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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

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To: Minister of Finance
Associate Minister of Finance (Joyce)
Minister of Housing (Smith)
Minister of Commerce (Foss)

Fact sheet on high-LVR lending and construction

1. This note provides information on the role of high-LVR bank loans in financing construction lending, and then provides some further details about the proposed construction exemption in question and answer format.

2. Table 1 provides a summary of how new construction projects are financed. We estimate that approximately 12 percent of new builds were directly financed by a high-LVR bank loan prior to the introduction of LVR restrictions. A further 2 percent of construction projects are estimated to have been financed by developers, but to have been sold to a high-LVR customer on completion. This latter category will not be subject to the proposed exemption. The exemption will cover loans that finance the construction of a new dwelling, including cost overruns, but will not cover the purchase of a new dwelling that is already complete.

Table 1: Composition of new build financing

	% of consents	Number of consents
Bank funding		
of which : LVR <= 80%	43%	714
of which : LVR > 80%	12%	191
Other sources:		
NBLI funding	3%	47
Developer/investor funding	9%	155
Cash purchase	33%	543
Monthly building consents	100%	1650
memo item: Developer funding with end purchaser LVR > 80%	2%	29

3. Banks suggest that due to the extra complexity and risk associated with construction lending, they would be unlikely to allocate much of this lending within their high-LVR speed limit. Furthermore, with the risk of cost overruns banks have also become more cautious about lending for new builds at LVRs of below 80 percent, so the proportion of affected projects could be somewhat larger than this estimate.

4. However, a number of affected projects may still proceed if customers are able to save a little extra or find another source of funding to meet increased deposit

requirements. Additionally, in areas of strong demand such as Auckland, higher-deposit buyers may replace cancelled orders.

5. While high-LVR loans represent a significant proportion of new construction lending, the share of overall mortgage lending is much smaller. Prior to the introduction of LVR restrictions, construction lending may have been around 4 percent of bank lending. About 25 percent of this lending was at high LVRs, so high-LVR lending for construction only represented 1 percent of mortgage lending.

Table 2: Approximate construction share of bank lending

	% of lending	$m
Construction lending	4%	$180
of which : LVR > 80%	1%	$45
Monthly mortgage commitments		$4,500

6. This relatively low share of bank lending means that a construction exemption should have a relatively limited effect on credit growth and overall bank resilience. To the extent that the exemption does result in higher construction activity, it is likely to further the policy goal of reducing house price pressure.

Further details on the proposed construction exemption

1. Did the Reserve Bank consider exempting new construction loans at the outset?

- 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.

2. What has changed?

- 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.

- As noted above, the issue of construction lending was not one that was widely raised either by the banks or building industry. The Bank was also conscious that most construction lending typically occurs at lower LVRs, suggesting there would therefore be limited efficiency costs.

- In response to feedback from banks and the building industry since LVR restrictions have come into effect, the Bank has 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.

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

3. Does this exemption defeat the purpose of the LVR restrictions?

- If the exemption supports increased supply of new housing, it should help to cool house prices. This is consistent with one of the objectives macro-prudential policy, which is to dampen excesses in house prices and credit growth.

- The Bank will be monitoring banks' construction lending, to ensure that any increase in such lending is appropriately risk-managed so as not to compromise our other objective of financial system resilience.

4. 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. The Reserve Bank still expects banks to act prudently in this area.

5. **What is classed as construction lending?**
   - For the purpose of the exemption, this means all residential mortgage lending to finance the build of a new residential property. The Bank expects 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, prior to the property being 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.

6. **Why is the Bank 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.
   - Developers are also not subject to the constraint of needing a buyer to fund the build. Combined with their greater market power, there would 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.

7. **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.

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

   - 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 and Christchurch currently accounts for more than half the country's new dwelling consents although their share of the country's high-LVR construction loans is not known. We would certainly expect a substantial

amount of the the effect of this initiative to be centred in Auckland and Christchurch.

9. 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.

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