31 March 2015

Mr Cavan O'Connor-Close
Prudential Supervision Department
Reserve Bank of New Zealand
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By email: cavan.oconnor_close@rbnz.govt.nz

Dear Cavan

NZPIF SUBMISSION ON THE RESERVE BANK CONSULTATION PAPER, HOUSING REVIEW STAGE TWO: ASSET CLASS TREATMENT OF RESIDENTIAL PROPERTY INVESTMENT LOANS

Please find attached the written response of the New Zealand Property Investors' Federation Inc to the consultation paper.

The Federation is is happy to provide the Bank any further information it may require and wishes to be heard in person should verbal submissions be required.

Yours sincerely

Terry le Grove
President

Submission of the

New Zealand Property Investors' Federation Inc to the

Reserve Bank of New Zealand

Housing review stage two: asset class treatment of residential property investment loans in BS2A and BS2B

March 2015

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Introduction

One of the Reserve Bank's core functions is to help maintain financial stability. This is done in part by regulating banks.

The Bank states that their proposed change to rules is to enable loans with similar risk characteristics to be grouped together. They believe that "lending for property investment has a different risk profile than lending to owner-occupiers, and banks therefore need to have a larger amount of capital for their investment property loans than they do for loans to owner occupiers". The Reserve Bank is proposing to define residential rental property loans as different from owner occupied loans and require banks to hold larger amounts of capital for these loans.

While the Reserve Bank says that the reason for the changes is purely risk based, most of their media comments have been around reducing property prices.

The Reserve Bank is basing their decisions on studies of mortgage default rates from Ireland during the severe economic downturn following the Global Financial Crises of 2009.

The NZ Property Investors' Federation (NZPIF) believes that any higher default rates for property investors in these studies are marginal and it is unrealistic to use the extreme economic occurrences of a foreign country to determine risk levels of rental property owners in New Zealand.

In addition, some of the studies use the same term "investors"' which may include property developers and rental property owners.. These two activities have distinctly different risk factors, with developers having greater risks than rental property owners.

The Reserve Bank has attempted to minimise the effect of their policy changes saying that "pricing of loans is a matter for negotiation between borrowers and their banks, and is not regulated by the Reserve Bank". However there is no doubt that any requirements for commercial banks to hold more capital against property investor loans will put pressure on banks to increase the cost of loans and maintain their profit margins.

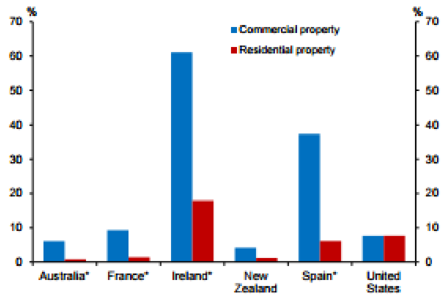
The NZPIF does not believe that there is a strong case for claiming that rental property loans have more risk than owner occupied loans. If banks are forced to hold extra capital for rental property loans and this increases the cost of borrowing for owners, it is highly likely that this extra cost will result in higher rental prices.

Analysis of the Reserve Banks rationale for change

The Reserve Bank uses information from research papers on housing loan defaults in Ireland to make their case that rental property loans in NZ are riskier than owner occupied loans.

The situation in Ireland was extreme however, with a complex series of factors that are unlikely to ever occur in New Zealand. The following Reserve Bank graph shows just how extreme the Irish situation was compared to other countries, including New Zealand.

Banks' post-crisis peak sectoral non-performing loan ratios
(percent of sectoral lending)



The papers that the Reserve Bank use to make their case state that "comparison between UK and Irish lending show loans are up to 5 times more likely to default in Ireland". The paper also states that "This reflects the seismic growth in the Irish mortgage market and relaxing of credit standards through the housing price boom, and this can be explained by the more favourable macro conditions in the UK market but puts the credit quality of the Irish book into context".

So rather than saying that financial stability can be addressed by holding more capital against investment property loans, the paper says that credit quality of loans was a key reason for a high level of defaults.

The Reserve Bank states that "evidence from Ireland suggests that loss rates for investors were nearly twice as high as for owner-occupiers". However to make this claim, the Bank has used estimates made in 2011 of expected losses in the years 2011 to 2013 rather than research of actual losses incurred.

The paper also states that the underlying arrears rate was lower on buy-to-let lending than on home-owner lending. They say that "this is unsurprising, as lenders offer extended forbearance to owner-occupiers to help them get through periods of financial difficulty without losing their home".

To summarise, the research uses estimates rather than actual outcomes to claim that rental investor defaults are almost twice that of owner occupiers. However they also say that fewer rental property owners were actually in arrears, but that banks are more likely to default rental property owners than owner occupiers.

The following graph from the UK Council of Mortgage Lenders backs this up. Both Buy-to-Let (The UK term for rental property owners) loan defaults and owner occupied loan defaults increase by similar amounts. The fact that banks are more likely to default BTL loans shows that there is very little difference in risk between the two types of loans.

Source: UK Council of Mortgage Lenders

The United States Federal Reserve produced a research paper on the risk of residential rental property loans compared to Owner occupied loans. They agreed that there appeared to be a higher default rate with rental property, stating that "over the 2005 to 2008 period, delinquency rates rose from around 5 to over 22 percent for subprime mortgages on investor owned properties, compared with a rise from 5 to around 18 percent for owner-occupied properties". However they concluded that the difference was small and "seems unlikely that they account for much of the rise in the overall delinquency rate "

Economist and Chief Research Officer for Strategic Risk Analysis Ltd, Rodney Dickens, "No matter how well justified the lending restrictions on low deposit borrowers and the planned targeting of investors by the Reserve Bank may seem, history teaches us that such interventions impose costs and will most likely have unexpected and undesirable consequences".

Dickens concludes that "Forcing banks to discriminate against investors because overseas evidence during major housing collapses has shown they have a higher default rate than owner-occupiers looks like being extremely reactionary to overseas events of potentially minimal relevance the NZ prospects. The cost of imposing such restrictions should to be weighed against what I believe is a phenomenally low probability NZ will experience an Irishscale housing collapse."

Question 1: Do you have any comments on this analysis or the Reserve Bank's rationale?

The NZPIF does not believe that the evidence is clear that rental property loans are a higher risk than owner occupier loans. The risk of increasing capital requirements for rental property loans is that loan costs will increase and rental prices will also rise.

We believe that the Reserve Bank has used its analysis of studies to find a way to introduce higher capital requirements for rental property loans.

Given the argument is not clear that rental property loans are in general at a higher risk than owner occupied loans, there does not appear to be any requirement to increase capital requirements for these loans.

The NZPIF recommends that the Reserve Bank does not proceed with plans to create an asset class for rental property loans or to require banks to hold higher capital reserves for such loans.

New Zealand Property Investors' Federation

This submission has been prepared by the New Zealand Property Investors' Federation Inc (the Federation) in response to the Reserve Bank's invitation to provide feedback on their consultation paper regarding Housing Review Stage Two: Asset class treatment of residential property investment loans in BS2A and BS2B.

Established in 1983, the Federation has twenty affiliated local associations situated throughout New Zealand. It is the national body representing the interests of over 7,000 property investors on all matters affecting rental-housing.

The Federation welcomes this opportunity to participate and comment on the draft legislation.

Industry background

The following points are provided to assist readers understand the extent of the economic and social importance of the private rental industry in New Zealand.

What is the extent of the private rental industry?

- According to a recent survey[1] of property investors it was estimated that there are over 300,000 landlords in New Zealand. There are no corporate or institutional residential landlords.

- There are over 464,000 residential rental properties[2], housing over 600,000 tenants, and worth around $150 billion[3].

[1] ANZ NZPIF Annual Survey 2007

- Private landlords are the largest providers of rental accommodation in New Zealand.

- 81% of tenants rent from a private landlord or trust[4].

- Median weekly rent for all accommodation is $350. The amount spent on rent each week is $162 million and annually this is $8.4 billion.

- Assuming a 20% equity rate on a $257,0005 property, the amount spent on mortgage interest payments, at 8% interest, ($16,000pa) is $4.8 billion.

- Most property investors (57%) have been engaged in the business for 10 or more years[6], which dispels the myth that people are investing in property to make a "quick buck". Instead, property investors are using their rental income business as a mechanism for saving for retirement and are professional and committed long-term service/accommodation providers.

Who rents?

- Census information shows 366,000 New Zealand households pay rent, up from 272,000 in 1996, with an average tenancy of around a year-and-a-half, and the average just 16 months for those with private landlords[7].

- There is a growing demand for private rental market places and the number of people living in flats or apartments is likely to increase.[8]

- The cost of renting the NZ median priced home in December 2014 was $7,852 cheaper per year than the cost of owning the same property[9]

What does the private sector offer?

- Private landlords provide rental accommodation to those seeking short or long-term housing options.

- Private rental housing owners are the most flexible and cost effective means of providing housing stock and accommodation to New Zealanders.

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[2] "Landlord group's code sets high standards" 5/9/08 NZ Herald
[3] NZ Herald 10/1/07
[4] Jo Goodhew MP, RTA Bill, First reading, Hansard 26/5/09
[5] The lower quartile figure from QV's Residential Property Sales Summary, Dec 2008
[6] ANZ NZPIF Annual Survey 2006
[7] Dept of Building & Housing Annual Report 06/07
[8] The Economic Impact of Immigration on Housing in New Zealand 1991 to 2016 At a Glance Published: June 2008 – Economic Impacts of Immigration Working Paper Series (Reported in the NZ Herald 7/6/08)
[9] Survey into the cost difference between owning a renting a home in New Zealand. Andrew King, May 2009