RESERVE BANK
O F N E W Z E A L A N D
T E P Ū T E A M A T U A

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Responsible Lending Code
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Ministry of Business, Innovation and Employment
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Reserve Bank submission on the draft Responsible Lending Code

Introduction and focus of submission

The Reserve Bank of New Zealand is the prudential supervisor of the banking system and the regulator of other non-bank deposit taking institutions. In dollar terms these institutions account for the majority of lending to consumers in New Zealand. More broadly, the Reserve Bank of New Zealand Act 1989 requires the Reserve Bank to promote the maintenance of a sound and efficient financial system.

In doing so, we do not have a primary focus on consumer protection, and we are not experts on consumer law. However, we have made public comments at times when we felt that the flow of consumer credit (particularly residential mortgage credit) has been offered by the key market players on terms that seemed to us to potentially create risks to financial stability. This was an important factor behind the development of our residential mortgage loan-to-value ratio (LVR) restrictions during 2013.

This submission accordingly focusses on making comments about some key features of the residential mortgage market and potential implications for the desirable features of the Responsible Lending Code (the Code).

Features of the mortgage market and risks to borrowers

The residential mortgage market is very significant in New Zealand, with mortgage credit the most substantial single item on the balance sheet of the banking system. Mortgage impairments and delinquency rates are low, with non-performing residential mortgage lending only around 1 percent of total outstanding residential mortgage lending, despite the housing market downturn seen in New Zealand over 2008-2009. In general, the Reserve Bank believes the mortgage market in New Zealand functions well and contributes to the well-being of the household sector.

However, banks in New Zealand, as in other countries, are prepared to lend much more to a household for a mortgage (both in terms of the percentage of the collateral value and as a multiple of borrower's income) than they are for other consumer lending products. In our view, this could create some risks for borrowers – two specific examples are discussed below.

First, if home buyers take on a mortgage at a high income multiple and/or with a very low deposit, they may have an expectation that they will be able to sell the property in the future or refinance the loan at another institution if they are unhappy with the terms that are offered. But in fact, when the housing market turns down, the property market tends to become a lot more illiquid (selling is harder) and lenders often tighten terms and conditions, deterring buyers and making refinancing difficult for some customers. While non-performing mortgage loan rates have been low in New Zealand over the last 20 years at least, housing and mortgage markets in some other countries have become dysfunctional at times during the post-Global Financial Crisis period (Ireland and the United States, for example). It is possible that a borrower may have limited options if they are having difficulty servicing a mortgage and are not happy with the terms being offered by their current lender.

Second, most residential mortgages in New Zealand amortise over long periods (e.g. 30 years) but have a floating interest rate or a rate that is fixed for a relatively small portion of that mortgage lifetime (e.g. 2 years). This exposes consumers to interest rate risk. Consumers will generally be aware of this, but in sustained periods of low interest rates it is possible many borrowers will not be aware of the extent to which rates can rise. Although the interest rates charged on other forms of lending may also rise, mortgage interest rates are much more responsive to changes in the Official Cash Rate than most other consumer credit rates.

Reserve Bank's interest in the residential mortgage market

Because of the importance of the mortgage market to banks and the financial system more broadly, the Reserve Bank monitors volumes, margins, and other trends in the mortgage market. However, this is done in order to monitor the soundness and efficiency of the financial system rather than with a specific consumer protection mandate. The Reserve Bank tends not to issue explicit guidance to lenders about their terms, with the exception of the recent introduction of LVR restrictions, but we do consider it important that diligent serviceability assessments are undertaken by lenders.

We are also aware of other recent policy work by other prudential regulators and central banks related to the residential mortgage market. For example the Bank of England Financial Policy Committee recently recommended that mortgage lenders should ensure customers would still be able to service their mortgage if interest rates rose three percentage points, as part of a suite of other responsible lending rules recently put in place by the Financial Conduct Authority. The Australian Prudential Regulation Authority (APRA) has recently published a draft Prudential Practice Guide on residential mortgage lending.

Implications for Responsible Lending Code

The issues discussed above suggest to us that the approach taken in the consultation document will help build an appropriate consumer protection regime for the residential mortgage market. Some related specific comments follow below.

- The Reserve Bank agrees it is appropriate that the Code generally requires lenders to test that a loan is affordable for an owner-occupier borrower without selling the property (this relates to questions 40/41). This is partly because an owner-occupier will not typically plan to repay the loan in this way, and partly because (as noted above) liquidity in the housing market can be quite cyclical so that being able to sell a property at reasonably near current prices cannot be relied upon. There may be exceptions (such as reverse annuity mortgages) that could require a different treatment.
- The Reserve Bank agrees that the relative size of the loan (generally large, in the case of a mortgage) should be a factor in the Code that should imply more extensive inquiries are appropriate than they would be for a smaller loan, and that the list of matters described in points 88-89 should be covered by those inquiries in the case of a mortgage.
- For certain of these matters it seems appropriate for the Code to expect the lender to check information provided by the borrower against other sources or models. For example, credit checks may reveal other debts that borrower has not declared. Regarding ‘variable expenses’, the Reserve Bank agrees that it is appropriate (point 109) for the Code to expect lenders to use objective indicators of likely variable expenses rather than relying solely on information provided by the borrower.
- On their own, current interest rates and income information are not sufficient for testing affordability of a mortgage. For example, if income is likely to be variable (because of the nature of a borrower’s work) then this needs to be taken into account. As noted above, interest rates are also likely to be variable, and a responsible lender should certainly be aware of the risks this creates for a mortgage borrower (relates to question 39). The Code might note, for example, that “for products where interest rates are likely to vary in the economic cycle and over the life of the loan (such as mortgages), lenders should ensure that borrowers will still be able to service the mortgage if interest rates rise significantly.” APRA’s draft Prudential Practice Guide (around points 30-32) elaborates one approach to how this can be achieved.
- Given that expense variability and other non-mortgage costs will vary between different customers, we think that a strict debt-to-income limit is not an efficient way for the Code to ensure that lending is being done responsibly (point 110). If the desire is to make the affordability test more explicit, then more explicit interest rate buffers (as discussed above) would probably be a more efficient option for the Code.
- We note that one area of potential overlap for the Code is with the Financial Advisers Act 2008, which imposes obligations on advisors either operating independently or as part of a qualifying financial entity.

Thank you for the opportunity to provide this submission, which we would be happy to discuss further.

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