27 September 2024

Senator Andrew Bragg | Chair
Senate Economics References Committee
Parliament House
Canberra ACT 2600

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Dear Chair

Inquiry into Financial regulatory framework and home ownership

APRA welcomes the opportunity to assist the Senate Inquiry into Financial regulatory framework and home ownership. APRA's submission seeks to provide contextual material to the Inquiry, by explaining APRA's role in promoting financial safety and stability, and APRA's key requirements of authorised deposit-taking institutions (ADIs) in managing prudential risks in housing lending.

As Australia's prudential regulator, APRA plays a key role in promoting a strong and stable banking system, a critical enabler of sustainable economic growth and higher standards of living for Australians. APRA's prudential requirements for housing lending aim to ensure that banks are making sound credit decisions, both individually and in aggregate. These requirements are calibrated to promote resilience and support credit availability, particularly in times of stress. For example, many of APRA's actions to promote financial stability during the pandemic were specifically aimed at providing banks with additional flexibility to support the flow of credit to the economy at a time when it was needed most.

APRA understands that the Inquiry will examine how Australia's financial regulation can influence home ownership. To assist the Inquiry, APRA's submission sets out as context:

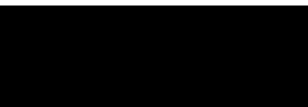
- **APRA's mandate**: APRA's mandate in supervising ADIs is to protect the interests of depositors and to promote financial stability. This objective is critical to the Australian community's long-term financial well-being – a safe and stable financial system enables households and businesses to confidently borrow, save and invest for the future. Financial failures and instability can result in significant social and economic harm.

- **APRA's prudential requirements**: APRA's focus on housing lending stems primarily from the high concentration of residential mortgages on the balance sheet of the banking system, one of the highest globally. A build-up of risks in this portfolio can present material risks to the financial system. It is critical for financial safety and stability that housing lending practices remain prudent through the cycle, and that capital requirements for housing loans are commensurate with their risk.

- **Current trends in housing lending**: APRA closely monitors housing lending conditions in conjunction with other financial regulatory agencies. Over the past year, housing credit grew by almost 5 per cent, slightly stronger than in the year prior; new lending to first home buyers remains in line with its long-run average share.

Appendix A explains these areas in more detail, providing context relevant to the Inquiry.

Yours sincerely



Therese McCarthy Hockey
Executive Board Member

Appendix A: Overview of APRA's housing lending requirements

APRA's mandate

APRA is an independent statutory authority established for the purposes of prudential supervision of financial institutions and promoting financial system stability in Australia. APRA's mandate is to protect the Australian community by establishing and enforcing prudential standards and practices.

The aim of prudential regulation is to ensure that, under all reasonable circumstances, financial promises made by the institutions APRA supervises are met within a stable, efficient and competitive financial system. As the prudential regulator of ADIs, APRA seeks to assure depositors that their deposits are safe and the Australian community that the financial system is stable.

Financial regulatory context

Australia's current financial regulatory framework, and APRA's mandate, has its origins in the 1997 Wallis Inquiry into the financial system.[1] The Wallis Inquiry established Australia's 'twin peaks' regulatory model, under which:

- The Australian Securities and Investments Commission (ASIC) would be responsible for market-conduct and consumer-protection for financial services; and
- APRA would be responsible for the prudential supervision of financial institutions and for promoting the stability of the Australian financial system.

The maintenance of sound housing lending standards is important to both regulators. As the financial safety regulator, APRA's focus is the risk that poor lending practices could undermine an ADI's financial soundness and financial system stability. ASIC's focus is on market conduct and consumer protection, aiming to address any poor lending practices, by either ADIs or non-ADI lenders.

For housing lending, APRA's key requirements are set out below. ASIC's key expectations for lenders are set out in responsible lending obligations, under the *National Consumer Credit Protection Act 2009*. ASIC also administers specific design and distribution obligations, which require ASIC-regulated entities to design financial products that meet the needs of consumers in their intended target market.

APRA's focus on housing

As a prudential regulator, APRA's focus on housing lending reflects the concentrated exposure of the banking sector to residential mortgages. These loans make up over 60 per cent of ADIs' loan portfolios – a high percentage by both historical and international standards. APRA therefore has a keen interest in ensuring the quality of ADIs' mortgage portfolios remains sound – it is critical to the ongoing financial health and stability of the financial system.

In assessing potential risks to individual banks' financial soundness and to financial system stability from housing lending, APRA focuses on:

- **Housing lending standards**: prudent lending standards aim to ensure that borrowers have reasonable income and equity buffers to mitigate the impact of future shocks, such as from higher unemployment or falling housing prices. While rising interest rates have created stress for some borrowers in recent years, banks' lending standards have cushioned against widespread defaults to date. As at June 2024, around 1 per cent of banks' housing loans were non-performing, similar to levels immediately prior to the pandemic, and well below arrears rates experienced in the United States during the Global Financial Crisis (4.5 per cent). With continued uncertainty in the economic outlook, it is important that lending practices remain prudent – weaker standards would amplify the impact of any future shocks, for borrowers and the economy.
- **Household leverage and credit growth**: A highly indebted household sector can create vulnerabilities for the economy and financial system, since highly indebted borrowers are likely to

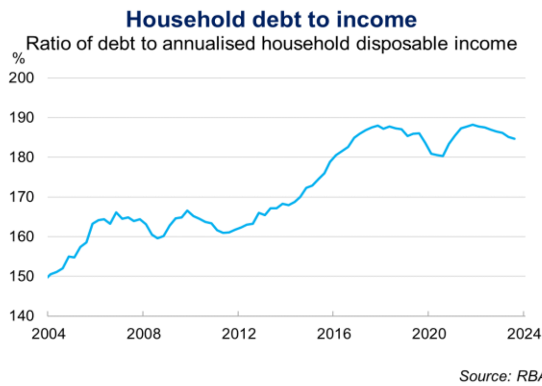
[1] Commonwealth of Australia, Financial System Inquiry Final Report (Wallis Inquiry) (March 1997) https://treasury.gov.au/publication/p1996-fsi-fr

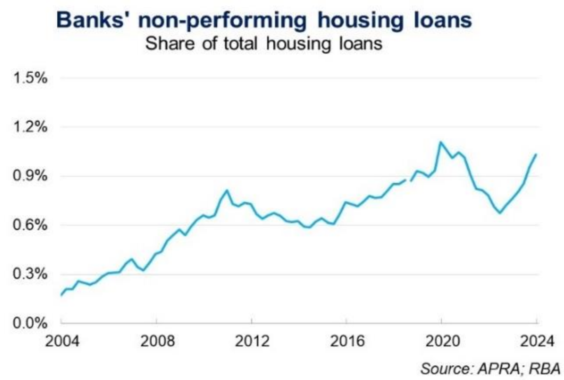
be less resilient to future shocks.[2] Australian household debt has risen significantly over the past 10 years, to be almost 2 times aggregate household income – a share that is also high by international standards. Over the past year, growth in lending for housing increased slightly, from 4.4 per cent to 4.9 per cent. The share of new lending to first home buyers is currently in line with the long-run average.

In consultation with the Council of Financial Regulators (CFR), APRA also monitors broader housing market trends.[3] House prices have continued to grow strongly, with population growth materially outpacing the housing stock in recent years. Australian house prices have risen by 7 per cent per cent over the past year, and by more than 40 per cent per cent since the start of the pandemic. In aggregate, Australian house prices are now more than 5.5 times the average household income, based on RBA data. Against this backdrop, it is estimated to take almost 12 years, on average, for first home buyers to accumulate a deposit to enter the housing market.[4] Some banks have reported that lower income borrowers are increasingly under-represented in new lending.

APRA also regularly monitors the impact of ADIs' lending practices for access to credit.[5] One area of focus is trends in non-bank lending. A potential indicator of overly restrictive prudential regulatory settings could be a migration of housing lending to non-bank lenders, which are not subject to APRA's rules. However, non-bank lenders continue to account for a small share of housing lending in Australia, at less than 5 per cent.

[2] International studies suggest highly indebted households are more likely to reduce their consumption in the event of a shock, amplifying the impacts of any economic downturn.
[3] ADIs are the main providers of housing finance in Australia, accounting for more than 95 per cent of total lending for housing.
[4] Measure from the ANZ CoreLogic 2024 Housing Affordability Report (September 2024). The measure calculates how many years it would take a household to save a 20 per cent deposit, based on median household income data.
[5] CFR: Australian Securities and Investments Commission (ASIC); APRA; Reserve Bank of Australia (RBA); and Treasury.





APRA's prudential requirements

The *Banking Act 1959* sets out APRA's powers to establish and enforce prudential standards for ADIs. To meet its mandate, APRA's prudential standards are designed to ensure that ADIs are well governed, prudently managed and financially sound. APRA adopts a principles-based approach to these requirements, avoiding excessive prescription where possible. This allows ADIs to meet certain prudential requirements in a manner best suited to their size, business mix and complexity.

APRA's approach to developing prudential standards is rigorous, proportionate and transparent. Proposed changes to policy are subject to public consultation, enabling external stakeholders to input on policy design. APRA seeks feedback to best balance competition and efficiency impacts, in line with its mandate. To reinforce accountability, APRA also makes public all non-confidential submissions and explains how feedback has been considered.

Prudential standards

APRA's prudential requirements are set out in prudential standards, which are legally binding regulations. Consistent with its mandate, APRA's prudential standards are focused on the key risks to an ADI's financial soundness and stability. Credit risk – the risk of borrower being unable to repay outstanding debts – is the single largest source of prudential risk for the Australian banking system.

Prudential Standard APS 220 Credit Risk Management (APS 220) sets out APRA's key requirements of ADIs in managing their credit risk. APS 220 encompasses all types of lending, including loans to households, small business and large corporates. It covers risks to ADIs over the life-cycle of a loan, requiring ADIs to have appropriate oversight and governance structures, maintain sound lending standards at the point of origination and actively monitor the risk of borrower default until the loan is repaid.

APRA's prudential standards are accompanied by prudential practice guides (PPGs). PPGs provide additional guidance to assist ADIs in meeting their prudential requirements, by setting out APRA's expectations of sound practice in particular areas. The key prudential practice guides for managing credit risk are *Prudential Practice Guide APG 220 Credit Risk Management* (APG 220) and *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223).

APRA understands that the Inquiry is interested in the application of APRA's prudential standards to first home buyer loans. There are generally two key assessments that a bank will undertake when a borrower applies for a housing loan: the first relates to the borrower's ability to repay the loan they have applied for (serviceability assessment); the second focuses on the level of savings or equity that a borrower has relative to the property valuation (commonly referred to as the loan-to-valuation ratio or LVR). APRA's key requirements relating to these assessments are summarised below.

1. Serviceability assessments for first home buyers

Under APS 220, ADIs must make a prudent assessment of a borrower's ability to repay the housing loan they have applied for. This would typically involve an assessment of whether a borrower has sufficient income to cover repayments on a new housing loan, building in buffers and taking into account existing expenses and debt commitments. APRA's serviceability requirements aim to ensure that ADIs' housing loan portfolios are resilient to future stress; this also benefits borrowers by reducing

their capacity to overextend themselves. Certain factors considered by banks in their serviceability assessments for housing loans are explained below.

The serviceability buffer

Under APS 220, ADIs must assess all new borrowers' ability to meet their housing loan repayments at an interest rate that is at least 3.0 percentage points above the loan product rate.[6] This provides an important contingency for risks over the life of the loan, by requiring borrowers to have an income buffer against shocks that may otherwise result in default. Importantly, shocks could stem from a range of sources, including from rising interest rates, a reduction in borrowers' income or an increase in their expenses.

APRA regularly reviews the setting of the serviceability buffer, as part of its formal macroprudential policy toolkit (see below). The setting of the serviceability seeks to promote resilience, taking into account credit growth and lending standards. APRA has maintained the minimum serviceability buffer at 3.0 per cent, since first setting it at this level in 2021. In the context of ongoing economic uncertainty and cost of living pressures, APRA has viewed this setting as remaining prudent.

Serviceability exceptions

APRA's prudential standards provide flexibility for ADIs to lend to borrowers that do not meet standard serviceability criteria, provided that these 'exceptions to policy' are managed prudently and limited. This approach allows banks to consider additional indicators of repayment capacity beyond those captured in the standard serviceability test, where appropriate. For example, banks could look through periods of temporarily low income, should they have confidence in borrower's future repayment capacity. For a borrower seeking to refinance, banks could also consider past repayment behaviour. Under APRA's prudential standards, exceptions to serviceability policy must be prudently monitored and reported – they currently account for less than 5 per cent of new housing lending.

Treatment of HELP

Under APS 220, there are no detailed requirements for how the Higher Education Loan Program (HELP) must be treated in ADIs' serviceability assessments. In practice, HELP repayments – like tax – are a mandatory Government deduction from a borrower's income. Banks therefore generally assume that income directed to HELP repayments cannot otherwise be used to service a housing loan. In APRA's view, this is prudent practice. Ignoring HELP repayments would increase the likelihood of borrowers experiencing future financial stress, given a distorted view of their loan repayment capacity.

ADI's serviceability assessments treat HELP repayments differently to a borrower's other existing liabilities. For credit cards or other mortgages, banks are expected to test borrowers' ability to meet higher repayments than they are currently making. HELP repayments, on the other hand, are typically taken at their face value.

Under APRA's prudential framework, banks must also report certain statistical data to APRA so that APRA can monitor trends in banks' lending at a portfolio level. One such indicator is lending at high debt-to-income ratios. The debt-to-income ratio is a prudential statistic that compares the total debt obligations of a borrower to its gross income. Under APRA's reporting requirements, banks must include HELP in the debt-to-income ratio.

2. Loan to valuation ratios for first home buyers

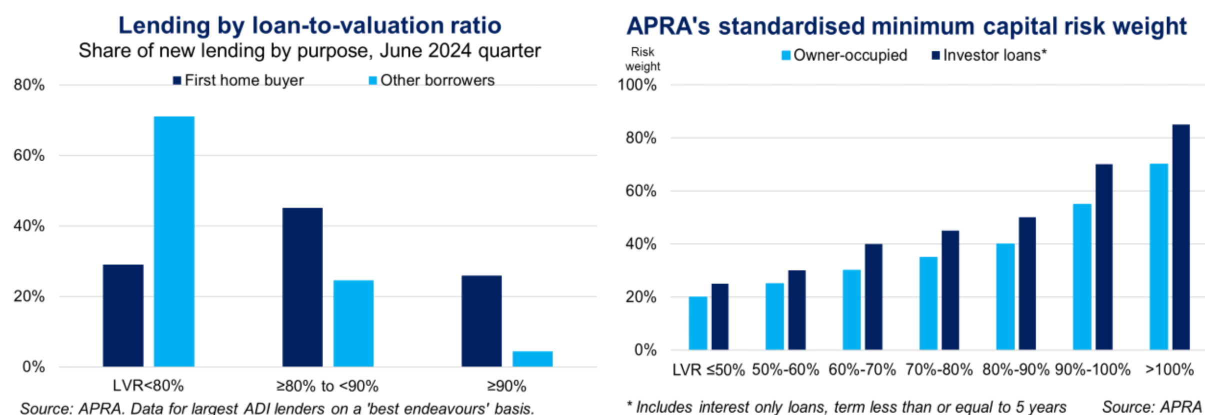
APRA has no formal limits on lending at high LVRs, meaning that high LVR lending in Australia is determined by banks' collective risk appetites. This flexibility is important, since first home buyers typically borrow a much higher share of the value of the property than other borrowers – accumulating a deposit is often the main barrier to first home buyers entering the housing market. More than two-thirds of first home buyers borrow at an LVR of 80 per cent or more, compared to just one-third of other borrowers.

Under APRA's capital framework, ADIs are required to maintain higher amounts of capital against higher risk loans, which can have an influence on risk appetite. From a prudential perspective, the aim

[6] The serviceability buffer does not impact the actual interest rate paid by the borrower when the loan is originated.

is to ensure that ADIs can withstand potential losses from their lending activities without threatening their financial soundness or financial stability. [7] Higher LVR loans are therefore subject to higher capital requirements than lower LVR loans, consistent with the approach set in international standards. These loans have historically had a higher probability of default than loans with lower LVRs; in the event of default, losses for banks are also higher, given that borrowers have smaller equity buffers.

In recent years, APRA has sought to introduce greater risk sensitivity to its standardised capital framework, differentiating between two main types of borrowers: owner-occupied housing loans (which include first home buyers) and investor housing loans. [8] For a given LVR, owner-occupied loans are now subject to lower capital requirements than for investors. Banks' interest rates on owner-occupier loans are, on average, 40 basis points lower than for investors.



APRA's standardised capital framework also calibrates minimum capital requirements for housing loans extended under the Government's Home Guarantee Scheme. This scheme aims to improve home ownership by first home buyers, and currently accounts for one-third of all new lending to the sector. APRA's capital requirements for these loans are materially lower than for those without a guarantee. For example, a first home buyer that is borrowing 95 per cent of the property value would be treated as if it were an 80 per cent LVR, for capital purposes. This recognises that the Government guarantee reduces the risk to banks' financial safety.

Macroprudential policy

Under APRA's mandate, APRA can also use macroprudential policy measures to mitigate risks to financial stability. APRA's formal macroprudential policy toolkit comprises three core tools: the countercyclical capital buffer; limits on bank lending; and the serviceability buffer (as discussed above). APRA views consultation with CFR agencies an essential prerequisite for changing macroprudential settings.

APRA has previously set temporary limits for growth in lending to investors (2015) and the proportion of new residential mortgage lending on an interest-only basis (2017). These lending limits reflected APRA's concerns over the impact for financial stability from aggressive or speculative risk taking in a period of quickly rising housing prices, falling interest rates and rising household indebtedness. First home buyers were not the target of these limits.

At the start of the pandemic, APRA used macroprudential policy to help cushion the potential risks to financial stability from an economic downturn. In a period of uncertainty, there can be a tendency by banks to curtail their lending in order to conserve capital – this can amplify the impacts of any initial shock, causing deeper economic stress. To mitigate this risk, APRA gave banks greater flexibility in meeting their capital requirements during 2020, seeking to ensure a steady supply of credit to the

[7] APRA's minimum capital requirements for credit risk are detailed in prudential standards *APS 110 Capital Adequacy, APS 112 Capital Adequacy: Standardised Approach to Credit Risk* and *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*.

[8] APRA's standardised capital requirements do not directly differentiate between first-home buyers and other owner-occupiers. This is consistent with recent studies, including by the RBA, which demonstrate that there has historically been little difference in default experience between these loans [Are First Home Buyer Loans More Risky? | Bulletin – March 2022 | RBA]

economy. APRA was able to provide this flexibility, given confidence in banks' financial strength going into that economic shock.

APRA's macroprudential policy measures can also have a strong interaction with monetary policy. APRA and RBA are currently working on measures to strengthen coordination arrangements between the two agencies, consistent with recommendations from the Independent Review of the RBA.[9] By mitigating risks to financial stability that would otherwise arise in a low interest rate environment, macroprudential policy can provide monetary policy with more 'space' to pursue its inflation and employment objectives. This is an important feature of Australia's regulatory architecture, requiring close cooperation between APRA and RBA.

[9] Commonwealth of Australia, An RBA fit for the future (Independent Review of the RBA) (March 2023) https://rbareview.gov.au/sites/rbareview.gov.au/files/2023-06/rbareview-report-at_0.pdf