Submission

Response to Consultation Paper on the introduction of debt-to-income ratios

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Download *the Reserve Bank Consultation Paper* (**PDF**)

Introduction

1. Positive Money Inc. has campaigned for more than a decade against the role of excessive bank credit relative to housing supply in driving house price inflation, credit misallocation and the associated mountain of unproductive private debt.

2. We welcome the Reserve Bank's position that this credit expansion has been a contributing factor in housing inflation and reduced financial stability.

3. We also welcome its position that monetary policy has contributed to this situation and that DTIs can lean against some of its negative impacts.

4. We ask the Bank to **tighten proposed DTI settings** from those proposed in this Consultation Paper. As proposed, they risk weakening the impact of DTIs and undermining the value of this powerful (and long overdue) tool.

5. We also **propose** that DTIs be accompanied by a **target for total residential credit growth** to begin a longer term process of lowering housing costs relative to income and reducing the associated national debt burden.

6. We hope that the introduction of the DTI tool will signal further action by the Bank to address the economic, social and efficiency distortions contributed by bank lending into the residential market – with many of these distortions resulting from the Bank's own regulatory policies.

Question 1 responses

Q1 : Do you have any comments on the proposed approach to using the DTI restriction? That is:

- *a) activating DTI restrictions at a setting which is 'binding' during a boom but minimally binding at other times;*
- *b) activating the DTI restrictions as soon as practical; and*
- *c) applying the policy to both owner-occupiers and investors albeit not at the same level for both groups.*

Settings and activation timing (Q1a and 1b):

7. Positive Money **supports** the introduction of DTIs and welcomes their prompt implementation at this point in the property cycle. It's important that house price inflation – like general price inflation – be restrained early with tightened credit to stop an inflation surge.
8. We **do not support** the Bank's general approach, i.e. "*activating DTI restrictions at a setting which is 'binding' – i.e., restricts lending – when financial stability risks are elevated, but is minimally binding at other times.*" (p9, #35).
    a. **There is a strong case that financial stability risks are already elevated** and need to be brought down. New Zealand has had boom-bust housing markets for generations but **the reduced ability to withstand these shocks is more recent**. DTIs are the best tool RBNZ has offered in years to restrict the high growth of mortgage credit that has now pushed household debt to a level where we have too-big-to-fail banks and the next bust could threaten financial stability.
    b. Credit that is too easy to come by has produced the problem that DTIs are meant to solve. So **the title of this Consultation Paper** – *Enhancing the efficiency of macroprudential policy* – **strikes us as odd**. Why is "efficiency" in the sense of making lending easy, the primary message?
    c. Putting *technical* efficiency front and centre and only minimally restricting residential credit placates banks but points to RBNZ watering down the potential of DTIs to achieve their stability goal – let alone other important parts of its mandate, especially economic efficiency and well-being, that have suffered from credit expansion and misallocation.

d. Therefore, we **propose** that RBNZ tighten the DTI settings in a way that addresses the **size of the mortgage debt** pile by restraining the high, long term rate of credit growth that underlies it.

e. In this time of heightened instability risk:
(1) household debt levels are much higher than Government debt but, unlike Government debt, **household debt sits mostly on the balance sheets of four highly-leveraged private companies**.
(2) economic efficiency has declined as most bank credit has shifted to unproductive residential debt.

f. This situation has developed in a highly-regulated industry **under RBNZ's watch** so it needs better regulation to reverse it. DTIs with appropriate settings provide such a tool.

9. We **do not support** the position that the Bank should apply DTIs "to both owner-occupiers and investors, but ***proportionately to the risks they represent*** [emphasis ours]." (p5, #8)

    a. The main point in introducing DTIs is to lean against the boom-bust credit cycles in order to reduce financial stability risk.

    b. So the Bank should prioritise settings that moderate the boom-bust credit cycles over those that reflect borrower credit risk. If you lower credit cycle volatility, you will lower the risk to all borrowers as well as the wider economy and financial system.

    c. For example, leaning harder against the speculative behaviour of investors is more likely to meet the objective than providing them with a credit advantage over owner-occupiers.

10. We **propose** that DTIs be accompanied by a **target for total residential credit and/or credit growth rate to help reverse the long term systemic risk**.

    a. Long term residential credit growth outpaced both wage growth and housing supply over several decades, leading to the housing affordability and high household debt problems we have now. We need to reverse this by expanding residential credit at a slightly slower rate than wage growth, to help rebalance this over time (decades).

    b. We propose that the Bank introduce a target along with the DTIs to achieve this. As an initial target, we suggest that **residential credit growth be capped at 50% of the rate of wage growth**. This would be consistent with delivering a long term reduction in DTIs and lower NZ Inc's high – and risky – private debt burden.

    c. Using a wage index supports "[a] key benefit of DTI restrictions … that they link credit availability to income growth". (p21, #80)

    d. It will help to change bank behaviour, leading banks to seek out replacement lending opportunities in other, more productive, areas.

e. It can be introduced in the first instance in the form of guidance and reported in each quarterly DTI review. However, it would be important to signal that regulation will follow if voluntary compliance fails.

f. An expectations-setting approach similar to that used in the Bank's monetary policy will set banks' expectations for credit growth and show the Reserve Bank's serious intent to step in if the market doesn't adjust by itself.

DTIs leaning against monetary policy

11. We **support** implementation of DTIs as a way to **lean against negative impacts of monetary policy** by countering some of the effects of interest rate changes on house prices and financial stability.

12. We believe it is vital for the RBNZ's monetary and financial sides to work together to mitigate harms from monetary policy on the financial system and the economy.

13. We note these examples from the Consultation Paper:

> *"Changing interest rates can also influence the housing market, and lower interest rates often lead to more high-DTI borrowing. ... The increase in borrowing capacity can contribute to the cyclicality of credit cycles, which can then exacerbate shocks."* (p19, #72)
>
> *"Having the DTI restriction in place should work to reduce these risks through the cycle by linking credit availability to income growth without reference to the prevailing interest rate. … This would also allow monetary policy to focus on maintaining price stability, as there would not be as much of a concern around financial stability risks as a result of increases in interest rates."* (p19, #73)

Owner-occupiers and investors (Q1c)

14. We **do not support** the proposal to have a two-tier system with a less restrictive DTI setting for investors.

    a. Investor demand is a key driver of house price inflation at the margin so the looser approach/"enhanced efficiency" will lean against the RBNZ's primary goal for DTIs without any obvious benefits beyond investors and banks.

    b. It will further push up house prices, forcing owner-occupiers to borrow more, raising NZ Inc's total level of mortgage debt and raising financial stability risk.

    c. The Consultation Paper states "a 'fire sale' dynamic" could create systemic risk. Again, this will be amplified by investors who, as noted in the Consultation Paper, "are more likely [than owner-occupiers] to respond to a downturn by selling some of their properties to reduce their leverage" (p12, #46).

d. As well as giving investors a DTI ratio advantage, the RBNZ further advantages investors by removing the “haircut” for rental income, now counting 100% towards DTI ratio income. Banks, when making loan assessments, typically trim this to 75% or less. A rent haircut of 50% should be included in investor income ratio calculations.

e. While acknowledging a single threshold would be simpler, the Bank dismisses this, feeling “not comfortable” that it would address the differences. It cites existing behaviour that “investors tend to borrow at higher DTI ratios than owner-occupiers” and uses this to justify continuing rather than changing this undesirable behaviour. (p15, #56).

f. We believe that personal discomfort is not a sound basis for making such an important and clearly counterproductive exemption. Like the headline claim in the Consultation Paper’s title (*“enhancing efficiency”)*, it gives the appearance that banks’ profits trump making the most of the DTI tool to address market distortions and systemic risks.

15. We **support** the exemption for new housing within a single-tier system, i.e. applicable to all buyer types, not just investors.

Question 3 responses

Q3. Do you have any feedback on our proposed DTI calibration of:

- *a DTI threshold of 6 with a speed limit of 20 percent for owneroccupiers;*
- *a DTI threshold of 7 with a speed limit of 20 percent for investors*

Calibration of DTIs (Q3)

16. We **do not support** the proposed ratios of the DTIs and speed limits.

17. We **do not support** separate thresholds for owner-occupiers and investors.

18. As we noted in our response to Question 1, we believe it is important that RBNZ tighten the DTI settings to reduce the **total size (GDP share) of the country’s mortgage debt** by restraining the high rate of long term credit growth that underlies it. The same settings will reduce short term cyclical volatility.

19. It is also important that the DTI tool be introduced with **settings that will deliver a clear impact**. If the settings produce only a marginal or ambiguous result, the tool’s value will be underrated and an important opportunity to fix long-term distortions will be lost.

    a. We propose **reducing** the DTI ratio and speed limit so that it begins to bind moderately on introduction.

b. There should be a single DTI for owner-occupiers and investors with this single threshold based on a level that binds moderately on introduction for the owner-occupier type.

c. A threshold that binds on introduction will signal that the RBNZ wants a permanent (moderate) tightening of mortgage credit with a long term goal to increase financial stability, rebalance credit allocation to more productive areas, and improve housing affordability.

d. A tighter DTI from the start will give more time in less stressed conditions for RBNZ to understand DTIs and for banks to modify their lending behaviour.

Question 6 responses

LVR proposals (Q6)

20. We **support** the retention of LVRs.
21. We don't have a detailed view on their proposed operation but expect that:
    a. They should not advantage investors relative to owner-occupiers
    b. They should not disadvantage first home buyers relative to other buyer types.

Conclusion

Overall, Positive Money is pleased that the debt-to-income ratio tool has finally reached implementation stage – it's been sorely needed and a long time coming.

But we are disappointed that the approach outlined in the Consultation Paper places "enhancing efficiency", i.e. lowering barriers to lending, over fixing financial stability, housing affordability and the economic efficiency of our financial system.

We hope that the Reserve Bank uses the consultation period to address this shortcoming and gives the DTI tool the best chance to realise its full potential.