30 September 2024

Dr Sean Turner
Committee Secretary
Senate Standing Committees on Economics

By email: economics.sen@aph.gov.au

Dear Committee Secretary

Inquiry into the Financial regulatory framework and home ownership

Thank you for the opportunity to provide input to the *Senate Economics References Committee Inquiry into Australia's Financial regulatory framework and home ownership.*

COBA is the industry association for Australia's customer owned banks (mutual banks, credit unions and building societies). Collectively, our sector has over $179 billion in assets and is the fifth largest holder of household deposits. Our members range in size from less than $200 million in assets to around $25 billion in assets – all significantly smaller than our ASX-listed peers. Customer-owned banks (i.e. mutual banks) account for around two thirds of the total number of domestic Authorised Deposit-taking Institutions (ADIs) and deliver competition and market leading levels of customer satisfaction in the retail banking market.

Key points

The most impactful policy response for Government to support home ownership is to boost the supply of housing. COBA supports governments of all levels implementing supply-side measures which will result in more Australians able to own their own home.

Closing the deposit gap is important and products such as Lenders Mortgage Insurance and the Government's Home Guarantee Schemes can support this. The financial regulatory framework and government actions should continue to support the sustainability and effectiveness of these measures.

Financial regulation also impacts mortgage serviceability assessments. HELP debt and its interaction with financial regulation can reduce first home buyers' ability to obtain mortgages. APRA's serviceability buffer also reduces first home buyers' borrowing power.

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Customer-owned banks support first home buyers

Customer-owned banks are retail focused banks, with COBA members primarily serving retail customers: offering savings accounts and term deposits for savers, and home loans, personal loans and credit cards for borrowers. Over 78 per cent of all home loans written by our sector are for owner-occupied housing[1], demonstrating the sector's commitment to and specialisation in supporting Australians to own their own home.

Our sector is primarily funded by retail deposits, which means that our members take household savings through the form of deposits in transaction and savings accounts and lend them to other households looking to buy a home. Providing residential mortgages is a core area of strength and expertise of the sector.

COBA members are proud to support first home buyers in cities and regional areas with tailored products, competitive interest rates and extensive participation in government first home buyer schemes. Many COBA members explicitly focus on supporting key workers to enter the housing market with tailored offerings at individual banks for teachers, firefighters, police, nurses, or paramedics. In these instances, COBA members intimately understand the professions which they serve and can offer better, more appropriate products to suit their needs which then helps these valuable key workers access a home of their own.

Customer-owned banks are characterised by robust balance sheets, conservative business models, strong customer loyalty and community involvement. The strengths of our sector are strengths for the financial system, contributing to stability and genuine consumer choice. The sector's singular focus on its customers is demonstrated by market-leading customer satisfaction ratings.

A strong customer-owned banking sector, supported by effective yet flexible regulation, is crucial to ensuring Australians have access to the credit and resources they need to take the important step toward home ownership.

Supply-side measures are critical to addressing affordability

Worsening housing affordability for first home buyers is a continuing problem with both metrics of loan repayment affordability and time to save for a deposit worsening in recent years.

Concerns over housing affordability and home ownership are not new and there have been many inquiries and reports that have examined housing affordability, home ownership and related issues.

The most impactful policy response is to boost the supply of housing which will have a direct impact on price. COBA supports governments implementing supply-side measures which will result in more Australians able to own their own home.

[1] Quarterly authorised deposit-taking institution property exposures, APRA, released 12 September 2024

Role of financial regulation

While housing prices are a significant barrier to homeownership, financial regulation and regulators can help or hinder the home ownership dreams of specific Australians. COBA provides our observations on these interactions in **Appendix A**.

Thank you for the opportunity to provide a submission. If you wish to discuss any aspect of this submission, please contact Alysia Smith (asmith@coba.asn.au).

Yours sincerely

MICHAEL LAWRENCE
Chief Executive Officer

Appendix A – Financial Regulation and First Home Buyers

The deposit gap is growing for first home buyers

The deposit gap is a significant barrier to home ownership, particularly for first home buyers or those in high-cost housing markets. The time to save for a 20% deposit has been rapidly increasing as the price of housing across Australia has grown much faster than wages.

This is particularly concerning for key workers such as nurses, teachers, emergency service workers etc. as the price of housing, particularly in areas close to employment centres for these key workers, has dramatically increased relative to wages. Australians working in relatively well-paid professional jobs are finding it increasingly difficult to afford property and at current rates of house price growth cities such as Sydney will see home ownership reserved for older Australians or those with access to large inheritances in the future.

The ability to demonstrate genuine savings and provide a significant deposit is an essential requirement for purchasing property in Australia, however, low wage growth relative to property prices combined with high rents which reduce the ability to save has resulted in an ever-increasing deposit gap for aspiring home buyers.

Measure to close the deposit gap are crucial for first home buyers as lenders, including customer-owned banks, are incentivised by the capital framework to lend to borrowers with higher deposits or those with access to lender risk mitigants such as lenders mortgage insurance (LMI) or government support schemes.

The capital framework disincentivises high LVR loans

All Australian banks are licenced and regulated by the Australian Prudential Regulation Authority (APRA) which places constraints on the nature and operation of lending practices, in order to ensure financial stability and safeguard depositors' interests.

Residential mortgage lending is subject to minimum capital requirements set by APRA. This is done to manage the risk of losses in the lending portfolio and the amount of capital required to be held generally corresponds to the riskiness of the loan funded. For owner-occupied residential property exposures, banks are required to hold more capital for higher loan-to-value (LVR) mortgages, and significantly more capital for high LVR loans which are not protected through LMI.

Table 1 illustrates APRA's requirements:

Table 1. Risk weights for standard loans

<table>
<tr><th colspan="2" rowspan="2">LVR (%)</th><th colspan="7">Risk weight (%)</th></tr>
<tr><th>≤ 50</th><th>50.01 - 60</th><th>60.01 - 70</th><th>70.01 - 80</th><th>80.01 - 90</th><th>90.01 - 100</th><th>> 100</th></tr>
<tr><td rowspan="2">Owner-occupied principal-and-interest</td><td>LMI</td><td rowspan="2">20</td><td rowspan="2">25</td><td rowspan="2">30</td><td rowspan="2">35</td><td>40</td><td>55</td><td>70</td></tr>
<tr><td>No LMI</td><td>50</td><td>70</td><td>85</td></tr>
</table>

Source: Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk

Given these risk weights, banks are incentivised to lend to lower LVR applicants. For high LVR applicants, which are typically first home buyers due to the large deposit gap, there is a strong incentive for banks to require LMI as a condition of the loan. As a result, banks generally require prospective applicants to hold a LMI policy in order to obtain a loan with an LVR over 80%.

LMI is a very important tool to assist first home buyers with low deposits into the housing market sooner than would be possible if they needed to save for a 20% deposit. Therefore, small banks, including customer-owned banks, rely on the existence of an accessible and affordable LMI market to continue to provide first home buyers with high LVR loans while managing their own credit risk. This stands in contrast to the major banks which have the scale and financial capacity to operate their own LMI in the absence of a private market (i.e. self-insuring).

To support the lending to first home buyers, the financial regulatory framework should continue to incentivise LMI and government actions should ensure that LMI remains available to customers and banks.

Challenges in lending through Government support schemes

In recent years, the Government has expanded first home buyer schemes which effectively reduce the deposit requirement for first home buyers and decrease the time it takes to enter the housing market.

APRA treats home loans written with the support of the Government's Home Guarantee Scheme (HGS) as <80% LVR loans for risk weighted purposes.[2] This ensures that this aspect of the capital framework does not act as a disincentive to write HGS loans, however the number of high-LVR exposures at an individual bank can be limited by APRA which can reduce the ability of some banks to write HGS loans. This capital treatment is provided because Housing Australia provides a guarantee of up to 20% of the property value to HGS lenders.

APRA requires banks to manage the overall level of risk from their lending activities which includes setting risk limits for a bank's residential mortgage portfolio. This includes limits to LVRs and specifically limits on high LVR loans for new originations and for the overall portfolio.[3] COBA members have identified these requirements as a potential barrier to increasing lending to first home buyers, even through the HGS.

Although HGS loans carry the same risk weight as standard <80% LVR loans (which do not require LMI), APRA considers the underlying LVR of the loan (which can be up to 98%) for reporting purposes when monitoring a bank's high LVR exposures. This inconsistency in treatment can result in a reduced ability for customer-owned banks to offer HGS loans compared to the major banks. This is because HGS loans can make up a relatively high proportion of the total lending of a customer-owned bank over any given period compared to that of a major bank which has a broader range of customers seeking loans across the LVR spectrum.

[2] Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk

[3] Prudential Practice Guide APG 223 Residential Mortgage Lending

Serviceability

Mortgage loan serviceability requirements ensure that borrowers can meet their loan repayments without undue financial stress. Lenders assess serviceability by reviewing a borrower's income, expenses, and existing debts, to determine their capacity to repay the loan. Financial regulation from APRA and the Australian Securities and Investments Commission (ASIC), combined with lenders' risk appetites determines the amount that they can lend to a home buyer for given level of income. Since first-home buyers often have higher LVR loans, they are more affected by any limitations due to serviceability constraints.

Impact of Higher Education Loan Program debt

Lenders consider Higher Education Loan Program (HELP) debt when assessing an individual's borrowing capacity for loans. The costs of a university degree can be significant and therefore result in significant HELP debts for first home buyers.

Although HELP debt does not require regular interest-rate linked repayments like conventional debt, it impacts an individual's disposable income since repayments are deducted once their income exceeds a certain threshold ($54,435 for 2024-25). An individual's disposable income is a critical factor in lenders' assessment of ability to service a mortgage.

Lenders factor in these compulsory repayments when calculating a borrower's serviceability (their ability to repay a loan) by reducing the amount of income available to service new debt.

Consequently, having HELP debt influences the mortgage size a home buyer may be eligible for.

Financial regulation and HELP

Customer-owned banks are subject to financial regulation that means that they need to incorporate HELP debt into their serviceability calculations.

Under the *National Consumer Credit Protection Act 2009*, customer-owned banks are required to meet responsible lending obligations to ensure that loans are considered 'not unsuitable'. ASIC's Regulatory Guide RG 209 Credit licensing: Responsible lending conduct outlines that HELP debt is an "outgoing[s] that a consumer is less likely to be able to reduce or eliminate" that is part of a potential consumer's financial situation. Given the compulsory nature of HELP debt repayments, it is unlikely to be within most bank's risk appetites to exclude these repayments from serviceability calculations in the absence of ASIC guidance explicitly permitting such behaviour.

All banks are also subject to lending standards regulation from APRA as the prudential regulator. As a result, banks are subject to requirements around serviceability assessments in Prudential Standard APS 220 Credit Risk Management and associated guidance (see table below). For the purposes of APS 220, HELP debt is considered an existing debt commitment.

Other existing debts	A prudent ADI would have effective processes to verify a potential borrower's existing debt commitments. This includes taking reasonable steps to identify any undeclared debt commitments, including the use of comprehensive credit reporting data.

Source: Prudential Practice Guide APG 220 Credit risk management

Home buyers with significant HELP debts will have higher debt-to-income (DTI) ratios as this debt factors into DTI ratios under APRA's framework (see table below). This may limit banks' ability to lend to home buyers where they are bound by either risk appetites or limits linked to APRA definitions. In addition, APRA's macroprudential measures also requires lenders to have the ability to limit DTI ratios (see APS 220 Attachment C). [4]

Debt-to-income ratio	The ratio of the credit limit of all debts held by the borrower, to the borrowers' gross income. Include the credit limit of any debts, such as other mortgage lending, personal loans, credit-cards, consumer finance, margin lending, buy now pay later debt, Higher Education Loan Program (HELP) or Higher Education Contribution Scheme (HECS) debt, and any other debts held by the borrower, to any party, to the extent this is known to the ADI.

Source: Reporting Standard ARS 223.0 Residential Mortgage Lending

Macroprudential policy settings reduce borrowing power

Further to restrictions on home lending imposed on banks on an individual borrower or individual bank perspective, APRA also imposes variable macroprudential policy settings on lenders which seek to mitigate financial stability risks at a system-wide level. These settings include mortgage serviceability buffers which are designed to provide a contingency for rises in interest rates over the life of a loan, as well as for any unforeseen changes in a borrower's income or expenses.

The serviceability buffer is currently set at 3%[5] which results in banks assessing borrowers' ability to repay a mortgage on a loan interest rate 3% higher than the actual rate. This buffer has the effect of reducing the borrowing power of prospective home buyers. This has a particularly significant effect on first home buyers who face both challenges in saving for a deposit and have reduced borrowing capacity through the imposition of the serviceability buffer.

Consideration should be given to the size and nature of the serviceability buffer to ensure it appropriately balances financial stability considerations with the impact on first home buyers.

[4] https://handbook.apra.gov.au/standard/aps-220#Attachment-C

[5] https://www.apra.gov.au/news-and-publications/apra-keeps-macroprudential-policy-settings-steady