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WAYNE BYRES
Chairman

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TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

EMBEDDING SOUND RESIDENTIAL MORTGAGE LENDING PRACTICES

In recent years, APRA has implemented a range of supervisory measures to reinforce sound residential mortgage lending practices. This has included benchmarks on investor loan growth and interest-only lending, prudential guidance to strengthen industry standards and targeted reviews to scrutinise lending practices. In an environment of heightened risk, this level of enhanced supervisory oversight has been, in APRA's view, important and required.

The benchmark on investor loan growth that APRA introduced in December 2014 was designed to be a temporary measure, introduced at a time when lending standards were not as robust as they needed to be: standards did not reflect the risks that were building in the environment. Growth in investor lending was accelerating, management oversight of risks in this area had relaxed, and competitive pressure was restraining many ADIs from tightening policies unilaterally.

Since the benchmark was applied in 2014, however, the ADI industry has taken steps to improve the quality of lending and increase balance sheet resilience. There has been a clear reduction in higher risk lending, with investor loan growth moderating, interest-only lending declining and high loan-to-valuation lending also markedly lower. There have also been improvements in lending policies, increasing the rigour of serviceability assessments for new borrowers. Accompanying this, there has been an uplift in capital resilience, as the industry makes progress towards the 'unquestionably strong' targets announced by APRA in mid-2017.

Removing the investor loan growth benchmark

In this context, APRA is now prepared to remove the investor loan growth benchmark for ADIs that have contained their growth and are able to provide assurance on the strength of their lending standards. The benchmark will no longer apply from 1 July 2018 where an ADI has been operating below it for at least the past 6 months, and the ADI's Board has provided the required assurance to APRA on both lending policies and practices.

Further detail on the specific issues on which Board assurance is sought is outlined in the Attachment to this letter. The benchmark on interest-only lending, established in March 2017, will continue to apply until further notice.

Next steps

Together with the other members of the Council of Financial Regulators, APRA will continue to closely monitor conditions in the housing market and the economic environment more generally. Despite the removal of the benchmark for individual ADIs, a return to more rapid rates of investor loan growth at an aggregate level would nevertheless raise systemic concerns. Such an environment could lead APRA to consider, for example, the need to apply the counter-cyclical capital buffer or some other industry-wide measure.

Yours sincerely,

ATTACHMENT

EMBEDDING SOUND RESIDENTIAL MORTGAGE LENDING PRACTICES

In order to no longer be subject to the investor loan growth benchmark from 1 July 2018, APRA requests each ADI's Board to provide written confirmation by 31 May 2018 that their policies and practices meet the expectations set out below. As part of this, Boards should also confirm that they have operated below the benchmark for at least the past 6 months. For ADIs that use the internal ratings-based (IRB) approach to capital adequacy, Boards should include confirmation that capital ratios will meet the 'unquestionably strong' benchmarks by January 2020.[1]

Lending policies

The assurance provided by the Board should confirm that lending policies meet APRA's guidance on serviceability assessments as set out in *Prudential Practice Guide APG 223 – Residential Mortgage Lending* (APG 223). This should include, in particular, that serviceability assessments incorporate:

- interest rate buffers comfortably above 2 percentage points over the loan product rate, and interest rate floors comfortably above 7 per cent;
- application of these interest rate buffers and floors to both a borrower's new and existing debt commitments, with sufficiently conservative proxies used where necessary;
- discounts on uncertain and variable income, with haircuts of at least 20 per cent for most types of non-salary income and expected rental income; and
- for interest-only loans, an assessment of serviceability for the period over which the principal and interest repayments apply (i.e. excluding the interest-only term).

Lending practices

The assurance provided by the Board should also confirm that lending practices meet APRA's guidance on the assessment of borrower financial information and management of overrides, as set out in APG 223. In particular, APRA expects ADIs to commit to:

- improving where necessary the collection of information on borrowers' actual expenses, to reduce reliance on benchmark estimates. The use of benchmarks should be closely monitored, and applied in a low proportion of lending (consistent with the typically low calibration of such estimates);[2]
- strengthening controls to verify borrowers' existing debt commitments, and preparing to participate in the new comprehensive credit reporting (CCR) regime in the future;

[1] APRA Information Paper, *Strengthening banking system resilience - establishing unquestionably strong capital ratios*, 19 July 2017.

[2] ADIs should not rely on benchmarks, which may not be an appropriate proxy of actual expenses. Benchmarks should provide a floor where declared expenses appear low, not a replacement for making reasonable inquiries.

- prudently managing overrides to lending policies, with risk tolerances set by the Board on the extent of exceptions to serviceability policy (negative serviceability) and serviceability verification waivers; and

- developing internal risk appetite limits on the proportion of new lending at very high debt to income levels (where debt is greater than 6 times a borrower's income), and policy limits on maximum debt to income levels for individual borrowers.

Where changes to limits, policies and systems are required to deliver commitments on lending practices, ADIs should include an indication of timing for implementation, which should be within the next 12 months (other than for CCR). APRA will monitor progress and continue to closely review changes to lending standards in the course of supervision.[3]

For ADIs that are not able to provide this confirmation or meet APRA's timelines, or have operated with investor loan growth above 10 per cent during the past 6 months, the benchmark will continue to apply. ADIs that are not able to provide the confirmation by 31 May 2018 may approach APRA after that date, should they subsequently be in a position to do so.

[3] At an individual borrower level, Boards should be cognisant that ADIs are required to comply with the responsible lending obligations in the National Consumer Credit Protection Act 2009 (NCCP Act). Any policy overrides or waivers must also comply with the NCCP Act.