Ms Rosalyn Bell, Assistant Commissioner
Productivity Commission
4 National Circuit
BARTON ACT 2600

Email: financialsystem@pc.gov.au

22 September 2017

Dear Ms Bell

INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM
LENDERS' MORTGAGE INSURANCE

The Insurance Council of Australia[1] (Insurance Council) understands that the Productivity Commission is interested in understanding the role and value of lenders mortgage insurance (LMI) in the context of its Inquiry into Competition in the Australian Financial System (the Inquiry).

The Insurance Council appreciates the opportunity to provide this submission focused on LMI to the Productivity Commission. In this submission, we outline the important role which LMI plays in facilitating affordable and accessible home ownership in Australia and how LMI more broadly supports and facilitates competition in Australia's mortgage lending market.

Background information on LMI

LMI was introduced into Australia in 1965, with the establishment by the Menzies Government of the government-owned Housing Loans Insurance Corporation (HLIC – since privatised). The HLIC was established to address structural deficiencies in the highly regulated financial system and its primary purpose was to assist low-income earners with small deposits to obtain housing finance. It did this by insuring lenders against the cost of mortgage defaults.

Where lenders loan more than 80 per cent of the value of the home being purchased, there is a greater risk that should the borrower default on their loan and the property have to be sold, the lender will suffer a loss. 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 able to lend to borrowers who are creditworthy but do not have a substantial deposit.

One of the major benefits of LMI is that it improves access to home ownership by enabling those who would otherwise have difficulty obtaining a home loan, particularly borrowers with low incomes or low levels of equity, to satisfy responsible lending criteria.

[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. June 2017 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $45 billion per annum and has total assets of $124.9 billion. The industry employs approximately 60,000 people and on average pays out about $135 million in claims each working day.

This is particularly beneficial for first home buyers. With the benefit of LMI, many first home buyers are able to:

- buy, move into and accumulate equity in their home much sooner than if they had to save for a full deposit (typically 20 per cent); and
- obtain a loan that may otherwise not be available if the lender could not pass on the risk to an LMI provider.

There is a cost to borrowers in that the lender will typically pass on to them the cost of the LMI premium. Depending primarily on the loan size and loan-to-value ratio (LVR), the average cost of an LMI premium is around $6,500[2]. This however, is usually capitalised into the home loan which means the borrower does not need to pay the cost of LMI up front, but over the life of the loan. When house prices are rising, the accumulation of equity in the home very often exceeds the premium cost in a relatively short period of time. Where markets are stable or falling, it means borrowers can take advantage of market conditions without having to wait until a full deposit has been accumulated. It also means that the first home buyer, if they were otherwise renting, now owns a home and can spend what they were paying on rent in paying down their mortgage.

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

With the median house price transacted in Sydney exceeding $1,000,000[3] and the average gross salary (before tax) being approximately $80,000[4], the significant challenge for a first home buyer is to save for a 20 per cent deposit, a challenge that may take many years to accomplish without LMI.

LMI providers are regulated by the Australian Prudential Regulation Authority (APRA) and are authorised as monoline insurers (meaning they do not provide any other type of insurance). LMI is a general insurance product, governed by the *Insurance Contracts Act 1984*. LMI is a capital intensive business, with LMI providers underpinned by substantial capital strength, both through APRA's regulatory capital requirements and the rating agencies' capital criteria.

The broader role and value of LMI

In addition to enabling accessibility and affordability of housing, particularly for first home buyers, LMI plays a much broader role in the financial system by enhancing the underlying efficiency in the mortgage lending market. LMI contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term),

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[2] Source: Insurance Council of Australia.

[3] Australian Bureau of Statistics Cat. No. 6416.0. Median Price of Established House Transfers Sydney June 2017.

[4] Australian Bureau of Statistics Cat. No. 6302.0. Average Full-time Adult Ordinary time earnings NSW May 2017.

increases competition and innovation amongst lenders, reduces barriers to entry in the lending market, and ultimately improves access to home ownership.

LMI smooths the effects of economic cycles, by facilitating the continuation of home lending at the bottom of a cycle and helping to keep in check imprudent lending at the top of a cycle. This was demonstrated during the Global Financial Crisis (GFC). LMI played a critical role in managing a layer of risk for lenders that could otherwise have had an adverse impact on them when mortgage default rates escalated. The availability of LMI also contributed to the success of the Australian Government's first home buyers' initiative introduced at the time to stimulate the economy.

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

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

Most critically, LMI has been fundamental in facilitating and supporting competition in the residential mortgage lending market.

LMI supports competition in the Australian residential mortgage lending market

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

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

Following the deregulation of bank mortgage interest rates in 1986, the major banks, with the support of the LMI industry, also entered the high LVR segment of the home lending market. A number of the largest building societies converted to regional banks at this time.

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

LMI is currently widely used among lenders offering high LVR mortgages in Australia, including the mutual banks, credit unions, building societies, regional banks, international banks and Australia's four major banks, as well as non-authorised deposit taking institutions (ADIs). About one in four residential home loans are supported by LMI, with up to one-third of these loans for first home buyers.

The support provided by LMI is significant for small and regional lenders as they cannot carry as much risk on their smaller balance sheets as larger ADIs. These lenders typically are often more geographically concentrated in particular regions due to local economic conditions. Therefore, where risk can be pooled market-wide, such as through the use of LMI, individual losses are absorbed within the distribution of all risk held, thereby providing added levels of stability to the Australian financial system. The use of LMI assists these lenders in diversifying their risk, enabling them to enter and compete in the high LVR lending segment.

In addition to diversifying risk, the use of LMI means these lenders can hold less capital for these risks than would otherwise be the case for such loans without the use of LMI. As such, LMI enhances the ability of smaller lenders to compete with larger lenders (i.e. the major banks), which enjoy a competitive advantage in the high LVR segment from having the balance sheet capacity to self-insure and the benefits of a model based approach for regulatory capital.

This is particularly important for smaller lenders with geographic concentration where LMI plays a critical role in enabling them to expand their lending across, for example, regional and rural Australia.

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 and to deliver new technology and new products such as shared equity mortgages.

With the major Internal Ratings-based (IRB) banks writing 76.9 per cent of all new residential mortgage lending in June 2017, down from a peak of 86.3 per cent in March 2009[5], LMI is a critical component of the Australian residential mortgage lending market that enables standardised banks and non-bank lenders to continue to compete in the market and offer high LVR home loans at competitive rates.

Attachment A of this submission canvasses the other significant benefits that LMI brings to the Australian financial system.

Enhancing Competition with the Appropriate Recognition of LMI

Australia's current capital framework for ADIs includes two approaches to determining risk weights for the purpose of calculating capital ratios. These are the:

- **Standardised Approach**: which is the default approach, where 'standardised ADIs' use a common set of risk weights that seek to reflect general risks of different broad asset classes. These risk weights are not tailored to a specific ADI and are set at a conservative level to ensure standardised ADIs are adequately capitalised.

[5] APRA Submission to the Productivity Commission Inquiry into Competition in the Australian Financial System. Page 12 refers.

- **IRB Approach**: which is where accredited ADIs (IRB lenders) use their own internal models to determine risk weights for credit exposures. These risk weights are tailored to the internally assessed risks of the asset and institution, and are more granular than standardised risk weights. To date, APRA has only accredited the four major banks and Macquarie Bank to use IRB models.

The different approaches to regulatory capital risk weights for residential mortgages have exacerbated the competitive imbalance between IRB lenders and those using the Standardised Approach.

This issue was considered in the Financial System Inquiry (FSI) with the FSI recommending mortgage risk weights should be closed to improve competitive neutrality and that APRA should:

> *"Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights'*[6]*.*

In determining the approach to implement this recommendation, the FSI also indicated that

> "*APRA should seek to maintain as much risk sensitivity in the capital framework as possible* ***and recognise lenders mortgage insurance where appropriate***"[7].

A detailed explanation of the significant challenge facing the LMI industry from the current capital requirements regime and the importance of the FSI recommendation is provided at Attachment B.

To help ensure that LMI continues to play its critical role in the Australian housing system of facilitating greater competition between lenders, the Insurance Council submits that the Productivity Commission consider the benefits of recommending that APRA increase the capital required to be held by IRB lenders not using LMI to the same extent as the LMI capital which would have been held had a high LVR mortgage been insured. This would be consistent with the FSI recommendation and would bolster financial and economic stability and improve access to home ownership, particularly through enhanced affordability.

The Insurance Council will contact your office to arrange a suitable time to discuss this with you and we would be pleased to elaborate further. In the interim, please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on (02) 9253 5121 or janning@insurancecouncil.com.au, if you have any questions or comments.

Yours sincerely

Robert Whelan
Executive Director and CEO

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[6] Financial System Inquiry, Final Report, page xxii refers.
[7] Financial System Inquiry, Final Report, page 66 refers (our emphasis).

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ATTACHMENT A

HOW LMI STIMULATES COMPETITION BETWEEN MORTGAGE LENDERS

LMI is a unique insurance product that enables lenders, loan purchasers, and investors to mitigate default risk on residential mortgages by transferring a portion of this risk to LMI providers, which specialise in managing this risk over the long term. Expressed in another way, LMI is used by a lender to insure itself against the risk of not recovering the full loan balance and interest should a borrower be unable to meet their loan payment obligations.

As canvassed earlier, one of the significant benefits of LMI to the Australian financial system is that it supports competition and innovation in the mortgage lending market by reducing barriers to entry and allowing a greater range of lenders, and increasing the choice of lenders and products available to borrowers across Australia.

In this regard, LMI plays an integral social role in Australia, in terms of providing greater access to home ownership for creditworthy borrowers who may otherwise be excluded because they do not have a large deposit or an extended credit history (e.g. young families seeking to buy their first home and small business owners). Indeed, LMI was instrumental in providing support to the Australian Government's first home buyer initiative in 2009 that was instigated to stimulate the Australian economy following the GFC.

LMI Provides Support and Risk Management Experience to Lenders

LMI providers are active in detecting and monitoring potential fraudulent activity across the mortgage industry. They also work closely with lenders, making their expertise and resources available to assist mortgage lenders improve their mortgage origination processes and borrower services. In particular:

- LMI providers have extensive experience in residential mortgage lending risk management and influence the credit standards of their lender customers. Due to the long term nature of mortgage risk, and coupled with LMI providers' whole of market view, LMI providers play an important role in influencing the credit standards of lenders.
- Lenders benefit from LMI providers' long-term view to insuring credit risk – stemming from their sole focus, as monoline insurers, on insuring mortgages. For example, at the peak of a business cycle (i.e. in an overheated market), it is in every interest of LMI providers that lenders do not originate imprudent loans. Therefore, LMI providers play an important role discouraging imprudent lending during such times, and act as an early warning system alerting the market of the riskiest portion of residential mortgages and irresponsible lending practices.
- LMI providers continually monitor lending practices and policies and consider applications for mortgage insurance only from lenders that have satisfied stringent LMI approval or accreditation processes. Even then, approved lenders are subject to regular quality control reviews to ensure ongoing compliance with LMI policy standards and procedures, which helps maintain lender loan origination quality and highlight areas for improvement in lenders' risk management practices.

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ATTACHMENT B

CHALLENGES CONFRONTING AUSTRALIA'S LMI INDUSTRY

Overview

A mortgage LVR of 80 per cent is the effective floor above which there is perceived to be a greater risk of loss arising in a borrower default situation. Consequently, APRA imposes additional capital requirements on lenders where a borrower has less than a 20 per cent deposit. With LMI, the lender has effectively transferred the credit default risk to the LMI provider. As an APRA-authorised general insurer, the LMI provider must hold capital against the risk.

As outlined in the FSI Final Report[8]:

> "*Prior to Basel II being introduced in 2008, all ADIs were required to operate with the same risk-weight model, which resulted in the same capital for a given asset, including loans. Since the IRB approach was introduced, the divergence in mortgage risk weights between the two approaches has widened, as IRB banks have refined their models and adjusted their balance sheets in light of modelled risks. The average mortgage risk weight for an ADI using the standardised model is currently 39 per cent — more than twice the size of the average mortgage risk weight for banks using IRB models, which is 18 per cent.*
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> *IRB risk weights are lower for many reasons, including because this method reflects a more refined calculation of the risks at IRB banks. However, the Inquiry notes that the principle of holding capital relative to risk should apply, not only within an institution, but also across institutions. In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another. This conclusion is supported by the findings of APRA's recent stress test, which found regulatory capital for housing was more sufficient for standardised banks than IRB banks.*
>
> *The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks. Because equity is a more expensive funding source than debt, this translates into a funding cost advantage for IRB banks' mortgage businesses to the extent that the riskiness of mortgage portfolios is similar across banks.*
>
> *Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of smaller ADIs will harm competition in the long run.*"

The difference in capital requirements, if allowed to persist, will continue to make it harder for Standardised lenders (i.e. smaller lenders such as regional banks, building societies and credit unions) to compete with the IRB lenders (i.e. the major banks in Australia) in offering high LVR loans.

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[8] Financial System Inquiry, Final Report, page 61 refers.

Where a lender using the Standardised Approach to credit risk utilises LMI, this is clearly recognised by APRA and the lender does not have to hold as much capital as they otherwise would without LMI. Whilst this also used to be the case with the larger banks that use the IRB Approach, this changed with APRA adopting the Basel II Standard requirements and IRB lenders do not explicitly receive recognition for LMI when determining their regulatory capital requirements given APRA's current "loss given default" (LGD) floor of 20 per cent.

With no explicit recognition for IRB lenders for the use of LMI, IRB lenders are also encouraged to use a combination of alternatives such as 'un-insured risk retention' (charging the borrower a fee and retaining the risk on balance sheet without insurance), waiving LMI (retaining the risk on balance sheet without charging a fee or seeking insurance) or the use of other credit risk mitigants provided by entities not regulated by APRA, along with LMI. This further exacerbates the competitive imbalance between the IRB lenders and other lenders for high LTV, where non-IRB lenders are heavily reliant on the use of LMI.

As the capital required to be held by IRB lenders will remain the same irrespective of their risk management decisions, any move away from using LMI could well result in the capital provided by LMI providers leaving the financial system to the detriment of competition in the home lending market and also system stability.

The Insurance Council submits that in the absence of any regulatory or structural recognition for IRB lenders' use of LMI, the important benefits that LMI provides to the Australian home lending market will be diminished. Consequently, this will place at risk both the accessibility to home ownership and affordability of homes within the Australian housing market.

Financial System Inquiry Recommendation and a Proposed Solution

The role of LMI in the Australian financial system was considered by the FSI in the context of Recommendation 2 of the FSI Final Report[9], which was to raise the IRB mortgage risk weights to narrow the mortgage risk weight differences between lenders using IRB Approach risk weight models and those using Standardised Approach risk weights. The underlying objectives of this FSI recommendation were to:

- improve the competitive neutrality of capital regulation by limiting distortions caused by the differential regulatory treatment of different classes of lender; and
- retain an incentive for lenders to improve risk management capacity.

The FSI recommendation seeks to limit the competitive advantage IRB lenders have gained from the material capital requirement differences, and improve system resilience.

The FSI Final Report indicated that the risk weight gap could be narrowed in a variety of ways and that in determining an approach to implement this recommendation:

> "*APRA should seek to maintain as much risk sensitivity in the capital framework as possible and* ***recognise lenders mortgage insurance****, where appropriate*". [Our emphasis].

The Insurance Council agrees with the FSI that in order to maintain a strong and stable LMI industry and to continue the beneficial impact of LMI for the financial system, the risk weights

[9] Financial System Inquiry, Final Report, page xxii refers.

for LMI-insured loans should appropriately reflect the additional system capital and broader risk mitigants provided by LMI. This should be the case *regardless* of whether a lender is using the Standardised Approach or IRB Approach to credit risk measurement, in the interests of encouraging competition between lenders.

The Insurance Council's proposed solution is that APRA should increase the capital required to be held by IRB lenders not using LMI to the same extent as the LMI capital which would have been held had a high LVR mortgage been insured.

We consider that this proposal – supported by thorough quantitative analysis and industry consultation – is consistent with the FSI recommendation. This would help ensure that LMI continues to benefit the Australian housing and financial systems with greater competition between lenders, as well as bolster financial and economic stability and home ownership access and affordability for Australian communities.