Submission to the Inquiry into National Housing Finance and Investment Corporation Amendment Bill 2019

September 2019

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About QBE

The QBE Insurance Group (***QBE***) is one of the few Australian-based financial institutions to be operating on a truly global landscape, with operations in and revenue flowing from over 31 countries.

Listed on the ASX and headquartered in Sydney, organic growth and strategic acquisitions have seen QBE grow to become one of the world's top 20 general insurance and reinsurance companies, with a presence in all key global insurance markets.

As part of QBE, QBE Lenders' Mortgage Insurance Limited (***QBE LMI***) has been providing lenders' mortgage insurance (***LMI)*** in Australia for more than 50 years. QBE LMI also has a keen interest in housing affordability initiatives and the critical role that housing plays in supporting the social and economic wellbeing of Australians.

First home loan deposit scheme

On 12 May 2019, the Prime Minister announced the Government's intention to establish the First Home Loan Deposit Scheme (***the Scheme***) to help certain eligible first home buyers (***FHBs***) to purchase a modest home by guaranteeing 15% of the proposed deposit. The Scheme, as announced, is intended to support up to 10,000 FHB each year, who have a minimum of 5% deposit and an income up to $125,000 (or $200,000 for a couple). Other eligibility criteria are yet to be announced, such as the value of homes that can be purchased under the Scheme.

The Scheme is to be implemented by the National Housing Finance and Investment Corporation (***NHFIC***). The *National Housing Finance and Investment Corporation Amendment Bill 2019* (the ***Bill***), introduced to Parliament on 12 September 2019, is intended to expand the functions of NHFIC to enable it to provide guarantees to improve access to home ownership and undertake research into housing affordability, including supply and demand.

We understand the Investment Mandate (made under the NHFIC Act) will be amended to outline the nature and conditions of the guarantee provided by the NHFIC to lenders for eligible first home buyers under the Scheme. The Government has indicated that amendments to the Investment Mandate will be the subject of separate consultation.

QBE LMI welcomes the opportunity to provide this submission on the proposed Scheme and the operation of LMI in Australia.

Lenders' mortgage insurance

Overview

It is important to understand that, consistent with the stated intention of the Scheme, LMI was introduced by the Menzies Government into Australia in 1965, with the establishment of the government-owned Housing Loans Insurance Corporation (HLIC – since privatised). LMI was introduced by the Government with a view to providing access to home ownership for a broader segment of the Australian population. Since that time, borrowers have been able to purchase properties and access home loans in Australia with deposits of as low as 5% of the purchase price, with the assistance of LMI.

Where borrowers do not have a substantial deposit (typically 20%) for a home, if the borrower defaults on their home loan, there is a greater risk that the lender will suffer a loss if the property has to be sold. LMI is insurance that a lender takes out to insure itself against the risk of such loss occurring. By transferring that risk to an LMI provider, the lender is prepared to provide home loans to borrowers who are creditworthy and have the capacity to make mortgage repayments, but do not have the required deposit. A once-only upfront premium is paid directly by the lender to the LMI provider, covering the lender for the entire life of the loan (generally up to 30 years). Typically (but not always), the cost of the LMI premium is passed on by the lender to the borrower as a fee, similar to valuation and other fees incurred by the lender during the mortgage origination process. The borrower generally has the choice to capitalise the cost of the LMI premium by adding it to the loan amount. This means the borrower does not need to pay this cost upfront, but can spread the cost over the life of the loan.

With the benefit of LMI protecting the lender, borrowers, and particularly first home buyers, have the opportunity to buy, move into and accumulate equity in their home much earlier than if they had to save for a full (20%) deposit.

LMI generally operates as a 'community-rated' rather than 'risk-rated' insurance product. In other words, to enable a larger proportion of the Australian population to access home loans, the LMI insurers determine the expected loss from the total population of borrowers and share this cost across the premium collected from all borrowers that do not have the 20% deposit. A more risk-based approach would cost more for many borrowers or exclude borrowers who are assessed as higher risk. QBE LMI considers this would be contrary to the purpose of LMI, which is to enable broad access to homeownership.

Importantly, with LMI, a lender does not need to charge a higher interest rate to cover the increased risk that a low deposit borrower presents. This allows a borrower to have access to the housing market at an interest rate that is comparable with that of a borrower who is able to provide the necessary deposit. Based on our experience, the cost of the once-only upfront LMI fee borne by a borrower is significantly less than the application of a higher risk-based interest rate that is applied over the life of the mortgage loan.

What are the broader benefits of LMI?

The value of LMI has been widely recognised by financial authorities – the Joint Forum has stated that:

> *Mortgage insurance provides additional financing flexibility for lenders and consumers, and supervisors should consider how to use such coverage effectively in conjunction with LTV requirements to meet housing goals and needs in their respective markets. Supervisors should explore both public and private options (including creditworthiness and reserve requirements),and should take steps to require adequate mortgage insurance in instances of high LTV lending - e.g. greater than 80% LTV*[1]*.*

In Australia, the 2014 Financial System Inquiry (***FSI)*** has also acknowledged the key role of LMI when it recommended that the Australian Prudential Regulation Authority (***APRA***) should **recognise lenders mortgage insurance**[2] where appropriate to narrow mortgage risk weight differences between IRB and standardised lenders to encourage competition and remove impediments to its development.

We are pleased that the Government also recognises the importance of the private LMI market as set out in the Explanatory Memorandum to the Bill[3]:

LMI is a crucial but some times overlooked component of the Australian home lending market. It supports the economic stability of the financial system and facilitates home ownership, accessibility to credit and competition.

In particular, LMI:

- **supports market accessibility**, enabling those who would otherwise have difficulty obtaining a home loan – particularly borrowers with lower than average incomes or low levels of equity who have difficulty saving a substantial deposit – to satisfy responsible lending criteria and purchase a home.
- **by community rating and sharing the risk across the LMI pool - supports accessibility and affordability,** enabling borrowers, who are creditworthy and have the capacity to make mortgage repayments but do not have the required deposit, to access home loans on similar interest rates to those with a substantial deposit.
- **maintains the integrity of lending practices** by being a 'second set of eyes' in addition to lenders' – promoting industry best practice, providing feedback on lender policies and ensuring that credit standards are maintained. LMI providers are also active in detecting potential fraudulent activity within the mortgage industry.
- **diversifies lending risk** by pooling risk across different lenders and borrowers and across time and geographical locations, and by sourcing reinsurance and capital from international financial markets.
- **lowers the cost of mortgages** by making mortgage-backed securities more attractive to investors, providing access to wholesale funding markets and reducing lender costs. The mid-1990s entry of these

[1] The Joint Forum, Review of the Differentiated Nature & Scope of Financial Regulation, January 2010, p.17. The Joint Forum was established under the aegis of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors.
[2] Financial System Inquiry Final Report, November 2014, p. 66.
[3] Explanatory Memorandum to the National Housing Finance and Investment Corporation Amendment Bill 2019, pp21-22.

securities into the Australian home loan market introduced significant competition, materially reducing the cost of borrowing for home owners.

- **smooths the effects of economic cycles** as LMI capital is deployed during economic downturns when there are increased mortgage defaults. This reduces the losses incurred by lenders, so they remain strong and protected and are therefore able to continue to provide credit while the market recovers. As such, LMI enhances the underlying efficiency in the market for home loans (primarily because its underlying risk preparedness is very long term).

Competition

Significantly, LMI encourages and facilitates competition in the high LTV lending segment - an important segment that includes many first-time home buyers:

- LMI is currently widely used among lenders offering high LTV mortgages in Australia. About **one in four residential home loans are supported by LMI, with up to one-third of these loans for first home buyers.**
- LMI is used by the mutual banks, credit unions, building societies, regional banks, international banks and Australia's four major banks, as well as non-ADIs.
- For small and regional lenders, the support provided by LMI is essential, as they cannot carry as much risk on their balance sheets. Typically, these lenders are exposed to greater regional concentration and have less capacity to bear the risk without some component of credit default protection.
- The use of LMI enhances the ability of smaller lenders to compete with larger lenders (i.e. the major banks), which currently enjoy a significant competitive advantage in the high LTV segment with lower cost of funds, balance sheet capacity to self-insure and the application of a model-based approach for regulatory capital.
- LMI assists these lenders to diversify their risk, enabling them to enter and compete in the high LTV lending segment. The use of LMI also means these lenders can hold less regulatory capital for these risks than would otherwise be the case for such loans without the use of LMI.
- This is particularly important for smaller lenders with geographic concentration where LMI plays a critical role in supporting their concentration risk in their "home market" (for example, regional and rural Australia) as well as enabling them to expand (and diversify) their lending across other geographies.
- Similarly, foreign banks and the non-banking sector, with the support of LMI, also continue to place competitive pressure on domestic ADIs to moderate margins.
- LMI is a critical component that enables smaller lenders and non-bank lenders to continue to compete in the residential mortgage market and to offer high LTV home loans at competitive rates. Increased competition facilitates innovation in the market with the delivery of new technology and new products, such as shared equity mortgages.
- LMI has also traditionally been used by non-approved deposit taking institutions (***ADIs***) as well as small and medium ADIs in their residential mortgage backed securitisation (***RMBS***) transactions to make RMBS more attractive to investors, providing them with access to wholesale funding markets and reducing their cost of funds. It was the entry of these lenders into the home loan market in the mid-1990s that introduced significant competition for home loans, leading to reduced mortgage repayment rates and material reductions in the cost of borrowing for Australian home owners.

Risk diversification and stability

The LMI industry plays a significant role in **facilitating the efficient management of capital and risk in the banking system, providing systemic housing loan risk protection by transferring risk outside the banking system.**

LMI is a very capital-intensive business. LMI providers are typically highly rated by independent ratings agencies, underpinned by substantial capital meeting both APRA's local regulatory requirements and independent rating agency capital requirements. LMI capital in Australia is typically invested in conservative, highly liquid assets, and is used as an independent layer of capital that specifically supports credit default risk and the costs associated with that default in the home lending market. LMI assists to diversify that risk across time, geography and a large group of borrowers and lenders.

LMI capital is available during times of increased mortgage defaults, which typically occurs during economic downturns. The deployment of LMI capital reduces losses incurred by lenders and helps to smooth the impact of economic cycles.

This additional support provided by LMI is critical at times when the financial system and the residential mortgage component of the system are under stress. This was evidenced during the global financial crisis where LMI providers, by supporting lenders with high LVR lending, were pivotal in the success of the then Australian Government's first home buyers' initiative that was introduced to stimulate the economy during that time.

Longer term, the LMI industry functions to smooth the effects of economic cycles. Just as it can facilitate greater amounts of housing lending at the bottom of a cycle, LMI also provides a curb on imprudent lending at the top of the housing cycle. In doing so, the LMI industry helps to bolster financial and economic stability while continuing to benefit the housing industry and its customers, borrowers and lenders alike.

LMI providers are highly regulated by APRA and operate under a monoline licence. LMI is considered to be a long tail economic catastrophe line of insurance. Importantly, as monoline LMI insurers of systemic residential mortgage risk, LMI providers in Australia have no incentive to compete away the risk margin that is received as the LMI premium. Alternative market structures, such as New Zealand, have demonstrated that lenders charging a risk premium for high LVR lending, tend to compete this away as competition increases and credit risk is underestimated. This is pro-cyclical and adds to financial system risk.

FHB Scheme and LMI

The importance of maintaining a viable and profitable LMI industry

QBE is pleased that the Government has recognised the extremely important role that LMI plays in the Australian housing market. The Explanatory Memorandum to the Bill outlines the role and importance of LMI and **emphasises that the development of the Scheme has prioritised the maintenance of a viable and profitable LMI industry**, as LMI enables high-LVR lending and benefits the financial system more broadly[4]. The Explanatory Memorandum notes:

> *LMI allows potential home buyers the ability to enter the property market sooner than they would otherwise be able to. Without LMI, potential home buyers with deposits of less than 20 per cent would not ordinarily be able to obtain a mortgage. In addition to insuring lenders against the higher risks involved in lending to FHBs, LMI providers also provide a 'second pair of eyes' on the loan assessment process. Taken together, this increases the willingness of lenders to lend to FHBs*[5]*.*
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> *…LMI also plays an important role in the credit creation process. LMI increases confidence for lenders to lend against residential housing assets through the economic cycle and reduces volatility in financial markets. LMI helps lenders manage risks by transferring the risk of borrower default of LMI-covered mortgages to LMI providers (and their global reinsurers). The ability to manage these risks is particularly relevant for smaller lenders, which are generally more geographically concentrated than larger banks and would otherwise find it difficult to manage higher-risk lending.*
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> *Smaller banks also benefit from LMI provision. Under prudential regulations, loans with LMI require banks to hold less capital compared to loans without LMI. Therefore, the absence of LMI would restrain the competitive position of smaller banks compared to larger competitors*
>
> *Finally, LMI contributes to the stability of the Australian financial system by providing the banking sector with a layer of additional private capital to absorb losses, which can be an important buffer for the system during an economic downturn*[6]*.*

Also as noted in the Explanatory Memorandum to the Bill, Australia is relatively unique in having an active market for LMI that is supported by private capital and operates without direct or indirect Government support.

LMI has operated very effectively in the Australian market for over 50 years. It improves access to home ownership, enhances the underlying efficiency and integrity in the home lending market, contributes to

[4] Explanatory Memorandum to the *National Housing Finance and Investment Corporation Amendment Bill 2019*, p20.
[5] Ibid, p20.
[6] Ibid, p21, 22

smoothing the effects of economic cycles (primarily because its underlying risk preparedness is very long term), reduces barriers to entry in the home lending market, and increases competition and innovation among lenders.

APRA is currently undertaking a consultation on revisions to the capital framework for ADIs[7]. Whilst APRA has acknowledged the value of LMI during this consultation process[8], QBE LMI is concerned that APRA's proposals do not sufficiently recognise the value of the LMI. Whilst APRA's proposals partially correct the disincentive for large lenders using an internal ratings based model (***IRB lenders)*** (subject to IRB lenders having accredited LGD models), there is an opportunity to correct the current distortions between IRB and smaller lenders using the standardised lending model. In the absence of such regulatory or structural incentives recognising the use of LMI, QBE LMI is concerned this, coupled with the potential impact of the Scheme if not constrained, may impact on the ongoing viability of LMI as a product.

This, in turn, may place at risk both the accessibility to home ownership and the affordability of homes within the Australian housing market as well as significantly reduce competition in the home lending market. Of critical significance, QBE LMI believes that without the support of a strong and stable LMI industry, small and medium ADIs and non-ADI lenders will be at a material disadvantage in this market compared to the IRB lenders and this is likely to negatively impact borrowers on lower than average incomes, such as first home buyers.

Impact of the Scheme on LMI

As recognised by the Government, the Scheme has the potential to impact or crowd out the private LMI sector by removing the need for borrowers to take out LMI. By introducing what could be considered to be a Government competitor into the private sector, there is a risk that the Scheme may displace a proportion of the LMI market, potentially impacting the ongoing viability of the private LMI market in Australia.

The Regulatory Impact Statement (***RIS)***, forming chapter 2 of the Explanatory Memorandum, does not estimate the potential impact of the Scheme on the LMI sector, noting it is difficult at this stage to predict how the introduction of the Scheme may impact on LMI. As such, implementing the Scheme in a way that complements, rather than crowds out, the private LMI sector will be critical. We believe ensuring appropriate eligibility criteria and constraining the size of the Scheme will be extremely important to prevent this occurring.

As noted in the RIS, the announcement of the Scheme has generated a high degree of community interest with potential home buyers holding off on purchases in anticipation of gaining access to the Scheme. This has raised expectations widely amongst first home buyers that will need to be addressed. A key implementation challenge for Government is likely to be managing potential demand for the Scheme, given these expectations, and determining who is best served by receiving explicit Government support. Otherwise, we anticipate the disappointment from first home buyers that were not successful, may increase pressure on the Government to expand the Scheme.

In this respect, QBE LMI considers it is important to ensure the Scheme is targeted in a way that supports those first home buyers in genuine need of assistance, rather than all first home buyers that could otherwise access a home loan, either through the use of LMI or other high LVR credit risk mitigants. We also strongly support the Government's stated intention for NHFIC to prioritise smaller lenders to deliver the Scheme in order to boost competition in the sector.

We look forward to continuing consultation on these important issues and would also like to work closely with the Government and NHFIC to increase understanding of home ownership for first home buyers. QBE LMI would also be very happy to assist on any broader operational issues and challenges that need to be resolved to ensure lenders can participate effectively in the Scheme and to ensure a relatively seamless experience for first home buyers, given our considerable expertise in this area.

Conclusion

LMI has been an integral component of the Australian housing market since 1965. 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. With LMI protecting the lender, home ownership is more accessible as borrowers can obtain a loan that would otherwise not be available or obtain a loan much earlier than if they had to save for a full (20%) deposit.

[7] https://www.apra.gov.au/consultations-revisions-capital-framework-authorised-deposit-taking-institu ions
[8] APRA, *Discussion Paper: Revisions to the capital framework for authorised deposit-taking institutions*, 14 February 2018, p24.

Most significantly, LMI encourages and facilitates competition in the high LTV lending segment, enhancing the ability of smaller lenders to compete with larger lenders.

LMI also plays an important role in maintaining the stability of financial markets. Firstly, it provides a second set of eyes in addition to the lenders, to ensure credit standards are maintained and both policies and practices of lenders are monitored. Secondly, LMI provides additional capital into the financial market to support home lending. This capital is dedicated to residential mortgage lending and is fungible across lenders and geography. Additionally, through reinsurance, LMI can access international financial markets to access foreign capital and disseminate risk.

QBE LMI is pleased that the Government has recognised the extremely important role that LMI plays in the Australian housing market and the need to **prioritise the maintenance of a viable and profitable LMI industry and to ensure the Scheme does not crowd out the private LMI sector.** We look forward to continued consultation on the development and implementation of the Scheme to ensure this objective is achieved.

Please do not hesitate to contact Kate O'Loughlin at [redacted] if you would like to discuss any aspect of this submission, or if you require any further information.