INSURANCE COUNCIL OF AUSTRALIA

Mr Neil Grummitt
General Manager Policy Development
Policy, Statistics and International Division
Australian Prudential Regulation Authority

By email: mortgagelending@apra.gov.au

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Dear Mr Grummitt

DRAFT PRUDENTIAL PRACTICE GUIDE: APG 223 – RESIDENTIAL MORTGAGE LENDING

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to provide comments on the Draft Prudential Practice Guide, APG 223 – Residential Mortgage Lending. The Insurance Council welcomes the discussion of Lenders Mortgage Insurance (LMI) in the Draft Prudential Practice Guide. We support rigorous due diligence by authorised deposit-taking institutions (ADIs) when assessing credit risk and oppose any complacency in lending standards driven by low default and loss rates.

The Insurance Council appreciates the references to LMI in the Draft Practice Guide. We take this to be an implicit acknowledgment of the benefits of LMI as a risk management tool. However, the references unnecessarily stress that LMI in itself is insufficient. The Insurance Council therefore suggests that in referring to LMI APRA could take a more positive stance, recognising that the lender is the first line of defence whilst the LMI provider is the second line of defence and the lender should not rely on the LMI processes to cover their own requirements.

We suggest the benefits of LMI should not be understated as they are fundamental in strengthening a number of key aspects of an ADI's risk management which underpin the risk management principles inherent in the Draft Prudential Practice Guide. LMI providers have considerable experience in residential mortgage lending risk management, together with a commercial incentive to ensure that lenders act prudently (as illustrated in the examples below).

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[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. March 2014 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $41.4 billion per annum and has total assets of $111.5 billion. The industry employs approximately 60,000 people and on average pays out about $111 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).

LMI providers have a whole of market view and this breadth provides them with unique insight into the housing market and lending standards. Given their close examination of the lender market, with a particular focus on prudent underwriting and claims mitigation, LMI providers are able to develop significant claims payment data benchmarked across lenders, focussing on high LVR loans and non-standard loans.

This depth of knowledge and experience cannot be easily developed or replicated by lending institutions. LMI providers are able to identify and communicate market trends, benchmark variances across lenders, and identify and action conflicting borrower information received from different lenders. The long term oversight function of LMI provides an important function that is not performed by any other commercial party.

LMI providers also take a long-term view to insuring credit risk, which has positive implications for ADIs. The longer view stems from the nature of LMI providers being monoline insurers with a sole focus on insuring mortgages. In the peak of the business cycle (i.e. in an overheated market), it is in the interests of LMI providers that lenders do not originate imprudent loans. LMI providers play an important role discouraging particularly risky lending during such times. LMI providers also take a whole of market view in setting risk appetite. An example is the greater restrictions placed on LMI offerings used for mortgages in speculative housing investments such as high density investments.

LMI providers as such act as an early warning system alerting the market of the riskiest portion of residential mortgages and unreasonably risky lending practices. This is an important leading indicator for the market.

The role of LMI providers as a "second set of eyes" over the origination process assists to minimise operational risk. Examples of this include the due diligence and assurance processes that are implemented by the LMI providers and through process focus and error tracking and measurement. More specifically, LMI providers are responsible for agreed credit policy and processes, in particular for delegated underwriting arrangements and arrears reporting and Mortgagee In Possession (MIP) management.

LMI providers also conduct post-underwriting audits, provide training to lender staff on delegated underwriting, arrears management and MIP management. They further provide an accreditation program for third party originators, and provide an audit scoring methodology to record, monitor and manage lender performance. LMI providers are also key to ensuring the integrity of the security valuation process is maintained. LMI providers have an interest in the property valuation process as incorrect property values affect LVRs, which is a key underwriting consideration. As a result, LMI providers determine acceptable industry valuation and underwriting practices for high LVR loans and low document loans. Furthermore, LMI providers work closely with local valuation experts for key markets.

In support of sound loan origination practices, LMI providers stimulate demand for high quality credit reporting, which allows LMI providers to extend credit more appropriately on an objective basis. LMI providers enable this through increased regulatory reporting obligations, strong communication and reporting with rating agencies and Residential Mortgage-Backed

Securities (RMBS) investors, industry benchmark reporting to customers and determination of minimum levels of acceptable electronic data to be captured on insured loans.

While the Draft Practice Guide makes clear the lender's responsibility in relation to risk assessment, control and monitoring of appetite, it neglects LMI as a legitimate avenue through which a responsible lender might want to address these issues (without full reliance on their LMI provider as a first line of defence). We hope APRA will correct this imbalance in the final draft by referring to the benefits of LMI in paragraphs 98 -100 and rather than categorical statements such as "LMI is not an alternative" discuss LMI as the second rather than first line of defence.

If you have any questions or comments, 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

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