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Wayne Byres
CHAIRMAN

26 June 2015

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam,

INQUIRY INTO HOME OWNERSHIP

The attached submission is being provided to assist the Standing Committee on Economics in its Inquiry into home ownership.

APRA takes a keen interest in the housing sector, from the perspective of APRA's prudential mandate and our objectives of stability, competition and efficiency in the regulated financial industries. Our submission relates to the following matters within the Inquiry's Terms of Reference:

- demand and supply drivers in the housing market; and
- the proportion of investment housing relative to owner-occupied housing.

In particular, the submission provides an overview of APRA's recent prudential initiatives relating to management of lending risks by authorised deposit-taking institutions (ADIs). While APRA has traditionally had a strong prudential focus on housing lending practices, our recent more intensive supervisory scrutiny of ADIs' lending standards and their plans for growth in investment housing lending is intended to reinforce sound lending behaviour in an environment of, in our view, heightened risks. This may have some impact on housing market dynamics, but we do not expect our supervisory measures to have a material impact on housing activity more broadly.

We are happy to answer any questions you may have related to this submission.

Yours sincerely,

Australian Prudential Regulation Authority

Inquiry into Home Ownership

Submission to the Standing Committee on Economics

June 2015

Purpose

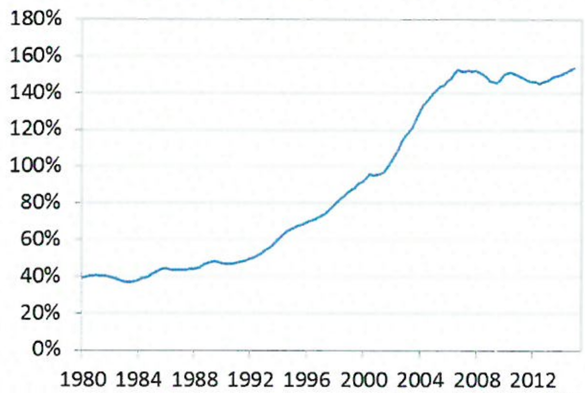
This submission is intended to aid the Committee's Inquiry into home ownership in Australia by providing APRA's perspective on current risks in housing lending and its associated supervisory response. In particular, this submission summarises APRA's recent supervisory initiatives aimed at ensuring authorised deposit-taking institutions (ADIs) maintain sound lending standards in an environment of historically low interest rates, high household debt, and high and rising house prices in some markets.

Background

APRA is the prudential regulator of the banking, insurance and superannuation industries in Australia. Specifically, APRA supervises banks, credit unions, building societies, general and life insurance companies, and most of the superannuation industry, to help ensure that these entities can meet the financial promises they have made to their customers and other beneficiaries.[1]

Lending for housing dominates the aggregate loan portfolio of the Australian banking system. For this reason, it is natural that it is an area of considerable interest for APRA. In recent years, Australia has seen uninterrupted growth in housing lending, driven by both demand and supply factors. On the demand side, households have been willing to take on an increasing amount of debt, given low inflation, the low interest rate environment and relatively low unemployment. This has been reflected in a rising aggregate household debt-to-income ratio (Chart 1). In terms of the supply of credit, continued lower funding costs and strong competition among large and small lenders since the Global Financial Crisis have meant that credit is readily available to borrowers that can demonstrate capacity to service a housing loan.

Chart 1: Household debt to income



Source: RBA

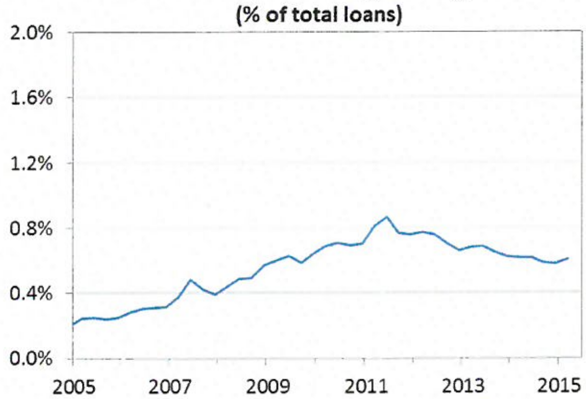
Historically, residential mortgage loans have been a very safe asset class for Australian banks (Chart 2). Since Reserve Bank of Australia (RBA) (in its then role as banking supervisor) began collecting data nearly 20 years ago, the quantum of non-performing housing loans has never been more than 1 per cent of total housing loans—extremely low by international standards. However, in APRA's view, the current economic environment for housing lenders is characterised by heightened levels of risk, reflecting the combination of historically low

[1] APRA will also become the prudential supervisor of the private health insurance industry from 1 July 2015.

interest rates, high household debt, subdued income growth, unemployment that has drifted higher, significant house price growth, and strong competitive pressures.

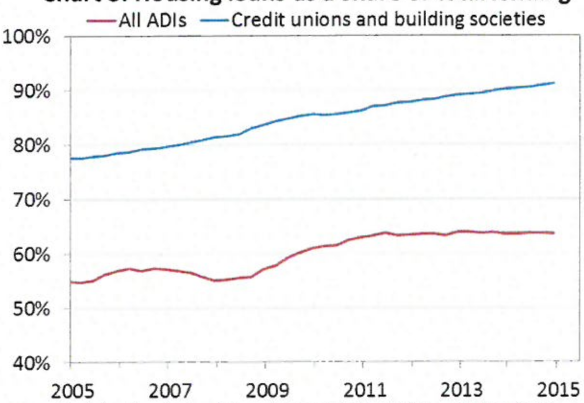
Moreover, recent experience from around the world shows that it is unwise to be complacent about imbalances that can build in the housing sector. Indeed, the Australian ADI sector has become particularly exposed to housing-related risks, with over half of all ADI lending arising from mortgage lending to households (Chart 3). For smaller ADIs, the proportion is considerably higher. Much of the ongoing trust and confidence in the Australian banking system, by local depositors and international investors alike, is founded on the history of stability traditionally provided by the housing loan portfolios of Australian ADIs. APRA considers it of great importance that this is not jeopardised by imprudent lending practices, as has occurred elsewhere in the world.

Chart 2: Non-performing housing loans (% of total loans)



Source: APRA

Chart 3: Housing loans as a share of total lending



Excludes foreign bank branches and 'other ADIs'. Source: APRA

APRA's recent focus on risks in the housing loan sector

With this backdrop, ADI lending to the housing sector has been a key focus of APRA's prudential oversight of ADIs for the last several years. APRA has taken a series of graduated actions aimed at ensuring ADIs are managing the risks that arise from this business. As housing-related risks have grown, APRA has sought to 'turn up the dial' of supervisory scrutiny on housing loan portfolios and, importantly, ensure that boards and management of ADIs are doing likewise. This has included the following supervisory activities:

- In 2011 and again in 2014, APRA wrote to boards of the larger ADIs, seeking their written assurances with respect to their oversight of the evolving risks in residential mortgage lending. Each of the ADI boards concerned provided assurances that they were actively monitoring lending portfolios and that they were comfortable with their credit standards.

- In 2013, APRA increased the level of detailed risk information supervisors obtain regularly on larger ADIs' mortgage portfolios. This included portfolio metrics and internal targets for risk indicators such as loan-to-value ratios (LVRs) and borrower loan-to-income (LTI) levels, as well as data on portfolio characteristics such as investment lending, interest-only lending, lending to self-managed superannuation funds and non-residents. Using this information, APRA supervisors have focused on identifying ADIs with housing loan portfolios that display higher risk profiles.

- APRA's 2014 stress test of the 13 largest ADIs involved two scenarios focused on a severe downturn in the housing market. The stress test provided useful information on the magnitude of losses on residential mortgages that would result were such scenarios to eventuate.

- In addition, APRA issued a Prudential Practice Guide (PPG) on sound risk management practices for residential mortgage lending in late 2014.[2] Among other things, the PPG stresses the need for strong underwriting standards, including assessment of borrowers' capacity to service a loan. Most ADIs have since assessed their own practices against this guide and, where necessary, are making improvements.

These steps were designed to ensure that risks within housing loan portfolios were actively monitored and understood. They did not, however, impose any additional formal requirements or limitations on ADIs' housing lending.

Despite these steps, concerns remained that potential vulnerabilities were building in the housing sector. In particular, APRA was alert to indications that strong competition was leading to an erosion of lending standards. Amongst other things, the industry was seeing strong demand for loans for housing investment (as opposed to owner occupation), and very strong growth in interest-only lending—loans where borrowers do not begin repaying any of their debt for some years (Charts 4 and 5). In its *Financial Stability Review*, the RBA noted that:

> *The low interest rate environment and, more recently, strong price competition among lenders have translated into a strong pick-up in growth in lending for investor housing - noticeably more so than for owner-occupier housing or businesses. Recent housing price growth seems to have encouraged further investor activity. As a result, the composition of housing and mortgage markets is becoming unbalanced, with new lending to investors being out of proportion to rental housing's share of the housing stock. Both construction and lending activity are increasingly concentrated in Sydney and Melbourne, where prices have also risen the most.*[3]

Chart 4: New investor housing loan approvals ($b)

Source: ABS

Chart 5: Interest only loans (% of new approvals)

Source: APRA

Toward the latter half of 2014, APRA worked closely with the RBA and the other members of the Council of Financial Regulators to develop appropriate responses to these concerns. After considering potential courses of action in conjunction with Council agencies, APRA wrote to

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[2] APRA 2014, *Prudential Practice Guide APG 223 Residential Mortgage Lending*, November.

[3] Reserve Bank of Australia 2014, *Financial Stability Review, September, p 1.*

all ADIs in December 2014 emphasising the importance of reinforcing sound lending standards in the current environment. Although APRA's intention was to continue to pursue this issue via normal supervisory processes (the nature of which are typically a confidential matter between APRA and each individual regulated entity), APRA also chose to publish this letter, to alert the broader community to its concerns and ensure that there was a common understanding of its intentions across interested stakeholders.

The follow-up actions to this letter have served as the basis of much of APRA's current supervisory program for ADIs relating to residential mortgage lending.

APRA's 2015 program for reinforcing sound lending standards

The objectives of APRA's December 2014 letter were to flag APRA's areas of specific concern, alert the industry to APRA's heightened level of supervisory intensity, and set out specific expectations for the industry to help address housing sector risks. This included some quantitative benchmarks that would be used by APRA's supervisors in assessing whether additional supervisory action might be needed.

Specifically, APRA's December 2014 letter focused on three key areas:

- ***Risk profile:*** There are many dimensions to assessing the soundness of mortgage lending portfolios. Higher risk lending includes, for example, a high proportion of lending at high LTI ratios, lending at high LVRs, lending on an interest-only basis to owner-occupiers for lengthy periods and lending for very long terms. APRA's letter noted that, in the current environment, where an ADI was undertaking large volumes of lending in these categories, or increasing this higher risk lending as a proportion of new lending, this would be a trigger for the consideration of supervisory action.

- ***Investor lending***: Fast or accelerating credit growth can also be a key indicator of a build-up in risk, both at an individual ADI and at an aggregate system level. For an individual ADI, excessive housing credit growth can generate a rapid shift in risk profile, especially if new borrowers are increasingly stretched to compete in a quickly rising property market. Given the recent very strong growth in investor lending, APRA's letter indicated that supervisors would be particularly alert to plans for rapid growth in this part of the portfolio. The letter also indicated that annual investor credit growth materially above a benchmark of 10 per cent would be an important risk indicator that supervisors would take into account when reviewing ADIs' residential mortgage risk profile and considering supervisory actions.

  The 10 per cent benchmark is not a hard limit, but ADIs were advised to be mindful that plans for investor loan growth materially above this rate would likely result in a supervisory response. The benchmark of 10 per cent was chosen to discourage further acceleration in investor lending, while not substantially disrupting housing markets. In this respect, APRA's preference was to seek a moderation in growth at a system as well as ADI-specific level, and to ensure that additional capital is held where that was not achieved.

- ***Serviceability:*** Serviceability assessments for new borrowers are critical in determining the capacity of the borrower to service and repay the loan. The serviceability buffer assumed by ADIs as part of this assessment accommodates not only future changes in interest rates but also unexpected changes in borrower income and expenses. Practice in setting the serviceability buffer varies across the industry, with some assessments allowing borrowers to take on debt at very high multiples of their income.

APRA's letter expressed the view that prudent serviceability policies should incorporate a serviceability buffer of at least 2 per cent above the loan product rate, with a minimum floor assessment rate of at least 7 per cent. These benchmarks were based on a number of considerations, including past increases in lending rates in Australia and other jurisdictions, market forecasts for interest rates, international benchmarks for serviceability buffers, and long-run average lending rates. APRA's letter also indicated that good practice would be to maintain a buffer and floor rate comfortably above these levels, rather than operate at the minimum expectation: low serviceability buffers would also prompt the consideration of further supervisory action. Finally, APRA's letter also noted that APRA supervisors would be monitoring other elements of the serviceability assessment, including income acceptance, minimum living expenses, and other debt commitments. To this end, a 'hypothetical borrower exercise' was also conducted by APRA in 2015 to test these other aspects of ADIs' lending policies.[4]

APRA has made it clear that a higher risk strategy for housing lending will likely require greater capital support. This will be implemented via the 'Pillar 2' process, by which an individual ADI's minimum capital ratios can be adjusted upwards (above the common 'Pillar 1' requirement that applies to all ADIs), having regard to the ADI's overall risk profile. This approach is regularly used by APRA to respond to a wide range of issues: it is not a supervisory tool that is being used solely in response to current housing-related risks. In fact, most ADIs already have a Pillar 2 capital add-on, reflecting their particular circumstances; in some cases, this will reflect housing-related risks identified by APRA's supervisors prior to the December 2014 letter.

To implement the measures set out in the December 2014 letter, APRA asked ADIs to provide submissions with information showing how they planned to meet the expectations for risk profile, investor lending growth and serviceability. The submissions were reviewed and benchmarked across the industry and relative to APRA's assessment of sound practice. Where responses were not considered adequate, supervisors held discussions with ADIs to seek additional information or actions.

APRA has completed this benchmarking process for the larger ADIs, which have received specific feedback on areas where APRA expects to see strengthened policies or practices. In some cases, supervisors have conducted on-site visits and obtained more detailed data on portfolio composition or serviceability methodologies. APRA is in the process of writing to individual ADIs, confirming agreed plans and revised policies and, where necessary, timetables for action.

In conjunction with this initiative, ASIC announced an investigation into interest-only lending.[5] APRA and ASIC have been working closely together on this review and APRA supervisors have participated in the on-site component of ASIC's initiative. While consumer lending obligations are primarily the purview of ASIC, APRA is alert to potential prudential implications, including potentially heightened credit risks, if ADIs do not make loans that are fully in compliance with relevant consumer protection obligations.

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[4] Byres, W. 2015, '*Sound lending standards and adequate capital: preconditions for long-term success*' speech to Customer Owned Banking Association (COBA) CEO & Director Forum, Sydney, May.
[5] See ASIC 2014, Media Release 'ASIC to investigate interest-only loans', 9 December.

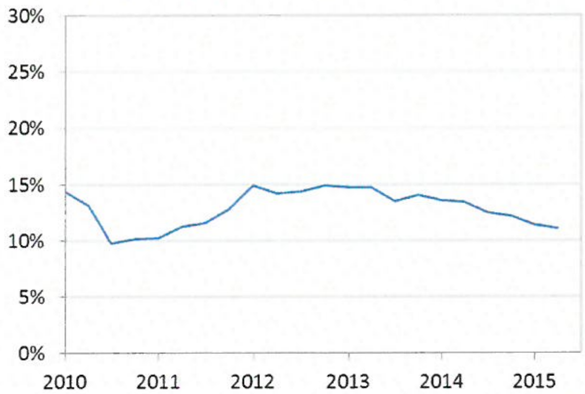
Impact of APRA's supervisory initiatives

It is important to stress that, through the measures described above, APRA is not seeking to determine an appropriate level of house prices, household debt or other macroeconomic parameters. In the context of the Committee's current inquiry, APRA's actions are not directed at housing affordability. APRA's objective is to ensure prudent lending behaviour by ADIs and a commensurate level of capital to support the risks they take on. This applies regardless of the markets in which an ADI operates, or the purpose of the loans that it is making.

Based on industry-level benchmarking and analysis across ADIs, APRA's supervisors have been engaged in very intensive discussions with ADIs since earlier this year. Throughout this process, Australian ADIs, and particularly the largest lenders, have acknowledged the need for collective action to ensure Australian housing loan portfolios remain sound and a source of stability. While some ADIs reacted very quickly to address identified areas for improvement, others have only recently announced changes to various aspects of their policies or pricing. A number of these changes to practices have been reported recently in the media, while others, such as changes to internal growth or risk targets, are less public but equally important.

It is too early to assess the overall effectiveness of APRA's actions. However, available evidence suggests the supervision-led approach has had some success in moderating the lending behaviour of those ADIs pursuing higher risk strategies. This has been achieved without the need to set formal quantitative limits on, for example, high-LVR lending (as some other countries have done). Such policies can be challenging to implement, and may penalise first-time home buyers who typically have a smaller deposit. In any event, high LVR lending has not been a driver of the growth in housing lending; its share of total lending has fallen over the past few years.

Chart 6: LVR > 90 per cent (% of new approvals)



Source: APRA

Changes in market practices that have been implemented in recent months include:

- Specific feedback APRA has provided to ADIs on their serviceability parameters, including interest-rate buffers and floors, has led to material changes to lending policies. Many ADIs have increased, or are in the process of increasing, existing buffers, which are often now in the range of 2.25 per cent, together with an assessment rate floor of 7.25 per cent, or in some cases as high as 8 per cent. Prior to APRA's focus on this issue, some ADIs had buffers of as low as 1.5 per cent and a floor of as little as 6.5 per cent, well below long-term average mortgage rates (a small number of ADIs did not apply a floor rate at all). Imposition of these higher buffers will tend to reduce the maximum loan size available to the more marginal borrowers, and will ensure new borrowers are less vulnerable to future increases in interest rates.

- A number of banks are moving to place limits on interest-only lending. Most ADIs only extend an initial interest-only period of 5 years, with principal payments commencing and being added to regular payments at the end of this period. Some banks that had previously been extending interest-only periods for 10, or even 15, years have limited the maximum interest-only period to a shorter, more prudent period. Data provided to APRA indicates that the majority of new interest-only loans have an interest-only period of five years or less.

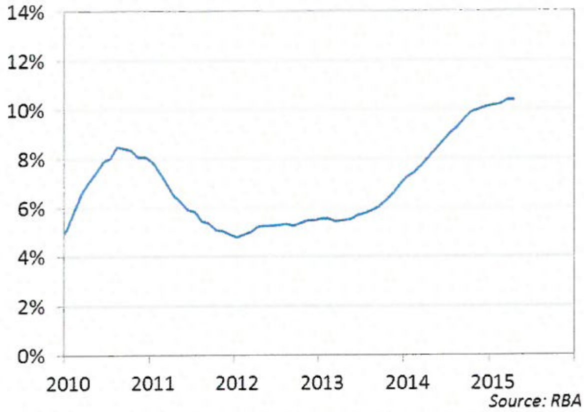
- Significant progress has also been made on addressing weaknesses in other elements of ADIs serviceability calculations, such as the prudent recognition of borrower income and expenses. However, there is still scope for improvement at some ADIs and APRA supervisors will be ensuring that agreed changes are appropriately implemented.

APRA's goal in encouraging these changes has not been to establish a one-size-fits-all approach to lending assessments. However, it is important that ADIs adhere to some minimum expectations with respect to, for example, interest-rate buffers and floors, and adopt prudent estimates of borrower's likely income and expenses. If these good practices can be maintained in the face of intense competition, it will hold the entire ADI industry in good stead regardless of to whom they lend and for what purpose.

With respect to the 10 per cent benchmark for investor lending growth, implementing consistent expectations across the industry has been more challenging. However, all ADIs with material investor loan portfolios have committed to operate at or below APRA's 10 per cent benchmark, although given lending pipelines and different starting points some will take longer than others to reach it. There are various market-based levers that ADIs can use to manage their flow of new lending. These include dampening demand naturally through pricing increases, or reducing successful loan applications through use of additional risk criteria. To date, there has been some differential impact on pricing with, for example, all of the major banks reducing interest-rate discounts for investor loans. In addition, some banks have lowered the maximum LVR for investor home loans, or tightened other eligibility criteria.

After accelerating throughout 2014, the growth in investment lending appears to have begun to plateau in 2015. Based on commitments made by ADIs, APRA expects to see a slowing trend for the second half of 2015. The larger ADIs will be required to report monthly to APRA against planned investor loan growth, and APRA will be requiring an explanation for any deviations from commitments they have given. An ADI's ongoing inability to manage lending growth in line with agreed targets may result in supervisors taking the view that a higher capital requirement is needed.

Chart 7: Investor housing credit growth (annual)



Source: RBA

Based on experience to date, APRA anticipates that sound lending standards can be maintained without the need for immediate additional supervisory action; indeed, in many instances ADIs have welcomed the industry-wide message to maintain consistent, prudent lending standards as allowing them to compete for borrowers without the need to jeopardise good lending practices.

Future supervisory actions

In response to APRA's expectations communicated in the December 2014 letter to all ADIs, most ADIs have strengthened, or made commitments to strengthen, their lending standards where necessary. APRA will be monitoring the impact of the current set of initiatives for the foreseeable future, and has not ruled out initiating further measures should that be necessary to ensure that emerging prudential risks in the housing market are appropriately contained. Such measures could include:

- additional measures to strengthen lending standards across the industry;
- additional capital requirements for individual ADIs pursuing higher risk strategies;
- high capital requirements for certain types of higher risk lending; or
- application of the counter-cyclical buffer introduced as part of the Basel III reforms.

APRA could also adopt the types of 'macroprudential' tools of the kind used by other countries (see the Attachment). To date, APRA has not seen necessary to use these types of tools, and prefers to use supervisory interventions to shift regulated entities collectively toward better practice. Nevertheless, APRA has not ruled out using other tools, such as limits on particular types of higher risk lending or more prescriptive serviceability parameters, if deemed warranted.

In addition, some regulatory initiatives currently in the pipeline are likely to have an impact on housing credit dynamics. For example, as previously foreshadowed, APRA is likely to act sooner rather than later on the recommendation of the 2014 Financial System Inquiry (FSI) to raise capital requirements for housing loans held by largest ADIs.[6] The Basel Committee on Banking Supervision's work underway on revisions to the capital adequacy framework will also have direct implications for the capital requirements applied by APRA to housing lending. APRA is actively involved in this international work, but does not need to wait for it to conclude to begin to implementation of the FSI recommendations.

[6] That is, those ADIs that use the internal ratings-based (IRB) approach to capital. See Byres, W. 2015, '*Achieving a stable and competitive financial system*' speech to Australian Financial Review Banking and Wealth Summit, Sydney, April.

Attachment: Recent regulatory actions affecting housing lending

Country	Dates	Actions
New Zealand	2013-2015	• Maximum 70% LVR for Auckland investment loans • Limit of 10% on new loans to Auckland owner-occupiers with LVR greater than 80% • Higher capital requirements for investment loans and high LVR loans (internal modelling banks)
Canada	2008-2012	• Maximum 95% LVR for owner-occupier loans • Maximum 80% LVR for investment and refinanced loans • Maximum debt servicing ratio • Maximum loan amortisation period of 25 years
Ireland	2014	• Limit of 15% on new loans to owner-occupiers with LVR greater than 80% • Limit of 10% on new investment loans with LVR greater than 70% • Limit of 20% on new loans to owner-occupiers with high LTI
United Kingdom	2014	• Minimum 3% interest-rate serviceability buffer • Limit of 15% on new loans with high LTI • Capital risk weight floor for mortgages of 15%
Sweden	2010-2015	• Maximum 85% LVR (guideline) • Capital risk weight floor for mortgages of 25% • Countercyclical capital buffer of 1%
Norway	2010-2015	• Maximum 85% LVR (guideline) • Countercyclical capital buffer of 1%
Singapore	2009-2013	• Maximum 80% LVR • Maximum debt servicing ratio • Minimum 3.5% interest-rate serviceability buffer

Country	Dates	Actions
Hong Kong	2009-2015	• Capital risk weight floor for mortgages of 15% • Minimum 3% interest-rate serviceability buffer • Maximum debt servicing ratio • LVR caps • Countercyclical capital buffer of 0.625%

Source: Regulator and central bank publications