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Ms [redacted]
[redacted]
Australian Prudential Regulation Authority
GPO Box 9836
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Email: ADIPolicy@apra.gov.au

Dear Ms [redacted]

MACROPRUDENTIAL POLICY FRAMEWORK: CONSULATION

The Australian Finance Industry Association (AFIA) appreciates the opportunity to provide this submission on the APRA Information Paper: Macroprudential Policy Framework.

AFIA[1] is a leading advocate for the Australian financial services industry. We support our members to finance Australia's future. We believe that our industry can best support Australia's economy by promoting choice in and access to consumer and business finance, driving competition and innovation in financial services, and supporting greater financial, and therefore social, participation across our community.

AFIA represents over 130 providers of consumer, commercial and wholesale finance across Australia, including authorised deposit taking institutions (ADIs) and non-ADIs. These banks, finance companies, fleet and car rental providers, and fintechs provide traditional and more specialised finance to help businesses mobilise working capital, cashflow and investment. They are also at the forefront of financial and technology innovation in consumer finance.

OUR SUBMISSION

AFIA supports the key objective for macroprudential policy to promote financial stability, at a system-wide level, by adjusting prudential requirements in response to the financial cycle. [2] We note that macroprudential policy measures are typically temporary and counter-cyclical in nature, with measures

[1] Australian Finance Industry Association (afia.asn.au)
[2] APRA Information Paper - Macroprudential Policy Framework. We note APRA explains that the financial cycle is 'a term used to describe the commonly observed cycle in financial system variables, and in particular credit growth and asset prices (such as property prices). An upswing in the financial cycle has often been observed to presage an economic downturn, as household, business or banking leverage can become stretched and reach unsustainable levels. The financial cycle may coincide with an economic or business cycle, but its length, timing and amplitude can differ.' page 7.

seeking to reduce excessive risk-taking during an upswing in the financial cycle and building additional resilience by providing flexibility for the finance industry in supporting the economy during a downturn.

AFIA believes giving consideration to the macroprudential policy framework at this time makes sense, with the ongoing demands and disruptions caused by the COVID-19 global pandemic continuing to impact on economic activity, market conditions, and community expectations, the interest rate cycle being at the low point, and the commencement of new prudential requirements for capital adequacy and credit risk management for ADIs over the next year.

However, AFIA makes the following observations:

- Regulation should not be 'one-size fits all', including macroprudential policy, rather regulation should be proportionate, targeted, and scalable
- Australia is experiencing a multi-speed economy and varied economic recovery, which makes the implementation of macroprudential policy measures more difficult to implement at this time without causing immediate and longer-term adverse and unintended consequences for access and choice, competition and innovation, and participation in finance
- Access and choice, competition and innovation, and participation must be considered along with financial stability to ensure the Australian financial system not only facilitates the smooth transfer of capital and promotes economic growth, but also supports financial inclusion.

Economic conditions

At aggregate, economic conditions are stronger than anticipated given the impacts of the COVID-19 global pandemic. However, there remains areas of economic under-performance and financial distress across our economy and markets, with the inevitable economic adjustment for some households and businesses likely this year, just as interest rates are expected to commence an upward cycle. Additionally, there is ongoing disruption to supply chains, which may be further exacerbated by overseas developments in geopolitics and that may directly and indirectly impact our economic recovery.

Current economic conditions shows that households and businesses are not homogenous, and even in the most impacted industries and geographies, economic activity is mixed. Therefore, we believe that any measures must be carefully considered from a macro and micro perspective as well as an immediate and longer-term outcome perspective.

In this context, AFIA notes there are an increasing number of public and media commentators focused on certain economic indicators or asset prices in certain markets, or even parts of markets, such as property. However, we do not believe it is appropriate for macroprudential policy measures to intervene to address housing prices, and that any particular levers should be given close consideration and carefully targeted to a clearly identified problem to avoid adverse and unintended consequences, especially for first home buyers access to property and competition and innovation across the finance industry, noting the impacts of interventions on larger institutions as well as the disproportionate impacts of interventions on smaller ADIs and non-ADIs.[3]

[3] AFIA made a submission to the House of Representatives Standing Committee on Tax and Revenue inquiry into housing affordability and supply in Australia. We made a number of recommendations on housing finance, land use and planning controls, and government policy, including proposing a new National Housing Strategy and Action Plan to galvanise and coordination action to support the different needs of homeowners and prospective homeowners.

AFIA believes any legislative or regulatory responses should be proportionate, targeted, and scalable, fit for the future, and evidence-based. Therefore, it is pleasing that APRA stated in the Information Paper that 'high and rising house prices would be an important risk factor that could signal that risks in the financial system are building, but financial stability, rather than housing affordability, would be the objective of any macroprudential policy measures'[4].

AFIA also believes Australia has a world-class financial system, which has not only withstood the most severe global economic crisis since the 'Great Depression', but is also emerging as a leading financial and technology centre.

While acknowledging that the outlook for our economy and financial system remains uncertain due to the COVID-19 global pandemic and other overseas developments, the RBA stated in their latest Financial Stability Review published in October 2021 that the Australian financial system is 'highly resilient' and well placed to withstand the economic effects of the pandemic and support our economic recovery.[5]

The RBA also stated in their Financial Stability Review published in October 2020 that 'stress tests of the Australian banking system indicate that… banks will remain very well capitalised even if the economic contraction is substantially more severe than expected. Given their strong balance sheets, banks will be well placed to continue lending, supporting the economic recovery and so in turn the Australian financial system'.[6]

Market developments

In the Information Paper, APRA outlines its objectives for APRA-regulated entities as being focused on the institution's own resilience as consistent with existing prudential requirements and proposes changes to Prudential Standard APS 220: Credit Risk Management (APS 220) for ADIs[7]. APRA also outlines its objectives for non-ADIs, which are narrower, and focused on reducing the contribution of these entities to financial stability risks.

ADIs and non-ADIs all play an important role in lending markets. Competition and innovation have increased access to finance for households and businesses in Australia. Different business models focused on offering products, services, and technologies in different ways means Australians have choice in not just the type of finance available, but in how they access finance, ensuring it is suitable to their personal and financial needs and circumstances.

ADIs are prudentially regulated because they hold deposits. Non-ADIs do not hold deposits, but are regulated for the activities they perform and the products, services, and technologies they offer customers. As at December 2021, non-ADIs comprised 5.1 per cent of total finance, and account for 4.6 per cent of new loan commitments (excluding refinancing) for housing in Australia.[8]

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[4] Ibid, page 8.
[5] Financial Stability Review – October 2021 | RBA. page 2
[6] Financial Stability Review – October 2020 | RBA. page 3
[7] AFIA notes that APRA is consulting on changes to formally embed specific credit-based macroprudential measures in prudential standards, provide greater transparency on likely credit measures that APRA could apply in the future, and bring together APRA's credit-based macroprudential measures into a single attachment to APS 220.
[8] ABS 5601 Table 2 and RBA Statistical Table B1

Therefore, non-ADIs do not pose systemic risks to financial system stability. ADIs and non-ADIs are required to maintain strong lending standards to meet regulations and protect capital. Furthermore, since 2018 and the addition of comprehensive data collection, APRA is well placed to understand the Australian financial system, including impacts of further macroprudential interventions with ADIs as well as financial system risk broadly, including the operational and portfolio performance of non-ADIs.

It should be noted that AFIA represents ADI and non-ADI lenders. AFIA members may provide their own submissions to this consultation.

RECOMMENDATIONS

Overall, AFIA does not believe that further macroprudential policy measures are warranted at this time to either strengthen resilience of institutions to risks in the financial system or moderate their risk taking, noting that the serviceability assessment rate was increased in October last year for ADIs[9].

RECOMMENDATION 1 – COMPETITION AND INNOVATION

AFIA recommends that when looking at potential changes to the implementation of macroprudential policy measures, especially for smaller ADIs and non-ADIs, it is important to ensure any changes do not impact on access to finance for households and businesses as well as competition and innovation in the financial services industry.

ADIs

AFIA notes that APRA's data collection and supervision activities ensure it has access to important information to assess and monitor system-wide and institutional levels. However, it is important that the data collection is based on clear definitions, so data comparability is not compromised. We suggest APRA liaise with ADIs to identify whether any definitions require clarification as applicable across different market segments and/or product classes. For example, the definition of debt-to-income ratio and the relevant use of income statements for employees, self-employed, and business borrowers.

Furthermore, it is important that any public reporting by APRA remains high-level. While we recognise the importance for APRA to gain insights regarding how ADIs (and non-ADIs) are managing their portfolios, public disclosure of certain information about portfolio performance could undermine competition and innovation in lending markets. For example, the level of lending against any limits or ratios could be interpreted (or misinterpreted) in ways that lead to unfair competitive outcomes.

Non-ADIs

AFIA notes that under Part IIB of the *Banking Act 1959*, APRA can extend macroprudential policy to non-ADI lenders where their provision of finance is materially contributing to risks of instability in the Australian financial system.

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[9] Media Release – APRA increases banks' loan serviceability expectations to counter rising risks in home lending – 6 October 2021

AFIA agrees that APRA needs to have a whole of financial services approach in relation to financial stability. This should include ADIs and non-ADIs and how they complement each other in an integrated financial system. We believe the factors that would determine whether applying macroprudential measures to non-ADIs should take into account:

- the combination of overall indicators, including credit growth and leverage, growth in asset prices, lending conditions, and financial resilience across the financial system
- the overall size of the non-ADI sector in lending markets and total finance
- the lending practices of ADIs and non-ADIs, including a balancing of factors and outcomes, such as market share, industry-wide standards (regulation and self-regulation), and financial inclusion
- insights from other regulators, such as ASIC, and evidence of systemic or particular industry practises that may contribute to concerns about financial stability risks.

As noted above, the non-ADI sector comprises around 5 per cent of total lending in Australia. Furthermore, there have been no examples of non-ADI failure in lending markets to support a change in APRA's approach and policy.

AFIA is concerned that extending macroprudential interventions into lending practices of non-ADIs may result in adverse and unintended consequences for customers, such as financial exclusion for certain customers, such as first home buyers, self-employed, and migrants. Furthermore, outside of property lending markets, it may result in lower consumer protections because customers seek finance from institutions that are not members of the Australian Financial Complaints Authority (AFCA), an industry association[10] and/or a signatory to an industry code, which binds them to behave in accordance with industry best practices.

It may also have adverse and unintended consequences for lending markets, such as smaller ADIs and non-ADIs deciding to scale back activities, adjust their operating models, or withdraw from markets due to the impacts on their ability to flexibly manage their portfolios and/or adhere to specific controls not easily absorbed into lenders reliant on securitisation markets for their funding.

RECOMMENDATION 2 – ACCESS TO CAPITAL FOR SMALLER LENDERS

AFIA recommends that if a change in APRA's approach or policy is proposed for smaller ADIs and non-ADIs, close consideration must be given to potential consequential impacts, including access to capital and future funding.

AFIA notes that during the COVID-19 global pandemic changes introduced by banks to support customers had a substantial impact on smaller ADIs and non-ADIs. Various forbearance measures, such as the 6-month repayment mortarium offered by banks, created customer expectations across the Australian financial system, and ultimately, had potential implications for non-ADIs funding agreements and warehouses.

[10] Under the AFIA Constitution, the Board may suspend or revoke membership if, among other things, a member is guilty of any conduct which, in the opinion of the Board, is unbecoming of a member or prejudicial to the interests of AFIA. Additionally, AFIA has developed an introduced a number of industry codes and is currently reviewing and developing additional industry codes. We believe industry codes are an important part of ensuring industry practices remain best practice, complement legal and regulatory obligations, and evolve as consumer and community expectations change.

The result was that the Australian Office of Financial Management (AOFM) introduced a forbearance SPV as part of the Structured Finance Support Fund (SFSF) to help normalise funding markets for non-ADIs. Fortunately, the forbearance SPV was not significantly relied upon due to a number of factors, including changes in capital markets as well as lockdowns not requiring a 'nation-wide hibernation' as initially predicted, with broader financial hardship assistance options being more suitable for customers. However, this demonstrates that interventions can have secondary implications for non-ADIs.

AFIA believes that the introduction of certain lending restrictions, such as debt-to-income ratios, loan-to-value ratios, type of customer (e.g. owner-occupier versus investor), or type of loan (e.g. interest only), would impact on how a non-ADI may be required to manage their loan portfolio, and thus, impact on lending convents in their funding agreements and warehouses and/or their ability to securitise their assets and fund future growth.

A lack of funding optionality for non-ADIs would have a material impact on competition and innovation and limit access to finance for customers who choose not to use the products, services, and technologies of an ADI or customers that sit outside the risk appetite of an ADI or outside the offerings provided by an ADI. As noted above, limiting access may result in customers seeking alternative finance from less or unregulated lenders and/or financial exclusion.

Consequential impacts on institution and markets should be avoided. Alternatively, AFIA observes that financial stability risks are limited because most of the non-ADIs funding agreements and warehouses are with ADIs, and thus, are set within their portfolio parameters.

RECOMMENDATION 3 – ALTERNATIVE MEASURES AND DATA COLLECTION FOR SMALLER LENDERS

AFIA recommends using other measures to assess and monitor the potential risk of increased financial instability.

AFIA agrees with APRA that the highest potential for increased financial instability would likely occur in home and commercial property lending portfolios. This is due to their relative high average dollar loan sizes and portfolio concentrations for some larger institutions.

In 2019, the RBA stated: 'Non-bank mortgage lenders account for less than 5 per cent of outstanding housing credit and so are not a substantial financial stability risk'.[11] Residential property market share for the non-ADI sector has slightly increased since this report.

In relation to commercial property, the same report outlines that the majority of the lending by non-banks is mezzanine debt, which is ranked below senior debt in the capital structure. This debt is relatively expensive and so reduces the likelihood that low-return projects will proceed, minimising the financial stability risk.

[11] Non-bank Lending for Property | Financial Stability Review – April 2019 | RBA

In 2021, the RBA updated its commentary and indicated that: 'The four major banks account for the bulk of exposures [to commercial real estate - CRE], with a smaller share belonging to foreign-owned banks… The available information suggests that financial stability risks from retail CRE are currently lower than previous retail sector downturns. This reflects that CRE lending has experienced only moderate growth over recent years and has been subject to conservative lending practices. Moreover, the largest landlords have maintained conservative balance sheets, which will position them well to cope with the challenges posed by weakening rental demand'[12].

Therefore, the two largest dollar value asset classes pose low financial stability risk with regards to the non-ADI sector. Other product classes include credit cards, personal loans, and small business lending. These products have lower loan balances and as outlined above, non-ADI assets in these product classes account for around 0.5 per cent of total finance.

AFIA notes that APRA already receives prescribed reporting on a monthly basis from non-ADIs as well as additional data and information as requested. Therefore, rather than impose macroprudential interventions, we propose, as part of the existing data collection and engagement program for the non-ADI sector, consideration be given to better integration of data series from APRA, RBA, and the Australian Bureau of Statistics (ABS) and better analysis of the data to provide a more fulsome picture of lending markets. Better data analysis will provide broader insights, but also identify potential leading indicators of financial stability risk.

Furthermore, AFIA notes the recent APRA publication on managing compliance risk. We support building on our existing industry engagement program, noting the AFIA-APRA webinar series, and providing additional opportunities for APRA to share insights and lessons from their ADI surveillance activities for a broader ADI and non-ADI sector audience. We would be pleased to discuss opportunities further with APRA.

CLOSING COMMENTS

AFIA recognises the important role macroprudential policy can play in mitigating risks at a system-wide level. The risk factors that APRA uses to identify emerging threats to financial stability and the tools available to strengthen resilience or moderate risk taking, such as temporary credit or capital measures, are appropriate.

However, we support APRA's proposed approach to consult with the Council of Financial Regulators and industry prior to implementing any macroprudential policy measures and provide an annual assessment of the effectiveness of any macroprudential policy measures, including an outline of the broader, direct and spillover impacts.

Finally, AFIA believes it is important to place this assessment in the context of not just the macroprudential interventions, temporary or otherwise, but also developments in the external environment, including the influence and impact of fiscal and monetary policies as well as broader actions taken following consultation with the Council of Financial Regulators.

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[12] Risks in Retail Commercial Property | Financial Stability Review – April 2021 | RBA

Should you wish to discuss our submission or require additional information, please contact me or Anna Fitzgerald, Executive Director, Communication & Strategy at [redacted] or [redacted]

Yours sincerely

[redacted]

Diane Tate
Chief Executive Officer