Mr David Murray AO
Chair
Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

26 August 2014

Dear Mr Murray

FINANCIAL SYSTEM INQUIRY: LENDERS' MORTGAGE INSURANCE

The Insurance Council of Australia[1] (Insurance Council) welcomes the opportunity to make a submission responding specifically to the issues relating to Lenders' Mortgage Insurance (LMI) raised in the Financial System Inquiry's (FSI) Interim Report[2]. We appreciate the consideration given to LMI in the Interim Report and the invitation to provide further views on the costs, benefits and trade-offs of either decreasing the risk weights for insured loans or maintaining the status-quo.

LMI 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. In other words, it is used by a lender to insure itself against the risk of not recovering the full loan balance should a borrower be unable to meet their loan payments.

LMI provides a number of benefits to the economy in general and to the housing industry in particular. Its benefits directly fall within the scope of the FSI, as LMI facilitates competition and innovation amongst lenders, reduces barriers to entry, and provides additional capital and risk management benefits to the lender market. It also smoothes macroeconomic cycles, particularly by facilitating greater amounts of housing lending at the bottom of a cycle, but also by providing a curb on imprudent lending at the top of the cycle. LMI also has a range of other social benefits such as providing greater access to home ownership, particularly for low income or high risk borrowers.

The Insurance Council strongly considers that there needs to be a change to the risk weights for insured loans in order to maintain a strong and stable LMI industry with its range of

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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).

[2] The Insurance Council will also be making a broader submission addressing general insurance issues.

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beneficial consequences. The Insurance Council submits that the Internal Ratings Based (IRB) risk weights for insured loans should specifically allow for the recognition of the broader benefits of LMI and the impact it has on reducing credit and operational risk for lenders. The reasons for this will be set out in this submission.

LMI assists ADIs to manage mortgage risk

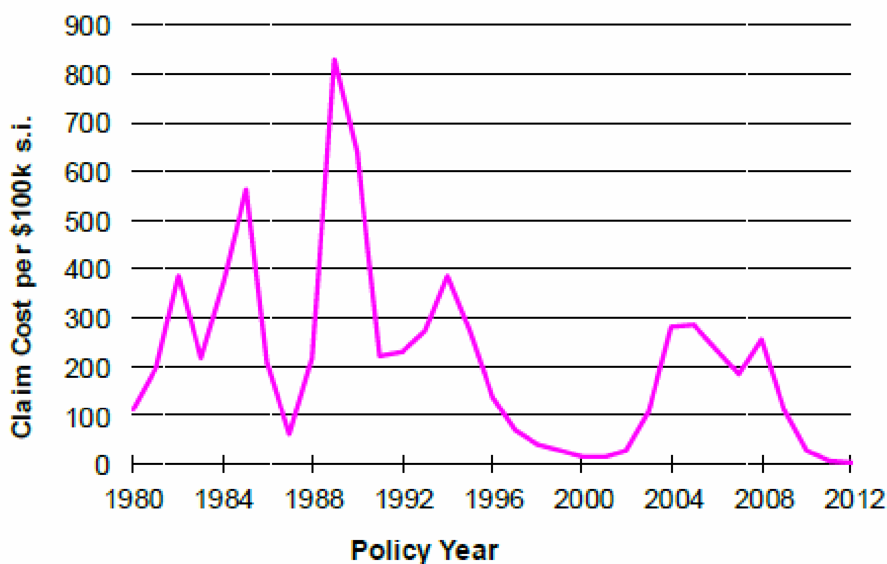
a. LMI assists with system stability by increasing capital in the system

LMI assists with financial system stability by increasing system capital. As of 2013, Australian LMI providers held approximately $4 billion in capital which represents approximately 4 times their gross earned premium income of $970 million. This provides a significant and independent layer of fungible capital that provides support specifically for credit default risk on residential housing adding to system stability in Australia.

LMI providers are required to hold a high level of capital relative to the general insurance industry to reflect the nature and amount of risk which they underwrite each year. This reflects the cover they offer which lasts the life of the underlying loan rather than the typical 12 month exposure underwritten by General Insurers. The Insurance Council wishes to stress the importance of the capital held because it is released to lenders in the event of borrower default, in accordance with their LMI contract.

The figure below shows the total in claims cost by policy year, which illustrates the level of capital released annually to lenders by LMIs in Australia. All claim cost figures are net of non-reinsurance recoveries such as proceeds of property sales.

Industry Claims Cost by Policy Year



Source: Finity, *Australian LMI Industry Historical Experience to 2012, p7*

As demonstrated, LMI results in significant payments to lenders in the event of mortgage default, and can be expected to do so even in the face of a severe shock to the housing market. A study which was undertaken in 2011 for the LMI industry and Australian Bankers' Association IRB working group by Rhino Risk considered the benefit provided by LMI to lenders in a severe downturn scenario. This study analysed historical payout percentages and modelled the amount that can be recovered by lenders in the event of default by an LMI.[3] The first model effectively found that LMI capital would be sufficient to cover 62% of bank credit losses for insured loans from a 1 in 999 year event. The second model found that LMI capital would be sufficient to cover 79% of bank credit losses for insured loans from a 1 in 999 year event.

A key point to recognise from the analysis is that a high percentage of any lender claim is covered by the LMI provider's capital, even in the event of an LMI defaulting. Further, in a scenario less extreme than a 1 in 999 event, an LMI provider would cover an even higher proportion of the lenders' claims, even if in default. Based on the evidence available, Rhino Risk recommended a severe downturn payout percentage of 70% on insured loans should be used for the Australian LMI industry as a whole.

b. inconsistent risk-weights between standardised and IRB banks

The determination of the appropriate risk-weights for standardised banks varies between mortgages with LMI and those without LMI. For standardised banks that have LMI cover of at least 40% of the value of the loan, APRA has determined that reduced risk weights will apply as outlined in the table below. The reduction for standardised banks in risk weights for LMI insured loans is in the range of 25% to 30%. This is a clear recognition of the benefits that LMI provides, particularly for higher Loan to Valuation (LVR) loans, which are typically considered higher risk.

Risk Weights applied by APRA under Standardised Approach

LTV	Risk Weight (no LMI)	Risk Weight (with LMI)
0 to 60	35%	35%
>60 to 80	35%	35%
>80 to 90	50%	35%
>90 to 100	75%	50%
>100.01	100%	75%

Source: APRA Prudential Standard APS112 Attachment D, p29.

[3] The study used two methods, of which the first model relies on the S&P bond default model and the S&P LMI model as its key inputs. The second model relies on the use of the Vasicek formula, which underlies some of the Basel II internal model calculation, as applied to bank capital.

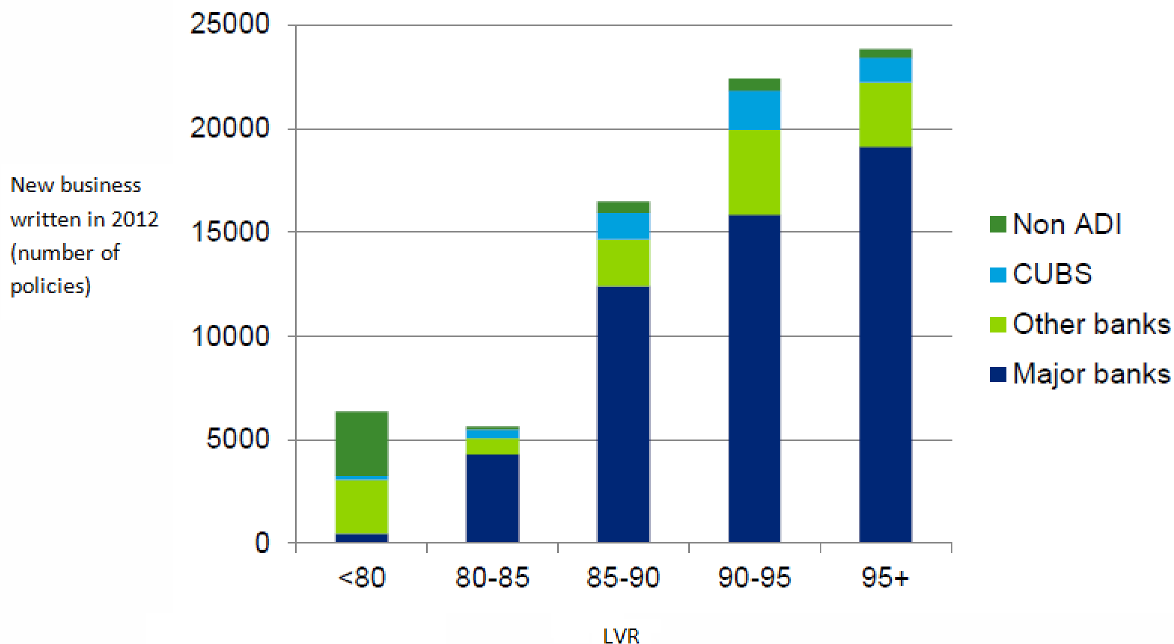
Currently, IRB banks receive no capital benefit for the use of LMI. To allow a reduction of risk weights for residential mortgage insured loans in line with that allowed for standardised banks, the LGD that is applied in IRB models would reduce by approximately 5 percentage points. This is consistent with the modelling referred to in section (a). IRB banks however are currently subject to a portfolio average LGD floor. To date APRA has been reluctant to recognise the benefit provided by LMI which is suggested to be approximately 5 percentage points as this would result in a reduction of the fixed Loss Given Default (LGD) floor of 20%.

Role of LMI in improving the competitive position of smaller ADI and non-bank lenders

While credit unions and building societies, major banks, other banks, and non-authorised deposit taking institutions (ADIs) all use LMI, its use is perhaps most significant to small and regional ADIs as they cannot carry as much risk on their smaller balance sheets. They have less capacity to self-insure, and some rely on LMI to help obtain funding through securitisation.

This is demonstrated by the following chart. The major banks dominate all categories with LVRs of 80% or more, but their share fluctuates between 71-95% of total LMI. Other banks and non-ADIs account for most LMI approvals in the sub-80% LVR bucket, which demonstrates the high dependency of these players on LMI for their ability to effectively compete.

LMI Shares by institution (2012)



Source: Genworth/Deloitte Access Economics, *Socioeconomic impact of LMI in Australia*, May 2014, p15

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The availability of LMI has a disproportionate benefit for these smaller lenders as it enhances their ability to compete with large lenders that enjoy a competitive advantage from having the balance sheet capacity to self-insure.

LMI ensures there is greater competition and innovation in the lending market. LMI lowers the level of economic capital required to be held against loans by lenders, while maintaining sufficient system capital. This reduces barriers to entry by creating a more level playing field for new entrants, encouraging greater competition in the mortgage market. By allowing a broader range of lenders into the market, LMI increases the choice of lender available to borrowers.

Further, the innovations associated with mortgage lending have important implications for competition. Foreign banks and the non-banking sector have with the support of LMI historically placed competitive pressure on domestic ADIs to moderate margins and to deliver new technology and new products.

Competition and innovation in markets leads to an increase in choice and more efficiently priced mortgage products. Part of the increase in choice of lender is through a greater number of small and regional ADIs offering mortgage products to borrowers. Small lenders are more exposed to volatility due to their small balance sheets and some of this risk can be mitigated through LMI. Hence, diversifying risk with LMI can play a vital role in enabling smaller lenders to increase their lending.

Since 1965, LMI has been a significant spur to increased innovation in lending products in Australia by supporting the entry of building societies post deregulation into the high LVR segment of the market and encouraging greater access to funding by non-ADI lenders through securitisation. In the economic environment that prevailed prior to the GFC, Australia's financial system benefited from greater competition between intermediaries and capital markets which resulted in a range of lending innovations.

This included an expansion of wholesale lenders - particularly non-ADI lenders - offering a variety of mortgage products and the introduction of instruments including RMBS securitisation. RMBS securitisations in Australia benefits from pool based LMI cover. Hence, LMI provided necessary support for investor confidence in these new products further encouraging the mortgage market in Australia.

By giving confidence to lenders, allowing them to compete in the market place and providing capacity for the lender to stand by the loan and allow time for the borrower to rectify default, lenders are more prepared to extend credit. Importantly, they do not have to charge a higher interest rate to cover the additional capital requirement or credit risk.

This also enabled borrowers, usually first home buyers, to bridge the deposit gap which was and still is a significant impediment for most first time buyers. LMI, for example, was instrumental in providing support to the Federal Government's first home buyer initiative in 2009 that was instigated to stimulate the economy post the GFC.

In sum, we believe that capital relief should be considered for both IRB banks and non-IRB banks/lenders that use LMI.

Other Benefits of LMI

a. Diversification benefit

Through diversification LMI spreads the risks associated with lending. LMI secured loans transfer the LGD from the loan originator to the LMI provider. Further, the pooling effect of LMI diversifies lender default risk across geography, lenders, time and loan product, which reduces the risk of over-exposure of any single ADI.

Through an LMI provider's reinsurance arrangements, a proportion of ceded risk is further spread outside the Australian domestic financial market, tapping deep global markets. Mortgage default losses rarely occur uniformly across national economies. There are almost always geographic regions or individual lenders that are disproportionately affected, due to local economic conditions and varying loan origination and servicing capabilities. Therefore, where risk can be pooled market-wide, individual losses are absorbed within the distribution of all risk held, thereby providing added levels of financial system stability.

b. Second line of defence against poor lending

LMI is a valuable tool which provides a second line of defence against poor lending standards. LMI providers have extensive experience in residential mortgage lending risk management along with a commercial incentive to ensure that lenders act prudently.

LMI providers have a 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 discipline that is not performed by any other commercial party.

LMI providers also take a long-term view to insuring credit risk, which is to the benefit of ADIs. The longer term view stems from the nature of LMI providers being monoline insurers with a sole focus on insuring mortgages. At 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 used for mortgages in speculative housing investments.

LMI providers 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 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.

LMI providers stimulate demand for high quality credit reporting, which allows them to extend credit more appropriately on an objective basis. Due to their business model, LMI providers have enhanced communication and reporting with regulators, rating agencies and RMBS investors. LMI providers further determine minimum levels of acceptable electronic data to be captured on insured loans.

In the US, studies have established that LMI reduces the PD on LVR loans greater than 80%. One study[4] showed that the PD was reduced by 24%-48%, due to “additional underwriting scrutiny and the lender’s (or borrower’s) obligation to maintain process integrity”.

Shortcomings of the current situation

APRA’s requirement for a portfolio average LGD floor of 20 per cent has significantly reduced the benefit to IRBs of holding LMI cover for their mortgage risks. Nevertheless, they still see the benefit of LMI as a risk transfer mechanism and thus continue to buy LMI protection for their high LVR loans.

However, the lack of explicit recognition of LMI for capital relief for IRBs is having an observable impact in Australia. There has been a shift amongst a few of the largest banks

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[4] Mortgage Insurance Companies of America (MICA) (2012) “Comments on Non-Recognition of Private Mortgage Insurance in Basel III”

over recent years to write home loans at LVRs up to 85% without LMI cover but with borrowers charged a higher fee to compensate for the greater risk.[5] This fee has been characterised as 'self-insurance' as the amount charged bears some resemblance to the quantum of the one-time premium charged when obtaining LMI cover. The database of successful applicants for LMI held by Genworth, one of the largest LMI provider in the Australian market, suggests that this shift is material.[6]

The LMI market in Australia under the existing regulatory settings is likely to follow one of two scenarios:

- Lenders use credit risk mitigants other than LMI. These could include self-insurance as well as simply holding the additional risk on the books rather than spreading it. This is likely to weaken stability rather than enhance it.
- Banks may continue to use LMI as a risk management tool for high LVR and riskier lending. However, this could lead to an overrepresentation of higher-risk loans in the overall LMI portfolio and potentially result in an unviable LMI industry.

Both scenarios if extrapolated could result ultimately in a commercially unviable LMI industry. The exit of LMI providers from the Australian market is not unimaginable. New Zealand, where Genworth and QBE have both wound down their operations, offers a possible precedent for what could happen in Australia.

Competition in the New Zealand market for housing finance saw the money set aside as the self insurance 'fee' melted away. There is therefore no additional capital held in New Zealand as actual or de facto LMI to counter mortgage risk.

Compared around the world to other jurisdictions where LMI exists, Australia is unique in that LMI does not receive government support, nor does it receive explicit regulatory capital relief for IRB lenders.[7] In Canada and Hong Kong, LMI is required on all high LVR loans made by any deposit-taking institutions. In the United States, LMI is required on all loans with high LVRs, which are sold to the government-sponsored housing enterprises (GSEs) (Fannie Mae or Freddie Mac).

Furthermore, LMI is incentivised through lower-risk weights on the capital requirements for underlying mortgages in Canada, France, Mexico, Spain, and the United Kingdom. As explained previously, it is only standardised banks in Australia which benefit from lower risk weights.

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[5] Joint Forum, *Mortgage Insurance: market structure, underwriting cycle and policy implications,* 2013

[6] The tightening of credit standards is evident in the increase in the average credit score of the lowest quintiles. Yet, at the same time, the average score of the highest quintile has been falling suggesting that the most creditworthy borrowers may have been removed from the pool.

[7] It is also worthwhile noting that LMI started out in Australia as a government initiative to improve access to housing, before evolving into the current private-provided model

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Governments directly participate in the provision of LMI in Canada, Hong Kong, Indonesia, Mexico, the Netherlands, and United States. In some of these countries, the government, or a government agency, is the primary or only provider of LMI. For example, the Canadian government provide a back-stop guarantee on all LMI obligations. While in the United States the US Federal Housing Administration (FHA) targets specific markets (low to moderate income, and first home buyers).

Recommendations

Given that LMI in Australia is privately provided compared to the Government run or heavily supported situation common in overseas jurisdictions and the demonstrated benefits of a strong and stable LMI industry in supporting the residential housing market, the Insurance Council submits that the benefits of LMI be appropriately recognised in reduced risk weights for residential housing risk for ADI lenders (whether they are standardised or IRB lenders) by approximately 5 percentage points, as outlined above.

In order to maintain a strong and stable LMI industry and to continue the beneficial impact of LMI, the risk weights for insured loans should appropriately reflect the additional system capital and broader credit and operational risk mitigants provide by LMI cover. This should be the case regardless of whether the lender is a standardised or IRB bank.

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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