bank presents a story around house price corrections rather than focusing on financial instability through credit growth. The picture on credit growth is incomplete, and there is a lack of clarity on the expected channels and impact of the policy.

- You could ask whether the LVR tool is the best way of targeting investor activity. The Treasury would like to see a greater examination of the evidence around the role of investors.

- You could ask for further analysis of other options, particularly around banking sector resilience. The Treasury would like to see the Reserve Bank's consideration of its other tools, including the counter-cyclical capital buffer. We would also like to see any analysis of how the existing LVR policy has impacted on bank capital levels and overall bank resilience since 2013.

- You could ask when the planned review of capital settings will take place and what this would involve.

- You could ask whether the Reserve Bank is still of the same opinion on the LVR proposals, given the Treasury options to tackle the same financial stability concerns that are now on the table. How will the proposals on the LVR policy be revised in light of the advice being put up by the Treasury before the wider consultation goes ahead? You could ask whether they see a risk of doing too much or around a lack of coordination?

## Recommended Action

We recommend that you:

a **Note** the content of the report

~~*Agree/disagree.*~~

- RBNZ dont need Treasury agreement
- expect these issues to go on outside context of RBNZ making independent statutory decisions

Girol Karacaoglu
**Deputy Secretary, Macroeconomics, International & Economic Research**

Hon Bill English
**Minister of Finance**

## Analysis

### Level of threat to financial stability

1. The Reserve Bank's policy proposal represents an escalation in their assessment of threat to financial stability, based on the developments in the Auckland housing market. Whilst the RBNZ has identified potential causes of instability in the FSR, and took action in October 2013 to cool the housing market, the RBNZ has identified that the pressures in the Auckland housing market are currently sufficient to require additional policy action to maintain stability.

2. The relative level of financial stability is an extremely complex and difficult thing to estimate with any level of accuracy. At the heart of the problem is that a financial crisis is a relatively low probability but high cost event. In addition, any financial instability can crystallise extremely quickly, as a result of the interlinkages in the financial system, the impact of debt funding and the leveraging of assets, and the way that asset prices may alter substantially in market value over a short space of time. This forms the basis of the case for macroprudential interventions.

3. The Reserve Bank identifies the recent house price increases in Auckland as providing a case for implementing further macroprudential policies, given the concern that current trends will continue over the next few years and lead to a 'nasty correction' causing credit losses.

4. The Treasury view is that the Reserve Bank's analysis supports an argument that the developments in the Auckland housing market could potentially pose a threat to financial stability and although there may not be signs that a nasty correction may be imminent, that there is cause for vigilance. Given the consequences of doing too little too late, we support the case for intervention at this stage on financial stability grounds on the basis of the data that are available. However, the case for the policy intervention chosen needs to be made more clearly and precisely, and the policy aims and goals need to be developed. We would expect to see a detailed examination of what other policies were considered and why the proposals were chosen. Further, the policy response needs to consider the impact of the policy package as a whole – both in terms of the other tools that the Reserve Bank is considering, and the tools that are available to Ministers.

### Use of macroprudential policies

5. There are two main aspects to supporting financial stability through macroprudential policy settings.

   - Firstly, the aim is to reduce the probability that a crisis will occur, by minimising the risk factors. Macroprudential policies can guard against the build up of systemic risk, and reduce the chance that instability in one sector will spill over into a broader crisis. For example, policies that reduce the build up of debt in a particular sector or increase the bank capital requirements reduce the risk that macroeconomic developments will spread through the system as a whole.

   - Secondly, macroprudential policies can be used in advance to mitigate the consequences and duration of a downturn. For example, where households have high levels of debt, they may reduce their consumption in the event of a crisis due to rising unemployment, house price falls or delaying purchases due to uncertainty.

6. There is very limited experience with macroprudential policies in nations with well developed financial systems, and therefore the evidence base is currently limited. The ability of regulators to judge the risks ex ante is also very uncertain, but the high costs of failing to prevent a crisis put a premium on being more cautious and applying a 'least regrets' approach. Similarly, there is less evidence on how effective the various tools are, and estimating a counterfactual is fraught with difficulties. This necessarily means that judgement by regulators forms a key part of the case for whether intervention is required, and further what mix of policy options should be used.

7. Given these issues around the evidence base, in order for any macroprudential policy to be adequately targeted and accountable, it needs to be properly specified. Macroprudential policies also impact across the economy, and can be used for very different purposes and effects depending on calibration. For example, limits on mortgage lending can be used to temporarily take the heat out of a specific market, or as a longer term countercyclical measure to lean against upswings. They also work through household balance sheets and bank balance sheets, both at the individual and aggregate levels.

8. Every policy intervention has negative consequences, costs and distortionary effects and these costs must to be weighed up with the benefits. This is of particular importance in the case of macroprudential interventions where the value can be hard to demonstrate, as the impact is on a range of interlinked macroeconomic variables and success is measured by the absence of a crisis. This means that carefully specifying the intent of the policy is key to determining its success, and allows policy makers to demonstrate that their policies are working as anticipated, maintaining credibility and confidence.

**Comment on the RBNZ policy advice**

9. The Treasury has not been given a sufficient view of the policy suggestions to be able to provide substantial analysis on the detail of the policy. However, from what we have seen, we consider that are a number of areas where there is room for their advice to be further developed before firm policy conclusions are reached.

10. In our view, although we agree that there is a case that intervention is required, we think that the arguments and judgement should be more fully developed. Furthermore, the analysis we have seen on what policies should be used needs more work, on the targets and expected impacts of the three LVR proposals, on why these were chosen over other measures at the Bank's disposal, and on how they fit in the overall policy package.

**Macroeconomic and financial variables**

11. The Reserve Bank cites net immigration and low interest rates as key variables in stimulating demand for housing, in particular in Auckland, along with supply shortages and constraints on future supply. Treasury analysis would agree that these are key drivers in the housing market. However, the Reserve Bank's note does not examine whether a reversal in either of these variables is seen as a potential trigger for instability, the extent any continuation would further exacerbate the problem, and the likelihood the Reserve Bank sees of a reversal. Obviously, the RBNZ has a degree of control over interest rates and can and should take into account the interaction of its price stability and financial stability tools. However, migration may be a bigger issue, particularly as any reversal in net migration is likely to be driven by a worsening in broader macroeconomic conditions.

12. The Reserve Bank's analysis identifies that credit losses resulting from a house price correction, if large enough, could destabilise the banking system. Rapid credit growth is a key indicator of financial stability risk. Private sector credit has been increasing at a moderate pace over the last few years suggesting limited risk of a generalised credit-fuelled boom/bust cycle (see charts 1 and 2 below). The RBNZ's analysis suggests that there is little evidence that lending standards are loosening. Nevertheless, the stock of household debt remains elevated, which presents an ongoing vulnerability. The overall picture around credit growth is somewhat mixed, and so more evidence and analysis of the dynamics is required.

13. Furthermore, having identified this channel of risk to financial instability, the Reserve Bank suggests that prudential settings are a better way of ensuring banking sector stability, and point to a planned review of capital settings. We are of the view that macroprudential settings should be evaluated as a package, and any proposal should include an examination of options that target bank balance sheets more directly to ensure the overall policy mix is well designed (see below).

Chart 1: private sector credit to GDP ratio (source RBNZ and Statistics New Zealand)

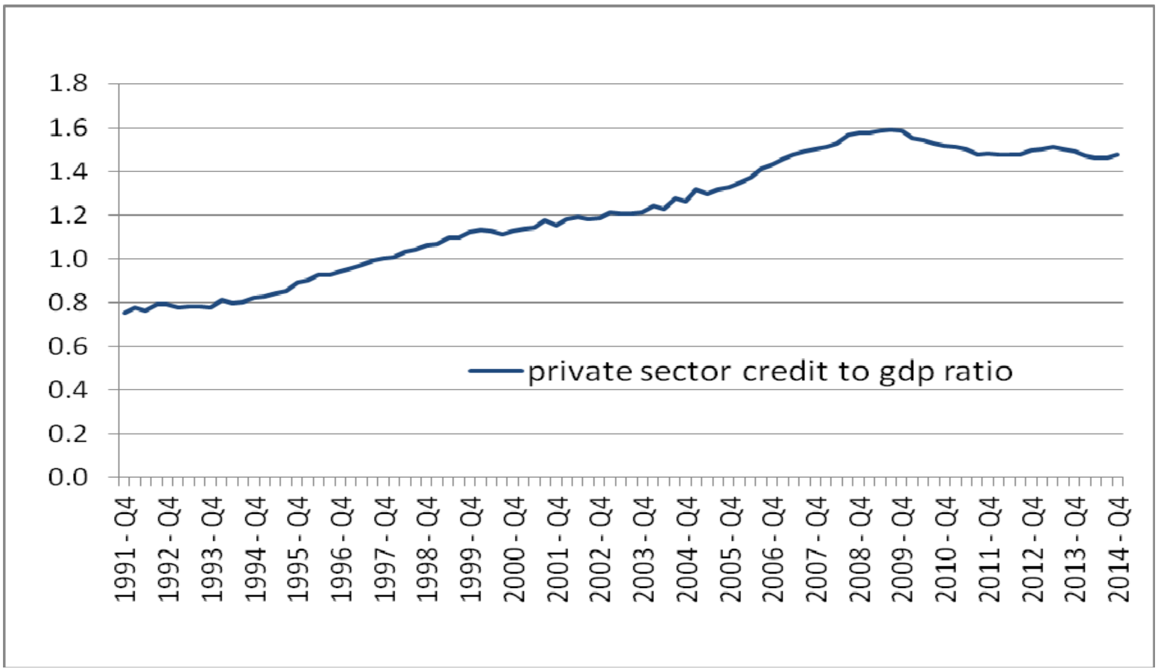
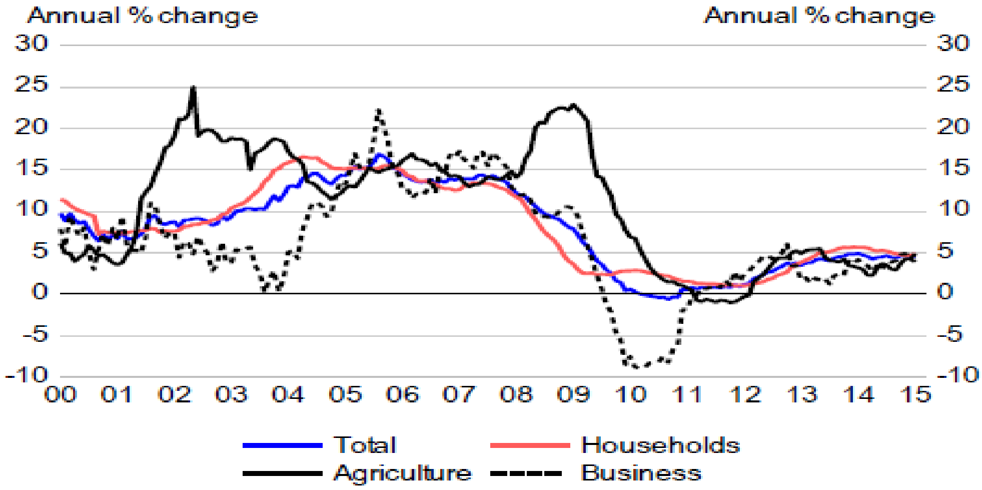


Chart 2: credit growth (source RBNZ)




14. The Treasury therefore agrees with the Reserve Bank's assessment that promoting resilience of household balance sheets is important to minimise the damage to wider macroeconomy in the event of a downturn. LVRs are a useful tool for reducing a potential debt overhang in the event of a crisis. However, the Treasury's view is that given that the stability implications stem from the issues around credit for both households and banks, the case for using LVRs needs to be made from a credit perspective, not a house price perspective. A correction in house prices will be most damaging from a financial stability perspective where households or investors find themselves in negative equity at the point of sale, or with debt repayment difficulties, or burdened with the consequences of large debt ratios. The focus on house prices and a potential house price correction does not get to the heart of the problem. House prices are not the fundamental source of instability or a macroeconomic problem *per se* – if everyone bought houses using equity, house prices would be unlikely to be subject to a damaging correction, and banks would not be exposed to losses. Instead, housing credit and the potential unsustainability of that credit motivate the policy.

15. Framing the policy around the impact on house prices therefore does not make a compelling case for using LVRs to dampen house price growth to support financial stability.

**Investor focus**

16. The Reserve Bank's proposals target investors in Auckland as these are identified as particularly risky on the basis that investors tend to default more readily in negative equity than owner occupiers, that half of all loans to investors have an LVR of over 70 per cent, and that a rising share of lending is going to investors in Auckland. The mechanism identified is the increase in the likelihood of fire sales in the event of a downturn in house prices.

17. Treasury would like to see the case for targeting investors to be made based on a greater examination of the evidence. We have seen analysis from the RBNZ on the role and share of investors in the property market which presents a mixed picture of investors depending on size and purchaser types. For example, there is evidence that cash buyers make up a proportion of the market, and these will not be affected directly by the proposed LVR limits. We would be interested in the RB's expected impact on the cluster of investors in the 75-80% LVR range, whether they would drop out of the market or whether they would be able to reduce their gearing for example.

## Regional limits and unintended consequences

18. The RBNZ has identified that the dynamics in the Auckland housing market are cause for concern, whereas house price inflation is much lower in the rest of New Zealand (excluding the specific circumstances in Canterbury). This has led the RBNZ to propose differentiating the LVR speed limit between Auckland and the rest of New Zealand. We have not seen analysis of the benefits and costs of taking a regional approach. The Bank has previously argued that regional LVRs would be unlikely to be justified given the administrative cost and complexity for an explicitly temporary measure.

19. We would also appreciate seeing the analysis on the impact of applying the policy on a regional basis as compared to a national basis, including the relative costs and benefits of the broader versus regionally targeted options.

20. In the policy document we have seen, the unintended consequences of the policy are limited to the availability of rental properties, the impact on rents and on the supply of housing. The reasury would expect the analysis of the unintended consequences to be much more developed before any specific policy suggestion is put forward.

## Examination of alternative policies

21. The RBNZ paper makes it clear that a number of options have been considered by the Bank's Macro Financial Committee. Treasury has not seen these papers and so has not been kept informed of the RB's position on the alternative options. Debt to income ratios (DTIs) are mentioned as currently technically difficult due to a lack of information, but that work is in progress. DTIs are particularly salient to financial stability as they are more reflective of sustainability of debt through the ability of borrowers to repay, and are less influenced by fluctuations in the asset prices (which bite at the point of sale) that LVRs are subject to.

22. Another set of policies which are of relevance to the current decision are interventions to improve the resilience of bank balance sheets. Reducing the instability of debt through reductions in LVRs does support the stability of the banking system, but where this is the primary aim there are other tools that are better able to do this. The paper mentions that additional work is ongoing on a planned review of bank capital levels and that this will report in due course. The Reserve Bank also have the option to impose countercyclical capital buffers available to them, and Treasury would expect that this has been considered as an alternative. We would appreciate seeing the analysis on this.

23. Overall, given the number of policy options currently on the table, and that the Reserve Bank see the issue as building over time rather than an immediate risk, Treasury would see value in a more coordinated approach across the policy areas to establish the optimal policy package as a whole. There may also be a risk of doing too much if there is insufficient coordination between the Reserve Bank and the Treasury. Although the RBNZ has different levers, reflecting its particular remit, it is important that the impact of its decisions are considered alongside other policy options to ensure that any intervention is appropriate and the combined impact of any actions is properly evaluated.

24. The level of impact anticipated in the RBNZ's analysis from the proposed policy settings is moderate, and according the RBNZ's own assessment, it will require additional action. This includes policy change around tax issues, which comes under the remit of the Treasury. Overall, this makes a strong case for a coordinated policy package, and for analysing the impact of any combined package.