INSURANCE COUNCIL OF AUSTRALIA

21 July 2020

The Housing Strategy Implementation Unit
Land and Housing Corporation
NSW Department of Planning, Industry and Environment
Locked Bag 4009
ASHFIELD BC NSW 1800

Dear Sir or Madam

A HOUSING STRATEGY FOR NSW

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to provide comments on the *Discussion Paper: A Housing Strategy for NSW* (**the Discussion Paper**) released on 15 June 2020.

The Insurance Council recognises the importance of establishing appropriate long-term policy settings so New South Wales can accommodate its future projected population growth. The Discussion Paper is a useful step towards that goal and the Insurance Council agrees that a partnered approach is required. In particular, as the Discussion Paper acknowledges, solutions to improved housing affordability involves working with the Australian Government, councils, industry, community housing providers and local communities.

It is a reality for many persons who do not have a substantial deposit, particularly in metropolitan Sydney, that it can difficult to obtain loan finance to purchase a home. This is a common problem for first home buyers. In most cases, the commercial solution which enables them to acquire a property is a product known as Lenders Mortgage Insurance (LMI). Approximately 23 percent of owner-occupier loans in Australia are covered by LMI, and a large proportion of these are made to first home buyers[2].

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent about 95 per cent 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.

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).

March 2020 Australian Prudential Regulation Authority statistics show that the general insurance industry generates gross written premium of $51 billion a year and has total assets of $133.8 billion. The industry employs about 60,000 people and on average pays out about $169.4 million in claims each working day.

Over the 12 months to March 2020 the industry's net profit after tax (NPAT) was $1.5 billion – a 56.7 per cent decrease from the prior year's NPAT of $3.5 billion. The industry's underwriting result was also $1.5 billion, falling by 47 per cent from $2.8 billion in the prior year.

[2] Productivity Commission (2018), *Competition in the Australian Financial System*.

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LMI was originally introduced by the Australian Government in 1965 to increase access to home ownership for families and first-time home buyers. Before LMI was available, lenders usually required borrowers to save a sizeable deposit to protect the lender in the event of foreclosure. They needed to guard against the risk of the property being sold at a price less than the outstanding amount of the loan.

With the ability to pass on this shortfall risk to an insurance company through LMI, lenders have been prepared to accept a lower deposit and also can usually offer lower interest rates for mortgages than they would otherwise be able to offer these higher risk borrowers. The end result is that home loans are available to more people and they are charged less through the use of LMI.

Accordingly, we suggest the Discussion Paper would also benefit from a consideration of the use of LMI, how it works and its affordability benefits. To this end, you may find the following information useful.

Value and Benefit of Lenders' Mortgage Insurance

LMI helps improve access to home ownership

The Explanatory Memorandum (EM) to the National Housing Finance and Investment Corporation Amendment Bill 2019 recognised the important role that LMI has in the home lending and credit creation process. The EM states:

> *LMI enables high-LVR lending and benefits the financial system more broadly and LMI allows potential home buyers the ability to enter the property market sooner than they would otherwise be able to. Without LMI, potential home buyers with deposits of less than 20 per cent would not ordinarily be able to obtain a mortgage. In addition to insuring lenders against the higher risks involved in lending to first home buyers, LMI providers also provide a 'second pair of eyes' on the loan assessment process. Taken together, this increases the willingness of lenders to lend to first home buyers.*[3]

With the benefit of LMI, many first home buyers are able to:

- buy and move into their home much sooner; and
- obtain a home loan that may otherwise not be available if the lender could not manage the risk or capital requirements.

LMI is a mechanism which enables a lender to offset additional risks associated with these higher risk loans.

LMI supports the financial system and continuation of lending through economic cycles

LMI also provides risk transfer and diversification to lenders, with most cover relating to high Loan to Value Ratio (LVR) lending. LMI providers are prudentially regulated. Their capital requirements are set to withstand 1 in 200 year stress events. LMI providers typically

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3 https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fems%2Fr6402_ems_1948f206-0327-4fe0-8837-4328fe9345b4%22 , p 20

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diversify their risk offshore through the use of reinsurance, providing foreign capital to support an Australian based downturn. The combination of capital and reinsurance promotes stability across the wider financial system. Additionally, the use of international reinsurance provides access to cost effective risk mitigation, which reduces costs to insurers and ultimately reduces costs to borrowers.

LMI is designed and priced for a long term “through-the-cycle” view and contributes to absorbing the effects of economic downturns (such as being currently experienced as a consequence of COVID-19). It facilitates the continuation of home lending at the bottom of a cycle and helps to maintain prudent lending at the top of a cycle.

In addition to increasing accessibility and affordability of housing, LMI plays a much broader role in the financial system by ensuring responsible residential lending standards are maintained by providing oversight of, and audit services to lenders.

LMI supports competition in the Australian residential mortgage lending market

LMI helps various parts of the Australian mortgage lending market compete vigorously for business:

1. The Australian Prudential Regulation Authority (APRA) recognises the benefits LMI contributes to the financial system and as a result provides explicit capital recognition of this benefit in the prescribed credit risk weights applied to the standardised lenders, which make up around 20 per cent of the market. This means that smaller lenders can hold less capital for these risks than would otherwise be the case for such loans without the benefit of LMI. This combined with the effective risk diversification increases their competitive position against the major banks. The support provided by LMI is significant for small and regional lenders as they cannot carry as much risk on their balance sheets as larger ADIs. These lenders typically are more geographically concentrated in particular regions.
2. The availability of LMI helps smaller lenders compete with larger lenders (i.e. the major banks) which would otherwise enjoy a competitive advantage in the high LVR segment from having the balance sheet capacity to self-insure and the benefits of a model-based approach for regulatory capital. This is particularly important for smaller lenders with geographic concentration where LMI plays a critical role in enabling them to expand their lending across, for example, regional and rural NSW based examples include Teachers Mutual Bank, IMB, Police Bank, Greater Bank and Newcastle Permanent Building Society. LMI helps these NSW based businesses make home ownership for more people across NSW.
3. Non-authorised deposit taking institutions (such as lenders that are not regulated by APRA – for example Resimac and Columbus) also use LMI widely when offering high LVR mortgages in Australia and to access funding at a lower cost.
4. LMI provides credit enhancement which 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-ADI lenders and smaller ADIs to compete with mainstream lenders on pricing and other features.

5. Foreign banks and the non-banking sector, with the support of LMI, also continue to place competitive pressure on domestic ADIs to moderate margins and to deliver new technology and new products such as shared equity mortgages.

LMI Helps Absorb the Cost of High LVR Lending

Borrowers with higher LVR mortgages are typically higher lending risks. Research published by the Reserve Bank of Australia (RBA)[4] clearly identifies the cohorts of borrowers (by LVR) which are at most risk of falling more than 90 days behind on their mortgage. The RBA's research shows that for borrowers taking out a mortgage with an LVR of 90 per cent or more, the likelihood of missing a payment is three and a half times greater than for a mortgage with an LVR of 60 per cent or less, and almost twice as great as mortgages with LVRs of 80 per cent to 90 per cent.

In this sense, given the inherently heightened risks, there are significantly higher costs associated with high LVR lending, particularly in terms of regulatory capital requirements and other prudential regulatory obligations. It is important to recognise that LMI offers a more economically efficient method of managing the higher risks associated with high LVR lending.

As a consequence of their specialised nature, APRA requires LMI providers to be 'monoline' insurers, which means they are not permitted to provide any other type of insurance. Additionally, as also emphasised by the RBA[5], to ensure LMI providers remain resilient to the key tail risk they face (i.e. a severe housing downturn), Australian LMI providers are required to hold higher capital requirements than general insurers which includes a substantial amount of capital against 'insurance concentration risk' (a component of their total capital requirement). LMIs, like all general insurers are subject to intensive regulatory supervision, including ongoing monitoring of risks and financial condition, scenario analysis and detailed on-site supervisory reviews.

Conclusion

Given the competitive nature of the housing market in metropolitan Sydney, entering it can be daunting for potential first home buyers. The core function of LMI is to make entry to the housing market more accessible by giving extra confidence to lenders and creating choice for borrowers. LMI began in Australia in 1965 as the original support to first home buyers and continues to be widely utilised today.

We suggest the NSW Government's consideration of mortgage accessibility, availability and cost would benefit from the consideration of the important role of LMI in the housing market. Further information about the role and importance of LMI is outlined in the EM. Additionally, the Insurance Council would be pleased to help the NSW Government in providing more detail about LMI and also any further consideration of high LVR mortgage risk or other relevant housing finance issues.

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[4] Reserve Bank of Australia, November 2014, '*Research Discussion Paper: Mortgage-related Financial Difficulties: Evidence from Australian Micro-level Data'*. Page 12 refers.

[5] Ibid.

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 telephone: 02 9253 5121 or email: janning@insurancecouncil.com.au.

Yours sincerely

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