General Manager
Policy Development
Policy and Advice Division
Australian Prudential Authority

16 June 2018

Dear Sir/Madam,

RE: CONSULTATION ON REVISION OF APG223 -MAY/JUNE 2019

Thank you for the opportunity to provide feedback on the above matter. As a borrower, who has been unable to refinance existing mortgages due to APRA's current serviceability guidelines, I welcome the intention to remove the requirement for an interest rate floor and replace it with an interest rate buffer.

However, I believe the current proposal does not go far enough to address the unduly restrictive impact of APRA's Lending Guidelines on borrowers, many of whom pay far too much in interest due to the rate creep which happens, when a borrower is unable to refinance a loan.

These excessive interest costs are significant, as those funds should be used to provide the necessary stimulatory boost to the economy, reduce existing debt or increase savings.

The restrictive guidelines also mean that borrowers as a whole are not only facing difficulties in refinancing mortgages, but also are unable to get new loans for renovations, construction or investment, the consequences of which flow right through the economy.

The longer the present restrictions continue, the more difficult it will be for borrowers to refinance mortgages due to ongoing falls in house prices, which will increase LVR levels on existing loans. This will become a further hurdle for borrowers in addition to the current serviceability related problems, as borrowers will have to contribute additional equity in order to refinance their loans. This can only lead to a less competitive mortgage market, higher average interest rates, and a host of detrimental flow-on effects on the economy, as a result.

It is therefore imperative, that APRA review the Serviceability and Income Assessment guidelines in full. As a priority, changes to the following elements of Prudential Practice Guide APG 223 should be considered to allow a greater number of low risk loan applications to proceed.

1.0 Clause 43 with a view to align it with ATO's rules on negative gearing.

2.0 Clause 35 with a view to reduce the credit card limit assessment rate downward from 36% per annum.

3.0 Clauses 32 and 33 with a view to amend the currently proposed changes to the assessment rate buffer from a flat rate of 2.5% to a differential rate of 2.5% for owner occupier loans and 2.25% for Investment loans, with the aim to improve loan mobility and support price competition in the investment product sector.

The aim of APG 223 is to ensure that borrowers are able to service their loans in the event of an economic downturn. However, current provisions in clauses 43 and 35 do not reflect a realistic or reasonable level of decline in a borrower's financial position should such an event occur. The detailed explanation in support of the above position is as follows:

1.0 ASSESSMENT OF NEGATIVE GEARING BENEFIT

The guideline for the assessment of negative gearing benefit in serviceability calculation is contained in clause 43 of APRA's Residential Lending Guidelines APG 223. It affects any borrower, who is refinancing, buying a new family home or taking out a further investment loan, who also owns a negatively geared investment.

APRA's directive is for lenders to calculate interest costs at a buffered interest rate, but the negative gearing tax benefit at the lower, unbuffered rate. However, to be consistent with the ATO rules, negative gearing credit should be assessed at the <u>same</u> interest rate that is used to calculate the deductible interest costs on the application.

Whilst APRA generally aim to base the serviceability assessment on a possible economic downturn, this assessment scenario has no possibility of eventuating under any circumstances. Due to the issue being unsuccessfully raised with APRA during the 2017 consultation process, this letter aims to outline in detail the flawed fundamentals of this guideline.

Clause 43 of APG 223 currently states:

"... Good practice would be for an ADI to place no reliance on a borrower's potential ability to access future tax benefit from operating a rental property at a loss. Where an ADI chooses to include such a tax benefit, it would be prudent to assess it at the current interest rate rather than one with a buffer applied."

It is clear from the wording above that the issues under consideration here by APRA are:

a) whether the tax credit received from the ATO should be considered a "future benefit".

b) whether the tax credit that the borrower receives from the ATO should be relied on at all in the serviceability calculation.

c) if it should be relied on, then at what rate?

The answer to these questions is outlined in a corresponding point form below:

a) Borrowers are able to receive the negative gearing tax benefit on a PAYG basis by filling out the ATO form 222D. This variation form can be submitted by any investor receiving a PAYG income and further, it can be adjusted or resubmitted if the interest rate goes up or down. Therefore, tax variation can be received by borrowers at the same time as their PAYG income is received and should not be considered by APRA as a 'future benefit' for loan applicants who have a PAYG source of income.

b) A borrower who owns and operates a rental property at a loss is entitled to claim negative gearing tax relief in accordance with the ATO rules. Thus, lenders should without question be able to consider the negative gearing credit in the serviceability model, just as they consider income tax in the equation. APRA has previously claimed that if the borrower's application relies on the negative gearing benefit, then it is a marginal application. This is not true for majority of investors, and in particular for investors with larger investment portfolios and corresponding loans, who rely on the negative gearing credit to carry out their investment activities until they turn cashflow positive.

APRA require that a serviceability assessment must show an income surplus using discounted income and buffered costs, which means that a variety of risks have already been taken into account. Marginality has thus been taken out of the equation, irrespective of how negative gearing benefit is assessed.

c) Prior to APRA's guidelines coming in force, lenders were allowed to assess the negative gearing tax credit at the same rate, as was used to determine the borrower's interest expense on the application. This was consistent with the ATO's negative gearing rules.

In February 2017, APRA issued the current version of clause 43, which instructs lenders to use a buffered interest rate to calculate interest expense, but to use an unbuffered rate to calculate the negative gearing tax credit. This conservative approach is detrimental to the applications and results in a lower approval rate.

APRA is committed to the use of buffered interest rate to calculate interest expense and this is largely seen as a fair call. However, the use of unbuffered interest rate for calculation of negative gearing credit at the same time is not consistent with the ATO regulations.

APRA's position is that where there is a choice of using an actual interest rate vs. buffered interest rate for negative gearing assessment, the choice of an unbuffered rate is the more conservative or prudent one. However, according to the ATO rules, this option is not reflective of any real possibility. The financial scenario, where a borrower incurs interest cost at a buffered rate, but gets a tax benefit at a lower, unbuffered rate is not an option that can eventuate.

Therefore, the current serviceability and income assessment guidelines do not present a credible model of a borrower's financial position in the event of an economic downturn, because the two interest rate assumptions implicit in the model have no chance of occurring at the same time.

It is entirely appropriate that interest costs on applications are assessed at a buffered rate, as it tests the borrower's ability to meet their obligations should interest rates rise. However, if they do, it is clear, that the corresponding negative gearing credit will also rise. This is why the negative gearing credit and the interest costs on applications should be assessed at the same rate, and this should be the buffered interest rate, for both.

There is no valid rationale in support of APRA's current guidance on assessment of negative gearing benefit. It is unduly conservative; it does not reflect any real scenario or represent real risks, it runs counter to ATO laws and is detrimental to assessment of credit applications. Clause 43 should be reviewed in fastest possible time to enable applications, which do not pass serviceability due to APRA's negative gearing requirements to proceed.

2.0 ASSESSMENT OF CREDIT CARD LIMITS

APRA require lenders to assess credit card limits on loan applications at an interest rate of 36% of available limit, or 3% per month (clause 35, APG 223).

There is a wide range of interest rates on offer for credit card debt. These range from 12% to around 22%. Hence, a fixed 36% assessment rate is highly and unduly conservative and bears no relevance to a market where most credit card rates are below 20%.

At this rate, even a relatively small card limit can have substantial impact on serviceability. Thus, borrowers are often asked to close down their credit cards or reduce their credit card limits when applying for a loan.

Australian consumers are now in a precarious position that in order to pass serviceability assessments to refinance to cheaper loans or get new ones, they have to take extreme measures that limit their spending, further exacerbating the economic conditions prevailing at present.

APRA should either reduce the mandatory credit card assessment rate, or introduce a reasonable and realistic rate buffer, similar to their proposed changes to clauses 32 and 33.

3.0 INTEREST RATE BUFFER CURRENTLY UNDER REVIEW

In 2014, APRA specified that lenders should incorporate in their serviceability assessments a buffer of at least 2% above the loan product rate, with a minimum floor rate of at least 7%. APRA are currently proposing to remove the floor rate requirement and replace it with a buffer 2.5% above the loan product rate.

One of the factors guiding this proposal, as outlined in APRA's letter dd. 21 May 2019 is that due to the lower cost of the owner occupier Principle and Interest (P&I) loans, the current use of the floor rate is most binding on owner occupiers with P&I loans and least binding on the higher cost investor Interest Only loans, a situation which APRA appear to want to redress.

However, the proposed system of a single buffer rate applied to both will be more binding on investors than owner occupiers and will do little to improve loan mobility for borrowers who have investment loans. Under this proposal, all things being equal, an investor on a higher rate Interest Only loan will need more income to refinance their loans than an owner occupier on a lower rate. This will continue to put downward pressure on loan mobility for investors and reduce price competition within the Investor loan sector.

It should be noted that Investor Interest Only loans do not display the same price elasticity and responsiveness to RBA cash rate reductions, as owner occupier P&I loans. This is largely because borrowers with an investment loan are mobility impaired due to APRA's requirement to have their investment loans assessed on a P&I basis, as well as being adversely impacted by APRA's negative gearing provisions. This means that an investor, who can comfortably afford payments on their loans may not be able to refinance any of his loans, including their owner occupier loan, due to serviceability requirements pertaining to his Investment loan.

This situation restricts the effectiveness of RBA monetary policy, as the aforementioned serviceability issues impact a wide cross section of borrowers. Investor loans account for a significant proportion of outstanding loans. Further, a significant portion of owner occupier loans are made to investors for their homes. As serviceability calculations are applicant, not loan specific, restrictions that apply to a single investment loan will restrict mobility of all other loans that the applicant holds. It also holds true that if restrictions on assessment of the investment loans are lifted, loan mobility of all loans that an investor holds will improve.

To this end, APRA should consider a differential buffer of 2.25% on the higher rate Investment loans and 2.5% on Owner Occupier loans.

Not only will this increase loan approval rates for borrowers with investor loans who are currently the most mobility impaired, but it is also a more prudent and socially responsible approach. An owner occupier has less ability to divest their security asset than an investor, should interest rates rise above the level allowed for by the buffer. Equally, an investment asset can be sold more easily and loan discharged during times of economic stress. Thus, a lower buffer rate should apply to reflect this difference.

It should be noted that because the owner occupier loans are already lower cost, the higher buffer ought not to disadvantage those buyers in the property market, but should ensure that they can withstand a higher level of economic downturn than an investor in a similar position.

In summary, the most powerful statement of encouragement that government can make for borrowers to “shop around for a better rate” is to address the limiting aspects of APRA’s serviceability and income assessment framework that stops borrowers from doing so.

I trust these comments will be reviewed with appropriate consideration and I look forward to further improvements of APRA’s lending framework which should aim to free up investment, reduce interest costs for borrowers and help the economy, whilst continuing to manage risk in the mortgage market.

Yours faithfully,

Anna Gamble
B Comm – Finance, University of South Australia

Cc: Hon Josh Frydenberg MP
Hon Scott Morrison MP
Hon Mathias Cormann MP
Hon Paul Fletcher MP
Hon Michael Sukkar MP
Dr. Philip Lowe, Governor, Reserve Bank of Australia