INSURANCE COUNCIL OF AUSTRALIA

16 March 2011

Senator David Bushby
Chair
Senate Economics References Committee
PO Box 6100
Parliament House
Canberra ACT 2608

Dear Senator Bushby

SENATE INQUIRY – COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR

The Insurance Council of Australia (***Insurance Council***)[1], the representative body of the general insurance industry in Australia, appreciates the opportunity to provide this submission outlining key information about LMI.

In view of recent commentary raised in relation to LMI during the inquiry, the LMI industry is concerned to ensure that there is a clearer understanding of LMI and the broader role LMI plays in the housing market and Australian economy. Set out below are key facts in relation to the operation of LMI in Australia. Also included in Appendix A is additional information about the broader role that LMI plays in facilitating competition in the mortgage market and enhancing financial system stability.

Lenders' mortgage insurance

- **Lenders'** mortgage insurance is a wholesale insurance product that **protects the lender** in the event a borrower defaults on the loan and there is a shortfall on the sale of the property.
- LMI is the insurance of the credit default risk of a specific loan provided by a specific lender at a specific time in relation to a particular mortgage (borrower, loan characteristics, property and lender or origination attributes).
- The lender is the beneficiary under the policy, not the borrower. In insurance terms, the borrower is actually the "risk" against which the LMI policy provides protection.

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1 The Insurance Council of Australia's 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. December 2010 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $33.4 billion per annum and has total assets of $101.7 billion. The industry employs approx 60,000 people and on average pays out about $87 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).

- As a wholesale product (and not a retail insurance policy protecting a borrower) it cannot be “transferred” by the borrower if the borrower wishes to refinance their mortgage with another lender.

Cost of LMI

- LMI is generally required by lenders where a borrower has saved less than 20% of the purchase price as a deposit.
- The once only up front premium is paid directly **by the lender** to the LMI provider for the provision of LMI. That premium covers the lender for the entire life of the loan (up to 30 years).
- Typically (but not always), the cost of the LMI premium is passed on by the lender to the borrower as a fee (similar to other fees incurred by the lender in the mortgage origination process, e.g. valuation fees).
- The cost of the once only up front LMI premium varies depending on loan size, loan type, loan to value ratio, etc however typically, the average cost of an LMI premium is approximately $3,000.
- The borrower generally has the choice to capitalise the cost of the LMI premium into the loan amount.

Consumer benefits

- While the cost of LMI protecting the lender is typically borne by the borrower, the borrower obtains significant benefit from the use of LMI by the lender.
- LMI provides greater access to home ownership, particularly for low income, low equity or higher risk borrowers who would otherwise have difficulty obtaining a home loan.
- These borrowers are able to obtain a loan that would otherwise not be available, or to obtain a loan much earlier than they would be able to if they had to save for a full (20%) deposit.
- LMI, by allowing borrowers access to home ownership sooner, enables borrowers to accumulate equity in their homes faster.
- By transferring the potential credit loss to an LMI provider, LMI pools credit default risk and the associated costs and acts to increase the availability of home loans to higher risk borrowers by freeing up lenders’ capital.
- Importantly, with LMI, **lenders do not have to charge a higher interest rate to cover the increased risk a low deposit borrower presents**.
- The cost of the once only up front LMI premium borne by a borrower is significantly less than higher risk based interest pricing that would apply to a higher risk borrower over the life of the mortgage loan.

Regulation of LMI in Australia

- The provision of LMI in Australia is highly regulated. LMI providers are regulated by the Australian Prudential Regulation Authority (APRA). LMI is a general insurance product offered in Australia by providers operating under a monoline licence. LMI operates under the Insurance Contracts Act 1984. As a wholesale or business to business product, LMI is not governed by Chapter 7 of the Corporations Act 2001 (consequently retail disclosure requirements such as for a Product Disclosure Statement do not apply).
- LMI is a very capital intensive business. LMI providers are typically highly rated by independent ratings agencies, underpinned by substantial capital strength, both through APRA's local regulatory requirements and through rating agency capital requirements.
- LMI capital in Australia is typically invested in conservative, highly liquid non-correlated assets and is used as an independent layer of capital or buffer to pool credit default risk and the costs associated with default across time, geography and a large group of borrowers and lenders.

"Portability" of LMI on refinances

- As outlined above, LMI is not the borrower's insurance policy but the lenders' and relates to the particular loan/mortgage that is entered into between the lender and the borrower.
- Premium refund practices vary in the industry. Typically an LMI provider will provide a partial refund of the premium to the lender if the loan is discharged in the early years (usually in the first year or two) and the lender advises the LMI provider of that discharge. The general practice is that the lender will then pass on the refund received to the borrower.
- On a refinancing, the mortgage is terminated and the borrower enters into a new loan arrangement and new mortgage with a new lender. In most instances, the circumstances of the new arrangement and mortgage are different to the original loan (e.g., change in loan amount, loan to value ratio, borrower circumstances etc).
- From an LMI perspective, the termination of the existing mortgage and new arrangement is treated operationally, legally, and from a regulatory, rating agency and capital perspective as a new risk. In addition to the borrower and new loan attributes, the new lender attributes may also constitute a different risk profile for an LMI provider and underwritten and priced accordingly.
- When a borrower refinances with a new lender, then that lender may or may not elect to seek LMI and require the borrower to reimburse it for that cost. If a loan has been in place for a number of years, usually the borrower has accumulated sufficient equity to meet the deposit requirements of the new lender and LMI is not required.
- Where this is not the position and LMI is required, the percentage of borrowers who wish to refinance on a like for like basis to another lender is less than one percent as outlined below.
- In this respect:
    - Approximately 20% of all mortgages are currently insured with an LMI provider;
    - Of those insured mortgages, approximately 30% are refinances;

- Of those insured loans which are for refinance purposes, approximately 10% only are “dollar for dollar” and do not involve some element of increased risk or equity withdrawal on the part of the borrower.

- From a risk perspective, it is also important to note that LMI industry experience shows that the performance of refinanced loans that fall within this category is significantly worse than new purchase loans.

Broader reform and transparency about LMI

- The LMI industry generally supports the Federal Government’s announcement as part of its Banking Reform Package announced on 12 December 2010 as they relate to mortgages:

  …to take further steps to boost the capacity of Australian home borrowers to transfer mortgages …, through the introduction of a central repository to hold all mortgages so that refinancing a mortgage would not involve a borrower discharging and reinstating their mortgage.

- In the interim, the LMI industry is keen to address consumers’ concerns and the lack of understanding about the benefits of LMI, how LMI operates and the broader role LMI plays in facilitating competition in the mortgage market and access to home ownership.

- The LMI industry is aware that as the cost of LMI is typically passed on by the lender to the borrower, it is critical that the borrower understands the nature of LMI, the way LMI operates and that LMI is not confused with mortgage protection or other consumer insurance products.

- The LMI industry is committed to facilitating greater transparency for consumers around the operation of LMI, the benefits it does provide to consumers and the broader role LMI plays in the economy, particularly as mortgage origination is now incepted at so many points within the industry.

- The LMI industry has been working closely with Treasury and Government in its review of these issues and appreciates the opportunity to contribute this information to the Senate Inquiry.

If you require any further information, please contact Mr Anning on (02) 9253 5121 or janning@insurancecouncil.com.au.

Yours sincerely,

Robert Whelan
Chief Executive Officer & Executive Director

Appendix A

Lenders Mortgage Insurance

LMI was introduced into Australia in 1965 to enable first home buyers to "bridge the deposit gap" which was at that time, and still is, a significant impediment to achieving homeownership.

LMI **protects a lender** in the event of a borrower credit default on a residential mortgage loan. If the security property is required to be sold as a result of the credit default and the sale proceeds do not cover the outstanding loan balance, LMI covers the lender for the loss.

Role and value of LMI

Lenders mortgage insurance enhances the underlying efficiency in the market for housing loans, it improves access to home ownership, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), increases competition and innovation among lenders and reduces barriers to entry in the lending market.

LMI smoothes macroeconomic cycles, by facilitating greater amounts of housing lending at the bottom of a cycle but also provides a curb on imprudent lending at the top of a cycle. During the recent global financial crises, LMI providers were pivotal in the success of the Federal Government's first home buyers' initiative that was introduced to stimulate the economy during this time.

LMI providers in Australia are in a unique position in that they have broad oversight of mortgage lending practices in Australia. LMI providers have a whole of market view given the breadth of the LMI customer base which includes authorised deposit taking institutions (***ADIs***), non-bank lenders, and mortgage managers, originators, brokers and valuers.

The independent LMI providers also exert market discipline and have encouraged prudent lending practices in the Australian mortgage market throughout the last 45 years. LMI provides an important "second set of eyes" for this industry.

LMI facilitates competition in the lending market

With the introduction of LMI in 1965, building societies were able to compete effectively with banks and provided high LVR loans (up to 95% LVR) with LMI.

Prior to that time, first home buyers were restricted to borrowing up to 66% of the value of the property from the savings bank, and then had to borrow the remainder from either the trading bank arm of the bank or from another finance company – generally at much higher rates and shorter term than the loan obtained from the savings bank.

Following the deregulation of bank mortgage interest rates in 1986, the major banks, with the support of the LMI industry, also entered the high loan to value segment of the home lending market. A number of the largest building societies converted to regional banks at this time.

One of the major benefits of LMI is that it improves access to home ownership, particularly amongst low income earners, low equity or high risk borrowers, who would otherwise have difficulty obtaining a home loan.2 .

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[2] The Allen Consulting Group, Economic Benefits of Lenders' Mortgage Insurance, 29 September 2005, p6

By transferring the credit loss to an LMI provider **lenders do not have to charge a higher interest rate to cover the increased risk a borrower presents without a substantial deposit.** By transferring the risk and cost of default away from lending institutions to LMI providers, LMI increases the availability of home loans to higher risk borrowers by freeing up lenders' capital.

This mechanism has given confidence to lenders, allowing them to compete in the marketplace, and it provides a capacity for the lender to stand by the loan in the event of consumer default, potentially allowing time for the borrower to rectify the loan and resume mortgage repayments.

This allows borrowers to have access to the housing market much earlier than would otherwise be the case and **at an interest rate that is comparable with that of a borrower who was able to make a substantial down payment**.

Accordingly, **the LMI industry has played an important role in enabling home buyers (with low equity in the range 0% to 20%) to purchase a home sooner than would otherwise be the case**, if they had to save a 20% deposit before being able to obtain a loan. LMI also enables home buyers to accumulate equity in their homes faster.

A large portion of this high LVR market segment is first home buyers. LMI support has been critical for the provision of and ongoing support of the First Home Ownership Boost. Without such a risk offset mechanism through LMI, it is unlikely the First Home Ownership Boost would have been as successful.

LMI has also played a key role in providing credit enhancement that underpins the mortgage backed securitisation market, enabling non-bank lenders to access funding at competitive rates. Securitisation has promoted competition in the home lending market as mortgage originators and non bank lenders have been able to compete with the mainstream lenders on price and other features, resulting in a significant fall in margins earned by lenders on housing loans with obvious flow on benefits for all borrowers.

The LMI industry plays a critical role in facilitating efficient management of capital and risk in the banking system and it provides systemic housing loan risk protection by transferring risk outside the banking system.

That capacity is critical at times when the financial system and the residential mortgage component of the system are under stress - as has been evidenced during the recent global financial crisis. Ultimately, it is the consumer that bears the brunt and the cost of such systemic dysfunction.

Benefits of LMI – market discipline

LMI providers also play an important role in helping to exert market discipline and encourage the maintenance of prudent lending practices in the Australian residential mortgage market. This is demonstrated in a number of ways including:

- providing information and expertise to the market and customers;
- providing parameters of "acceptable risks" by setting credit policy and practice boundaries;
- providing a "second set of eyes" on customers' overall credit operations (policy and practice) for residential mortgages;
- providing post quality assurance reviews;

- working with customers to address and improve compliance issues; and
- working with customers to address and improve default and claims management.

Financial System stability

From a financial system stability perspective, the LMI providers hold significant capital in Australia that provides an additional independent layer of capital that assists in diversifying risk across lenders, across time and across geography.

LMI has contributed significantly in ensuring a stable and competitive residential mortgage market during the last 45 years.

LMI plays and will continue to play a significant role in meeting the housing aspirations and needs of the Australian people in the future.