The Deloitte Australian Mortgage Report 2016
Regulatory focus and prudential policy implications

An extract from Australian Mortgage Report 2016

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REGULATION

What is your biggest concern for the mortgage market in 2016?

RESPONSES:
(two answers selected)

3
Unemployment rising placing pressure on serviceability

3
House price growth reducing or falling

3
Risk of any inappropriate lending tainting the industry

4
Regulatory focus on investor lending stifling growth

5
Prudential policy implications on capital pressuring prices

James Hickey (Deloitte)
Kevin, I am keen to get your thoughts around our biggest concerns for the market in 2016? The two responses that stand out are regulatory focus and prudential policy implications on capital. Can you give us a quick update on where the landscape in 2016 might go?

Kevin Nixon (Deloitte)
We are all familiar with the Murray recommendation to get internal model banks closer to standardised model banks.

That recommendation was not made in a vacuum, and in fact the FSI final report refers to the international developments underway. APRA Chairman, Wayne Byres, when making his statements around the IRB risk weights, also refers to the comprehensive rethink of the Basel framework that is going on at the moment. Although the Basel Committee resists calling it Basel IV, preferring to think of it as adjustments to the Basel III framework, the reality is it's a fairly fundamental shift.

Credit risk and capital weightings

The debate about internal models started two years ago at Basel. It was triggered by analysis of the variance between banks using internal models for the same hypothetical portfolio and getting very different answers.

As the Basel Committee dug deeper it became increasingly concerned. In Australia we have focused on mortgage risk weights, but the global discussion is all about credit exposures. The current work – intended for completion during 2016 – focuses on every credit risk a bank has.

This international work on credit risk will impact mortgage capital calculation in three ways:

1. The new standardised Basel consultation paper that was recently published outlines new standardised calculations for mortgages.
2. A consultation paper on internal modelling in banks, due in the first quarter of this year, will propose constraints on the parameters to reduce the variance across internal models, including those for mortgages.
3. A consultation paper due later this year will detail the level of a floor. This is where banks will have to calculate their numbers on a standardised framework and then calculate their numbers on an internal model framework. The internal model framework won't be allowed to produce numbers below a fixed percentage of the standardised approach.

   A number often proffered is 80%. In other words, internal model numbers used for regulatory capital can't be lower than 80%, which will have the net effect of increasing capital for the internal model for banks. The actual number is far from final and will not be known for sometime yet.

APRA – national timing

The approach to internal modelling and standardised models is still being decided at a global level. However on mortgages, APRA has already moved by adjusting the internal model calculations such that they achieve an average mortgage risk weight on their portfolio of 25%. The Murray recommendation was a range of 25%-30%. This was announced as an interim move. As the global picture becomes clearer we should expect further changes in Australia.

Standardised model

The current Basel framework requires that standard mortgages should have a minimum risk weight of 35%, with discretion for national authorities to go higher, and a second weight of 75% for non-standard. So the only existing weight in Basel for standard mortgages is a minimum of 35%. APRA currently has a scale from 35% to 100% for standard mortgages. So it is important to note that we already have a framework that has higher numbers than the existing Basel minima.

The new proposed Basel framework provides a sliding scale of risk weights relative to LVR for standard mortgages with a range of risk-weights for loans of less than 100% LVR from 25% to 55%. This is against the existing flat rate of 35%. So some Basel risk weights have gone down and others have gone up, and again these are minima.

One should not therefore automatically assume that this means there will be any changes to current standardised APRA risk weights as a result of the Basel proposal.

The Basel table certainly provides market participants with an argument for changes to those APRA weights. But APRA is under no obligation to change, and in fact Basel encourages national authorities to set standards above the minima if they believe it is prudent for their banks and market circumstances. And as noted APRA already exercises that discretion for mortgages.

Investment loans

Basel has singled out loans that are materially dependent on rental income for the servicing of the loan.

Patrick Tuttle (Pepper Group)

That's already having an impact in the UK mortgage market. We provide loan servicing to a large proportion of the UK residential mortgage market and are already aware of a potential buyer of a 'buy-to-let' portfolio withdrawing from a recent sale process due to the Basel Committee's recent announcement that it will apply a higher risk weighting to loans which rely on a rental income stream to service the loan.

Kevin Nixon (Deloitte)

Although there has been some press speculation that this will only apply to 2% of investor loans, it has yet to be defined. Another consideration is whether the investor needs to sell the home to repay the loan.

An interest-only loan could be classified in that area as well. That will take the risk weight for an LTV loan of between 60% and 80%, up to 90%; and if the LTV is greater than 80%, that risk weighting is 120% compared with a proposed standardised between 35% and 55%.

'Materially dependent' has not yet been defined, and is something to watch very, very closely. The distinguishing characteristic is the positive correlation between the prospects for repayment of the obligation and the prospects for recovery in the event of default.

Both depend materially on the cash flows generated by the property. The announcement[2] says the primary source of these cash flows would generally be lease or rental payments or the sale of the residential property.

Lisa Claes (ING Direct)

To service any mortgage where the term of the mortgage would exceed the borrower's period of earning, one would need to have significant lazy equity or deep pools of cash equal to the value of your borrowings. This is problematic for most.

Finished property vs under construction

Kevin Nixon (Deloitte)

The discussion we have had here so far applies to finished property. The Basel proposal now holds that for unfinished property (with an exception for one to four housing units on a property that will be the residence of the borrower) there will be a flat minimum risk weight going forward of 150%. This is a significant jump, and is well above the risk weight for general unsecured retail exposures of 75%.

Malcolm Watkins (AFG)

What this actually means is that it will impact fairly heavily on a large part of our employment base – the construction industry. So although the regulators may think they are protecting the health of the banking industry, their decisions could have a material impact on the health of the economy.

The problem is when you take a global viewpoint Australia doesn't sit in current global economics. We have to make sure our regulators see that.

The mortgage broking sector is highly regulated, and justifiably so. All broker mortgage deals are placed under tough scrutiny, and brokers are heavily regulated by ASIC and NCCP[3] laws.

A viable mortgage broking sector is crucial for retaining an element of competitive pressure in the mortgage market. All Australians currently have access to a 'free' mortgage broking service where the fees are fully disclosed, reasonable and provide real choice and competitive tension.

Many of Australia's smaller banks rely on mortgage brokers to act as a de facto distribution network for their products. If mortgage brokers had to apply a fee for their services, not only would their services become expensive and potentially out of reach for customers, but the products of smaller banks would no longer be competitive.

Just as importantly, without the diversity of the underlying mortgage assets particularly in terms of customer type and their location, the ability of these smaller financial institutions to attract ongoing funding at commercially competitive terms becomes hindered, thus driving a lack of competition in the market place.

2,3. NCCP – National Consumer Credit Protection

The Government has asked APRA to take additional steps in 2016 towards the 'unquestionably strong' goal

Patrick Tuttle (Pepper Group)
Also the Basel Committee is now advocating a position which requires bank warehouse facility providers to rely on external ratings provided by the rating agencies, despite the rating agencies being at the centre of all the pre-crisis problems.

My concern is that if the banks can't be trusted to do their own sophisticated internal modelling, the regulations will dumb the market down to the lowest common denominator (in this case a rating agency), which will drive inefficiencies in the market and reduce competition.

Frank Ganis (Macquarie Bank)
We would expect that the re-pricing cycle for mortgages that started some six months ago across the industry will continue.

Kevin Nixon (Deloitte)
There is another reason as well. The Government's response to Murray said quite clearly that it wants banks to have unquestionably strong capital.

The round of mortgage risk weight changes at the end of last year added about 80-100 basis points equivalent of capital. The Government has asked APRA to take additional steps in 2016 towards the 'unquestionably strong' goal, so in addition to changing how mortgages get calculated, there is the potential for further pressure for banks to hold more capital overall.

Patrick Tuttle

Frank Ganis

Kevin Nixon
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Partner, Financial Services
Global Leader Centre for Regulatory Strategy
T: +61 2 9322 7555
kevinnixon@deloitte.com.au