Response to Submissions

APG 223 – Residential Mortgage Lending

5 November 2014

Preamble

In May 2014, APRA released for public consultation, a draft *Prudential Practice Guide APG 223 Residential Mortgage Lending* (draft APG 223), which sought to provide guidance to ADIs on sound risk management practices for residential mortgage lending.

This response paper sets out key issues raised in the submissions received on draft APG 223 and APRA's response to those submissions. Although the key messages in the guidance are largely unchanged, APRA has amended or clarified its original proposals in several areas, details of which are set out in this paper. Accompanying this paper is the final *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223).

This response paper and the final APG 223 are available on APRA's website at:

http://www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-packages.aspx

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Glossary

Term	Definition
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APG 223	*Prudential Practice Guide APG 223 Residential Mortgage Lending*
APS 110	*Prudential Standard APS 110 Capital Adequacy*
ASIC	Australian Securities and Investment Commission
Draft APG 223	Draft *Prudential Practice Guide APG 223 Residential Mortgage Lending* released in May 2014
CPS 220	*Prudential Standard CPS 220 Risk Management*, effective 1 January 2015
RG 209	ASIC's *Regulatory Guide 209 Credit licensing: Responsible lending conduct*
HEM	Household Expenditure Method
HPI	Henderson Poverty Index
CPS 510	*Prudential Standard CPS 510 Governance*
LVR	Loan-to-valuation ratio
LMI	Lenders mortgage insurance
PPG	Prudential practice guide

Executive summary

In May 2014, APRA released for consultation draft *Prudential Practice Guide APG 223 Residential Mortgage Lending* (draft APG 223). The purpose of APG 223 is to outline prudent practices in the management of risks arising from lending secured by mortgages over residential properties. Submissions closed in July 2014; APRA received sixteen submissions from a range of industry stakeholders.

Overall, submissions indicated that the general expectations outlined by APRA in the draft guidance were reasonable, although certain areas of concern were identified. This response paper addresses the key issues raised in submissions, with Chapter 1 addressing some of the general themes contained in submissions and Chapter 2 detailing APRA's responses on specific issues raised.

One theme raised in submissions was that the guidance was unduly prescriptive in some areas, e.g. in relation to the guidance on risk appetite, management information systems and serviceability assessments. As set out in the 'About this Guide' section of APG 223, prudential practice guides (PPGs) provide guidance on APRA's view of sound practices, and do not create enforceable requirements. Not all practices outlined in APG 223 will be relevant for every ADI and the appropriateness of different aspects will vary depending on the size, complexity and risk profile of the institution. APRA has deliberately included examples throughout APG 223 to elaborate on the guidance to assist ADIs in meeting APRA's expectations in relation to prudent residential mortgage lending. However, these examples are not intended to be exhaustive, and should not be read or interpreted as enforceable requirements.

Some submissions indicated that draft APG 223 inappropriately sought to hold ADIs to a higher standard than consumer credit legislation, especially in the area of serviceability assessments. Conversely, a few submissions supported the level of guidance and asked for APRA to be more explicit in several areas, including specifying interest rate buffers. APRA has a prudential interest in ensuring that ADIs are not unduly exposed to high defaults. That said, APRA has amended the guidance on serviceability to seek to ensure that the portfolio in aggregate, and not the individual loan, is able to absorb substantial stress such as in an economic downturn without producing unexpectedly high loan default losses for the lender.

Several submissions commented on the references in the draft guidance relevant to brokers and third-party originators, objecting to a perceived inference that third-party originated loans are riskier than proprietary loans and that broker remuneration, in particular guidance on claw back arrangements, did not reflect commercial reality. The intention of APG 223 is that entities do not seek to outsource responsibility for sound practices when they use third parties for various services. Therefore, APG 223 cites instances where additional controls and monitoring would be advisable when third party services are used. APRA has, however, amended the guidance in a number of areas, including risk appetite and remuneration, in response to submissions received.

Finally, APRA has made several wording changes in APG 223 to provide further clarity and context.

Chapter 1 — General comments

This chapter addresses some of the general themes raised in the submissions received on draft APG 223.

1.1 Nature of guidance

A common theme in a number of submissions on the draft APG 223 was that it was unduly prescriptive, particularly in relation to the guidance provided on risk appetite, management information systems and the assessment and verification of income, expenses and debt commitments. Conversely, some submissions advocated that more detailed guidance be provided in certain areas, e.g. interest rate buffers. Comments were also received indicating the need for a transition period for implementation and suggesting that the guidance could increase compliance costs.

One submission also queried whether the scope of APG 223 is limited to residential mortgage lending in Australia, or whether it should also be applied to subsidiaries and offshore businesses.

APRA's response

As set out in the 'About this Guide' section of APG 223, PPGs provide guidance on APRA's view of sound practices, but do not set out enforceable requirements. Not all practices outlined in APG 223 will be relevant for every ADI, and the appropriateness of different aspects will vary depending on the size, complexity and risk profile of the institution. APRA has deliberately included examples throughout APG 223 to elaborate on the guidance to assist ADIs in meeting APRA's expectations in relation to prudent residential mortgage lending. However, these examples are intended to be illustrative, and should not be read or interpreted as enforceable requirements.

Given the nature of the principles it contains, APG 223 is likely to be relevant for ADIs with operations outside Australia. The guidance constitutes APRA's view of sound practices that should have relevance across the entirety of an ADI's operations. However, when using the guidance in overseas markets, ADIs would need to do so in a manner that is consistent with any local regulatory requirements.

Overall, APG 223 summarises good lending practices, including addressing credit risk within the ADI's risk management framework, sound loan origination and security valuation practices, the management of hardship loans and stress-testing. Given that APG 223 does not create any new prudential requirements for ADIs, APRA does not consider that any transitional period is needed.

1.2 Materiality

One submission requested that APG 223 include materiality levels, suggesting that it be aligned with APRA's intention to amend the Board's annual risk management declaration to include the concept of materiality.

APRA's response

APRA's letter of 7 October 2014[1] outlined its proposal to amend the risk management declaration section of *Prudential Standard CPS 220 Risk Management* (CPS 220), to include the phrase 'in all material aspects'. This is intended to become effective from 1 January 2015. APRA does not intend defining materiality in CPS 220 and does not consider it appropriate to do so in APG 223. APRA considers that ADIs are best placed to assess and set materiality levels that are appropriate to their size, complexity and risk profile.

1.3 Overlap with other regulation, legislation or guidance

In relation to several areas in draft APG 223, submissions suggested that, as these topics were dealt with in other pieces of regulation, legislation or guidance, it was unnecessary for APRA to address them in APG 223. Particular examples raised in submissions included the serviceability requirements in the Australian Securities and Investments Commission's (ASIC's) *Regulatory Guide 209 Credit licensing: Responsible lending conduct* (RG 209) and provisions on broker remuneration in ASIC's credit licensing requirements.

1 http://www.apra.gov.au/CrossIndustry/Documents/Letter-to-industry-CPS-220-CPG-220-October-2014.pdf

APRA's response

APRA has a prudential interest in ensuring that ADIs are not unduly exposed to high defaults. Such a focus is different from standards for lending behaviour that apply to individual borrowers, which are addressed in consumer protection legislation.

To ensure that the guidance does not conflict with existing requirements, including the recently updated RG 209, APRA has consulted with ASIC in finalising APG 223. The final APG 223 is consistent with the updated RG 209, which clarifies the expectations on lenders in relation to serviceability assessments.

Chapter 2 — Specific comments

This chapter addresses some of the specific issues raised in the submissions received on draft APG 223.

2.1 Risk management framework

2.1.1 Board and senior management

One submission noted that draft APG 223 did not accurately reflect the three lines of defence model outlined in draft *Prudential Practice Guide CPG 220 Risk Management* (CPG 220), in particular by creating an expectation that the Board will take on a more management than oversight role in some areas. A particular example raised in submissions was paragraph 73 of draft APG 223, which stated 'significant increases in high LVR (loan to valuation ratio) lending would typically be a trigger for the Board and senior management to review risk targets and internal controls over high LVR lending'.

APRA's response

APRA acknowledges that any significant increases in high LVR lending would, in the first instance, be a trigger for an ADI's senior management to review risk targets and internal controls for high LVR lending. Any material changes in residential mortgage lending that may indicate a deviation from the ADI's stated risk appetite would, however, be expected to be brought to the attention of the Board in a timely manner. Draft APG 223 has been amended to clarify APRA's intention that senior management would review risk targets and internal controls, as appropriate, with Board oversight.

2.1.2 Risk tolerances

Industry noted that use of the term 'risk tolerances' in draft APG 223 is inconsistent with CPS 220.

APRA's response

APRA has amended draft APG 223 to be consistent with CPS 220. That is, an ADI would set risk limits for various aspects of residential mortgage lending, so that the ADI operates well within its tolerance for credit risk.

2.1.3 Comprehensive review

Submissions queried an apparent inconsistency between draft APG 223 and CPS 220 on the frequency of the independent comprehensive review of residential mortgage lending. One submission also asked for more guidance on those aspects of the framework that would need to be reviewed.

APRA's response

APRA confirms that, consistent with CPS 220, comprehensive review of aspects of the risk management framework with respect to residential mortgage lending would be undertaken every three years.

APRA does not intend to provide further guidance on specific aspects of the framework that would need review. Consistent with CPS 220, the scope of the comprehensive review must have regard to the size, business mix and complexity of the ADI, the extent of any change to its operations or risk appetite, and any changes to the external environment in which it operates.

2.2 Serviceability assessments

There were several comments on different aspects of the guidance on serviceability assessments in draft APG 223.

2.2.1 Serviceability buffers and absorption of stress for individual loans

Some submissions asserted that draft APG 223 inappropriately sought to hold ADIs to an overly conservative level of stress absorption with respect to serviceability buffers for individual loans – in particular, that every individual loan needed to be serviceable under a scenario of severe stress and over long horizons.

APRA's response

APRA has carefully considered the submissions and has made two changes to the guidance on serviceability:

- APRA accepts that an ADI should seek to ensure that the portfolio in aggregate, and not the individual loan, is able to absorb substantial stress (such as in an economic downturn) without producing unexpectedly high loan default losses for the lender; and
- APRA has also clarified that the interest rate buffer would factor in increases over several years rather than the full term of the loan.

2.2.2 Interest rate floors

Draft APG 223 included a reference to a prudent ADI using an 'interest rate buffer in conjunction with an interest rate floor' along with guidance on calculation of the floor. Some submissions disagreed with the need for a floor as well as a buffer and guidance on the way the floor should be calculated. One submission also proposed that six monthly rather than quarterly reviews of interest rate buffers should be sufficient as a matter of sound practice.

APRA's response

APRA has considered the comments received but remains of the view that the guidance in APG 223 represents sound practice, given the importance of maintaining robust standards at the point of loan origination. It is APRA's view that an ADI would determine the combination and method of calculation of buffers, floors and other adjustments that are most appropriate to its circumstances.

2.2.3 Income and expense assessment

When estimating a borrower's living expenses, draft APG 223 made reference to ADIs using a borrower's declared living expenses, rather than the Household Expenditure Measure (HEM) or the Henderson Poverty Index (HPI), which can considerably understate a borrower's actual living expenses. If an ADI uses the HEM or HPI, draft APG 223 suggested that a margin be added. Two submissions submitted that this aspect of the guidance was too prescriptive, while one noted that applying a margin could result in double counting of expenses. One submission also noted the challenges of estimating a borrower's living expenses.

Conversely, one submission suggested that ADIs be required to hold specific margins above HEM or HPI.

APRA's response

As noted in APG 223, APRA expects ADIs to assess and verify a borrower's income and expenses having regards to the particular circumstances of the borrower. In view of the uncertainty and challenges in estimating living expenses, APRA supports ADIs adopting a prudent approach. This would include the use of margins when benchmarks like HEM or HPI are incorporated into the assessment. Furthermore, consistent with the updated RG 209, APRA advises that the use of benchmarks such as HEM or HPI is not a replacement for verification and assessment of the borrower's declared expenses. The APG 223 has been amended to ensure consistency with ASIC's updated RG 209.

2.2.4 Superannuation

Draft APG 223 proposed that when assessing a borrower's income it would be prudent not to rely on the presumption of future superannuation lump sums, unless the lump sum is verifiable and reasonably imminent. Some submissions considered this unnecessarily penal. One submission claimed that if restrictions were to be placed on relying on future superannuation lump sums being 'verifiable and reasonably imminent', borrowing capabilities of impending retirees would be restricted.

APRA's response

It is not APRA's intention to restrict access to finance for impending retirees. However, it is not prudent for ADIs to rely on superannuation lump sums for repayment unless their quantum is verifiable and timing reasonably known, which is likely to be the case closer to retirement. Consequently APRA does not propose to amend the guidance in draft APG 223.

2.3 Third-party originated loans

2.3.1 Perception of third-party originated loans

Several submissions objected to a perceived inference in draft APG 223 that third-party originated loans are riskier than proprietary loans and requested that such references be removed.

APRA's response

APRA's industry-wide data on residential mortgage lending indicates that, over the past several years, both direct and broker originated home loan loss rates have been quite low, due to low default rates and continued growth in home loan collateral values. APRA's data also indicates, however, that there is a significantly higher default rate for broker-originated loans compared to loans originated through proprietary channels. This higher default rate would be expected to translate to higher loss rates, particularly in adverse circumstances.

APRA has, however, made some amendments to APG 223 to address some of the specific comments made in submissions, e.g. the sections on risk appetite and remuneration.

2.3.2 Remuneration policy

Prudential Standard CPS 510 Governance (CPS 510) requires an ADI's Board-approved remuneration policy to apply to responsible persons, risk and financial control personnel and all other persons whose activities may affect the financial soundness of a regulated institution. Draft APG 223 indicated that, where the residential mortgage lending portfolio is material, a prudent ADI would apply its remuneration policy to those persons involved in residential mortgage lending. This would include the remuneration of third parties, particularly brokers, when they are responsible for the origination of a material proportion of the residential mortgage loan portfolio.

Submissions generally did not agree that an ADI's remuneration policy should apply to non-employee brokers.

APRA's response

The application of the remuneration requirements to all 'persons whose activities may affect the financial soundness of the regulated institution' is an existing requirement of CPS 510. Therefore, including brokers in an ADI's remuneration policy is not new and APG 223 aligns remuneration and risk management in the important area of residential mortgage lending origination. For the avoidance of doubt, APG 223 is intended to capture an ADI's engagement with its brokers, not how a broker firm pays its staff.

As noted in one submission, CPS 510 provides that some service contracts may be exempt from inclusion in an ADI's remuneration policy where they are explicitly addressed in its risk management framework and the risks are subject to appropriate oversight. APG 223 has been amended to refer to this option.

2.3.3 Claw back of commissions

Draft APG 223 proposed that ADIs should consider implementing measures to facilitate ending or clawing back commissions where there are high levels of delinquency or process failures on loans originated by third parties. Submissions objected to this guidance on several grounds, including that it did not reflect commercial reality.

APRA's response

APRA considers it appropriate to retain references in APG 223 to the claw back of commissions; however, some amendments have been made to the guidance in this area. References to specific circumstances under which claw backs should occur have been removed; APG 223 instead refers to the importance of ensuring remuneration arrangements 'discourage conflicts of interest and inappropriate behaviour'. In addition, APRA continues to encourage ADIs to monitor the performance of third-party originators, with a view to restricting or terminating relationships with originators who have unexpectedly elevated levels of loan defaults or materially deficient loan documentation and processing.

2.4 Specific loan types

Draft APG 223 noted that a prudent ADI should recognise, in its risk appetite, portfolio limits for loans that may be more vulnerable to serviceability stress and possible material decreases in property prices where these are material. Such loans might include interest-only loans, foreign currency loans, loans with non-standard/alternative documentation, reverse mortgages, and home equity lines-of-credit (HELOC).

Some submissions objected to singling out these loan types, arguing their appropriateness in certain circumstances.

APRA's response

APRA considers that it is appropriate for ADIs to pay particular attention to potentially riskier loan types. The guidance identifies several types of loans that may fall into this category, but the examples are not intended to be exhaustive or definitive. Each type of loan may be appropriate in certain circumstances, and ultimately the need for specific portfolio limits should be assessed by each ADI with respect to its own portfolio.

2.5 Security valuation

2.5.1 Valuation management

As part of a robust management framework, draft APG 223 proposed that valuer selection be conducted by an ADI's risk management area, rather than by sales staff, and that the involvement of ADI sales or product staff in panel management would be minimal. Views on this aspect of draft APG 223 were mixed; while some submissions supported this proposal, others asserted that it was overly restrictive.

APRA's response

APRA understands that several ADIs outsource valuation management to service providers. Further, in the case of some ADIs, third parties may order valuations in certain circumstances, albeit under consistent standing instructions and an approved policy framework. Given the number of parties involved in the process, APRA considers that the guidance in draft APG 223 strikes the right balance between appropriate risk management of valuer selection and the operational realities of these relationships.

2.5.2 Loan-to-valuation ratios

Draft APG 223 noted that prudent LVR limits serve as an important element of portfolio risk management, and experience has shown that LVRs above 90 per cent (including capitalised lenders mortgage insurance (LMI) premium or other fees) are likely to expose an ADI to a higher risk of loss. One submission suggested that the draft guidance focussed too much on LVRs and should instead emphasise the importance of risk assessment.

APRA's response

APRA notes that there are several risk factors associated with residential mortgage lending, including high LVRs, and this section of APG 223 should be read in the broader context of the overall guidance in APG 223. Further, default data indicates that high LVRs increase the risk of losses to the lender, other things being equal, and existing industry practice is to have limits on high LVR lending.

2.6 Hardship loans and collections

Draft APG 223 proposed that, where a residential mortgage loan is in default, a prudent ADI would undertake a full revaluation of the underlying collateral. One submission suggested that this was overly prescriptive and that in some cases a risk-based assessment rather than full revaluation would be appropriate.

APRA's response

The type of valuation undertaken may depend on the level of risk involved; however, the valuation approach should ensure adequate provisioning where required. APRA has amended the guidance to indicate that valuations other than a full revaluation may be appropriate in certain circumstances, e.g. for loans with a very low LVR.

2.7 Stress testing

Prudential Standard APS 110 Capital Adequacy (APS 110) requires ADIs to conduct enterprise-wide stress testing as part of internal capital planning. Draft APG 223 noted that a core element of enterprise-wide stress testing would be the development of loss expectations for material credit exposures, including residential mortgage lending (where relevant).

One submission noted that for a relatively homogeneous loan book (in terms of products, security and geography), the monthly internal and external risk monitoring and documented trigger levels should be sufficient to mitigate the need for frequent formal stress testing. It was also noted that some ADIs may not retain serviceability data to the level of detail required for certain stress-testing exercises.

APRA's response

As noted earlier in this response paper, not all practices outlined in APG 223 will be relevant for every entity and the appropriateness of certain aspects of the guidance will vary depending on the size, complexity and risk profile of the ADI. As set out in *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review* (CPG 110), appropriate stress testing should be tailored to the particular risk exposures of an individual ADI.

APRA's supervisory experience is that serviceability data collected at loan origination remains useful for ongoing stress testing and portfolio risk management, and good practice suggests that this data should be retained while it possesses material value.

2.8 Lenders mortgage insurance (LMI)

Two submissions indicated that, while APG 223 is suitably explicit about the responsibilities of ADIs for their risk appetite and lending standards and outcomes, there is little acknowledgement of the value of LMI as a risk management tool.

APRA's response

APRA has amended the section on LMI to acknowledge its use by ADIs as a risk mitigant, to smooth out the normal variability of losses that occurs over time and to diversify regional concentrations of risk.

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