



31 March 2017

TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

FURTHER MEASURES TO REINFORCE SOUND RESIDENTIAL MORTGAGE LENDING PRACTICES

APRA, in conjunction with the other members of the Council of Financial Regulators (CFR), has been closely monitoring trends in residential mortgage lending and the resulting impacts on the resilience of lenders, as well as on the household sector more broadly. This increased scrutiny of housing lending has been in response to an environment of heightened risks, which necessitates that lending standards across the authorised deposit-taking institution (ADI) sector remain prudent and are adjusted, as needed, to changing conditions.

In December 2014, APRA wrote to all ADIs outlining a range of measures to reinforce sound residential mortgage lending practices.¹ A number of these measures - such as minimum interest rate buffers within borrower serviceability assessments - have subsequently been incorporated within *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223). APRA has also maintained an ongoing focus on the strengthening of mortgage lending and risk management practices more broadly. At the same time, the Australian Securities and Investments Commission (ASIC) has acted to address responsible lending and other market conduct concerns.² Collectively, these actions have served to improve the quality of new mortgage lending generally, and moderated the growth of investor lending in particular.

Notwithstanding these positive developments, the environment of heightened risk that has prevailed for the past few years has not lessened: the environment remains one of high housing prices, high and rising household indebtedness, subdued household income growth, historically low interest rates and strong competitive pressures. APRA has therefore concluded that further steps to address risks that continue to build within the mortgage lending market are appropriate.

As detailed in this letter, APRA expects ADIs to:

- limit the flow of new interest-only lending to 30 per cent of new residential mortgage lending, and within that:
 - place strict internal limits on the volume of interest-only lending at loan-to-valuation ratios (LVRs) above 80 per cent; and
 - ensure there is strong scrutiny and justification of any instances of interest-only lending at an LVR above 90 per cent;

¹ APRA letter to all ADIs, 'Reinforcing sound residential mortgage lending practices', 9 December 2014.

² See ASIC Report 445, *Review of interest-only home loans*, 20 August 2015.

- manage lending to investors in such a manner so as to comfortably remain below the previously advised benchmark of 10 per cent growth;
- review and ensure that serviceability metrics, including interest rate and net income buffers, are set at appropriate levels for current conditions; and
- continue to restrain lending growth in higher risk segments of the portfolio (e.g. high loan-to-income loans, high LVR loans and loans for very long terms).

APRA expects all ADIs to immediately take steps to address the issues set out below. This letter updates and replaces the guidance and expectations established in the December 2014 letter, and should be read in conjunction with the broader expectations for sound residential mortgage lending set out in APG 223.

Measures to reinforce sound lending practices

Interest-only lending

Lending on interest-only terms represents nearly 40 per cent of the stock of residential mortgage lending by ADIs - a share that is quite high by international and historical standards. While there are a range of reasons why an individual borrower might seek interest-only terms, at an aggregate level this creates additional vulnerabilities to 'payment shock' (the increase in payments when loans revert from interest-only to amortising), interest rate increases or house price falls.

Against this background, APRA views a higher proportion of interest-only lending in the current environment to be indicative of a higher risk profile. APRA supervisors will therefore be monitoring the share of interest-only lending within total new mortgage lending for each ADI, and will likely impose additional requirements on an ADI if the proportion of new lending on interest-only terms exceeds 30 per cent of total new mortgage lending, over the course of each quarterly period. For ADIs currently above this benchmark, APRA will be discussing their plans to bring the share of interest-only lending down as quickly as possible. ADIs with levels of interest-only lending below this benchmark are expected to remain below it and not increase the share of new interest-only loans materially from current levels.

In addition to this general benchmark, interest-only loans at higher LVR levels pose particular risks for lenders and borrowers alike. APRA therefore expects ADIs lending on an interest-only basis at or above 80 per cent LVR to implement strict and closely monitored internal risk limits. Further, interest-only lending above an LVR of 90 per cent should be limited and warrant particular justification; ADIs should consider, for example, adopting additional oversight of any such approvals. Over the coming months, APRA will engage with ADIs to determine the most practical means of implementing the expectations for high LVR interest-only loans, including through additional quantitative benchmarks if appropriate.

Investor lending

In December 2014, APRA indicated that growth in an ADI's portfolio of investor lending above a benchmark of 10 per cent would be viewed as a cause for supervisory action, including the consideration of increased capital requirements. At an industry-wide level, investor lending growth has remained below 10 per cent since October 2015 but has, in more recent times, begun to accelerate again.

APRA has concluded that the 10 per cent growth benchmark continues to provide an appropriate constraint in the current environment, balancing the need to continue to moderate new investor lending with the increasing supply of newly completed construction which must be absorbed in the year ahead. As a result, APRA has chosen not to revise the 10 per cent benchmark at this time. However, an ADI operating in excess of this level will prompt an immediate review of the adequacy of the ADI's capital requirements. APRA expects ADIs to target a level of investor lending growth that allows them to comfortably manage normal monthly volatility in lending flows without exceeding this benchmark level.³

Serviceability assessments

APRA considers that it is important that borrowers retain an adequate financial buffer to allow for unexpected events, especially for borrowers that have high levels of indebtedness. It would be prudent for ADIs to ensure that a borrower retains a reasonable income buffer above expenses to account for both variability in income or expenses and the possibility of higher interest rates.

Over the last two years, many ADIs have made improvements in their methodology for assessing a borrower's ability to service a loan. At this point in time, APRA does not intend to set out minimum quantitative expectations for net income buffers. However, APRA will be monitoring closely the trend in lending to borrowers with a relatively small monthly net income surplus (e.g. less than \$200 per month). A number of ADIs are already working to strengthen their assessments of borrower serviceability, and APRA intends to do further work with the ADI industry in the coming months to investigate strategies to build prudent net income buffers into serviceability assessment methodologies.

The minimum expected interest rate buffer - the higher of either at least 2 per cent above the loan product rate and a minimum assessment interest rate of at least 7 per cent - have been incorporated into the recently updated APG 223. These buffer rates are now reflected in practices across the industry. However, APRA views these interest rate serviceability buffers as minimum expectations - ADIs should not adopt them simply as default settings, but periodically consider whether they should be increased or otherwise adjusted to reflect the lending environment.

APRA will continue to monitor other elements of ADIs' serviceability assessments, and expects all ADIs to maintain prudent policies without loosening key parameters. ADIs should continue to notify their APRA supervisor in advance of any changes to their serviceability methodologies or policies.

Warehouse facilities

A number of ADIs provide warehouse facilities to other lenders, allowing them to build a portfolio of loans that will eventually be securitised. APRA has been monitoring the growth in warehouse facilities provided by ADIs. APRA would be concerned if these were growing at a materially faster rate than an ADI's own housing loan portfolio. APRA would also expect ADIs funding such warehouses to ensure that the lenders' mortgage lending standards are consistent with industry-wide sound practices.

³ The 10 per cent benchmark is calculated on a rolling 12-month basis each month, and includes lending to non-residents and self-managed superannuation funds for both loans on-balance sheet and loans that have been securitised. Where necessary, the growth rate is adjusted for portfolio sales/acquisitions, and borrowers that switch between owner-occupied and investor status.

Risk profile

In addition to the specific issues noted above, APRA continues to monitor the prevalence of higher-risk mortgage lending more generally. This includes lending at high loan-to-income ratios, lending at high LVRs, and lending at very long terms or with long interest-only periods (e.g. beyond five years). As previously advised, where an ADI is undertaking a large volume of lending in these categories, or increasing this higher risk lending as a proportion of new lending, this will be a trigger for the consideration of supervisory action.

Next steps

ADIs should consider the issues outlined in this letter and be prepared to discuss any resulting actions with their APRA supervisor.

Yours sincerely,



Wayne Byres
Chairman