SUBMISSION 6

Mr. Andrew McGowan
Inquiry Secretary
House of Representatives
Economics Committee
Parliament House
Canberra ACT 2600

Friday, July 20, 2007

Dear Mr. McGowan

INQUIRY INTO HOME LOAN LENDING PRACTICES AND PROCESSES

I refer to the Committee's letter to Genworth Financial dated 19 July 2007 concerning the upcoming Inquiry into current home lending practices and processes in Australia and, in particular, current practices for dealing with people in financial difficulty. Genworth Financial is pleased to make this submission and looks forward to participating in the roundtable discussions on Friday, 10 August 2007.

GENWORTH FINANCIAL

Genworth Financial is a leading provider of Lenders Mortgage Insurance (LMI) and credit enhancement solutions in Australia and New Zealand.

Together with our predecessor business (Housing Loans Insurance Corporation and GE Mortgage Insurance Services), we have insured over AUD $250 billion of residential mortgages since 1965. We have in excess of AUD $2 billion of capital invested in Australia and support over 200 lenders in the mortgage market. Approximately one in every five residential mortgages is insured.

Internationally, Genworth Financial is a leading financial security company with strong and expanding global operations, serving more than 15 million customers. Genworth Financial currently offers mortgage insurance in over 25 countries, including the U.S., Canada, Australia, Japan, Mexico, the U.K. and continental Europe.

LMI

Introduced by the Federal Government in 1965 to facilitate home ownership, LMI has assisted over 2 million Australians to purchase a home notwithstanding the lack of a sufficient deposit – thus promoting home ownership in Australia. LMI is designed to ensure lenders can prudently expand their lending boundaries to lend to a broader selection of individuals. As a product, LMI protects the lender from loss should a borrower default on their residential mortgage (and the net proceeds from sale of the insured property are not enough to cover the outstanding loan balance).

LMI is generally acquired by approved deposit taking institutions (**ADIs**) on high loan-to-value ratio (**LVR**) mortgages, typically over 80% and up to 97% LVR. ADIs currently obtain a regulatory capital concession for obtaining LMI in respect of high LVR standard loans and non-standard mortgages (generally defined as low doc and no doc mortgages). Non ADIs also use LMI quite extensively to credit enhance their RMBS issues, thus ensuring that they obtain cost effective funding in the capital markets to fund their growing mortgage lending operations.

LMI helps to promote financial system safety and soundness. LMI providers are regulated by APRA as mono-line providers (this is the only line of insurance LMI providers are authorised to issue). This means that LMI providers have an extremely focused approach to risk management, as their capital is at risk in relation to high loan-to-value ratio mortgages. This risk management discipline helps minimise upswings and downswings in the economic cycle and introduces third party discipline to both underwriting and portfolio and arrears management.

1. Credit Standards in Australia

We agree with the general view of Dr Laker, in a recent speech to the Institute of Chartered Accountants in Australia[1] that "*ADIs have been willing to move out the risk spectrum by loosening their credit standards, around the edges certainly*".

Given Australia's historically low default levels, our view is that broadening the risk spectrum isn't necessarily a bad thing, provided it is accompanied by an increased risk management focus and attention to ensure this increased risk is prudently managed. While some lenders have invested heavily in this area through prudent processes and procedures, we are not seeing this evolve in a uniform manner throughout the 200 lenders across the regulated and non-regulated sectors.

An increase in higher loan-to-value (LVR) lending, or loans with a lower deposit has been an industry trend over recent years. It is important to note that an increase in high LVR lending does not automatically equate to a decline in credit standards. The increase high LVR lending in recent years can largely be attributed to the obstacles many borrowers have in saving up a significant deposit to acquire a property.

This was illustrated in a recent report released by Genworth Financial, the 2007 Mortgage Trends Report, a copy of which is **enclosed** with the hard copy of this letter[2]. This Report, based on a survey of 2000 Australians, focussed on property ownership, entry into the property market and managing debt. Highlighted was the level of declining housing affordability over the past ten years and it was noted that the biggest obstacle to entering the property market was the inability to save a deposit. In our opinion, any attempt to set LVR lending caps or similar restrictions will only serve to exclude legitimate first home buyers from entering the market sooner with the support of products such as LMI.

Set out below is a list of areas in which Genworth Financial helps to maintain prudent lending practices:

We Are Involved In Determining Credit Policy For Prime High LVR Loans:

- We issue detailed underwriting guidelines setting out our credit policy for high LVR loans that we are willing to insure
- We provide an independent underwriting review of a large proportion of all proposals submitted to us for insurance
- We agree on processes and policies with lenders and undertake audits and quality assurance reviews on a continual basis

We Provide Guidelines & Train Industry On Underwriting And Verification:

- Detailed verification policy lays out exactly what's required for underwriting
- We provide underwriting training, and help up-skill our customers' underwriting teams

We Double Check Valuations and Help Lenders Develop Valuer Panels:
- Trained Valuers are on staff to review high loan balances and risky valuations (we have a 20% pushback rate)
- Our "Valuer Watch List" & "Security Location Guide" ensures suitable security or collateral

We Actively Monitor Broker & Originator Performance:
- Scoring techniques are used to identify high-risk loans, and underwriting is adjusted accordingly
- Process & policies are routinely audited - an unacceptable review results in "full re-underwrite" or disaccreditation

We Decline $2 Billion of Loans Each Year ($25 million of Premium):
- With each decline, we give feedback to the relevant lender / originator
- We run fraud and "watch list" screens against every policy

Genworth declines between 5% and 10% of all proposals for LMI submitted to it each year. This decline rate has remained steady within this range for several years. Often, these declined mortgages are then resubmitted using a different product in the sub-prime market, where lenders such as Liberty, BlueStone, Pepper Home Loans and GE Money participate. Genworth Financial does not insure sub-prime loans.

As outlined above, LMI providers such as Genworth Financial have a strong incentive to maintain prudent lending practices.

1.1 Current issues

Notwithstanding the above comments, we believe there are a number of issues within the mortgage lending industry in Australia that need to be addressed in order to ensure the maintenance of robust credit standards in housing lending as outlined below.

- **Lack of industry consistency concerning loan verification:**

One of the current key issues for the mortgage lending industry is the lack of industry consensus on what it actually means to verify or validate the information contained on a loan application. Genworth Financial has reviewed hundreds of loan files in the past 12 months. Based on that review, we believe that the industry has, in an increasing number of cases, adopted a "tick and flick" mentality and failed to apply appropriate rigour and robustness in implementing appropriate procedures to verify or validate the accuracy of information contained on a loan application form. This led Genworth Financial to releasing minimum verification guidelines for all loans subject to Genworth LMI assessment in early 2007. A copy of these guidelines is **enclosed** with the hard copy of this letter.

- **Lack of industry consensus around servicing**

We endorse the comments of Dr Laker in his recent speech[1] concerning the vast differences in methodology and assumptions across debt servicing policies. Genworth Financial believes these vast differences and resulting lack of consistency has resulted in quite a degree of "forum shopping" amongst borrowers and brokers.

- **Subsequent appetite for consumer debt**

Whilst it may be fair to criticise the quality of the initial credit assessment for a residential mortgage loan in some cases, in many other cases a hindsight review of the credit underwrite at the time of application of the residential mortgage loan will reveal that a prudent assessment was undertaken at that time. Commonly, we have come across many situations in which borrowers obtain significant consumer debt after acquiring the mortgage in order to

buy household goods such as plasma TVs, motor vehicles and other household consumables. The increased financial burden associated with this additional consumer debt often triggers a move to refinance both the consumer debt and original mortgage loan into a new mortgage facility. Genworth Financial has witnessed a significant difference between the probability of default for an owner-occupied loan and a loan that has been refinanced in an endeavour to consolidate debts, with the latter having a default rate approximately two and a half time that of an owner-occupied loan.

- **Increased reliance on third parties to originate loans**

We further agree with Dr Laker's comments that the increased reliance on third party mortgage originators and brokers to originate and, in some cases, perform the credit underwrite on a loan application has led to increased risk associated with residential mortgage lending. These parties' interests are often misaligned with the ultimate credit provider and LMI provider in the sense that they are remunerated on a commission basis and bear no real risk associated with the loan defaulting.

1.2 Scope For Improvement

Listed below are factors we believe will assist the industry to help achieve and maintain more robust credit standards.

- **Effective regulation of the Non-ADI sector**: We believe that the competitive pressure imposed on the ADI sector by the non-ADI sector has contributed to a loosening of credit standards within the ADI sector in an endeavour to 'remain competitive'. We believe effective regulation of the non-ADI sector will contribute to addressing this issue.

- **Greater industry consensus around loan minimum verification and servicing requirements**: We believe the entire residential mortgage lending and LMI sectors would benefit from more prescription by APRA in the area of minimum loan verification requirements and minimum debt servicing requirements.

- **Positive credit reporting**: Genworth Financial supports recent initiatives concerning the moves towards a positive credit-reporting regime in Australia. This will enable lenders and LMI providers to have a more informed assessment of a borrower's financial history and help lenders more easily identify those potential borrowers to whom credit ought not to be extended at the time of application, thus ensuring that these potential borrowers do not 'get in over their heads'. It should also ensure that more credit worthy borrowers are extended credit on more favourable terms.

- **Anti-Money Laundering/Counter Terrorism Finance Laws**: Genworth Financial believes that the full introduction of these laws in December 2007 will have a positive impact on the residential mortgage lending market as the laws will impose additional obligations on a broad range of participants in the industry, particularly with respect to the requirement to adopt more rigorous 'know your customer' requirements. This should help alleviate the increased incidences of mortgage fraud that have occurred in recent years. A copy of Genworth Financial's recent article: *Managing Fraud in the Mortgage Market* is **enclosed** with a hard copy of this letter[3].

- **The introduction of a mortgage broker licensing regime**, which we understand is unlikely to occur until 2008-2009. We believe this should be a priority for government and regulatory bodies. Once enacted, this legislation should ensure that rogue elements are forced to exit the industry.

2. Low-Doc products

Low Doc Loans are offered to borrowers who are self-employed and who are unable to produce current financial information or documentation. Low-doc loans, which were introduced by the non-ADI sector in the late 1990's in an endeavour to meet a need for the growing self-employed and contractors markets, have enabled certain types of borrowers, such as the self-employed, to purchase a home sooner. The vast majority of low-doc loans are granted to professional and skilled self-employed and contract workers who have a high propensity of repaying their loan.

There is a distinction between prime low doc loans, insured by LMI providers such as Genworth Financial, and low doc loans offered by sub-prime lenders such as Liberty and Bluestone, which aren't insured. LMI providers such as Genworth Financial only insure low doc loans up to 80% LVR, and have stringent criteria in place for these types of loans. For example, the borrower must have a clear credit history.

Genworth Financial makes the following points with respect to the history and development of low doc products in Australia:

- Since 1999, Genworth has insured over 100,000 low doc loans and has paid approximately 100 claims.

- Our observation is that low doc loans have performed in accordance with our original expectations. Whilst the product has an arrears rate of approximately double that of a comparable standard loan, this does not translate into the same proportion of increased claims. The higher arrears reflect the nature of the ultimate borrower of a low doc loan, who is typically self-employed and or a non-PAYG employee. This employment status typically results in the borrower having lumpy cash flow and a fluctuating ability to service the loan, particularly compared to a PAYG employee under a standard full documentation loan. However, in our experience with the product over the past 8 years, this increased arrears has not translated into double the rate of claims when compared to an equivalent standard loan, as the arrears will more frequently 'cure' for a low doc loan than for a standard full documentation loan.

- Based on the arrears and claims data at Genworth's disposal, we do not believe that low doc loans are a material contributor to the current increase in mortgage defaults and mortgagee in possession sales. Notwithstanding this, Genworth is of the view that the product has been abused in certain instances, particularly in cases of borrowers seeking to conceal their true earnings, as well as in the case of property developers seeking take out finance.

3. Borrowers in Financial Difficulty

The property market in Australia is slowing in comparison to the strong growth experienced in recent times. As interest rates tend to more normal long-run averages and home price appreciation slows and in some areas reverses, Genworth Financial expects to experience increases in arrears and defaults as we move to a more normal loss environment.

As an LMI provider, we keep a close eye on emerging trends in delinquencies. Our portfolio analysis suggests that many of our delinquencies are the result of unforseen, short-term hardship type circumstances and that by being proactive; many borrowers can be helped to 'get back on their feet'.

From a customer perspective, it was also emerging that there was a large gap in practices across lenders in this area, with some customers having tried and tested arrears management and hardship processes, whilst other lenders are still developing processes and policies in this area. This is largely due to two main factors. First, Australia has not experienced a material level of mortgage arrears for over ten years. Little investment in

people, technology and resources has therefore been made in this time. Secondly, some lending organisations (particularly in the non-ADI sector) have only been established in the last ten years, and may not have fully developed process and policies in this area in any event.

The question as to whether or not borrowers in financial difficulty are being treated appropriately by lenders is one that is best answered by lenders. Genworth Financial makes the following limited comment in response to this point:

- it appears that most lenders do not interpret the hardship provisions of the Uniform Consumer Credit Code as giving rise to any positive obligation to proactively identify instances of borrowers in financial difficulty, although some lenders do this in any event. In our experience, borrowers typically approach lenders.
- Genworth Financial would like to see lenders capturing more data at an earlier stage of the arrears process, that describes the borrower's circumstances for being unable to meet their commitments at that time.

In response to this market dynamic, in 2006 Genworth Financial launched a "Work-Out" program to assist lenders to provide short-term solutions to borrowers experiencing hardship. This program consists of a team of dedicated Genworth Financial professionals monitoring customer delinquency reports to identify any cases where a solution may be applicable. Genworth Financial works together with the lender and the borrower to negotiate a solution aimed at curing mortgage defaults and keeping borrowers in their homes.

Genworth Financial has extremely successful Workout programs in the U.S. and Canada. In the U.S. alone, Genworth has helped over 44,000 families keep their homes in the past ten years.

Since its inception in Australia in 2006 we have received 540 hardship applications and approved 473 of them, with 22 awaiting further information. **This equates to 473 families that have been able to stay in their home.**

Notwithstanding these successes, we believe there are a number of obstacles that are currently limiting the effectiveness of our Workout program. They include:

- **Lender's Collection staff:** We believe that lenders are still finding it difficult dealing with borrowers who have faced a financial hardship. This may be due to high turnover of staff, lack of training or poor systems, or a combination of all three.

- **Lender's processes:** Lenders often refer to 'systems limitations' as to the reason they cannot accommodate solutions available for periods of financial hardship.

- **Super release:** It is common practice among many lenders to have a standard letter that the borrower can send to APRA, when they are in arrears, seeking access to superannuation entitlements before any hardship request will be considered. We have been working with lenders to seek our help in the first instance through a Workout solution, rather than using this option.

- **Arrears reporting:** Many lenders do not obtain and/or record detailed information from borrowers as to the reason for falling into arrears. Without such information, it is difficult to identify true hardship cases.

4. Lessons From the Current Situation in the United States

Obviously the Committee is aware of current developments in the sub-prime lending market in the United States concerning the rapidly increasing level of mortgage arrears. To put things in perspective, arrears levels (90 days past due) for sub-prime mortgages in the U.S. are currently in the vicinity of 15-20%. In contrast, arrears levels for prime mortgages in Australia (90 days past due) are at approximately 0.35%, with arrears rates on sub-prime mortgages in Australia currently between 7%. (Which is approximately 20 times the arrears rate of prime mortgages.) It is also worth noting that the sub-prime market in Australia is currently estimated by the Reserve Bank to be in the order of 4% of all new home loans in Australia. In contrast, about 15% to 20% of all new home loans in the U.S. are classed as sub-prime (being a tighter definition in the US).

As one of the leading mortgage insurers in the U.S., Genworth Financial has a unique perspective on this matter. We believe the following key points can be drawn from the experience in the United States:

- Sub prime lenders in the U.S. have no effective regulatory supervision, with all such lenders being regulated on a state-by-state basis.

- The mortgage insurance industry in the U.S. has only insured a small portion of the total sub-prime market, with sub-prime mortgages typically comprising less than 10% of the entire mortgage insurance industry portfolio. The relative lack of involvement by the mortgage insurance sector in the U.S. has meant limited scrutiny by a third party on the credit standards and origination practices of U.S. sub-prime lenders.

- Sub-prime lending organisations in the U.S. have typically been funded by “hot money” from the capital markets, where liquidity has been in abundance in recent years. This “hot money” has taken the form of untried and untested capital market instruments such has credit default swaps and collateralised debt obligations.

- The development of such instruments, which have been used to fund the growth of the sub-prime lending market, has resulted in lack of transparency in terms of the ultimate owner of the mortgage credit risk undertaken.

CONCLUDING COMMENTS

Genworth Financial insures over 5,000 residential mortgages a week for over 200 lending organisations across Australia and thus often acts as a second set of eyes for the industry for higher risk loans. With over 40 years of data and trends concerning the residential property market in Australia, Genworth Financial is in a unique position to provide commentary and insights on home lending practices and processes. We also help to maintain discipline in credit underwriting standards and practices. The first mortgage insurer to establish operations in Australia, Genworth Financial has built a reputation for being experts in understanding the evolving market. We pride ourselves on working with the industry to overcome challenges as well as developing opportunities for sustained growth and increased homeownership across the country.

Whilst we believe lending organisations have expanded their lending guidelines in recent years, this has, in our experience, generally been met by increased risk management focus, both from the lending organisation itself and APRA where relevant. Certainly this has resulted in increased usage of LMI in order to support these expanded lending guidelines. The LMI industry has a vested interest in ensuring the maintenance of robust credit standards.

Although the number of loans in arrears and repossessions has certainly increased in the past 12 to 18 months, this has occurred from historically low levels. This submission makes a number of recommendations as to how we believe lending organisations can better serve borrowers in financial hardship situations.

Please do not hesitate to contact the writer if you have any questions, or require any further information, in connection with this submission. Genworth Financial would be willing to participate in the roundtable on 10 August 2007.

Yours sincerely

Peter Hall
Country Executive
Genworth Financial Mortgage Insurance

[1] Dr JF Laker – "Credit Standards in Housing Lending – Some Further Insights", Speech to the Institute of Charted Accounts in Australia, Melbourne 20 June 2007

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[2] See Genworth Mortgage Trends Report
[3] See Spotlight Article: Managing Fraud In The Mortgage Market