SUBMISSION 14

PMI

New ways of thinking

11 July 2008

Mr Craig Thomson MP
Chair
House of Representatives Standing Committee on Economics
Parliament House
Canberra ACT 2600

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

Dear Mr Thomson and Committee members

Inquiry into competition in the banking and non-baking sectors

PMI Mortgage Insurance Ltd (***PMI Australia***) appreciates the opportunity to comment on the issues raised by the House of Representatives Standing Committee on economics and in particular the terms of reference for the inquiry into competition in the banking and non-banking sectors. We look forward to further consultations with the Committee in the coming months and would welcome the opportunity to present to the Committee on pertinent matters.

Background

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***).

Lenders mortgage insurance (***LMI***) enhances the underlying efficiency in the market for housing loans, it improves access to home ownership, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), increases competition and innovation among lenders and reduces barriers to entry in the lending market.

LMI providers in Australia are in a unique position in that they have broad oversight of mortgage lending practices in Australia. The independent LMI providers have a whole of market view given the breadth of the LMI customer base which includes authorised deposit taking institutions (***ADIs***), non-bank lenders, and mortgage managers, originators, brokers and valuers.

Role of LMI in enhancing competition and providing market stability

LMI has historically been a key factor in facilitating higher levels of home ownership in Australia. LMI is widely utilised by Australian ADIs and non bank lenders in order to mitigate the risk involved to lenders in mortgage lending. LMI enables a lender to advance a higher proportion of the purchase price towards a residential property. In Australia an ADI may also obtain capital relief for higher risk loans if those loans are insured with an acceptable LMI provider.

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In addition, the growth of the non-bank lending sector, with the support of LMI companies, has been an important factor in the increased level of competition and product innovation in the housing finance industry. This increased level of competition has generally led to lower lending margins throughout the entire industry, resulting to benefits to all borrowers, but particularly to first home buyers.

LMI plays an important role in Australia in ensuring a stable and competitive residential mortgage market and has a number of broader economic and social policy benefits that need to be recognised. LMI diversifies the risk of mortgage lending amongst lenders, across geography and across time by pooling these risks thereby facilitating efficient management of capital and risk in the banking system and providing systemic housing loan risk protection by transferring risk outside the banking system.

The LMI industry has developed innovative LMI products, in conjunction with both bank and non-bank mortgage lenders, which are more flexible to meet the changing needs and circumstances of first home buyers.

The independent LMI providers adopt responsible practices, operate in a disciplined manner and display prudent risk management, which add to the overall stability of the home buyer market. This has exerted market discipline and has encouraged prudent lending practices in the Australian mortgage market throughout the last 40 years.

Attached to this letter is a more detailed history of the LMI market in Australia and an explanation of the manner in which LMI exerts market discipline.

Economic Benefits of LMI

An analysis of the LMI sector was conducted in 2005 (Economic benefits of LMI) by The Allen Consulting Group. The report was produced on behalf of the Insurance Council of Australia and the major independent LMI providers in Australia (PMI Australia and Genworth).

The report highlighted key economic benefits, among which was the structural underpinning LMI offers to the bank and non-bank mortgage lenders.

The report also identified the following benefits of LMI:

- improving the allocation efficiency of capital markets by pooling and diversifying credit default risk and freeing up capital for lending institutions (and the economy as a whole);
- providing greater access to home ownership, particularly for low income and high risk borrowers;
- smoothing macroeconomic cycles, particularly by facilitating more housing lending at the bottom of the cycle and providing a curb on imprudent lending at the top of the cycle;
- providing an additional level of management of credit risk; and
- facilitating competition and innovation amongst lenders, including reduced barriers to entry.

Residential mortgage backed securitisation (*RMBS)*

The growth of the non bank sector and the use of RMBS has been a critical factor in providing competition in the mortgage lending market over the last 10 years.

LMI has played a pivotal 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 and non bank lenders 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.

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.

As the Committee is aware, the RMBS market has been effectively closed for some time and the effect on the non bank lender sector is marked. The access to wholesale funding has risks and the current market issues have highlighted these issues. PMI Australia in principle supports the proposal of the Australian Securitisation Forum to consider the implementation of an agency model, similar to that applicable in Canada and would be pleased to provide further input over the coming months.

Consultation

PMI Australia has operated in the Australian market for 40 years and has extensive experience and expertise in understanding the Australian residential mortgage market. Due to its unique position and important role in the market, PMI Australia believes it can provide a significant contribution to the deliberations regarding competition in the banking and non-banking sectors.

PMI Australia has provided input into a number of industry review processes and would welcome the opportunity to play a key role in industry consultation during the drafting of the inquiry report.

Please do not hesitate to let us know if you require further information or clarification on any of the matters raised in this letter.

Yours faithfully,

Ian Thomas Graham
Chief Executive Officer

Additional Information

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.

ADIs have historically obtained LMI for two principal reasons. First, they can obtain a capital concession for certain housing loans that 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.

This 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 and non bank lenders 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.

Benefits of LMI – market discipline

Market discipline

The independent LMI 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.

Information and expertise

PMI Australia has been operating in Australia as a LMI 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.

Residential mortgage backed securitisation

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

Influencing credit standards and better practices

As a LMI, 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.

Over the last 10 years the residential housing lending market has seen continual innovation and expansion of 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 strategies 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.

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.