# PRODUCTIVITY COMMISSION INQUIRY ON FIRST HOME OWNERSHIP

## Submission by the Australian Prudential Regulation Authority (APRA)

### *Purpose*

The purpose of this submission is to briefly explain APRA's prudential framework governing the provision of housing loans by authorised deposit-taking institutions (ADIs).

### *Background*

APRA was established on 1 July 1998 as an integrated prudential regulator of ADIs (banks, credit unions and building societies), insurance companies, superannuation funds and friendly societies. APRA-regulated entities account for around 85 per cent of the assets in the Australian financial system.

APRA's mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by financial institutions it supervises are met within a stable, efficient and competitive financial system. In carrying out its functions, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.

### *Prudential framework*

APRA's approach to the prudential supervision of ADIs is predicated on the principle that the prime responsibility for the prudent management of an ADI rests with the ADI's Board and senior management. It is the responsibility of the Board and senior management to assess the risks in the lending activities undertaken by the ADI and to continually monitor and control those risks. APRA has a range of prudential standards to ensure that ADIs are adequately capitalised and have appropriate risk management systems in place.

The Australian Prudential Standards (APS) that relate to residential mortgage lending are:

- APS 112 Capital Adequacy : Credit Risk[1] ;
- APS 220 Credit Quality; and
- APS 120 Funds Management and Securitisation.

### *Capital adequacy*

As the prudential regulator, APRA's focus is to ensure that ADIs have appropriate credit risk management systems in place to manage their lending exposures, including exposures arising from residential property lending. APRA does not directly regulate the extent of an ADI's residential property lending. However, APRA's prudential

[1] Guidance note AGN 112.1 Attachment C (Eligible Residential Mortgages) is particularly relevant to this discussion.

requirements may have an indirect impact in certain circumstances. For example, where an ADI is judged to be assuming excessive risk through poor lending practices, APRA may increase the capital adequacy requirements for the institution and this may impact on the price and/or supply of lending.

APRA's prudential standards require ADIs to maintain a minimum ratio of total capital to risk-weighted assets (on both a consolidated group and stand-alone basis) of 8 per cent, to ensure that ADIs have a sufficient buffer of capital to meet unexpected losses.

In the normal course, loans to individuals (and commercial loans) have a risk-weight of 100 per cent. However, reflecting the low loss rates on residential property lending in Australia, loans that are fully secured by a registered mortgage over a residential property are assigned a concessional risk weight of 50 per cent, provided they satisfy lending criteria outlined in the prudential standards and associated guidance notes. This is equivalent to a 4 per cent minimum capital requirement. The concession is available:

- for loans which have a loan-to-valuation ratio of 80 per cent or less at origination; and

- for loans which have a loan-to-valuation ratio above 80 per cent at origination but which are fully insured through a mortgage insurer which is at least A-rated.

Under proposed international reforms to capital adequacy requirements (known as the New Capital Accord or Basel II), prudential supervisors will have discretion to reduce the risk weight on housing lending to 35 per cent (for ADIs adopting the so-called "standardised" approach). APRA will shortly be announcing whether it will be exercising this discretion. Any new risk weights would not come into effect until 1 January 2007.

The concessional 50 per cent risk weight for loans secured by residential property allows ADIs to support a given pool of residential loans with half the level of capital required for other loans. As a result, the lower risk weight decreases the underlying cost of providing housing loans and increases their availability. The majority of on-balance sheet assets for APRA-regulated ADIs are residential property loans.

***Securitisation of housing loans***

Securitisation allows ADIs (and other property lenders) to package residential mortgages into special purpose trusts which are financed through bonds that are sold to investors in Australia and overseas. Securitisation represents a cost-effective funding mechanism that allows a financial institution to restructure its balance sheet for more lending.

APRA's prudential framework requires ADIs to hold adequate capital against any exposures arising from securitisation. In some cases, that exposure takes the form of a "first loss protection" piece of the pool that is retained by the ADI.[2] ADIs must also

---

[2] "First loss protection" is where the seller (in this case the ADI) agrees to bear a pre-determined proportion of the losses estimated to occur in the pool of receivables over the term of the transaction. For prime residential housing mortgages, the first loss protection piece is usually not more than 5 per cent of the pool.

have systems in place to identify, monitor and control the risks associated with securitisation, and must make clear disclosures to investors that there is no recourse to the institution originating the loan. Where an ADI has no exposures to a pool of housing loans which it has securitised, no capital needs to be held against that pool.

The securitisation of residential mortgages has grown rapidly in Australia over the past decade. Securitisation has allowed ADIs to fund housing loans at a lower cost and, in turn, provide housing loans at lower interest rates, obtain capital relief and balance sheet benefits and grow their lending book. Similarly, securitisation has given unregulated financial institutions direct access to capital markets to obtain funding for their residential mortgage book. These developments have considerably strengthened competition in the provision of housing loans.

***Residential mortgage products***

With deregulation of the financial sector and greater competition, a myriad of new residential mortgage products have become available to borrowers over the past few years. ADIs continually develop new products to remain competitive, and this pressure has increased with the emergence of third-party originators who are able to select the most competitive lender on behalf of a borrower.

For some ADIs, lending criteria have become less restrictive in the current housing cycle. Some ADIs offer loans up to 95 per cent of the property value, and a few will lend to 110 per cent (the additional loan principal is intended to finance borrowers' legal costs and stamp duty).

Products such as low documentation ("low doc") and no documentation ("no doc") loans have gained popularity in catering for self-employed and other customers who are unable or unwilling to fulfil the income verification procedures required under conventional lending practices. In these instances, borrowers are only required to self-declare their income levels and/or their debt servicing ability. The lender, in turn, dispenses with its normal verification procedures.

A growing niche lending segment is the "sub-prime" or "non-conforming" mortgage market, where institutions lend to borrowers with poor or non-existent credit histories. The growth in this market has enabled borrowers who have previously faced very limited opportunities for buying a home to access housing credit. This type of lending is currently provided by non-regulated mortgage originators. As far as APRA is aware, no APRA-regulated financial institutions undertake sub-prime lending.

It is the responsibility of the Board and senior management of an ADI to ensure that the institution has in place risk measurement, monitoring and control capabilities that are commensurate with the risk inherent in any new products offered, and that it maintains sufficient capital to support the exposures that may arise from such lending.

For its part, APRA would intensify its prudential supervision of an ADI whose lending practices, including new lending initiatives, were judged to be unsound. Where appropriate, APRA would lift minimum capital requirements to ensure that depositors are protected from the associated risks. APRA is currently reviewing the criteria which housing loans need to meet to be eligible for the concessional 50 per cent risk weight.

***Conclusion***

The deregulation of the Australian financial system and the associated increase in competition among lenders has played a major role in increasing the availability of credit to households. Favourable economic conditions, low inflation and sustained low interest rates have reduced the cost of credit, allowing more households to obtain finance and to borrow much more than in the past. The capacity of households to service this debt depends, of course, on their ability to generate sufficient cash flow to meet their principal and interest obligations.

APRA's prudential framework, supported by existing prudential standards, aims to ensure that ADIs adopt prudent practices to manage the risks arising out of their lending activities and hold sufficient capital against these risks. In APRA's view, the current prudential framework underpins a robust and well managed ADI sector in Australia, in the interests of depositors, while allowing vigorous competition in housing lending.

Australian Prudential Regulation Authority

17 October 2003

`