INSURANCE COUNCIL OF AUSTRALIA

Ms Rosalyn Bell, Assistant Commissioner
Productivity Commission
4 National Circuit
BARTON ACT 2600

Email: financialsystem@pc.gov.au

29 March 2018

Dear Ms Bell

DRAFT REPORT – COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM LENDERS' MORTGAGE INSURANCE (LMI)

Further to its initial submission of 22 September 2017[1] to the Productivity Commission's (the Commission) Inquiry into Competition in the Australian Financial System (the Inquiry), the Insurance Council of Australia (Insurance Council) welcomes the opportunity to provide additional information to facilitate the Commission's understanding of LMI.

The Insurance Council appreciates the Commission's recognition that LMI is "*an important financial product*"[2] which helps support competition in Australia's home loan market. As we explained in detail in our initial submission, LMI plays a key role in facilitating affordable and accessible home ownership in Australia and broadly supporting and facilitating competition between lenders in Australia's home lending market.

In order to provide context for the information in this submission, we would like to reiterate the value and benefits of LMI to prospective home buyers, competition in the lending market and the financial system more broadly.

Value and Benefit of Lenders' Mortgage Insurance

LMI helps improve access to home ownership

By enabling those who would otherwise have difficulty obtaining a home loan due to lack of a 20 per cent deposit or an established credit repayment history, LMI is particularly beneficial for first home buyers. With the benefit of LMI, many first home buyers are able to:

- buy, move into and accumulate equity in 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 higher risk loans, such as loans to first home buyers.

[1] The Insurance Council of Australia's submission of 22 September 2017 to the Productivity Commission's Inquiry into Competition in the Australian Financial System Consultation Paper (released 6 July 2017).

[2] The Productivity Commission's Competition in the Australian Financial System Draft Report, 7 February 2018, page 239.

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

LMI 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 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. Furthermore, 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 in the aftermath of the global financial crisis). 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 reaches out to help 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 Australia.
3. Non-authorised deposit taking institutions (such as lenders that are not regulated by APRA) 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.

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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

As the Commission would appreciate, borrowers with higher LVR mortgages are typically higher lending risks. Research published by the Reserve Bank of Australia (RBA)[3] clearly identifies which cohorts of borrowers (by LVR) 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, LMI providers have liabilities that are concentrated in highly correlated risks, which, as pointed out by the RBA[4], exposes them to potentially significant insurance risks as they can experience a heightened number of policy claims during economic downturns. This is different from other general insurers, in that many of their policyholders are insured against losses from relatively unrelated physical events (e.g. accident or theft), with multiple policyholders affected by the same event only in infrequent cases (e.g. natural catastrophe events).

APRA therefore 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 hold 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.

The Need for LMI

At the Commission's public hearings in Sydney and Melbourne[6], there was discussion of a stakeholder suggestion that there was no need for LMI and that it should be replaced with lenders charging higher interest rates on home loans what would otherwise be LMI-supported.

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

[4] Reserve Bank of Australia, September 2013, '*Financial Stability Review – September 2013, Box C: Lenders Mortgage Insurance*'. Page 39 refers.

[5] Ibid.

[6] The Productivity Commission's public hearings for its Inquiry into Competition in the Australian Financial System.

The Insurance Council strongly disagrees with this suggestion, which demonstrates a lack of appreciation of the use of LMI, how it operates in Australia's home lending market, and the benefits it provides.

The benefits of the financial system for both borrowers and lenders include:

- increased accessibility and affordability of homeownership;
- access to capital and global reinsurance capital;
- pricing of risk and supporting system stability through various economic cycles; and
- supporting the borrower if they find themselves in a position of hardship (LMI providers have financial hardship programs and work closely with their lenders to assist borrowers struggling with their mortgage repayments).

It is important to understand that by reducing a lender's risk from the outset, through passing on the risk of loss to an LMI provider, a lender is prepared to allow borrowers to secure a mortgage for a home loan with a lower deposit which without LMI would not be made available. Affordability and accessibility to home ownership has and continues to be a key focus of Australian governments. This is the key purpose and benefit of LMI, and LMI providers specialise in managing the higher risks presented by that cohort of borrower (i.e. borrowers with less than a 20 per cent home loan deposit).

Therefore, if the risks were managed via the price of a home loan rather than LMI, there may be significant negative implications for low income-earning families seeking home loans. In overseas jurisdictions where the use of LMI is not prevalent, lenders charge borrowers a higher risk-based interest rate. This additional cost will apply for the life of the loan, or at least until the LVR has reduced sufficiently to be considered a normal loan. This approach will almost certainly cost more than the use of LMI.

If lenders did not use LMI to alleviate potential lending losses, those losses may need to be recouped from the earnings of other home loans, in effect increasing home loan interest rates. Secondly, where the potential risks are too high for lenders, borrowers may be declined home loans.

Further Information

The Attachment contains information responding to the discussion of specific LMI-related issues in the Commission's Draft Report. The Insurance Council understands that the Commission has recently met our LMI members individually and that discussions are ongoing in relation to the provision of LMI data for the Commission. 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,

Yours sincerely

Robert Whelan
Executive Director & CEO

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ATTACHMENT

INSURANCE COUNCIL RESPONSE TO DRAFT RECOMMENDATION, DRAFT FINDING AND INFORMATION REQUEST

Draft Recommendation 8.5: "*The Australian Government should require all lenders to offer home loan customers refunds for the cost of lenders mortgage insurance when customers choose to refinance or pay out their loan. The refund schedule for the remaining life of the loan should be set and made available to the borrower at the time the policy is started.*"

- As explained in the Draft Report[7], LMI may be partially refundable if a home loan is terminated early in the life of the loan. This needs to take account of the LMI premium being calculated on the risk of default being greatest in the early years of the loan. Generally, to be eligible for a partial LMI refund, a borrower must have paid out the loan less than one or two years from the date of settlement of the property, and they must not have made any late payments or allowed the loan to be in arrears. This will depend on the lender's arrangements and the Insurance Council suggests that a borrower contact their lender to understand what arrangements might be in place.
- However, the Insurance Council does not support Draft Recommendation 8.5 in its current form because it does not take account in practice of whether a refund would be payable or not. It is important to understand that the pricing of LMI premiums is driven by regulatory capital requirements, global reinsurance conditions and obtaining an adequate return on capital, which are factors that are modelled into the refund policies that are currently available.
- If a mandated refund schedule is imposed, LMI providers would need to reprice LMI across the board, leading to higher LMI premiums. Critically, any mandated refund schedule would need to reflect the emergence of risk (higher risk of default in the earlier years) and the current capital requirements, which are heavily weighted to the early part of a mortgage loan.
- The impact of a mandated refund schedule would affect all borrowers who need LMI, not just those borrowers that want to refinance their home loan, resulting in a higher initial price for all.

Draft Finding 8.3: "*Home loan consumers with a loan to value ratio in excess of 80% are often required to compensate lenders twice for this risk: by bearing the cost of lenders mortgage insurance, and also by paying a higher interest rate on their home loan, even after other loan and borrower characteristics have been accounted for.*"

- The Insurance Council would emphasise that the mortgage interest rate that a lender decides to set and offer its customers is a commercial decision that rests solely with the lender. There is no involvement from the lender's LMI provider.

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[7] The Productivity Commission's Competition in the Australian Financial System Draft Report, 7 February 2018, page 244.

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Information Request 8.3: "*Are there any circumstances in which it is reasonable for a home loan consumer to be paying both lenders mortgage insurance and a higher interest rate? If not, what changes could feasibly be implemented?*"

- Similar to the response to Draft Finding 8.3, the mortgage interest rate that a lender decides to set and offer its customers is a commercial decision which rests with the lender, based on their view of capital required and operational risk.

Response to LMI related observations in the Draft Report

This section provides the Insurance Council's response to a number of observations in the Draft Report relating to competitive tension within the LMI market, refinancing of an LMI-supported mortgage loan, LMI prudential capital requirements and consumer LMI factsheets.

Draft Report observation A, page 239: "*Since providers usually pass on the cost of LMI to consumers, there is no strong incentive to make sure the price is competitive. And because the LMI policy represents a relationship between a lender and an insurer, consumers who are bearing the cost of LMI cannot exert competitive pressure on providers.*"

- The Insurance Council emphasises that LMI providers operate in a competitive market and need to ensure that the LMI premiums they offer to lenders are keenly priced, particularly in the context of the current market headwinds, such as relatively slower economic growth and a decline in home financing. These collectively operate to dampen demand which further incentivises scrutiny of LMI provider tenders by lenders.
- For example, there is a robust and competitive dynamic between QBE and Genworth, two locally based and regulated LMI providers. The nature of the tender processes which these LMI providers engage in is highly competitive and ensures that the best possible price is offered to the lender and the least expensive price is passed through to the borrower. In addition, there are competitive pressures on the domestic LMI providers due to the role of offshore reinsurers. Finally, there is no obligation on lenders to use LMI to insure high LVR mortgage risk, meaning that lenders can also self-insure if they prefer.
- Lenders are incentivised to negotiate with their LMI provider to ensure that the LMI premium they pay for their policy is competitive because the cost of the LMI premium is typically passed onto the borrower, usually as a fee, and capitalised into the borrower's home loan. It is common practice for lenders to conduct a commercial tender process to test the LMI market.

Draft Report observation B, page 239: "*Each time a loan is refinanced, it is considered a 'new' loan for the purposes of LMI cover, so consumers who remain above the 80% LVR threshold can be required to pay an additional LMI fee each time they refinance their loan. This can discourage switching, if borrowers are aware of it.*"

- A home loan borrower may decide to switch lenders for a number of reasons. These include their home loan interest rate, their home loan features, the quality of service and advice they are receiving from their lender and potential changes in the borrower's personal circumstances (e.g. relocation or change in employment circumstances). Some of these may relate to a change in their risk profile and therefore affect the calculation underlying the LMI.

- With reference to the example situation cited in Observation B, if a borrower decides to enter a new lending arrangement with a different lender, a new risk assessment would need to be made – an APRA regulatory requirement – and a new LMI policy would need to be arranged to cover their new lender. The borrower may therefore need to pay the cost of the LMI for their new lender if they still have a low amount of equity in the property (e.g. if they are borrowing more than 80 per cent of the property's value).

Draft Report observation C, page 243: "*Importantly, capital requirements 'reset' each time a lender issues a loan that requires LMI, regardless of whether it is a new or refinanced loan. Therefore, each time a borrower refinances a loan while remaining above the 80% LVR threshold, they are likely to be charged an additional LMI fee that is equivalent to what a borrower taking out a loan for the first time would be charged … This is a serious pricing inefficiency, as well as raising the more subjective issue of fairness.*"

- As pointed out in the Draft Report, the cost of LMI is heavily influenced by APRA's capital requirements for LMI providers[8]. These requirements are adjusted depending on the age of the underlying loan and are 'reset' each time a lender issues a new loan because a new risk assessment is made.
- As acknowledged by the Draft Report[9], the Commonwealth Treasury in 2011 advised against the introduction of a scheme to allow the transfer of LMI between lenders because it would be expensive, extremely complex to implement and administer, and would likely benefit less than 1 per cent of all borrowers[10].

Draft Report observation, page 247: "[the Productivity Commission] *encourages all lenders to produce similar* [LMI] *factsheets to increase consumers' understanding of LMI and make it easier for consumers to compare different products.*"

- As the Commission may be aware, the Insurance Council has developed an LMI Fact Sheet, which is available on the Insurance Council's *Understand Insurance* website[11] and also the Australian Securities and Investments Commission's *MoneySmart* website[12].
- The final report of the Independent Review of the Code of Banking Practice, released January 2017, recommended (Recommendation 68) that:

  > "*The ABA* [Australian Bankers' Association – now Australian Banking Association] *and signatory banks should develop a fact sheet that explains lenders mortgage insurance to home loan borrowers. The Code should require this to be provided to a Code customer who is required by a signatory bank, as a condition of their home loan, to obtain lenders mortgage insurance.*"[13]

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[8] The Productivity Commission's Competition in the Australian Financial System Draft Report, 7 February 2018, page 243.

[9] The Productivity Commission's Competition in the Australian Financial System Draft Report, 7 February 2018, page 244.

[10] Media Release from the then Deputy Prime Minister and Treasurer, Wayne Swan, 21 August 2011.

[11] The Insurance Council of Australia's *Understand Insurance* website.

[12] The Australian Securities and Investments Commission's *MoneySmart* website.

[13] The Report of the Independent Review of the Code of Banking Practice, 31 January 2017, Recommendation 68, page 163.

- The ABA's response[14] to Recommendation 68 is that it supports providing home loan borrowers with information explaining lender's mortgage insurance, but that a uniform fact sheet is not recommended. Its preference is for signatories to the Code of Banking Practice to be able to design and maintain LMI customer fact sheets individually and independently, given the differences which exist across the industry. To this end, the Insurance Council has provided its LMI Fact Sheet to the ABA for consideration.

[14] The Australian Bankers' Association's Response to the Code of Banking Practice Review, 28 March 2017.