

Box B

Responses to Risks in the Housing and Mortgage Markets

Recent trends in housing and mortgage markets have raised some concerns about the level of risk being taken by authorised deposit-taking institutions (ADIs) and households (see the chapters 'The Australian Financial System' and 'Household and Business Finances' for a discussion).¹ In response to these concerns, the Australian Prudential Regulation Authority (APRA) announced measures in December 2014 to reinforce sound housing lending practices. At the same time, the Australian Securities and Investments Commission (ASIC) announced that it will review whether mortgage lenders' interest-only lending complies with their responsible lending obligations. These actions were taken following discussions with member agencies of the Council of Financial Regulators (CFR), and build on the increased supervision and communication on housing market risks that CFR member agencies have been engaged in over the past year or so.

APRA's Response

The measures recently announced by APRA outline prudential expectations of ADIs' lending behaviour regarding: the extent of higher-risk mortgage lending; the pace of growth in investor housing lending; and the interest rate buffers and floors used in loan serviceability assessments. The benchmarks specified are not intended to be hard limits, but rather to serve as a trigger for more intense supervisory action, potentially including additional capital requirements.

APRA supervisors will be alert to growth in an individual ADI's investor housing loan portfolio that is materially above a benchmark of 10 per cent

per year. This benchmark was established by APRA after consultation with other members of the CFR, and takes into account a range of factors including household income growth and recent market trends. The benchmark is specified in terms of an ADI's national lending to investors; although recent investor activity has been concentrated in Sydney and Melbourne, data on investor loan exposures are difficult to monitor on a state level. The benchmark is intended to be temporary and hence should not entrench a structural change in the competitive environment.

As part of its regulatory response, APRA has also specified that ADIs' loan serviceability assessments should include an interest rate buffer of at least 2 percentage points above the standard variable rate (less any discount that is applied for the whole term of the loan), with a floor assessment rate of at least 7 per cent. APRA noted that good practice would be to maintain a buffer and floor rate comfortably above these levels, rather than operate at the minimum expectation.

The use of interest rate buffers and floors in serviceability assessments provides some allowance for borrowers to accommodate future increases in interest rates (or declines in their servicing capacity). One implication is that when lending rates are low, such that the interest rate floor is higher than the lending rate plus the buffer, a borrower will not be able to take out a larger loan just because lending rates have fallen. The recommended buffer and floor rates are based on a number of considerations, including the size of past increases in lending rates in Australia and other jurisdictions, international benchmarks for serviceability buffers and long-run average lending rates in Australia. Supervisors will also

¹ ADIs include banks, credit unions and building societies.

be monitoring other elements of ADIs' serviceability assessments such as allowable income, minimum living expenses, and other debt commitments to ensure these are not relaxed and that prudent loan serviceability standards are maintained.

APRA also stated that in the current environment it would consider enhanced supervisory action when ADIs undertake large volumes of lending in risky categories, or increase higher-risk lending as a proportion of total new lending. Higher-risk loans include those with high loan-to-valuation ratios, loans with high debt-servicing levels, loans to owner-occupiers with lengthy interest-only periods and loans with very long terms.

Supervisory action

When an ADI does not adhere to APRA's prudential expectations as outlined above, this will lead to a graduated increase in the level of supervisory intensity (e.g. increased reporting obligations and additional on-site reviews) and the consideration of additional capital requirements. APRA will use its discretion as to the appropriate size of its response based on a number of factors, including the behaviour of each ADI and their share of the mortgage lending market. ADIs that meet APRA's expectations will continue to be closely monitored but will be otherwise unaffected.

Any additional capital requirements would be implemented through changes to individual ADIs' 'Pillar 2' capital adjustments. Pillar 2 supervisory adjustments are a feature of the international Basel III capital framework that take into account institution-specific risks not adequately captured by 'Pillar 1' minimum capital requirements, and form part of an ADI's binding capital requirement. Pillar 2 adjustments can vary for an individual ADI through time and have been used by APRA for some years, although they are not disclosed publicly. The advantages of using Pillar 2 capital adjustments in these circumstances are that they are sufficiently

flexible to target areas of prudential concern, and allow for a proportionate, incentive-based response.

APRA's approach differs from some international precedents on housing market regulatory intervention, which have tended to rely more on hard limits to certain lending behaviours rather than a supervisory guidance and capital approach. This difference arises, among other reasons, because APRA considers that at this stage a supervisory approach backed by the capital flexibility built into its current rules balances prudence and efficiency better than setting hard quantitative limits or prohibiting certain lending behaviours outright.

ASIC's Review of Interest-only Housing Lending

As part of the coordinated response to housing and mortgage market risks by CFR member agencies, ASIC announced a review of interest-only housing lending in December 2014. The review will investigate whether lenders are complying with their responsible lending obligations set out in the *National Consumer Credit Protection Act 2009*. Lenders are required by law to assess loan serviceability such that new borrowers do not overstretch themselves to purchase property or rely on expectations of future increases in housing prices to enable them to do so. The heightened scrutiny by ASIC should help to prevent borrowers from obtaining loans that they are unlikely to be able to repay without experiencing undue hardship. ASIC is working closely with APRA, as well as other members of the CFR, on this review.

Monitoring and Evaluation

APRA is currently in the process of reviewing ADIs' housing lending practices and ASIC's review of interest-only lending is also underway. While many ADIs already operate broadly in line with APRA's and ASIC's expectations, current lending practices of some ADIs are likely to attract the attention of the regulators. These measures and subsequent

behavioural adjustments should help to ensure that prudent lending standards are maintained across the system, which is particularly important in the current environment of low interest rates, strong competition among lenders and rapid housing price growth in some locations.

The overall effectiveness of these actions will be subject to ongoing monitoring, and regulators will consider whether additional steps are needed depending upon the evolution of risks in the housing and mortgage markets in the period ahead. ❖

