Re: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Written Submissions of the Australian Prudential Regulation Authority (APRA)

Round 1: Consumer Lending

Introduction

1. Pursuant to an application made by APRA on 2 March 2018, APRA was granted leave to appear at the Royal Commission hearings commencing on 13 March 2018 (**Round 1**).

2. The case studies investigated by the Commission in Round 1 have focused on a range of conduct issues in consumer lending, in respect of which the Commission now seeks submissions.

3. While the specific questions of misconduct in each case study are for the relevant financial institutions to address, the case studies have also raised broader issues in connection with ADI industry lending practices in respect of which APRA has a perspective as prudential regulator.[1]

APRA's role as prudential regulator

4. APRA is established by the *Australian Prudential Regulation Act 1998* (Cth) (**APRA Act**). APRA's powers and functions in the case of the banking sector, are conferred under the *Banking Act 1959* (Cth). APRA is empowered under the *Banking Act* to make prudential standards and issue prudential guidance. Other than for specific financial ratios which ADIs must maintain APRA's prudential standards typically adopt a principles based approach supported by additional guidance on implementation.

5. APRA's objective in undertaking prudential regulation and supervision of the banking industry is to protect depositors and support financial stability,[2] ensuring the banking sector is resilient to risks and well positioned to support the Australian economy through the financial cycle. The focus of APRA's prudential supervision is therefore on the bank rather than market regulation, the safety of deposits rather than outcomes for individual consumers, and overall financial system

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[1] See *Australian Prudential Regulation Act 1998* (Cth), s8(2) (APRA objectives in performing its functions); s9 (APRA functions conferred); and eg s12 of the *Banking Act 1959* (Cth) (Protection of depositors of ADIs).

[2] Pursuant to s12 of the Banking Act s12(1) "It is the duty of APRA to exercise its powers and functions under this Division for the protection of the depositors of the several ADIs and for the promotion of financial system stability in Australia."

stability rather than specific cases of conduct.

6. There are, however, industry issues which are relevant to both prudential and conduct regulation. For example, several of the steps that APRA has taken in recent years to strengthen bank lending practices, and thereby improve the quality of loan portfolios, will also have improved compliance with responsible lending requirements and helped to enhance controls against fraud.

7. APRA has, therefore, worked closely with ASIC in the supervision of lending practices, both through the Council of Financial Regulators (CFR) and on a bilateral basis. For example, APRA's industry guidance on mortgage lending, *Prudential Practice Guide APG 223 – Residential Mortgage Lending*, specifically refers to ASIC requirements on responsible lending, and APRA's supervisors have reinforced the importance of meeting these requirements in the course of reviews and engagements with entities.

8. APG 223 states that "Failure to meet responsible lending conduct obligations, such as the requirement to make reasonable inquiries about the borrower's requirements and objectives, or failure to document these enquiries, can expose an ADI to potentially significant risks. A prudent ADI would conduct a periodic assessment of compliance with responsible lending conduct obligations to ensure it does not expose itself to significant financial loss".

APRA submissions on questions raised by Consumer Lending case studies

9. The Commission has focused in the first round of public hearings on consumer lending practices, including case studies in residential mortgage lending and a range of other retail products. The hearings have centred on some general themes, such as poor decision making and the "first mover" commercial disadvantage for lenders in raising their standards. They have also covered several specific issues, such as weaknesses in the use of expense benchmarks for borrowers, inappropriate remuneration structures and inadequate systems and processes.

10. In its role as prudential regulator, APRA has in recent years substantially increased the intensity of its supervision of residential mortgage lending. APRA has placed a strong focus on strengthening mortgage lending standards, given the scale and materiality of the portfolio from a prudential perspective.[3] APRA has focussed less on car finance and credit card lending at an industry level, given the smaller relative materiality of these portfolios and hence reduced potential to impact on the financial soundness of individual institutions.

11. These submissions focus on the following questions posed by Counsel Assisting and the Commissioner during the course of closing address:

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[3] At an industry level, residential mortgages account for around 60 per cent of ADI lending. For some ADIs, this proportion is significantly higher. APRA, *Statistics: Quarterly ADI Performance* (December 2017), (Table 1b: ADIs' financial position).

(a) the first mover issue as a commercial impediment to change;

(b) use of the HEM benchmark in connection with home lending;

(c) waiver of bank policies in assessment of home loan applications; and

(d) the impact of remuneration and incentives.

First mover disadvantage

12. APRA's increased supervision has, in large part, been in response to the risks in the operating environment, with high and rising household debt, high house prices, low interest rates, and subdued income growth. In such an environment, it might be expected that prudent lenders would tighten their lending standards in the face of higher risks. In practice, however, APRA observed that competitive instincts and a drive to retain and grow market share was leading to a steady erosion in standards. Competitive pressures not only deterred lenders from moving unilaterally to raise standards and tighten controls, but produced a weakening in standards at a time when the opposite would be more appropriate.

13. This outcome is a product of the "first mover" commercial disadvantage that the Commission has rightly highlighted as a key concern. However, APRA's concern has also been that, at a time when standards are being eroded, the first mover disadvantage plays out as a 'last mover disadvantage' – the lender that seeks to maintain its standards is disadvantaged as market share flows to competitors who adopt a more lax approach.

14. APRA has observed reluctance from institutions to be the first mover to adopt more prudent practices (or be the hold-out against an erosion of standards across the industry) across all APRA-regulated industries. Instead of self-discipline, there is often a preference among regulated entities for regulators to mandate improved practices so that there is a simultaneous response amongst all industry participants. APRA acknowledges that, when unilateral action is taken by an institution itself, there are understandable commercial considerations where customers, market-share and profits may be lost to other institutions that do not adopt similarly prudent practices. APRA accepts there is a balance to be struck between prudent risk management and the broader commercial considerations, and this balance can at times be difficult for institutions to manage. Ultimately, however, this is not a legitimate reason to adopt or maintain poor practices.

15. APRA has observed this tension playing out in a number of areas in relation to residential mortgage lending. A reluctance to improve lending standards, voluntarily adopt comprehensive credit reporting, and change sales incentives in the face of concerns that such changes would not be adopted by competitors have all led to APRA needing to be more interventionist in its approach to supervision of mortgage lending than it would ordinarily be.

16. APRA's view is that the impact of the steps that APRA has taken has been to reduce higher risk lending, raise lending standards and increase capital resilience.[4] ADIs have in aggregate reduced growth in investor lending, as well as the proportion of new lending that is on an interest-only basis. There have also been improvements in ADI serviceability assessments, which are used to test borrowers' ability to service and repay the loans. ADIs now, for example, consistently assess borrowers' ability to repay assuming an interest rate of more than 7 per cent (or more than 2 per cent above the loan's interest rate, if higher). This seeks to ensure that potential increases in interest rates do not adversely impact on a borrower's capacity to repay a loan. Some ADIs were, prior to APRA's guidance, using interest rate assumptions materially below these levels. ADIs also now apply larger discounts to certain sources of income in their serviceability assessments, adding an additional level of conservatism into their judgements about the borrowers' ability to repay.

17. APRA is mindful of significant media commentary on the robustness of bank lending practices and potential financial implications arising. APRA considers it is important to balance this with a recognition of the steps that have been taken to date, and are continuing to be made, to maintain a prudentially sound industry. The case studies typically date to some years prior, and APRA has sought to drive an improvement in standards to help limit the potential for them to be repeated.

18. Further detail as to the supervisory measures taken by APRA is contained in the paper issued by the Royal Commission on Consumer Lending Reforms (Background Paper 5).

Targeted Review

19. Despite these improvements, APRA's view is the environment remains one of heightened risk and APRA is maintaining its close supervision of mortgage lending standards. As part of this, APRA has been conducting a Targeted Review of bank lending practices.[5]

20. The aim of the Targeted Review has been to look beyond stated lending policies of the ADI under review, to also scrutinise actual lending practices. The review has examined lending controls through a granular audit of a sample of loan files, seeking to assess whether tighter policies have been consistently translating into more prudent lending decisions in practice.

21. The review is being conducted by external audit firms, reporting on the effectiveness of controls to ensure the completeness and accuracy of borrower financial information used in loan

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[4] See Attachment (Selected housing-related charts) to APRA Chairman's Opening Statement to Senate Economics Legislation Committee, Canberra, 1 March 2018. http://www.apra.gov.au/Speeches/Pages/Opening-Statement-01Mar18.aspx.

[5] Under APRA's Prudential Standard APS 310: Audit and Related Matters, APRA has the power to require an ADI to appoint an auditor to prepare a report on a particular risk area. Generally, APRA will select a different area annually for review by auditors.

serviceability assessments. The scope of the review has encompassed a range of large and small ADIs. The first stage was completed for large ADIs in 2017, and has also extended to cover a number of smaller ADIs. APRA is in the process of assessing these latest reports.

22. APRA has summarised publicly the key themes identified by the Targeted Review.[6] These centre on ensuring that ADIs accurately assess borrower income and living expenses, establish robust controls to check for information on borrowers' pre-existing debts, and maintain effective oversight of lending outside of policy. This includes the monitoring, management and limiting of policy waivers, as well as lending where the borrower has a negative net income surplus in the serviceability calculation.

23. Many of these themes are relevant to the topics discussed by the Commission in the first round, although they have been approached by APRA from a prudential perspective. Outlined below is the guidance that APRA has provided to the industry, and an update on some of the management responses initiated by ADIs to address the prudential concerns arising from the Targeted Review.

Borrower living expenses

24. The first round of hearings have referenced aspects of the Targeted Review reports, and the Commission has invited submission on questions relating specifically to the use of benchmarks in the assessment of borrower living expenses.

25. The assessment of borrower expenses is a core component of serviceability, as living expenses account for a substantial proportion of household income. In accordance with prudential guidance and responsible lending requirements (as reflected in APG 223 and RG 209), ADIs are expected to make reasonable inquiries into borrower living expenses. ADIs typically use a benchmark to provide a floor where borrower declared estimates appear low. The most common benchmark for this floor is the Household Expenditure Measure (HEM).

26. The Targeted Review identified that the HEM floor was being used in the majority of lending decisions for most of the banks reviewed. As currently calibrated, HEM is based on a relatively low estimate of borrower living expenses: the use of a low floor for the majority of borrowers suggests that there is a risk of significant under-estimation of expenses. There was also a clustering of borrower declared expenses around the HEM level, indicating that the benchmark was providing an anchor for borrowers' own estimates.

[6] *Key issues for the year ahead: Bank Capital and the approaching BEAR*, APRA Chairman (8 September 2017). http://www.apra.gov.au/Speeches/Pages/Key-issues-for-the-year-ahead-Bank-Capital-and-the-approaching-BEAR.aspx

APRA guidance: assessing borrower expenses

27. APRA has included guidance on the assessment of borrower living expenses within Prudential Practice Guide *APG 223 – Residential Mortgage Lending*. This states that:

> "*ADIs typically use the Household Expenditure Measure (HEM) or the Henderson Poverty Index (HPI) in loan calculators to estimate a borrower's living expenses. Although these indices are extensively used, they might not always be an appropriate proxy of a borrower's actual living expenses. Reliance solely on these indices generally would therefore not meet APRA's requirements for sound risk management.*"[7]

28. APRA expects ADIs to use the greater of a borrower's declared living expenses or an appropriately scaled version of the HEM or HPI indices. Consistent with this guidance, in APRA's view:

   (a) **Reasonable inquiries:** ADIs should be making reasonable inquiries into borrower's actual living expenses, in accordance with ASIC's responsible lending obligations.[8] Recently, APRA considers ADIs have been enhancing their approach to this, including by developing more granular breakdowns of different categories of expenses to facilitate and record customer conversations, improving training and coaching for lenders, and increasing their monitoring and surveillance on the reliance of benchmarks.

   (b) **Floor, not a replacement:** ADIs should not be relying on a benchmark in lieu of making reasonable inquiries. The benchmark should provide a floor for a borrower's declared expenses where these appear to be too low; they should not be used as a replacement or proxy in place of investment in collecting information on actual expenses. The extent of the reliance on the benchmark, as identified by the Targeted Review Reports is not consistent with this approach.

   (c) **Prudent calibration:** Where a benchmark is used, however, ADIs should review its calibration and application to ensure that it is providing a prudent floor. In APRA's view, the current calibration of the HEM benchmark does not provide a sufficiently conservative floor given the extent of reliance that ADIs are typically placing on it.

29. The large ADIs subject to the first phase of the review are addressing the issues raised in the

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[7] Prudential Practice Guide APG 223 – Residential Mortgage Lending (paragraph 44). APG 223 also states that if the HEM or HPI is used, a prudent ADI would apply a margin linked to the borrower's income to the relevant index. In addition, an ADI would update these indices in loan calculators on a frequent basis, or at least in line with published updates of these indices (typically quarterly).

[8] These are outlined in ASIC's Regulatory Guide 209: *Credit licensing: Responsible lending conduct* (November 2014). This sets out expectations for compliance with the responsible lending conduct obligations in chapter 3 of the National Consumer Credit Protection Act 2009 (National Credit Act).

Targeted Review reports through a range of improvements to lending policies, practices and systems. APRA is monitoring progress and engaging with the banks in two main ways: at an industry level and on a bilateral basis with specific ADIs.

30. The major banks have also initiated joint discussions with APRA about options around changes to living expense benchmarks and top down leverage limits. To facilitate these discussions, PricewaterhouseCoopers (PwC) have conducted some analysis of changing the calibration of expense benchmarks and of limits on borrower leverage as measured by debt-to-income. APRA supports an industry-led approach to dealing with this issue and continues to engage with the banks as that work progresses.

31. The Commissioner noted during Closing Address that practices regarding serviceability vary internationally. In Australia, ADIs generally use a form of net income surplus model to make an assessment of whether the borrower can service a particular loan. The advantage of this method is that it can be tailored to an individual borrower's circumstances through a detailed bottom-up calculation of serviceability. In other countries, other top-down methods have been implemented, such as measures around debt repayments as a proportion of income or maximum loan-to-income levels. These can provide a useful complementary backstop on serviceability if calibrated effectively, but in APRA's view should not be a replacement for a more individual assessment of a borrower's capacity to service and repay the loan. They are also not without their own measurement difficulties and may not be sufficient to meet ASIC's requirements on responsible lending.

Policy waivers and overrides

32. Prudential Practice Guide *APG 223 – Residential Mortgage Lending* includes guidance for ADIs on dealing with exceptions or overrides to an ADI's internal policies.

33. Paragraph 47 of APG 223 states:

> *An override occurs when a residential mortgage loan is approved outside an ADI's loan serviceability criteria or other lending policy parameters or guidelines. Overrides are occasionally needed to deal with exceptional or complex loan applications. However, a prudent ADI's risk limits would appropriately reflect the maximum level of allowable overrides and be supported by a robust monitoring framework that tracks overrides against risk tolerances. It is also good practice to implement limits or triggers to manage specific types of overrides, such as loan serviceability overrides. APRA expects that where overrides breach the risk limits, appropriate action would be taken by senior management to investigate and address such excesses.*

34. APRA has expressed concern for some time that there is inconsistency in the way that ADIs measure and monitor overrides. Weaknesses in managing overrides can limit the ability to control

and monitor the quality of lending, as well as the capacity of Boards and senior executives to gain comfort that the standards they have approved are being consistently applied in practice. APRA took steps in 2016 to improve the consistency of reporting on overrides, with a view to gaining a better understanding of the extent of overrides across the industry. This is reflected in a revised definition for exceptions to serviceability policy and serviceability verification waivers within APRA's formal data collection, ARF 223.0 Residential Mortgage Lending. Monitoring and reporting of overrides was also examined in the Targeted Review Reports, and a number of improvements in this area are in progress.

Remuneration in the Banking Sector

35. Another key issue identified from the Round 1 case studies is the role of remuneration and incentive policies in influencing the behaviour of bank staff and mortgage brokers. Of particular interest to the Commission is the impact on consumer outcomes of volume-based incentive and trailing commission structures for mortgage brokers.

36. While APRA does not regulate mortgage brokers, APRA's prudential framework recognises the potential risks inherent in broker remuneration structures. *Prudential Practice Guide APG 223 Residential Mortgage Lending*, outlines measures a prudent ADI would take to control such risks. This guidance expands on principles outlined in *Prudential Standard CPS510 Governance* and *Prudential Practice Guide PPG 511 Remuneration*.[9]

37. The core objective of APRA's prudential framework requirements in the area of remuneration is that performance-based components of remuneration should encourage behaviour that supports the effective risk management and long-term financial soundness of the regulated institution. While this objective differs from the consumer outcome objective which the Commission is exploring,[10] APRA's recent observations and activities in this area may be of interest to the Commission.

38. Remuneration frameworks, and the outcomes they produce, are important barometers and influencers of risk culture. As noted in its 2016 Information Paper on Risk Culture,[11] APRA's overarching objective is for a regulated institution to establish and maintain a sound risk culture that is aligned with its organisational objectives, values and risk appetite. This serves to reduce the potential for undesirable behaviours to jeopardise an institution's financial well-being. Well-

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[9] The Prudential Standards and Prudential Practice Guides can be found at http://www.apra.gov.au/adi/PrudentialFramework/Pages/adi-prudential-framework.aspx.

[10] It should be noted that APRA's prudential framework on remuneration principally applies to executive level staff within regulated entities.

[11] http://apra.gov.au/MediaReleases/Pages/16_40.aspx.http://www.apra.gov.au/CrossIndustry/Documents/161018-Information-Paper-Risk-Culture.pdf

designed and implemented remuneration frameworks can positively influence risk culture, and provide incentives to act responsibly, with integrity, and in a manner consistent with the risk management framework.[12] APRA will shortly release an Information Paper titled "Remuneration practices at large financial institutions" (**Information Paper**). This Information Paper, which is focused on executive remuneration, continues APRA's attention on the culture, governance and remuneration practices amongst prudentially regulated institutions. It includes findings from a review undertaken across a sample of 12 large regulated institutions, from across the ADI, life insurance, general insurance and superannuation industries, which collectively account for a material proportion of the total assets of the Australian financial system.

39. Accompanying release of the Information Paper will be a speech by APRA which provides broader context on APRA's interest areas in relation to remuneration and also discusses forces external to the industry that impact on executive remuneration, such as the short-termism of institutional investors. The Information Paper and speech will be available at http://www.apra.gov.au and will be provided to the Commission when released.

40. The findings of the review include observations on short-term and long-term incentives structures in the industry (at a senior executive level) and the factors impacting the awarding and adjustment of those incentives.

41. The Information Paper flags the next phase of APRA's work in the area of remuneration to be a review of the prudential framework to support a more robust and credible implementation of the existing prudential requirements and guidance.

42. As part of its broader work plan on risk culture, APRA will continue to assess how remuneration practices are interacting with the risk cultures of regulated institutions.

Other topics

43. APRA has taken note of other aspects of the Commission's Consumer Lending hearings which touch on the operation of risk frameworks of ADIs, such as oversight of loan origination channels, fraud risk management, and data management. Aspects of the case studies have also raised issues concerning the risk culture within ADIs.

44. Further, while not directly relevant to the present case studies, APRA has in recent years also identified issues regarding legacy systems, investment in back office functions, and new technology, as areas requiring increased attention by industry participants.[13]

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[12] See CPG-220 Risk Management: http://www.apra.gov.au/CrossIndustry/Documents/Final-Prudential-Standard-CPS-510-Governance-(January-2014).pdf - paragraph 26 p7.

[13] http://www.apra.gov.au/Speeches/Pages/Six-issues-for-2016.aspx
http://www.apra.gov.au/Speeches/Pages/Opening-Statement-Parliamentary-Joint-Committee.aspx.

45. These areas may form part of APRA's prudential supervision activities, with APRA determining the scope and intensity of any entity-specific, or industry-wide, supervisory action based on an assessment of the risk to the financial health or prudent operation of the ADIs (or other entities) in question. However APRA's interest in these areas will inevitably be from a prudential perspective, rather than having the consumer lending lens that has been the focus of the Round 1 hearings.

Further assistance

46. Insofar as APRA may be able to provide any further assistance to the Commission in respect of the matters addressed in these Submissions or otherwise raised by the Round 1 case studies, APRA would be very willing to do so.

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