Australian Prudential Regulation Authority

APRA's Perspective on the Residential Mortgage Lending Market

Submission to the House of Representatives Standing Committee on Economics

18 July 2008

Purpose

This submission provides APRA's perspective on residential mortgage ('housing') lending by authorised deposit-taking institutions (ADIs) in Australia. Its purpose is to assist the House of Representatives Standing Committee on Economics in its stocktake of the Australian retail banking industry. APRA is not in a position to comment on the unregulated housing lending sector, although competition from this sector does have an impact on institutions regulated by APRA.

Background

As a general matter, APRA does not have responsibility for competition policy or consumer matters outside its core mandate. However, the *Australian Prudential Regulation Authority Act 1998* does charge APRA with balancing the objectives of financial safety and efficiency, contestability, competition and competitive neutrality in the prudentially regulated financial sector and, in balancing these objectives, to promote financial system stability in Australia.

In providing guidance to APRA about the balancing of objectives, the Government's *Statement of Expectations* of APRA (2007) recognised that prudential regulation should not seek to guarantee a zero failure rate of prudentially regulated institutions or provide absolute protection for market participants (including consumers). Rather, the objective is to maintain a low incidence of failure of regulated entities while not impeding continued improvements in efficiency or hindering competition. In its *Statement of Intent* in response, APRA confirmed that it fully supported this objective.

In the housing lending market, APRA's activities involve the prudential oversight of:

- the ADI sector, comprising banks, building societies and credit unions, which are the major providers of housing finance to the Australian community; and
- lenders mortgage insurers (LMIs), a special category of general insurance companies which have significant exposures to credit risk in housing lending.

APRA's approach to the prudential supervision of these two sectors is predicated on the principle that the primary responsibility for the prudent management of an ADI or LMI rests with its Board and senior management. APRA's role is to promote prudent behaviour by these institutions through a robust prudential framework and a risk-based approach to the supervision of individual institutions.

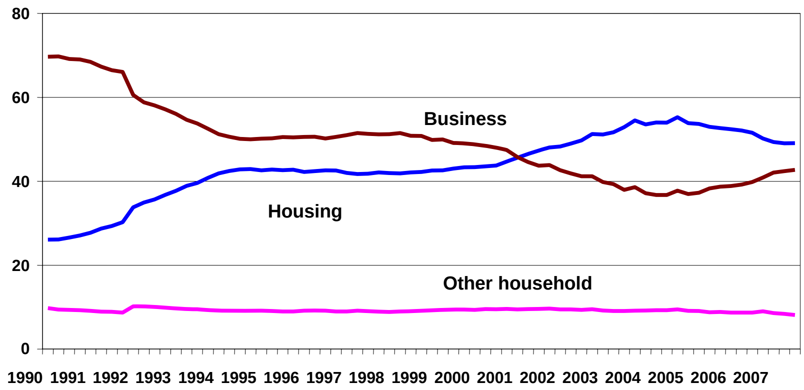
In the difficult global financial market environment of the past year, APRA has stepped up its supervisory intensity in the ADI and LMI sectors, particularly with respect to credit and liquidity risks. However, the heightened focus on financial safety and soundness has not, in APRA's view, compromised efficiency or competition in these two sectors.

Competitive landscape

Over recent years, sustained growth in housing lending has transformed the balance sheets of ADIs in Australia. That growth has been driven, on the demand side, by the willingness of Australian households to take on debt in the low unemployment, low inflation, low interest rate environment that prevailed until recently and, on the supply side, by intense competition among housing lenders, both APRA-regulated and otherwise.

Housing lending now comprises almost half of total domestic lending by ADIs, compared with only around a quarter in 1990 (Figure 1). The switch in the composition of lending portfolios has unwound a little over the past couple of years with renewed strong growth in business lending, but it remains pronounced nonetheless.

Figure 1: ADI lending by sector



As a group, building societies and credit unions have continued to grow in absolute terms but have lost market share to banks, both through differences in organic growth rates and through the conversion of several major building societies to banks (and, more recently, the takeover of some building societies by banks). Building societies and credit unions account for around six per cent of total ADI housing lending (excluding securitised assets), though they remain strong competitors in the localities they serve. Consolidation has been a feature of the smaller end of the ADI sector, with the number of building societies falling from 19 to 13 between March 2000 and March 2007, and the number of credit unions from 218 to 137 over the same period.

Two major spurs to competition in the housing lending market in Australia over the past decade have came from:

- the entry of specialist mortgage originators (not regulated by APRA) in the mid 1990s; and
- the emergence of mortgage brokers, who act as intermediaries between lenders and borrowers and make it easier for borrowers to compare costs and features of different loans.

Foreign bank subsidiaries of major US, UK and European banks have also made inroads into the housing lending market over the past few years.

A contributing factor to the heightened competitive pressures, at least until mid-2007, was the availability of competitively priced term funding via the residential mortgage-backed securitisation (RMBS) market. Mortgage originators have relied almost entirely on this source of funding, while regional banks and some building societies have also made extensive use of the RMBS market for funding or capital management purposes. However, the larger Australian banks have made relatively little use of this source of funding, preferring to retain the bulk of their housing loans on balance sheet.

Banking products

One major consequence of the substantial increase in competition in the housing lending market has been the reduced cost, and greater availability, of housing finance to Australian households[1]. The variety of mortgage products has also expanded. Many of the products were first promoted by unregulated lenders but are now offered as mainstream products by the larger banks and other ADIs. These products include higher loan-to-valuation (LVR) loans, interest-only loans and shared-equity loans, which make it easier for households, particularly first-home buyers, to purchase their home. Low-doc loans, typically available to enable self-employed borrowers without regular wage/salary documentation to obtain a loan, have also become more common over recent years.

In late 2006, APRA collected information from 44 ADIs on every housing loan they approved during the month of September 2006. The data sample comprised around 112,000 approved loans involving $27.6 billion in loan commitments. Compared with produce choice 15 years ago, it is clear that ADIs are now providing a wide range of mortgage products reaching a broad segment of the Australian community.[2]

This snapshot of lending data showed that across ADIs:

- low-doc lending, mostly originated by the larger ADIs, comprised around 10 per cent of approvals;

- first-home loans also comprised around 10 per cent of approvals. Around two-thirds of first-home lending by value was at an LVR of over 80 per cent and almost half over 90 per cent;

- around one-third of loans were sourced through a third party (mortgage brokers, money managers or other third party);

- around 35 per cent of the loans were refinancings of existing home loans, pointing to considerable ‘churn’ in the market; and

- around 30 per cent of the loans were covered by mortgage insurance, with most of the insured loans in the higher LVR ranges. Only 2 per cent by value of housing loans with LVRs between 90 and 100 per cent were not mortgaged insured.

Credit quality

Another consequence of the substantial increase in competition, especially from unregulated lenders, has been the pressure on ADIs to depart from traditional housing lending practices. This has involved increased reliance on mortgage brokers to originate loans; greater use of alternative property valuation methods; introducing a range of higher risk mortgage products; and relaxing debt serviceability criteria. While these departures from traditional lending practices can be seen as an easing of credit standards in response to heightened

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[1] Joint RBA-APRA submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration, Inquiry into Home Loan Lending Practices and Processes, August 2007.

[2] Laker, JF “Credit standards in housing lending-some further insights”, Speech to Institute of Chartered Accountants in Australia, 20 June 2007. See also “ADI housing lending”, APRA *Insight*, Issue 1, 2008.

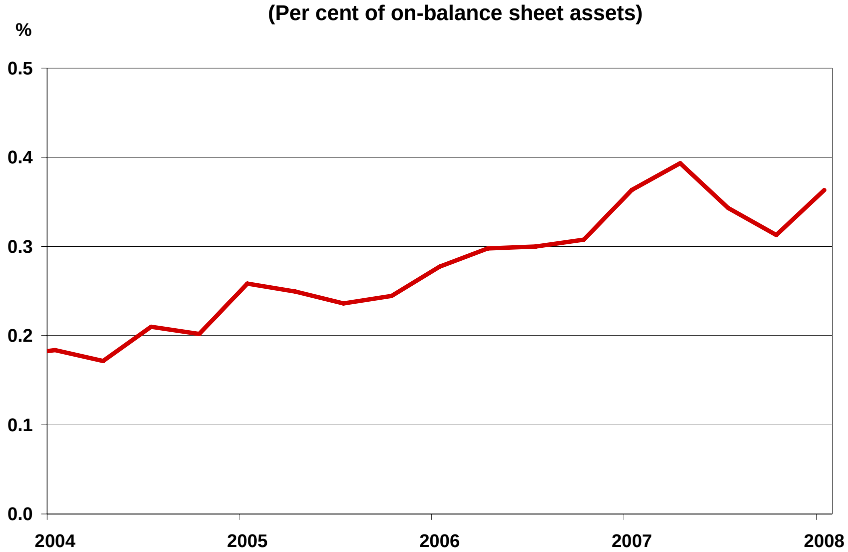
competition, they can also be interpreted in some ways as part of the normal product innovation process to meet the community's demand for more varied and flexible mortgage products.

Against this background, credit standards in housing lending have been a major focus of APRA's prudential oversight of ADIs, both in its supervision of individual institutions and in applied research to better understand housing lending risk in Australia. The departures from traditional lending practices have signalled an increased appetite for risks on the part of ADIs and, in its supervisory activities, APRA has sought to reassure itself that these risks are identified and carefully managed.

APRA's research has covered a number of dimensions of ADI housing lending including, in 2002/03, a major stress test of the resilience of housing lending portfolios to a substantial housing market correction; in 2003/04, a survey of property valuation practices used by ADIs and lenders mortgage insurers; and in 2006/07, a survey of the methods used by ADIs to assess the ability of their customers to service their housing loans ('debt serviceability').

Based on its supervisory activities and research, APRA's assessment is that the quality of ADI housing lending remains among the strongest in the world. Not unexpectedly, in an environment of tighter domestic financial conditions, arrears rates on housing lending have begun to edge up again in 2008 (after declining in the second half of 2007), but arrears rates remain very low by historical and international standards (Figure 2).

Figure 2: ADI non-performing housing loans
(Per cent of on-balance sheet assets)



One feature of the housing lending market in Australia is the extensive use of lenders mortgage insurance. As noted above, ADIs generally pass the risk of higher LVR loans to LMIs, which also provide support to much of the Australian RMBS market.

As a consequence, the LMI sector in Australia naturally has significant exposures to credit risk in housing lending. As with ADI arrears rates, data on LMI claims have shown an upward trend in LMI claims payouts over the past two years. However, claims experience has been readily manageable and the LMIs continue to report solid underwriting profits that support the strong capital base of the industry in Australia. While the major rating agencies have recently downgraded some foreign-owned LMIs due to reported group losses, the agencies have also acknowledged the strength of the Australian subsidiaries and of APRA's prudential framework for lenders mortgage insurance.

Prudential framework for housing lending

APRA has a range of prudential standards that ensure that ADIs are adequately capitalised and have appropriate risk management systems in place.[3] New prudential standards for capital adequacy were implemented in Australia from 1 January 2008. These standards are based on the Basel Committee on Banking Supervision's global capital regime for banks, commonly known as Basel II, and have been amended by APRA, where appropriate, to accommodate local conditions. APRA applies the Basel II regime to all ADIs.

Regulatory capital for housing lending is generally less than that required for other retail exposures, reflecting the historic low loss rates for this class of lending. Under Basel II, regulatory capital requirements for conventional housing loans are lower than under the previous regime, and also more granular.

The vast majority of ADIs use the so-called Basel II 'standardised' approaches in determining their regulatory capital charge. Under these approaches, the risk-weighting scheme for housing loans is based on the outstanding amount of the loan to the value of the residential property or properties that secure the loan (LVR), whether the loans are standard or non-standard (which include 'low doc' loans) and whether the loan has acceptable lenders mortgage insurance covering a minimum of 40 per cent of the original loan amount. Depending upon these characteristics, a loan may be risk-weighted at 35, 50, 75 or 100 per cent.

APRA has also provided approval for a small number of ADIs to use the so-called 'advanced' approaches available under Basel II. Under these approaches, ADIs may use their own estimates of the probability of customer default (the probability of default), the value of the exposure at the time the customer defaults (exposure at default) and the loss that will be incurred if the customer defaults (loss given default) as inputs into determining the risk-weight for housing loans.

APRA has previously stated that it does not view Basel II as a vehicle for changing the competitive landscape for ADIs but as an opportunity to align regulatory capital more closely with the risks that ADIs assume and how well those risks are managed.

APRA does not expect the implementation of the Basel II regime to change materially the pricing of housing loans. Over time, the requirements could contribute to a small increase in the pricing of riskier loans and a small decrease in the pricing of less risky loans. Such changes would likely be difficult to discern from other changes in pricing resulting from movements in official interest rates and industry competitive pressures on lending margins. For those ADIs using the advanced approaches, there will be a change in the risk-weights of many of their assets. APRA is currently assessing the immediate capital impacts of Basel II for these ADIs and early indications suggest these impacts are not significant.

[3] *APRA's Prudential Framework for Housing Lending*, Submission to the Senate Economics References Committee, April 2008.

Implications of recent market turbulence

The turbulence in global financial markets since last August, triggered by the sharp deterioration in the US sub-prime mortgage market, has had two particular implications for the housing lending market in Australia.

Firstly, lenders have had to pay substantially higher rates for wholesale funding, both in absolute terms and relative to risk-free (government debt) rates as global credit markets have turned much more risk-averse. This has in turn led to more competition between ADIs for retail deposits, particularly retail deposits sourced through online deposit accounts.

Secondly, those lenders in particular that use securitisation markets to fund their housing lending have found that source of funding has virtually dried up. Since mid-2007, local and global capital markets have become much less supportive of asset-backed and structured funding of any sort, including Australian RMBS issues. Very few RMBS issues have been made globally over this period and spreads on these issues have been much greater than for RMBS issues prior to mid-2007. There have been tentative signs of revival in the Australian RMBS market recently, but for some time it had not generally been economical for lenders to issue RMBS since the interest earnings on the housing loans securitised were not sufficient to pay the coupon demanded by investors and other RMBS costs.

The combination of higher funding costs, reduced availability of term funding for lower rated institutions and a virtually closed securitisation market has, in the short term at least, changed the competitive landscape in the housing lending market in Australia. The larger banks with stronger credit ratings have re-established their traditional funding and distribution advantages, while many smaller ADIs that have been more reliant on securitisation markets have had to moderate their lending growth. Some ADIs have also reduced their use of mortgage brokers and/or renegotiated commission structures.

A number of unregulated housing lenders have either exited, ceased new lending or significantly curtailed their rate of new lending. Moreover, many have re-priced their higher risk mortgage products, particularly low-doc loans, to take account of the more challenging funding conditions facing unregulated lenders.

Funding difficulties have put pressure on some smaller ADIs to merge with their larger peers to improve access to funding. In addition, some foreign banks over recent months have scaled back or have been considering plans to scale back their activities in Australia. The likely consequence will be some further consolidation in the ADI sector (apart from the pending merger of Westpac and St George banks, the largest bank merger for many years).

Notwithstanding these developments, APRA's view is that borrowers with sound credit records, reasonable equity in the home and documented ability to service a mortgage should have little if any difficulty in accessing housing finance from competing lenders. Many borrowers who are good credit risks but with more limited capacity to provide equity will continue to benefit from access to lenders mortgage insurance and will receive housing finance on this basis. This view is supported by APRA's regular liaison with credit officers of the larger ADIs, who have noted that credit standards for housing lending in their institution have not been tightened outright but that there has been some reduction in lending outside internal credit policies ('policy exceptions') and heightened scrutiny of assessments of debt serviceability.

On the other hand, borrowers with impaired credit records, little or no equity and uncertain income sources to support a loan, who might previously have used the services of a mortgage broker or unregulated lender, are likely to find it more difficult to access housing credit, particularly at the risk spreads charged by lenders up to mid-2007. This is not a local phenomenon but a reflection of the global repricing of risk and the sharply reduced risk appetite of investors in the wake of the US sub-prime difficulties.

As global financial market conditions become more settled, these changes to the competition landscape for housing lending in Australia may begin to unwind. At some point, domestic and international investors will recognise the strength of Australia's housing lending portfolios and Australian RMBS will again be well received. However, the risk premia for credit risk in global markets are not expected to return to levels prevailing before mid-2007, which subsequent events have shown to be unsustainably low.

Summary

After a long period of robust asset growth, product innovation and declining interest margins on mortgages, the business environment for housing lending in Australia has deteriorated over the past year. Nonetheless, the funding, profitability and capital quality of the ADI sector have held up well and there are no signs, at this point, that the ADI sector is facing material losses from housing lending or funding adversity. APRA does not expect to make any significant changes in its capital adequacy regime for ADIs in response to recent market turbulence.

The LMI sector in Australia has seen claims increase from historic lows but this sector, too, remains profitable and well capitalised.

The strength of ADI credit standards and LMI underwriting standards in Australia stands in sharp contrast to the US sub-prime mortgage market, where a significant number of loans have been extended on unsound terms and conditions.

Experience over the past decade and more is that the housing lending market in Australia has been quite flexible and institutions have been able to enter and exit the market relatively freely. Over the longer term, in settled global financial market conditions, APRA would expect that new entrants would again be able to assert competitive pressure on housing lending costs and availability.

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