Reference: 20150363

18 September 2015

Thank you for your Official Information Act request, received on 21 August 2015. You requested the following:

> *"I am writing to request copies of any and all material prepared by The Treasury and its staff on the Reserve Bank's investor finance restrictions between 3 June (when the consultative document was released) and today. This request encompasses any internal briefing or analytical papers, material provided to the Minister of Finance (or his office) and any comments or papers provided to the Reserve Bank itself."*

Context for Information Being Released

Please note that overall, 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. Although there may not be signs that a systemic risk may crystallise imminently, 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.

As the Secretary to the Treasury Gabriel Makhlouf noted in his letter to Graeme Wheeler of 6 July 2015 (attached for your information), "*the Treasury will continue to provide an independent perspective, and aim to add value to agencies' business in doing so. Our goal is to be collaborative and challenging at the same time, engaging in a constructive spirit, with a shared sense of ambition and focus on getting better outcomes for all New Zealanders"*.

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	14 July 2015	Treasury comments on RBNZ LVR consultation document	Release in full (withholding contact details of officials)
2.	28 July 2015	Briefing for Gabs on Ian Harrison House of Cards	Release in full
3.	24 August 2015	Treasury comments sent to RBNZ with proposed changes to RBNZ speech	Release in part
4.	24 August 2015	Briefing for Girol on recent RBNZ speech	Release in part

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people,
- advice still under consideration, under section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials, and
- names and contact details of junior officials and certain sensitive advice, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Jennie Kerr
Team Leader, Financial Markets

THE TREASURY
Kaitohutohu Kaupapa Rawa

Gabriel Makhlouf
Secretary to the Treasury

6 July 2015

Graeme Wheeler
Reserve Bank of New Zealand

Dear Graeme,

As we head into 2015/16 I am writing to share the Treasury's focus for the year ahead, and some changes we're making to support stronger relationships with you and the Reserve Bank.

Our focus for 2015/16

The Treasury's vision is unchanged: we want to be a world-class organisation working towards higher living standards for New Zealanders. Our definition of living standards goes beyond the traditional focus on economic growth. We want to create a New Zealand that is prosperous, sustainable and inclusive.

In this context, we have chosen to focus on seven strategic intentions which reflect the Government's priorities and span different aspects of living standards. These are set out in our Statement of Intent:

- The State sector efficiently and effectively delivers results for New Zealanders
- People have the capacity and opportunities to participate in society and the economy
- There is a faster improvement in Māori living standards
- The economic cycle is managed in a way that supports sustainable growth
- We have an internationally connected & competitive business environment
- The Crown balance sheet is managed effectively and efficiently
- The Treasury is a high performing organisation

1 The Terrace
PO Box 3724
Wellington 6140
New Zealand

tel. 64-4-917-6250
fax. 64-4-473-0982

www.treasury.govt.nz

The strategic intentions will be key drivers of how we prioritise our work over the coming year, within the wider context of our four-year plan. They are ambitious, and require us to work closely with others inside and outside the State sector if we are to make real headway.

How stakeholders see the Treasury

Our recent stakeholder survey showed that stakeholders see us engaging more, and want to see and hear more from us. Public sector stakeholders in particular have asked us to be clearer about what is needed to improve State sector performance, clearer about our expectations, to get better at modelling the behaviours we expect of other public service agencies, and to make sure different parts of the Treasury are operating in a cohesive way.

How we work with you

To respond to these challenges, and to meet the appetite for greater engagement, we have refocused the role of Deputy Secretaries at the Treasury. Line management and operational responsibilities have been transferred to our Director group to enable Deputy Secretaries to spend much more time investing in strategic relationships and working on cross-cutting issues. The accompanying diagram provides an overview of our new operating structure.

As a central agency with a broad mandate and set of responsibilities, staff and managers in the Treasury's teams will continue to lead our work and be the main day-to-day contacts for public sector agencies. Deputy Secretaries and Directors will support this work by playing a more active role in "sponsoring" relationships. We would like to discuss how we can best make this work for you, but in practice we envisage it would involve:

- Checking in regularly to discuss how effectively our organisations are working together, your agency's priorities, and how we can support those.
- Working together to resolve difficulties and barriers to the progress of key priorities for both agencies.
- Once or twice a year, having a relationship "health check" meeting; this would be a conversation involving pre-work from both sides, such as internal conversations with relevant managers about their views on the health of the relationship, reflections on expectations of the relationship, and ideas on how the relationship could be made as effective as it can be.

I will be the relationship sponsor for the RBNZ and I look forward to discussing this with you when we next meet.

The Treasury will continue to provide an independent perspective, and aim to add value to agencies' business in doing so. Our goal is to be collaborative and challenging at the same time, engaging in a constructive spirit, with a shared sense of ambition and focus on getting better outcomes for all New Zealanders. The changes we are making will help to make sure we are getting the balance right, and we are looking forward to working together in the year ahead.

Yours ever,

Gabriel Makhlouf

Executive Leadership Team

Gabriel Makhlouf | Fiona Ross | Cath Atkins | Brendon Doyle | Girol Karacaoglu | Bill Moran

Cheryl Barnes
Director, Budget and Public Services

Justice & Security
Manager
Fiona Whiteridge

Health
Manager
Ben McBride

Fiscal & State Sector Management
Team Leader, Corporate Centre Votes Betty Scurr

Team Leader, Strategy & Design
Anna Everton

Team Leader, Financial Performance & State Sector Management
Warwick White

Team Leader, Expenditure Management
Simon McLoughlin

Social Inclusion
Manager
Nick Carroll

Paul Helm
Chief Government Accountant

Office of the Government Accountant
Head of Government Finance Profession & Chief Government Accountant
Paul Helm

Ministry of Finance Function
Team Leader
Richard Downing

Fiscal Reporting
Manager
Nicola Haslam

Jane Frances
Director, Growth and Public Services

Economic Performance & Strategy
Team Leaders
Katherine Meerman
Matthew Gilbert

Education & Skills
Manager
Grace Campbell-Macdonald

Labour Market & Welfare
Manager
David Mackay

Team Leader
Hayden Fenwick

Natural Resources
Acting Manager
Mark Vink

Regulatory Quality
Manager
Colin Hall

Sarah Vrede
Director, Financial Operations

NZ DEBT MANAGEMENT OFFICE (NZDMO)

Accounting & Transactional Services
Head
John Toomath

Business Information
Head
Clive Trott

Portfolio Management
Acting Head
Murray Jones

Risk Policy
Head
Andrew Hagan

NEW ZEALAND EXPORT CREDIT OFFICE (NZECO)
Manager
Chris Chapman

Chris White
Director, Commercial Operations

Commercial Advice
Acting Manager
Angela Graham

Governance & Performance
Acting Manager
David Stanley

Team Leader, Governance
Ngaire Best

Strategy & Policy
Acting Manager
Juston Anderson

Transactions Unit – Social Housing
Head
Stacey Wymer

Team leader
Craig Murphy

Andrew Blazey
Director, Investment Management

Government Investment Portfolio
Manager
Ricky Utting

High Value Project Assurance & Monitoring, Business Case Centre of Excellence
Manager
Jason Webber

National Infrastructure Unit
Manager
David Taylor

Balance Sheet
Manager
Andrew Hagan

Tim Ng
Director, Economic System

Macroeconomic & Fiscal Policy
Acting Manager
Renee Philip

Forecasting
Manager
Angela Mellish

Modelling
Acting Manager
Paul Rodway

Analytics & Insights
Manager
Andrew Hunter

Economic Research & Analysis
Acting Manager
Angela Mellish
Team Leader
Kristie Carter

Housing
Manager
Tom Hall
Team Leader, Housing Affordability
Nick McNabb

Financial Markets , Tax & International
Manager
James Beard
Team Leaders
Jennie Kerr (FM)
Chris Nees (Int'l)
Suzy Morrissey (Tax)

Chief Financial Officer
Fergus Welsh

Stakeholder Engagement & Communications
General Manager
Anna Symmans

Office of the Executive
Manager
Dasha Leonova

Change
Manager
Jo Hickling

Legal & Business Services
Manager and Treasury Solicitor
Jeremy Salmond

Team Leader, Legal
Adam Wood

Team Leader Ministerial Advisory Services & Business Support
Anabelle Alis

Team Leader, Facilities
Kelly Coburn

Central Agency Shared Services
Director
Alastair Mackay
Human Resources Manager
Fiona Foster
Finance Manager
Sara Brownlie
Chief Information & Technology Officer
Brett Annan

THE TREASURY
Kaitohutohu Kaupapa Rawa

A contribution that counts 1840-2015

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OIA 20150363

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Treasury Comments on RBNZ LVR Consultation Document

Date:	Tuesday 14 July 2015	**Report No:**	T2015/1544
		File Number:	SH-11-4-3-7

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** the attached Treasury paper providing comments to the RBNZ on their *Consultation Paper: Adjustments to restrictions on high-LVR residential mortgage lending*	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Lucy Greig	Senior Analyst	04 917 6085 (wk)	*Withheld under s9(2)(a)*	✓
James Beard	Manager, Financial Markets and International and Tax	04 917 6161 (wk)		

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

Return the signed report to Treasury.

Enclosure:
RBNZ consultation paper Tsy contribution FINAL (Treasury:3234748) Add to worklist

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Treasury Report: Treasury Comments on RBNZ LVR Consultation Document

1. The attached paper sets out the Treasury's view of the RBNZ's proposed changes to the current macroprudential policy settings. It looks to promote discussion as we continue to work together according to our respective mandates on macroprudential policy as set out in the Memorandum of Understanding on Macroprudential Policy.

2. Overall, 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 that although there may not be signs that a systemic risk may crystallise imminently, 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.

3. The paper provides more comprehensive comment on the consultation document than we expect could be incorporated at this stage, and identifies a number of areas where further analysis would be useful.

   - Our intention is to address more broadly what we would expect to see from the RBNZ when announcing a macroprudential policy proposal, and as such our paper goes beyond commenting specifically on the consultation document.
   - We hope our comments will be useful for the regulatory impact analysis of the policy, which is required in advance of any policy based on conditions of registration for banks, and also will add value over the longer term.

4. This Treasury paper was submitted during the consultation period with industry, but is an informal submission. The RBNZ were given the opportunity to provide comments on the Treasury paper, and these comments were taken on board.

Next Steps

5. We will continue to work with the RBNZ on the macroprudential framework, including reviewing how the process went to identify improvements we might want to make, and will report to you on the outcome. We are proposing working together with the RBNZ to ensure that the framework delivers as intended and that any changes required to achieve these objectives are made.

Recommended Action

We recommend that you:

a **note** that the attached Treasury comments were shared with the RBNZ on their *Consultation Paper: Adjustments to restrictions on high-LVR residential mortgage lending*

James Beard
Manager, Financial Markets and International and Tax

Hon Bill English
Minister of Finance

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RBNZ Consultation Paper: Adjustments to restrictions on high-LVR residential mortgage lending.

Treasury policy response July 2015

1. Executive summary

This paper sets out the Treasury's view of the RBNZ's proposed changes to the current macroprudential policy settings. It looks to promote discussion as we continue to work together according to our respective mandates on macroprudential policy as set out in the Memorandum of Understanding on Macroprudential Policy (the MoU)[1].

The paper provides more comprehensive comment on the consultation document than we expect could incorporated at this stage and identifies a number of areas were further analysis would be useful. Our intention is to address more broadly what we would expect to see from the RBNZ when announcing a macroprudential policy proposal and as such goes beyond commenting specifically on the consultation paper. We hope our comments will be useful for the regulatory impact analysis of the policy, which is required in advance of any policy based on conditions of registration for banks, and also will add value over the longer term.

As the Secretary to the Treasury Gabriel Makhlouf noted in his letter to Graeme Wheeler of 6 July 2015, "*the Treasury will continue to provide an independent perspective, and aim to add value to agencies' business in doing so. Our goal is to be collaborative and challenging at the same time, engaging in a constructive spirit, with a shared sense of ambition and focus on getting better outcomes for all New Zealanders*".

Overall, 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 systemic risk may crystallise imminently, 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.

Looking forward, and in the spirit of fulfilling the Treasury's challenge function, this paper suggests the following ways of improving the ongoing policy-making on macroprudential policy:

- Providing a more detailed problem definition and rationale for proposed macroprudential interventions

[1] http://www.rbnz.govt.nz/financial_stability/macro-prudential_policy/5266657.html

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- Improving clarity of RBNZ policy communications of the channels the proposals are targeting and the expected impacts of the policy
- Providing additional evidence and analysis on a number of issues where possible, and continuing to develop the evidence base for the policy. This should include substantial analysis of the ongoing effects of previous policy settings
- Overall taking a more proactive and forward-looking stance to macroprudential policy settings, such as setting out and maintaining evidence on the key indicators for risk, which might include some form of forward policy guidance on the potential medium-term policy direction. This relates to the proposed adjustments to the temporary LVR policies, and would help support credibility and reduce market uncertainty
- Relating policy proposals to the stress testing of banks, to increase the emphasis on the direct stability impact of the proposals

In the Treasury's view, the delivery of the RBNZ's financial stability mandate and effective use of macroprudential tools will be more effective and better understood when the RBNZ coordinates with the Treasury to ensure overall coherence in the signals that are sent to the market. The Treasury has two key roles in this regard. First, it is responsible for the overall macroeconomic framework. Macroprudential policies are an important part of this framework, and we have a clear interest in ensuring that the objectives of these policies support the broader macroeconomic framework. In addition, Treasury has a responsibility to ensure that institutional arrangements appropriately reflect Ministers' views and interests where possible.

We welcome the current engagement with the RBNZ on its ongoing work around financial stability and look forward to working together on policy designs and engaging in policy debate in the future.

2. Aims and objectives

This paper sets out the Treasury's view of the RBNZ's proposed changes to the current macroprudential policy settings. Under section 68 of part 5 of the Reserve Bank of New Zealand Act, the Bank is conferred with powers for the purpose of "promoting the maintenance of a **sound** and **efficient** financial system". Policy should act to:

- maintain financial stability; but also
- ensure the financial system continues to operate efficiently through the economic cycle.

As specified in the MoU, the RBNZ are required to keep the Minister of Finance and the Treasury regularly informed on its thinking on significant macroprudential policy developments and must consult with the Minister and the Treasury from the point where macroprudential intervention is under active consideration. The MoU aims to ensure that there is appropriate consultation with the Government at the framework design stage – reflecting the broad economic and fiscal implications of macro-

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prudential tools – but that instrument deployment is insulated from short-term political pressures.

The ongoing involvement of Treasury on macroprudential policy is desirable as the Crown faces large externalities arising from failure to mitigate systemic risk, and as macroprudential policies form part of the overall macroeconomic framework for which Treasury is responsible. The Treasury's role, however, should not compromise the operational independence of the RBNZ. At the same time, greater transparency and accountability will ensure higher quality decision making and is in the interests of both the Treasury and the RBNZ.

This requirement recognises that the RBNZ have the maintenance of a sound and efficient financial system as a primary objective and currently have independence around the use of conditions of registration, but that there is an important role for the Treasury to play. This is driven by the impact or interaction of macroprudential policies with respect to economic and fiscal objectives that are of primary importance to the Government's objectives. Macroprudential policies sit within a wider policy framework, and it is crucial that the wider policy framework is coordinated and that the individual policy settings ensure that any intervention is appropriate and the combined impact of any actions is properly evaluated

The Treasury's perspective is useful to identify additional factors or test assumptions and works to help both the Treasury and RBNZ understand the interconnections that may exist between policy areas. It also can support RBNZ to ensure that its analysis has been communicated in a way that presents as well-developed and clear. Clear communication, notably on goals and objectives, supports the RBNZ's accountability and forms a key part of a good policy development process. This paper is intended as part of that policy development process and is as such intended as a positive and routine contribution to the RBNZ's work in this area, both on the specific policy proposals and over the longer term.

Therefore, this paper looks to promote discussion as we continue to work together according to our respective mandates on macroprudential policy and to identify areas where more analysis would be useful, for example for the regulatory impact analysis or for evaluating the policy once in place.

3. Problem definition

For any policy, having a strong problem definition is the key to success. This is especially the case with macroprudential policies since the RBNZ are a relatively new tool in those countries with a well-developed financial sector. There is a lack of clear evidence on their use and effectiveness, data are often limited, and the models and analytical tools available for evaluating the potential impact and post-implementation effect are still continuing to develop. These factors add to the difficulties around establishing a counterfactual for what would have happened in the absence of a policy intervention.

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Given these challenges, to make a good case for using a macroprudential instrument, we believe it is very important to describe the goals of the policy, the objective that the policy is meant to achieve, the channels through which the policy should work, and what the success criteria are. This includes identifying the relevant indicators that would prompt policy action, and how developments in the specific indicators might inform the policy calibration. There needs to be clarity around the difference between the symptoms and the cause of an issue. For example, what factors might be sufficient to cause the banking system to become unstable? Under what kinds of circumstances would a specific policy be removed?

i. Does the level of house prices and their rate of increase in Auckland present a risk for financial stability?

The RBNZ analysis presents a mixed picture of what the RBNZ see as driving the price rises in the Auckland housing market. It initially presents the case that the inflation is driven by the current historically low interest rates and strong inward net migration. However, the consultation document also notes that prices are "stretched". We are not clear what this means – whether this refers to strong demand pressures, or to frothiness and 'bubble' dynamics based on expectations – and how much this represents expectations of future price rises. The consultation document problem definition does not refer to the magnitude of the effect of the Auckland situation or of investor activity in Auckland on the stability or efficiency of the financial system.

The Treasury acknowledges that identifying a bubble is difficult and that the debate is still very much ongoing in the academic literature. Rapidly rising prices are required to fuel a bubble and the question is how far and fast does asset price inflation need to be in order to rise to give rise to unsustainable expectations dynamics that may stoke developments ending in financial instability. For a policy-maker who has to deal with the practical side of the issue, this offers limited helpful guidance. That said, in these circumstances, it may well be better to act early than too late, given the extreme costs of a potential crisis scenario. In this regard, we support the RBNZ in its assessment that some form of action is expedient at this current time.

The Treasury also agrees with the RBNZ that fundamentals (that is, the lack of supply in Auckland in the face of strong demand pressures and the lowest financing costs on record) are largely driving the Auckland price rises, and that in addition to this there is some anecdotal evidence of frothiness that gives cause for concern. The impact of a fall in prices will depend on the causes of that fall, for example a migration outflow would have a different impact to a sharp rise in unemployment. Defaults are driven largely by the sustainability of repaying a loan, and although negative equity will make repayment less attractive for the borrower it is not necessarily sufficient to result in default. Similarly, banks are able to provide forbearance on loans that cannot be paid at the agreed rate, and did so quite extensively in a number of nations hit by house price falls during the GFC and are sensitive to loss given default.

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The Treasury acknowledges that planning constraints and broader incentives also play a key role in the broader picture of housing market dynamics. The Treasury is undertaking a work programme involving a number of departments to increase housing supply in New Zealand. The Treasury believes it is important to work with the RBNZ to ensure government policy initiatives and action and macroprudential policy decisions are mutually supportive of macroeconomic and financial stability. We will continue to work with the RBNZ to ensure the whole policy package related to the housing market works well and in a consistent direction.

That said, households and investors who are heavily leveraged, and/or have high servicing requirements are more vulnerable to defaulting on that debt. The most vulnerable are likely to include purchases based on expectations of future prices rises if a mortgage is unsustainable in the absence of expected appreciation in the value of the property over time. Even if froth drives prices higher than they otherwise would have been and then expectations reverse/collapse, highly indebted buyers for whom continuation with their mortgage becomes a problem will be more likely to default whether they bought on the expectation of continuing asset price inflation or not.

The Treasury would also like to stress our view that house prices movements in themselves are not the root cause of a financial stability problem – if houses were purchased without mortgages, the consequences of a downturn in prices would be much less severe as the banking system would not be affected by non-performing housing loans and any impact would largely be through the wealth effect. Many homebuyers are using a significant amount of leverage to buy houses, meaning that the macroprudential consequences is a credit story. Asset price overvaluation is only a one aspect of a systemic risk assessment, a necessary but not sufficient indicator.

There is also the potential for the fundamentals to reverse, for example if employment prospects in New Zealand worsened significantly enough to produce net outward migration, potentially supported by a combination of wider macroeconomic factors. We see that there is therefore a potential for house prices to fall as a result of fundamentals.

ii. <u>Rental yields</u>

The RBNZ consultation document suggests that a capital gain expectation in Auckland could be pushing down rental yields. The RBNZ suggestion that capital gains expectations may be suppressing rental yields is logical and can be justified by fundamentals, given population growth and inelastic housing supply.

However, this picture is complex and deserves further unpicking. Whilst rental yields may be low relative to house prices, they don't look out of line relative to other asset markets over the medium term. For example, bond yields are near the record lows of 2013. To put this in context, this is quite different to 2007, where there was significant divergence between bond yields and rental yields. This divergence was followed by a

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house price correction, albeit not one that created any difficulties for the financial system.

The Treasury agrees that high house price to income ratios in Auckland are cause for concern, in two respects. Firstly, from a stability perspective, this means that for a given income and given deposit, mortgage payments will be larger as house prices rise, and therefore households would require a higher proportion of their income to go on housing. This means these households may be more vulnerable to defaulting in the event of an income shock. Secondly, the affordability of owner occupation raises a number of other questions that are relevant to wider government objectives.

iii. Credit story

As already noted above, credit is a fundamental factor in any financial stability risk, given the effects of leverage and the risks around default at an aggregate level.

The RBNZ's consultation document notes that net credit growth remains subdued, but points to concern around the existing levels of household indebtedness, at around 160% of disposable income. Repayment rates have kept the net figures in check, whereas gross lending flows are a key indicator for financial stability purposes, given the characteristics of new lending as more susceptible to default.

We would encourage the RBNZ to provide further detail on the indicators they think are of relevance to financial stability, and to provide a more forward-looking analysis. For example, what would sustainable levels of household debt might be in the New Zealand context, and therefore what rates of net and gross credit formation would be tolerated, and what might present a cause for concern and justification for action.

Treasury analysis shows that aggregate debt of New Zealand households increased significantly in the decade leading up to 2008. The increase was large and historically unprecedented, but not exceptional compared to other countries' experience over the same period. Credit growth then slowed between 2009 and 2012, but more recently, as the economic recovery has strengthened, growth in household debt has picked up but remains moderate. Rising asset prices and a lift in household saving have supported households to modestly reduce the ratio of debt to assets. Low interest rates have kept debt servicing ratios at moderate levels. Moreover, there is little evidence that lending standards are declining, a crucial component for assessing systemic risk. Although this picture does not present a case that the risks from credit growth are immediate, Treasury believes that there is cause for increasing vigilance.

The potential warning signs in the credit story are around the impact of high household debt, as it forms a substantial proportion of banks' balance sheets and due to potential impact on household consumption in the event of a macroeconomic shock. High levels of debt also increase the vulnerability of households to downturns, and as acknowledged by the RBNZ this is particularly important where debt is concentrated amongst particular assets (both for households and banks). Housing assets represent

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a large proportion of both household and bank balance sheets, so any significant negative developments in the housing market would pose a more significant and systemic risk.

The rise in household debt in the 2000s was largely due to the rise in house prices and, to a lesser extent, changes in interest rates, and the Treasury would agree with the RBNZ that this is a trend that requires further analysis. We would like to raise some initial points for discussion around how the credit story relates to macroprudential policy. The key aspect is that a rise in debt relative to income means an increase in the vulnerability of households in the event of a shock to income. There are a range of tools available for addressing this. LVR limits target one aspect of loan sustainability, that is, credit loss given default. Debt-to-income limits (DTIs) are an alternative macropudential tool that would offer an alternative or additional way of managing financial system vulnerability by targeting the likelihood of default.

We appreciate that this is more difficult to implement in practice and that various technical issues meant that LVRs were chosen in 2013. We welcome the RBNZ's work on DTI data since then, and look forward to the developments in this area.

The RBNZ notes that the proposed policy would promote the resilience of household balance sheets and reduce the likelihood of forced sales and reduction in consumption in the event of a severe downturn. The Treasury welcomes the inclusion of this aspect in the consultation document as it recognises the broader effects of macroprudential policy that support growth in a post-downturn world.

4. Financial sector resilience

The RBNZ's consultation document notes that the current LVR settings have improved the resilience of the New Zealand banking system through reducing the share of high LVR loans on bank balance sheets, but the resurgence of pressure in Auckland is leaning to a re-emergence of financial stability risks.

The Treasury's view is that the resilience of the banking system should form a key part – perhaps the principal motivation – of any case for the use of a macroprudential tool. We would encourage the RBNZ to provide more analysis of what impact the proposed changes are likely to have on the banking system as a whole. Similarly, more cost-benefit analysis of any proposals would increase the understanding of the policy aims and expected impacts, and aid the RBNZ in communicating its view of the impact on the banking system. It would also support the recognition of the efficiency/stability trade-off inherent in macroprudential policy-making.

As for any macroprudential intervention, the ability of the banking sector to bear losses in a downturn is key to whether additional measures are required to support financial stability. Normal business-as-usual prudential policy is charged with ensuring that individual banks remain resilient, and macroprudential policy supplements this where there are systemic risks. This includes externalities and spillover effects to other sectors (for example a potential knock-on impact on commercial lending). The RBNZ's

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stress tests from 2014 featured a housing downturn following a sharp downturn in China or a sharp increase in interest rates, and the scenario produced the result that overall capital ratios fell to within 1 percent of minimum requirements. The consultation paper notes that since Auckland prices are judged to be at risk of a greater fall than modelled, the risks for the banking sector may be greater than previously thought.

The source, channels and symptoms of a financial stability risk need to be distinguished. As discussed above, the Treasury does not believe that rising house prices are the *source* of instability, but rather may provide a transmission mechanism between a macroeconomic shock and financial stability, via the banking system. This would involve and may accelerate any crisis in the New Zealand economy. This is a distinction between a shock **to** financial stability and **from** financial stability.

This framing supports the RBNZ's position that banks are stable, profitable and passed last year's stress tests without dipping below the minimum current capital requirements, but that even in this context the recent developments in the housing market warrant action. The banks may limit new lending providing a pro-cyclical shock to the economy regardless of whether they fail i.e. a capital constrained banking system is not consistent with financial market efficiency. Any shock sufficient to rock the banking system would likely require a deterioration in the domestic economy most likely following a shock from abroad. In this context, a large fall in house prices as occurred in the stress tests could cause defaults and loan losses of a magnitude that could prove uncomfortable for banks. It is important in these situations that policy mitigates the risks that banks contribute to the broader macroeconomic effects (such as a credit crunch, or a reduction in consumption and/or investment). Propagation may be increased as a result of firesale dynamics, a loss of market confidence, or a significant reduction in lending or foreclosures contributing to risk in the real economy. Reducing the chance of this propagation through the banking system is a good use of macroprudential policy.

The Treasury has shared some initial analysis with the RBNZ that suggests that banks have shifted their portfolios slightly as a result of the reduction in leverage in their mortgage portfolios. To the extent that the concentration of high-leverage housing debt is the potential stability risk, this is a natural consequence of the policy and does not increase the overall vulnerability of bank balance sheets to loan losses.

The Treasury appreciates that the RBNZ have done some thinking around these issues, and we agree with their analysts that macroprudential tools are one way of addressing spillovers, externalities and non-linearities that are not well captured in the risk weighting framework. As the RBNZ have noted, this is an extremely complex issue and difficult to entangle. We would welcome seeing any additional analysis on the impact of the LVR limits on bank capital levels and overall vulnerability.

5. Specific policy specification

i. Investor focus

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The proposed new macroprudential settings identify investors as a particularly important group to target, as a result of their relatively higher propensity to default in a downturn. They demonstrate a range of structural reasons why investors may be prone to default in times of downturn and make a convincing case that investors may be a source of instability.

However, the RBNZ consultation document could be clearer on the magnitude of the problem that investors pose and how this might impact on the banking system, for example the potential loss given default from the investor sector. We acknowledge that it is a complex issue to unpick and is made more difficult by the lack of evidence and data around this topic, and. We would like to encourage the RBNZ to continue to work on the relative stability risks of investors to add to the evidence base. This could include more analysis of international experiences, including identifying similarities and differences to New Zealand's situation.

The new proposals recognise that investors may require a stronger LVR limit than other borrowers. They note that the investor share of borrowing in Auckland has increased to over 40%, and that some of this may be from first home buyers being unable to access the market. They also point to evidence that investors are paying high prices on housing relative to the returns they will receive in the form of rent and that the current high prices do not seem to be reducing this demand.

Treasury also notes that the growth of investors amongst Auckland mortgage holders could be a result of removing a proportion of first time buyers from the market, intensifying the concentration of a risky set of borrowers. This may be an unintended consequence of the 2013 LVR policy settings, underlining the importance of carefully considering the potential impacts of any change to policy.

ii. Auckland focus

The consultation document notes that not only are market pressures rising in Auckland, but that it represents around half of existing mortgages and new mortgage flows, and that this concentration leads to systemic risk. They state that a 'correction' in Auckland house prices could have a range of triggers, and cite default rates and credit losses as the mechanism that would unleash financial instability, if significantly large. The use of regional macroprudential tools is relatively innovative and represents a departure for the RBNZ, who previously cited practical difficulties and the distortionary effect of regional targeting.

The Treasury agrees that any sharp fall in house prices in New Zealand would most likely be the result of a macroeconomic trigger, most likely exogenous to the banking sector, and as such represent a transmission mechanism rather than the root cause of financial instability.

The RBNZ are also looking to relax the speed limit for households outside of Auckland, allowing a slight increase in the volume of new high LVR lending originations. They point to the reduction in house price growth outside of Auckland, and the lower house price to income ratios.

The Treasury recognises that macroprudential policies have a distortionary effect on markets, including impacting on the ability of first time buyers to enter the market. However, we do not see that these distortions currently justify relaxing the LVR limits in the rest of the country. The proposed relaxation is relatively minor (allowing the proportion of high-LVR lending to rise by around 5ppt, increasing house price growth by around 1 percent) and therefore will not significantly remove the distortionary effect of the policy, yet sends a confusing policy message.

The RBNZ note that the effects in and outside of Auckland somewhat offset each other, and this weakens the case for reducing the limits outside of the region with respect to the impact on banking sector resilience. Rather, risky lending is a worry wherever located, as banks will bear losses from the portfolio overall and not just Aucklanders. This rather depends on the nature of the shock that might trigger defaults amongst mortgage holders, but the impact on the banking system will be at the national level.

Additionally, looking forward to possible future macroprudential settings, the Treasury would like to highlight that there is a trade-off between the policy being more targeted and the additional complication that this entails. The number of classifications and exclusions are growing (Auckland/rest of country, investors/non-investors, new buildings/existing buildings), detracting from the simplicity of the original policy and requiring more resource on the part of buyers to understand and banks to administer the policy. We appreciate, however, that this is new territory for both the RBNZ and the Treasury and we will need to work together to ensure that we continue to develop our understanding of these policy settings.

The Treasury is also concerned with the LVR relaxation, given the lack of messaging and communication around when and why the LVR limits would be removed. The RBNZ state that there is 'little evidence of exuberance' outside of Auckland and use this to justify relaxing the measure, yet note the possibility of resurgence and suggest a graduated approach would allow them to test the water as to the market response to the relaxation.

It would be useful for the RBNZ to set out possible indicators or reasons for further action over the medium term (whether tightening or relaxation) and avoid policies appearing reactionary. This would send signals to the market on the RBNZ's intentions, and would help the market set expectations. This itself would help support stability in the market, and would be of significant value.

The Treasury would like the RBNZ to set out what path might provoke them to continue releasing the limits, or would lead to a reimposition. Further, Treasury would also encourage the RBNZ to take more of a medium-term view of possible policy options. This could involve identifying specific indicators that are relevant to the decision-making process, and how the RBNZ expects them to evolve over time.

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6. Conclusion

Overall, 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 systemic risk may crystallise imminently, 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.

We recognise that this is new policy territory, and welcome working with the RBNZ to ensure that the policy settings are well made and support financial system stability and efficiency. We will work with the RBNZ to ensure that the framework delivers as intended and that any changes required to achieve these objectives are made.

Looking forward, and in the spirit of fulfilling the Treasury's challenge function, this paper suggests the following ways of improving the ongoing policy-making on macroprudential policy:

- Providing a more detailed problem definition and rationale for proposed macropudential interventions
- Improving clarity in RBNZ policy communications of the channels the proposals are targeting and the expected impacts of the policy
- Providing additional evidence and analysis on a number of issues where possible, and continuing to develop the evidence base for the policy. This should include substantial analysis of the ongoing effects of previous policy settings
- Overall taking a more proactive and forward-looking stance to macroprudential policy settings, such as setting out and maintaining evidence on the key indicators for risk, which might include some form of forward policy guidance on the potential medium-term policy direction. This relates to the proposed adjustments to the temporary LVR policies, and would help support credibility and reduce market uncertainty
- Relating policy proposals to the stress testing of banks, to increase the emphasis on the direct stability impact of the proposals

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Thoughts on ‘House of Cards’ by Ian Harrison

A House of Cards is a note by Ian Harrison of Tailrisk economics on the arguments/evidence in the RBNZ consultation on the LVR proposals, specifically the evidence for the restrictions on investor lending.

The paper is stored here: [Lies final 2 PDF (Treasury:3251334)] [Add to worklist]

<u>Summary of Harrison’s position</u>

- Harrison examines five papers cited in the consultation document and a number that were cited in later documents.
- Harrison notes that additional strong evidence of the lack of additional riskiness of investor mortgages, and that the RBNZ cite two papers that do not control for LVR and income.
- The RBNZ relies on overseas empirical evidence from systemic events that may not apply to New Zealand, as banking practices and laws are different (eg non recourse mortgages).
- New Zealand evidence suggests that retail investor loans are not riskier than other housing loans.
- The report concludes that the literature does not support the RBNZ’s position that investors are more risky than other housing loans. None of the papers cited by the RBNZ provide ‘substantive support’.
- ‘Bad analysis does not lead to good policy outcomes’

<u>Argument in the paper</u>

- Most investor loans in NZ are to small lenders. The loans will be serviced by salary/wages. Professional investors are will rely more on rental income, belong to other asset classes and carry more risk weight.
- The UK and Irish examples were on buy-to-let (BTL) mortgages, which had risky characteristics such as low deposit and low margin between rental income and loan repayment, and were often advanced by non-mainstream institutions. Ireland had a huge construction boom, and repossession of defaulted houses was legally extremely difficult. These are not the case for NZ investor loans, where lending standards are higher. Other papers have also found that BLT status does not impact on default rates, which are instead driven by lending standards and the sheer quantity of BTL loans that were made at the time.
- Some of the evidence presented by the RBNZ is based on subprime loans, or investment in holiday destinations, which has little relevance to New Zealand. S&P use an adjustment factor (higher capital requirement) of 1.1 on investors, but this is described as ‘qualitative’.

<u>Relevance for macroprudential policy</u>

- Banks should manage their loan portfolios to achieve a desired level of risk. For individual banks, this is regulated by prudential policy

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- Macroprudential policy's role is to protect the economy against systemic risk, that is, where there are systemic consequences not accounted for in normal prudential policy
- Therefore, the case for targeting investor loans needs to show that they are riskier than other loans, *and* that this risk may manifest at a systemic level (ie across the banking system/macroeconomy)
- Other tools for dealing with systemic risk for particular lending categories are available, such as sectoral capital overlays or increasing risk weights.

<u>Treasury comment</u>

- We have raised a number of issues around targeting investors with the RBNZ. These include the strength of the evidence base for the policy, the assumption that wage income is the key income for residential investors, and whether the magnitude of the systemic risk arising from the investor sector is sufficient to warrant specific targeting of macroprudential policy.
- Without repeating the review of the evidence, a number of the criticisms raised do seem to have some merit. However, the issues around whether it agrees with international standards and the Basel framework look more open to interpretation.
- Overall, 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 systemic risk may crystallise imminently, 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.
- We will continue to work with the RBNZ to ensure that macroprudential policy is based on a strong evidence base (whilst recognising data limitations), is based on a clear rationale, and has well-defined success criteria.

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Comments for RBNZ on Grant Spencer LVR speech 24th August 2015

Thanks for sharing the speech with us and providing the opportunity for us to provide a few comments. Overall we are happy with the references to Treasury policies, and welcome the messages that are being communicated.

There are a few points for clarification. These are:

1. Housing supply story

We were interested by the comments suggesting that an excess supply situation could easily develop. Our view is that while it is plausible that an excess supply situation could occur, it is more likely to occur as a result of changes in demand like a reversal of migration flows than simply building too many houses. Particularly given the estimates on page 5 that the shortage is 15-20,000 dwellings which is 2-3 times the amount of annual additions to the housing stock. Residential investment growth is looking weaker than we had assumed in our Budget forecasts, adding to concerns that the housing supply response has been modest relative to the demand pressures.

Withheld under s9(2)(g)(i) [redacted]

3. The credit story

We would be interested to see more on how the Bank interprets the moderate growth of (net) credit, which we've tended to view as one of the more robust indicators of systemic financial risk.

4. Some minor wording clarification:

- Pg 4 –' investor demand only affects composition' – this is potentially a bit too strong. For example, it does not hold if houses are left empty.
- Pg 5 – what data is referred to when talking about investor cash sales?
- p.g 5 – not all purchasers are required to provide an IRD number. There are exemptions for purchasers of their main home as well as a range of other exemptions *Withheld under s9(2)(f)(iv)* [redacted] We can provide details as needed.
- Pg.6 – second paragraph – we suggest dropping the word "town" in front of planning. That term is not commonly used.
- Same paragraph – we were not sure what the "relaxation of density rules" is referring to. If it is the proposal by Auckland Council to reintroduce the no density rule into the Auckland Unitary Plan then this is just a proposal at this stage.
- Pg 9 – the discussion of the impact on house prices via housing demand here mixes demand by investors for an asset and demand for housing as a place to live.

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Briefing for Girol: RBNZ speech on LVR limits, 24th August 2015

The draft speech is saved here:
RBNZ LVR - Speech final 24 Aug 2015 (2) (Treasury:3269425) Add to worklist

Key points to note

- Overall, **the speech provides a clear and detailed rationale for the RBNZ's alterations to the LVR limits policy**. There is more on the potential channels of instability than in the consultation paper, and on how instability may unfold via the housing market. There are also more data on the role of investors, which we should welcome. However, the case that investors are more risky than other lenders is still relatively weak.

- The speech also doesn't address the fact **that credit growth in New Zealand remains modest** and therefore the risks to financial stability may not be growing so fast. We have suggested that the RBNZ could provide more detail on this.

- The speech is relatively **expansive on the role of increasing supply, and finishes with a call for better progress in increasing housing supply**. There may be media interest in this and any implied criticism that the Government and Auckland Council are not making the changes necessary to increasing housing supply at the pace needed to address house prices.

- *Withheld under s9(2)(g)(i)*

Points on broader macroprudential policy approach

- The speech talks about the **anti-contractionary role of macroprudential policy as the primary goal** (as opposed to preventing bank failure). This aspect is more prominent here than in previous communications, and we welcome this development.

Withheld under s9(2)(g)(i)

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