

MEMORANDUM FOR Graeme Wheeler, Grant Spencer
COPIED TO Bernard Hodgetts
FROM Lamorna Rogers, Macro-financial Policy
DATE 11/11/2013
SUBJECT LVR restrictions and construction lending

We are currently investigating the impact of LVR restrictions on construction lending, as part of which we are engaged in consultations with the banks and building industry. At this point, it is not possible to make a conclusive call on whether LVR limits are likely to materially impact the building of new housing.

Our survey responses from banks indicate that high-LVR construction lending makes up only a small share of overall housing lending, potentially somewhere between \$15 – \$100 million per month (Table 1). However, we caution that these numbers are likely to underestimate banks' total funding of new build lending, as they only include staged construction loans in the construction lending category (i.e. exclude loans paid in one instalment). Given monthly dwelling consents of around \$500 million, an upper limit of \$450 million per month in construction lending for new builds seems plausible (refer Appendix for details). This would imply that the banks' monthly high-LVR construction lending could be as much as \$150 million.

Table 1

Construction lending and dwelling consents			
	Share	Banks' estimates	RBNZ estimates
	%	Monthly (\$m)	Monthly (\$m)
Construction lending for new builds (share of housing lending)	2% - 6%	200 - 300	300 - 450
- High-LVR share of construction lending	18% - 30%		
High-LVR, construction share of housing loan approvals	0.3% - 2%	15 - 100	20 - 150
Housing loan approvals (\$m)		5,059	

Memo item:

Newdwellings consented (based on year to Sep-13) 504

While low relative to overall housing lending flows of \$5 billion, our adjusted estimate is significant when compared to average flows of \$500 million per month in new dwelling consents. Clearly there are large uncertainties however, with the direct effect on new building potentially amounting to a cutback in funding of as little as \$20 million or as much as \$150 million.

There are also large uncertainties around behavioural responses. For example, these numbers could be higher if banks were to lower their LVR requirements for construction lending to below 80 per cent, in order to pre-empt the possibility of construction overruns jeopardising their speed limit management. They could also be higher if banks decided to pull back from construction lending, due to the greater complexity and uncertainty attached to this lending. On the flip side, banks do have some speed limit capacity for high-LVR lending, so they could choose to fund some construction lending out of this (although feedback suggests this would typically not be prioritised over other lending, except perhaps in the case of Christchurch rebuilds). The effect could also be lower if potential high-LVR borrowers were able to increase their deposit i.e. around one-third of high-LVR recent purchasers of new homes said they could have raised a bigger deposit if necessary.

Another mitigating factor, given the housing supply shortage, is that even if some potential buyers of new homes are constrained, in many cases another buyer might be found. This will vary by region of course – in areas experiencing strong demand (e.g. Auckland) the pool of replacement buyers is likely to be significantly larger than in other regions. Investors might also be potential replacement buyers - there is some anecdotal evidence of yield-driven investors returning to the market, attracted by what they see as more fundamentally-priced housing in the absence of first-home buyers.

On the subject of first-home buyers, the general consensus seems to be that they are less likely to be high-LVR new builders. A bank noted that new housing is generally higher spec so more expensive per square metre than existing property, and initial feedback on the building industry survey of recent purchasers of new houses was that there were very small numbers of first-home buyers.

We note that house prices remain high enough for construction to be profitable once developments are approved, so the price imperative remains for new construction. Against this, Master Builders have stressed that demand is a key imperative in the building industry, and that builders continually factor this into their planning. They gave the example of a Christchurch spec builder (800 homes per annum) that has seen a sharp decline in interest, and is considering laying off half the workforce.

Originally we had thought that one reason LVRs would have little impact on housing supply is that developers are not in scope. This is looking less compelling, with around 90 – 95 per cent of new builds seemingly client-commissioned (this doesn't include new apartments, which make up around 10 per cent of dwelling consents). The strong linkages between buyer funding and new builds could mean that the NZ construction industry is particularly exposed to changes in financing conditions, and that the newness of LVR restrictions – at least in the transition period – could have a significant impact on the willingness of both borrowers and builders to commit themselves in a market where there is heightened uncertainty around the likely path of housing demand and prices. This is consistent with the general flavour of industry feedback to date, although of course we also need to remain cognisant of the lobbying factor.

Appendix

Given monthly dwelling consents of around \$500 million, an upper limit of \$450 million per month in bank lending for new builds seems plausible, under the following assumptions:

- we scale up the value of dwelling consents to account for an average cost of land of 40 percent, giving total building cost of around \$840 million;
- we assume that 10 per cent of properties are bought outright, another 10 per cent involve builder-funded projects and 3 per cent are funded by non-bank lenders, giving total potential bank funding of building cost of around \$650 million;
- we assume an average 70 percent LVR on bank funding, giving an upper limit of \$450 million.

House prices and construction costs (*January 2002=1000*)



