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TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS (ADIs)

REINFORCING SOUND RESIDENTIAL MORTGAGE LENDING PRACTICES – RESPONSE TO CONSULTATION ON REVISED PRUDENTIAL PRACTICE GUIDE

On 24 October 2016, the Australian Prudential Regulation Authority (APRA) released for consultation a draft revised *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223). APRA proposed amending APG 223 to provide more detailed guidance on quantitative supervisory parameters and other qualitative measures, consistent with expectations for prudent practices communicated to ADIs through supervisory process over the last two years.

APRA received eight submissions from industry associations, individual ADIs and other interested parties. This letter outlines APRA's response to issues raised in submissions.

Together with this letter, APRA has today released the final APG 223, which strengthens existing guidance and formalises expectations communicated to ADIs through APRA's supervisory focus on reinforcing sound residential mortgage lending practices.

Serviceability assessments

Interest rate buffer and floor

A number of submissions raised concerns regarding the inclusion of a quantitative interest rate buffer on the basis that it may not always be appropriate to apply a minimum buffer of two per cent, particularly in periods where interest rates are high relative to historic norms. Respondents proposed that an ADI should use an interest rate buffer appropriate for the current position within the interest rate cycle and particular market conditions in the relevant jurisdiction.

APRA acknowledges that its guidance on interest rate buffers and floors is more detailed than is typically contained in a prudential practice guide, but believes this additional specification is necessary given its observation that the principles-based approach advocated in submissions had failed to ensure sound residential mortgage lending assessments. APRA also has the ability to modify its guidance in relation to prudent interest rate buffers, should there be material changes to the interest rate environment and/or lending practices.

Submissions also noted that the proposed interest rate buffer does not consider different market conditions faced by ADIs with subsidiaries operating outside Australia. The revised APG 223 includes a general statement that APRA expects an ADI to adopt similarly conservative lending practices as those outlined in APG 223 for residential mortgage lending outside of Australia, but provides a degree of flexibility as to how this is best achieved.

In relation to existing debt commitments, APRA confirms that applying the interest rate buffer and floor to all of a borrower's existing debt commitments, including personal loans, would be consistent with its expectations for prudent lending standards.

One respondent highlighted that the use of an interest rate buffer in relation to home loans may affect the choice of lending product. In addition, APRA has become aware that some ADIs may have had a practice of permitting changes to the loan type after settlement without conducting a serviceability assessment under the revised loan terms. To address this, APRA has included additional guidance in APG 223 that a prudent lender would undertake a new serviceability assessment when making a material change to current or originally approved loan conditions (for example, changing between principal and interest and interest-only repayment terms). The revised APG 223 also sets out the expectation that a prudent ADI would not rely on longer-term access to 'honeymoon' or discounted introductory rates in assessing ongoing serviceability.

Revolving personal debt

Submissions requested further guidance on APRA's expectations regarding the 'suitably prudent' period used to calculate revolving debt repayments, noting that customers may choose to manage their revolving debt in a number of ways and it may also be relevant to consider outstanding balance, patterns of use and minimum repayment levels in establishing revolving debt repayment assumptions.

Based on APRA's review of the range of industry practices, paragraph 35 of APG 223 provides that using an assessment rate of three per cent per month on a borrower's total committed limit for credit card and other revolving debt is an example of a prudent approach for assessing a borrower's repayment obligations for such facilities.

General buffers

One respondent expressed concern in relation to references to the use of 'buffers' in paragraphs 29 and 31 of APG 223, noting that these references could be interpreted as suggesting that an ADI should apply a general buffer in all circumstances. In these references, APRA is seeking to convey the view that a loan should not automatically be considered prudent merely by having a positive net income surplus. An ADI should satisfy itself that it is applying sufficient buffers to achieve prudent serviceability outcomes. APRA considers that the language in these paragraphs remains appropriate.

Assessment and verification of income, living expenses and other debt commitments

Non-salary income

A number of submissions raised concerns regarding the proposal that ADIs should apply a haircut of at least 20 per cent to non-salary income. Respondents noted that some non-salary income – such as shift work or overtime pay in some professions – can be a significant and predictable source of income that should not necessarily be subject to a haircut of at least 20 per cent, and recommended this provision refer to 'non-stable' rather than 'non-salary' income.

Paragraph 39 of APG 223 specifies that prudent practice is to apply haircuts to 'most types of non-salary income' of at least 20 per cent. APRA believes this guidance is sufficiently flexible to cater to situations of stable non-salary income, which may include certain social security income. However, discretion needs to be closely monitored. APRA notes that in recent years a number of ADIs have made considerable efforts to reduce the ability for serviceability assessment parameters, such as haircuts, to be manually adjusted or overwritten.

Verification of non-salary income

Some respondents suggested two years as a reasonably prudent timeframe for assessing non-salary income. APRA believes that two years may be adequate in some circumstances, but that ADIs should use appropriate judgement as to whether a longer period should be used. APG 223 has not been amended to be more prescriptive in this area.

Investment properties

One respondent proposed alternative means of accounting for investment property costs in the serviceability assessment. APRA accepts that there are different methodologies to account for investment property costs. Paragraph 43 has been revised to reflect the range of prudent practices that exist in this area and to indicate that the primary purpose of applying haircuts to expected rental income is to account for instability in that income due, for example, to the risk of non-occupancy. However, as rental income is typically less stable than expenses relating to investment properties, a prudent ADI would apply the haircut to gross rental income rather than net rental income.

Another submission noted that ADIs may face operational impediments to applying haircuts of more than 20 per cent to expected rental income for certain properties with higher risks, but that other measures may be used to account for property-specific risks. Given investment lending represents a substantial portion of overall lending, APRA does not agree that operational impediments justify less robust practices in this area; however similar risk mitigation could potentially be achieved through other mechanisms. APRA did not consider it necessary to amend its guidance in this area.

Regarding a borrower's potential ability to access future tax benefits from operating a rental property at a loss, one respondent recommended paragraph 43 specify that future tax benefits should be assessed using an appropriate interest rate and considering relevant market conditions. Draft APG 223 indicated that if future tax benefits are recognised, the more prudent practice is to calculate them at the actual interest rate (rather than a higher rate). APRA believes the guidance remains appropriate.

Living expenses

One respondent expressed concerns regarding the specific nature of the proposed guidance in paragraph 44 that the HEM or HPI should be scaled to a borrower's income. The submission noted that there are multiple ways to appropriately tailor a base level of living expenses to an individual borrower's circumstances, including but not limited to using the borrower's income or geographic location. APRA is not convinced that it is appropriate to use a borrower's geographic location to determine an appropriate margin above the relevant living expense index and remains of the view that its guidance in this area is appropriate. Until recently very few ADIs employed any margin above living expense indices, instead applying a flat baseline HPI or HEM assumption to all assessments.

One respondent also suggested that it would be appropriate for an ADI to implement updates to living expense indices no less than twice per year and as soon as practicable where material change has occurred. APRA is of the view that a prudent ADI would always use the most up-to-date indices and continues to consider the guidance in this area appropriate.

Loans to self-managed superannuation funds

Whilst amending APG 223, APRA has also taken the opportunity to incorporate guidance in relation to the appropriate capital treatment for loans to self-managed superannuation funds. This guidance is consistent with expectations communicated to ADIs in January 2013.[1]

Hardship loans and collections

A number of submissions noted that the proposed revisions to paragraph 97 (paragraph 98 in revised APG 223) are unclear and requested further clarification by way of examples.

The proposed changes to paragraph 97 were intended to improve clarity and did not represent a change in APRA's expectations for appropriate practice in this area. In response to consultation feedback that the proposed changes did not achieve this objective, APRA has further refined its guidance in this area to clarify that the guidance relates to prudential reporting purposes only. Subject to meeting the relevant consumer credit obligations, an ADI can manage its internal collections and reporting in a manner of its choosing. APRA will continue to address institution-specific queries regarding hardship loans and collections though the normal supervisory process.

APRA has released the revised final version of APG 223 with amendments as set out in this letter. The final APG 223 is available at: http://www.apra.gov.au/adi/PrudentialFramework/Pages/authorised-deposit-taking-institutions-ppgs.aspx.

Yours sincerely,

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[1] http://www.apra.gov.au/adi/Publications/Documents/130117-Letter-to-ADIs-Loans-to-SMSFs.pdf