Australian Banking Association

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ADI Policy
Australian Prudential Regulation Authority
By email: ADIpolicy@apra.gov.au

To whom it may concern

Macroprudential Policy: Consultation

The Australian Banking Association (**ABA**) welcomes the release, on 11 November 2021, of the information paper setting out the Australian Prudential Regulation Authority's (**APRA**) macroprudential policy framework, the associated proposed new attachment to Prudential Standard APS 220 Credit Risk Management (**APS 220**) and change to Reporting Standard ARS 223 Residential Mortgage Lending (**ARS 223**).

Our Position

Increasing the macroprudential policy options available to APRA and transparency regarding when and how they may be used, should assist with enhancing the financial stability and resilience of the Australian economy. The ABA is supportive of these measures which offer a useful complement to the resilience provided by Australia's well capitalised and well managed banks.

In developing and implementing market interventions, such as macroprudential policies, it is vitally important that unintended consequences, regulatory burden and competition distortions are minimised. As such, and considering the system wide consequences of macroprudential interventions, the ABA strongly recommends APRA incorporates and imbeds processes to ensure early and close engagement with the banking industry before any macroprudential policies are implemented.

Additional recommendations and points for clarification are included in the attachments.

The ABA looks forward to continued engagement on these important reforms. If you have any queries, please contact me at

Yours sincerely,

Brendon Harper

Policy Director
Australian Banking Association

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

Attachment A: Policy design and implementation

Close and early engagement with the banking industry is vital to enhance the effectiveness of market intervention via macroprudential policy tools. Additionally, it is critical that the goal of financial system stability is adequately balanced against efficiency, competition, contestability and competitive neutrality. In times of heightened financial system risk, these can seem second order considerations. However, if they are not adequately considered, unintended consequences can be irreversibly induced, such as altering competitive dynamics, inefficiently distorting the allocation of funding in the economy and pushing financial activities into unregulated or less regulated sectors.

To reduce the likelihood of these unintended consequences, the ABA strongly recommends APRA incorporates and imbeds processes to ensure early and close engagement with the banking industry before any macroprudential policies are implemented. Where appropriate, this early engagement could include APRA publicly indicating its increased focus in a particular area as a method to induce a change in customer behaviour before any formal limits are induced.

Avoiding inefficiencies and unintended consequences

In designing macroprudential policies, APRA should actively consider and take into account the impacts on authorised deposit-taking institutions (**ADIs**) versus non-ADIs, including 'bank like' providers, as well as the impacts between various cohorts of ADIs. This consideration should include the types of policies implemented, definitions used and timing of implementation.

The timing of intervention is also vitally important to aid industry participants implement the policy changes in a manner supportive of the policy intent without causing undue disruption or generating unnecessary operational risk, hardship or value destruction. The timing and pace of implementation should consider not only (macro)economic factors but also the various other government and government agency led initiatives being implemented across the finance industry.

Policies implemented in a rushed manner can cause various inefficiencies. For example, in the context of macroprudential intervention, they can cause customer hardship and value destruction where insufficient consideration is given to an ADI's existing pipeline and how this is to be managed – where appropriate, the ABA recommends APRA consider excluding applications received prior to the implementation date of any proposed change. Practically, a customer may rely on an approved borrowing application (which may or may not have been committed) when making a contractual commitment, to enter a business relationship or purchase a property for example. APRA should avoid the rapid implementation of macroprudential policy changes, to reduce the likelihood of causing avoidable hardship and value destruction. At its extreme, rapidly implemented and unforeseen changes to lending practices may undermine the public's confidence to borrow (in the future).

Rapidly implemented policy and systems changes can also result in avoidable resource wastage within ADIs, such as from stopping alternative projects and quickly redirecting resources, therefore increasing operational and reputational risks. This is particularly the case where policies are being implemented for the first time.

Industry understands the benefits to APRA and the wider economy of building greater flexibility into the macroprudential framework. However, greater flexibility and reduced clarity, comes at the expense of reducing industry's ability to prepare for any intervention. If APRA intends to prioritise flexibility, commensurate allowance must be given to industry to reduce the likelihood of the avoidable inefficiencies and unintended consequences.

The ABA recommends the banking industry be engaged as early as possible in the development of macroprudential policies. In circumstances where banks have not previously been provided with detail of the proposed intervention, at least 6 months' notice may be required to implement the required systems changes.

Additional design and implementation considerations

Definitions

While industry is generally comfortable with the overarching definitions proposed in the new Attachment C of APS 220, some definitions/measures are not sufficiently specific to ensure there is alignment between ADIs (or consistency with non-ADIs) on how they are implemented. This particularly applies to calculation of serviceability and debt-to-income (**DTI**).

Similarly, some of the referenced definitions are open to different interpretations. Such as the definition of DTI in ARS 223, where the treatment of HECS/HELP and VET Student Loans is unclear. Where possible, definitions should be aligned with current APRA/industry practices, such as linking the definition of investor definition to that used in ARS 223.

There also remains inconsistency between definitions, such as acquisition, development and construction (**ADC**) contained in APS 112, the indicative mapping of asset classes (including ADC) in the draft APG 113, and the draft Attachment C to APS 220. Specifically, there appears to be inconsistency as to whether ADC is purely a collateral attribute, or can be considered as a sub-set of Commercial Property/Income Producing Real Estate exposures where the collateral is land for development or assets under construction. In this instance, it is industry's preference that APRA align the guidance across APS 112, APG 113 and APS 220, with ADC recognised as a subset of Income Producing Real Estate (for non-retail exposures).

The ABA recommends further engagement with industry regarding the new and referenced definitions before the finalisation of the new Attachment.

Flow Limits

A lack of clarity in how the flow limits would be introduced for residential mortgages and commercial property lending could hamper industry's ability to implement policy changes quickly, particularly if they are required to be introduced differently to current controls/reporting. For example, there is uncertainty regarding per cent of new flow versus per cent of total portfolio, time periods that any limit applies to – monthly/quarterly/rolling quarterly – and the application of limits or drawn balance (particularly for construction).

Additionally, harsh limits applied abruptly, such as to DTI >=4x <6x which accounted for over 40 per cent of new lending in the December quarter 2021, could have a material impact on borrowers' ability to access credit with significant adverse flow on effects to household and/or investor sentiment and asset prices, causing additional macroeconomic concerns.

Furthermore, limiting DTI flows may be challenging for some ADIs as the measure is typically calculated during the application process rather than known upfront like other loan types. As noted above, individual borrowers may be negatively impacted if a bank must decline credit due to DTI being determined late in application process and a borrower has limited time to look at alternatives.

For larger and well-established commercial property customers, it is typical to have pipelines of projects so that at any point in time they may have several developments at different stages. The pipeline is fundamental to their cashflows and hence viability, so a sudden and prolonged restriction on access to finance may trigger actual financial losses and potential customer failure. This would crystallise the potentially excessive risk that the restrictions are trying to manage.

Again, flexibility and a pragmatic implementation timeframe would likely reduce the risk of these negative outcomes.

In considering the adoption of flow limits versus buffers or floors, consideration should be given to minimise, where possible, distortionary effects on competition, for example on smaller ADIs were flow percentages can be more volatile due to lower volumes.

Disclosure

Disclosure of individual ADI lending levels against macroprudential limits could have competition (and pricing) implications. Any form of public disclosure should be structured to be as consistent as possible

across all market participants. As such, public disclosure should relate to those areas of consistent definitions and applicability, rather than requiring an ADI to also provide clarifying statements and corrections.

Further information is required, for example, on APRA's intentions regarding:

- The frequency of the public disclosure;
- The format (for example, would it be in Pillar 3 disclosures?); and
- If APRA would require its own reporting (for example, a new ARF), as this is not mentioned?

The ABA recommends disclosure of lending against any limits should be provided (by APRA) on an industry basis.

Verification of gross income

It is unclear to industry if APRA is expecting banks to only use verified gross income or to verify all gross income. Clarification of APRA's intent would be appreciated.

Industry assumes APRA's intent is the former. The ABA notes that, where borrowers can pass a serviceability assessment without providing all sources of income, this means that the resultant ratios may appear higher than they actually are.

Requiring the verification all gross income would be a material change to current industry practice. Typical industry practice is to verify the amount of income required to service the loan. Verifying *all* income would result in a material increase in turnaround time for customers. The ABA recommends retaining the current definition of borrower's income for verification purposes.

Loan-to-value ratio (LVR) metrics

The LVR metric is proposed to apply to loans with an LVR *greater than or equal to* 80% or 90%. Bank policy thresholds are based on LVRs *greater than*, and there can be significant volume at the threshold. The ABA recommends APRA adopt a *greater than* limit for this metric.

Prioritisation of implementation

Industry asks that APRA indicate if it has a preference for banks to prepare for certain aspects of the proposed changes as a priority. This would assist banks in effectively allocating internal resources across these, and the many other prudential changes currently being implemented.

More than four properties

In its consultation on the revised capital framework, APRA has proposed to include within the definition of IPRE exposures to individuals, family trusts or family companies where, *inter alia,* "*the borrower has mortgaged more than four housing units (excluding the borrower's primary residence) with the ADI or other lenders.*"

Industry recommends that APRA allow customers with more than four residential properties to be classified as residential mortgage retail exposures. This is in line with the published Prudential Standards.

APRA could then require ADIs to monitor the risks of these borrowers, on a best endeavours basis. Should the risks of this population appear to be inadequately captured by the existing models and capital framework, industry and APRA could explore an appropriate treatment, possibly through macroprudential intervention, once more information is known.

Attachment B: Points for clarification

Measurement periods

Guidance is required regarding APRA's expectations for the management of macroprudential measures when implemented. The draft Attachment C does not specify the measurement period, which is critical to operationalising a restriction. For example, it is not clear to industry if monitoring and compliance is expected on a spot year-on-year basis, three-month rolling average, or another approach that could smooth out portfolio seasonality or volatility in portfolio flows. Paragraph 9 indicates monthly reporting to the Board, but greater clarity is required.

Lending Limits

It is unclear to industry which types of limits APRA intends to use in respect to various portfolios. For example, notional caps, new origination caps, or growth caps (year-on-year growth) with regard to the underlying book size, or if alternative approaches should be considered. Providing specific details on the potential limits, well in advance, is essential to increase banks' ability to operationalise future macroprudential policies.

Particularly, clarity is required as to whether lending restrictions would apply to the existing portfolio or to new lending. It is the strong view of industry that restrictions should apply only to new lending as:

1. ADIs have limited rights to terminate performing customer relationships in the back book;
2. As APRA's macroprudential restrictions would affect the entire industry, an ADI will most likely be unable to refinance the affected customers in the back book;
3. If the lending conditions were such that APRA imposed restrictions, then it is also most likely that providers of other portfolio management techniques that lay off risk in the back book (such as credit derivatives, credit insurance and risk participation agreements) would either not have appetite or would require uncommercial pricing; and
4. Applying limits to a portfolio, where a particular set of data has historically not been collected, could be particularly difficult or practically impossible.

It is industry's view that percentage caps of new lending would also be easier to operationalise than a dollar cap (for example, it might require a "quota" system that would require limits to be pre-booked). Though both may have distortionary impacts on competition.

Greater clarity on the granularity of lending limits is also required. For example, for commercial property, the attachment references lending for land acquisition, development, construction, and investment. However, if APRA intends to implement more granular restrictions, further industry consultation would be required to ensure that all ADIs have the systems and reporting capabilities in place to support them. Additionally, there may be unintended effects on parts of the economy if macroprudential policies are applied to all commercial property investment lending regardless of asset type, size or the nature of the borrower, rather than being more targeted. For example, to a specific asset class (for example, office, retail, industrial) or borrower type (for example, private households, commercial property operators).

Residential Mortgage Lending

The definition for residential mortgage lending could, applied literally, capture exposures that are non-retail (including SME Retail) in nature, for example, a loan for businesses purposes, secured by a residential property. It is industry's assumption that the definition of residential mortgage lending, and the loan types listed in the draft Attachment (DTI, LVR, etc.), relate to retail residential mortgage exposures.

Interest Only (IO) Loans

For IO loans, is it APRA's intent to capture all exposures with an IO component? For example, construction loans during the construction period, Lines of Credit, or only those that convert to principal and interest (**P&I**) after an IO period.

Investor Loans

For investment loans, is it APRA's intent that investment is determined based upon the distinction between investment and owner-occupied in ARS 223?

Bridging Loans

Is it APRA's intent that bridging loans are included in DTI limits? It is industry's view that the peak debt should be excluded from DTI reporting metrics / limits and only the continuing debt position included.

New Originations and Increases

Industry assumes limits would be applied to new originations and increases only, and would not apply to maintenance activities such as partial discharges. Similarly, industry assumes limits will not be applied to the existing portfolio.

Lenders Mortgage Insurance (LMI)

Is it APRA's intent to include exposures that are subject to LMI in any LVR limit?

Extension of limits

Would the macroprudential limits only apply to exposures booked to the ADI's book, or also exposures booked to inter-affiliate books which are secured by a property in Australia?

Would any macroprudential limits extend to indirect lending via securitization of residential mortgages?

Would macroprudential limits only apply to secured lending?