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APRA

21 October 2021

Committee Secretary
House of Representatives Standing Committee on Tax and Revenue
PO Box 6021
Parliament House
Canberra ACT 2600

Dear Secretary

To assist the Committee's work, our submission provides context on APRA's role in regulating authorised-deposit taking institutions (ADIs), the main providers of housing credit in Australia.

In regulating ADIs, APRA's role is to set prudential requirements that are designed to protect the interests of depositors and promote financial system stability in Australia. Under APRA's prudential framework, ADIs are required to maintain prudent lending practices. In residential mortgage lending, APRA seeks to ensure that regulated lenders are making sound credit decisions that are appropriate, individually and in aggregate, in the context of broader housing market and economic trends.

Residential mortgages are the largest asset class on ADIs' balance sheets, and conditions in housing lending are a key area of prudential focus. A build-up of risks in this portfolio can have a material impact on APRA's objectives for maintaining financial soundness and financial stability. APRA closely monitors housing lending and many other aspects of the financial system in conjunction with other Council of Financial Regulator (CFR) agencies.

In setting prudential requirements of ADIs, APRA may influence the terms, amount and price at which ADIs provide housing finance. This may have flow on impacts to credit growth, which may in turn impact housing prices. However, it is difficult to separate these effects from other macro influences. House prices are not the objective of any prudential requirements for housing lending; APRA's objective is to maintain the financial safety of ADIs and stability of the financial system.

Annex A explains APRA's mandate and objectives in more detail, providing context relevant to the inquiry's Terms of Reference. It also outlines APRA's recent actions to mitigate rising risks in housing lending, which were announced on 6 October 2021.

Yours sincerely,

[redacted]

Renée Roberts
Executive Director
Policy and Advice Division

ANNEX A: APRA's role in housing

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. The aim of prudential regulation is to ensure that, under all reasonable circumstances, financial promises made by the institutions APRA supervises are met within a stable, efficient and competitive financial system. As the prudential regulator of authorised deposit-taking institutions (ADIs), APRA seeks to assure depositors that their deposits are safe and the Australian community that the financial system is stable.[1]

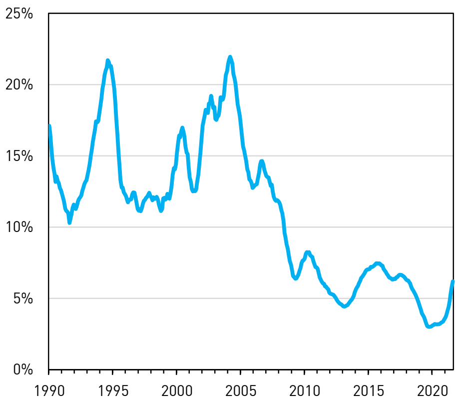
APRA's focus on housing lending

ADIs are the main providers of housing loans in Australia. ADIs currently account for more than 95 per cent of total loans extended to the housing sector.

Residential mortgages also represent a large share of ADIs' balance sheets. As at June 2021, housing loans accounted for 63 per cent of total loans extended by ADIs. Given this high concentration, significant stress in ADIs' housing loan portfolios could have a material impact on APRA's objectives for maintaining financial soundness and financial stability.

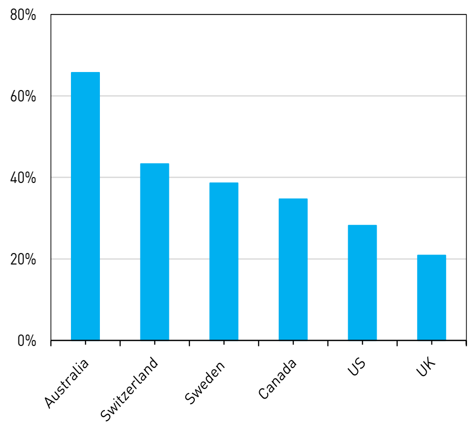
Housing has traditionally been a very low risk asset class for ADIs in terms of realised losses, due in large part to ADIs' historically prudent lending practices as well as a generally supportive economic environment over the past 30 years. The types of lending that contributed to large losses for overseas banks during the Global Financial Crisis, for example, have not been a feature of Australian banks' lending practices.[2] However, more risk-taking by borrowers and lenders has been observed in more recent years and, as a result, the share of total housing loans that are non-performing loans has been rising (albeit remaining lower than in comparable overseas jurisdictions). Aggregate household indebtedness has also risen.

Housing credit growth - annual



Source: RBA

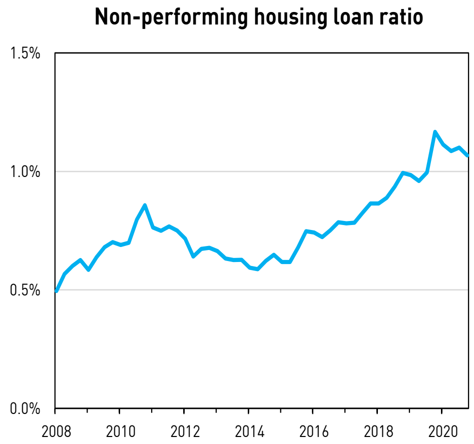
Housing loans, proportion of total loans



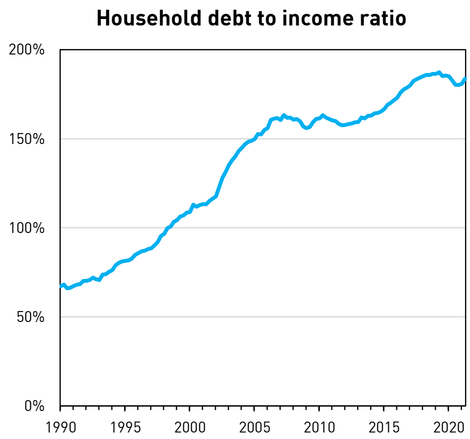
Source: IMF
Note: Chart represents latest available data for each country (generally 2020Q4 and 2021Q1)

[1] ADIs are authorised under the *Banking Act 1959* and typically operate as banks, building societies and credit unions. The *Banking Act 1959* sets out APRA's powers to establish and enforce prudential standards for ADIs.

[2] In contrast to some overseas jurisdictions, Australian mortgages are also 'full recourse'. This means that a borrower cannot simply hand in the keys and extinguish the debt.



Source: APRA



Source: RBA

To ensure ADIs maintain prudent lending practices, APRA sets prudential requirements for ADIs which are legally binding and made under delegated legislation. APRA's key requirements relevant to housing lending are set out below.

Prudential standards

APRA's *Prudential Standard APS 220 Credit Risk Management* (APS 220) sets out APRA's key requirements of ADIs in managing their credit risk. APS 220 encompasses all types of lending, including loans for individuals, 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 sets out specific requirements for lending to households, including for housing.[3] Under APS 220, ADIs are required to make a prudent assessment of a borrower's income, living expenses and other debt commitments. These credit assessments must include consideration of the borrower's repayment capacity under various scenarios, such as an increase in interest rates or a decrease in income, particularly for less stable income sources such as bonuses.

To assist ADIs in complying with these requirements, APRA provides additional guidance through prudential practice guides (PPGs). PPGs set 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). 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.

In addition to the APS 220 requirements, ADIs must also meet minimum capital requirements for lending. These capital requirements are designed to protect depositors from incurring losses associated with banks' lending activities. APRA's minimum capital requirements for credit risk are detailed in prudential standards *APS 110 Capital Adequacy*, *APS 112 Capital*

[3] APS 220 also includes general principles for prudent lending to other types of borrowers. This would include property developers with direct influence on the supply of housing.

Adequacy: Standardised Approach to Credit Risk and *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*.

Under these standards, ADIs must set aside higher amounts of capital against higher risk loans, creating additional incentives for prudent lending. APRA is currently finalising changes to the ADI capital framework that will further strengthen capital requirements for higher risk mortgage lending such as interest-only and investment loans. These changes will come into effect from 1 January 2023.

To ensure ADIs are meeting their prudential requirements, APRA places a strong emphasis on active supervision. APRA's supervision is focused on identifying and addressing issues before they cause the failure of an ADI, or materially contribute to financial system instability.

Other financial stability powers

Consistent with its mandate, APRA may also set heightened expectations for ADIs or require ADIs to temporarily moderate certain types of lending activity if this is contributing to risks of instability in the Australian financial system. In 2014 and 2017, for example, APRA set temporary benchmarks for growth in lending to residential mortgage investors and the proportion of new 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.

APRA has also recently announced measures to address emerging risks associated with rising household indebtedness and an increasing prevalence of borrowers seeking to borrow at high debt-to-income levels. In the current environment, APRA is concerned that high and rising household indebtedness would increase risks to future financial stability. Highly indebted borrowers are likely to be less resilient to future shocks, such as from rising interest rates or a reduction in income.

Consistent with these concerns, on 6 October 2021, APRA outlined an expectation that ADIs would assess borrower's capability to meet their loan repayments at an interest rate that is at least 3.0 percentage points above the loan product rate.[4] This compared to a buffer of 2.5 percentage points that had been commonly used in recent years.

In raising banks' serviceability buffers, APRA's objective is to ensure that mortgage lending is conducted on a prudent basis, and that borrowers are well-equipped to service their debts – both today and into the future. A higher serviceability buffer reduces the risks to financial stability from new borrowers overstretching in an environment of very low interest rates and rapidly rising house prices. In broad terms, a 50 basis points increase in the serviceability buffer will reduce maximum borrowing capacity for the typical borrower by around 5 per cent.

Measures aimed at reducing risks to financial stability are commonly referred to as macroprudential policy. In implementing these measures, APRA's objective is to reduce systemic risks from banks' lending practices. In doing so, APRA can influence the terms and price at which banks extend housing credit. APRA's actions are not targeted at housing affordability or supply.

APRA's decision to raise the serviceability buffer was supported by other members of the Council of Financial Regulators, comprising the Reserve Bank of Australia, the Treasury and the Australian Securities and Investments Commission. In determining its course of action, APRA also consulted with the Australian Competition and Consumer Commission.

[4] A 3 per cent serviceability buffer is more in line with international benchmarks.

The increase in the serviceability buffer is not expected to have a material impact on aggregate housing credit growth. It will impact only those borrowers that are borrowing at or near their maximum capacity. APRA anticipates a greater impact on investors, compared to first home buyers, since these borrowers tend to borrow at higher levels of leverage. Competition impacts are not expected to be material.

Later this year, APRA will publish an information paper setting out its framework for macroprudential policy. This information paper will provide greater detail on APRA's objectives for macroprudential policy, toolkit of options and approach to implementation.

Non-ADI lender powers

In 2018, APRA was granted new powers to introduce similar macroprudential requirements for non-ADI lenders, where there are concerns over risks of instability in the Australian financial system. These powers allow APRA to make rules relating to the lending activities of non-ADI lenders if APRA considers that lending by non-ADI lenders is materially contributing to financial system stability risks. 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.

In raising banks' serviceability buffers in October 2021, APRA did not consider there to be a basis for a policy response in relation to non-ADI lenders at this point in time. Non-ADI lenders currently account for a small share (less than 5 per cent) of total housing lending. Under Part IIB of the *Banking Act 1959*, APRA can only make rules in relation to non-ADI lenders if those lenders are considered to materially contribute to risks of instability in the Australian financial system.