



9 December 2019

TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

RESPONSE TO SUBMISSIONS – CAPITAL TREATMENT OF MORTGAGES UNDER THE FIRST HOME LOAN DEPOSIT SCHEME

APRA recently consulted on adjustments to its capital requirements for authorised deposit-taking institutions (ADIs) to support the Government's First Home Loan Deposit Scheme (FHLDS). The scheme aims to improve home ownership by first home buyers through a Government guarantee of eligible mortgage loans for up to 15 per cent of the property purchase price. Recognising that the Government guarantee is a valuable form of credit risk mitigation, APRA proposed to reflect this in the capital framework by applying a lower capital requirement to eligible FHLDS loans.

APRA received 10 submissions in response to its consultation— non-confidential submissions have been published on APRA's website. This letter sets out APRA's response to the issues raised in submissions.

Capital treatment

APRA proposed adjusting the residential mortgage capital requirements detailed in *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112), by allowing eligible FHLDS loans to be treated in a comparable manner to mortgages with a loan-to-valuation ratio (LVR) of 80 per cent. This would allow eligible FHLDS loans to be risk-weighted at 35 per cent under APRA's current capital requirements. Once the Government guarantee ceases to apply to eligible loans, ADIs would revert to applying the relevant risk weights as set out in APS 112.¹

Comments received

Respondents were generally supportive of APRA's proposed capital treatment, noting that it would allow lenders to offer FHLDS mortgages at a competitive interest rate. Without a change, the current capital requirements may adversely affect lender appetite for these loans. Respondents also sought confirmation as to whether the same capital treatment would apply to eligible FHLDS loans under the revised ADI capital framework, commencing from 1 January 2022.

Some respondents expressed concern that the proposed capital treatment does not adequately reflect the risks associated with loans to first home borrowers and suggested that FHLDS mortgages should be treated within ARPA's existing guarantee framework, or be afforded the same risk weight treatment as mortgages covered by lenders mortgage insurance (LMI). It was suggested that the proposed approach creates a regulatory distortion between loans covered by a Government guarantee and those covered by LMI, and that this does not

¹ This could be because the outstanding loan amount has fallen below 80 per cent of the property purchase price, or the borrower refinances or otherwise uses the property for a purpose not within the scope of the guarantee.

reflect an appropriate balancing of competition, competitive neutrality and contestability considerations.

Two respondents also sought clarification on the capital treatment of FHLDS loans under the internal ratings-based (IRB) approach to credit risk.

APRA's response

APRA is proposing to proceed with the capital treatment as initially outlined in the consultation letter. ADIs that use the standardised approach to credit risk will be permitted to treat eligible FHLDS loans in a comparable manner to mortgages with an LVR of 80 per cent and apply a risk weight of 35 per cent. When the guarantee is no longer in effect, the adjusted capital treatment will also cease to apply and ADIs must revert to applying the capital treatment as set out in APS 112. On balance, APRA considers that this approach is simple to implement, appropriately reflects the value of the Government's guarantee as a form of credit risk mitigation and will improve competition for the provision of these mortgages. APRA will apply this same approach under the revised APS 112, although the risk weight may differ from the currently applicable 35 per cent, depending on the calibration of the final mortgage risk weights.

APRA is not proposing adjustments to IRB capital requirements for FHLDS mortgages.

Reporting requirements

APRA did not propose changes to regulatory reporting requirements as part of the adjusted capital requirements.

Comments received

Respondents sought clarification on the treatment of FHLDS mortgages for the purposes of high LVR reporting and setting of internal limits, with some respondents suggesting that APRA also treat FHLDS mortgages as having an 80 per cent LVR for these purposes.

APRA's response

For regulatory reporting purposes, ADIs should report FHLDS mortgages as having an 80 per cent LVR only under *Reporting Standard ARS 112.1 Standardised Credit Risk – On Balance Sheet Assets*. For all other regulatory reporting forms, ADIs must report FHLDS mortgages according to their actual LVR.

Similarly, for the purpose of setting internal limits on high LVR lending, APRA expects that FHLDS mortgages would still be included based on their actual LVR. Irrespective of the presence of the Government guarantee, ADIs should still be setting prudent limits on the amount of this type of lending that they will offer, consistent with their risk appetite.

Next steps

APRA will shortly provide those standardised ADIs that have been included on the National Housing Finance and Investment Corporation's panel of lenders with formal written approval to apply the adjusted capital treatment, as set out in this letter.

If you have any questions, please contact your responsible supervisor.

Yours sincerely,

John Lonsdale
Deputy Chair