Committee Secretary
The Senate Economics References Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Via Email: *economics.sen@aph.gov.au*

25 March 2014

Dear Committee Secretary

SPOTLIGHT ON HOUSING AFFORDABILITY

The Insurance Council of Australia (the Insurance Council)[1] appreciates the opportunity to provide this submission providing key information about Lenders Mortgage Insurance (**LMI**) and explaining the important role it plays in facilitating affordable and accessible home ownership.

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.

Background
Where lenders lend more than 80% of the value of the home being purchased, there is a greater risk that should the borrower default on their home loan, the lender will suffer a loss should the property have to be sold. 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, this enables the lender to lend to borrowers who are creditworthy, but who do not have a 20% deposit. LMI was introduced into Australia in 1965, with the then government setting up the government-owned Housing Loans Insurance Corporation (HLIC – since privatised).

With the benefit of LMI, many first home buyers are more likely to be able to afford to buy, move into and accumulate equity in their home sooner, as they are able to obtain a loan that would otherwise not be available, or obtain a loan much earlier than they would be able to if they had to save for a full (20%) deposit.

[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 2013 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $40.9 billion per annum and has total assets of $112.8 billion. The industry employs approximately 60,000 people and on average pays out about $107.9 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).

There is a cost to borrowers – in that the lender will typically pass the LMI premium on to the borrower. Depending primarily on the loan size and loan to value ratio (**LVR**), the average cost of an LMI premium is $5,500. However, this is usually capitalised into the home loan. This means the borrower does not need to pay this 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. 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.

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 typically being highly rated by the ratings agencies, underpinned by substantial capital strength, both through APRA's regulatory capital requirements and the rating agencies' capital criteria.

Role and value of LMI

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

LMI smooths macroeconomic cycles, by facilitating the continuation of home lending at the bottom of a cycle but also helps keep in check imprudent lending at the top of a cycle. This was demonstrated during the global financial crisis. LMI played a critical 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 Federal 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[2] banks, non-bank lenders, credit unions and building societies, this gives LMI providers a whole of market view. It enables LMI providers to help ensure prudent lending practices, resulting in a more robust and secure mortgage market, through:

- providing a "second set of eyes" on lenders' credit operations;
- 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).

[2] "Standardised" banks have their regulatory capital determined by an APRA formula as compared to Internal Risk Based (IRB) banks which use APRA approved internal models.

LMI facilitates competition

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

Prior to that time, first home buyers were restricted to borrowing up to 66% 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.

With the major trading banks today having about 80% of market share in residential lending, LMI still enables standardised banks to compete and offer high LVR home loans at competitive rates.

LMI also plays an important role in providing credit enhancement that 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 main stream lenders on pricing and other features. This in turn ensures competitive mortgage interest rates, with flow on benefits for borrowers.

Access to and affordable home ownership

If lenders transfer credit risk and the cost of default to LMI providers, lenders arguably should not have to charge a higher interest rate to cover the increased risk a borrower presents if they do not have a 20% deposit. This gives confidence to lenders, allowing them 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% or higher.

The LMI industry can therefore play an important role in enabling first home buyers to purchase homes sooner than would otherwise be the case if they had to save a 20% deposit. With the average house price in Sydney exceeding $700,000 and the average salary being approximately $70,000, the challenge for a first home buyer is to save two years' salary before tax if they have to come up with a 20% deposit.

Potential challenges

80% LVR is the effective floor above which there is perceived to be a greater risk of loss arising in a default situation. Given this greater risk, APRA imposes additional capital requirements on lenders where a borrower has less than a 20% deposit. With LMI, the lender has effectively transferred the risk to the LMI provider. As an authorised general insurer, the LMI provider has to hold capital against the risk. Where standardised lenders utilise LMI, this is recognised by the regulator and they do not have to hold as much capital than they otherwise would without LMI.

Whilst this also used to be the case with the larger banks (which are Internal Risk Based – or IRB - banks), this relief changed with APRA adopting the Basel II standard requirements. However, whereas the Basel standards require that banks should hold capital against losing 10% of a mortgage's value, APRA requires double this. For the IRB Banks, this mean they have to hold a higher amount of regulatory capital beyond what the risk models would require them to hold, effectively meaning that they receive little to no capital benefit from LMI.

Whilst IRB banks still utilise LMI for risk transfer, there is less incentive to obtain LMI without the capital relief that they previously benefitted from. It also means that with LMI, both the LMI provider and the IRB lender are holding additional capital against the same risk. This could result in the IRB lender choosing to take more risk without LMI on high LVR loans, particularly in the lower 80% to 85% range.

This could then potentially reduce the LMI providers' risk pool, which would ultimately lead to increased premium costs and which the lenders would in turn pass on to the borrower, most likely negatively impacting on the cost of home loans for borrowers. From a regulatory perspective, a level playing field for all lenders is likely to result in more competition and more accessible funding and thus housing for first home buyers.

Recommendation
In light of the above, the Insurance Council submits that the Senate Economics References Committee should consider the benefits of recommending that APRA give greater capital relief to IRB Bank lenders which utilise LMI. This would ensure that LMI continues to benefit the housing system, with increased competition between lenders, bolstering financial and economic stability and, importantly, improved access to and affordability of home ownership.

If you have any questions or comments in relation to our submission, please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on tel: (02) 9253 5121 or email: janning@insurancecouncil.com.au.

Yours sincerely

Robert Whelan
Executive Director & CEO