The Treasury

Reserve Bank Act Review Phase 2 Review Update Proactive Release

March 2020

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[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

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TE TAI ŌHANGA
THE TREASURY

Date: 26 September 2019

To: Minister of Finance
(Hon Grant Robertson)

Deadline: None

Aide Memoire: Workshop on Macro-prudential Policy and Housing (30 September)

You are attending a workshop on 30 September, hosted by Minister Twyford, on the connections between housing and banking regulation and the role of macro-prudential policy. Members of the Phase 2 Review Team and Independent Expert Panel will also be attending. Shamubeel Eaqub will be present to discuss his paper 'Housing and Banking Regulation', which was a report commissioned by the Ministry of Housing and Urban Development.

Following are some observations on the report and the broader role of macro-prudential policy, which is being considered as part of the Reserve Bank Act Review.

Key Points from the Eaqub Report

- A key theme is that current regulation over-incentivises demand for housing and dis-incentivises real investment in the economy. The report argues that the quantity and flow of credit needs to be better managed and that the Reserve Bank should be given this role as prudential regulator.

- The Report states that the Basel risk-weighting system has contributed to the misallocation of credit because housing mortgages attract a lower risk weight than lending to the business sector.

- The Report argues that the Reserve Bank should be directed to use macro-prudential tools to manage the stability of the financial system with due consideration on the amount of leverage in the economy and on ensuring that credit flows are appropriately allocated across sectors such as housing and construction.

- There is an assertion in the Report that macro-prudential policy has the tools to achieve the above outcomes but that the Reserve Bank needs to use them more actively and forcefully.

Some Pointers for Discussion

- Phase 2 of the Reserve Bank Act Review is examining the role of macro-prudential policy, the governance and decision-making arrangements, and whether there should be particular requirements (eg in terms of consultation or prescribing which tools can be used). The Eaqub paper is an interesting contribution for the Review Team and the Reserve Bank to consider in undertaking this work.

- You have taken an in-principle decision that 'financial stability' will be the overarching goal of the Reserve Bank's prudential policy. We think this should empower the Reserve Bank (using tools like LVRs) to lean against boom-bust cycles in mortgage credit provision because of the stability threat they pose. The Reserve Bank has recently published a framework document describing in more detail how macro-prudential policy helps achieve its (current) statutory objectives.

- The Eaqub report goes beyond these prudential issues and raises the issue of whether banks are allocating credit in an efficient and equitable way. These are legitimate questions, but it would be unusual to ask the prudential regulator to decide and design policy responses. Instead, Governments often influence credit allocation with tools like guarantees (Fannie Mae in the US, Welcome Home Loans here), subsidies (like Kiwisaver subsidies, which can be used to buy first homes) and tax policy.

- The evidence suggests that macro-prudential policy has made a useful contribution to dampening excessive growth in housing credit and house prices since being introduced in 2013. However, caution needs to be exercised around the practical limits of macro-prudential tools and what the costs of using them more forcefully would be. While tools such as loan-to-value ratios could potentially have been used over the past decade to lean against the build-up of leverage in the housing sector to a greater extent, this would have involved disproportionately greater costs in terms of access to credit for groups such as first home-buyers. Moreover, there are technical limits to the use of such tools – aggressive application is likely to encourage avoidance behaviour on the part of borrowers and lenders. Finally, while a particular focus of the Report is excessive leverage, there may also be periods where housing suffers from a lack of credit rather than too much.

- Care also needs to be exercised in relation to adjusting the risk-weighting of assets for capital calculation purposes. Firstly, risk weights are only one of a number of factors driving bank credit allocation. For example, banks tend to have limited appetite for loans which require complicated monitoring and have a relatively high risk of loss (e.g. unsecured business lending. Secondly, risk weights are lower for housing than for business lending because housing lending has been shown over time to be less risky than business lending. This is exactly what risk-weighting sets out to achieve – to ensure capital held for a given type of lending is proportional to the risks. Adjusting risk weights in an attempt to influence the allocation of capital may sound enticing, but runs the risk of creating distortions across the economy. Policymakers need to be careful not to assume that they know more about the optimal allocation of credit than those making the decisions to borrow and lend.

- When it becomes clear that lending to a particular sector such as housing has become excessive, macro-prudential tools may offer additional scope to help manage the risks associated with such lending. However, international experience to date suggests they are a useful adjunct rather than a ‘magic bullet’. Even in countries where such tools are used aggressively, they have not succeeded in countering credit cycles.

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