Submission to the Inquiry into Competition in the Australian Financial System

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About QBE

The QBE Insurance Group (***QBE)*** is one of the few Australian-based financial institutions to be operating on a truly global landscape, with operations in and revenue flowing from 37 countries.

Listed on the ASX and headquartered in Sydney, organic growth and strategic acquisitions have seen QBE grow to become one of the world's top 20 general insurance and reinsurance companies, with a presence in all key global insurance markets.

As a global insurer, QBE believes that Australia must continually look to refresh its financial and regulatory systems so that the nation remains competitive with global financial markets and attractive to investment.

Background

In May 2017, the Australian Government tasked the Productivity Commission to hold an inquiry into competition in Australia's financial system (***the Inquiry***) consistent with the Government's commitment to implement periodic reviews of competition in the financial system, as recommended by the 2014 Financial System Inquiry (***FSI)***.

QBE understands the Inquiry is broad ranging, and will take a holistic view of the financial system – including products and services provided to households, small businesses and large corporations, as well as financial system infrastructure. We also understand, to avoid overlap with other active reviews, the Inquiry will consider insurance products only in so far as they affect competition between banks and other financial service providers, including as part of vertically and horizontally integrated business models.

As such, QBE understands that the Inquiry may be interested in lenders mortgage insurance (***LMI***), to the extent that LMI may affect competition between banks and other financial service providers.

LMI plays an extremely important role in the Australian housing market. It improves access to home ownership, enhances the underlying efficiency and integrity in the home lending market, contributes to smoothing the effects of economic cycles (primarily because its underlying risk preparedness is very long term), reduces barriers to entry in the home lending market, and increases competition and innovation among lenders.

As part of QBE, QBE Lenders' Mortgage Insurance Limited (***QBE LMI)*** has been providing LMI in Australia for more than 50 years. QBE LMI welcomes the opportunity to provide this initial overview of LMI, how it operates in Australia, and how it facilitates competition in the residential home loan market and supports the long-term stability of Australia's financial system.

Lenders mortgage insurance

What is the purpose of LMI?

LMI was introduced by the Menzies Government into Australia in 1965, with the establishment of the government-owned Housing Loans Insurance Corporation (HLIC – since privatised) with a view to providing access to home ownership for a broader segment of the Australian population.

Where borrowers do not have a substantial deposit (typically 20%) for a home, there is a greater risk that if the borrower defaults on their home loan, the lender will suffer a loss if the property has to be sold. LMI is insurance that a lender takes out to insure itself against the risk of such loss occurring. By transferring that risk to an LMI provider, the lender is prepared to provide home loans to borrowers who are creditworthy and have the capacity to make mortgage repayments, but do not have the required deposit.

With the benefit of LMI, many first home buyers are more likely to be able to afford to buy, move into and accumulate equity in their home sooner. With LMI protecting the lender, home ownership is more accessible as borrowers can obtain a loan that would otherwise not be available, or obtain a loan much earlier than if they had to save for a full (20%) deposit.

LMI also plays an important role in maintaining the stability of financial markets. Firstly, it provides a second set of eyes in addition to the lenders, to ensure credit standards are maintained and both policies and practices of lenders are monitored. Secondly, LMI provides additional capital into the financial market to support home lending. This capital is dedicated to residential mortgage lending and is fungible across lenders and geography. Additionally, through reinsurance, LMI can access international financial markets to access foreign capital and disseminate risk.

LMI capital is available during times of increased mortgage defaults, which typically occurs during economic downturns. The deployment of LMI capital reduces losses incurred by lenders and helps to smooth the impact of economic cycles.

Significantly, as outlined in this submission, the operation of LMI in Australia has and continues to play a critical role in facilitating and supporting competition in the high loan to value (***LTV)*** lending segment that includes many first time home buyers.

What is LMI?

It is important to understand that LMI is a **wholesale insurance** product that **protects a lender** in the event that a borrower defaults on a loan, and there is a shortfall between the loan amount and the amount subsequently recovered by selling the property. The **lender is the beneficiary** under the policy, not the borrower. In insurance terms, the **borrower is the "risk**" against which the LMI policy provides protection.

LMI provides insurance against the credit default risk of a particular home loan provided by a specific lender at a specific time. As such, each LMI policy is written to cover the individual loan between the lender and the borrower on the basis of the specific attributes of that loan (borrower, loan characteristics, property and lender or origination characteristics).

LMI is generally required by a lender where a borrower has a deposit which is less than 20% of the property purchase price. A once-only upfront premium is paid directly by the lender to the LMI provider, covering the lender for the total value of the loan for the entire life of the loan (generally up to 30 years).

LMI generally operates as a 'community-rated' rather than 'risk-rated' insurance product. In other words, to enable a larger proportion of the Australian population to access home loans, the LMI insurers determine the expected loss from the total population of borrowers and share this cost across the premium collected from all borrowers that do not have the 20% deposit. A more risk-based approach would cost more or exclude borrowers who are assessed as higher risk, which QBE LMI considers would be contrary to the purpose of LMI, which is to enable broad access to homeownership.

Typically (but not always), the cost of the LMI premium is passed on by the lender to the borrower as a fee, similar to valuation and other fees incurred by the lender during the mortgage origination process. The borrower generally has the choice to capitalise the cost of the LMI premium into the loan amount. This means the borrower does not need to pay this cost upfront, but can spread the cost over the life of the loan.

Importantly, with LMI, a lender does not have to charge a higher interest rate to cover the increased risk that a low deposit borrower presents. This allows a borrower to have access to the housing market at an interest rate that is comparable with that of a borrower who is able to provide the necessary deposit. Based on our experience, the cost of the once-only upfront LMI fee borne by a borrower is significantly less than the application of a higher risk-based interest rate that is applied over the life of the mortgage loan.

What are the broader benefits of LMI?

LMI is a crucial but some time overlooked component of the Australian home lending market. It supports the economic stability of the financial system and facilitates home ownership, accessibility to credit and competition. In particular, LMI:

- **supports market accessibility**, enabling those who would otherwise have difficulty obtaining a home loan – particularly borrowers with low incomes or low levels of equity – to satisfy responsible lending criteria and purchase a home.
- **by community rating - supports affordability,** enabling borrowers, who are creditworthy and have the capacity to make mortgage repayments but do not have the required deposit, to access home loans on

similar interest rates to those with a substantial deposit.

- **maintains the integrity of lending practices** by being a 'second set of eyes' in addition to lenders' – promoting industry best practice, providing feedback on lender policies and ensuring that credit standards are maintained. LMI providers are also active in detecting potential fraudulent activity within the mortgage industry.
- **diversifies lending risk** by pooling risk across different lenders and borrowers and across time and geographical locations, and by sourcing reinsurance and capital from international financial markets.
- **lowers the cost of mortgages** by making mortgage-backed securities more attractive to investors, providing access to wholesale funding markets and reducing lender costs. The mid-1990s entry of these securities into the Australian home loan market introduced significant competition, materially reducing the cost of borrowing for home owners.
- **smooths the effects of economic cycles** as LMI capital is deployed during economic downturns when there are increased mortgage defaults. This reduces the losses incurred by lenders, so they remain strong and protected and are therefore able to continue to provide credit while the market recovers. As such, LMI enhances the underlying efficiency in the market for home loans (primarily because its underlying risk preparedness is very long term).

Most significantly, LMI encourages and facilitates competition in the high LTV lending segment - an important segment that includes many first time home buyers:

- Many of the small and medium sized lenders would not be attracted to the high LTV lending segment without an LMI partner to both support their origination and credit assessment practices as well as cover unforeseen losses in their home loan portfolios. LMI also operates systemically to diversify the aggregate geographic and industry concentrations of the small and medium lenders.
- LMI has also traditionally been used by non-approved deposit taking institutions (***ADIs***) as well as small and medium ADIs in their residential mortgage backed securitisation (***RMBS***) transactions to make RMBS more attractive to investors, providing them with access to wholesale funding markets and reducing their cost of funds. It was the entry of these lenders into the home loan market in the mid-1990s that introduced significant competition for home loans, leading to reduced mortgage repayment rates and material reductions in the cost of borrowing for Australian home owners.

The value of LMI has been widely recognised by financial authorities – the Joint Forum has stated that:

> *Mortgage insurance provides additional financing flexibility for lenders and consumers, and supervisors should consider how to use such coverage effectively in conjunction with LTV requirements to meet housing goals and needs in their respective markets. Supervisors should explore both public and private options (including creditworthiness and reserve requirements), and should take steps to require adequate mortgage insurance in instances of high LTV lending - e.g. greater than 80% LTV*[1]

In Australia, the 2014 Financial System Inquiry (***FSI)*** has also acknowledged the key role of LMI when it recommended that the Australian Prudential Regulation Authority (***APRA***) should **recognise lenders mortgage insurance**[2] where appropriate to narrow mortgage risk weight differences between IRB and standardised lenders to encourage competition and remove impediments to its development.

Facilitating competition in the lending market over the last 50 years

LMI has contributed significantly in enabling a stable and competitive residential mortgage market in Australia during the last 50 years. LMI has given lenders confidence to compete, and borrowers have benefited through greater access and choice.

Prior to the introduction of LMI, first home buyers were restricted to borrowing up to 66% of the value of the property from the savings banks, 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 terms than the loan

[1] The Joint Forum, Review of the Differentiated Nature & Scope of Financial Regulation, January 2010, p.17. The Joint Forum was established under the aegis of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors.

[2] Financial System Inquiry Final Report, November 2014, p. 66.

obtained from the savings bank. With the introduction of LMI in 1965, building societies were able to compete effectively with banks and provided high LTV loans (up to 95% LTV) with the support of LMI.

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

LMI has also played a key role in providing credit enhancement that underpins the RMBS market, enabling ADIs and non ADIs lenders to access funding at competitive rates. Securitisation has promoted competition in the home lending market as mortgage originators and non ADI lenders have been able to compete with the mainstream lenders on price and other features resulting in competitive mortgage interest rates. Competition has driven efficiency gains that have enabled, a significant reduction in net interest margins earned by lenders on home loans, with obvious flow on benefits for all borrowers.

Facilitating competition in the lending market today

LMI is currently widely used among lenders offering high LTV mortgages in Australia. About **one in four residential home loans are supported by LMI, with up to one-third of these loans for first home buyers**.

LMI is used by the mutual banks, credit unions, building societies, regional banks, international banks and Australia's four major banks, as well as non-ADIs.

For small and regional lenders, the support provided by LMI is essential, as they cannot carry as much risk on their smaller balance sheets. Typically, these lenders are exposed to greater regional concentration and have less capacity to bear the risk without some component of credit default protection.

The use of LMI enhances the ability of smaller lenders to compete with larger lenders (i.e. the major banks), which currently enjoy a significant competitive advantage in the high LTV segment with the cost of funds and from having the balance sheet capacity to self-insure and who also apply a model based approach for regulatory capital.

LMI assists these lenders to diversify their risk, enabling them to enter and compete in the high LTV lending segment. The use of LMI also means these lenders can hold less regulatory capital for these risks than would otherwise be the case for such loans without the use of LMI.

This is particularly important for smaller lenders with geographic concentration where LMI plays a critical role in supporting their concentration risk in their "home market" (for example, regional and rural Australia) as well as enabling them to expand (and diversify) their lending across other geographies.

Similarly, foreign banks and the non-banking sector, with the support of LMI, also continue to place competitive pressure on domestic ADIs to moderate margins.

LMI is a critical component that enables smaller lenders and non-bank lenders to continue to compete in the residential mortgage market and to offer high LTV home loans at competitive rates. Increased competition facilitates innovation in the market with the delivery of new technology and new products, such as shared equity mortgages.

Risk diversification and stability

The LMI industry plays a significant role in facilitating 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 is a very capital-intensive business. LMI providers are typically highly rated by independent ratings agencies, underpinned by substantial capital meeting both APRA's local regulatory requirements and independent rating agency capital requirements. LMI capital in Australia is typically invested in conservative, highly liquid assets, and is used as an independent layer of capital that specifically supports credit default risk and the costs associated with that default in the home lending market. LMI assists to diversify that risk across time, geography and a large group of borrowers and lenders.

This additional support provided by LMI is critical at times when the financial system and the residential mortgage component of the system are under stress. This was evidenced during the recent global financial crisis where LMI providers, by supporting lenders with high LVR lending, were pivotal in the success of the then Australian Government's first home buyers' initiative that was introduced to stimulate the economy during this time.

Longer term, the LMI industry functions to smooth the effects of economic cycles. Just as it can facilitate greater amounts of housing lending at the bottom of a cycle, LMI also provides a curb on imprudent lending at the top of a cycle. In doing so, the LMI industry helps to bolster financial and economic stability while continuing to benefit the housing industry and its customers, borrowers and lenders alike.

The provision of LMI in Australia is highly regulated. LMI providers are regulated by APRA, and 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*.

Capital recognition for lenders that use LMI

The value of LMI for ADIs varies depending on if they are operating under the standardised or Internal Ratings Based (***IRB***) approaches to calculating minimum capital requirements.

Currently, LMI providers exist in an environment where IRB lenders do not explicitly receive recognition for LMI when determining capital requirements, whereas the value of LMI is clearly recognised for standardised lenders.

Under the existing Basel arrangements, there is no capital incentive, or rather, no capital disincentive to ensure that IRB lenders continue to use LMI on residential mortgages. Following the implementation of Basel II, APRA has required all IRB lenders to maintain a floor of 20% for the Loss Given Default (***LGD***) on residential mortgages. This floor has been the adopted assumption for LGD for mortgages with and without LMI protection, giving no recognition for the use of LMI by IRB lenders and effectively negating the capital benefits for LMI being recognised in the capital calculations.

The current IRB approach has proven to yield a lower regulatory capital requirement for residential mortgages than the standardised approach. At present, all of the 'Big Four' Australian banks and Macquarie have IRB status. In practice, the vast majority of residential mortgages originated by ADIs are subject to the IRB approach.

In the absence of such regulatory or structural incentives recognising the use of LMI, QBE LMI is concerned about the ongoing viability of LMI as a product. This, in turn, may place at risk both the accessibility to home ownership and the affordability of homes within the Australian housing market as well as significantly reduce competition in the home lending market. Of critical significance, QBE LMI believes that without the support of a strong and stable LMI industry, small and medium ADIs and non-ADI lenders will be at a material disadvantage in this market compared to the IRB lenders.

Today, without capital recognition for the use of LMI, we are already seeing IRB lenders use a combination of 'un-insured risk retention' (charging the borrower a fee and retaining the risk on balance sheet without insurance), waiving of LMI (retaining the risk on balance sheet without charging a fee or seeking insurance), the use of other credit risk mitigants provided by entities not regulated by APRA, along with LMI. Evidence is now emerging that this is impacting competition. For example, we are aware that small and medium ADIs are unable to compete for first home buyers in the medical profession as the major IRB lenders waive LMI and hold no additional capital against these loans.

As the capital required to be held by IRB lenders will remain the same irrespective of their risk management decisions, any move away from using LMI could well result in the capital provided by LMI providers leaving the financial system. LMI capital is regulated, the majority of which is held locally, and the LMI industry has a proven track record of paying claims throughout economic cycles. Additionally, should the use of LMI decline, so will our ability to utilise our 'second set of eyes' position to help ensure fraud identification and prudent lending standards are maintained by lenders across the home lending market. Most importantly, the critical support LMI provides to

the smaller ADIs and non-bank lenders will not be available, which we believe will significantly impact competition in the residential mortgage market.

Individual banks and the LMI and banking industries, through the Insurance Council of Australia and the Australian Bankers Association, have submitted extensive claims data, modelling and analysis to APRA on the effect of using LMI in the context of the LGD floor in the event of a severe downturn. Similarly, extensive representations have been made to APRA on the important role of LMI in the Australian market and the need to recognise the use and value of LMI from a capital perspective for lenders in the IRB's LGD model.

The role and value of LMI was specifically considered by the FSI in the broader context of its considerations on IRB mortgage risk weights for residential mortgage risk. In the context of the recommendation that IRB mortgage risk weights should be raised to improve competitive neutrality and increase resilience, the Inquiry observed on page 66 that on implementation:

> *The risk weight gap [between standardised and IRB lenders] could be narrowed in a variety of ways. In determining the approach, APRA should seek to maintain as much risk sensitivity in the capital framework as possible and recognise lenders' mortgage insurance where appropriate*.

As outlined by the FSI, the LMI industry has continued to liaise with APRA to determine how to address this disparity in line with the FSI's recommendation. In essence, the LMI industry has provided further information to APRA including a proposition that the capital for IRB lenders for high LTV loans should be increased where those lenders do not use LMI for such loans. This increase could be commensurate with the LMI capital that would have been held, if that loan had been insured. QBE LMI considers this proposition would improve the competitive neutrality of capital regulation by limiting distortions caused by the differential regulatory treatment of different classes of lender (and also between the lenders and the LMI providers), while retaining an incentive for lenders to improve risk management capacity. An alternative proposition would be for LMI to be mandatory for high LTV loans, as is the position in some other jurisdictions, including Hong Kong and Canada.

From a financial system stability perspective, LMI provides a significant additional independent layer of capital that diversifies risk across lenders, across time and across geography. LMI has contributed significantly in ensuring a stable and competitive residential mortgage market during the last 50 years. In the absence of any regulatory or structural incentives for using LMI, market forces (reflected in the points above) may drive LMI as a product out of the market. This is the case in New Zealand where LMI is no longer available and there is significantly less competition in the home lending market. In that market where loans are uninsured, lenders are more likely to charge borrowers additional fees and higher interest rates for the life of the loan to compensate for the higher risk retained by lenders.

Our submissions[3] to the FSI on LMI outline in detail the potential consequences of the lack of a strong independent LMI regime for broader financial system stability.

Conclusion

Lenders mortgage insurance has been an integral component of the Australian housing market since 1965, facilitating home ownership, accessibility to credit and competition, particularly in the LTV lending segment that includes many first home buyers. Currently, IRB lenders receive no capital recognition for the use of LMI (or no capital disincentive if they cease to use LMI), despite the fact that the LMI providers are required to, and do hold, significant capital for the risk that is transferred.

QBE LMI believes the Productivity Commission should consider the important role that LMI plays in the financial system, particularly in relation to supporting competition in the home lending market.

Please do not hesitate to contact Kate O'Loughlin at if you would like to discuss any aspect of this submission, or if you require any further information.

[3] http://fsi.gov.au/files/2014/04/QBE_Lenders_Mortgage_Insurance.pdf; http://fsi.gov.au/files/2014/09/QBE.pdf