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29 March 2018

Mr Peter Harris
Presiding Commissioner
Productivity Commission
4 National Circuit
Barton ACT 2600

Via email: financial.system@pc.gov.au

Dear Mr Harris,

Genworth's second response to the Inquiry into Competition in the Australian Financial System

Genworth Mortgage Insurance Australia Limited ("Genworth") welcomes the Productivity Commission's Draft Report into Competition in the Australian Financial System (the Draft Report), and in turn, the opportunity to respond to the Draft Report.

Genworth is a leading provider of lenders mortgage insurance (LMI) in Australia. Not only does LMI enable more Australians to buy their own home sooner, and safely, but LMI also enables borrowers and mortgage lenders alike to participate in Australia's mortgage market and financial system.

Genworth made an initial submission to the Inquiry on 4 October 2017 and in this submission seeks to respond to each of the individual recommendations, responses and requests for information in relation to LMI contained in your draft Report.

Where Commissioners are interested in further information that we can provide on Genworth or the LMI industry more generally, we would be pleased to do. If so, please contact Alexander Drake, Head of Government and Industry Affairs

Yours sincerely,

Georgette Nicholas
Chief Executive Officer and Managing Director
Genworth Mortgage Insurance Australia Limited

Contents

Executive summary

Although Commissioners are clearly well-informed about the nature of the LMI industry in Australia, and how it interacts with borrowers and lenders alike, it is worth briefly reiterating the role and importance of LMI to the Australian housing market, and wider financial system.

With $384 billion of new loans originated in 2017 and over one-fifth of all new mortgage loans at 80% loan to value ratio (LVR) and above[1], LMI plays an important role in making it easier for more Australians to realise the dream of home ownership. Genworth remains a market leader and we are proud of our contribution to the great Australian dream of home ownership.

Notable features of LMI in Australia include:

- LMI is one of many types of risk protection that can be taken by a lender to protect it against financial loss resulting from borrower default;
- Of the 8.4 million residential homes in Australia at June 2017, 2.9 million are mortgaged and 2.6 million are rented;
- LMI providers have around 1.6 million policies in force on residences (including 1.2 million on owner occupied loans);
- LMI covers around 40% of Australian households with owner occupier finance; and
- Half of the 300,000 LMI policies issued in the 18 months to June 2017 relate to loans provided to young homebuyers (aged 35 or under).

Unlike our earlier submission made in October 2017, our response to the Draft Report is organised around specific requests for information, recommendations or observations made by Commissioners.

The key items that Genworth seeks to respond to in this submission are:

- **Draft Finding II.1 – State of competition in the financial system** (pages 32 and 103 of the Draft Report);
- **Draft recommendation 8.5 – Lenders Mortgage Insurance refund** (pages 38 and 245 of the Draft Report);
- **Information Request 8.3 – Are changes needed to Lenders Mortgage Insurance?** (pages 38 and 247 of the Draft Report);
- **Draft Finding 8.3 – If you have a high loan-to-value ratio, you are probably paying for it twice over** (page 246 of the Draft Report); and
- **Draft Finding 11.1 – Market power in general insurance provision** (pages 42 and 327 of the Draft Report).

[1] APRA, 13 March 2018, *Quarterly Authorised Deposit-Taking Property Exposures*, page 6. Available at: http://www.apra.gov.au/adi/Publications/Documents/QPEX_December_2017.pdf

Additionally, Genworth notes the favourable remarks in the Draft Report about the efforts of LMIs to promote the fact sheet on LMI[2] and is willing to work with other stakeholders to continue this educational process.

In addition to the responses to the matters above, if there is more information that Commissioners would be interested in, Genworth would be pleased to assist further.

[2] Draft Report, page 247. Available here: http://www.pc.gov.au/inquiries/current/financial-system/draft/financial-system-draft.pdf

Genworth

Response to the Draft Report into Competition in the Australian Financial System

Draft Finding II.1 – State of competition in the financial system

(Pages 32 and 103 of the Draft Report)

Australia's banking sector is a strong oligopoly with a long tail of smaller providers. The general insurance sector similarly has a small number of very large providers and a long tail of smaller providers.

Prudential regulation substantially limits the scope for traditional price competition in banking and, to a degree, in insurance. The Reserve Bank of Australia setting of cash rates offers an opportunity for coordinated pricing in banking that is unique to this industry.

Competition on product features and service is less constrained, and thus more evident. But the large number of marginally different products appears more reflective of a capacity for price discrimination than of competition.

- *Although at less than desirable levels, there is evidence of more competition (albeit on product features rather than price) in the markets for home loans, consumer credit cards, home insurance, wealth management and financial advice.*
- ***There is evidence of less competition in** the markets for small business credit, **lenders mortgage insurance,** add-on insurance and pet insurance.* [our emphasis]

Genworth response

In the Australian LMI market, there are currently two active independent LMI providers - Genworth and QBE (formerly PMI). At the present time, it is estimated that between the two companies, they hold approximately 64% of total LMI market share.[3] This market concentration compares with the top four lenders in Australia representing approximately 72% of mortgage originations in 2017. The remaining 36% of the LMI market is held by the captive LMI providers – Westpac LMI and ANZ LMI.

At different times over the last 20 years, there have also been other independent LMI providers and captives that have competed in the Australian market. The following LMI providers are either in run-off or have ended operations:

- MGIC (US mortgage insurer);
- Vero LMI;
- Mortgage Risk Management Pty Ltd;
- Permanent LMI Pty Limited (PMI Group and Heritage Building Society);

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[3] UBS research note – "QBE Insurance Group", 19 March 2018.

- Sunstate Lenders Mortgage Insurance Pty Ltd; and
- Western Lenders Mortgage Insurance Company Limited.

It is understandable for Commissioners to look at the various levels of market share held by independent LMI providers when considering whether competitive pressures are strong enough in the LMI market to result in outcomes that benefit consumers. However, those figures themselves are insufficient to fully appreciate the competitive nature of the LMI market in Australia.

First, although a mortgage lender might sign a contract with an LMI provider so that that provider provides its policies exclusively to that lender[4], there is no obligation by the lender to use those products to cover every single HLVR loan. When a lender invites tenders from interested LMI providers, the onus is on LMI providers to offer a product and value proposition that is compelling, so that a lender will want to insure as much of their HLVR lending book as possible with that LMI provider.

The effect of this on the market is to make their product as competitive against other LMI providers as possible. After all, there are alternate structures available to lenders, should they wish to use them other than traditional LMI, and involve a fee being charged to the borrower equivalent to an LMI premium, such as the Commonwealth Bank's Low Deposit Premium[5], where risk is retained by bank with some catastrophic risk transferred to reinsurers.

Second, the contracts that the LMI providers sign with lenders to provide LMI products to lenders can be to cover the loans in part of a lender's HLVR book, or in some cases, to provide LMI exclusively to that lender. An LMI provider entering into a contract with a new lender, whether for part or the whole of its book, can have a considerable effect on the LMI market.

The possibility of gaining or losing such relationships puts significant disciplinary pressure on LMI providers to keep their product offering as attractive and competitive as possible, as, in extremis, it can mean that a major revenue source is lost immediately to the LMI. The tendering process and the nature of LMI contracts with individual lenders have a significant effect on keeping the LMI market competitively priced throughout the life of a contract with a lender.

Finally, LMI providers that are registered and based in Australia are obliged to adhere to the rules established by the Australian Prudential Regulation Authority (APRA)[6]. However, lenders may also choose to reinsure their risk via a reinsurer based overseas, that is not obliged to follow requirements made by APRA of local LMI providers[7]. In effect, this means that locally based LMI providers are constantly positioning their product offering to ensure they remain competitive with numerous potential offshore reinsurers that are not obliged to follow the same APRA requirements and could potentially enter the Australian market at any time. This is not true compared to other lines of business in general insurance, such as motor insurance.

Although there are presently only two Australian-based LMI providers competing for business of insuring HLVR loans written by ADIs, there are multiple significant competitive pressures on the LMI industry and market, namely:

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[4] See as an example http://investor.genworth.com.au/DownloadFile.axd?file=/Report/ComNews/20161103/01798325.pdf

[5] https://www.commbank.com.au/personal/home-loans/low-deposit-premium.html

[6] More information is available here: http://apra.gov.au/GI/Pages/general-insurance-authorisation-guidelines.aspx

[7] One such example arose from the situation outlined here: http://investor.genworth.com.au/DownloadFile.axd?file=/Report/ComNews/20150217/01599689.pdf

- The lack of any requirement by ADIs to use LMI, even when a lender uses an LMI provider exclusively (subject to the contract signed);
- The risk that an LMI provider might lose a major customer keeps LMI providers competitive and conscious of their need to offer a compelling value proposition; and
- The ability of lenders to reinsure as much of their book as they may wish to, with various insurers or reinsurers based offshore, and not operating under APRA regulations or expectations.

These all combine to ensure that the LMI market in Australia remains competitive, ensuring that lenders and their customers get the best, most reasonably priced, cover for HLVR mortgage lending.

From a global perspective, the following table gives some insight into how mortgage insurance markets operate elsewhere:

Jurisdiction	Mortgage insurance or equivalent program or providers	Known mortgage insurers
Australia	Lenders mortgage insurance	• Genworth • QBE LMI • Westpac LMI • ANZ LMI
Canada	Canada Mortgage and Housing Corporation (CMHC) Private mortgage insurance	• CMHC (Crown Corporation with 100% government catastrophic guarantee) • Genworth (90% Government catastrophic guarantee) • Canada Guaranty Mortgage Insurance (90% Government catastrophic guarantee)
China	Mortgage loan guarantees by guarantee company (抵押贷款担保)	• eg Beijing Housing Guaranty (Local Government owned) • Shanghai Housing Guaranty Co (Local Government owned)
France	La garantie de prêt immobilier de Crédit Logement	• La garantie de prêt immobilier de Crédit Logement (bank owned mutual guarantee company) • AmTrust
Germany	Required of building societies	• AmTrust
Hong Kong SAR	Mortgage Insurance by HKMC (按揭保險計劃) Private mortgage insurance	• Hong Kong Mortgage Corporation (Government owned) • QBE • Arch
India	Credit risk guarantee fund scheme for low income housing Mortgage guarantee companies	• India Mortgage Guarantee Corporation Private Limited (Joint venture between National Housing Bank of India (Reserve Bank of India owned), World Bank, Asia Development Bank and Genworth)

		• Credit Risk Guarantee Fund Scheme For Low Income Housing (National Housing Bank of India)
Indonesia	Credit insurance by Askrindo (Asuransi Kredit)	• Askrindo (State owned Bank)
Italy	Fondo di garanzia per la prima casa (Fondo prima casa) Credito Fondiaro	• AmTrust
Japan	Bank-owned “credit guarantee” companies Japan Housing Finance Agency	• Bank-owned captives
Korea	Mortgage credit insurance (for <70LTV) [모기지 신용 보험] Mortgage insurance (for 71~85LTV) [모기지 보험]	• SGIC (Government owned) • Genworth and AIG formerly there
Mexico	Sociedad Hipotecaria Federal (SHF) Private mortgage insurance	• SHF (Government owned) • Genworth
Netherlands	de Nationale Hypotheek Garantie	• Government Owned Mortgage Guarantee Company
Russia	The Agency for Housing Mortgage Lending	• Central Bank owned Mortgage insurance reinsurance company (in runoff) • Over 20 general insurers wrote AHML backed mortgage insurance
Saudi Arabia	Real Estate Finance Law Saudi Vision 2030	• Government owned mortgage guarantee fund for first time homebuyers
United Kingdom	“Help to Buy” mortgage guarantee Private mortgage insurance	• AmTrust • “Help to Buy” (Government owned – in run off)
United States	Federal Housing Authority (FHA) mortgage insurance Veteran Affairs (VA) guaranty Department of Agriculture (USDA) guaranty Private mortgage insurance	• Federal Housing Authority (FHA) mortgage insurance (Government program) • Veteran Affairs (VA) guaranty (Government program) • Department of Agriculture (USDA) guaranty (Government program) • Arch Mortgage Insurance • Genworth • MGIC • Radian • Essent • NMI

It is worth noting that the only country with more than three independent LMI providers is the United States (US) with nine (three of which are Government programmes).[8]

Continuing the international comparisons, from a global perspective, Australian LMI pricing is significantly lower than some other jurisdictions. For example, Canadian premium rates are between 33-175% higher (varies by LVR) for the same full cover product. In the US there are both monthly premiums and single up-front premium borrower paid options, although please note that LMI coverage in the US is lower than in Australia (top 12-30% vs full cover). When comparing their single premium rates to Australia, rates are estimated to be 20-60% higher in the US (varies by LVR) with lower coverage. This suggests that although Australian market participants are broadly in line with global norms, there is significantly better value in Australian LMI premium pricing than that which may be found in other jurisdictions.

[8] Source: Genworth research (2018).

Draft recommendation 8.5 - Lenders Mortgage Insurance refund

(Pages 38 and 245 of the Draft Report)

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.

Genworth response

The Draft Report[9] has already recognised that LMI premiums can be partly refunded if a home loan is terminated very early on in the life of the loan. As things stand, if a borrower wants to seek a partial refund on their LMI premium, they must have already paid out the loan entirely within a year or two of settling the property. In addition, the borrower should have a clear record on avoiding late payments. These requirements will vary from lender to lender, and borrowers should ask their lenders what their own requirements are.

While expanding the scope for refunds may have some high-level appeal as a flexible initiative that could benefit some borrowers, it overlooks the fact that LMI premiums are set in the context of capital requirements for lenders and effectively represent "sunk costs" upfront for such items as capital, expenses and losses which feature more extensively in the earlier years of a policy, reducing the potential value of extending refunds as a mechanism over the policy period. This makes it likely that a refundable LMI product would not see the significant downward pressure on LMI premiums that some might wish for but quite the reverse with prices potentially significantly higher depending on the level and timing of refunds.

The other major issue to consider is profitability – the need to realise an adequate return by both the lender and the LMI after taking into account those regulatory requirements. So, expanding the scope of potential refunds is unlikely to put downward pressure on LMI premiums, despite that the fact that the LMI market has multiple competitive pressures on it (see responses to Draft Response II.1 above). Premiums are at current levels because this reflects the cost of the risk and capital early in the life of a loan, not later on.

Finally, a potential danger that could arise from broadening the scope of refunds is that, where the refunds exceed the surrender value of the premium, LMI providers would be forced to reassess the pricing of the product, meaning this would result in higher premiums.

[9] Productivity Commission Draft Report, into Competition in the Australian financial system, 7 February 2018, page 244.

Draft Finding 8.3 – If you have a high loan-to-value ratio, you are probably paying for it twice over

(Page 246 of the Draft Report);

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.

and

Information Request 8.3 - Are changes needed to Lenders Mortgage Insurance?

(Pages 38 and 247 of the Draft Report)

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?

Genworth response

It is difficult for LMIs to respond to questions or comments about interest rates being set by lenders. They are commercial decisions made by lenders and are beyond the scope of LMI providers. Questions about interest rates settings are best directed to lenders themselves. LMI providers set premiums for individual loans made by lenders, based on the data that they have available to assess losses and expenses as well as holding the regulatory capital required.

However, it should be acknowledged that lenders still retain a capital requirement and some residual operational risk. The way that lenders choose to price risk to their customers is up to them, but LMIs are willing to work with lenders to entertain alternatives, within the constraints imposed by the incidence of risk and the regulatory capital system.

Moreover, the Draft Report suggests that where the average interest rate for all borrowers was 5%, the average interest rate for borrowers would be approximately 5.003%.[10] Although the Draft Report acknowledges this difference is “small”, it should be pointed out that the 3-basis point difference represents $9 pa on the average $300,000 LMI-insured loan. This indicates to us that lenders do not use the borrower interest rate as a risk-pricing tool, and hence there is no appreciable double-charging of customers.

Finally, it is worth noting that if LMI were no longer offered it could result in:

- Reduced access to credit/home ownership, particularly for low income, low equity or higher-risk borrowers (often first home buyers) who will have difficulty obtaining a home loan. This is particularly relevant to borrowers in regional areas where smaller lenders will not provide HLVR loans without LMI
- Fewer home loans being approved, or approval delayed unless (and until) the borrower can save for a 20% deposit.

[10] Draft Report, page 246.

- Increased volatility from housing market and economic downturns as LMI providers are APRA regulated and hold significant capital in Australia that provides an additional independent layer of regulatory capital that supports financial stability;
- Borrowers with low deposits being forced to use low deposit premium products (such as that used by CBA in some cases) and pay higher interest rates than rates payable on comparable loans with LMI; and
- Reduced ability for lenders to transfer risk in respect of catastrophic loss – LMI providers support the credit quality of the Australian banking system and discourage imprudent lending and act as an early warning system to lenders and the market.

Draft Finding 11.1 - Market power in general insurance provision

(Pages 42 and 327 of the Draft Report)

Because many general insurers provide insurance under multiple brands, this creates the illusion of more competition than actually exists in the general insurance market.

In every general insurance market considered — home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance — the largest four firms (which are not always the same four) account for more than 70% of the relevant market.

The domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance markets are highly concentrated. While the domestic home insurance market is less concentrated, the two largest firms account for more than half the market.

Genworth response

See our earlier response in relation to the “State of Competition in the Financial System”, noting that there currently are 4 LMI providers in Australia which, relative to global markets is a reasonable number of product providers. We have also noted that there are significant barriers to entry for LMI providers, notably the amount of regulatory capital required to be held by LMI providers by the Australian prudential regulator to conduct an LMI business; the relatively low return on equity and the fact that the use of LMI is not mandatory. We believe, given these barriers to entry that there is a healthy level of competition and share of market power within the LMI industry. We also point out to the Commission that the LMI product (being insurance taken out by the lender not the borrower) is in no way comparable or analogous in any way to the consumer market for motor vehicle or consumer credit add-on or pet insurance products.