INFORMATION PAPER

Countercyclical capital buffer

29 January 2019

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Executive summary

Banks hold capital to ensure that they can repay their creditors and continue to lend, even during a severe downturn. The countercyclical capital buffer is an additional amount of capital that APRA can require authorised deposit-taking institutions (ADIs) to hold at certain points in the economic and financial cycle. The primary purpose of the countercyclical capital buffer is to increase the resilience of the ADI sector during periods of heightened systemic risk due to excessive credit growth. The buffer was set at zero per cent of risk-weighted assets upon its introduction in 2016, and has remained unchanged.

APRA reviews the level of the buffer on a quarterly basis. One major input to these decisions is a set of core systemic risk indicators that cover credit growth, asset prices, lending conditions and financial stress. Other relevant considerations include the pre-existing level of ADI resilience, supervisory and prudential measures in place, and supplementary data sources. Input is also sought from other members of the Council of Financial Regulators.

APRA considers that a zero per cent countercyclical capital buffer remains appropriate at this point in time. Key factors in this assessment include moderate overall credit growth, continued improvement in the risk profile of new housing lending, and continued strengthening in capital positions.

APRA will continue to monitor the level of systemic risk, including through a revised set of indicators as outlined in the paper. A potential future reversal of the recent improvement in housing lending standards is one example of a scenario in which APRA would consider activating the buffer. Separately, APRA will continue its analysis of whether a non-zero default level of the countercyclical capital buffer should be implemented as a component of the changes to capital requirements needed to implement unquestionably strong capital benchmarks and the Basel III framework.

Chapter 1 – Countercyclical capital buffer decision

APRA requires banks to hold capital to absorb losses and increase the likelihood they continue to operate during a severe downturn. Capital protects bank creditors, including depositors, and ensures that the banking system can continue providing its essential payment and lending functions. Most of APRA's capital requirements for authorised deposit-taking institutions (ADIs) do not vary over the economic cycle.

The countercyclical capital buffer, which has been part of APRA's capital adequacy framework since 2016, is different. This buffer is an additional amount of capital – equivalent to between 0 and 2.5 per cent of risk-weighted assets – that APRA can require ADIs to hold at certain points in the economic and financial cycle. APRA's primary objective when adjusting the countercyclical capital buffer is to ensure that the resilience of the banking sector is higher during periods of heightened systemic risk. The 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.

APRA set the level of the Australian jurisdictional countercyclical capital buffer applying to ADIs at zero per cent upon its introduction on 1 January 2016, and it has remained unchanged since.[1]

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 (see Chapter 2), 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.

APRA considers that a zero per cent countercyclical capital buffer remains appropriate at this point in time.

Key drivers of the decision to maintain the countercyclical capital buffer at zero include moderate overall credit growth, ongoing improvement in the risk profile of new housing lending, and continued strengthening in capital positions.

Business credit, including commercial property lending, grew at a moderate pace over 2018. Housing credit growth has stabilised at a moderate level over the past year, with most growth coming from lending to owner-occupiers rather than investors. The shares of new lending done at high loan-to-value ratios (LVRs), or on an interest-only basis, have fallen substantially over recent years, and this improvement in the risk profile of new housing lending was maintained over 2018. At a national level, housing prices have been falling since late 2017, after rising by around 45 per cent over the preceding five years.

[1] See Media Release: APRA announces countercyclical capital buffer rate for ADIs, 17 December 2015.

Some areas of concern remain. Household indebtedness remains at historically high levels, as wages and household income have continued to grow slowly. Commercial property prices have grown rapidly over recent years, and significantly faster than rents in some sectors.

These concerns have been mitigated to some degree by prudential and supervisory activities. Capital positions in the banking system continue to increase as they move towards levels considered necessary to meet unquestionably strong benchmarks.[2] APRA has continued to closely monitor residential mortgage lending practices, including through improved data collection.

In consultation with the other agencies on the Council of Financial Regulators, APRA will continue to monitor the level of systemic risk. APRA considers the countercyclical capital buffer to be an effective macroprudential tool, and will adjust the buffer level should future conditions warrant it. APRA has previously signalled that the countercyclical capital buffer could be used if investor credit growth increases substantially after the removal of the 10 per cent benchmark. Separately, APRA is also considering whether a non-zero default level of the countercyclical capital buffer should be a component of APRA's changes to the capital framework to implement 'unquestionably strong' capital ratios.

[2] See Information Paper: Strengthening banking system resilience – establishing unquestionably strong capital ratios, July 2017.

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 (listed in table below). These indicators are associated with the financial cycle and assist in determining whether there is a build-up of systemic risk. There is no direct formulaic link between the indicators and the level of the buffer.

Risk Area	Core Indicators
Credit growth	Credit–to-GDP 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 gap

The credit-to-GDP gap is defined as the difference between the credit-to-GDP ratio and its long-run trend.[3] It is intended to indicate periods of excessive credit growth, and has been found to be a useful early warning indicator of banking crises in some studies. The credit-to-GDP gap for Australia was -7 percentage points at the end of the September quarter. 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

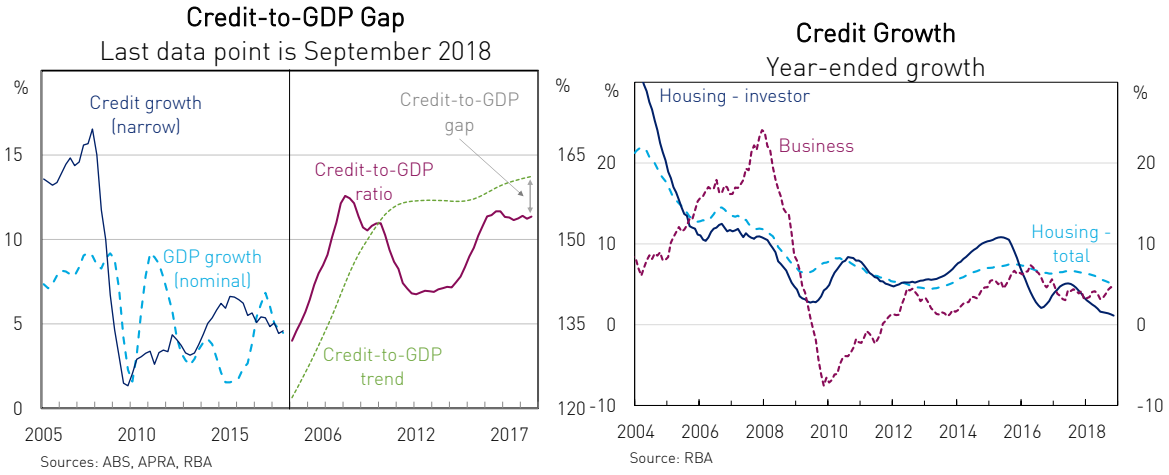
Housing credit grew by around 5 per cent over the past year. Most of this growth was in lending to owner-occupiers, as lending to investors grew by only around 1 per cent. This is consistent with trends in the demand for investor credit as well as the continued pricing differential between these types of loans (see below) and other lending policy changes. The

[3] 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.

majority of ADIs are now not subject to the benchmarks instituted by APRA in 2014 and 2017 on investor loan growth and interest-only lending respectively, as they have provided the required assurances on the strength of their lending standards.[4]

Business credit growth

Business credit growth was moderate over much of the past year, but picked up over the end of 2018 to reach 4.5 per cent over the year to November. Data from the ABS and listed companies' financial accounts indicate that leverage in the broader business sector remains at moderate levels. Growth in commercial property lending was also moderate over the year, a significant reduction from the double digit levels seen in late 2015 and early 2016.



Asset prices

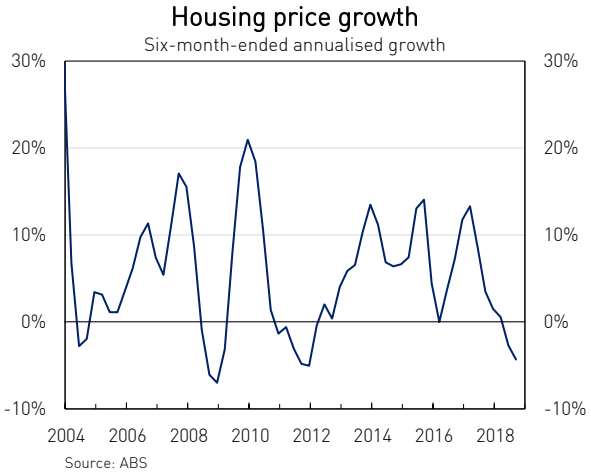
At a national level, housing prices are falling. Data from CoreLogic indicate that annual growth was -5 per cent at the end of December 2018. Much of this is being driven by price falls in Sydney (-9 per cent over 2018), Melbourne (-7 per cent) and Perth (-5 per cent), with prices flat or rising in some smaller capitals and regional areas. To the extent that it has been driven by a reduction in speculative activity, the reduction in housing price growth over the past 18 months has reduced systemic risk. A range of factors is likely to have influenced prices over recent years, including increases in the housing stock, less foreign buyer demand, the size of the earlier increase in prices, revised expectations for future appreciation and strengthened lending standards.[5]

Commercial property prices continued to grow strongly over 2018, though there was some moderation in office property price growth towards the end of the year. Prices of retail and industrial property continue to grow significantly faster than rents. APRA continues to

[4] See Media Release: APRA announces plans to remove investor lending benchmark and embed better practices, April 2018, and Media Release: APRA to remove interest-only benchmark for residential mortgage lending, December 2018.

[5] For more information, see Reserve Bank of Australia, Financial Stability Review, Chapter 5, October 2018, and Reserve Bank of Australia, Speech – Guy Debelle, Assessing the Effects of Housing Lending Policy Measures, November 2018.

monitor this sector, given the historical cyclicality of commercial property in Australia, and the fact that lending to this sector was a source of substantial losses during both the early 1990s recession and the global financial crisis.



Lending indicators

APRA continues to closely monitor the quality of new housing lending by ADIs, and this monitoring is an input to countercyclical capital buffer decisions.

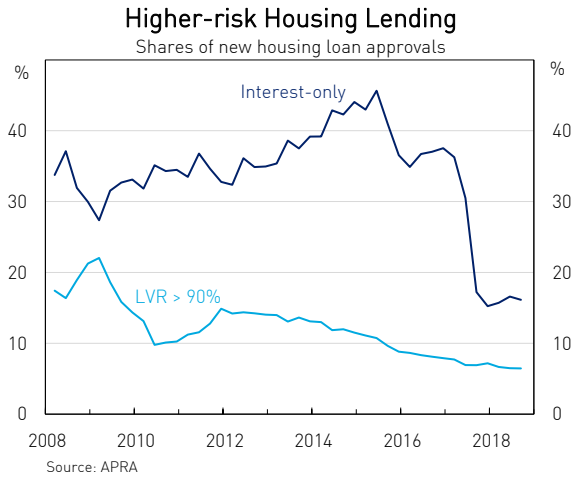
The higher-risk share of new housing lending has declined significantly since the introduction of the countercyclical capital buffer regime at the start of 2016. The interest-only share of new housing loan approvals remained around 16 per cent over 2018, down considerably from earlier years. The share of new loan approvals with an LVR above 90 per cent remained around 7 per cent. Importantly, these improvements in the quality of new lending have flowed through to the stock of outstanding lending. The share of outstanding housing lending that is interest-only is at the lowest level seen since these data began to be collected in 2008. Similarly, the share of outstanding lending that was originated with an LVR above 90 per cent has fallen from 9 per cent to 6 per cent over the past four years.

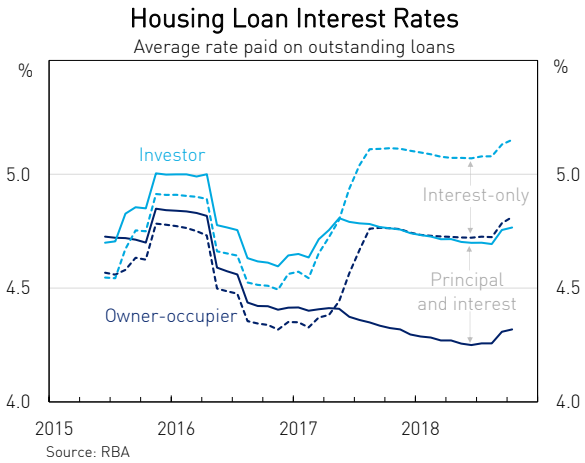
These improvements in housing lending standards have been driven by APRA's actions on residential mortgage risks and changes in ADIs' risk appetite.[6] One way ADIs have changed the composition of housing lending is through the introduction of different pricing for different loan types. Differences in average interest rates between (outstanding) owner-occupier and investor loans, and between (outstanding) principal-and-interest and interest-only loans, have been steady at 35-45 basis points since mid-2017.

Changes in business lending standards have been mixed over the past year. Data from APRA's Credit Conditions and Lending Standards Survey indicate continued tightening in commercial real estate lending standards, but largely unchanged standards for other loans

[6] For a detailed assessment of APRA's residential mortgage benchmarks, see Information Paper: Prudential measures for residential mortgage lending, January 2019.

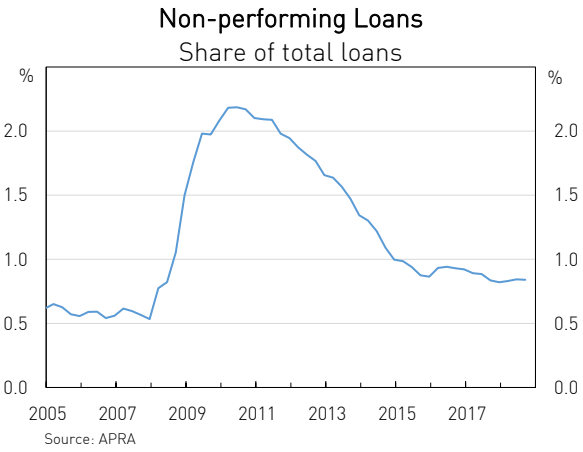
to large companies. Other survey data indicate that access to finance by small businesses may have worsened over 2018.[7]





Financial stress

Indicators of financial stress are used to inform decisions to release any countercyclical capital buffer. The current financial stress core indicator is the share of ADIs' loans that are non-performing. This share remained low over the year to September 2018, at around 0.8 per cent. Sectoral non-performing loan ratios were also relatively stable over this period.



[7] See Reserve Bank of Australia, Bulletin, Access to Small Business Finance, September 2018.

Indicator	Dec 15	Mar 16	Jun 16	Sep 16	Dec 16	Mar 17	Jun 17	Sep 17	Dec 17	Mar 18	Jun 18	Sep 18
Credit-to-GDP gap	-5.5	-4.2	-4.4	-4.2	-4.6	-5.9	-6.3	-6.9	-6.9	-6.7	-7.3	-7.0
Housing credit growth (year-ended)	7.4%	7.1%	6.7%	6.4%	6.3%	6.5%	6.6%	6.6%	6.3%	6.1%	5.6%	5.2%
Business credit growth (year-ended)	6.4%	6.6%	6.6%	5.0%	5.6%	3.6%	4.3%	4.2%	3.1%	4.0%	3.2%	4.3%
Housing price growth (6-month annualised)	4.4%	0.0%	3.7%	7.2%	11.8%	13.3%	8.6%	3.5%	1.5%	0.5%	-2.7%	-4.3%
Lending Standards (share of new loans with LVR > 90)	8.8%	8.6%	8.3%	8.1%	7.9%	7.7%	6.9%	6.9%	7.2%	6.7%	6.5%	6.5%
Non-performing loans (share of total)	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.8%	0.8%

Expansion of indicators

In late 2018, APRA reviewed the indicator framework and decided to adopt an expanded set of core indicators for assessing the countercyclical capital buffer in the future. Four new indicators have been added to the current set of core indicators: the growth in investor housing credit, the growth in commercial property lending, the change in the household debt-to-income ratio, and the banking system's return-on-equity. In addition, the credit-to-GDP gap is to be replaced by the *broad* credit-to-GDP gap. The broad credit-to-GDP gap incorporates lending to Australian borrowers by offshore entities, and is likely to have better signalling performance over time.

The revised group of core indicators makes it easier to incorporate sectoral information into countercyclical capital buffer decisions, and better acknowledges the concentration of ADIs' portfolios in residential mortgage lending. At the same time, the new core indicator set remains consistent with principles set out in APRA's framework for the countercyclical capital buffer.[8] Quarterly countercyclical capital buffer decisions during 2019 will reference the revised set of core indicators.

Summary and other considerations

When setting the level of the countercyclical capital buffer, APRA also takes into account the current level of ADI resilience, supervisory activities, and other information relevant to the level of systemic risk. On the first of these, ADI capital levels have continued to move towards the unquestionably strong capital benchmarks APRA outlined in 2017. Outside of the indicators mentioned above, information on macroeconomic conditions, and downside risks to domestic and international economic conditions, are key considerations.

Overall, the available information, including the core indicators, indicates a level of systemic risk that is consistent with the countercyclical capital buffer remaining at zero.

[8] For more information on APRA's framework for the countercyclical capital buffer, see Information Paper: The countercyclical capital buffer in Australia, December 2015.

Glossary

ABS	Australian Bureau of Statistics
ADIs	Authorised deposit-taking institutions, which includes banks, building societies and credit unions.
APRA	Australian Prudential Regulation Authority
APS110	*Prudential Standard APS 110 Capital Adequacy*
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 APRA to protect the banking sector from systemic risk.
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-value ratio
RBA	Reserve Bank of Australia

APRA