INSURANCE COUNCIL OF AUSTRALIA

Committee Secretary
House of Representatives Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600

26 June 2015

Dear Sir/Madam

Inquiry into Home Ownership

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to provide comments to the Inquiry into Home Ownership (the Inquiry) by the House of Representatives Standing Committee on Economics (the Committee). We wish to take this opportunity to provide the Inquiry with information about Lenders Mortgage Insurance (LMI) and explain the important role it plays in facilitating affordable and accessible home ownership. One of the key benefits of LMI is that it improves access to home ownership by enabling those who would otherwise have difficulty obtaining a home loan, particularly borrowers with low incomes or low levels of equity, to satisfy responsible lending criteria.

Background

LMI is insurance that a lender takes out to insure itself against the risk of the borrower defaulting on their home loan. Where lenders lend more than 80% of the value of the home being purchased, there is an increased risk that it will suffer a loss should the property have to be sold. Transferring that risk to an LMI provider enables the lender to service to borrowers who are creditworthy, but who do not have a 20% deposit. LMI was introduced into Australia during 1965 in part to improve the access to home ownership along with the establishment of the government-owned Housing Loans Insurance Corporation (HLIC), which has since been privatised.

Lenders will typically pass the LMI premium on to the borrower, which is usually capitalised into the home loan. This means the borrower does not need to pay the LMI premium up front, but over the life of the loan. When house prices are rising, the accumulation of equity

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. September 2013 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $40.4 billion per annum and has total assets of $112.6 billion. The industry employs approximately 60,000 people and on average pays out about $92.5 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

INSURANCE COUNCIL OF AUSTRALIA

in the home very often exceeds the premium cost in a relatively short period of time. It also means that the first home buyer owns a home and can reallocate rental payments to paying down their mortgage.

LMI providers are regulated by the Australian Prudential Regulation Authority (APRA) and are authorised as monoline insurers, which means they do not provide any other type of insurance. Approximately 34% of households live in dwellings with loans backed by LMI cover.[2] LMI is also classified as a general insurance product, which is governed by the Insurance Contracts Act 1984. LMI is a capital intensive business, with providers typically being highly rated by the ratings agencies, underpinned by substantial capital strength, in line with both APRA's regulatory capital requirements and the rating agencies' capital criteria.

LMI Improves Access to Home Ownership

LMI improves access to home ownership, particularly amongst low income earners, low equity or higher risk borrowers, who would otherwise have difficulty obtaining a home loan. This is one of the key reasons why the Government introduced LMI into Australia 50 years ago. With the benefit of LMI, many first home buyers are more likely to be able to afford to buy, move into and accumulate equity in their home sooner, as they are able to obtain a loan that would otherwise not be available, or obtain a loan much earlier than they would be able to if they had to save for a full 20% deposit.

With low and stable interest rates over recent years, increased house prices have more than offset the benefits of low interest rates on affordability. It can be argued that the boom in house prices has been caused in large part by low interest rates and lack of supply, as home owners and investors have attempted to take advantage of the lower interest rates, increasing demand over supply and putting upwards pressure on pricing.

For creditworthy people who don't have the funds for a deposit but are seeking to buy a home, low interest rates are of little help. LMI however has helped these buyers. By transferring the cost of default away from lending institutions, and towards LMI providers, LMI has acted to increase the availability of home loans to borrowers with a limited deposit by freeing up lenders' capital. LMI acts to pool the risks associated with these borrowers (who are perceived to be higher risk) and therefore eliminates (or greatly reduces) the incentive lenders would otherwise have to charge higher rates of interest. Borrowers are able to access LMI on equitable terms, rather than being discriminated against based on individual credit profiles, geography, or the lender chosen. Instead, borrowers are charged an LMI premium based on the LVR of their loan, loan amount and other factors.

If lenders transfer credit risk and the cost of default to LMI providers, lenders do not have to charge a higher interest rate to cover the increased risk a borrower presents if they do not have a 20% deposit. This gives confidence to lenders, allowing them to compete in the marketplace, providing capacity for lenders to stand by the loan in the event of a default, potentially allowing time for the borrower to rectify the situation and resume mortgage repayments. This confidence in turn allows borrowers to continue to access the housing

[2] If securitised loans are included, the proportion of LMI insured loans increases to approximately 40%.

market earlier and at an interest rate comparable to a borrower with a deposit of 20% or higher.

The LMI industry can therefore play an important role in enabling first home buyers to purchase homes sooner than would otherwise be the case if they had to save a 20% deposit. With the average house price in Sydney exceeding $880,000 and the average pre-tax wage for a full-time employee (including overtime) being $80,000 annually, the challenge for a first home buyer is to save two years' salary before tax if they have to come up with a 20% deposit. In addition, first home buyers have to face other costs, such as stamp duty and conveyancing fees, when buying a property. These additional costs add to the importance of LMI to first home buyers looking to enter the market.

Other Benefits of LMI

LMI enhances the underlying efficiency in the market for home loans, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), encourages better quality lending, increases competition and innovation amongst lenders, reduces barriers to entry in the lending market and ultimately improves access to home ownership.

LMI smooths macroeconomic cycles by facilitating the continuation of home lending at the bottom of a cycle but also helps keep in check imprudent lending at the top of a cycle. This was demonstrated during the global financial crisis. LMI played a critical role in managing a layer of risk for lenders that could otherwise have had an adverse impact on them when mortgage default rates escalated. The availability of LMI also contributed to the success of the Federal Government's first home buyers' initiative introduced at the time to stimulate the economy.

LMI providers are in the unique position of having broad oversight of mortgage lending practices across Australia. With lender customers including the major trading banks, smaller standardised[3] banks, non-bank lenders, credit unions and building societies, LMI providers have a whole of market view. It enables them to help ensure prudent lending practices, resulting in a more robust and secure mortgage market, through:

- providing a "second set of eyes" on lenders' credit operations;
- providing information and expertise to the housing market;
- providing parameters of acceptable risks by setting credit policies and introducing underwriting criteria;
- providing quality assurance;
- maintaining compliance standards; and
- addressing and improving default and claims management (noting that it is often the case that where a borrower has defaulted, the LMI provider will work with them to try and keep them in their home rather than the home being sold).

[3] "Standardised" banks have their regulatory capital determined by an APRA formula as compared to Internal Risk Based (IRB) banks which use APRA approved internal models.

INSURANCE COUNCIL OF AUSTRALIA

Historically, when LMI was introduced in 1965, building societies were able to compete effectively with banks by providing high LVR loans (up to 95% of the value of the security property) with LMI.

Prior to that time, first home buyers were restricted to borrowing up to 66% of the value of the property from the savings bank, and then had to borrow the remainder from either the trading bank arm of the bank or from another finance company – generally at much higher rates and shorter term than the loan obtained from the savings bank.

Following the deregulation of bank mortgage interest rates in 1986, the major banks, with the support of the LMI industry, also entered the high LVR segment of the home lending market. A number of the largest building societies converted to regional banks at this time. With the major trading banks today having about 80% of market share in residential lending, LMI still enables standardised banks to compete and offer high LVR home loans at competitive rates.

LMI also plays an important role in providing credit enhancement that underpins the mortgage backed securitisation market, enabling non-bank lenders to access funding at competitive rates. Securitisation promotes competition in the home lending market, enabling non-bank lenders to compete with main stream lenders on pricing and other features. This in turn ensures competitive mortgage interest rates, with flow on benefits for borrowers.

Stability of LMIs

LMI assists with financial system stability by increasing system capital. This provides a significant and independent layer of capital that provides support specifically for credit default risk on residential housing adding to system stability in Australia.

LMI providers are required to hold a high level of capital relative to the overall general insurance industry to reflect the nature and amount of risk which they underwrite each year. This reflects the cover they offer which lasts the life of the underlying loan rather than the typical 12 month exposure underwritten by General Insurers. The Insurance Council wishes to stress the importance of the capital held because it is released to lenders in the event of borrower default, in accordance with their LMI contract.

LMI results in significant payments to lenders in the event of mortgage default, and can be expected to do so even in the face of a severe shock to the housing market. A study which was undertaken in 2011 for the LMI industry and Australian Bankers' Association's Internal Risk Based (IRB) working group by Rhino Risk considered the benefit provided by LMI to lenders in a severe downturn scenario.

This study analysed historical payout percentages and modelled the amount that can be recovered by lenders in the event of default by an LMI.[4] The first model effectively found that LMI capital would be sufficient to cover 62% of bank credit losses for insured loans from a 1

[4] The study used two methods, of which the first model relies on the S&P bond default model and the S&P LMI model as its key inputs. The second model relies on the use of the Vasicek formula, which underlies some of the Basel II internal model calculation, as applied to bank capital.

INSURANCE COUNCIL OF AUSTRALIA

in 999 year event. The second model found that LMI capital would be sufficient to cover 79% of bank credit losses for insured loans from a 1 in 999 year event.[5]

LMI spreads the risks associated with lending through diversification. LMI secured loans transfer the loss given default (LGD) from the loan originator to the LMI provider. Further, the pooling effect of LMI diversifies lender default risk across geography, lenders, time and loan product, which reduces the risk of over-exposure of any single Authorised Deposit-taking Institutions.

Through an LMI provider's reinsurance arrangements, a proportion of ceded risk is further spread outside the Australian domestic financial market, tapping deep global markets. Mortgage default losses rarely occur uniformly across national economies. There are almost always geographic regions or individual lenders that are disproportionately affected, due to local economic conditions and varying loan origination and servicing capabilities. Therefore, where risk can be pooled market-wide, individual losses are absorbed within the distribution of all risk held, thereby providing added levels of financial system stability.

Potential challenges

An LVR of 80% is the effective floor above which there is perceived to be a greater risk of loss arising in a default situation. Given this greater risk, APRA imposes additional capital requirements on lenders where a borrower has less than a 20% deposit. With LMI, the lender has effectively transferred the risk to the LMI provider. As an authorised general insurer, the LMI provider has to hold capital against the risk. Where standardised lenders utilise LMI, this is recognised by the regulator and they do not have to hold as much capital than they otherwise would without LMI.

Whilst this also used to be the case with the larger banks (which are IRB banks), this relief changed with APRA adopting the Basel II standard requirements. However, whereas the Basel standards require that banks should hold capital against losing 10% of a mortgage's value, APRA requires double this. For the IRB Banks, this mean they have to hold a higher amount of regulatory capital beyond what the risk models would require them to hold, effectively meaning that they receive little to no capital benefit from LMI.

Whilst IRB banks still utilise LMI for risk transfer, there is less incentive to obtain LMI without the capital relief that they previously benefitted from. It also means that with LMI, both the LMI provider and the IRB lender are holding additional capital against the same risk. This could result in the IRB lender choosing to take more risk without LMI on high LVR loans, particularly in the lower 80% to 85% range.

[5] A key point to recognise from the analysis is that a high percentage of any lender claim is covered by the LMI provider's capital, even in the event of an LMI defaulting. Further, in a scenario less extreme than a 1 in 999 event, an LMI provider would cover an even higher proportion of the lenders' claims, even if in default. Based on the evidence available, Rhino Risk recommended a severe downturn payout percentage of 70% on insured loans should be used for the Australian LMI industry as a whole.

INSURANCE COUNCIL OF AUSTRALIA

This could then potentially reduce the LMI providers' risk pool, which would ultimately lead to increased premium costs and which the lenders would in turn pass on to the borrower, most likely negatively impacting on the cost of home loans for borrowers. From a regulatory perspective, a level playing field for all lenders is likely to result in more competition and more accessible funding and thus housing for first home buyers.

In light of the above, the Insurance Council submits that the Committee should consider the benefits of recommending that APRA give greater capital relief to IRB Bank lenders which utilise LMI commensurate with the capital that the LMI industry holds. This would ensure that LMI continues to benefit the housing system, with increased competition between lenders, bolstering financial and economic stability and, importantly, improved access to and affordability of home ownership.

Yours sincerely

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