



3 February 2021

Committee Secretary  
Senate Economics Legislation Committee  
PO Box 6100  
Parliament House  
Canberra ACT 2600

Dear Secretary

APRA welcomes the opportunity to assist the Senate Economic Legislation Committee's Inquiry into the National Consumer Credit Protection Amendment (Supporting Economic Recovery) Bill 2020. This submission seeks to provide additional context to the Government's proposed reforms, by explaining APRA's approach to establishing and enforcing prudential requirements of authorised deposit-taking institutions (ADIs). It is intended to provide factual material on APRA's lending requirements, to assist the Committee in its deliberations.

### **Executive Summary**

In summary, APRA's objective in supervising ADIs is to protect the interests of depositors and to promote financial stability. APRA's prudential standards for lending practices are therefore focused on managing the impact of credit risk – the risk of borrower default – on an ADI's financial soundness and stability. From a prudential perspective, this means an emphasis on systemic lending issues at an institution level, rather than a direct focus on outcomes at an individual loan or customer level.

The Government's announcement of proposed reforms to consumer credit noted changes to the Responsible Lending Obligations (RLOs), which are administered by the Australian Securities and Investments Commission (ASIC). Under these changes, non-ADI lenders would be subject to new lending requirements, based predominantly on certain requirements in APRA's prudential standards. ADIs would be removed from RLOs and APRA would continue to regulate ADIs in relation to its existing prudential standards. APRA therefore does not expect to have to make material changes to the prudential framework on the basis of the Government's proposed consumer credit reforms.

Given the expected role of APRA's prudential standards under the proposed consumer credit reforms, Annex A explains APRA's mandate and the broader financial regulatory landscape. It sets out APRA's objectives in setting prudential requirements of ADIs and APRA's approach to supervision, providing relevant context to the proposed reforms.

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Executive Director  
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## **ANNEX A: Overview of APRA's lending requirements – context for proposed consumer credit reforms**

### **APRA's mandate**

APRA is an independent statutory authority established for the purposes of prudential supervision of financial institutions and promoting financial system stability in Australia. APRA's mandate is to protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions it supervises are met within a stable, efficient and competitive financial system. As the prudential regulator of ADIs, APRA seeks to assure depositors that their deposits are safe and the Australian community that the financial system is stable.<sup>1</sup>

### **Financial regulatory context**

As you know, Australia's financial regulation is founded on the 'twin peaks' model. As a result, the key components of financial regulation in Australia are primarily split between two agencies, APRA and ASIC. The distinction between APRA and ASIC, as well as areas of common interest, are important context to the proposed reforms. As described in APRA's mandate above, APRA is the financial safety regulator, with a focus on the financial soundness and stability of APRA-regulated entities (ADIs, insurers and superannuation funds).<sup>2</sup> As the conduct regulator, ASIC is responsible for regulating companies, market conduct and consumer protection. ASIC also oversees specific design and distribution obligations, which require ASIC-regulated entities to design financial products to meet the needs of consumers in their intended target market.

Despite this basic distinction, APRA and ASIC have many areas of common interest. This includes lending standards for consumer credit. As the financial safety regulator, APRA's focus is the risks that poor lending practices may create for an ADI's financial soundness and financial system stability. ASIC's focus is the impact of poor lending practices, by both ADI and non-ADI lenders, for market conduct and consumer protection. Despite these differing focuses, the maintenance of sound lending practices are important to both regulators, and generally speaking the efforts of one reinforce the activities and objectives of the other. Sound lending practices help promote the financial soundness of ADIs, maintain the stability of the financial system and ensure borrowers are provided with loans they can afford to repay without substantial hardship.

APRA and ASIC have a strong working relationship and regularly consult and engage on matters of shared interest. In consumer credit, for example, APRA and ASIC have previously

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<sup>1</sup> ADIs are entities authorised under the *Banking Act 1959* as banks, building societies and credit unions.

<sup>2</sup> The RBA also has a longstanding responsibility for financial stability, and incorporates financial stability assessments in its monetary policy decision process and publications. For further information, see [Macroprudential Policy Frameworks and Tools | Bulletin – December Quarter 2016 | RBA](#).

coordinated several measures to reinforce sound residential mortgage lending standards in response to emerging risks in the housing market.<sup>3</sup> This coordination is facilitated through the Council of Financial Regulators and regular APRA-ASIC engagement.

APRA has also developed a strong working relationship with the Australian Financial Complaints Authority (AFCA), the main dispute resolution body for the Australian financial system. While not a regulator of the financial services industry, the establishment of AFCA in 2018 has created a stronger framework for borrowers to access external dispute resolution. Through regular engagements, APRA would refer individual borrower complaints to AFCA, and AFCA would share data on systemic issues with APRA.

### **APRA's prudential requirements**

The *Banking Act 1959* sets out APRA's powers to establish and enforce prudential standards for ADIs. To meet its mandate, APRA's prudential standards are designed to ensure that ADIs are well governed, prudently managed and financially sound. APRA adopts a principles-based approach to these requirements, avoiding excessive prescription where possible. This allows ADIs to meet certain prudential requirements in a manner best suited to their size, business mix and complexity.

#### *Prudential standards*

APRA's prudential requirements are set out in prudential standards, which are legally binding regulations.

Consistent with its mandate, APRA's prudential standards are focused on the key risks to an ADI's financial soundness and stability. Credit risk – the risk of borrower being unable to repay outstanding debts – is usually the single largest source of prudential risk for ADIs. Poor credit risk management can create significant risks to an ADI's financial safety and financial system stability.

*Prudential Standard APS 220 Credit Risk Management* (APS 220) sets out APRA's key requirements of ADIs in managing their credit risk.<sup>4</sup> APS 220 encompasses all types of lending, including loans to households, small business and large corporates. It covers risks to ADIs over the life-cycle of a loan, requiring ADIs to have appropriate oversight and governance structures, maintain sound lending standards at the point of origination and actively monitor the risk of borrower default until the loan is repaid.

APS 220 includes requirements for consumer credit lending standards. This includes prudent assessment and verification of a borrower's income, living expenses and other debt commitments. Under APS 220, ADI's credit assessments must include consideration of the borrower's repayment capacity under various scenarios, such as an increase in interest rates

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<sup>3</sup> 9 December 2014: APRA letter to all ADIs, [reinforcing sound residential mortgage lending practices](#); and ASIC media release, [ASIC to investigate interest-only loans](#).

<sup>4</sup> Prior to the reforms being considered by this Committee, this prudential standard was intended to come into force from 1 January 2022. APRA is currently consulting on a possible earlier implementation date for APS 220, to align with the timing of any new non-ADI regime introduced by the Government.

or a decrease in income, particularly for less stable income sources such as bonuses. ADIs must also collect reasonable estimates of a borrower's living expenses, and must not rely solely on benchmarks. In response to the reforms proposed by the Government, APRA is currently consulting on an additional explicit requirement that would require an ADI to assess an individual borrower's repayment capacity without substantial hardship. This is discussed further below.

In addition to APS 220 requirements, ADIs must meet minimum capital requirements for lending. APRA's capital requirements are designed to ensure that ADIs can withstand potential losses from their lending activities without threatening their financial soundness or financial stability. APRA's minimum capital requirements for credit risk are detailed in prudential standards *APS 110 Capital Adequacy*, *APS 112 Capital Adequacy: Standardised Approach to Credit Risk* and *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*. These standards require ADIs to set aside higher amounts of capital against higher risk loans, creating additional incentives for prudent lending.

### *Prudential guidance*

APRA's prudential framework also includes prudential practice guides (PPGs). PPGs provide additional guidance to help ADIs meet their prudential requirements, by setting out APRA's expectations of sound practice in particular areas.

The key prudential practice guides for managing credit risk are *Prudential Practice Guide APG 220 Credit Risk Management (APG 220)* and *Prudential Practice Guide APG 223 Residential Mortgage Lending (APG 223)*.<sup>5</sup> For example, APG 223 contains detailed guidance for assessing serviceability of residential mortgages, such as the minimum increase in interest rates that prudent ADIs would assess borrower repayment capacity at.

### *Other financial stability powers*

Consistent with APRA's mandate, APRA may also require ADIs to temporarily moderate certain types of lending activity if this is contributing to risks of instability in the Australian financial system. In recent years, APRA has set temporary growth benchmarks for lending to residential mortgage investors and residential mortgage lending on an interest-only basis. These benchmarks were subsequently removed as they delivered the intended improvement in lending standards and risks to financial stability ameliorated.

In 2018, APRA was granted new powers to introduce similar requirements for non-ADI lenders, where there are concerns over risks of instability in the Australian financial system. These powers allow APRA to make temporary rules relating to the lending activities of non-ADI lenders if APRA considers that lending by non-ADI lenders is contributing to financial system stability concerns. APRA's powers for non-ADI lenders are considered a reserve power. No such rules have been made since the powers were given to APRA.

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<sup>5</sup> In December 2019, APRA released, for consultation, Draft APG 220. APRA anticipates that it will finalise APG 220 in the first quarter of 2021.

## APRA's prudential supervision

In undertaking its mandate and enforcing the prudential standards, APRA places a strong emphasis on active supervision to identify and address issues before they cause the failure of an ADI, or materially contribute to financial system instability.

APRA's supervisory approach is underpinned by three core attributes: risk-based, forward-looking and outcomes-focused. The risk-based approach directs the supervisory focus to issues that would place the greatest risk to an ADI's financial safety or the stability of the financial system. With regards to lending standards, this means an emphasis on systemic matters at an institution level, rather than at an individual loan level, given financial safety and stability risks will typically be reflected in aggregate or systemic weaknesses in practices.

Consistent with a risk-based approach, APRA's supervision of ADIs' lending practices will intensify as prudential risks increase. In 2014, for example, APRA initiated an intensive supervisory effort to lift and reinforce housing lending standards in an environment of strong competitive pressures, high and rising house prices and high household indebtedness. At the time, APRA's concern was that ADIs' lending policies were not suitably calibrated to vulnerabilities in the environment, and that this was creating risks to ADIs' future financial soundness.

As part of these measures, APRA issued additional supervisory guidance, undertook a series of deep-dive reviews of lending policies and stress-tested the largest ADIs' ability to remain financially sound in the event of a significant housing market downturn. This brought about a marked strengthening in serviceability assessments, reflected in more robust consideration of borrower's ability to meet their loan repayments under a range of scenarios, including a return to higher interest rates. ADIs also adjusted their appetite for lending to higher-risk borrowers, such as those with minimal loan deposits.<sup>6</sup>

APRA has wide-ranging supervisory tools at its disposal to ensure that ADIs are meeting their prudential requirements. APRA's supervisory toolkit includes the use of non-formal and formal tools, which are used to address systemic matters at an institution level that may present a risk to an ADI's financial soundness or the stability of the financial system. Non-formal tools are used in day-to-day supervision, such as offsite analysis of financial data and onsite deep-dive reviews into a particular risk area. APRA's supervisory toolkit also includes the formal use of APRA's legal powers to compel the remediation of prudential risks, such as formal directions or licensing conditions. APRA also has other, more intermediate supervisory tools, such as imposing higher minimum capital requirements, which can be powerful and highly effective in influencing the behaviour of entities and individuals, where appropriate.

The Banking Executive Accountability Regime is an important tool for holding ADIs and individuals to account for prudently managing risks, including with regards to prudent lending standards.<sup>7</sup> This regime sets heightened expectations of accountability for ADIs, their directors and senior executives, requiring them to, amongst other things, act with honesty and

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<sup>6</sup> Further information is available at: Byres (2015), [Sound lending standards and adequate capital: preconditions for long-term success](#), or Richards (2016), [A prudential approach to mortgage lending](#).

<sup>7</sup> Further information is available at: [APRA information paper, implementing the bear](#).

integrity, and with due skill, care and diligence. Where an individual fails to meet his or her accountability obligations, and/or the entity fails to do the same APRA has the power to seek a disqualification of the individual and/or impose a civil penalty on the entity.

### **Government's proposed reforms**

In September 2020, the Government announced a series of proposed reforms to consumer credit laws, including that:

- ADIs would no longer be subject to the RLOs, which had been administered by ASIC; and
- non-ADI lenders would be subject to new lending requirements, administered by ASIC, based in large part on certain requirements in APRA's new APS 220.

Consistent with the Government's announcement, APRA's intent is to continue to regulate ADIs in accordance with existing prudential standards. APRA is not planning material revisions to its credit-related prudential standards or guidance. However, some amendments will be necessary in the event that the Government's proposed credit reforms are passed as legislation.

APRA recently consulted on two minor changes to APS 220, which would be progressed if the Government's proposed reforms are legislated. This includes a drafting amendment and a revised implementation date, to more closely align with the non-ADI regime.<sup>8</sup> APRA may also consult on some minor amendments to APG 223, once the outcome of the Government's proposed credit reforms is known. Based on current proposals, APRA does not expect that revisions to APG 223 would be material.

The expected amendments to the prudential framework will not change APRA's approach to supervising ADIs' lending practices, or enforcing APRA's prudential requirements. APRA's objective remains to set prudential requirements of ADIs for sound lending practices, which support the financial soundness of ADIs and the stability of the Australian financial system.

APRA continues to engage with relevant financial agencies as Treasury progresses the Government's proposed consumer credit reforms. APRA looks forward to assisting the Committee further with its inquiry.

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<sup>8</sup> Further information is available at: <https://www.apra.gov.au/consultation-on-revisions-to-new-prudential-standard-aps-220-credit-risk-management>.