Australian Prudential Regulation Authority

Inquiry into possible links between household debt, demand for imported goods and Australia's current account deficit

Submission to the Senate Economics References Committee

4 February 2005

Purpose

This submission briefly explains APRA's prudential framework governing the provision of household credit by authorised deposit-taking institutions (ADIs) and APRA's experience in supervising the lending practises of these institutions.

Background

APRA was established on 1 July 1998 as an integrated prudential regulator of ADIs (banks, credit unions and building societies), insurance companies, superannuation funds and friendly societies. APRA-regulated entities account for around 85 per cent of the assets in the Australian financial system.

APRA's mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the financial institutions it supervises are met within a stable, efficient and competitive financial system. In carrying out its functions, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.

ADIs are normally best-placed to determine the level and nature of credit risk that they are prepared to carry. APRA's prudential focus is on ensuring that ADIs provide credit in a financially sustainable and prudentially sound manner. APRA's responsibilities do not include ensuring that the terms and conditions of any loan are fair to the borrower and fully disclosed; these are matters for other regulatory agencies.

Prudential framework

APRA's approach to the prudential supervision of ADIs is predicated on the principle that the prime responsibility for the prudent management of an ADI rests with its Board and senior management. It is their responsibility to assess the risks in the lending activities undertaken by the ADI and to continually monitor and control those risks. APRA has a range of prudential standards that ensure that ADIs are adequately capitalised and have appropriate risk management systems in place.

The ADI Prudential Standards (APS) that relate to the provision of household credit are:

- APS 112 Capital Adequacy: Credit Risk;
- APS 220 Credit Quality; and
- APS 120 Funds Management and Securitisation.

Capital adequacy

As the prudential regulator, APRA's focus is to ensure that ADIs have appropriate credit risk management systems to manage their lending exposures, including exposures arising from residential property lending and other lending to households. APRA does not regulate the extent to which ADIs lend to households or to business. However, APRA's prudential requirements may have an indirect impact in certain circumstances. For example, where an ADI is judged to be assuming excessive risk through poor lending practices, APRA may increase the minimum capital requirement for the institution and this may impact on the price and/or supply of lending by that institution.

APRA's prudential standards require ADIs to maintain a minimum ratio of total capital to risk-weighted assets (on both a consolidated group and stand-alone basis) of at least eight per cent, to ensure that ADIs have a sufficient buffer of capital to meet unexpected losses. Most ADIs are on higher minimum capital requirements, in some cases imposed by APRA and in most cases self-imposed by an ADI's board. Typical capital ratios in Australia range from 9.5 per cent to 14 per cent of risk-weighted assets.

Usually, loans to individuals (and commercial loans) have a risk-weight of 100 per cent. However, reflecting the historic low loss rates on residential property lending in Australia, loans that are fully secured by a registered mortgage over a residential property are assigned a concessional risk-weight of 50 per cent, provided they satisfy lending criteria outlined in the prudential standards and associated guidance notes. This is equivalent to a four per cent minimum capital requirement. The majority of loans by ADIs are residential property loans.

In early 2004, APRA released a discussion paper proposing the introduction of more detailed criteria for ADIs to qualify for the concessional risk-weighting of residential mortgage lending. APRA's proposal followed its earlier survey of the experience of ADIs with 'low doc' loans, which are written with considerably less documentation and verification of income and serviceability than conventional mortgage lending, and which ADIs themselves consider carry a higher risk of loss. Under the revised criteria, loans where ADIs do not verify the borrower's servicing ability would require a higher equity contribution by the borrower, or would need to be fully mortgage insured with an acceptable lenders mortgage insurer (LMI), before such loans qualify for the concessional risk-weight. These changes came into effect on 1 October 2004.

APRA has also strengthened the capital adequacy standard for ADIs by requiring them to treat certain types of capitalised expenses – such as loan origination fees and commissions paid to mortgage originators and brokers – as intangible assets for prudential purposes, and to deduct them from capital. The revised standard came into effect from 1 July 2004.

In August 2004, APRA released a discussion paper proposing an improved capital framework for LMIs. The proposed new framework involves a new, more risk-sensitive regulatory capital model and a significant increase in minimum regulatory capital requirements. Following industry consultations, a discussion paper outlining some amendments to the original proposal will be released shortly.

Under proposed international reforms to capital adequacy requirements (known as the Basel II Framework), national prudential supervisors will have discretion to reduce the risk-weights on lending to households. For ADI's adopting the so-called "standardised approach", the Framework permits a 75 per cent risk-weight for "other retail" exposures (eg personal and credit card lending) and a 35 per cent risk-weighting for residential property lending that currently attracts the concessional 50 per cent risk-weight. (ADI's with more sophisticated risk management systems will be able to use their own internal-ratings-based approaches to determine the risk-weights for household and other lending.) APRA will shortly be announcing how it will be exercising its discretion on credit risk-weights. Any new risk-weights will come into effect from year-end 2007.

APRA's supervision of ADI household lending

ADIs have remained major beneficiaries of the robust economic fundamentals and strong demand for household credit in Australia. APRA monitors a range of indicators of the health of ADIs – such as loan arrears, large exposures, profitability and capitalisation – and these indicators show that the ADI sector is currently in very sound condition. The asset quality of ADIs is currently particularly strong. At end September 2004, impaired assets accounted for only 0.37 per cent of ADIs' on-balance sheet assets, a figure around decade-low levels. In housing lending, the impaired assets ratio is lower again, with only 0.17 per cent of ADI housing loans in arrears by 90 days or longer.

In an environment of rising household indebtedness and debt-servicing burdens and uncertainty about the future course of housing prices, the focus of APRA's supervision of ADIs for some time now has been the underlying quality of ADI lending portfolios, particularly housing lending.

In late 2003, APRA undertook a rigorous stress test to help gauge the resilience of ADI housing loan portfolios in the event there were to be a substantial housing market correction. The stress scenario – a 30 per cent fall in housing prices and a significant increase in mortgage defaults - was well outside Australia's post-war experience but not as severe as the fate of some other industrial countries and regions over the past twenty years.

The stress test demonstrated that the ADI sector as a whole remains well capitalised and could withstand a substantial housing market correction without putting depositors at undue risk. Over 90 per cent of the ADIs that participated would survive such a shock, without breaching minimum regulatory capital requirements. For a small number of ADIs, the losses incurred would not be covered by surplus capital, but the breaches of minimum capital requirements would not be large. No ADI would fail in the face of the shock. APRA's stress scenario did not, however, allow for the more general impact of a substantial housing market correction on the quality of other ADI lending and on other profit sources.

Though the stress test results were reassuring, APRA has warned ADIs to proceed with caution in housing lending and it has kept the lending practices of ADIs under close scrutiny. In its supervisory activities, APRA has identified slippages in basic lending practices, in areas such as verification of customer data and valuation processes. APRA also sees increasing reliance on the information collected by third parties (such as mortgage brokers and mortgage managers) without independent verification by the ADI. The share of ADI housing loans sourced through third parties has continued to grow and it is essential that loan quality is not compromised as a result. As noted above, APRA has revised its policies in this area to provide more explicit guidance to ADIs.

APRA has also observed that ADIs are no longer relying on conservative rules of thumb when assessing a borrower's capacity to repay debt. The traditional "30 per cent rule", under which lenders would limit repayments to no more than 30 per cent of a borrower's gross income, has been giving way to a debt servicing ratio approach, which treats all income above a cost of living estimate as potentially available for servicing debt. This approach allows higher income applicants to borrow much higher percentages (up to 50 per cent) of their gross income, since cost of living expenses are regarded as a relatively fixed commitment for individuals.

While acknowledging that this approach and new "scorecard" techniques have the sensible aim of capturing more relevant details about borrowing capacity, APRA has warned ADIs that the approach is untested in adverse circumstances and needs to be applied conservatively. It should, as a minimum, be based on realistic – not poverty line – estimates of living costs which are regularly updated and provide for contingencies in family circumstances. It should also allow for potential interest rate increases over the life of the loan. That said, ADIs typically build in a buffer for potential interest rate increases of around one to two per cent when assessing the ability of borrowers to service their loans.

As part of its on-going supervision, APRA reviews the robustness of ADIs' credit assessment and lending procedures to ensure that lending standards are maintained and that lenders are fully aware of a potential borrower's circumstances and capacity to service debt. APRA intensifies its supervision of an ADI whose lending practises, including new lending initiatives, are judged to be unsound. Where appropriate, APRA lifts minimum capital requirements to ensure that depositors are protected from the associated risks. However, it remains the responsibility of the Board and senior management of an ADI to ensure that the institution has in place risk measurement, monitoring and control capabilities that are commensurate with the risk inherent in any new products offered, and that it maintains sufficient capital to support the exposures that may arise from such lending.

Conclusion

Household debt levels in Australia have risen strongly over the past decade. The major factors have been the move to a low inflation/low interest rate environment and deregulation of the Australian financial system, with the associated increase in competition among lenders. Together, these factors have increased the availability and lowered the cost of credit to households. The capacity of households to service this debt depends, of course, on their ability to generate sufficient cash flow to meet their principal and interest obligations.

APRA's prudential framework, supported by prudential standards, aims to ensure that ADIs adopt prudent practices to manage the risks arising out of their lending activities and hold sufficient capital against these risks. The prudential framework for ADIs is comprehensive and well-seasoned, but APRA has seen the need to strengthen this framework in response to developments that were causing it unease, particularly in housing credit. As a consequence of this strengthening, it is APRA's view that the current prudential framework underpins a robust and well-managed ADI sector in Australia.

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