Australian Prudential Regulation Authority

APRA’s Prudential Framework for Housing Lending

Submission to the Senate Economics References Committee

1 April 2008

Purpose

This submission briefly explains APRA's prudential framework governing the provision of residential mortgage ('housing') lending by authorised deposit-taking institutions (ADIs) in Australia and APRA's approach to supervising the lending practices of these institutions.

Background

APRA was established on 1 July 1998 as an integrated prudential regulator of ADIs (banks, credit unions and building societies), insurance companies, superannuation funds and friendly societies. APRA-regulated entities account for around 75 per cent of the assets in the Australian financial system.

APRA's mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the financial institutions it supervises are met within a stable, efficient and competitive financial system. In carrying out its functions, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

ADIs should be best-placed to determine the level and nature of credit risk that they are prepared to carry. APRA's prudential focus is on ensuring that ADIs provide credit in a financially sustainable and prudentially sound manner. APRA's responsibilities do not include ensuring that the terms and conditions of any particular loan are fair to the borrower and fully disclosed; these are matters for other regulatory agencies.

Prudential framework

APRA's approach to the prudential supervision of ADIs is predicated on the principle that the primary responsibility for the prudent management of an ADI rests with its Board and senior management. It is their responsibility to assess the risks in the lending activities undertaken by the ADI and to continually monitor and control those risks.

APRA has a range of prudential standards that ensure that ADIs are adequately capitalised and have appropriate risk management systems in place. 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.

The ADI Prudential Standards (APS) that relate to the provision of credit are:

- APS 112 Capital Adequacy: Standardised Approach to Credit Risk;
- APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk;
- APS 220 Credit Quality; and
- APS 120 Securitisation.

Capital adequacy

As the prudential regulator, APRA's focus is to ensure that ADIs have appropriate credit risk management systems to manage their lending exposures, including exposures arising from residential mortgage lending. APRA does not regulate the extent to which, or the terms — including pricing — on which ADIs lend to households. However, APRA's prudential requirements may have an indirect impact in certain circumstances. For example, where an ADI is judged to be assuming excessive risk through poor lending practices, APRA may increase the minimum capital requirement for the institution and this may impact on the price and/or supply of lending by that institution.

Regulatory capital for residential mortgage 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 residential mortgage loans are lower than under the previous regime, and also more granular.

The simplest approach to determining the credit risk capital charge for residential mortgage loans under Basel II is the standardised approach. Under this approach, the risk-weighting scheme for residential mortgage 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 so-called 'low doc' loans) and whether the loan has acceptable 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, as detailed in Table 1. This greater granularity adds considerably to the risk sensitivity of capital.

LVR (%)	**Standard eligible mortgages**		**Non-standard eligible mortgages**	
	Risk-weight (no mortgage insurance) %	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI) %	Risk-weight (no mortgage insurance) %	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI) %
0 – 60	35	35	50	35
60.01 – 80	35	35	75	50
80.01 – 90	50	35	100	75
90.01 – 100	75	50	100	75
> 100.01	100	75	100	100

Under the internal ratings-based (IRB) approach, there is even greater risk-sensitivity. ADIs approved by APRA to use this approach may, in determining the risk-weight for residential mortgage loans, 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).

Impact on pricing

APRA does not expect the implementation of the Basel II regime to change materially the pricing of residential mortgage 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 IRB approach, there will be a change in the risk-weights of many of their assets; however, it is still too early to determine the net capital impacts of Basel II for these ADIs.

APRA's supervision of ADI housing lending

The prudential framework underpins APRA's on-going supervision of the financial soundness and risk management of ADIs. APRA monitors a range of indicators of ADIs' health, such as loan arrears, large exposures, profitability and capitalisation. In the case of housing lending, APRA reviews the robustness of ADIs' credit assessment and lending procedures to ensure that lending standards are maintained and that lenders are fully aware of a potential borrower's circumstances and capacity to service debt. APRA intensifies its supervision of an ADI whose lending practises, including new lending initiatives, are judged to be unsound. Where appropriate, APRA lifts minimum capital requirements to ensure that depositors are protected from the associated risks. However, it remains the responsibility of the Board and senior management of an ADI to ensure that the institution has risk measurement, monitoring and control capabilities that are commensurate with the risk inherent in any new products offered, and that it maintains sufficient capital to support the exposures that may arise from such lending

Over recent years, intense competition in the housing lending market has inevitably put pressure on ADIs to depart from traditional lending practices; at the same time, competition has reduced the cost, and increased the availability, of housing finance to households. The departures from traditional lending practices have taken a number of forms, including 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.

On the latter issue, APRA has observed that ADIs are no longer relying on conservative rules of thumb when assessing a borrower's capacity to repay debt. The traditional '30 per cent rule', under which lenders would limit repayments to no more than 30 per cent of a borrower's gross income, has given way to more complex 'net income surplus' models, under which borrowers are assumed to be willing to continue repaying their mortgage until they reach minimum 'subsistence' levels of family consumption. These models allow higher income applicants to borrow much higher percentages of their gross income, since cost of living expenses are regarded as a relatively fixed commitment for individuals.

APRA's survey data show that, in September 2006, the median debt servicing ratio for owner-occupied housing lending was 21 per cent; over a quarter of new loans were provided at ratios above 30 per cent but only 9 per cent had ratios greater than 40 per cent.[1]

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[1] Laker, J.F., "Credit standards in housing lending - some further insights", Speech to Institute of Chartered Accountants in Australia, 20 June 2007.

While acknowledging that net income surplus models have the sensible aim of capturing more relevant details about borrowing capacity, APRA has warned ADIs that the approach is untested in adverse circumstances and needs to be applied conservatively. It should, as a minimum, be based on realistic – not poverty line – estimates of living costs that are regularly updated and provide for contingencies in family circumstances. It should also allow for potential interest rate increases over the life of the loan. That said, ADIs typically build in a buffer, averaging around two per cent, for potential interest rate increases when assessing the ability of borrowers to service their loans.

Credit standards in housing lending were the subject of a joint RBA-APRA submission in August 2007 to an inquiry by the House of Representatives Standing Committee on Economics, Finance and Public Administration.[2] This submission concluded, *inter alia*, that

> "Any impact on the stability of the Australian financial system from changes to lending standards and the increased availability of [housing] credit is likely, on current assessments, to be small. Various stress tests of the financial system over recent years have indicated its resilience to events that are well outside historical experience". (p1)

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[2] 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.