INFORMATION PAPER

Countercyclical capital buffer

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Glossary

ABS	Australian Bureau of Statistics
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 110	*Prudential Standard APS 110 Capital Adequacy*
Basel III	Basel Committee, Basel III: *A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011)
Capital conservation buffer	An additional layer of Common Equity Tier 1 Capital above the minimum regulatory requirement that can be utilised in times of stress to absorb losses, subject to constraints on dividends and other distributions. See APS 110 for further information
Countercyclical capital buffer	An extension of the capital conservation buffer that can be imposed by the national authority to protect the banking sector from periods of excess credit growth that have often been associated with the build-up of system-wide risk. See APS 110 for further information
Credit	Credit provided by financial institutions operating domestically
Credit-to-GDP gap	The difference between the credit-to-GDP ratio and its long term trend
GDP	Gross domestic product
LVR	Loan-to-valuation ratio
RBA	Reserve Bank of Australia

Chapter 1 — Countercyclical capital buffer

The countercyclical capital buffer is designed to be used to raise banking sector capital requirements in periods where excess credit growth is judged to be associated with the build-up of systemic risk. This additional buffer can then be reduced or removed during subsequent periods of stress, to reduce the risk of the supply of credit being impacted by regulatory capital requirements.[1]

The countercyclical capital buffer became part of the Australian capital adequacy framework from the beginning of 2016. From that date, the Australian Prudential Regulation Authority (APRA) may set a countercyclical capital buffer within a range of 0 to 2.5 per cent of risk weighted assets. On 17 December 2015, APRA announced that the countercyclical capital buffer applying to the Australian exposures of authorised deposit-taking institutions (ADIs) from 1 January 2016 would be set at zero per cent.[2]

APRA reviews the level of the countercyclical capital buffer on a quarterly basis, based on forward looking judgements around credit growth, asset price growth, and lending conditions, as well as evidence of financial stress. APRA takes into consideration the levels of a set of core financial indicators, prudential measures in place, and a range of other supplementary metrics and information, including findings from its supervisory activities. APRA also seeks input on the level of the buffer from other agencies on the Council of Financial Regulators.

Since determining the initial setting, APRA has continued to monitor indicators of systemic risk within the Australian financial system, including a continued focus on heightened housing sector risks. In that time, APRA has not observed a change in the level of systemic risk that would necessitate a change in the level of the countercyclical capital buffer.

This decision has been made taking into account APRA's other supervisory activities and prudential measures. This includes APRA's supervisory work on housing lending standards and the establishment of the benchmark on investor lending growth, with actual growth in investor lending currently at around half the benchmark rate. In 2016 APRA maintained its focus on reinforcing and improving sound lending standards. In response to this, APRA believes the industry has appreciably improved its residential lending standards. APRA is continuing to work to have the improved standards firmly embedded into industry practice.[3]

[1] For further information on the countercyclical capital buffer and APRA's approach to assessing the appropriate setting for Australia, see APRA's December 2015 Information Paper, *The countercyclical capital buffer in Australia.*

[2] http://www.apra.gov.au/MediaReleases/Pages/15_38.aspx

[3] APRA is currently consulting on amendments to *Prudential Practice Guide APG 223 Residential mortgage lending (APG 223).* For further information please see http://www.apra.gov.au/MediaReleases/Pages/16_41.aspx.

The core indicators used to guide decision-making are summarised in chapter 2. These indicators are associated with the financial cycle and assist in determining whether there is a build-up of unsustainable cyclical leverage.

In consultation with the other agencies on the Council of Financial Regulators, APRA will continue to closely monitor developments, including in riskier segments of housing lending such as lending to investors and interest-only lending. APRA's monitoring will include, but not be limited to, movements in the core risk indicators, and APRA will adjust the buffer level should conditions warrant it in future. An announcement to increase the buffer may have up to 12 months' notice before the new buffer comes into effect; a decision to reduce the buffer will generally be effective immediately.

Chapter 2 — Summary of core indicators

The following section summarises the core indicators as set out in APRA's framework for the countercyclical capital buffer. There is no direct formulaic link between the indicators and the level of the buffer. APRA considers these indicators along with a number of supplementary indicators, other information and input from other agencies on the Council of Financial Regulators.

Risk	Core indicators
Credit growth	Credit–to-GDP ratio (level, trend and gap) Housing credit growth Business credit growth
Asset prices	Commercial property price growth Housing price growth
Lending indicators	Higher-risk residential mortgage lending Business lending conditions Loan pricing and margins
Financial stress	Non-performing loans

Credit growth

Credit-to-GDP ratio (level, trend and gap)

The credit-to-GDP gap is defined as the difference between the credit-to-GDP ratio and its long-run trend.[4] The credit-to-GDP gap for Australia is currently negative at -3.9. The Basel Committee suggests that a gap level between 2 and 10 percentage points could equate to a countercyclical capital buffer of between 0 and 2.5 percent of risk-weighted assets.

Housing credit growth

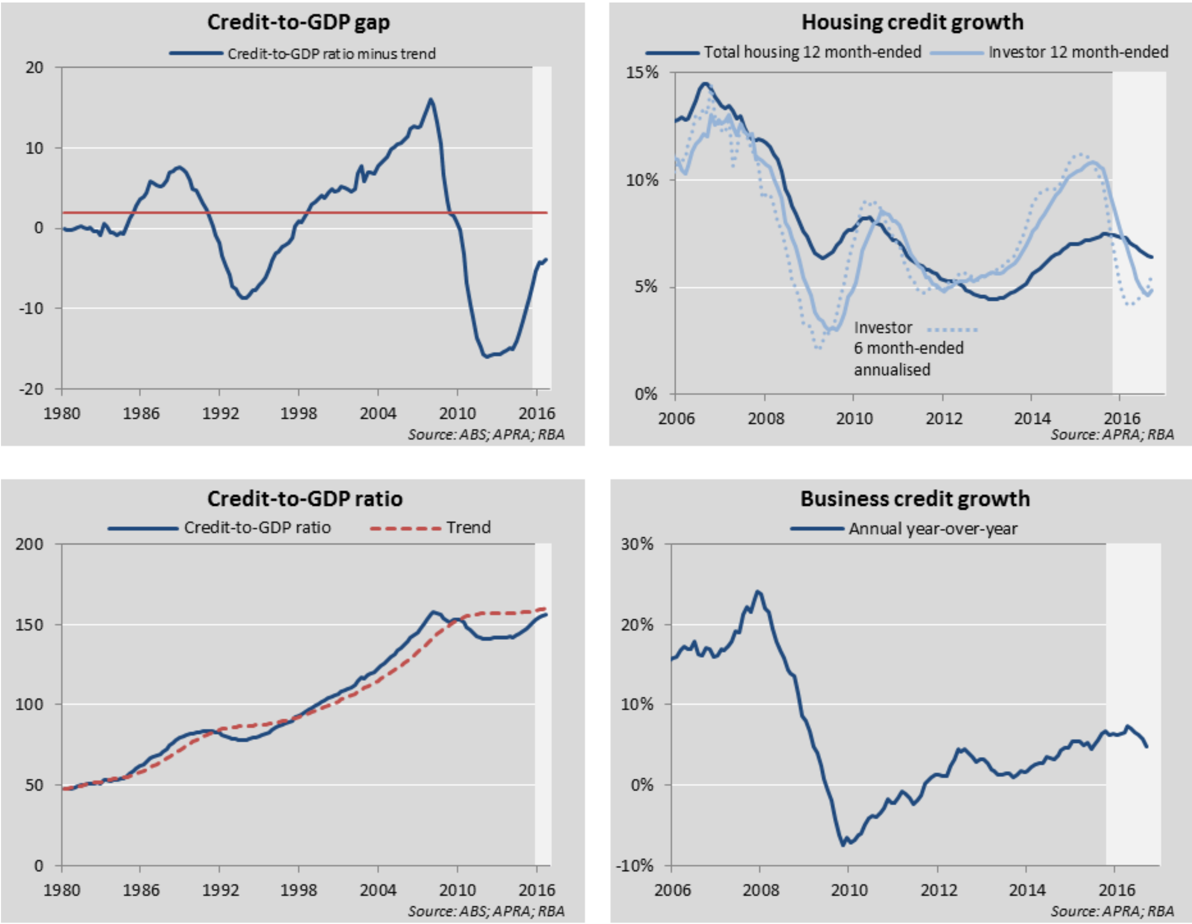
The pace of housing credit growth has slowed this year, growing at 6.4 per cent year on year as at September 2016, down from 7.5 per cent at the time the buffer was initially set. Investor

[4] The long-run trend is calculated using a one sided Hodrick-Prescott filter, a tool used in macroeconomics to establish the trend of a variable over time. For more information see Basel Committee, *Guidance for national authorities operating the countercyclical capital buffer, December 2010*: http://www.bis.org/publ/bcbs187.htm

housing credit growth fell from 10 per cent to 4.9 per cent over the same period, however the pace of growth has been increasing again more recently. APRA has identified strong growth in lending to property investors (portfolio growth above a threshold of 10 per cent) as an important risk indicator for APRA supervisors.

Business credit growth

Business credit growth increased marginally in the first half of 2016. However, business credit growth has fallen over recent quarters; annual growth in business credit was 4.8 per cent over the year to end September 2016, down from 6.3 per cent as at September 2015. Notwithstanding the lower overall rate of growth, commercial property lending growth (not shown) has remained strong, growing 10.5 per cent year on year as at September 2016.

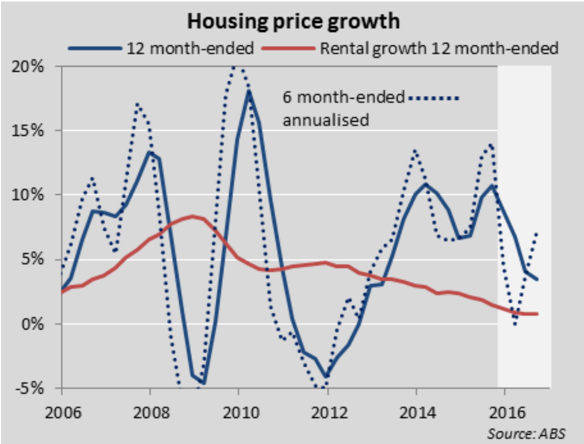


Shaded areas (right side of charts) show period since initial buffer setting

Asset Prices

National housing price growth remains strong, but has slowed relative to 2015 peaks, growing nationally at around 3.5 per cent over the 12 months to September 2016. However, over a shorter horizon, prices have been reaccelerating recently with six month-ended annualised price growth of 7.2 per cent nationally as at September 2016 (albeit still a slower pace than 2015 peaks). Conversely, rental growth and household income growth have been relatively weak. Looking beyond the national averages, conditions vary significantly across individual cities and regions. In particular, housing price growth has strengthened in Sydney and Melbourne over recent months with six month-ended annualised growth rates of 11.4 per cent and 9.0 per cent respectively.

Non-residential commercial property has also been exhibiting strong price growth, though this has moderated somewhat in recent months (not shown).



Lending indicators

APRA monitors a range of data and qualitative information on lending standards. For residential mortgages, the proportion of higher-risk lending is a key metric. Over the past few years, APRA has heightened its regulatory focus on the mortgage lending practices of ADIs in order to reinforce sound lending practices. This has included, but not been limited to, the introduction of benchmarks on loan serviceability and investor lending growth, and the issuance of a prudential practice guide on sound risk management practices for residential mortgage lending.

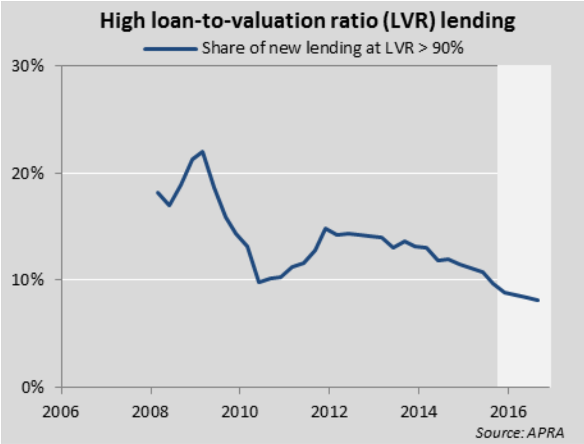
In general, higher-risk mortgage lending has been falling recently with the share of new lending at loan-to-valuation ratios greater than 90 per cent falling from 9.5 per cent to 8.1 per cent over the year to September 2016. Other forms of higher-risk mortgage lending including high loan-to-income and interest-only lending (not shown) have also moderated from 2015 peaks, although there has been some pick-up in the share of interest-only lending recently.

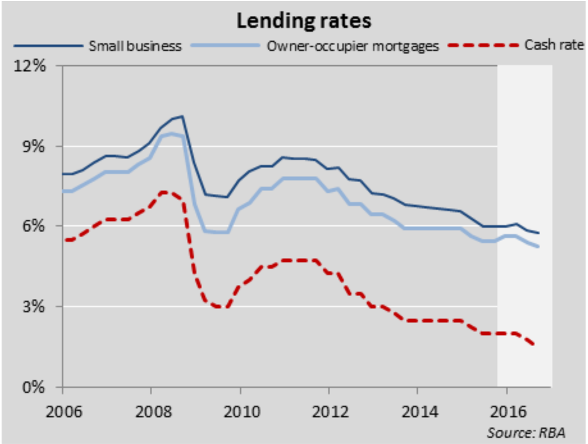
In business lending, banks have showed some evidence of tightening lending standards more recently, in particular for commercial property lending, with the lowering of loan-to-valuation and loan-to-cost ratios on certain development transactions (not shown).[5]

Lending rates had been steadily falling for both housing and business lending to historical lows. More recently however, lending rates have fallen by less than the cash rate, with banks passing on around half of the August cash rate reduction. Lending rates have also risen in recent weeks in response to higher costs in wholesale funding markets. In particular, a

[5] APRA's confidential quarterly survey of credit conditions and lending standards provides qualitative information on whether conditions are tightening or loosening in the industry.

number of ADIs have recently announced increases to their mortgage lending rates with some ADIs specifically targeting investor and interest-only loans.

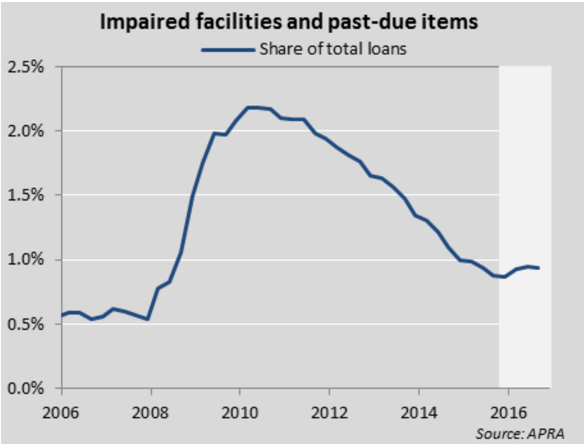




Financial Stress

Indicators of financial stress are used in informing decisions to release any countercyclical capital buffer. While a wide range of indicators could signify a deterioration in conditions, APRA has identified non-performing loans as its core indicator of financial stress.

The share of non-performing loans remains low, though it has increased moderately over 2016, to 0.93 per cent as at September 2016, largely driven by increases in regions and sectors with exposures to mining.



Indicator	Sep 15	Dec 15	Mar 16	Jun 16	Sep 16
Credit-to-GDP gap	-6.8	-5.4	-4.3	-4.3	-3.9
Housing credit growth (year-on-year)	7.5%	7.4%	7.1%	6.7%	6.4%
Business credit growth (year-on-year)	6.3%	6.4%	6.5%	6.5%	4.8%
Housing price growth (year-on-year)	10.7%	8.7%	6.8%	4.1%	3.5%
Lending standards (share of new mortgage lending with LVR>90)	9.5%	8.8%	8.6%	8.3%	8.1%
Non-performing loans	0.88%	0.86%	0.93%	0.94%	0.93%

APRA