SUBMISSION 10

New ways of thinking

23 July 2007

Andrew McGowan
Inquiry Secretary
Parliament of Australia
House of Representatives Standing Committee on
Economics, Finance and Public Administration
By email: andrew.mcgowan.reps@aph.gov.au

Dear Mr McGowan

Submission for the inquiry into home lending practices and processes

PMI Australia appreciates the opportunity to provide the enclosed background material for the inquiry into home lending practices and process by the House of Representatives Economics Committee and looks forward to attending the hearing.

Our submission is enclosed. Please let us know if you require any further information or detail.

Yours faithfully,

Ian Thomas Graham
Chief Executive Officer

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Submission for the inquiry into home lending practices and processes

PMI

1. Introduction

PMI Mortgage Insurance Ltd (***PMI Australia***) greatly appreciates the opportunity to present to you some background material pertinent to your deliberations into home lending practices. We also offer some material dealing with the support mechanisms that underpin the residential mortgage market in Australia outlined in Appendix A and will, if this should be of assistance, provide some associated contemporary data on mortgage defaults that may assist your enquiry. Please do not hesitate to let us know if you require further information or clarification on any of the matters noted below.

PMI Australia is a locally incorporated licensed mono-line lenders mortgage insurer. PMI Australia is wholly owned by PMI Mortgage Insurance Co. (***PMI MIC***) (an Arizona corporation) and ultimately owned by The PMI Group, Inc. a Delaware Corporation listed on the New York Stock Exchange (***TPG Group***) and one of the largest providers of lenders mortgage insurance (***LMI***) in the world.

PMI Australia has been operating in the Australian market for 40 years and has extensive experience and expertise in understanding residential mortgage risk.

Australia has relatively sophisticated and efficient primary and secondary mortgage markets, along with extremely high levels of homeownership by global standards. We set out below specific commentary in relation to the matters under consideration by the Committee however, in summary:

- We are coming off a period of very strong growth and now are starting to see a period of adjustment where arrears rates and claims are currently at levels that have not been seen for sometime, **although they are still quite low by historical standards.**
- It is difficult to make generalisations about "declining credit standards". Our experience is that different products behave in different ways. Also different sectors and in fact different lenders approach the assessment of credit in different ways. What can be said is that the competitive nature of residential mortgage lending and the recent benign economic experience of the last 10 years have been the drivers of significant innovation and changes to traditional lending practices.
- The independent lenders mortgage insurers play an important role in helping to exert market discipline and encourage the maintenance of prudent lending practices in the Australian residential mortgage market.

2. Lenders mortgage insurance

LMI was introduced into Australia in 1965 to enable first home buyers to "bridge the deposit gap" which was at that time, and still is, a significant impediment to achieving homeownership.

LMI protects a lender in the event of a borrower credit default on a residential mortgage loan. If the security property is required to be sold as a result of the credit default and the sale proceeds do not cover the outstanding loan balance, LMI covers the lender for the loss.

Following the deregulation of bank mortgage interest rates in 1986, the major banks, with the support of the LMI industry, entered the high loan to value segment of the home lending market. The major banks account for approximately 50% of all high loan to valuation ratio (***LVR***) lending today.

Prior to that time, first home buyers were restricted to borrowing up to 80% of the value of the property from the savings bank, and then borrow the remainder from either the trading bank arm of the bank or from another finance company – generally at much higher rates than the loan obtained from the savings bank. Building societies also provided high LVR loans with LMI when the loan exceeded 75% of the LVR.

Currently, authorised deposit taking institutions (***ADIs***) obtain LMI for two principal reasons. First, they can obtain a 50% capital concession for housing loans over 80% LVR if they have LMI. Second they transfer the credit loss. **Therefore, they do not have to charge a higher interest rate to cover the additional capital requirement or credit risk**. Credit risk loss exponentially increases as LVR increases.

The mechanism has given confidence to lenders, allowing them to compete in the marketplace, and it provides a capacity for the lender to stand by the loan in the event of consumer default, potentially allowing time for the borrower to rectify the loan and resume mortgage repayments.

Accordingly**, the LMI industry has played an important role in enabling home buyers (with low equity in range 0% to 20%) to purchase a home sooner than would otherwise be the case**, if they had to save a 20% deposit before being able to obtain a loan. A large portion of this high LVR market segment is first home buyers. This support has been critical for the provision of and ongoing support of the First Home Ownership Scheme. Without such a risk offset mechanism through LMI, it is unlikely the First Home Ownership Scheme would exist unless the Federal Government had offered its own guarantee along the lines of the former HLIC.

LMI also plays a key role in providing credit enhancement that underpins the mortgage backed securitisation market enabling non bank lenders to access capital. Securitisation has promoted competition in the home lending market as mortgage originators have been able to compete with the ADIs on price and other features, resulting in a significant fall in margins earned by lenders on housing loans with obvious flow on benefits for borrowers.

When one considers the fact that housing loans make up more than half of the assets of most ADI's, the LMI industry therefore plays a critical role facilitating efficient management of capital and risk in the banking system and it provides systemic housing loan risk protection by transferring risk outside the banking system.

That capacity is critical at times when the financial system and the residential mortgage component of the system is under stress - as it is in certain areas today. Ultimately, it is the consumer that bears the brunt and the cost of such systemic dysfunction.

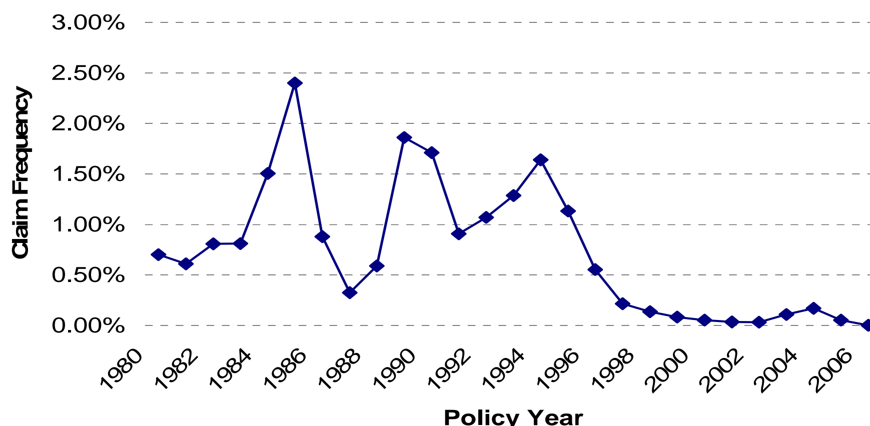
3. Current home lending practices and processes

3.1 The nature of residential mortgage risk

Residential mortgage risk is long term risk that is generally cyclical in nature. Large credit loss periods arising from residential mortgage risk are generally created by future events that are correlated to economic factors (eg increases in unemployment, increases in interest rates, reductions in nominal house prices, recessions). Low arrears and defaults occur in times when these factors all work in a positive direction. However, when these factors work in a negative fashion, these factors tend to affect many properties simultaneously in a geographic region (eg city, state or in some circumstances, the entire country). As long as there is a residential property market, property prices will go up and, inevitably, at some point in time will come down again.

It is widely acknowledged that the benign economic conditions of the last 10 years are anomalous and this is clearly demonstrated in the attached chart outlining the historical LMI claims experience by policy year.

Chart 1 – Total claim frequency

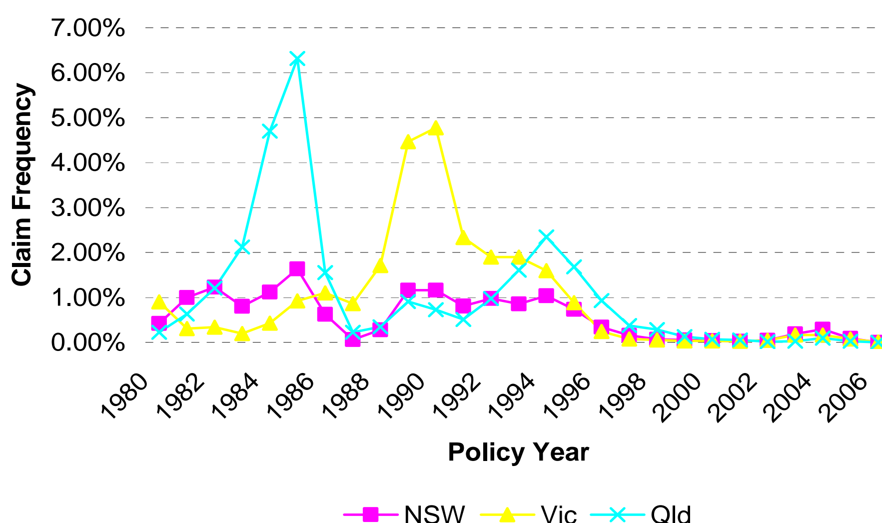


As the data is on a policy year basis some development in the frequency of claims is expected to emerge for the more recent policy years.

We are coming off a period of very strong growth and now are starting to see a period of adjustment where arrears rates and claims are currently at levels that have not been seen for sometime, **although they are still quite low by historical standards.**

The Australian residential mortgage market is made up of a number of submarkets. Even within states, certain areas can perform in quite different ways (eg recent experiences in Western Sydney). The current stress experience is generally limited to a number of submarkets and is not widespread.

Chart 2 – claim frequency by state



With affordability constraints causing a property market slowdown and consequent price declines in areas of Sydney, it is not surprising that this market has contributed most to the increase in both loans in arrears and also the proportion of claims.

However, it must be noted the rise in arrears and market risk is still relatively low compared to previous downturns we have experienced in the property market and is supported by increased consumer spending, a strong resources sector, low unemployment and historically low interest rates which continue to underpin strong economic growth.

3.2 Credit standards in Australia in recent years

Credit standards have certainly changed in recent years as products have evolved in the market and the consumer's appetite for debt has increased. However, it is difficult to generalise that credit standards have declined as different sectors and in fact different lenders, approach the assessment of credit in very different ways. What can be said is that the competitive nature of residential mortgage lending and the recent benign economic experience of the last 10 years have been the drivers of significant innovation and changes to traditional lending practices. Also the substantial rise in housing prices over the last cycle and resulting rise in home equity has increased the collateral for borrowing. Relatively low nominal interest rates have also encouraged households to leverage on this collateral to finance spending. Coupled with more sophisticated delivery and risk management systems by lenders and a vastly increased consumer appetite for debt and convenience, the residential housing market in Australia has seen a number of changes to traditional lending including (to name a few):

- the expansion of the role of the broker or mortgage originator;
- movement up the risk curve to include the introduction of "non-standard" products (lowdoc, no doc, equity share mortgages, reverse mortgages, high loan to value (***LVR***) lending, asset lending etc);
- changes to methodology in debt servicing calculations;
- the use of alternative property valuations;
- the increased role of securitisation in funding non bank lenders; and
- the introduction of "non-conforming" lenders.

While some of these innovations may herald a movement into higher risk areas, it should be acknowledged that this competition and innovation has played a very significant role in improving access and affordability for borrowers to enter or remain in the housing market. As the Committee is aware, affordability concerns continue to remain front of mind for many home borrowers. Without such innovation, it is likely there would be significantly greater pressure for government substitutes to maintain at least the same level of affordability as present.

3.3 Have declining credit standards caused an increase in arrears and repossessions?

Again it is difficult to make such a generalised statement. PMI Australia's experience is that different products behave in different ways and the loss experience of lenders also differs. PMI Australia typically does not insure credit impaired loans.

Standard loans account for the vast majority of the Australian mortgage market. These loans require full documentation.

Low doc loans are those for which borrowers self-verify their income in the application process. They are designed primarily for the self-employed or those with irregular incomes who do not have the documentation required to obtain a standard home loan. Within Australia this sector has been growing rapidly over the past five years. Typically however, the average LVR is much lower than standard loans. Due to the increased risk profile, ADIs and insurers are required by APRA to hold higher levels of capital to compensate.

No doc loans are those which require no evidence of or even declaration of income; they simply request the borrower to sign a statement asserting that they can afford the repayments. These loans are a relatively new phenomenon in Australia of which there is little experience to demonstrate arrears and default levels.

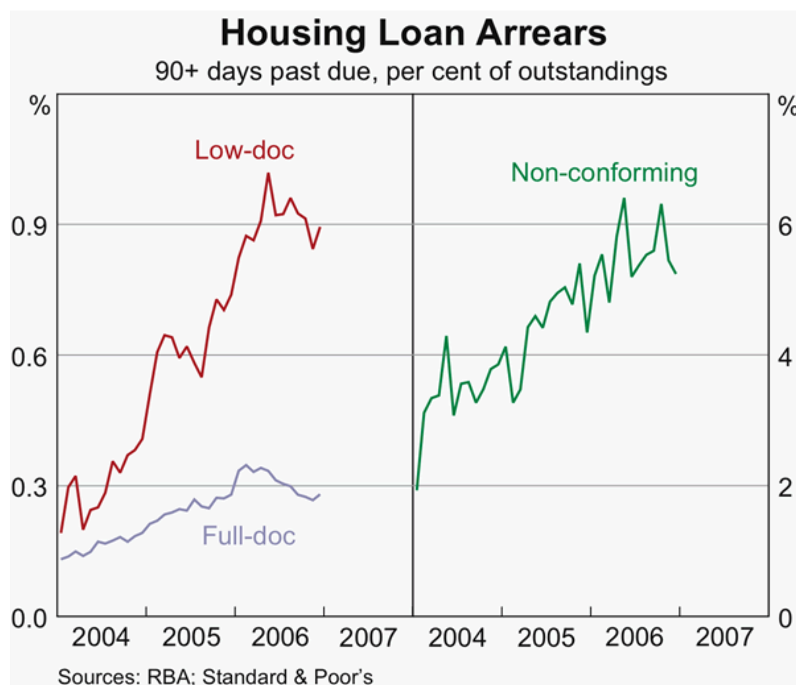
PMI Australia has been operating in the Australian market for 40 years and uses this data and experience to estimate the amount of loss characterised by particular types of lending across various cycles in the housing market. PMI Australia's expectation and experience shows that low doc loans and high LVR lending is generally more risky that prime or standard loans.

This is consistent with current market experience as reported by lenders to APRA and Standard & Poor's RMBS recent arrears statistics report (May 2007). In this report, Standard & Poor's arrears comparison as at May 07 is:

- Full doc SPIN – 1.01%
- Lowdoc SPIN – 2.37%
- Prime SPIN 1.15%.

Also, in its recent Financial Stability Report, the Reserve Bank of Australia comments that the general pattern of rising arrears in 2004 and 2005 (and little change in 2006) is evident

in the data for standard loans, low doc loans and non conforming (credit impaired) loans at 0.28 per cent, 0.89 percent and 5.25% respectively.



Source – RBA Financial Stability Report March 2007

However, the Reserve Bank goes on to say:

> …*While the overall picture suggests that in aggregate, the household sector is coping well with the higher levels of debt and interest servicing, there are some limited pockets where the financial stress is evident. Areas of western Sydney, in particular, look to have been adversely affected by the fall in residential property prices, with a disproportionate number of households in this area taking out loans with high loan to valuation and debt-servicing ratios near the peak of the house price boom…*[1]

3.4 Are borrowers in financial difficulty being treated appropriately by lenders?

In PMI Australia's experience, our customers work closely with borrowers to preserve home ownership where possible in accordance with regulatory obligations. It also makes good commercial sense to canvass all feasible options to assist the borrower.

From PMI Australia's perspective, our policy is to work in close co-operation with lenders in a supportive way to preserve home ownership where possible. PMI staff will always encourage a lender to explore all feasible possibilities of resolving a default rather than resorting to forcing a sale of the security property.

PMI Australia also supports our lenders in offering immediate relief packages in emergency situations. For example, attached as Appendix B is our recent response to storms and flooding across various regions in NSW and Victoria in the case of hardship arising from the loss or damage of property or loss of income.

[1] Reserve Bank of Australia, Financial Stability Review, March 2007, pp16,17

3.5 Are declining credit standards likely to have any long-term implications for the Australian financial system?

The US sub-prime collapse has become a global phenomenon; its potential knock on effect within Australia is one of the most talked about phenomena of recent months.

In answering speculation about the potential knock on effect to Australia, the general view is that it could not happen here; the non-conforming (or credit impaired) market in Australia is much smaller and less aggressive than that of the US, and underwriting standards and product innovation are more conservative. Also considerable stress testing and review of the residential mortgage market has been undertaken in recent years in view of the importance of the housing market in the economy. In the current stable economic climate, problem housing loans remain low by historical and international standards.

As previously indicated however, residential mortgage risk is long term and cyclical and appropriate risk identification, management and risk mitigation is essential. What has been apparent in Australia, in echoing the move towards high risk and non conforming loans, is a departure from traditional lending practices. There can be no room for complacency in this sector, as has been demonstrated by other markets around the world.

PMI Australia has previously raised concerns with the Committee in relation to APRA's Basel II proposals in so far as they relate to residential mortgage risk. PMI Australia reiterates its view that there are potentially negative unintended consequences that may flow from the implementation of APRA's proposed Basel II capital reforms on the residential housing and lending market. If the APRA interpretation and implementation of the Basel II accord does, as we foreshadow, have negative unintended consequences, ultimately it will be the consumer who will bear the brunt and cost of this dysfunction.

PMI Australia believes there should be broader and more transparent debate on these issues.

PMI

1. LMI operations – market discipline

1.1 Market discipline

The independent lenders mortgage insurers play an important role in helping to exert market discipline and encourage the maintenance of prudent lending practices in the Australian residential mortgage market. This is demonstrated in a number of ways including:

- providing information and expertise to the market and customers;
- providing parameters of "acceptable risks" by setting credit policy and practice boundaries;
- providing a "second set of eyes" on customers' overall credit operations (policy and practice) for residential mortgages;
- providing post quality assurance reviews;
- working with customers to address and improve compliance issues; and
- working with customers to address and improve default and claims management.

1.2 Information and expertise

PMI Australia has been operating in Australia as a lenders mortgage insurer since 1965. Over this time, PMI Australia has developed a deep understanding and collected extensive data on the risk factors that underpin the long term and cyclical nature of credit risk in the residential mortgage markets.

PMI Australia is in a position where it is able to develop a whole of market view given its close examination of the lending market. PMI Australia constantly monitors local, regional and national economic conditions. By studying population growth, employment growth, the supply of existing housing, housing starts and other economic factors, and having the expertise and data to assist in assessing the underlying risk, PMI Australia has developed an important risk assessment and scoring capability to assist in predicting the likelihood of residential mortgage default. These tools were developed in partnership with our US parent, utilising PMI Australia's extensive historical data and based on the key risk drivers of Australian residential mortgage claims.

PMI Australia uses these tools and the expertise it has developed in its day to day operations. PMI Australia also uses these tools to analyse, inform and educate the market and its customers of trends and risk factors impacting the residential housing market.

PMI Australia also works extensively with its individual customers to assess and analyse their portfolios to support the improvement of their residential property mortgage risk management. PMI Australia uses its tools and expertise to help relevant customers review their individual portfolio exposures and scores (compared to PMI Australia's consolidated book), credit policy, concentration of risk, exposures in particular segments, particular pools of loans and so on.

PMI Australia is also a key player in the credit enhancement of Australian RMBS. Again, because of PMI Australia's expertise and deep understanding of the market, the securitisation industry looks to PMI Australia as an expert in assessing RMBS credit risk.

1.3 Influencing credit standards and better practices

As a lenders mortgage insurer, PMI Australia directly and indirectly influences the credit standards of lenders. Residential mortgage risk is long term risk and LMI is recognised as a catastrophe insurance line. Due to the long term nature of the risk, and coupled with PMI Australia's whole of market view, PMI Australia plays a role in directly influencing the residential market when setting its policy.

The ever increasing cost of housing and the competition in the mortgage lending market has spurred the expansion of lending products to meet market needs.

The competitive nature of residential housing lending leads our customers to innovate and continually expand their lending products. While PMI Australia is constantly requested to expand its appetite for risk to meet the continually changing market demands, we draw from our longstanding knowledge and expertise in managing residential property mortgage risk and use sophisticated risk management to assess what is acceptable and what is unacceptable long term risk. In the process we develop the parameters upon which PMI Australia is prepared to insure the particular product. Typically, PMI Australia will undertake a review of:

- the potential market size of the proposed product;
- expected risks of the product including economic factors, expected losses, competitor reaction and ethical risks;
- possible experience of our US parent;
- risk mitigants that can be utilised; and
- loss levels in a normal market.

In doing so, PMI Australia influences the market by setting parameters of "acceptable credit risk" by its credit policy and practice.

Examples of this are numerous over the years but include imposing restrictions on insuring loans for:

- high density inner-city dwellings (implemented around 2001);
- specific post-code locations (see PMI location wizard);
- certain types of properties;
- lowdoc lending above 80% LVR;
- lowdoc lending for PAYG borrowers; and
- non-prime lending.

By way of specific example, the Committee is aware of the growth over the last 5 years of "lowdoc" lending. Lowdoc loans originally grew out of the need to provide faster finance to self employed borrowers. For lowdoc loans, PMI Australia will not accept PAYG borrowers as the primary applicant and requires as part of its underwriting criteria that the borrower has an ABN for its business (generally for a period of 2 years prior to the application).

1.4 Working with lenders – a second set of eyes

PMI Australia indirectly influences credit standards and lending practices by working with individual customers to improve risk management by assisting the customer to understand the risk-rewards at both a portfolio and individual deal level. This can include working with the customer on credit policy, underwriting, e-

business solutions, quality assurance reviews, reporting, claims management and data matching.

PMI Australia's policy is to consider applications for mortgage insurance only from lenders who have satisfied our approval or accreditation process. This review includes consideration of the following factors:

- it is an established organisation with experience in residential mortgage lending;
- it is financially sound;
- it has acceptable loan default rates;
- it has commercially sound lending policies and guidelines;
- it has competent loan management and assessment personnel; and
- it has sound loan administration and collection practice.

PMI Australia works with its customers to ensure appropriate parameters are in place when accepting LMI risk. A brief outline of PMI Australia's approach in these areas is set out below.

1.5 Underwriting

Once a lender is approved, underwriting guidelines are implemented, developed or tailored depending on the arrangements between the parties.

Generally, PMI Australia will enter into arrangements with its customers to provide:

- **Direct underwriting -** in accordance with the underwriting guidelines and arrangements agreed with the specific customer.
- **Delegated underwriting authority** (***DUA***) - to specific lenders who have well established credit processes, policies and practice. Compliance with DUA is expected to be high and is subject to hindsight review of issued policies using AURA to identify higher risk policies (see below).
- **E-business -** to specific lenders to enable the electronic transmission of data for underwriting by PMI Australia or with DUA for specific customers.

1.6 Quality assurance reviews

PMI has a formal hindsight quality assurance process covering all areas of underwriting. On a monthly basis underwriting reviews are conducted on:

- **Direct underwriting -** Individual underwriters' compliance with policy and their individual delegations are reviewed.
- **DUA -** All DUA customers' underwriting is sample reviewed for policy compliance. Results are reported to each customer and PMI Australia works with them to improve future outcomes.
- **E-assurance and claims assurance -** E-assurance or claims assurance customers are subject to additional review of the data quality.

PMI Australia's customers view the quality assurance process as an important value added process that highlights areas for improvement. As defaults and claims increase, we are also seeing increased focus by customers on the better management of operational risk.

1.7 Data matching and rightsizing

PMI also works closely with lenders to cleanse expired policies (where the loan has been paid out) and improve the quality of data held.

1.8 Arrears reporting and claims management

This has resulted in a focus by PMI Australia to work in close co-operation with lenders to assist and support our customers in resolving defaults and administering and managing the insured mortgage. PMI Australia's policy is to encourage the lender to preserve homeownership where possible and where resolution is feasible.

2. The nature of LMI capital

2.1 PMI Australia's on shore assets

PMI Australia is highly rated[2] and part of a highly rated group of insurance companies whose ratings are interdependent. As an Australian licensed lenders mortgage insurer, PMI Australia is subject to APRA's specific regulatory capital requirements for lenders mortgage insurers, which are significantly higher than those currently applied for general insurers.[3] In addition, PMI Australia, in order to maintain its high rating, must adhere to the rating agency capital requirements that either meet, or in some instances, exceed APRA capital requirements.

PMI Australia maintains liquid, high credit quality conservative investments in uncorrelated assets in accordance with the investment mandate that is approved by the Board from time to time. PMI Australia's investment portfolio consists mainly of high-grade Australian currency-denominated, fixed income securities issued by sovereign, semi-government and corporate entities, with a small allocation of equity securities. The entire bond portfolio is rated investment grade. PMI Australia **does not** invest in residential properties or in investments backed by residential mortgages (eg RMBS). This non-correlation of insurance risk and asset risk helps to ensure that PMI Australia will retain sufficient capital to pay all claims, during times of severe financial stress within Australia. This same non-correlation of asset risk and insurance risk exists throughout the PMI Group of companies, mandated by overlapping regulatory requirements, rating agency requirements and internal policy.

2.2 International diversification

The TPG Group, through its consolidated and unconsolidated subsidiaries, has a global presence in a number of different countries and economies including:

- United States of America
- Europe and the United Kingdom
- Hong Kong
- Canada (mid 2007)
- Australia and New Zealand

[2] Rating Agencies (1) Standard & Poor's "AA" Rating, (2) Fitch "AA" Rating and (3) Moody's Investors Service "AA" Rating

[3] Australian Prudential Regulatory Authority (APRA) 2006, GPS 110 Capital Adequacy
Available from: http://www.apra.gov.au

PMI Australia believes that there is further diversification benefit provided to the Australian banking sector where LMI is provided by PMI Australia. This is because PMI Australia is part of the TPG Group, which itself is diversified internationally.

The Australian banking sector benefits in three ways from the risk diversification provided by PMI Australia and the TPG Group. First, PMI Australia's insurance portfolio is geographically diversified within Australia. This geographic diversification creates measurable capital benefits to the combined banking and insurance systems. Second, as noted previously, PMI Australia's capital is invested in assets whose risk is not correlated with the insurance risk PMI Australia writes. This provides greater assurance to policyholders that in the event of a severe downturn in Australian residential real estate markets, the value of PMI Australia's investment assets will be retained, providing the means for the company to pay its claims.

The third way in which the Australian banking sector benefits from the risk diversification provided by PMI Australia and PMI MIC is from the lower risk correlation between the two major markets served by the insurance entities - the United States and Australia. There is less than a 1:1 correlation of GDP growth between the Australia and the United States.[4] In addition there is actually a negative correlation between the United States and Australia on employment growth[5], which is a key driver for mortgage defaults and claims. This lower risk correlation between the two major markets creates a lower probability that both PMI Australia and its U.S. parent, PMI MIC, will be experiencing economic stress simultaneously. This should drive greater certainty that there will be sufficient financial resources available to policyholders to honour all claim obligations.

3. Claims payment willingness

LMI has been an integral part of the funding and capital equation for ADIs and non-bank lenders in the Australian residential mortgage market for nearly 40 years. Lenders mortgage insurance requires a long term commitment in terms of understanding the nature of the risk in the market, carrying the capital to support that risk and working directly and indirectly with the market to influence credit standards and processes.

Lenders mortgage insurers have a unique economic incentive to work with customers to ensure appropriate management of the arrears, default and claims process. It is generally uneconomic to routinely challenge the obligation to pay a claim. Also the reputation with lenders who purchase LMI and the future goodwill and development of LMI business, are both dependent on the fact LMI providers will pay all valid claims in a timely fashion.

As such, PMI Australia also has a strong commercial incentive to work with its customers to maintain prudent lending practices in the Australian residential market.

PMI Australia's willingness to pay claims is a fundamental tenet of the LMI value proposition. PMI Australia's ability to pay claims is clearly acknowledged by the ratings agencies.

5 Further information

PMI Australia would be pleased to elaborate or provide further information on any of the matters referred to.

[4] Understanding OECD Output Correlations, Otto, Voss & Willard (September 2001)

[5] International Business Cycles: Theory vs. Evidence, Backus, Keyhoe & Kydland