INSURANCE COUNCIL OF AUSTRALIA

Mr Stuart Irvine
Adviser, Financial System Policy
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140
NEW ZEALAND

Email: stuart.irvine@rbnz.govt.nz

17 April 2013

Dear Mr Irvine

REVIEW OF BANK CAPITAL ADEQUACY REQUIREMENTS FOR HOUSING LOANS

The Insurance Council of Australia[1] (the Insurance Council) would like to take the opportunity of responding to the consultation paper issued for Stage One of the Reserve Bank of New Zealand's review of bank capital adequacy arrangements for housing loans (the Consultation Paper). We do this on behalf of our members that are licensed to provide Lenders' Mortgage Insurance (LMI) in New Zealand[2].

The LMI industry, which has been operating in Australia for over 40 years and in New Zealand for over 25 years, has extensive data in the area of residential mortgage defaults and understands the unique long term and cyclical nature of this risk.

LMI enhances the underlying efficiency of 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 among lenders and reduces barriers to entry for homeowners in the lending market.

From a system stability perspective, the LMI providers hold significant capital that provides an additional independent layer of capital that assists in diversifying risk across lenders, across time and across geography. LMI is a valuable ingredient and has played a significant role in ensuring a stable and competitive residential mortgage market in the housing sector.

---

[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. December 2012 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $38.7 billion per annum and has total assets of $115.8 billion. The industry employs approx 60,000 people and on average pays out about $102 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

[2] Genworth Financial and QBE LMI

INSURANCE COUNCIL OF AUSTRALIA

Drawing on the considerable experience of Insurance Council members in providing LMI in New Zealand, Australia and other economies, the Insurance Council would like to address the first two of the Consultation Paper's specific questions.

Q1. Do you consider the Basel correlation factor of 15 per cent accurately reflects the true correlation for New Zealand housing portfolios?
The Insurance Council considers that, while 15% might be appropriate for the overall portfolio, the correlation for HLVR loans should be set higher given differences between the responses to economic stress of HLVR borrowers and low LVR borrowers:

- In the case of residential mortgage loans, the single 15% correlation factor assumes that HLVR response rates will be similar to that of low LVR loans.
- However, historical data suggests that under stress, the cure rates on 90 day delinquent HLVR loans can change drastically compared to the cure rates of delinquent low LVR loans, reflecting the loss of borrower net equity when there is a severe drop in property prices.

Q2. Do you agree that there is more systemic risk in higher LVR loans? Please explain why you agree or disagree.
Insurance Council members agree that there is greater risk in higher LVR loans but would consider that this risk is more "catastrophic" than "systemic". In normal economic situations, higher LVR loans tend to demonstrate risk attributes that can be actuarially determined and subject to the law of large numbers. Only in times of catastrophic economic stress does the portfolio show signs of correlated risk.[3]

If you require further information in relation to this submission, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at janning@insurancecouncil.com.au.

Yours sincerely

Robert Whelan
Executive Director & CEO

---

[3] See, Joint Forum, 2013, Mortgage insurance: market structure, underwriting cycle and policy implications, Consultative Document at 3, 4, and 18 accessible at http://www.bis.org/publ/joint30.pdf; also Jaffee, D., 2006. Monoline restrictions, with applications to mortgage insurance and title insurance. Review of Industrial Organization 28, 88-108.