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MEMORANDUM FOR	Grant Spencer
FROM	Macro-Financial Policy
DATE	6 December 2013
SUBJECT	**Q & A: Construction exemption (internal)**
FOR YOUR	Information

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1. What do you define as construction lending?

- For the purpose of the exemption, this means all residential mortgage lending to finance the build of a new residential property. We would expect that the construction loan would be for a property where the borrower has made a financial and legal commitment to buy in the form of a purchase contract with the builder, and the property has not yet been built. This could be traditional 'construction lending' where the loan is disbursed in staged payments, or it could be a loan to finance the purchase of a property, which will be settled [in one payment] once the build is complete.
- The exemption would also apply to top-ups to the loan arising from construction cost overruns during the build. It would not apply to borrowing for discretionary expenditure, such as furnishings.

In scope	
Construction loans – both progress payments and single payment tranche	We don't insist that payments are staged during construction (could be at end)
Owner-occupiers and investors	Whether buyer owner occupier or not, construction still adds to supply
Construction cost overruns	This is still funding a new build
New home, existing home demolished	Adding to supply (old home must have no longer been appropriate for section)
Buyer commits before build	Buyer must have paid deposit before construction starts (not be buying partially built spec home)
Not in scope	
Purchases of newly built houses (spec/off the shelf)	See Q&A
Remediation and renovation	See Q&A
Furnishings etc	Not adding housing to supply.
Buyer commits when construction underway or complete	See Q&A re spec homes. Partially built spec homes – as with complete spec homes, we don't see a need to exempt.
Loan to buy section	Don't want to encourage land speculation. Section can still be collateral when construction loan occurs. Buying a section to build on, the buyer will need a substantial deposit relative to section value (to be able to complete the build) so lack of exemption should not be an impediment.

2. **When does the exemption apply from?**
   - The exemption is applicable to all construction lending flows from 1 October 2013. Banks that wish to take advantage of the exemption will need to furnish data on their construction lending flows, similar to that already provided as part of the LVR new commitments exemption reporting.
   - We will shortly be contacting banks with further details of the construction exemption reporting requirements.
   - We will also be consulting on the requisite changes to implement this in BS19.

3. **Will the exemption mean that anyone can now get a 100% LVR construction loan?**
   - Not necessarily. Banks apply their own lending criteria to construction loans and are likely to set their own limits on maximum LVRs at which they are prepared to lend. We still expect banks to act prudently in this area.

4. **Will investors benefit from this at the expense of FHBs?**
   - This exemption will apply to all construction loans, including those to FHBs.
   - Hence we don't see it conferring a particular benefit to investors over FHBs.

5. **Why are you not exempting purchases of newly built houses (spec/off the shelf)?**
   - The reason for exempting banks' construction lending is to ensure that we do not discourage banks from lending to households to build new houses, as this could impede the supply of new homes, which we see as key to resolving the underlying imbalances in the housing markets.
   - In the case of newly built houses, the houses have already been built, with the build being funded by developers (not subject to LVR restrictions) or investors.
   - We estimate that the share of newly built houses that would be sold to high-LVR borrowers is very small, at around 2 percent of all new builds. We expect that in regions where there is excess housing demand, replacement buyers should be able to be found.
   - Developers are also not subject to the constraint of needing a buyer to fund the build. Combined with their greater market power, therewould be a higher risk of distortions in the housing market, in the form of over-building or raising prices. We also don't want to encourage investor flippers i.e. middle men.
   - Such an exemption would also be difficult to ring-fence, making it difficult to monitor and enforce.

6. **Is there a risk of too much construction happening because of the exemption?**
   - It is possible that the construction exemption will increase the relative attractiveness of new housing compared to existing housing, for some low-deposit borrowers. However, we expect that banks will maintain their normal prudential standards around any high-LVR lending.

7. **Why are you excluding remediation lending, such as leaky homes?**
   - Banks have some capacity to meet such lending though the use of their high LVR speed limits. Given that they already have an existing exposure to the property, they have an incentive to finance the remediation.
   - There is already some government assistance in place for leaky home remediation.

- Remediation lending is potentially very broad and would be very difficult to ring-fence in a way that would avoid creating distortions or other unintended consequences.

8. What effect will the construction exemption have on financial system risk?

- Objective of dampening excesses in house prices and credit growth -
  - At the margin, we would expect exemption to help mitigate the risk of a destabilising correction in house prices, by ensuring that LVRs don't interfere with the housing supply response, which we see as key to resolving the underlying imbalances in the housing market.

- Resilience objective
  - bank feedback is that construction lending is inherently more risky and complex due to the nature of the building process, but actual loan performance is no different to rest of portfolio. Banks typically manage this risk through tight controls around approvals of such lending. We will be monitoring banks' use of the exemption, particularly any large scale increases in activityThis is already a planned topic of discussion between PSD and the banks.

- Unintended consequences
  - There is a risk that unsuitable borrowers might opt to build due to greater relative attractiveness, leading to low quality loans, overbuild etc. However, we would expect banks to continue to apply tight prudential criteria to the provision of such loans even in the presence of an exemption. In practice, Australian experience with new build subsidies shows no such consequences.

9. Regional effects???

- We would expect these exemptions to be of most benefit in those regions currently facing excess demand for housing and where the economics of building a new house compare favourably to buying an existing one e.g. Auckland. Of course, an exemption will not alleviate other possible constraints on housing construction, such as shortages in the supply of suitable land.

10. How much difference will this initiative have on new builds and will the effect most likely be in Auckland ?

- Our estimates suggest that up to 12 percent of total new-builds would fall into the exemption category. This would be the equivalent of about 200 new builds per month.
- Auckland currently accounts for about 25 percent of the country's new dwelling consents although its share of the country's high-LVR construction loans is not known. We would certainly expect some of the effect of this initiative to be centred in Auckland.

11. Did the Reserve Bank consider exempting new construction loans at the outset (i.e. did we simply forget about it) ?

- Yes, we did consider it at the outset, but were guided by feedback from the LVR consultation, which did not generally focus on the effect of restrictions on construction lending.

- The overall philosophy when designing the LVR regime was to keep the approach simple and to limit exemptions given the risk of distortions and unintended consequences. We felt that the speed limit approach would provide the banks with some capacity to meet such lending, which we understood to be a small proportion of total residential lending.

12. Why didn't you do this from the start [long answer]?

- As noted in our response to submissions to the consultation on LVR restrictions, the intent of exemptions is to mitigate efficiency costs without unduly undermining the effectiveness of LVR restrictions.

- When we undertook our consultation on LVRs the issue of construction lending was not one that was widely raised either by the banks or building industry. We were also conscious that most construction lending typically occurs at lower LVRs, suggesting that most construction lending would be unaffected by the restrictions and there would therefore be limited efficiency costs.

- One of the reasons for adopting the speed limit approach to LVRs was to ensure that banks would have capacity to continue to undertake some high LVR lending to creditworthy borrowers. There was thus an assumption that such lending could be met out of the speed limit, again mitigating efficiency costs.

- We were trying to keep the number of exemptions to a minimum, on order to reduce complexity in the framework, and risk to its effective implementation.

- In response to feedback from banks and the building industry since LVR restrictions have come into effect, we have since sought additional information on high LVR construction lending which suggests it may be more important than previously thought. The evidence further suggests that banks are less likely to prioritise such lending within their speed limits owing to the greater uncertainty and complexity associated with such loans. Banks have also suggested that they might lower their maximum LVR on construction lending from 80% to 70%, in order to reduce the risk of overruns compromising their speed limit management. This makes the LVR restrictions more far-reaching than expected.

- Since the purpose of LVR speed limits is to dampen excess demand for housing, the exemption is consistent.

13. To what extent has the LVR speed limit already had an adverse effect on new construction activity i.e. prior to today's announcement?

- We do not believe there has been a significant effect on actual construction activity to date particularly given the long lags between expressions of interest in new building through to the actual work being undertaken. Building consent data weakened slightly in October but this followed strong growth in the previous two months - thus there is little evidence to date of a major reduction in building intentions. Moreover, most banks have continued to honour pre-approvals for high LVR loans (including construction loans) in the first two months of the speed limits.

- Potential high LVR borrowers who may have been turned down for new construction lending over October and November may now be able to continue with their construction plans.

14. Did the Govt tell you to do this? What consultation with them did you do?

- No, we have been looking at this issue for some months as already acknowledged (e.g. in our November FSR).
- We consulted with the Government as is required under the Memorandum of Understanding.

15. What impact will this have on your previously published effects on house prices and the OCR impact?

- At the margin, it should help to reinforce the dampening effect of LVR restrictions on house price inflation but we would expect the influence to be small given the magnitude of lending and construction that will be affected by the restriction.

16. What else are you considering exempting? If this, why not regional?

- We have no other exemptions under consideration nor are we considering regional application of LVRs.

17. Will you consider treating NZ buyers differently from foreigners?

- No, not if they are borrowing via the NZ banking system.

18. How are the exemption shares calculated (Table 1 of factsheet) ?

- The recommended exemption amounts to 10.4 percent when expressed in value of dwellings, or 11.5 percent when expressed in number of dwellings.
- The share of new dwellings by number that directly depend on high-LVR lending by banks (2nd column) has been calculated using:
  - the number of dwellings
  - the estimated high-LVR share of banks' construction lending (based on banks' replies to the recent survey)
  - the ratio of low to high LVR lending in banks' overall housing portfolio (from the LVR new commitments survey).
- The share of new dwellings by value that directly depend on high-LVR lending by banks (3nd column) has been backed out of the share by number, assuming that the average high-LVR share is 90 percent.

Funding of new builds	% of dwelling consents (units) Mid point	% of dwelling consents (units) Scaled to eliminate residual	% of dwelling consent value (value)
Bank funding			
Construction lending (staged instalments)			
of which : LVR <= 80%	43.0%	40.5%	26.3%
of which : LVR > 80%	10.0%	**9.4%**	**8.5%**
Construction lending (other)			
of which : LVR <= 80%	3.0%	2.8%	1.8%
of which : LVR > 80%	2.3%	**2.1%**	**1.9%**
Other sources:			
NBLI funding	3.0%	2.8%	2.0%
Developer/investor funding	10.0%	9.4%	6.6%
of which : end purchaser LVR > 80%	1.9%	1.8%	1.6%
Cash purchase	35.0%	32.9%	32.9%
Memo item			
Residual	-6.3%	0.0%	
Customer deposit contribution			20%