Insurance Council of Australia

Insurance Council of Australia – Questions on Notice responses

Senate Economics Reference Committee – Inquiry into financial regulatory framework and home ownership.

In addition to the responses below, we note that the question on notice asked by the Committee Chair of Helia or the ICA was responded to by Helia on 6 November.

Question

What opportunities are there to reduce the overall cost of mortgages?

Answer

The Australian Prudential Regulation Authority's (APRA's) current capital framework for Authorised Deposit-taking Institutions (ADIs) was designed to embed unquestionably strong capital in the banking system and to align with the internationally agreed Basel III framework.[1] Specifically for residential mortgage lending, APRA's objective was to strengthen the amount of capital held by banks given the industry concentration in this asset class (being, on average, the largest asset class for Australian banks).

We are of the view that the capital framework as designed operates to increase the cost of high loan-to-value ratio (LVR) residential mortgages that are protected by lenders' mortgage insurance (LMI) – lending that commonly comprises first home buyers (FHBs). This is because ADIs are required to hold higher levels of capital for high-LVR loans protected by LMI through higher risk weights attaching to those loans, and ADIs are also required to maintain higher capital ratios against those total higher risk weighted assets. This disproportionately impacts high-LVR borrowers.

As would be expected, given ADIs are required to hold increased levels of capital under the current regulatory framework, ADIs need to generate a return on this additional capital. A measure to achieve this could be through higher interest rate charges.

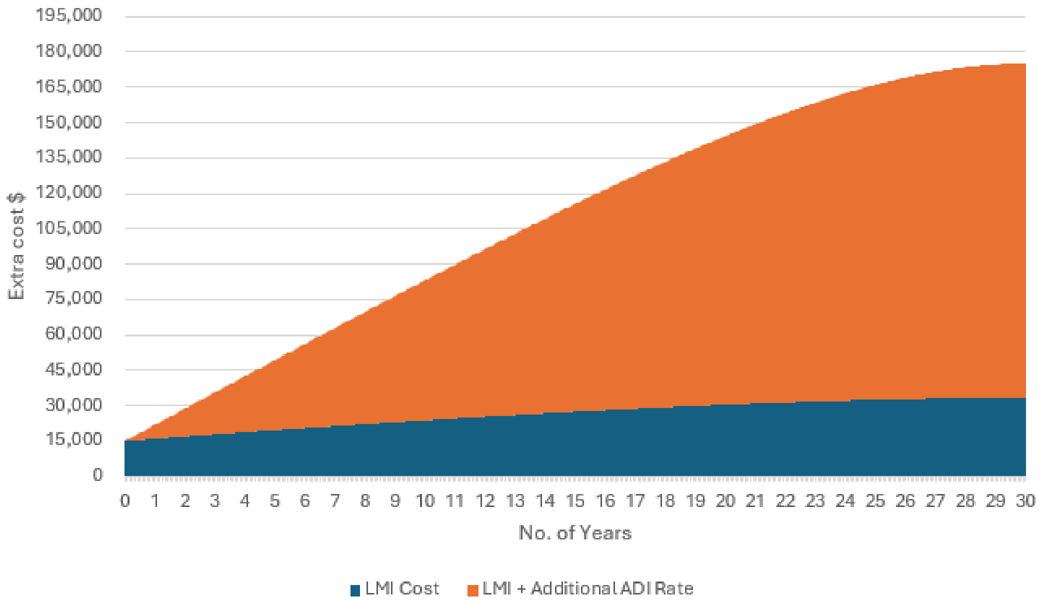
Additional interest rate costs for high-LVR lending with LMI impacts borrowers by increasing serviceability (higher monthly repayments), and also significantly increases the total cost to borrowers over the life of the loan. As LMI already covers the risk of credit default, the higher interest rate is effectively a surcharge for the additional APRA capital required post LMI for high-LVR loans.

To illustrate, based on the advertised interest rates of a sample seven of the largest Australian lenders, borrowers with an LVR loan of 90-95% are paying interest rates of 1.09% higher on average (or median rate of 1.15% higher), than borrowers with an LVR loan of 80%. This is in addition to the cost of LMI (where the lender passes on this cost to the borrower). By way of contrast, prior to APRA's implementation of Basel III, a Productivity Commission study (2018) found that borrowers with LMI were on average charged a slightly higher interest rate than the average rate for all borrowers.[2] Our assumption is that this reflects the position that lenders are now seeking a return on the additional

[1] APRA, Information Paper: *An Unquestionably Strong Framework for Bank Capital*, November 2021. Note, the "Basel III framework" was developed by the Basel Committee on Banking Supervision.
[2] Productivity Commission, *Competition in the Australian Financial* System, Inquiry Report, p365. The average higher interest rate amounted to 0.00066%, meaning that if the if the average interest rate for all borrowers was 5%, the average interest rate for borrowers with LMI would be approximately 5.003%.

capital they are required to hold for high-LVR lending post Basel III by charging a higher interest rate to high-LVR borrowers.

The below chart shows the cumulative costs of this scenario to a borrower using an example of a $500,000 95% LVR loan, protected by LMI. Unless the borrower is able to renegotiate or refinance their loan, the higher rate of interest will apply for the life of the loan.



We suggest that recalibrating the risk weightings for high-LVR residential mortgages (for owner-occupiers repaying principal and interest, not investor and interest-only loans) with LMI would lower the capital costs for ADIs. This in turn should work to reduce the costs of residential mortgage lending to high-LVR borrowers (typically FHBs). This would better align to the original intent of LMI which was to enable home buyers with low deposits to access a home loan at rates equivalent to those with a 20% deposit, as the increased credit risk of these loans has been appropriately mitigated by the use of LMI. LMI providers, as the Committee is aware, are separately regulated by APRA and must hold significant capital to support high-LVR home lending in Australia.

Question

Has LMI been effectively double counted or not correctly counted in calculating capital risk weights?

Answer

We suggest the current capital risk weights do not appropriately reflect the proven value of LMI.[3] In particular, this additional financial system capital that supports residential mortgage default risk is held locally by APRA-regulated LMI providers. It is supported by the global reinsurance market, acts as a first loss for insured risks (providing 100 percent cover for the lenders' credit risk loss), operates efficiently and fairly and is privately provided (i.e. does not require government support).

[3] LMI's proven value includes, for example, supporting lenders through the recession in the early 1990s, the Global Financial Crisis in 2007-08, the mining downturn in 2013 and more recently the Covid pandemic.

The risk weights allocated to high-LVR lending protected by LMI are higher as compared with other credit risk mitigants such as the Home Guarantee Scheme (HGS) and parental guarantees (both of which are not available to all FHBs), and also the international recommendations (Basel III).

In fact, LMI supported loans provide significantly more cover than loans covered under the HGS and we believe are lower risk for a lender, as LMI covers the full loss to the lender in a claim event. Conversely, the HGS does not fully cover a lender's exposure, as it only covers up to 15% of the loan value. In addition, in the event a property covered by the HGS is no longer owner-occupied, the guarantee ceases. This leaves the lender unprotected, regardless of LVR or underlying risk.

LMI supported loans are also lower risk to the lender than loans with a parental guarantee as in practice it is difficult for a lender to call in the security provided by a parental guarantee, particularly if the property is currently occupied by retirees. Our understanding is that a bank will rarely action this.

The following table provides a comparison of the standard owner-occupied residential loan (principal and interest) risk weights by LVR band for Standardised ADIs under Basel III (these do not reflect LMI recognition) and those that currently apply for APRA regulated ADIs.

		Australian Owner-Occupied P&I Mortgage Risk Weights				
LVR Band	Basel III - recommended	APRA - no LMI	APRA - post LMI	APRA - post HGS	APRA – post parental guarantee	Our suggested revised post-LMI
0-50.01%	20%	20%	20%			20%
50.01-60%	25%	25%	25%			25%
60.01-70%	30%	30%	30%			30%
70.01-80%	30%	35%	35%	35%	35%	35%
80.01-85%	40%	50%	40%	35%	35%	35%
85.01-90%	40%	50%	40%	35%	35%	35%
90.01-95%	50%	70%	55%	35%	35%	35%
95.01-100%	50%	70%	55%	35%	35%	35%

The above table illustrates:

- APRA's risk weights (no LMI) are materially higher than the equivalent Basel III risk weights for high-LVR mortgages. While this may be considered appropriate in the Australian context, it also has the impact of increasing ADIs' capital costs associated with high-LVR lending.
- APRA's risk weights (post-LMI) do provide some capital benefit for LMI, however these are still higher than Basel III (no LMI) for high-LVR mortgages with a deposit of less than 10 percent (which would typically include FHBs). So even with the protection of LMI, the risk weights applicable to high-LVR loans are higher than the international Basel III recommendation.
- In contrast, the beneficial treatment for eligible loans under the Government's HGS and loans with a parental guarantee compared with loans of the same LVR protected by LMI, is stark. This means ADIs are required to hold more capital for loans protected by LMI as compared to loans under the HGS or with a parental guarantee. Although we recognise the HGS is backed by a government guarantee, the 15% cover provided to a lender under the HGS on default is significantly less than the 100% cover that LMI provides.

Question

How could LMI support a lower capital risk weighting for first home buyers without reducing systemic risk protection?

Answer

We recommend that APRA's capital settings be recalibrated in respect of the LMI benefit, with the risk weights post-LMI being equivalent to the risk weight for an 80 percent LVR loan (this also aligns to the treatment for loans under the HGS). Again, we note that LMI providers are APRA-regulated and also hold substantial capital locally.

To the extent this recalibration may decrease the level of ADI capital in the financial system (notwithstanding the LMI capital in the system), this could be addressed through the application of higher capital ratios against total risk weighted assets to maintain system capital. This approach would more fairly distribute the cost of maintaining unquestionably strong capital for Australian ADIs across all cohorts of borrowers and not disproportionately impact high-LVR borrowers (who are likely to be least able to afford it).

As above, LMI protected loans are lower risk than HGS and parental guarantee backed loans, noting LMI provides 100 percent cover for the lenders' credit risk loss, unlike the 15 percent cover provided under the HGS. We suggest therefore, that credit risk protection for ADIs is in no way reduced.

LMI providers have the expertise and risk appetite to prudently support competition in residential mortgage lending and in particular, high LVR lending. The support of LMI has been a key factor in bolstering competition in the residential mortgage lending market in Australia ever since its introduction by the Government in 1965. With LMI, home lending in Australia has become more competitive for lenders and also more equitable for borrowers. By giving lenders the confidence to compete, borrowers benefit through greater and cheaper access to home ownership and increased choice driven by innovation and competition amongst lenders.

More broadly, the LMI industry facilitates the efficient management of capital and risk in the banking system, providing systemic housing loan risk protection by transferring risk outside the banking system. LMI assists to diversify that risk across time, geography and a large group of borrowers and lenders. LMI also accesses international reinsurance markets to diversify what can be highly correlated Australian residential mortgage risk outside the country. The additional support provided by LMI is critical at times when the financial system, and the residential mortgage component of the system, are under stress. LMI provides a fungible independent layer of capital that specifically supports credit default risk and the costs associated with that default in the Australian home lending market. Just as it can facilitate greater amounts of housing lending at the bottom of a cycle, LMI supports system stability by providing a curb on imprudent lending at the top of a cycle. LMI helps to maintain the integrity of lending practices by being a 'second set of eyes' in addition to lenders', promoting industry best practice, and detecting potentially fraudulent activity within the mortgage industry. The long history of investment in underwriting and risk expertise by LMI providers helps bolster financial and economic stability through the cycle.