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TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

STRENGTHENING RESIDENTIAL MORTGAGE LENDING ASSESSMENTS

The current environment for residential mortgage lending is underscored by very low interest rates and rapidly increasing housing prices. Household debt levels relative to income are high, both historically and internationally, and the rate of household credit growth is likely to exceed income growth for the foreseeable future, further adding to debt levels.

While the banking sector is well capitalised and lending standards have generally remained sound, there are heightened risks for the financial system from lending at very high levels of indebtedness. This letter sets out the action that APRA is taking, with the support of the Council of Financial Regulators (CFR), to reduce financial stability risks in the system.

Serviceability assessments

Given risks in the current environment, APRA expects all ADIs to adopt a more prudent setting for the mortgage serviceability buffer that is used to test borrowers' capacity to repay. All ADIs should be operating with a buffer of **at least 3.0 percentage points** over the loan interest rate.[1,2] The buffer provides an important contingency for rises in interest rates over the life of the loan, as well as for any unforeseen changes in a borrower's income or expenses. Where ADIs continue to approve loans using a lower buffer rate beyond the end of October 2021, APRA will adjust individual prudential capital requirements to reflect higher credit risk inherent in new lending.

Prudently assessing a borrower's ability to service and repay a loan, including in potential adverse conditions, is fundamental to sound credit risk management. Under *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223), APRA expects that prudent ADIs would keep the level of the buffer under review to assess whether it remains appropriate in relation to the broader risk environment. Even with record low interest rates and increasing levels of lending at high multiples of borrower income, most ADIs have made no changes to their serviceability buffers and have let floor rates atrophy.

APRA therefore also requests ADIs to review their risk appetites for lending at high debt-to-income ratios. While the use of a higher serviceability buffer will reduce risks for individual borrowers, growing portfolio concentrations of high debt-to-income loans also need to be monitored closely. Should concentrations of this lending continue to rise, APRA would consider the need for further macroprudential measures.

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1 In *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223), APRA set an expectation that banks would utilise a serviceability buffer of at least 2.5 per cent. This letter replaces that guidance, which will be more formally reviewed as part of a broader consultation on macroprudential policy tools later this year.

2 In calibrating the increase in the buffer, APRA has consulted with other CFR agencies and the ACCC, and had regard to the impact on different borrower cohorts, credit risk, loan growth and competition. A buffer of 3.0 per cent is also more in line with international practice.

Macroprudential policy toolkit

In addition to these near-term measures, APRA is also taking steps to ensure that macroprudential policy more broadly is placed on a sound longer-term footing. Later this year, APRA plans to publish an information paper outlining its framework for macroprudential policy, which will cover all capital and credit options.

This information paper will set out:

- APRA's approach to macroprudential policy, including objectives, the full toolkit of options, and implementation;
- how APRA would apply macroprudential policy to non-ADI lenders, should circumstances warrant it; and
- a process of consultation on proposals to embed macroprudential policy tools more clearly in APRA's formal prudential requirements.

Together with other members of the CFR, APRA will continue to monitor and assess the risks in residential mortgage lending as they evolve. If there is a further increase in key risk trends, APRA will consider additional measures beyond those announced today.

Yours sincerely,

Wayne Byres
Chair