Australian Prudential Regulation Authority

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To All Authorised Deposit-taking Institutions (ADIs)

BASEL II: TREATMENT OF REVERSE MORTGAGES AND SHARED EQUITY MORTGAGES

The purpose of this letter is to clarify the appropriate capital treatment of reverse mortgages and shared equity mortgages under APRA's Basel II capital adequacy framework.

Reverse mortgages do not require principal and interest payments until termination of the facility, which is not fixed and normally occurs when nominated residents die, vacate the mortgaged property or the property is sold. At termination, repayment is expected from the proceeds of the sale of the mortgaged property, with general recourse to other potential repayment sources normally being unavailable. In some cases, reverse mortgage lenders offer to guarantee borrowers a minimum share of the future sale proceeds of mortgaged properties.

Shared equity mortgages differ from reverse mortgages in that both the lender and borrower share in any gain or loss in the value of the mortgaged property.

Existing guidance on the appropriate capital treatment for reverse mortgages and APRA's broader expectations relating to risk management of these products is contained in our letter to ADIs of 15 November 2005. That broader guidance remains applicable for both reverse and shared equity mortgages. The documents mentioned are posted on APRA's website, www.apra.gov.au.

Internal ratings-based (IRB) approach

The IRB approach requires accredited institutions to develop probability of default estimates. As the concept of payment default is essentially meaningless for reverse and shared equity mortgages, there is currently no relevant available IRB approach for these types of products. Accordingly, IRB-accredited institutions will need to use the standardised risk-weights outlined below.

Standardised approach

Reverse mortgages

As noted in our 2005 letter, the management of a reverse mortgage portfolio can present challenges due to the long and uncertain maturity profile of the assets. There are also a number of unique operational, legal and reputational risks associated with reverse mortgages. These higher risk characteristics mean that it remains appropriate to align the capital treatment of reverse mortgages with that of other non-standard residential mortgage products, for which the lowest risk- weight under APRA's revised Basel II standards is 50 per cent.

That said, the risk-weighting categories for non-standard loans with loan-to-valuation ratios (LVRs) between 60 per cent and 100 per cent that were introduced under APRA's Basel II standards are not considered to be particularly relevant or well calibrated for reverse mortgages and as such should not be applied to those exposures.

We have also taken the opportunity to provide some additional guidance with respect to reverse mortgages where the LVR has risen above 100 per cent or where the borrower has been guaranteed a minimum share in the future sale proceeds of the mortgaged property. There is no allowance for lenders mortgage insurance as this is not offered for reverse mortgages.

Accordingly:

- a 50 per cent risk-weight will continue to apply for reverse mortgages with LVRs of 60 per cent or less and a 100 per cent risk-weight for reverse mortgages with LVRs above 60 per cent and up to 100 per cent;

- where the LVR rises above 100 per cent, the exposure should be treated as impaired. The difference between the outstanding amount (net of any provisions) and the value of the mortgaged property (taking into account disposal costs) should be deducted from Fundamental Tier 1 capital, with the remaining outstanding amount risk-weighted at 100 per cent (partial deduction);

- where a borrower has been guaranteed a minimum share in the future sale proceeds of a mortgaged property, the calculation of the LVR for regulatory purposes must be adjusted by reducing the value of the mortgaged property by the quarantined percentage share.

Also, consistent with our letter of 2005, in order to receive a risk-weight of less than 100 per cent, the lending and other relevant criteria set out in Attachment C of APS 112 must be met. In all cases where a risk-weight of less than 100 per cent has been assigned, the reverse mortgage must continue to comply with the relevant criteria at all future times. If any of the criteria is breached at any time, the exposure will immediately attract a 100 per cent risk-weighting.

Shared equity mortgages

Shared equity mortgages are akin to direct investments in property; as such, a 100 per cent risk-weight is applicable.

Please contact the relevant Responsible Supervisor for your institution if you need any further clarification.

Yours sincerely,

C.W. Littrell

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