20 September 2024

Committee Secretary
Standing Committee of Economics

Via email: economics.sen@aph.gov.au

Dear Chair

Financial Regulatory Framework and Home Ownership

The Insurance Council of Australia (ICA) is the representative body for the general insurance industry of Australia. Our members represent approximately 90 per cent of total premium income written by private sector general insurers, spanning both insurers and reinsurers. Our work with our members, consumer groups and all levels of government serves to support consumers and communities when they need it most.

As a foundational component of the Australian economy the general insurance industry employs approximately 46,000 people, generates gross written premium of $66 billion per annum, and on average pays out $159 million in claims each working day ($39.4 billion paid out per year).

The insurance industry welcomes government initiatives designed to improve access to home ownership in Australia. Housing plays a critical role in supporting the social and economic wellbeing of Australians.

Lenders' Mortgage Insurance

We note the Committee's interest in understanding "examples of effective priority treatment for aspiring Australian homeowners that do not compromise financial stability."

Lenders' mortgage insurance (LMI), a crucial but sometimes overlooked component of Australia's housing market, is a product that facilitates early access to housing for first home buyers with high loan-to-value ratios (LVR). LMI is an insurance product that protects a lender against the risk of not recovering the outstanding loan balance if a borrower is unable to meet their loan payments and the property is sold for less than the outstanding loan balance.

Typically (although not always), the cost of the LMI premium is passed on by the lender to the borrower as a fee, and the borrower generally has the choice to capitalise the cost of the LMI premium. This means the borrower does not need to pay this cost upfront and instead can spread the cost over the life of the loan.

In addition to facilitating early home ownership, the LMI industry plays a significant role in facilitating the efficient management of capital and diversification of risk in the financial system, providing systemic housing loan risk protection by transferring risk outside the banking system. This is true for both bank and non-bank mortgage lenders.

LMI provides a significant independent layer of capital supporting credit risk default for home lending. Without LMI, lenders would be required to either carry more risk on their balance sheet or reduce their loan book. LMI capital is available during times of increased mortgage defaults, which typically occurs during economic downturns. The deployment of LMI capital reduces losses incurred by lenders and

helps to smooth the impact of economic cycles. This reduces losses incurred by lenders, so they remain strong and able to continue to provide credit during economic downturns.

LMI both facilitates priority access to housing and protects financial system stability, removing a level of risk from the lending system. These benefits are delivered without cost to the taxpayer and less market distortion than government-backed, demand side housing programs.

LMI also facilitates competition among lenders. As the Productivity Commission has noted, LMI provides a way for smaller lenders to manage their risks and "makes them more willing to lend to higher-risk borrowers", which can encourage them to "more fully compete in the home loan market."[1] Increased competition creates more loan options for home buyers at lower interest rates.

While the private LMI market facilitates early access to housing and supports financial system stability, it is currently under pressure.

Most notable among these pressures is the Australian Government's Home Guarantee Scheme (HGS), comprising the First Home Guarantee (FHG), Regional First Home Buyer Guarantee and Family Home Guarantee. The FHG commenced on 1 January 2020, guaranteeing up to 15% of the value of a property for up to 10,000 eligible First Home Buyers (FHBs) each year. The HGS has since been expanded, providing up to 50,000 guarantees per year.

Inevitably, there has been significant crossover between those users accessing HGS and those who could have otherwise accessed LMI.

The HGS operates as a government competitor to the private LMI market and does not compete on a level playing field with LMI providers, most notably because it is free. As the Productivity Commission has noted, government backed, low deposit products "effectively represent a public competitor" to LMI, reducing the industry's potential market.[2]

Recommendation: the Australian Government should ensure regular reviews of Housing Australia's activities to assist FHBs to ensure they are undertaken in accordance with s57A of the *Housing Australia Act 2018*. Recognising the importance of the LMI industry in supporting the Australian housing market and financial systems, these reviews should consider, asses and report on:

- The impact of the HGS on the ongoing viability of the LMI market.
- Whether the HGS and impacts on the LMI market are impacting housing prices, housing affordability, or otherwise distorting borrower behaviour.
- Based on the above point, consider potential adjustments to the eligibility criteria to address these impacts and ensure access to the HGS for those borrowers most in need.
- The impact of the HGS on lenders and whether there are any disadvantages for smaller lenders and competition among lenders.
- The Australian Government's liability exposure under the HGS, taking into consideration the risk profile of the guaranteed loans and analysis of arrears, and any appropriate stress or scenario testing to measure the potential future exposure to Government in the context of current and more severe economic and housing market conditions.

Recommendation: the Australian Government should prioritise housing commitments and initiatives most likely to have a more meaningful impact on FHBs, such as those that increase housing supply.

[1] Productivity Commission. 2018. Competition in the Australian Financial System. Page 363. Available here.
[2] Productivity Commission. 2022. *In need of repair: The National Housing and Homelessness Agreement*. Page 389.

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As the Australian Housing and Urban Research Institute (AHURI) notes, government policies targeted at FHBs in recent decades "have focused almost exclusively on demand-side measures designed to boost the capacity" of FHBs to pay for housing.[3] The AHURI states government schemes do not price risk, nor are they required to hold prudential capital. Lenders' mortgage insurers are required to do both. This means that government schemes compete unfairly with LMI and have a significant impact on the viability of the Australian LMI market, while distorting Australia's housing market and having little impact on getting more first home buyers into homes.

Recommendation: the Australian Government should better target the design of the HGS, ensuring it is able to operate effectively alongside a well-functioning LMI market as was originally intended. The HGS should:

- Target those in greatest need of assistance through reduction in the property price caps, income thresholds and other measure to better target those for whom LMI, or other non-government supports are not a viable option.
- Be reduced to the original 10,000 guarantees.
- Not roll over unissued guarantees for one year to the next.

As acknowledged by the Productivity Commission, if the viability of the LMI market is threatened, this "would work to make home ownership less affordable and accessible for those who cannot access government support".[4] The collapse of the LMI market would also mean government would need to consider supporting high LVR lending beyond FHBs.[5] Should Australia face budget deficits and continued tightness in the housing market, these calls would only add further budgetary pressure for future governments.

Beyond the HGS, we urge caution around policies which would further degrade the LMI market in its capacity to supporting FHBs. As noted above, the degradation of the LMI market is likely to increase calls for government supported high LVR lending elsewhere in the housing market.

Recommendation: the Australian Government should closely evaluate the effect of existing and future housing policies on the LMI market to ensure that the market remains competitive, and access to home ownership through LMI remains available via a well-functioning and competitive market.

Australian Prudential Regulation Authority capital framework for authorised deposit taking institutions

We are concerned that the Australian Prudential Regulation Authority's (APRA) capital treatment of mortgages under the HGS does not adequately reflect the risk associated with the guarantees issued under the HGS. We are also of the view that the approach is inconsistent with APRA's approach to risk weighting loans with a LVR of greater than 80 percent as well as inconsistent with the capital treatment of LMI.

As such, we are of the view that the capital treatment has the potential to undermine the recommendation of the Financial System Inquiry that APRA set capital standards for authorised deposit-taking institutions (ADIs) so that capital ratios are "unquestionably strong."[6] We are concerned

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[3] Stephen Whelan etc all. 2023. Australian Housing and Urban Research Institute. *Financing first home ownership opportunities and challenges.* Page 4.
[4] Productivity Commission. 2022. *In need of repair: The National Housing and Homelessness Agreement*. Page 389.
[5] Australian Parliament. 2019. *National Housing Finance and Investment Corporation Amendment Bill 2019 Explanatory Memorandum*. Page 21.
[6] The Treasury. 2014. *Financial System Inquiry Final Report*. Recommendation 1.

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this, together with a regulatory distortion between treatment of the HGS and LMI, may negatively affect competition, financial system stability and resilience.

We recognise that a government guarantee is a valuable form of risk mitigation. We are concerned however, that APRA's treatment of eligible HGS loans in a comparable manner to mortgages with a LVR of 80 percent does not reflect the limitations of the guarantee and the potential losses to ADIs that may arise from defaults on these loans, particularly in a stress scenario. In particular:

- ***Limitations of the guarantee*** – as set out in the *Housing Australia Investment Mandate Direction 2018*, guarantees issued under the HGS are limited to 5-15 percent (dependent on the LVR of the eligible loan) of the value of the property. The guarantee also ceases when the balance of an eligible loan becomes less than 80 percent of the value of the residential property or when eligibility criteria is no longer met, exposing lenders to the risk that the protection of the guarantee may not be available when they need it. This is unlike LMI which provides protection for the principal and interest of the loan (as well as costs) for the life of the loan.
- ***Potential for losses through the cycle*** – in the context of residential mortgage lending, loans with a higher LVR are widely recognised as having a higher risk of default and a higher likelihood of loss by lenders. With lower proportions of equity being available to absorb losses, high LVR loans are particularly vulnerable to potential losses.

  An eligible loan under the HGS must, amongst other criteria, have an LVR between 80 and 95 percent. Such loans cannot be assumed to be equivalent to a loan with an LVR of 80 percent as experience shows there is a higher probability of default for loans above 80 percent LVR. We believe allocation of a risk weight of 35 percent for a 95 percent LVR loan, consistent with the treatment of an 80 percent LVR loan, does not reflect the inherent additional risk and higher probably of default of high LVR loans.
- ***Potential for higher losses in a stress scenario*** – again, due to a higher probability of default for high LVR loans, there would likely be significantly greater losses on loans under the HGS as compared with loans at an 80 percent LVR in times of economic stress. In addition, experience suggests that default frequency and claims severity are positively correlated in an economic stress, so greater unexpected losses will therefore have less protection under the HGS.

We believe APRA's approach that all eligible loans under the HGS would attract a risk weight of 35 percent, regardless of the LVR, is inconsistent with *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112). APS 112 requires loans above 90 percent LVR (with or without LMI) to be risk weighted higher than loans with an LVR of between 80-90 percent (reflecting the higher risk of these loans).

In addition, there is a beneficial treatment for eligible loans under the HGS as compared with loans of the same LVR protected by LMI. That is, standard residential property loans between 80-90 percent LVR attract a risk weight of 40 percent, and those loans above 90 percent LVR attract a risk weight of 55 percent, if protected by LMI. This is higher than the 35 percent for eligible loans under the HGS (i.e. ADIs will be required to hold more capital for loans protected by LMI).

While we acknowledge that APRA has explicitly recognised value provided by LMI in the regulatory capital framework, we are of the view that the recognition of LMI should be set at a higher level. This would not only better reflect the proven value LMI provides to lenders and the financial system more broadly, but also align to the capital recognition of loans under the HGS and remove the uneven playing field and regulatory distortion between the HGS and LMI. It would also be more consistent with

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the original intention of government that the HGS operate alongside a viable and profitable LMI industry and avoid crowding out the industry.[7]

Recommendation: APRA should remove the disparity in regulatory capital requirements for lenders between home loans guarantees by the Australian Government through the HGS and those with LMI.

While we again acknowledge APRA's capital requirements for ADIs to be unquestionably strong following the Financial Systems Inquiry, we note the cost of this prudential strength is being borne equally between FHBs and other borrowers. This is occurring despite FHBs not having financial resources equal to those of other borrowing cohorts. There may be opportunities to rebalance the carrying of ADIs capital strength between FHBs and other borrowers to better reflect each cohort's own financial strength.

Recommendation: the Australian Government explore options to lower ADI capital requirements for FHBs and concurrently increase ADI capital requirements for other borrowing cohorts to maintain Australian ADIs unquestionable prudential strength.

The Insurance Council welcomes the opportunity to further assist the Committee with its inquiry. If you have any queries, please contact Eamon Sloane, Policy Adviser at esloane@insurancecouncil.com.au or on 0423 671 072.

Regards

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Executive Director and CEO

[7] Australian Parliament. 2019. *National Housing Finance and Investment Corporation Amendment Bill 2019 Explanatory Memorandum*. Page 21.