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Mr Neil Grummitt
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Dear Neil,

Draft Prudential Practice Guide 223 – Residential Mortgage Lending

The Australian Bankers' Association (ABA) welcomes the opportunity to provide comment on draft *Prudential Practice Guide 223 Residential Mortgage Lending (Draft APG 223)* released by the Australian Prudential Regulation Authority (APRA) to provide guidance to Approved Deposit-Taking Institutions (ADIs) on sound risk management practices for residential mortgage lending.

The ABA is the peak national body representing banks that are authorised by APRA to carry on banking business in Australia. The ABA's membership of 26 banks comprises the four major banks, former regional banks that now operate nationally, foreign banks that are represented and carry on banking business in Australia as Australian banks and two mutual banks.

This submission comprises two parts:

- Part 1 - General observations on the appropriateness of the approach taken by APRA in Draft APG 223; and
- Part 2 - Specific observations on particular paragraphs in Draft APG 223.

1. General observations

Residential mortgage lending, as a lending class, is of systemic importance to Australia's banking system. As noted in para 1 of Draft APG 223 "lending secured by mortgages over residential property ... constitutes the largest credit exposure in the Australian banking system." It is therefore wholly appropriate for APRA to provide guidance on how ADI's manage credit risk. However, less appropriate, from the ABA's perspective, is the current form of that guidance particularly in relation to the level of prescription which is at odds with current APRA initiatives to reduce regulatory burden and invites a "tick

the box” mentality. A better approach would be for APRA to enunciate principles across each of the topic headings without prescribing how ADIs should run their mortgage lending activities.

That said, the general expectations in Draft APG 223 are for the most part reasonable and the ABA appreciates that APRA has set guidance out in the PPG while other regulators have taken macroprudential actions to limit residential mortgage lending. The ABA also appreciates that APRA has set out its concerns in the Guidance Note and has written to ADIs as it seeks to address this industry risk. However, the overarching concerns regarding Draft APG 223 are as follows:

- *Unduly prescriptive* - too often opting for a “one size fits all” approach, rather than establishing a set of principles which allow ADI’s to prudently and flexibly manage credit risk within the parameters of their business models and risk appetites. It should be remembered that it is as much in the ADI’s interest to manage credit risk on residential mortgage lending prudently as it is in interests of the economy.
- *Fails to complement and align properly with ASIC guidance* - thereby confusing rather than guiding. ASIC guidance is appropriately focused on “the individual loan level”, as is consistent with its consumer protection mandate. APRA guidance should be focused on “the portfolio level” which is consistent with its system protection mandate.
- *Duplicates content contained elsewhere* - again, likely to confuse rather than guide. This is particularly evident in relation to comments in Draft APG 223 relating to responsibilities of the board. CPS 220 is the risk management standard (supported by CPG220) which sets out expectations of the board.
- *Uncertain application to subsidiaries* - it is unclear whether Draft APG 223 is solely focused on residential mortgage lending in Australia and how it would apply to subsidiaries (if at all);
- *Absence of materiality considerations* - these are generally appropriate in a risk-based approach.
- *Implementation period* - Draft APG 223 is silent on implementation time frames. There are several issues related to this including length of period and APRA’s supervisory approach during the period.

Our concerns in relation to the above issues are further explained below.

1.1. Unduly prescriptive

APRA typically provides “principles-based” guidance. This approach is consistent with its system-based approach to banking regulation and the current Federal Government’s regulation reduction agenda. However, there has been a trend in more recent guidance notes and standards towards greater prescription. This trend is also evident in Draft APG 223 and relates to a number of areas including risk management framework, loan origination, valuation, hardship and collection, and also in relation to the requirements of the board. Excessive prescription tends to translate into additional compliance cost, given that different ADI’s have different processes and risk appetites. Despite this being a Guidance Note rather than a Standard, there will inevitably be the expectation from frontline supervision teams that ADI’s comply in full with the final PPG as this is the experience across the industry.

The ABA recommends that APRA revisit its approach in Draft APG 223 and re-cast the document as principles-based guidance in relation to prudent lending practices at a portfolio level. It should not specify the details of how the principles should be applied. For example, paragraphs 35 and 36 are highly prescriptive on how an ADI should verify a borrower’s stated income. A more appropriate manner

for APRA to express its views on how a principle should be applied, or a process conducted, is by way of examples.

1.2. Complement and alignment with ASIC guidance

ADI's as credit providers have responsible lending obligations under ASIC's National Consumer Credit Protection (NCCP) requirements, in particular Regulatory Guide 209 (RG 209). RG 209 provides guidance on individual lending requirements. This is appropriate given ASIC's "consumer watchdog" function and the ABA considers that it is appropriate for ASIC to continue to be the primary regulator with respect to responsible lending requirements.

The ASIC guidance is drafted from the perspective of whether or not the loan is suitable for the borrower. In contrast APRA's perspective is one of prudential risk management, e.g. how will the lender ensure that it can recover its money? Accordingly, ASIC and APRA approach this same subject matter, but from different perspectives.

APRA's guidance should therefore be restricted to the portfolio level. Focusing APRA's guidance at this different level will increase the likelihood of APRA guidance complementing and aligning with ASIC guidance rather than being contradicting and confusing. For example, there are a number of obligations set out in Draft APG 223 which go further than the responsible lending requirements in the NCCP, including:

- Buffers and the requirement to "*seek to ensure that an individual borrower, and the portfolio in aggregate, would be able to absorb substantial stress, such as in an economic downturn, without producing unexpectedly high loan default losses for the lender*";
- Both the NCCP and Draft APG 223 require an ADI to take a view on what will happen in the future. However, the level of prediction required under the NCCP is limited to changes in customer circumstances that are:
 - reasonably obvious e.g. retirement;
 - disclosed by the customer e.g. impending maternity leave; and
 - a reasonable interest buffer, of typically around 2% although in the present low-interest environment that buffer may be higher or an interest floor may be used; and
- The NCCP imposes a base level of responsible lending requirements which cannot be reduced e.g. in relation to foreseeable changes. APRA, on its face, is seeking to set a higher level of responsible lending requirements in relation to predicting future matters and buffers.

1.3. Duplication of content

Content which is included in other documents should not be duplicated in Draft APG 223. Retention of duplicated references runs the risk that the language across standards and guidance notes may be, or become over time, inconsistent leading to confusion. This risk is most evident with the duplication of content from CPG 220 and CPS 220 in relation to the role of board. For example, Draft APG 223 does not accurately reflect the three lines of defence model outlined in CPG 220 with an apparent expectation that the board will take a more management than supervisory role. This concern is consistent with previously expressed ABA concerns that CPS 220's requirements on the board are too prescriptive and similarly blur the boundaries of the role of the board and management. For example, paragraph 73

requires that the Board and senior management review targets and controls. In our view senior management should be accountable for such a review.

1.4. Application to subsidiaries

In the case of APRA Standards it is clearly articulated that the application is at Level 1, Level 2 or Level 3. Draft APG 223 however is not clear as to which parts of the guidance apply to which level. Accordingly, it is not clear whether Draft APG 223 is solely focused on residential lending within Australia, or whether it extends to subsidiaries located outside Australia.

If APRA's intention is that Draft APG 223 is to apply to off-shore subsidiaries then it is noted that in its current form there are likely to be some inconsistencies, or conflicts, with domestic rules.

1.5. Materiality levels

Draft APG 223 should have materiality levels consistent with APRA's risk assessment approach. For example, Draft APG 223 conflicts with APRA's intention to amend the annual risk management declaration to include the concept of materiality for the Board declaration.

1.6. Implementation period

The ABA notes that Prudential Practice Guidelines, unlike Prudential Standards, do not typically have an implementation date from which it is enforceable. However, in this instance the ABA recommends that if the views in Draft APG 223 are retained largely in their current form then an implementation period is necessary. This will allow ADIs time to make system changes. As previously advised, industry needs a 12 month implementation period from the time a Standard, or in this case Guideline, is finalised to implement needed changes. The ABA is also interested to learn of APRA's intended supervisory approach during any implementation period.

2. Specific Observations

The ABA makes the following specific observations of Draft APG 223:

- Paragraph 7 hard and soft limits - CPS220 defines tolerances as the maximum level that ADIs are prepared to take for each material risk. The discussion of these as potentially soft limits seems to be a contradiction which will cause confusion. The ABA suggests that an alternative and preferable way to express the underlying concept is to distinguish between tolerance levels (approved by the Board) which are hard, and management limits (below the tolerance levels) which could be either hard or soft. Accordingly, paragraph 7 should be either removed or simply refer back to paragraph 30 of CPS 220.
- Paragraph 13 – the requirement for an independent audit every five years should be removed since CPS 220 already requires that this be done every three years. The five year requirement therefore at the same time both duplicates an existing requirement, and is inconsistent with that existing requirement.
- Paragraphs 17 to 19 remuneration policies - CPS 510 requires the board approved ADI remuneration policy to be aligned with prudent risk taking. Draft APG 223 outlines that an ADI's remuneration policies include amounts paid to third parties, in particular mortgage brokers where they originate a

loan. Further, there is an expectation of a claw back of commissions in particular circumstances. The suggestion that an ADI's remuneration policy be applied to non-employee brokers is problematic for a number of reasons. First, it ignores that mortgage brokers and their remuneration is already subject to regulation under ASIC's credit licensing requirements. Second, it does not represent commercial reality and the existing contractual arrangements between ADIs and mortgage brokers. It is not appropriate to extend ADI remuneration policies which are intended for salaried staff to mortgage brokers. Any general contractual term ostensibly allowing an ADI to claw back commissions may contrast the prohibition of penalties in the law of contracts, thereby rendering the term void.

The ABA recommends that these paragraphs be amended to remove the application of the ADI's remuneration requirements to mortgage brokers who are covered by their own NCCP obligations. We note that APS 510 was subsequently changed for the same reasons,

- Paragraph 22 - presumption of additional risk management measures where the credit decision is made distant from the customer location. The ABA considers the presumption unwarranted. ADIs use a scorecard mechanism to assess loans. That mechanism includes a range of factors including the location of the customer. The scorecard mechanism is robust and any additional prescriptive requirements in relation to any one factor, including customer location, is likely to undermine the effectiveness of the scorecard mechanism.
- Paragraph 24 - requirement for serviceability assessment to include periods of economic stress. This generalised requirement goes beyond the NCCP requirements which only require this factor to be considered when there is good reason to think that a customer will be individually impacted. This limitation should be retained in Draft APG 223.
- Paragraph 28 - income buffer. This requirement again goes beyond the NCCP requirements, which only requires than a reasonable income buffer above expenses for unexpected changes which are reasonably predicted. The reasonably predicted requirement should be retained in Draft APG 223. The term "retains" in this context refers to "at origination" and not the life of the loan which is covered by the hardship provisions. The ABA does not support the suggestion that ADIs should use both interest rates and floors. In the ABA's view interest rate buffers are more efficient in managing delinquency risk and meeting customer requirements on loan approval amounts.
- Paragraph 30 - discussion on buffers and absorption of stress. The paragraph includes the concept of the individual borrower with consideration of portfolio risk. This combination is confusing. Under NCCP ADIs are not required to consider the impact of "an economic downturn" on an individual borrower unless there is good reason. ADIs already have processes to consider portfolio changes and extending this to individuals is not necessary. There is already an interest rate buffer to factor in changes in the environment and the focus should be on the portfolio's capacity to absorb substantial stress, not that of an individual borrower.
- Paragraph 31 - use of standard variable rate (plus a buffer) for serviceability calculations. The ABA considers that this basis would penalise certain customers and reduce their borrowing capacity. The ABA considers that a more appropriate basis is to use the expected rate (i.e. the actual rate the customer would pay for the loan generally the standard variable rate less any discounts) that the customer will be required to pay.
- Paragraphs 33 to 40 - should just reference ASIC's responsible lending requirements with the detail removed. The ABA considers these sections are unnecessary in the light of the NCCP regime. The ABA notes in relation to paragraph 35 that there are other forms of verification available which are not specified, again highlighting the ABA's concern with draft APG 223's prescriptive approach.
- Paragraph 41 - duplicates the requirements for buffers required throughout previous paragraphs 30 to 40 and the previous comments also apply here.

- Paragraph 47 - verification of information requirements from third parties are too prescriptive. Moreover, third parties are regulated by ASIC.
- Paragraph 56 - omits reference to other forms of verification which are available to ADIs which are not prescribed e.g. bank held information can be an equally valuable source of truth when compared against customer declared values.
- Paragraph 60 - inclusion of equity lines of credit specifically in risk appetite settings is too prescriptive. Draft APG 223 should not call out a single segment of higher risk lending.
- Paragraph 63 - regarding security valuation suggests that valuer selection should be conducted by the ADI's risk management area, rather than sales staff and that the involvement of ADI sales or product staff in panel management would be minimal. The ABA and its members agree that the valuer selection should not occur within sales or product reporting lines, however the ABA believes it is appropriate for selection to be made by operational areas within the ADI. Operational areas have the expertise to undertake valuer selection and are not sales or product areas. The ABA recommends that paragraph 63 be amended to reflect the fact the appropriateness of operations areas being involved in valuer selection with appropriate input from the risk management function.
- Paragraph 86 - requirement for an updated valuation at default is overly prescriptive. There will be many instances where this is not necessary.

Yours sincerely,



Paul Stacey