INFORMATION PAPER

Countercyclical capital buffer

7 December 2017

Glossary

ABS	Australian Bureau of Statistics
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 110	*Prudential Standard APS 110 Capital Adequacy*
Basel III	Basel Committee, Basel III: *A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011)
Capital conservation buffer	An additional layer of Common Equity Tier 1 Capital above the minimum regulatory requirement that can be utilised in times of stress to absorb losses, subject to constraints on dividends and other distributions. See APS 110 for further information.
Countercyclical capital buffer	An extension of the capital conservation buffer that can be imposed by the national authority to protect the banking sector from periods of excess credit growth that have often been associated with the build-up of system-wide risk. See APS 110 for further information.
Credit	Credit provided by financial institutions operating domestically.
Credit-to-GDP gap	The difference between the credit-to-GDP ratio and its long term trend.
GDP	Gross domestic product
LVR	Loan-to-valuation ratio
RBA	Reserve Bank of Australia

Chapter 1—Countercyclical capital buffer

The countercyclical capital buffer is designed to be used to raise banking sector capital requirements in periods where excess credit growth is judged to be associated with the build-up of systemic risk. This additional buffer can then be reduced or removed during subsequent periods of stress, to reduce the risk of the supply of credit being impacted by regulatory capital requirements.[1]

Consistent with the international capital framework developed by the Basel Committee on Banking Supervision, the Australian Prudential Regulation Authority (APRA) adopted a countercyclical capital buffer within the Australian capital adequacy framework in 2016. The countercyclical capital buffer may range from 0 to 2.5 per cent of risk weighted assets. APRA set the countercyclical capital buffer applying to the Australian exposures of authorised deposit-taking institutions (ADIs) from 1 January 2016 at zero per cent.[2]

APRA reviews the level of the countercyclical capital buffer on a quarterly basis, based on forward looking judgements around credit growth, asset price growth, and lending conditions, as well as evidence of financial stress. APRA takes into consideration the levels of a set of core financial indicators (see Chapter 2), prudential measures in place, and a range of other supplementary metrics and information, including findings from its supervisory activities. APRA also seeks input on the level of the buffer from other agencies on the Council of Financial Regulators.

APRA considers that a zero per cent countercyclical capital buffer remains appropriate.

APRA has observed a change in the level of systemic risk in some sectors, including further increases in household indebtedness, since the initial buffer setting. However, this change has not been sufficient to necessitate a change in the level of the countercyclical capital buffer. The decision to maintain the buffer at zero takes into account the continued strengthening of capital ratios within the banking system, as well as APRA's other supervisory activities and prudential measures targeting property-related risks, particularly on housing lending standards and the establishment of benchmarks on investor lending growth and interest-only lending. A targeted response that focuses on specific risks has the additional benefit of not impacting credit to other sectors.

APRA considers that the quality of housing lending is improving. As at end-September 2017, growth in investor lending remained comfortably below the investor benchmark, and the industry share of loans written on interest-only terms had declined to 23 per cent of new lending, well below the 30 per cent interest-only benchmark.[3] APRA's monitoring of the commercial property sector also suggests that ADIs' underwriting standards have broadly improved in this area. APRA is working to ensure the improved standards are firmly

[1] For further information on the countercyclical capital buffer and APRA's approach to assessing the appropriate setting for Australia, see APRA's December 2015 Information Paper, *The countercyclical capital buffer in Australia*.

[2] http://www.apra.gov.au/MediaReleases/Pages/15_38.aspx

[3] See Byres, W (2017), 'Housing - The importance of solid foundations' http://www.apra.gov.au/Speeches/Pages/Housing-The-importance-of-solid-foundations.aspx

embedded into industry practice, and that tighter loan policies are translating into more prudent lending decisions.

In consultation with the other agencies on the Council of Financial Regulators, APRA will continue to closely monitor movements in the core risk indicators and developments in riskier segments of housing lending. While current conditions do not warrant it, APRA considers the countercyclical capital buffer to be a potentially effective macroprudential tool in other circumstances, and will adjust the buffer level should future conditions warrant it. An announcement to increase the buffer may have up to 12 months' notice before the new buffer comes into effect; a decision to reduce the buffer will generally be effective immediately.

Chapter 2—Summary of core indicators

The following section summarises the core indicators as set out in APRA's framework for the countercyclical capital buffer. These indicators are associated with the financial cycle and assist in determining whether there is a build-up of systemic risk. There is no direct formulaic link between the indicators and the level of the buffer. APRA considers these indicators along with a number of supplementary indicators, other information and input from other agencies on the Council of Financial Regulators.

Risk	Core indicators
Credit growth	Credit–to-GDP ratio (level, trend and gap) Housing credit growth Business credit growth
Asset prices	Commercial property price growth Housing price growth
Lending indicators	Higher-risk residential mortgage lending Business lending conditions Loan pricing and margins
Financial stress	Non-performing loans

Credit growth

Credit-to-GDP ratio (level, trend and gap)

The credit-to-GDP gap is defined as the difference between the credit-to-GDP ratio and its long-run trend.[4] The credit-to-GDP gap for Australia remained negative at -6.4 as at end-September 2017. The Basel Committee suggests that a gap level between 2 and 10 percentage points could equate to a countercyclical capital buffer of between 0 and 2.5 percent of risk-weighted assets.

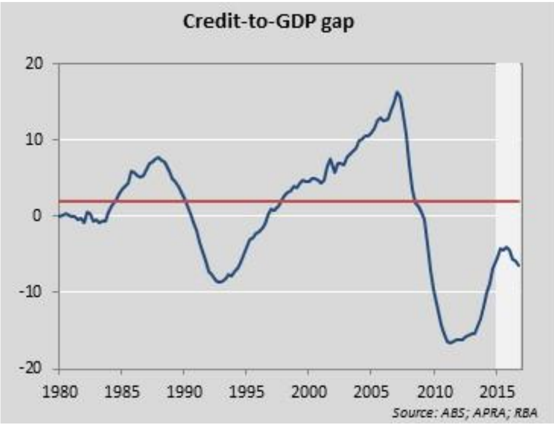
[4] The long-run trend is calculated using a one sided Hodrick-Prescott filter, a tool used in macroeconomics to establish the trend of a variable over time. For more information see Basel Committee on Banking Supervision, *Guidance for national authorities operating the countercyclical capital buffer, December 2010*: http://www.bis.org/publ/bcbs187.htm.

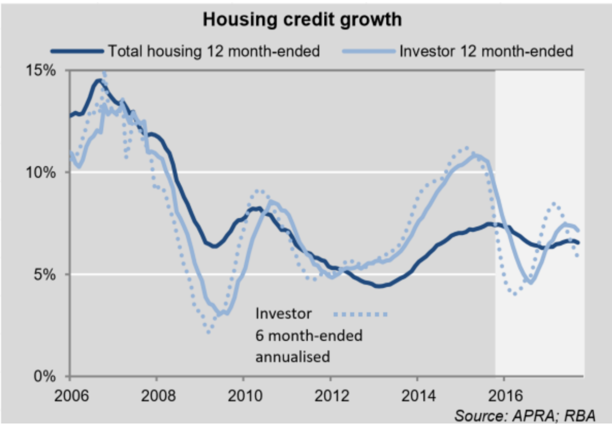
Housing credit growth

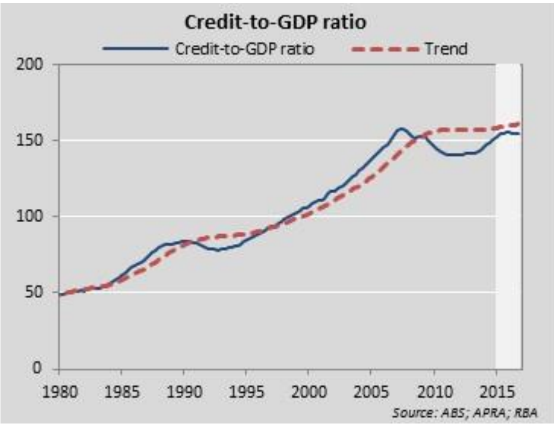
Housing credit growth has remained stable over the year and is currently 6.6 per cent year-on-year as at end-September 2017. However total housing credit growth masks some variation by loan purpose; a pick-up in investor credit was observed over the year, following a sustained decline over the preceding 12 months. More recently, the pace of investor credit growth has moderated, consistent with recent loan repricing trends for investor and interest-only products. APRA continues to consider strong growth in lending to property investors an important risk indicator for APRA supervisors, and has communicated to industry the expectation that growth in investor lending remains comfortably below 10 per cent. While housing credit growth had stabilised, strong growth in housing prices relative to household incomes has seen the household debt-to-income ratio continue to touch new highs.

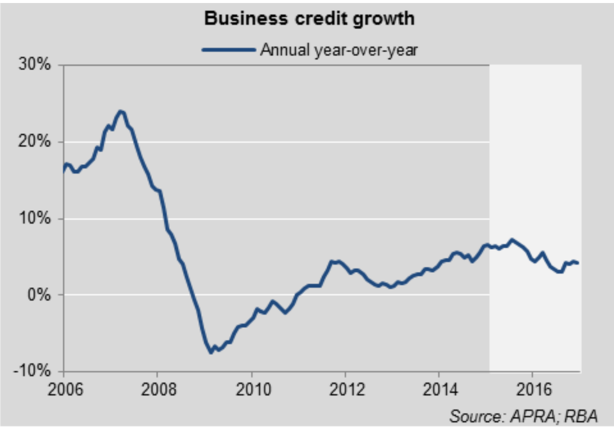
Business credit growth

Annual growth in business credit declined slightly over the year to end-September 2017 to 4.3 per cent, down from 4.8 per cent a year prior. APRA also considers growth in domestic commercial property lending as a supplementary indicator to overall business credit. Consistent with lower growth in total business credit, commercial property lending growth (not shown) has also slowed in pace, growing at 3.8 per cent over the year to end-September 2017, down from 9.0 per cent as at September 2016.







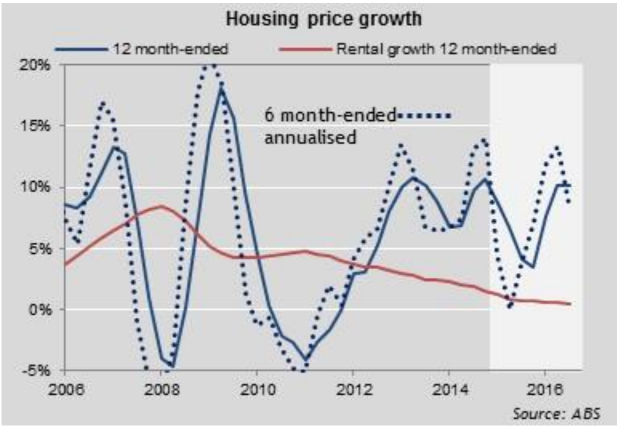


Shaded areas (right side of charts) show period since initial buffer setting

Asset Prices

National housing price growth remains strong relative to historic norms at 10.2 per cent over the 12 months to end-June 2017. More recently, price growth has softened somewhat, with CoreLogic data showing six month-ended annualised price growth of around 7 per cent nationally as at end-September 2017. Notwithstanding, rental growth and household income growth continue to have been relatively weak in comparison. Looking beyond the national averages, conditions continue to vary across the country. The pace of housing price growth in Sydney has slowed over recent months, consistent with a decline in auction clearance rates, while housing market conditions remain relatively strong in Melbourne. Weak conditions in Western Australia and a large increase in supply of new apartments in Brisbane are reflected in relatively flat price growth in these regions.

Non-residential commercial property has also been exhibiting strong annual price growth (not shown), which continues to far outpace annual growth in rents.



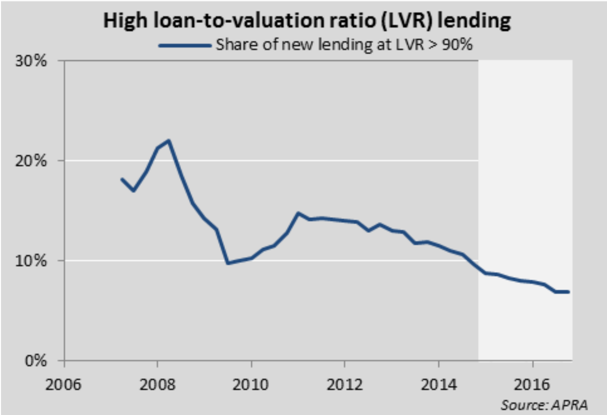
Lending indicators

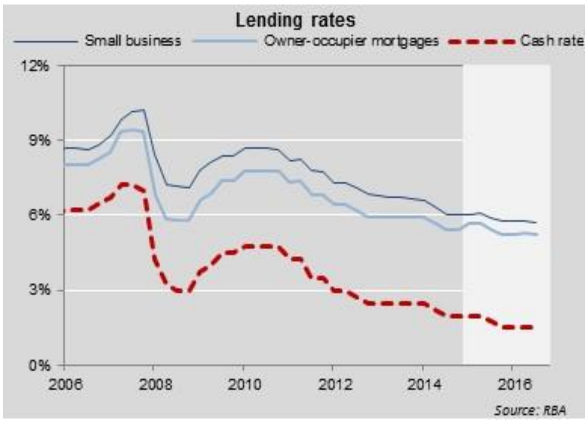
APRA monitors a range of data and qualitative information on lending standards. For residential mortgages, the proportion of higher-risk lending is a key metric. Earlier in the year, APRA announced further measures to reinforce prudent standards across the industry, including the benchmark on interest-only lending. Since this announcement, the share of interest-only lending (not shown) has declined significantly to within APRA's 30 per cent benchmark. APRA is continuing to work to increase scrutiny over lending practices; particularly, to ensure that policies are not only strengthened, but are genuinely put into practice, resulting in more prudent lending decisions.

At an industry level, higher-risk mortgage lending has broadly continued to moderate over the past year. The share of new lending at loan-to-valuation ratios greater than 90 per cent reduced to 6.9 per cent as at end-September 2017, down from 8.1 per cent in September 2016. Other forms of higher-risk mortgage lending including interest-only lending at high loan-to-valuation ratios and high loan-to-income lending (not shown) have also moderated from 2015 peaks. However, APRA maintains its focus on ensuring that borrower leverage is appropriately constrained, with the introduction of *ARF 223 residential mortgage lending* in 2018 to capture additional information on borrower debt-to-income levels.

In business lending, there has been evidence of tighter lending standards (with the exception of some loosening for SME lending contracts), particularly for commercial property lending. This follows APRA's review of commercial property lending practices and subsequent communication to industry that appropriate underwriting standards should be maintained through the credit cycle. In residential development lending, there has been evidence of lower loan-to-valuation and loan-to-development cost ratios (not shown) amid concerns of oversupply and settlement risks in some regions. Furthermore, banks have indicated that settlement failures do not appear to have elevated from historic norms.[5]

Lending rates have continued to fall to historic lows for both housing (owner-occupier) and business lending, consistent with the low-interest rate environment. However, more recently, lending rates for interest-only and investor loans have increased (not shown), despite no change in the official cash rate. Conversely, rates for owner-occupier lending on principal-and-interest terms and SME lending have declined slightly in recent months.

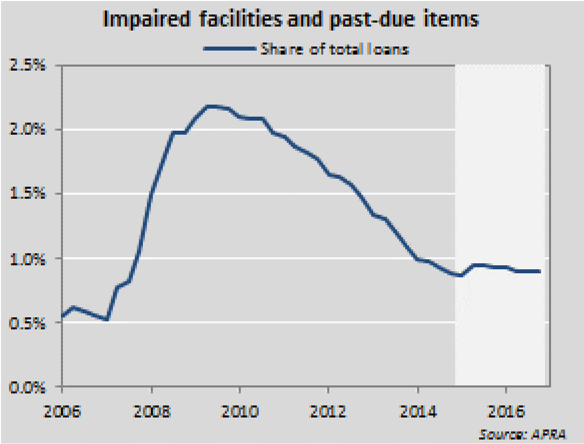




[5] APRA's confidential quarterly survey of credit conditions and lending standards provides qualitative information on whether conditions are tightening or loosening in the industry.

Financial Stress

Indicators of financial stress are used in informing decisions to release any countercyclical capital buffer. While a wide range of indicators could signify a deterioration in conditions, APRA has identified non-performing loans as its core indicator of financial stress. The share of non-performing loans remains low, at around 0.89 per cent as at September 2017, largely reflecting lower arrears rates in NSW and Victoria. However, NPL rates remain elevated in regions and sectors with exposures to mining.



Indicator	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Credit-to-GDP gap	-6.8	-5.5	-4.3	-4.4	-4.0	-4.3	-5.6	-5.8	-6.4
Housing credit growth (year-on-year)	7.5%	7.4%	7.1%	6.7%	6.4%	6.3%	6.5%	6.6%	6.6%
Business credit growth (year-on-year)	6.4%	6.4%	6.5%	6.5%	4.8%	5.5%	3.5%	4.3%	4.3%
Housing price growth (year-on-year)	10.7%	8.7%	6.8%	4.1%	3.5%	7.7%	10.2%	10.2%	Not yet available
Lending standards (share of new mortgage lending with LVR>90)	9.6%	8.8%	8.6%	8.3%	8.1%	7.9%	7.7%	6.9%	6.9%
Non-performing loans	0.88%	0.87%	0.94%	0.95%	0.94%	0.93%	0.90%	0.89%	0.89%

APRA