

Q&A: APRA's tightening of residential mortgage lending practices

Overview

APRA initially raised concerns in 2014 around residential mortgage lending practices, particularly in relation to the growth in investor lending. However, the regulator has since considered that factors such as rampant growth in metropolitan dwelling prices, high levels of household debt, subdued wages growth, record-low interest rates and an increase in interest-only lending to investors have contributed to a heightened risk environment.

APRA chairman Wayne Byres stated in March 2017 that interest-only terms represented almost 40% of residential lending, which was high by global and historical standards. He advised that APRA had issued supervisory measures under which it expected ADIs to:

- Limit new interest-only loans to 30% of total new residential mortgage lending
- Manage lending to investors to below a 10% growth rate
- Ensure that interest rate and net-income buffers are set at appropriate levels
- Restrain lending growth in high-risk areas of the portfolio such as high LVR loans.

"Our objective with these new measures is to ensure lenders are recognising the heightened risk in the lending environment, and that their lending standards and practices appropriately respond to these conditions," Byres said.

Featured interviewee



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Quynh Truong • Manager (licensing and compliance) • Sophie Grace Compliance and Legal

Learning objectives

After reading this article you should be able to:

- Identify the supervisory measures APRA set for mortgage lending
- Explain APRA's reasons for tightening residential mortgage lending practices
- Outline the major impacts of the tightening of the rules
- Describe the potential challenges of the changes for the mortgage broking industry.

Knowledge areas and accreditation

Knowledge area: Credit and Mortgage Broking (30 minutes/0.5 points).

FPA CPD points 0.5 Dimension: Capability (FPA 009289).

AFA CPD points 0.5 (AFA 01022009).

FBAA CPD points 0.5.

CPA Australia CPD points 0.5 (CPA 000335).

TPB CPE (30 minutes/0.5 points)

Introduction

Welcome to Kaplan Professional's Q&A series. To provide an overview of APRA's tightening of residential mortgage lending practices and the practical implications of the changes for lenders and customers alike, we're joined by Sophie Grace Compliance and Legal's manager (licensing and compliance), Quynh Truong.

Question 1

Could you please take us through APRA's perceived risks in the residential mortgage market that prompted the tightening of the lending rules?

Answer

APRA did some studies, and market research and found that interest-only lending represented nearly 40% of the residential mortgages lent by the authorised deposit-taking institutions [ADIs] — the banks. They found that this rate was really high in comparison to international standards and historical standards, so this prompted some questions and a warning.

Interest-only loans are perceived as a higher risk because most are for quite short periods — five or so years. [Many interest-only lenders encounter] what they term “payment shock” at the end of the term where there's a huge jump in the repayments that have to be made once the interest-only loans revert to principle and interest. I don't think a lot of those issues were being taken into account by banks when they were doing their responsible lending assessments and serviceability assessments.

Any slight interest rate increase will obviously increase the amount you have to pay. There's also — it hasn't really happened yet — the chance of house prices falling [which would expose] the high-risk profile of interest-only loans.

APRA wanted to highlight this to ensure that investors know what they're getting into five or so years after taking out the loan. There could be these larger repayments which could then be even riskier if other factors [such as a fall in property prices] come into play.

Question 2

APRA has set a 10% benchmark for the banks for the growth in lending to investors, with some commentators saying it should be even lower. What's your view on that particular limitation?

Answer

Rather than setting a benchmark, I think there might be other ways to ensure that the risks are managed — things like ensuring serviceability assessments are done correctly, ensuring that they're being reviewed on a regular basis, getting in touch with investors just to ensure that they can meet these repayments, a benchmark for growth in [overall] lending.

A benchmark [on loans to investors] is quite hard to manage. It just depends on how many people want to borrow money, the amount of money they want to borrow, and the types of loans that people are after.

Setting a benchmark gets a bit tricky and it may not really serve the purpose of protecting the consumer, or [helping a lender meet] the responsible lending obligations.

I think more important things to focus on are ensuring that the consumer is reviewing their income, their expenditure, reviewing whether they can service the loan or not; and not just at the present time, but when the interest-only period ends. Also taking into account interest rate rises, especially [within the context of] the housing bubble and whether that's going to burst or not.

It's about ensuring that each individual consumer is protected and not over-reaching and taking on loans that they just can't afford to repay.

Question 3

What have been the major impacts of APRA's tightening of mortgage lending rules to date?

Answer

The licensing process is usually where it all starts. I see ACL holders that have been applying for new credit licenses and have had ASIC come back with increased levels of questioning in relation to their responsible lending obligations and their serviceability matrices.

Previously, we've seen just very general questions about this. But now ASIC is getting quite specific just to ensure that these ACL holders — once they are granted their ACL and start lending money to consumers — are able to meet these obligations and assess the consumer to ensure that they can meet these repayments, not only now, but in the future should anything arise.

We've seen that ASIC is willing to take APRA's lead and follow through. I think we might see ASIC issue notices to review the lending practices of a lot of ACL holders.

Question 4

To what extent do you expect the reforms to be successful in actually raising lending standards?

Answer

I think they will in the fact that they have at least raised awareness of the issue [of poor lending standards]. If you couple that with ASIC's increased surveillance and their increased scrutiny in responsible lending obligations, serviceability assessments and compliance obligations, I think it will increase [the standard of] lending practices.

Question 5

On the other side of the coin, what challenges do you think the reforms will create for the mortgage broking industry?

Answer

The feedback we've received from some clients is that it's been difficult to find out what the banks are willing to lend, whether they're willing to lend to their current clients, whether to go down the interest-only path or the principal-and-interest path and just to balance it with the best structure for the clients.

If it's an investment property, they may want to structure interest-only loans for tax reasons or income reasons. So, it's been difficult for our clients to find out where their bank is at in terms of their limit. It has just been a matter of looking at the market and approaching more banks and alternative lenders.

Question 6

So you have seen a move more towards non-bank lending?

Answer

We've had some feedback that the assessments for some of our clients are much broader now. There have been more instances where clients have been knocked back for interest-only loans and they've had to look for alternatives, whether it be a smaller bank or otherwise.

Question 7

How can ADIs ensure that their interest rate and net income buffers are set at appropriate levels?

Answer

It will be a matter of continually testing and ensuring that their initial assessments of the consumers are done correctly in the first place — just regular tests with that, especially if there have been interest rate rises or any out-of-the-ordinary market movements.

So continual reporting, ensuring that their compliance processes are up to date, and just having that constant contact with the client to ensure that nothing has changed in their personal circumstances.

Question 8

Do you have any final comments on the topic of APRA's tightening of residential mortgage lending standards?

Answer

It's such a new contentious issue at the moment. APRA has come out saying they're not being extremely prescriptive about how you should assess an application. Serviceability levels are held. They have set this cap, so we really haven't seen how banks have yet to respond there — whether it's like a blanket rule that a client can only have three interest-only loans, whether that cap is for current clients and new clients.

So, it's very much a wait and see how it all pans out. It's all part of this good movement into ensuring that people don't end up in a situation where they can't afford to repay their mortgages.

End

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