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Appendix B – Letter from APRA to all ADIs 9 December 2014

Australian Prudential Regulation Authority

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APRA

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To: All authorised deposit-taking institutions

REINFORCING SOUND RESIDENTIAL MORTGAGE LENDING PRACTICES

In the current economic environment, prudential risks in the housing market appear to be increasing. Interest rates remain at historically low levels, household leverage remains high, and housing loans represent a large and increasing concentration on many ADI balance sheets. Strong competition in the housing market is also evident, which is accentuating pressure on lending standards. Against this backdrop, housing credit growth has accelerated, with lending to property investors particularly strong; the Reserve Bank of Australia (RBA) has noted that this could be funding additional speculative activity in the market. These forces have contributed to strong house price growth, particularly when viewed against the more subdued growth in household incomes.

Over the past year, APRA has taken a number of steps aimed at strengthening residential mortgage lending standards. This has centred on ensuring that ADIs increase their understanding and active monitoring of risks within their residential mortgage portfolios. In addition to a heightened level of supervisory activity at individual ADIs, APRA has:

- increased the level of analysis of mortgage portfolios, including regular review of detailed data on ADI underwriting policies and key risk indicators, to identify outliers. APRA also recently completed a stress test of the ADI industry, with two scenarios focused on a severe downturn in the housing market;

- written to boards and chief risk officers on their oversight of the evolving risks in residential mortgage lending. APRA supervisors have been following up on this communication through on-site prudential reviews of residential mortgage lending; and

- issued a prudential practice guide (APG 223) on sound risk management practices for residential mortgage lending.[1] Some ADIs are currently conducting self-assessments against APG 223, which APRA considers to be good practice.

With the current risk environment in mind, APRA has been discussing with other members of the Council of Financial Regulators (CFR) further steps that could be taken to reinforce sound lending practices and mitigate any speculative pressures that may be building.

[1] *Prudential Practice Guide APG 223 – Residential Mortgage Lending*, APRA, 5 November 2014.

Reinforcing sound lending practices

There are a number of additional regulatory and supervisory tools that APRA can apply to address emerging risks, building on the enhanced monitoring and review of recent years. These include additional supervisory monitoring and oversight, supervisory actions involving Pillar 2 capital requirements for individual ADIs, and higher regulatory capital requirements at a system-wide level.[2] Beyond this, there are also more direct controls such as regulatory limits on lending activities, as introduced in other jurisdictions to manage risks emerging in the housing market.

At this stage, APRA does not propose to introduce increases in system-wide capital to address current risks in the housing market, or introduce new regulatory limits, although we will keep these options under active review. Based on our current assessment of the risk outlook, however, APRA considers that it is necessary to further increase the level of supervisory intensity in this area, to reinforce sound lending practices, with a particular focus on some specific areas of prudential concern. These are set out below, providing transparency on the key aspects of mortgage lending that APRA supervisors will be focusing on in the period ahead. Where concerns on risk profile or serviceability are identified, this will lead to further supervisory action, including the consideration of individual Pillar 2 capital requirements.

Risk profile

There are many dimensions to assessing the soundness of mortgage lending practices. In recent years, supervisors have been discussing and reviewing these in depth. Higher risk lending includes, for example, a high proportion of lending at high loan-to-income ratios (LTI), lending at high loan-to-valuation ratios (LVRs), lending on an interest-only basis to owner-occupiers for lengthy periods and lending at very long terms. In the current environment, where an ADI is undertaking large volumes of lending in these categories, or increasing this higher risk lending as a proportion of new lending, this will 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 currently very strong growth in investor lending, supervisors will be particularly alert to plans for rapid growth in this part of the portfolio. For example, annual investor credit growth materially above a benchmark of 10 per cent will be an important risk indicator that supervisors will take into account when reviewing ADIs' residential mortgage risk profile and considering supervisory actions.[3] The benchmark is not intended as a hard limit, but ADIs should be mindful that investor loan growth materially above this rate will likely result in a supervisory response.

[2] There are two principal mechanisms for changes to capital at a system level: changes to Pillar 1 capital requirements for individual assets (through changes to specific risk weights) or changes to overall capital requirements for all ADIs. From 1 January 2016, APRA will also have the option of applying the countercyclical capital buffer.

[3] This benchmark has been established by APRA, after advice of CFR agencies, taking into account trend nominal household income growth and recent market trends.

Serviceability assessments

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.

In APRA's view, 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 7 per cent.[4] This is 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.

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 will prompt the consideration of further supervisory action. APRA supervisors will also be monitoring other elements of the serviceability assessment, including income acceptance, minimum living expenses, and other debt commitments. It will be important that these assumptions are not relaxed, to ensure that overall loan serviceability standards are maintained.

Next steps

In the first quarter of 2015, APRA supervisors will be reviewing key risk indicators, serviceability policies and ADIs' investor loan growth plans. Where an ADI is not, in APRA's view, maintaining prudent lending practices, this will lead to a graduated increase in the level of supervisory action. As with any supervisory response, this will include further communication with senior management and boards, changes to APRA's risk assessment as defined by the PAIRS and SOARS framework, and enhanced monitoring and review. In the first half of 2015, supervisors will also reflect any concerns through changes to Pillar 2 capital requirements, proportionate to the risks identified and the scale of the residential mortgage loan portfolio.

For higher risk lending, APRA will also conduct further investigation to better understand how ADIs are monitoring and managing origination flows and the associated credit risk during 2015. This may include additional detailed information requests and on-site and off-site reviews. For all ADIs, supervisors will continue to place a strong focus on reviewing loan origination practices in residential mortgage portfolios, given the risks in the current environment.

Together with other members of the CFR, APRA will continue to monitor and assess the risks in the housing market as they evolve. As outlined above, there are a range of further measures that APRA could apply. These options remain open, and we will consider the need for additional steps as market conditions and lending standards develop.

[4] The loan product rate is the lender's current standard variable rate (SVR) minus any discount applied for the term of the loan.

If you have any questions on the issues outlined in this letter, please contact your supervisory team.

Yours sincerely,

Wayne Byres
Chairman