CUSTOMER OWNED BANKING ASSOCIATION

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Mr Neil Grummitt
General Manager, Policy Development
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Australian Prudential Regulation Authority

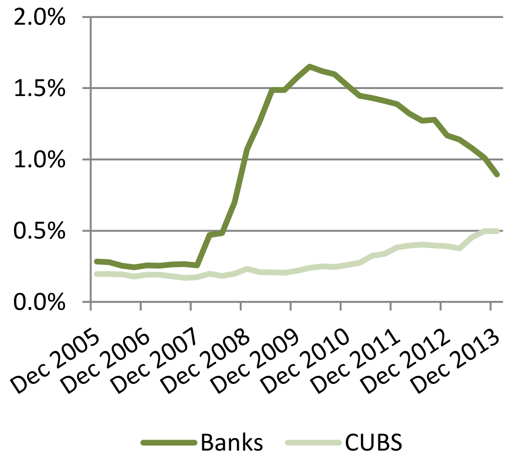
Via email: mortgagelending@apra.gov.au

Dear Neil,

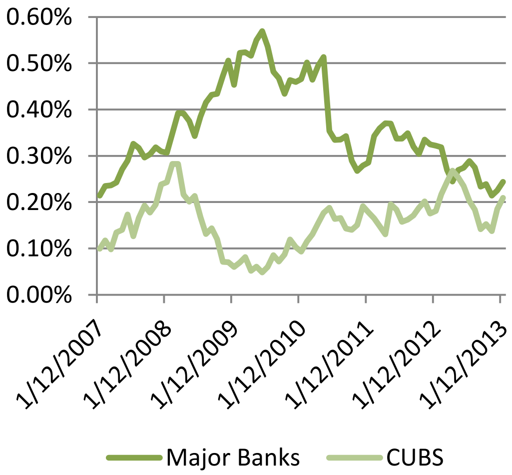
Draft prudential practice guide on residential mortgage lending

Thank you for the opportunity to comment APRA's draft Prudential Practice Guide on residential mortgage lending. Customer-owned banking institutions – credit unions, building societies and mutual banks – are clearly and consistently the strongest performers in the banking market for prudent and responsible lending.

Impaired Facilities (Percentage of Total Loans)



Comparison of Mortgage Arrears (90+ days)



The interim report of the Financial System Inquiry published last week noted that credit unions and building societies have experienced low impairments in recent years.

COBA members recognise the need for sound prudential practice for residential mortgage lending, and welcome additional guidance. However, prudential standards need to be applied in a flexible manner, and we strongly support the observation in the 'About this guide' section that:

> "Not all of the practices outlined in this PPG will be relevant for every institution and some aspects may vary depending upon the size, complexity and risk profile of the institution."

It is also important that it is absolutely clear to APRA supervisors and to regulated institutions that PPGs:

> "provide guidance on APRA's view of sound practice…" but "do not themselves create enforceable requirements."

A common theme in feedback from our members on the draft PPG is that while the majority of the provisions reflect current lending and risk practices, in some sections the guidance is highly prescriptive, and may go beyond what would be considered reasonable for some ADIs. It may be more appropriate for some of these sections to be drafted in more general terms, with APRA outlining the underlying policy intent and perhaps presenting the more prescriptive elements as "one way" rather than the "only way" of delivering the prudential outcome.

Overly prescriptive guidelines could have consequences for current business and operating models, potentially imposing unnecessary costs.

Member feedback on specific aspects of the PPG is outlined below.

Risk management framework

Risk Appetite Statement
The draft PPG proposes quite granular detail around setting of credit risk appetite and quantifiable risk tolerances within aspects of mortgage portfolios. We note that paragraph six is highly prescriptive in setting out the areas that ADIs should examine. While we agree that these issues are relevant considerations in developing a Risk Appetite Statement (RAS), it would be useful if APRA could confirm that is does not expect each of these items to be included within that Statement. Members have noted that this level of detail may be more appropriately covered within an ADI's policy settings. Taking the RAS to a more granular level may require a substantial re-write of the current frameworks for ADIs, and may result in overlap with policy settings.

In addition, incorporating this level of detail into the RAS would require flexible wording to permit exceptions that arise from time to time in lending decisions.

We note that, consistent with CPS220 and draft CPG220, paragraph 13 flags the "comprehensive review" of the risk management framework by an independent third party. Paragraphs 78 and 79 of the draft CPG220 provide some guidance on the elements that APRA would consider appropriate to cover in such a review. Similar guidance around how APRA would see residential mortgage lending feeding into this review could be of value.

Management Information Systems
Members have indicated that paragraph 16 may go too far in its list of indicators of a 'robust management information system'. While we understand the nature of the PPG in providing guidance, we note that the depth of expectations, if adopted by ADIs, may stifle innovation, create a burdensome checklist, or restrict more flexible approaches.

For many ADIs, significant investment in management information systems would be required to make assessments based on the indicators outlined in paragraph 16. For some ADIs the only way for these assessments to be met would be though manual data recording, monitoring and extraction. These include indicators of servicing calculations and tracking of loans insured by LMI providers.

In this regard, we note APRA's expectation that an ADI's MIS would "typically" rather than "always" include these things, and that this is one area where APRA should be particularly conscious of the need to vary some aspects "depending on the size, nature and risk profile of the institution."

Remuneration
The PPG states at paragraph 17 that Prudential Standard CPS 510 requires the remuneration policy to apply to responsible persons, risk and financial control personnel and "all other persons whose activities may affect the financial soundness of the regulated institution." We note that under paragraph 59(c) of CPS510 that the "all other persons" obligation only applies to staff "for whom a significant portion of total remuneration is based on performance," and it would be useful if the draft PPG could be amended to clarify this point.

Loan Origination

Serviceability Assessments
Paragraph 31, where it relates to the interest rate floor, is viewed as too prescriptive. While the methodology outlined is a sound one, there are also other, equally worthy, methodologies available. APRA's overarching objective should be the one set out in paragraph 30, namely, that individual ADIs select buffers and other adjustments which ensure that they can absorb "substantial stress … without producing unexpectedly high loan default losses…" ADIs should have the flexibility to determine the adjustments and buffers applied to achieve this outcome. While one possible tool would be the use of an "interest rate floor … based on the average mortgage interest rate over an appropriately long time period…" this may not be the best approach for all ADIs to take in all situations. Directing organisations to utilise one singular methodology might stifle innovation and lead to homogenisation of loan offerings.

Assessment and verification of income, living expenses and other debt commitments
The wording of the PPG at paragraph 34 suggests that additional restrictions would be placed on the borrowing capabilities of impending retirees, particularly if restrictions were to be placed on reliance on future superannuation lump sums, unless the lump sum is verifiable and reasonably imminent. The PPG might seek to clarify what is meant by verifiable and imminent.

In relation to the use of indices including HPI and HEM, as outlined at paragraph 38, not all ADIs are currently applying "a margin linked to the borrower's income to the relevant index". We query whether this level of prescription is required, as methodologies will vary significantly, and buffers will be built into other aspects of the serviceability equation.

Specific Loan Types

Reverse mortgages
Paragraph 58 outlines measures that an ADI may consider in relation to reverse mortgages but it should be made clear that not all of these will be appropriate or necessary in all circumstances. For example, actuarial advice will not always be necessary, and a combination of prudent lending policy and stress testing will often provide appropriate risk mitigation.

Security Valuation

Paragraph 63, which relates to periodic review of valuation professionals by senior risk management, has been identified as overly restrictive. One member has stated that their operational credit team is tasked with this function which is independent of the sales team, which goes to mitigating conflicts. Within this organisation, senior risk management provides further assurance over the operational credit team, creating an additional layer of accountability. Paragraph 63 should be softened to allow for flexibility in business models.

In relation to paragraph 80, some organisations have indicated that they do not have a portfolio limit on guarantor loans. We note that ADIs vary significantly in the nature of their size, customer demographics, and the types of loans they provide. As such, they will utilise alternative – but equally sound – portfolio monitoring mechanisms to mitigate risk associated with these types of loans.

Stress Testing

Paragraph 92 indicates that organisations should be stress testing frequently. However, for a relatively homogeneous loan book (in terms of products, security and geography) the monthly internal and external risk monitoring, and documented trigger levels, should be sufficient to mitigate the need for frequent formal stress testing.

In relation to stress testing by various indicators, some ADIs do not always retain data at the level of detail required to meet expectations outlined including:

- Serviceability metrics (paragraph 94); and
- Loans written at minimum serviceability levels (paragraph 6(c)).

Members note that stress testing in relation to servicing metrics would not be a true representation of a portfolio's status, given that servicing calculations often only include base income, if this is sufficient for servicing to be established. Further, if a lender were to apply margins to the HPI or HEM indices linked to income level (as suggested in paragraph 38 and 41(c)), then it is possible that servicing calculations might be skewed towards not including regular additional income (such as overtime and industry allowances) if it is not necessary for servicing.

An individual's financial situation is dynamic, and reviewing or stress testing a portfolio of loans written over a period of time, based on an historical snapshot financial position, might not add value to an analysis.

COBA members will be pleased to provide additional feedback or information as required. Please contact me on 02 8035 8448 or Micah Green on 02 8035 8447 to discuss any aspects of this submission.

Yours sincerely

Luke Lawler
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