18 June 2019

Ms Heidi Richards
General Manager – Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Via email: adipolicy@apra.gov.au

Dear Ms Richards

**Consultation on revisions to Prudential Practice Guide APG 223 Residential Mortgage Lending**

Thank you for the opportunity to provide COBA's views on the proposals outlined in APRA's Letter to ADIs *Consultation on revisions to Prudential Practice Guide APG 223 Residential Mortgage Lending.*

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $118 billion in assets, 10 per cent of the household deposits market and 4 million customers.

**Removing APRA prescribed floor in favour of ADI set floors**

COBA supports APRA's proposal to remove its quantitative guidance on the serviceability floor rate. This will allow greater flexibility for ADIs to set their own floors. This aligns with previous practices prior to APRA's 2014 lending standards interventions.

ADIs should be permitted to exercise this flexibility in a reasonable manner in line with the comments in APRA's letter where "…ADIs will be able to choose a prudent level based on their own portfolio mix, risk appetite and other circumstances."

ADIs should be given clarity as to the principles that APRA requires them to apply in order to be able to freely set their own floors. These expectations should be appropriate for all sizes of ADIs and not place an excessive burden on smaller ADIs. COBA notes that APRA's letter implies that the APG 223 para 37 covers buffers and floors with respect to being assessed based on the interest rate cycle, historical interest rate movements, interest rate forecasts and key economic indicators over the appropriate time horizon. We recommend revisions to APG 223 to confirm this view.

In cases where APRA chooses to intervene in the setting of the floor rates, it must ensure that it considers the competitive impacts of doing so. There is the potential for competitive impacts where the floor rate is a binding constraint. COBA estimates that a 50-basis points difference in serviceability rate can decrease borrowing power by around 5 per cent.[1] Similarly, if a group of ADIs were able to set their floors lower than another group of ADIs then the second of ADIs would be unfairly disadvantaged.

We agree that the alternative approach, i.e. APRA retaining but reducing the interest rate floor, is not appropriate . A revised interest floor may still need to be revised in future given the expectation of at

[1] This is based on constant home loan repayment for a 30 year loan with floors of 6.0% and 6.5%.

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least one more interest cut by the end of 2019.[2] If this approach was taken, then this floor should not be in the APG as this would reduce APRA's flexibility to change the benchmark. It could be set as a dynamic benchmark in a similar manner to Canadian Office of the Superintendent of Financial Institutions (OSFI). The OSFI sets this floor rate as the Bank of Canada's five-year mortgage rate. However, COBA notes there is also significant operational complexity with a constantly changing benchmark.

COBA also agrees with APRA's views that APRA prescribing multiple floor rates for different products is "too complex and unnecessarily prescriptive".

**Clarification on the use of multiple sets of serviceability criteria**

COBA seeks more commentary in the APG on whether APRA expects ADIs to set multiple floor and buffer rates. COBA's view is that it should be clear that ADIs are allowed to do so but are not forced to do so.

This potential expectation is raised given APRA's observation that differential pricing "may not warrant a uniform mandated interest rate floor of 7 per cent across all products" and its previously mentioned alternative to consider multiple APRA-prescribed floors.

COBA recognises that some ADIs may want to set multiple floors. However, other ADIs may find it simpler and in line with their risk appetite to maintain a single floor. For example, for operational risk purposes some ADIs may set a single floor to reduce the risk that consumers are put into inappropriate products purely based upon serviceability metrics.

While a multiple floor approach is more complex, COBA draws a distinction between an ADI choosing to set multiple floor rates against this being imposed as regulatory requirement. Such requirements should not impose complexity but provide the option to 'opt-in' to complexity if an ADI chooses to take a more complex approach.

COBA notes that the letter implies an expectation for some product-level buffers by "recognising that for certain types of mortgage products higher buffers may be appropriate".

COBA also seeks more clarity about how these proposals interacts with APG 223 para 27 which sets a 'single set of serviceability criteria'. This section notes that:

> "Loan serviceability policies would include a set of consistent serviceability criteria across all mortgage products. A single set of serviceability criteria would promote consistency by applying the same interest rate buffers, serviceability calculation and override framework across different products offered by an ADI."

**Remove ambiguous wording to give greater clarity around buffers**

COBA supports removing references to "comfortably above". This language is ambiguous. However, COBA seeks further clarification to ensure that these minimums include the minimum amount.

It should be clear that if the minimum buffer rate is set at "at least" [X] per cent, then it should be clear that this includes the minimum buffer of [X] per cent. In all cases, it should also be clear that ADIs are able to set a buffer above this level.

COBA suggests APRA uses wording that clarifies that this includes the minimum buffer. One possible formulation could be "greater than or equal to [X] percentage points" or a "minimum buffer of [X] percentage points".

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[2] https://www.afr.com/news/economy/monetary-policy/rba-cash-rate-could-fall-as-far-as-0-5pc-20190614-p51xsg

**Retain the buffer at 2 per cent**

COBA questions the proposal to increase the buffer to 2.5 per cent given that APRA's previous expectations had been a buffer of 2 per cent. We support retention of the buffer at 2 per cent. An increase in the buffer leads to a decreasing borrowing power by around 5 per cent. This buffer would also be in line with the buffer used by Canada's OSFI.

In our view, this additional conservatism does not provide a corresponding level of additional protection, but rather serves to unnecessarily restrict access to credit and potentially sends more borrowers into the non-ADI space. A higher buffer will have negative impact on the borrowing power for higher interest rate products, including products that have 'honeymoon' rates off the standard variable rate.

To understand these changes COBA examined the RBA's mortgage interest rate data over the last 30 years for periods where a hypothetical loan would be subject to an interest rate than is higher than its original interest plus a 2 per cent buffer.

In these instances, the average time it takes to 'breach' the buffered rate at 2 per cent (2.25 per cent) is 5.9 years (6.2 years) with a minimum of 1.2 years (2.3 years) and median of 5.0 years (5.5 years). This provides borrowers plenty of time to adjust spending habits to minimise the 'shock' of higher repayments. Similarly, wage growth over this period would also offset higher repayments. While COBA agrees that using a buffer protects against large interest rate increases, it is unclear how much additional protection is provided from a larger buffer given the time it takes to 'breach' the buffer.

**Table 1: Time to breach buffered rates over the last 30 years**[3]

| (Years) | Minimum | Average | Maximum | Median |
|---|---|---|---|---|
| 2.25 per cent buffer | 2.3 | 6.2 | 10.9 | 5.5 |
| 2 per cent buffer | 1.2 | 5.9 | 11.4 | 5.0 |

In light of these initial observations, COBA seeks greater transparency around APRA's "analysis of previous Australian interest rate cycles and international regulatory practices for serviceability buffers" in order to justify the proposed increase to the buffer.

Thank you for the opportunity to comment on APRA's proposal. Please contact [redacted] if you would like to discuss any aspect of this submission.

Yours sincerely

[redacted]

**MICHAEL LAWRENCE**
**Chief Executive Officer**

[3] COBA analysis based on RBA's F5 Lending Rates Table: Lending rates; Housing loans; Banks; Variable; Standard; Series FILRHLBVS.