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Submission regarding APRA's consultation on the proposed new attachment to Prudential Standard APS 220 Credit Risk Management (APS 220)

As an organisation that works closely with the ADI sector, in particular small to medium sized Mutual Banks, credit unions and RADI's, Grant Thornton Australia proposes that a number of changes be made to APRA's proposed new attachment to Prudential Standard 220 Credit Risk Management (APS 220).

As part of our review of the proposed new attachment to APS 220, we engaged with a number of our clients in the sector to discuss this submission. This submission reflects both the views of our clients and of Grant Thornton Australia.

Below we outline our response to the proposed attachment and key changes that we believe should be made.

These changes include:

1. Providing more clarity on the measures proposed
2. Increasing the focus on lending standard measures rather than lending limits
3. Having a proportional application of the proposed measures
4. Limitations on public disclosure

1. Providing more clarity on the measures proposed

The proposed attachment outlines the loan types on which APRA may implement lending limits. The loan types are defined quite broadly and do not give consideration to the sub-types of loans within each loan category, which impact the actual credit risk of the loans funded. Examples include:

- Interest only loans: Construction loans for owner occupied housing are generally interest only initially and then automatically convert to a principal and interest facility upon construction completion. The ADI sector does not view construction loans for owner occupiers to have the same level of risk as interest only loans for investment purposes.

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- Lending with high LVR or DTI ratios:
  - High LVR or DTI loans often include guarantors, particularly for first home buyers.
  - First home buyers often have higher DTI or LVR. In general, the total debt of first home buyers is low and they rely on a stable employment income for their serviceability (i.e. essential service workers where the income, whilst not high, is consistent and secure). Application of lending limits has the potential to disadvantage certain groups including first home buyers, where the resulting credit quality would not be compromised due to other factors resulting in lower risk overall for the ADI
  - Lending above 80% LVR is accompanied by Lenders Mortgage Insurance in a majority of cases
  - Application of DTI limits has the potential to result in unfair outcomes or unintended consequences for ADIs. APRA should, at a minimum, seek to ensure consistency of application of DTI calculations to allow for an equitable approach across the industry.

We would like to see APRA clarify each loan type or conversely what types of loans would not be expected to fall into each category.

Additionally, the proposed attachment does not provide any timeframes for the lead-time ADI's would be required to implement any limits APRA sets. The implementation of any limits set by APRA and the monthly reporting requirements will require time particularly for smaller ADI's where resourcing is limited and/or changes to reporting from lending systems requires interaction with third party service providers. Excessive levels of regulatory reporting may place unnecessary pressure on resourcing at smaller ADIs with minimal overall benefit for the industry.

We request that minimum lead times be addressed by APRA to ensure that ADI's have appropriate time to comply with any new limits or lending standards, while managing pipeline and customer experience.

2. Increasing the focus on lending standard measures rather than lending limits

The ability for ADI's to implement changes to lending standards such as serviceability buffers is generally easier than having to apply lending limits as it is at an individual loan level and can be discussed with borrowers at the initial application phase.

Lending limits at a portfolio level can be difficult to manage, particularly for small and medium ADI's as loans may have already been approved and in the ADI's loan pipeline. The actual funding of the loan may be months later and therefore it is difficult to stop or reduce the funding without impacting the customer experience. For smaller ADI's, who fund a limited number of loans each month, breaching a lending limit can occur with as few as 2 or 3 loans and can be largely impacted by the timing of when approved borrowers are ready for funding.

Additionally, as outlined in point 1 above, changes to lending limits do not fully reflect the nuances of individual loans and may impact the ability of ADI's to fund higher quality loans. Changes to lending standards and serviceability could be implemented at the loan initiation stage with a focus on limiting borrowers who represent a genuine higher risk in line with the objectives of APS 220.

Where borrowers are prevented from obtaining funding from a particular ADI due to lending limits at a portfolio level, these borrowers will likely seek funding from an alternative ADI who has capacity in their lending limits (generally a larger ADI). Rather than reducing lending to customers who represent a higher risk to the financial system, the focus shifts to which ADI has capacity in their lending limits to provide the funding.

We would like APRA to increase their focus on lending standard measures rather than lending limits in their macroeconomic policy.

3. Proportionate application of the proposed measures

APRA has acknowledged that proportionate regulation in CPS 511 Remuneration with certain expectations only applies to significant financial institutions (SFI's). We believe APRA should consider appropriate proportionality to this new attachment if they apply any portfolio level lending limits. Lending limits at a portfolio level disproportionately impact the growth of small and medium ADI's. We note that having lending limits in place for these ADI's does not provide any benefit to the overall financial stability of the Australian banking industry, more specifically, Mutual ADI's only represent 2.8% of total Australian ADI assets.

Not applying proper proportionality provides a competitive advantage to larger ADI's against smaller entities as lending limits based on a percentage often create restrictions that impact the ability for these smaller ADI's to service their existing customer base without any additional growth.

For example, a restriction on growth in LVR lending above 80% to 10% per month, may restrict a smaller ADI to a very small number of new loans per month. This may not be enough to service an ADI's existing members (i.e. deposit holders who are entering the housing market for the first time) and therefore these customers may move to alternative banking providers, reducing competition.

We also need to take into consideration the considerably different business models across the industry. For example, smaller ADI's generally have lower risk appetites for higher risk lending than larger ADIs and therefore their loan portfolios are generally weighted towards lower LVR and owner occupied lending. Where lending occurs at higher LVRs or DTI levels they are generally more heavily scrutinised and are based on a very thorough review and approval process. Smaller ADI's also have strong customer relationships that are leveraged to make appropriate lending decisions.

4. Limitations on public disclosure

The proposed attachment states that APRA may require ADIs to publicly disclose the level of lending against any limits specified by APRA for the period in which they apply.

Public disclosure may confuse the general public and customers of the impacted ADI's. This could negatively impact competition within the banking industry if customers use this information to make decisions about which ADI to approach for their financial services needs. This is particularly critical for small and medium ADIs who have smaller customer bases and don't have a strong industry presence. Public disclosure could impact their ability to attract and/or retain customers.

We request APRA to remove or clarify this requirement from the attachment.

Conclusion
In summary, we believe that by focussing on these four areas, the application of APRA's proposed attachment to APS 220 will be clearer and achieve a fairer more proportionate outcome whilst maintaining APRA's objectives of promoting financial stability.

Yours sincerely
Grant Thornton Australia Limited

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