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| **MEMORANDUM FOR** | PSD |
| **FROM** | Macro-Financial Policy |
| **DATE** | 10 December 2013 |
| **SUBJECT** | **Q & A: Construction exemption (PSD)** |
| **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** | |
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| 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. **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.

5. **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.

6. **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 activity. This 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.

**7. 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.

**8. 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.

**9. Will you consider treating NZ buyers differently from foreigners?**

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