



Response to submissions on the proposed construction exemption in BS19

March 2014

Introduction

1. On December 20, the Reserve Bank published a consultation paper with proposals to add a construction exemption to BS19 (“Framework for Restrictions on High-LVR Residential Mortgage Lending”) and some other material related to the potential for non-mortgage debt of mortgage customers becoming a BS19 avoidance channel. Submissions closed on 14 February 2014. Nine submissions were received, principally from registered banks.
2. This document reports on the submissions received that were related to the construction exemption and explains the final shape of this exemption within BS19. The Reserve Bank expects to shortly consult on the final step in the second stage of the review of housing capital, namely revised definitions in the capital adequacy framework documents BS2A (standardised approach) and BS2B (internal models based approach). The exact form of the BS19 anti-avoidance clauses is somewhat contingent on the definitional decisions arrived at within BS2A and BS2B, so we have delayed reporting on this aspect of the December BS19 consultation and will provide that information nearer the time that BS2A and BS2B are finalised.

Submissions related to the construction exemption

3. In general, submitters supported the general framing and intent of the construction exemption. Banks that were involved in lending for construction generally said they would use the exemption and saw few practical difficulties in supplying information on exempt construction loans as part of the existing new commitments reporting supplied to the RBNZ.
4. Respondents noted that new build residential lending generally exhibits similar risks to other residential mortgages, and is subject to similar high LVR lending premiums as other residential mortgages. However, extra provisions/buffers are usually required within the loan to account for extra uncertainties/delays inherent in construction. Residential construction loans also carry stricter valuation (e.g. initial and revised Registered Valuations) and verification requirements (e.g. consents). Construction is generally classified as a separate category of loan (included with other types of construction at present) and re-booked as residential on completion. As such, a direct comparison between asset quality of existing and new construction residential mortgages is not currently available.
5. Submitters suggested there was a small risk that the exemption could increase risk by increasing the exposure of banks to high LVR construction lending. However, banks’ higher precautionary credit risk standards in construction lending are expected to mitigate this.

Points around the buyer needing to be committed prior to the “commencement of construction”

6. A number of submitters queried the proposed rules requiring that the buyer “committed to the construction or purchase of the new residential dwelling prior to the commencement of construction of the dwelling”. Some submitters requested additional clarity about what this allowed, while others felt that it should be possible for the exemption to apply to partially built, nearly complete or complete new dwellings, generally stating that this would increase the effectiveness of the exemption in boosting new construction.
7. Specific questions about the proposed definition included the following:

- a. Can the costs associated with removing an existing dwelling from a section (rather than demolishing it) be included?
 - b. Are apartments bought “off the plan” in scope?
 - c. Does the term ‘essential services’ allow for things like driveways to be completed?
8. A more general point made by submitters was that it may sometimes be easier to sell a property to buyers once early construction reveals something of the shape of a house (e.g. once the slab is poured).

Response

9. We developed the proposal to cover homes that were not yet built, as homes that are already built have already had their construction funded. The development of rules that required that the buyer had committed prior to the construction was also seen as diminishing any risk that the construction exemption encouraged speculative behaviour. Specifically, we had concerns about people being able to buy or fund construction projects to completion then sell them (with an exemption) to high-LVR buyers who might (since the house was complete) be able to obtain near-100% finance under the exemption. Conversely, buyers who commit at an early stage of construction are not going to actually move in for a number of months and are inherently making a longer-term choice. They will also need to have a reasonable deposit (to satisfy the bank’s credit policy) given the risks around construction lending.
10. For these reasons, we are still uncomfortable with an exemption for complete or largely complete homes. We agree that the exemption as framed will not overly increase risk on bank balance sheets, but would be more concerned about this if the exemption extended to near-complete properties. We acknowledge that the exemption might stimulate a bit more construction if it extended to fully complete properties, but industry feedback suggests that a large majority of residential construction is undertaken with a buyer committed at the time construction begins.
11. However, we always intended that the policy would not stop some houses in a subdivision being sold with an exemption once the subdivision had started, and made that clear in the consultation paper (“it is acceptable for the services to a section (e.g. roading, power and phone lines) to have been (already provided)”). The responses described above have led us to revise the wording of BS19 slightly to make it clear that infrastructure like driveways and removal of existing properties are in-scope. For the avoidance of doubt, we also note that off the plan apartment purchases are also in scope.
12. To provide a more general scope for some construction work to be completed before a builder finds a buyer we have also amended our proposal to allow loans to be exempt if the buyer is committed to the construction “before the commencement or at an early stage”. In the guidelines, we provide examples of the sort of building work we consider is included in the “early stages” of typical projects, namely “substructure and framing”. Industry contacts suggest that less than 30% of total construction costs have been incurred in a typical project by the substructure and framing stage, and we consider that this 30% metric can also be used as a guide as to when construction is at an “early stage”. The relevant Reserve Bank team will be happy to provide further guidance to banks in interpreting this rule.

Non-essential inclusions in building contract

13. Submitters made a number of submissions related to the precise language on the items which are able to be included in an exempt loan. We intended the exemption to be able to facilitate the funding of any item which is typically considered “part of the house” but our exact wording excluded “moveable chattels” and at one point the consultation paper suggested “furnishings” were not in scope. One submitter mentioned curtains and appliances (e.g. ovens) as boundary issues – these are strictly speaking moveable but are typically sold with a house. Another submitter mentioned light fittings and carpets and noted that it would be impractical for lending officers to carefully scrutinise building contracts for items that are not able to be lent against under the exemption. Finally, one submitter requested confirmation that professional expenses (architects, engineers, etc) are included.

Response

14. The boundary items noted above (carpets, light fittings, ovens, and carpets) are intended to be included within the exemption. We have altered the words in BS19 (to restrict “the purchase of items (such as movable furniture or appliances) that are not normally retained in a property when it is sold”) to make this clearer. We will also be happy to provide guidance on any further uncertain cases to the banking community.
15. We do not want loan officers to have to scrutinise a building contract in major detail to identify and exclude items commonly sold as part of a new construction. However, if there are major items included in a contract that cannot reasonably be construed as chattels (for example a furniture package or perhaps even a car included in a package deal) we would expect this to be identified by the bank as part of standard due diligence. If the bank was comfortable under its normal credit practice writing the loan with these non-exempt items included, we would expect the non-exempt items to be considered a top-up to the exempt loan for the purposes of the new-commitment template, as noted in the original consultation paper. Similarly, when funding cost overruns or variations the bank will need to identify any major non-exempt items included within the requested overrun or variation.
16. Both the existing loan and any lending to cover overruns can indeed include funding for professional expenses.

Other matters related to construction

17. One submitter suggested it would be appropriate for a loan to purchase land and build to only be eligible for the exemption when it is envisaged that the construction will be complete a reasonable period after the purchase of the land. Otherwise, it might be possible to effectively use the exemption to buy vacant sections with a notional plan to construct on the property a long time after the land was bought.
18. Some submitters made some technical definitional suggestions which led to the changes and comments outlined below.

Response

19. The Reserve Bank concurs that it is appropriate for BS19 12(1)(e)ib to include an explicit requirement that the new residential dwelling “is expected to be completed no more than 18 months after the loan commitment date”. Industry contacts have noted that this length of time period is appropriate given comments from the Builders Association regarding the current shortage of qualified builders. Note that the loan will be exempt on the basis of **expected** completion time (so unforeseen delays will not cause loans to retrospectively lose their exempt status).
20. A few technical amendments to BS19 have also been made, including the following:
- a. The possibility of staged loans for construction has been captured in 12(1) e (1) by including the full amount of the previously made loan and the subsequent (staged) increase in the loan value within the definition of a “construction loan”.
 - b. An incorrect reference to 12(1)(f)(i) in 14(1)(c) has been removed and replaced by 12(1)(e)(i) i.e. “bank must determine that the loan is for one of the purposes in 12(1)(e)(i)”.
21. The consultation paper referred in several places to construction of a residential property – as one commenter noted, it would have been clearer for this to say construction of a residential “dwelling”. BS19 itself refers to construction of a residential dwelling, but a mortgage over a residential property, which appears appropriate.

Operation of the Construction Exemption

22. In December, the Reserve Bank said the construction exemption would apply retrospectively, so that construction lending could be exempted in the first LVR measurement period (6 months ending 31 March 2014).
23. As previously advised the Reserve Bank has requested banks to report any construction lending they consider exempt for BS19 purposes as part of the new commitments reporting, beginning with the March 2014 survey (due in mid-April). At this time the Bank also expects banks to provide backdated information on any construction loans they wish to exempt dating back to the start of the LVR restriction period. Further information on this is available from the Reserve Bank statistical contacts.