17 June 2019

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

By Email

To whom it may concern:

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

I refer to your letter to All Authorised Deposit-Taking Institutions ("*ADIs"*) dated 21 May 2019 *("APRA Letter"*) inviting feedback in the form of written submissions on the draft revisions to APG 223.

By way of background, Satterley has been in the housing and land development industry since 1980 and is today one of Australia's largest land developers. Satterley operates in Western Australia, Victoria and Queensland having created over 170 communities and sold more than 67,000 lots. Having very long term experience and dealing with real estate buyers on a daily basis, Satterley is well attuned to factors impacting credit availability to consumers, and therefore a buyer's ability to achieve home ownership.

Satterley acknowledges APRAs focus on sound lending practices which assists in ensuring Australia's banking system continues to be financially stable and enables the banks to actively and prudently facilitate provision of financial services to consumers, business and government.

Satterley is not an ADI however in our capacity as one of Australia's most experienced residential property participants, we welcome the opportunity to provide constructive industry feedback and comments on the draft revisions.

Saving a deposit and/or accumulating equity to purchase a home is the first financial challenge for intending buyers, and for many is a very difficult obstacle, especially a deposit above 5%. Thereafter, the availability of securing bank finance is the remaining crucial factor in the home ownership equation. Securing capital is a fundamental characteristic of all real estate market transactions in Australia, no matter the stage in the 'demand and supply' cycle for a particular market. Buyers of real estate in Australia view the banks as an essential service provider akin to utility provider of electricity, water, gas or communications.

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Real markets in Australia do not operate uniformly, being at different points of the 'demand and supply' cycle, influenced by many varying factors, and therefore each experiencing vastly different trading dynamics. However, Satterley has observed an increasingly consistent trend across Australian real estate markets over the past 12-24 month period, that being the increasing constraint of home loan availability for buyers of residential property. This is negatively impacting consumers ability to participate in the property market and ultimately leading to either sale contract cancelation or default, and much weaker sales results (by both volume and price) in general. Reduced trading activity results in a reduced flow of funds, ultimately having a negative influence on the growth of the Australian economy.

This trend of increasing lending constraints (including finance declines) being experienced by consumers is a result that Satterley considers an intended consequence of APRAs changes to tighten ADI lending. The changes were implemented by APRA through a variety of prudential measures and guidelines introduced between 2015 and 2017 to limit excessive borrowing. As earlier mentioned, Satterley fully supports a prudent lending environment, and given the property market conditions that were prevailing at the time, principally in the Melbourne and Sydney property markets, the prudential changes were well founded. Satterley is however of the view that APRAs tightening of ADI lending was during the latter phase of the market upswing and collectively resulted in a sudden retreat of investors which marked the beginning of residential dwelling price falls now being experienced.

The APRA Letter now acknowledges that changes in the market and economic environment have since occurred and Satterley is fully supportive of APRAs decision to review current guidance. In particular, Satterley concurs with APRA that:

- The low interest rate environment will persist. In fact, the Minutes of the Monetary Policy Meeting of the Reserve Bank Board May 2019 notes the most recent RBA assumptions reflect that "*the cash rate followed the path implied by market pricing, which suggested interest rates were expected to be lower over the next six months*".
- APRAs prudential management and the ADIs own risk appetite has led to structural change in the lending market. There is now clear pricing and availability differential for owner-occupier and investor loans, along with product type being principal and interest or interest only.

Specifically, on the proposed changes to prudential measures, Satterley provides the following feedback:

- **An interest rate buffer of at least 2.00% is considered a prudent measure, rather than the proposed 2.50%.**
- **The requirement for prudent ADI's to determine, and keep under regular review, their own interest rate floor is considered unnecessary.**

Further rationale and considerations for the above feedback is discussed below:

- APRA proposes to increase the serviceability buffer from at least 2.00% to 2.50%. APRA notes most ADIs currently use 2.25% however Satterley considers that the existing 2.00% APRA buffer remains appropriate. The proposed removal of an APRA mandated interest rate floor is APRAs rationale for the 0.5% increase, however given the 'effective' serviceability buffer adopted by the prudent ADIs is currently 2.25% and this has been considered appropriate by APRA, the justification for further increase appears arbitrary.
- Whilst APRA consider that a prudent ADI should continue to use an interest rate floor in a 'low' interest rate environment, Satterley consider a serviceability buffer of 2.00% a prudent measure alone. In fact, arguably in the low growth environment expected to prevail for the medium term, Satterley consider a buffer of 1.50% to 1.75% would be reasonable.
- Since Year 2000 the largest upward Cash Rate cycle was from a trough of 4.25% (April 2002) to peak of 7.25% (March 2008). This 3.00% increase was over a period of 6 years and in the lead up to the Global Financial Crisis. The next largest upswing in Cash Rate was 1.75% between September 2009 (Cash Rate 3.00%) and November 2010 (Cash Rate 4.75%). Since the November 2010 peak, the Cash Rate has continued to reduce to current level of 1.25%. In the context of Cash Rate history (which influences interest rates), a serviceability buffer above 2.00% appears excessive and unnecessary.
- Structurally, the ratio of household debt to disposable income in Australia is at historical highs. In recent years, the RBA have highlighted high household debt levels as a vulnerability to domestic financial stability. In Satterley's view, an increase in interest rates by a magnitude of 2.00% would, in light of the current household debt structure and broader economic trends (and forecasts) in Australia, have a very negative impact on economic growth and conditions. We are already seeing that the falling prices of residential dwellings in Australia is having a significant detrimental impact on consumer confidence and spending and dampening employment growth opportunities. In other words, even in a 'low' interest rate environment, it is considered highly unlikely that interest rate increases in aggregate of greater than 2.00% over a short period could be withstood. Conversely, if such an increase could be sustained by households and businesses, then it could also be assumed that economic conditions are very strong (including inflation and wages growth) enabling households to accelerate repayment of home loans.
- The serviceability buffer and floor were announced by APRA in December 2014, at which time the Cash Rate was 2.5%. In addition to the above, during 2015 to 2017, APRA required additional tightening to the banks' lending practices including restrictions on high LVR and investor lending, restrictions on interest only lending, and more responsible lending assessments through greater verification of income and expenses. Given where interest rates have traded since 2015, the far more conservative (and now unnecessarily wide) minimum serviceability floor of 7.00% (noting most ADIs use 7.25%) will have been the measure applied by the ADIs in the assessment of home loans rather than the serviceability buffer.
- APRA have removed the imposed investor lending benchmark (removed in April 2018 – subject to ADIs providing satisfactory assurances to APRA of their lending policies and practices) and interest only lending benchmark (removed in December 2018). However, consumers have continued to operate in a home loan assessment environment which requires greater verification of income and expenses, and an unnecessarily wide serviceability floor of minimum 7.00% (noting most ADIs use 7.25%).

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- With the combination of an unnecessarily wide serviceability measure and other tightening measures, a significant slowing of credit growth has resulted. This constraint of credit has in turn been a factor in effectively shifting all property markets in Australia downwards in both prices and volumes.
- Satterley's experience over the last 24 months in dealing with property buyers reveals:
  - Purchasers are taking significantly longer to obtain finance (if secured). As an example, the average time frame from contract signing to contract settlement for titled lots sold by Satterley in Perth has increased substantially to a current unprecedented high of 144 days. Principally, this delay is caused by the finance approval process. This slow flow of funds has many negative consequential impacts.
  - Many potential purchasers are finding the quantum of approved loan amount is significantly less than anticipated. Satterley believe that the proposed revision to APG 223 may provide eligible applicants the opportunity to borrow up to say an additional $85,000 which would be an adequate solution to the typical loan shortfalls that we are observing potential buyers experience.
  - Many consumers are simply suffering finance declines due to serviceability equations. This would be principally due to the unnecessarily wide serviceability floor. This includes investors who are refinancing interest only loans, whereby in some cases only principal and interest loans are being offered, thus forcing investors to sell properties and repay loans.
  - In Satterley's experience, the increased lending constraints imposed on the banks by APRA has caused the highest ever application declines for home loans.
- The RBA Governor recently expressed a view that tighter credit conditions do not appear to be the main reason for declining housing credit growth. Satterley agrees that demand for real estate has softened as part of the 'natural' property cycle, however anecdotal experience of Satterley would show that tighter credit is definitely a significant contributing factor to the slowdown in housing credit growth, house prices and volume of transactions.
- With the regulatory measures and prudential supervision of the banks by APRA in recent years, along with the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, there has been a significant shift in the culture and governance of banks, including application of responsible lending practices. By virtue of the 2018 removal of benchmarks and now the proposed revisions, it would suggest APRA is comfortable that the banks have improved lending standards and reduced higher risk lending.
- However, despite the proposed removal of a mandated minimum floor assessment interest rate by APRA, there is a continued expectation by APRA that a prudent ADI will continue to use an interest rate floor in conjunction with an interest rate buffer. For several reasons, Satterley observe the use of a floor as arbitrary, redundant and at odds with the banks improved lending standards:
  - In regularly assessing applicable interest rates for various home loan products, the banks will determine applicable rates based on their own circumstances including portfolio mix and risk appetite. With these factors inherently reflected in actual interest rates, plus the required serviceability buffer, an effective floor rate will exist.
  - There is nothing stopping ADIs from applying a higher serviceability buffer should they consider appropriate for their own circumstances (and which approach the prudent ADIs have been adopting in any case).

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- The APRA Letter notes that with the introduction of differential pricing for mortgage products, the merit of a single floor rate is questionable. In fact, its operation is contrary to prudent risk management and serviceability assessment intent, in that a single floor rate penalises lower risk principal and interest owner occupied borrowers compared to higher risk interest only borrowers.
- The APRA Letter noted the prescribing of multiple floor rates for different products was too complex and unnecessarily prescriptive. It is for exactly this reason the proposal for prudent ADIs to continue to apply their own interest rate floor would not be appropriate.
- The APRA Letter notes an interest rate floor is appropriate in 'low' interest rate environments. Whilst interest rates in Australia (and globally) are historically low, the global economy could well be in a new, long term interest rate paradigm. The long term downward trend in risk-free return benchmarks (i.e. government bonds) would support this.
- An interest rate floor would also give no recognition to the fact that there is opportunity for borrowers to fix interest rates at 'low' levels should there be expectation of interest rate rises. This interest rate risk mitigation would also provide opportunity for borrowers to save in a rising interest rate environment.

The opportunity to provide the above constructive industry feedback is most welcomed. I would like to reiterate that having experienced many property cycles, Satterley recognises the importance of sound lending practices and the role that APRA plays in supervising such outcomes.

In addition to providing direct feedback on the proposed revision to the APRA guidance, Satterley would also like to provide the following commentary relevant to the continued efficient provision of home loan credit to a significant portion of the first home buyer segment in Western Australia.

Since being established in 1989, *Keystart* has been a crucial participant in the Western Australian property market, enabling thousands of first home buyers to enter home ownership through the provision of low deposit (as low as 2%) home loans. Keystart is a State Government-owned mortgage lender with a current lending capacity of $4.8 billion. During the 2018 financial year, Keystart approved 2,789 loans with 2,169 loans for housing construction or newly constructed homes. From our experience, Keystart have always applied a highly disciplined and responsible approach to home loan approval, with particular focus on income, expense and savings assessment.

Fundamental to the Keystart model that provides a high volume of loans including recycling of capital to do so, has been the ability to refinance borrowers into the commercial bank lending market. This occurs after a sustained period of loan performance and repayment of principal to a level acceptable to commercial banks. Typically, Keystart home loans have been refinanced by commercial banks once the LVR has reduced to 95% or less. Whilst LVR's at this level are higher-risk, the borrowers will have demonstrated over a number of years their ongoing ability and discipline to service and repay home loans, along with other risk measures including Lenders Mortgage Insurance.

It is important that APRA recognise the vitally important role that Keystart has in the Western Australian housing market. Equally, APRA should recognise the vital role that commercial banks play in ultimately refinancing Keystart home loans and enabling capital to be recycled to assist more first home participants to enter home ownership.

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If the commercial banks have overly-restrictive prudential guidelines, this in turn leads to volume limitations for Keystart which is a negative for many Western Australia home buyers and the wider economic activity generated by this sector.

APRA will be well aware of housing affordability issues prevalent throughout Australia. This has also again been recognised at a federal level with the Morrison Government recently announcing the First Home Land Deposit Scheme from 1 January 2020 to enable eligible first home buyers to purchase a house with a deposit as low as 5%. Satterley is of the view that funding models such as Keystart assist eligible home buyers in addressing housing affordability issues and Keystart could be nationalised or similar models become prevalent in other states of Australia. In this regard, Satterley would request the policy development team at APRA consider appropriate prudential measures are in place that enable the efficient functioning and continuation of a lending framework that supports the first home buyer segment, particularly that of Keystart and lending ADIs.

Finally, I would like to acknowledge the recent visit to Perth during May 2019 by senior representatives of APRA, including the Deputy Chair. It was extremely encouraging and beneficial that senior representatives of APRA met with some Industry Groups and business community to gain first hand insights into prevailing economic conditions in Western Australia. Local business leaders and the home building industry were extremely impressed with APRAs senior representatives who were well prepared and had a genuine interest in understanding the soft business conditions current in Western Australia. The regular scheduling of visits to Western Australia would be most welcome and I am sure this would enable APRA to actively keep abreast of general market conditions and trends that may influence the role of APRA in promoting financial system stability.

Kindest regards

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Chief Executive
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