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WAYNE BYRES
Chairman

21 May 2019

TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

CONSULTATION ON REVISIONS TO PRUDENTIAL PRACTICE GUIDE APG 223 RESIDENTIAL MORTGAGE LENDING

In December 2014, APRA wrote to all authorised deposit-taking institutions (ADIs) to reinforce sound residential mortgage lending practices.[1] Among other measures, APRA specified that a prudent ADI's serviceability assessments should incorporate a buffer of at least 2 per cent above the loan product rate and a minimum floor rate of at least 7 per cent. APRA further noted that prudent practice would be to maintain a buffer and floor rate comfortably above these levels.

The principal purpose of the serviceability buffer and floor, which have been subsequently incorporated within *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223), is to ensure borrowers are able to continue to service and repay their loans if interest rates rise.[2] They also add a level of conservatism into serviceability assessments, given the inherent uncertainty in lending decisions. As set out in APG 223, APRA expects a prudent ADI would keep the level of the buffer and floor under review to assess whether it remains appropriate in relation to the interest rate cycle. In its assessment, an ADI would also consider historical rate movements, interest rate forecasts and key economic indicators over an appropriate time horizon.

In APRA's view, the expectations introduced in 2014 have served an important purpose by limiting excessive borrowing in an environment of low interest rates and high household debt. However, changes in the market and economic environment since that time have caused APRA to review the appropriateness of the current guidance. Two factors, in particular, suggest a reconsideration of the current approach may be warranted:

- the low interest rate environment is now expected to persist for longer than originally envisaged. This may mean that the gap between actual rates paid and the floor rate may become unnecessarily wide; and

- compared to 2014, when a single standard variable rate was used as the basis to price all mortgage loans, ADIs have introduced differential pricing for mortgage products. The merits of a single floor rate are therefore less obvious, particularly as it will be most binding

[1] APRA, 'Reinforcing sound residential mortgage lending practices' (Letter, 9 December 2014), https://www.apra.gov.au/sites/default/files/141209-Letter-to-ADIs-reinforcing-sound-residential-mortgage-lending-practices.pdf

[2] APRA, *Prudential Practice Guide APG 223 Residential Mortgage Lending* (February 2017) https://www.apra.gov.au/sites/default/files/APG-223_0.pdf

on owner-occupiers with principal and interest loans, and least binding on investors with interest-only loans.

Given these changes, APRA is seeking views on proposed revisions to its guidance on the buffer and floor rates currently set out in APG 223. As detailed in Attachment A of this letter, APRA is proposing to:

- remove the quantitative guidance on the level of the serviceability floor rate, i.e. the reference to a specific 7 per cent floor. APRA will still expect ADIs to determine, and keep under regular review, their own level of floor rate, but ADIs will be able to choose a prudent level based on their own portfolio mix, risk appetite and other circumstances;

- increase the expected level of the serviceability buffer from at least 2 per cent (most ADIs currently use 2.25 per cent) to 2.5 per cent, to maintain prudence in overall serviceability assessments; and

- remove the expectation that a prudent ADI would use a buffer 'comfortably above' the proposed 2.5 per cent, to improve clarity of the prudential guidance.

APRA considers that these changes will provide greater flexibility for ADIs to manage and set floor rates which reflect the outlook for interest rates, while still ensuring sufficient prudence is retained in serviceability assessments through the proposed higher buffer rate. This move is not intended to signal any lessening in APRA's focus on the importance of sound lending standards, but to simply acknowledge that the current interest rate environment, and the introduction of differential pricing, may not warrant a uniform mandated interest rate floor of 7 per cent across all products.

As an alternative approach, APRA considered retaining but reducing the interest rate floor, and leaving the existing interest rate buffer unchanged. However, APRA considered that this approach would not address the emergence of differential pricing as effectively. Prescribing multiple floor rates for different product types was also considered, but was regarded as too complex and unnecessarily prescriptive.

APRA's guidance on the proposed level of the interest rate buffer rate is informed by analysis of previous Australian interest rate cycles and international regulatory practices for serviceability buffers. As set out in paragraph 34 of APG 223, APRA continues to expect that ADIs apply the buffer to new and existing debt, recognising that for certain types of mortgage products higher buffers may be appropriate.

Next steps

APRA invites feedback on the draft revisions to APG 223, which will be subject to a four-week public consultation.

Written submissions on the proposal should be sent to ADIPolicy@apra.gov.au by 18 June 2019 and addressed to:

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

APRA intends to release the revised final version of APG 223 as soon as practicable after the consultation period.

Yours sincerely,

Wayne Byres
APRA Chairman

Important disclosure notice – publication of submissions
All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

ATTACHMENT A – EXTRACT OF PRUDENTIAL PRACTICE GUIDE APG 223 RESIDENTIAL MORTGAGE LENDING

Serviceability assessments

32. Good practice would ~~apply~~ be to apply a buffer over ~~the~~ a loan's interest rate to assess the serviceability of the borrower (interest rate buffer). The interest rate buffer would be applied to the loan's interest rate ignoring any introductory or honeymoon rates offered for a limited period at origination of the loan. This approach would seek to ensure that potential increases in interest rates do not adversely impact on a borrower's capacity to repay a loan. The buffer would reflect the potential for interest rates to change over several years. APRA expects that a prudent ADI's serviceability policies ~~should~~ would incorporate an interest rate buffer of at least two and a half percentage points. ~~A prudent ADI would use a buffer comfortably above this level.~~

33. In addition, a prudent ADI would use the interest rate buffer in conjunction with an interest rate floor, to ensure that the interest rate buffer used is adequate when the ADI is operating in a low interest rate environment. ~~Prudent serviceability policies should incorporate a minimum floor assessment interest rate of at least seven per cent. Again, a prudent ADI would implement a minimum floor rate comfortably above this level.~~