# Submission on the draft report of the inquiry into competition in the Australian financial system

March 2018

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# About QBE

The QBE Insurance Group (***QBE***) is one of the few Australian-based financial institutions operating on a truly global landscape, with operations in, and revenue flowing from 36 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 part of QBE, QBE Lenders' Mortgage Insurance Limited (***QBE LMI***) has been providing lenders' mortgage insurance (***LMI***) in Australia for more than 50 years.

# Background

In May 2017, the Australian Government tasked the Productivity Commission (***Commission***) to hold an inquiry into competition in Australia's financial system (***the Inquiry***). The Commission's draft report was released on 7 February 2018 (***Draft Report***) and the Commission has subsequently held a series of public hearings in Sydney and Melbourne.

A key area of interest for the Inquiry has been the operation of the residential home loan market, *given the choice of a home loan is, in many cases, the biggest financial decision that people make.*[1] As noted by the Commission, *it is therefore important that the home loan market is competitive, efficient and fair.*[2] As an integral part of the residential home loan market, the Inquiry has also expressed an interest in the use and operation of LMI.

LMI is a crucial but often overlooked component of the Australian home lending market.  In particular, LMI:

- **supports the Australian dream of homeownership**, enabling those who would otherwise have difficulty obtaining a home loan (particularly borrowers with low incomes or low levels of equity who have difficulty saving a substantial deposit) to purchase a home.
- **by community rating and sharing the risk across the LMI pool - supports accessibility and affordability,** enabling borrowers, who are creditworthy and have the capacity to make mortgage repayments (but lack the required deposit), to access home loans at similar interest rates to borrowers 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.
- **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, helping maintain greater confidence in the Australian financial market during such times. As such, LMI enhances the underlying efficiency in the market for home loans (primarily because its underlying risk preparedness is long term-focused).

**Most significantly, LMI encourages and facilitates competition** in the high loan to value ratio (***LVR***) lending segment - an important segment that includes many first-time home buyers:

- **With the critical support of LMI, new entrants have brought additional competition and innovation to the Australian market.** The entry of the non-authorised deposit-taking institutions (***non ADIs***) into the Australian home loan market in the mid-1990s (including Aussie Home Loans) introduced significant competition for home loans. This led to reduced mortgage repayment rates and material reductions in the cost of borrowing for Australian home owners.  This step change was only achievable with LMI support.

[1] Draft Report (*DR*) 211.
[2] Ibid.

- **More lenders can compete in high LVR lending because of LMI.** Many of the small and medium sized lenders would not be attracted to high LVR lending without LMI support for their origination and credit assessment practices as well as cover for unforeseen losses in their home loan portfolios. LMI also diversifies the aggregate geographic and industry concentrations of the small and medium lenders enabling them to continue competing in these areas.
- **LMI lowers the cost of funds for lenders, enabling lenders to reduce home loan interest rates, facilitating competition.** By absorbing risk, LMI facilitates lenders access to cheaper or deeper sources of funding from more risk averse investors. This is most evident in securitisation markets where LMI has been used in warehousing and residential mortgage backed securitisation (***RMBS***) enabling non ADIs as well as small and medium authorised deposit-taking institutions (***ADIs***) 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.

The value of LMI has been widely recognised by financial authorities – the Basel Committee 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.*[3]

In Australia, the 2014 Financial System Inquiry (***FSI***) also acknowledged the key role of LMI when it recommended that the Australian Prudential Regulation Authority (***APRA***) should **recognise lenders mortgage insurance**[4] where appropriate to narrow mortgage risk weight differences between IRB and standardised lenders to encourage competition and remove impediments to its development.

In its Draft Report, the Commission recognises that LMI is an important financial product and can at the margin increase competition in the home loan market.[5] The Commission has, however, also expressed concerns around some features of the LMI market that it believes could lead to outcomes that do not support competition. In particular, the Commission has indicated that:

- As the cost of LMI is usually passed on by lenders to consumers, there may be no strong incentive to make sure the price is competitive. Also, that consumers cannot exert competitive pressure on LMI providers as the relationship is between a lender and an insurer.
- When a loan is refinanced, as it is a new loan for LMI purposes, this can discourage switching, if borrowers are aware of it.

QBE LMI provided an initial submission (***initial submission***) on LMI to the Inquiry. In light of the commentary on LMI in the Draft Report and discussion at the public hearings, we believe it is also important for the Commission to understand some essential contextual information in relation to the use of LMI in Australia.

The role LMI plays in the Australian residential home lending market is complex and needs to be considered holistically. The micro and macro-economic support for the home lending market that is provided by LMI is generally not well understood and often underestimated.

We appreciate the opportunity to provide the **following additional information** to assist with the Commission's understanding of the use and operation of LMI in Australia.

# The intrinsic risk of high loan to value residential lending

Certain types of loans are considerably more risky than others.

In the context of residential mortgage lending, loans with a higher LVR ratio (***high LVR loans***) are widely recognised[6] as having a higher risk of default and a higher likelihood of loss by lenders.

[3] Bank for International Settlements Basel Committee on Banking Supervision Joint Forum, *Basel III: Finalising post-crisis reforms*, December 2017 (*Basel Committee Basel III Framework paper*), 21.
[4] Treasury, *Financial System Inquiry Final Report*, November 2014, 66.
[5] DR 239.
[6] By such bodies as Moody's Investor Services, Standard and Poor's Global, and the Reserve Bank of Australia.

With lower proportions of equity being available to absorb losses, high LVR loans are particularly vulnerable to potential losses.

Losses can arise from unforeseen changes in an individual borrower's circumstances (such as illness or divorce). These losses are typically described as expected or attritional losses. Losses also arise from broader macro-economic impacts, such as rising unemployment and pressure on repayments from things (such as rising interest rates). This is often coupled with declining house prices, which quickly erodes the limited equity in the property. These losses are typically described as unexpected or catastrophic losses.

By way of illustration of the intrinsic risk of high LVR loans, Figure 1 (sourced from ratings agency Standard & Poor's (***S&P***)) maps the relative risk of Australian mortgages with different LVRs.

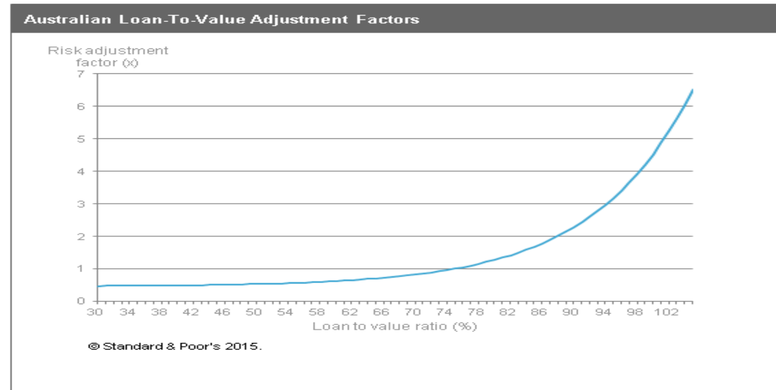


*Figure 1*

From this, we can see that S&P considers that the **relative risk** for Australian mortgages **rises exponentially for loans with an LVR above 80%**. For example, a 95% LVR mortgage is considered to be approximately three times riskier than a 75% LVR mortgage.

It is well established globally that LVR is a primary indicator of the relative riskiness of residential mortgages. This has most recently been demonstrated by the Basel Committee for Banking Supervision (***BCBS***) in its proposed review of the standardised approach for credit risk.[7] Supported by consultation with international regulators, the BCBS is proposing revisions for the risk weights for standardised lenders for residential mortgage lending that vary based on the LVR of the mortgage (instead of the existing single risk weight)[8] to make them more risk-sensitive.[9]

This more risk-sensitive LVR approach by the BCBS is consistent with the approach adopted by APRA some years ago for residential mortgage lending by ADIs using the standardised approach, and for LMI providers in Australia.

In addition to the prospect of higher losses due to the relative riskiness of high LVR loans, lenders may also face increased volatility in earnings. Regulatory and commercial factors therefore create a tangible additional cost for high LVR lending. Lenders respond to this in different ways including:

- not participating in high LVR lending;
- limiting supply or selecting only what are considered to be the best risks;
- increasing the price of the loan to cover the increased risk (charging higher interest rates or a low equity fee);
- using credit risk mitigation tools, such as LMI.

**It is important for the Commission to appreciate that, in the absence of LMI, lenders will still need to take measures to address the cost (from a regulatory capital and commercial perspective) of the increased risk of high LVR lending.**

**Although substitute mechanisms to address the cost may be available to some lenders, without the support of LMI, many other lenders may not have the risk appetite to participate in high LVR lending.**

**We believe this would have significant negative consequences for both competition in the sector and access to home ownership for borrowers.**

[7] Bank for International Settlements Basel Committee on Banking Supervision, *High-level summary of Basel III reforms,* December 2017 (*BCBS Summary*), 2, 4.
[8] BCBS Summary 2.
[9] BCBS Summary 11.

# Competition

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.

## Facilitating competition and innovation in the lending market for over 50 years

With the introduction and support of LMI in 1965, building societies were able to compete effectively with banks and provide high LVR loans (up to 95% LVR). Prior to that time, first home buyers were restricted to borrowing up to 66% of the value of the property from savings banks. Any additional funds, if they could be accessed, had to be borrowed from the trading bank or from another finance company – usually at much higher rates and on shorter terms - 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 LMI, also entered the high LVR segment of the home lending market. A number of the largest building societies converted to regional banks at this time.

LMI, over this time, has also been instrumental in providing credit enhancement that underpins the RMBS market. LMI lowers the cost of mortgages by making RMBS more attractive to investors, enabling lenders to access wholesale funding markets and reducing lender costs. The mid-1990s entry of these securities into the Australian home loan market enabled mortgage originators and non ADI lenders (such as Aussie Home Loans) to vigorously compete with mainstream lenders. This competition, facilitated by LMI, has driven efficiency gains that significantly reduced net interest margins earned by lenders on home loans, with obvious flow on benefits for all borrowers.

## Helping more lenders compete in the market today

LMI is currently widely used among lenders offering high LVR mortgages in Australia[10]. These include mutual banks, credit unions, building societies, regional banks, international banks and Australia's four major banks, as well as non ADIs.

Without LMI, fewer lenders would compete in the high LVR segment of the market.

### *Small and regional lenders*

For small and regional lenders, the support provided by LMI is essential. Without LMI, smaller lenders are unlikely to have the capacity or risk appetite to participate in and compete against larger lenders in high LVR lending whose size gives them a significant competitive advantage.[11] These lenders are typically exposed to greater regional concentration and cannot carry as much risk on their smaller balance sheets. As such, they have less capacity to bear high LVR risk without some component of credit default protection.

These lenders use LMI both as a credit risk mitigant (supporting the inherent risk of high LVR lending) and for the regulatory capital benefit that applies through the use of LMI.

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

The table below illustrates this point. It shows the current top 10 lender rates for a $475,000 loan at a 95% LVR with LMI.[12]

[10] DR 239. As the Commission notes, about one in four residential home loans are supported by LMI, with up to one-third of these loans for first home buyers.
[11] For these lenders, the cost of funds is relatively low, they have balance sheet capacity to 'self-insure', and many also apply an internal ratings based model approach resulting in relatively lower regulatory capital requirements.
[12] Sourced from Mortgage Broker - NewPath Finance.

| TOP 10 LENDER RATES * | RATES FOR 475,000 LOAN, 95% LVR AS AT 24 MARCH 2018 | |
|---|---|---|
| **Westpac** | 3.59% | 2 year introductory rate variable P&I, O/O |
| **St George** | 3.68% | variable P&I, O/O |
| **NAB** | 3.89% | variable P&I, O/O |
| **AMP** | 3.79% | Professional package variable P&I, O/O |
| **Suncorp** | 3.79% | First Home Buyers variable P&I, O/O |
| **Heritage Bank** | 3.89% | variable P&I, O/O |
| **ANZ** | 3.99% | variable P&I, O/O |
| **CBA** | 3.99% | variable P&I, O/O |
| **Firefighters Mutual Bank** | 3.79% | 3 year fixed |
| **UniBank** | 3.79% | 3 year fixed |

*Figure 2*

As expected, the major banks all feature. With the support of LMI protecting both the principal and interest margin, regional banks and small mutual lenders are also able to provide price competition and discount their margin.

### *Foreign lenders and non ADIs*

Similarly, LMI provides essential support to foreign banks and the non ADI sector through the direct provision of LMI and also through credit enhancement of RMBS securities. These lenders continue to place competitive pressure on domestic ADIs to moderate margins and provide borrowers with more choice.

### *Larger lenders*

LMI is also widely used by major lenders in Australia, even though these lenders are arguably able to bear the risk of high LVR lending and also diversify this risk across their own geographic spread. As well being a credit risk mitigant for these lenders (and assisting to mitigate operational risk), LMI is used as it is a cost effective mechanism for larger lenders for high LVR risk. This helps improve their competitive position.

Increased competition facilitates innovation in the market delivering broader benefits with the delivery of new technology and new products.

## Facilitating competition in the residential mortgage market through the cycles

Over a considerable period of time, LMI has demonstrated its credentials as a cost-effective form of credit risk transfer that competes favourably against alternative and substitute products.

We believe competition in the residential mortgage lending sector needs to be considered through the economic cycle, rather than at a point in time. LMI is established to operate through the cycles and its underlying risk preparedness is very long term.

The LMI industry functions to smooth the effects of economic cycles. This was evidenced during the global financial crisis where the support of lenders by LMI providers was pivotal in the success of the then Australian Government's first home buyers' initiative - introduced to stimulate the economy. At the same time, in New Zealand, lenders effectively withdrew from high LVR lending post the global financial crisis. The exception was Kiwi Bank, which continued to offer residential mortgage loans above 80% LVR, with the support of LMI.

At the peak of the competitive cycle, experience in overseas markets shows that alternate options to LMI, such as additional risk margins and increased risk based interest rates, were quickly competed away by lenders, leaving an overall weaker financial system and considerably more volatility in earnings for lenders during the downturn.[13] As lenders withdraw due to mispricing of risk or changes in the cycle, competitions is lacking in markets at a time the economy often needs it most.

[13] Based on observations of the New Zealand LMI market's poor performance during the 2008-09 Global Financial Crisis and lack of resilience (following contraction, the supply and range of LMI providers has not been restored).

LMI, through community pricing of residential mortgage risk, levels the field for riskier borrowers. This means competition for all eligible borrowers is similar and strong and is sustainable throughout the economic cycles. By contrast, a risk-based pricing alternative would mean competition would typically be fierce for the strongest borrowers, but there would be limited or no competition for other credit worthy but higher risk borrowers, particularly during times of economic stress.

# How LMI works

Historically, LMI has been introduced by governments to help bridge the deposit gap and to support or facilitate home ownership for more people. In most jurisdictions where LMI is used, LMI is either mandatory for high LVR lending, incentivised by capital requirement relief on the underlying mortgages or the government itself participates in or supports its provision.[14]

With the expertise and support of LMI, more lenders are prepared to participate in and compete for residential mortgage lending, particularly high LVR lending. Many lenders otherwise would not have the risk appetite, expertise or capacity for this risk.

Although initially introduced by the Federal Government in 1965, LMI in Australia is now provided by private market participants and supported solely by private capital (unlike most other jurisdictions where LMI is extensively used).

## What is LMI?

In Australia, LMI is a specialist commercial insurance product that protects a lender against the credit default risk of a particular home loan on the basis of the specific attributes of that loan (borrower, loan characteristics, property and lender or origination characteristics). LMI provides protection for the lender for the entire life of that loan (which can be up to 30 years).

Although each LMI policy operates on an individual basis for a specific loan, the accumulation of high LVR credit default risk means that LMI insurers have liabilities that are concentrated in highly correlated risks. As noted by the Reserve Bank of Australia:

> *…this exposes them to significant insurance risk as they can experience a heightened number of policy claims during economic downturns. This is different from other general insurers: 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 disasters).*[15]

As a result, although LMI in Australia is a general insurance product, APRA requires LMI providers in Australia to be ‘monoline’ insurers to ring-fence this risk from other insurance activities.

APRA's prudential settings for LMI reflect the concentration of correlated risks in an LMI's business (which are closely linked to the banking sector). Compared with Australian general insurers, LMI providers must hold a substantial amount of capital against ‘insurance concentration risk’ (a component of their total capital requirement).[16] For example, as at June 2017, the capital base of the regulated LMI providers in Australia was over 3.5 times the annual gross earned premium. In contrast, the capital base of regulated general insurers in Australia was approximately 0.57 times the annual gross earned premium.[17]

This is to ensure LMIs are resilient to the key tail risk they face (a very severe housing market downturn) and reflects the fact that LMI cover is very long term (unlike many general insurance products, which typically provide annual cover). Also, if there is an economic downturn, LMI providers are likely to face claims from multiple underwriting years, at the same time.

As such, LMI providers are required to hold significant capital against the possibility of a systemic or catastrophic downturn. They do this by building long-term capital buffers and reserves, which are partly built up during the lower loss periods of the underwriting cycle to cover claims during the peaks.[18]

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[14] Reserve Bank of Australia, *Financial Stability Review,* September 2013, (*RBA Financial Stability Review*) 40.
[15] RBA Financial Stability Review 39.
[16]Insurance Council of Australia, Finity Consulting Commission by LMI Standing Committee, Australian Lenders Mortgage Insurance Industry Experience to June 2017 (draft), March 2018, available at file:///C:/Users/204902/AppData/Local/Microsoft/Windows/INetCache/Content.Outlook/LSB8NU4K/2017%20LMI%20industry%20report_draft20180306.pdf (*Finity Consulting draft report*) 28.
[17] Ibid.
[18] Bank for International Settlements Basel Committee on Banking Supervision Joint Forum, *Mortgage insurance: market structure, underwriting cycle and policy implications*, February 2013, available at https://www.bis.org/publ/joint30.pdf (***Joint Forum paper***) 2.

During more benign economic times, LMI providers will typically incur lower claims costs and may have better operating margins than general insurers (as demonstrated in the following graph).

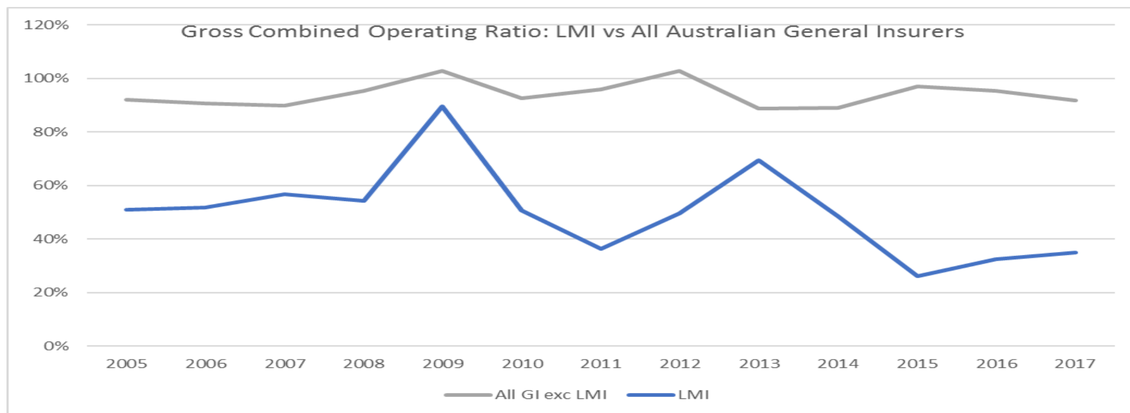


*Figure 3*

During periods of cyclical residential mortgage stress however, LMI provider losses can be very significant. The Basel Committee Joint Forum in its paper on *Mortgage insurance: market structure, underwriting cycle and policy implications* indicated that:

> *… long term capital buffers are needed in dealing with the tail event losses of LMI. LMI tends to have a relatively consistent level of risk for many years, and then is subject to (typically short) extreme tail events creating much worse loss experience. This cyclicality then repeats over a long cycle. In the US for example, it was about 75 years between the two worst events; however, less severe cycles of 10 to 20 years are common in many countries. Higher capital standards in normal times will provide additional resources to mitigate the effect of the serious downturns when they occur.* [19]

We have provided some confidential information about QBE LMI's loss experience through the cycle (see confidential appendices – annexure A).

We have set out this information to provide context for the Commission in light of recent commentary about low loss ratios and LMI. A comparison of loss ratios of LMI with the loss ratios of other general insurance products is not apposite given the very different nature of risk involved and the regulatory framework pursuant to which LMI providers operate.

## LMI supporting system stability

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 potential 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.

## The cost efficiency of LMI

LMI typically produces lower returns on equity (***ROE)*** than general insurers or ADIs, as demonstrated in the following graph.

[19] Joint forum paper, Recommendation 4.

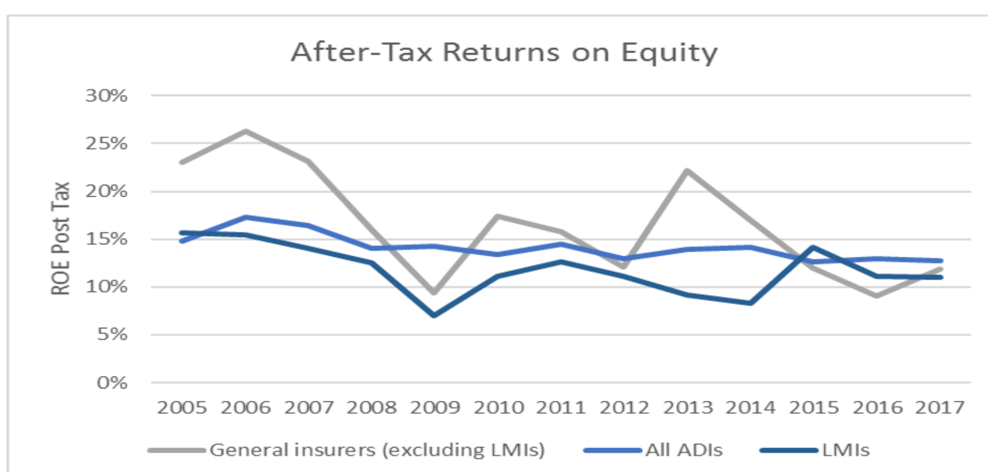


*Figure 4*

With a long history of specialist underwriting and risk expertise in high LVR lending and access to the benefit of global reinsurance (which provides diversification benefits), LMI providers can more effectively underwrite and diversify high LVR residential mortgage risk (across time, lenders and geography). Coupled with a different risk and return profile to that of lenders, LMI providers are able price the intrinsic risk of high LVR lending more efficiently than most ADIs.

This is an important factor for consideration by the Commission. Particularly in the context of concerns that the cost of LMI, which is typically passed on to borrowers, should be fair and competitive. The Australian LMI market is one of the few efficient risk transfer markets in the world. By pricing credit risk more efficiently, LMIs operates to provide a discount to the borrowers who ultimately pay for the transfer of high LVR credit risk.

We have provided some confidential information about QBE LMI's pricing of LMI (see confidential appendices – annexure B).

# Benefits of LMI for borrowers

The notions that LMI does not benefit borrowers, or that it is unfair as the premium for lender protection is generally passed on to the borrower, are misconceived. LMI provides many benefits for including the opportunity for borrowers to:

- buy property (and avoid paying rent);
- buy at today's price and interest rates (a key concern when house prices continue to rise);
- benefit from increases in the value of their house; and
- avoid paying more than is necessary (alternative options are likely to cost more).

### *Obtaining a high LVR loan*

A borrower always has a choice of whether to take out a higher LVR loan now, with the benefit of LMI, or wait until they have saved sufficient deposit (usually 20%) for a normal loan.

One of the greatest concerns expressed by borrowers who would like to achieve the dream of home ownership, is that by waiting to save a deposit, they are "going backwards" as they must continue to pay rent or because house prices may rise faster than their deposit accumulates.

By de-risking the loan for a lender, LMI enables higher risk borrowers (often first home buyers) to access financing, that otherwise may not be available.

### *A cost-effective price for more borrowers for the inherent risk*

LMI also enables a borrower to access a high LVR loan at a cost-effective price for the inherent risk.

LMI effectively "buys" the borrower access to a high LVR loan at a much lower rate of return than they would otherwise have to pay (assuming the borrower was actually able to access a loan). From an economic perspective it can be described as follows:

- the borrower would like a high LVR loan which will enable them to participate in leveraged house price asset growth and avoid rental costs;

- as the borrower does not have sufficient equity or savings of their own, the borrower is renting the equity of the LMI in return for a fee;
- because LMI backs the borrower's ability to repay by agreeing to reimburse the lender for the loss of principal and interest on the loan, the lender is willing to accept the added risk of the high LVR loan. In other words, LMI acts in a similar way to a guarantor for the borrower enabling them to borrow at a rate that reflects the support of the LMI provider.

LMI also operates as 'community-rated' rather than 'risk-rated' product and LMI premiums do not generally vary according to the individual characteristics of borrowers. In other words, to enable a larger proportion of the Australian population to access home loans, 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 relevant (20%) deposit. A more risk-based approach would either exclude borrowers who are assessed as higher risk, or result in charging higher risk borrowers more.

The community-rated approach and pricing efficiency of LMI significantly benefits more borrowers than alternative options to compensate lenders for high LVR risk (as outlined below).

### *Capitalising LMI into the value of a loan*

Lenders typically pass the cost of the LMI premium onto the borrower in the form of a fee (along with other loan origination fees such as property valuation and mortgage establishment fees). Lenders often allow the borrower to capitalise these fees into the mortgage.

Much discussion has been devoted to LMI capitalisation costs in the course of the Inquiry.[20] Just as saving a substantial deposit takes time, lenders usually allow borrowers to capitalise the cost of LMI into the loan amount as accumulating these funds will delay the purchase. Lenders allow this for borrower convenience. For borrowers, delaying the purchase to accumulate additional funds is not a desirable option.

For LMI providers, capitalisation of the cost of the LMI premium into the loan increases the LVR of the high LVR loan, which increases both the risk and capital required to be held by the LMI provider.

Despite this, whether paid upfront or capitalised, LMI is price efficient and as shown in the following graph is generally a better option for a borrower than alternate solutions for high LVR lending.

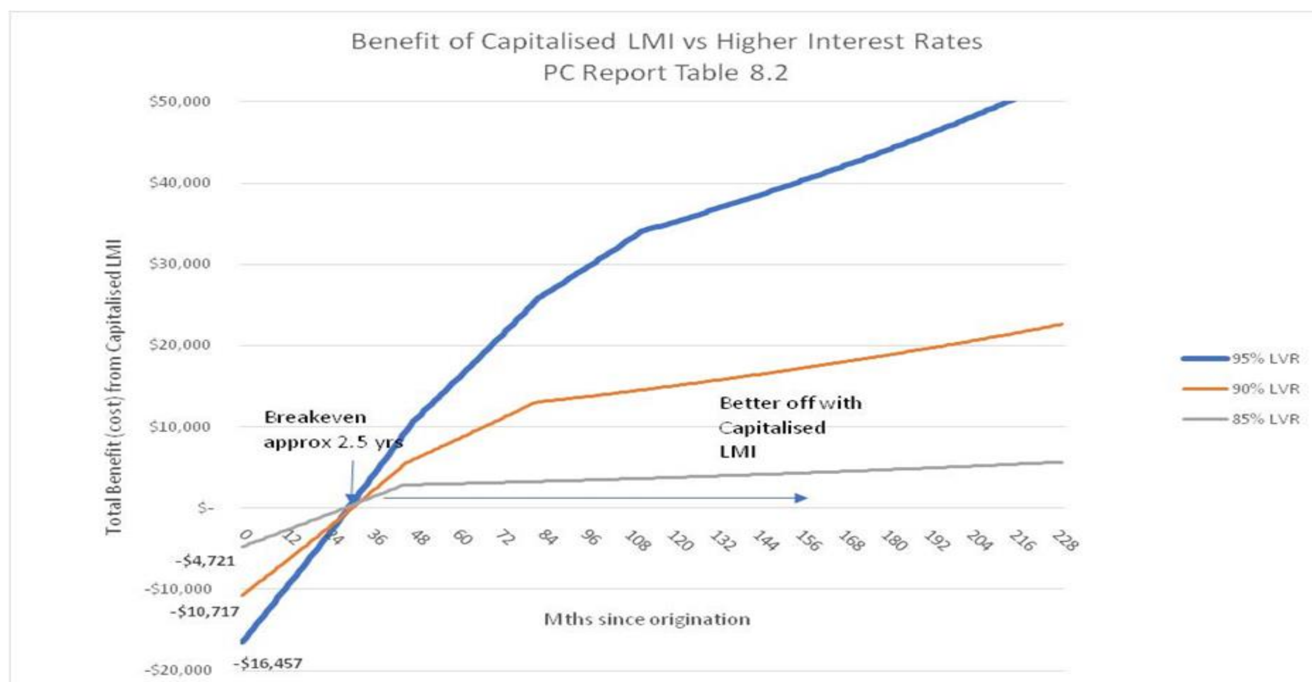


*Figure 5*

[20] For example, DR 241- 242.

### *Borrower's return on investment*

What is often overlooked, is that a high LVR borrower can generate very significant returns through house price growth relative to the small amount of cash they outlay due to the higher level of gearing achieved, with the help of LMI.

The following table uses the scenarios from the Commission's Draft Report table 8.2 to illustrate the house price growth required to recover the LMI premium over the initial period of the loan.

| LVR | LMI PREMIUM FROM PC REPORT TABLE 8.2 | APPROX. HOUSE PRICE GROWTH REQUIRED TO RECOVER LMI PREMIUM OVER FIRST YEAR | APPROX. HOUSE PRICE GROWTH REQUIRED TO RECOVER LMI PREMIUM OVER 2 YEARS |
|---|---|---|---|
| 85% | 4,721 | 2.0% | 1.4% |
| 90% | 10,717 | 3.5% | 2.3% |
| 95% | 16,457 | 4.9% | 3.2% |

Key assumptions: 4.5% mortgage interest rate, 2.75% rental yield

*Figure 6*

This table shows if the house price increases by 5% in the first year or 3% over two years, the borrower has fully covered the cost of the LMI for a 95% LVR loan. As such, the borrower can then benefit from potential house price growth (which can be significant).

This can be put into perspective using historical house price growth in the table below:

| HOUSE PRICE GROWTH PER ANNUM | SYDNEY | MELBOURNE | BRISBANE | ADELAIDE | PERTH | AUSTRALIAN CAPITAL CITIES |
|---|---|---|---|---|---|---|
| 3 years to Sep 17 | 10.6% | 10.0% | 3.3% | 3.7% | -3.2% | 7.5% |
| 5 years to Sept 17 | 11.5% | 8.7% | 4.0% | 3.7% | 0.3% | 7.8% |
| 10 years to Sep 17 | 7.2% | 6.6% | 2.7% | 3.2% | 0.4% | 5.3% |

Source: ABS

*Figure 7*

In fact, a high LVR borrower will typically earn a higher rate of return on investment from house price growth than a someone who borrows 80% LVR or less (as their investment outlay is smaller).

## The advantages of LMI compared with alternative options for high LVR risk

We understand that one of the submissions to the Commission has called for LMI to be abolished and proposes instead that lenders should charge higher interest rates for more risky borrowers.[21]

It is important to understand that LMI is not mandatory in Australia. Other options to address the inherent risk of high LVR loans in Australia exist and are currently being used.

LMI, however, is efficient and cost effective for both lenders and borrowers and is the choice of the market. We strongly believe alternative mechanisms to address high LVR risk are inferior, as outlined below.

### *Lenders increase interest rates to cover the high LVR loan risk*

The most common alternative to LMI for high LVR loan risk is for lenders to charge borrowers a higher risk based interest rate. For a borrower, this additional cost is an ongoing cost. For a borrower, this cost may apply for the life of the loan (which is currently the case with investor loans) or, on a best case basis, will continue at least until the LVR has reduced sufficiently to be considered a normal loan (typically 80%).[22]

[21] Most notably, public hearing 28 February 2018; post-draft written submission No. 97 by Choice group.

[22] For example, in the UK most lenders' upper limit on loans is 80%. In Hong Kong, LMI is mandatory for residential loans over 66% and in New Zealand, ABS bank charges a 'low equity margin' fee of borrowers with LVRs above 80%. This is also the ratio at which APRA regulatory capital burden on the lender increases.

This approach will almost certainly cost considerably more than LMI over the normal course of a loan contract, due to the time it takes for a loan to amortise. Using the example in table 8.2 of the Draft Report, the time taken to amortise a loan to 80% LVR can be calculated as follows:

| LVR | LOAN SIZE | MTHS TO AMORTISE TO BELOW 80% LVR | MTHS TO AMORTISE TO BELOW 80% LVR ASSUMING 1% INTEREST RATE LOADER |
|---|---|---|---|
| 85% | $ 425,000 | 42 mths | 49 mths |
| 90% | $ 450,000 | 74 mths | 84 mths |
| 95% | $ 475,000 | 100 mths | 111 mths |

*Figure 8*

In contrast, the table below expresses the cost of LMI premiums from table 2 of the Draft Report as equivalent interest rates over the various periods.

| | | | CAPITALISED LMI COST EXPRESSED AS EQUIVALENT INTEREST RATE P.A. | | | | |
|---|---|---|---|---|---|---|---|
| **LVR** | **Loan Size** | **LMI Premium** | **2 years** | **3 years** | **5 years** | **10 years** | **30 years** |
| 85% | $425,000 | $4,721 | 0.61% | 0.42% | 0.27% | 0.16% | 0.09% |
| 90% | $450,000 | $10,717 | 1.30% | 0.90% | 0.58% | 0.35% | 0.20% |
| 95% | $475,000 | $16,457 | 1.89% | 1.31% | 0.85% | 0.50% | 0.29% |

*Figure 9*

As LMI is an upfront cost typically capitalised into the loan, its cost diminishes over time. Interest rates, on the other hand, can vary during the loan and a higher risk-based interest rate charged by a lender may also increase. In contrast, LMI is a fixed cost, paid up front, that cannot increase over time.

This is particularly important for those borrowers who are more likely to experience financial difficulty (for example, where house prices have not risen).

It is helpful to consider this practice in other jurisdictions where LMI use is not prevalent, such as the United Kingdom and New Zealand.

For example, a $450,000 loan with a 90% LVR will cost $10,717 in LMI (or, based on the first five years, equivalent to an additional 0.58% per year including interest assuming the premium is capitalised into the loan). By contrast, the cost of this loan based on the additional interest rate charged by lenders currently using this mechanism, is significantly higher (UK - Lloyds: 0.92%, UK - Yorkshire BS: 1.25%; New Zealand - ASB (100% owned by CBA): 0.75%).

As the loan duration increases, the gap widens: for a 30-year loan, the capitalised LMI payment is only $19,549 but the lenders' replacement risk premium (assuming a 1% interest rate loading) would equate to $98,988.

This approach means borrowers would pay significantly more than the cost of LMI, whether capitalised or not, particularly where house prices remain flat or fall.

Most importantly, borrowers that are the highest risk and most likely to default, will end up having to pay more, despite the fact that they are less able to afford the additional cost. Similarly, from a loan servicing perspective, if a lender charges significantly higher interest rates without LMI, fewer borrowers will satisfy loan servicing requirements and qualify for a loan than with the use of LMI.

### *Lenders charge a "low equity margin"*

Another option, which operates in a similar way to higher interest rates, is for lenders to charge borrowers a low equity margin.

In New Zealand, ASB Bank (owned by CBA) charges a low equity margin (***LEM***) for loans with LVRs of 80% and over. Borrowers will pay this additional margin annually until their LVR falls below 80% (which takes, for a 95% LVR loan approximately 9.5 years through loan amortisation, with no house price increase or decrease).

This means borrowers with a 95% LVR effectively pay three times – 1.30% while they are within the 95% LVR bracket, then 0.75% in the 90% bracket and then 0.30% in the 85% bracket. Fortunate borrowers may be able to lower their LVR faster if they can repay early, or experience property value gains, but unless these are significant, they will still likely pay more than the cost of LMI.

Meanwhile, those borrowers who cannot repay earlier than expected and do not enjoy capital gains – the least wealthy – pay the highest margin cost.

#### *Retention of risk by lenders*

Some lenders choose to charge borrowers an additional risk charge (low equity fee), rather than utilising LMI.

Unlike LMI, this fee is not earned in accordance with the forecast emergence of risk in the manner of an APRA-regulated LMI provider. Nor can this risk be disseminated through reinsurance.

Some lenders currently retain part or all of the risk associated with high LVR lending. In fact, there appears to be an emerging trend of certain major lenders waiving LMI premiums for select groups of borrowers that are deemed to be low risk (for example, certain types of professionals, such as medical doctors).

Although some borrowers of high LVR loans are clearly less of a risk that others, our view is that these alternative practices are likely to reduce competition in the longer term. This practice causes adverse selection and although it might appear that competition increases, it does so only for the few highly credit worthy borrowers but reduces competition for the less strong but still credit worthy borrowers.

### More borrowers benefit from LMI

Affordability and accessibility to home ownership has and continues to be a key focus of Australian governments for some time. Buying a home is part of ‘the Australian dream’.

Simply put, with LMI, more borrowers can buy a house at today’s price and interest rates rather than wait to save a 20% deposit. If the borrower defaults, LMI compensates the lender so that the lender can continue to give *other* high LVR borrowers access to equity.

LMI is currently the most efficient and equitable way we have of giving less wealthy borrowers access to home ownership while maintaining capital system stability.

We believe alternative options open to lenders to compensate for the inherent risk of high LVR loans will, on balance, result in less attractive outcomes for the majority of borrowers and, in the longer term, reduce competition. In addition, alternative options do not perform the broader role LMI plays in supporting system stability and facilitating competition in the high LVR lending segment.

## Specific issues raised in the Draft Report

### Refunds

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 outlined above, there is a cost associated with assuming the inherent risk of a high LVR loan. This cost must be borne by someone. In the context of considering mandatory refunds of LMI for borrowers who choose to refinance or pay out their loan, this needs to be recognised.

The cost of LMI is not an arbitrary fee (like an exit fee) but is charged for the risk that is assumed by the LMI. A borrower does not obtain a refund of interest charges on a loan on termination - this is considered to be the cost of extending the credit. Similarly, LMI premiums are directed to the costs that LMI providers must bear for the provision of the LMI.

As indicated, LMI pricing is primarily driven by the regulatory capital requirements to prudentially manage LMI risk across cycles, the need to cover operating expenses (including global reinsurance) and obtain an adequate ROE. As such, the cost of LMI becomes an equation. The current limitation on refund availability (partial, for termination early in the life of the loan) has a sound economic justification:[23] the premium is not simply pocketed by the LMI provider and cannot easily be separated from the cost of covering the whole pool.

[23] DR 245.

Expressed in another way, a farmer could not get a refund for the delivery cost of a load of feed if, six months later, she chose to graze her cattle on neighbouring land. While she might complain that the feed delivery charge was no longer of value to her now that she was not using the feed, that does not change the fact that, at the time of purchasing the load, the delivery fee was a fair and necessary cost. The farmer could not have contracted to purchase the whole load of feed but only agree to pay some of the delivery cost, pending the eventuality that not all the feed would be used.

Mandating a refund requirement for LMI would mean the product would need to be fundamentally repriced. Although this is possible, it would increase LMI premiums for a significantly higher proportion of borrowers than those borrowers it would assist.

In addition, incentivising switching by mandating refunds may have other unforeseen consequences including promoting churn. Switching costs are not confined to purchasing LMI but include loan origination costs, documentation, valuation fees and so on. These costs of refinancing for the scenarios in the PC report table 8.2 are estimated at $3,000-$5,000. Typically, a lender earns interest over time to cover costs not directly passed on to borrowers. If these costs are not recovered due to refinancing, ultimately these costs will be passed on to other borrowers.

Also, as the Commission is aware, LMI (or a suitable alternative) may still need to be paid by the borrower for the refinanced loan if the LVR of the refinanced loan is still greater than 80% (as it constitutes a new loan under the current regulatory framework).

The graph below compares the position of a refinanced loan using LMI compared with a higher risk-based interest rate.

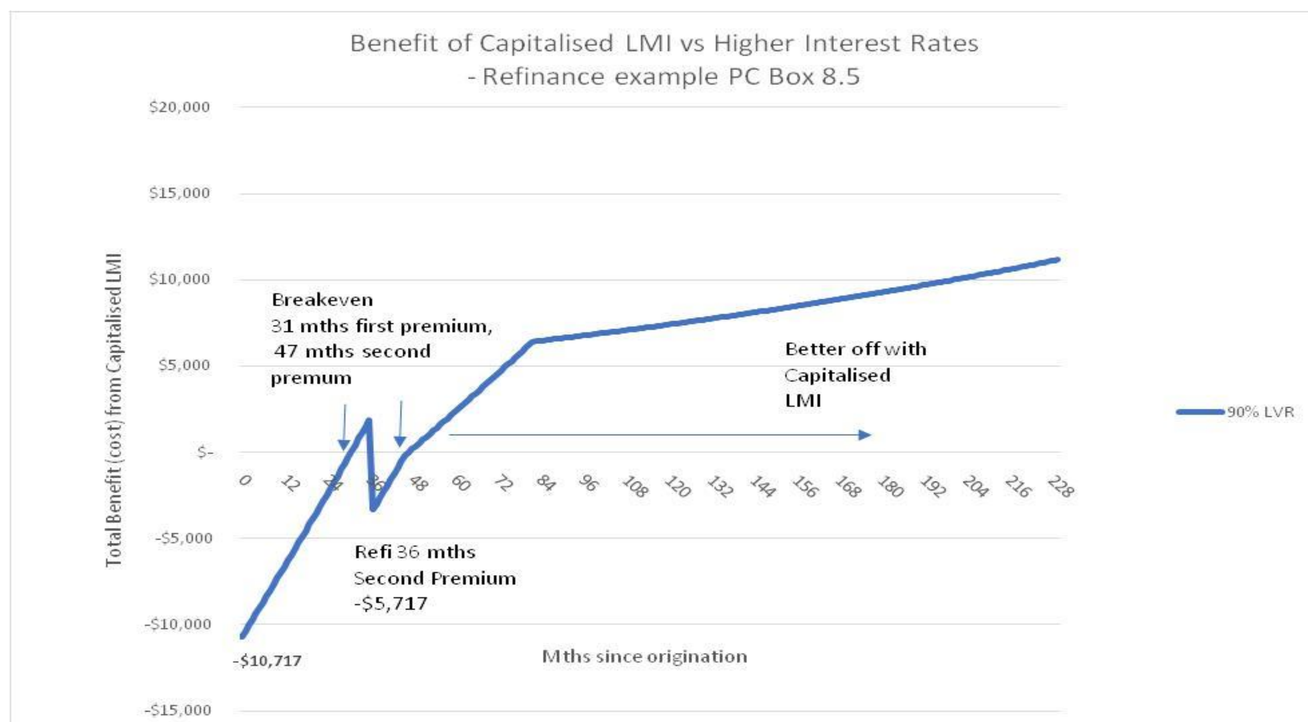


*Figure 10*

As noted in the Draft Report, LMI may be partially refundable if a home loan is terminated early in the life of the loan. This depends on the specific arrangements between the lender and the LMI provider. Some lenders like to offer the most competitive LMI cost to the market, whereas others may prefer to offer partial refunds (which means the cost of the LMI for that lender will need to be adjusted to compensate). This facilitates competition in the market.

We do agree however, that increased transparency for borrowers around the use of LMI would be helpful. In particular, we believe it would be helpful for lenders to clearly outline for borrowers what refunds may (or may not) be available for all fees and charges (including LMI).

## Paying ‘twice’ theory

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.”*

We note at the outset that the question of what mortgage interest rate is charged by a lender, is clearly a decision of the lender.

Of note, the difference in interest rate payments for high LVR loans raised by the Commission for its statistical significance[24] has only recently arisen. We suggest this very recent development may be more a reflection of new macro-prudential settings implemented by APRA for certain types of lending. The prevailing economic climate with concerns around high house prices, high and rising household indebtedness, low interest rates, and subdued income growth[25] has given impetus to a number of macro-prudential regulatory changes by APRA.[26] These include restrictions on the level of high LVR lending which we suggest may be the underlying driver of recent changes. Lenders have been prompted to consider portfolio concentrations and act to restrict the flow of new business in certain cohorts subject to such restrictions.

Although the development is cause for comment, we believe it should not be misconstrued as “paying twice” for the cost of assuming the inherent risk of a high LVR loan. The use of LMI by lenders has not materially changed nor has the product coverage or price charged for LMI. As such, we believe that the changes noted by the Commission are unrelated to LMI.

## Incentive to ensure LMI price is competitive

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.*”

As previously indicated, LMI is not mandatory. It functions unassisted by Government in a competitive private market. Also as outlined, there are alternative options for lenders to address the cost of high LVR loan risk.

LMI, however, is generally used by most lenders as it is the most cost effective and efficient mechanism to manage this risk.

Although the LMI market is concentrated (which is a feature of all global LMI markets given the nature of the risk and increased regulatory requirements), there is always market competition amongst lenders. Some lenders prefer to ‘put their business to tender’ every 3 or 5 years, some more frequently. Some lenders prefer the LMI providers to compete on a loan by loan basis rather than partner exclusively with one LMI provider.

All lenders want to deliver a competitive product to win and retain market share. The broker market also provides continuous feedback to lenders as to how their product costs and credit requirements compare to other lenders.

As such, lenders have every incentive to obtain the lowest price and best deal possible from their LMI providers; this is their chance to gain (or lose) a competitive foothold against other lenders. The LMI providers are also incentivised to compete alongside their lenders as the LMI provider only receives a premium when their lender successful competes and writes the loan.

LMI is one of a number of costs that are often passed on to borrowers. The fact that the cost of the premium is paid by the borrower does not reduce the lender’s overriding commercial imperative: to maintain and increase market share. As opposed to borrowers having to bargain individually to get interest rate discounts, the force of the market lowers LMI prices on their behalf. Less financially literate borrowers are therefore not in danger of paying more than they need in contrast to other terms (see ACCC’s Residential Mortgage Price Inquiry, Interim Report, March 2018), where disadvantage can arise.

LMI competition is not just about LMI premiums – it is also a question of risk appetite and willingness to accept credit risk. Lenders are constantly testing the boundaries of LMI underwriting criteria, in order to compete more effectively in the market.

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[24] DR 246.

[25] DR 168.

[26] See APRA, *Reinforcing Sound Residential Mortgage Lending Practices*, Letter to all Authorized Deposit-Taking Institutions, 9 December 2014; APRA, *Further Measures to Reinforce Sound Residential Mortgage Lending Practices*, Letter to all Authorized Deposit-Taking Institutions, 31 March 2017.

We have provided some confidential information in relation to QBE LMI's competitive arrangements with lenders (see confidential appendices – annexure C).

### Alleged 'barriers' – the true price of refinancing

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."*

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.*"

The many reasons borrowers refinance makes it difficult to quantify and compare them. Potential 'fairness' concerns for borrowers[27] arises only in the very few cases where the borrower's risk and loan profile is entirely unchanged. This seldom occurs. Additionally, as the Commission has noted, portability of LMI was rejected by the Treasury in 2011 due to the expense and complexity that would be involved in its administration for the very few borrowers it would assist.

From an LMI perspective, it is also important to understand that not only are the refinanced loan attributes usually different from the original loan, all lenders are not the same. Different lenders constitute different risks for an LMI provider, as does the types of loans and processes they use to originate them.

Under the prudential regulatory framework, LMI providers are obliged to treat a refinanced loan as a new loan which needs to be assessed as such and regulatory capital held on this basis. On the whole, it is unsurprising that the regulatory standard requires a refinanced loan to be considered as a new loan, given the high incidence of borrowers refinancing to service new and increased risk. In this context, to refer to this situation as "a serious pricing inefficiency"[28] is, in our view, a misunderstanding of the nature of refinanced loans and the regulatory framework within which lenders and LMI providers operate.

The Commission has expressed concern that this system discourages switching[29] but the main issue presented by refinancing involves higher risk borrowers with altered loan profiles.

From a borrower perspective, switching and need to pay for the cost of LMI twice, is still likely to be more beneficial than paying a higher interest rate for the same LVR, as outlined above.

### LMI fact sheets

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.*"

QBE is very supportive of the Commission's comments encouraging lenders to provide LMI fact sheets to borrowers to increasing transparency about LMI. As the Commission may be aware, the industry developed an LMI Fact Sheet which is available on the Insurance Council of Australia's Understand Insurance website and also the Australian Securities and Investments Commission's MoneySmart website.

This has also been supported by the Australian Banking Association's independent review of the banking code of conduct.

## Conclusion

LMI has been an integral component of the Australian housing market since 1965, facilitating home ownership, accessibility to credit and competition.

Given the systemic risk in residential mortgage lending (particularly high LVR lending), we believe competition, in and of itself, needs to be balanced with broader considerations. Equitable access to home ownership by credit worthy borrowers and maintaining financial system stability, also needs to be factored into the equation.

[27] DR 243.
[28] Ibid.
[29] DR 239.

Similarly, given nature of residential mortgage lending, we believe competition needs to be considered in the context of the economic cycle, rather than at any given point in time.

For small and regional lenders, the support provided by LMI is essential. Without the support of LMI, these lenders would not have the capacity nor risk appetite to participate in and compete against larger lenders in high LVR lending. Similarly, foreign banks and non ADIs, with the support of LMI, continue to place competitive pressure on domestic ADIs to moderate margins. Larger lenders also use LMI as a cost effective mechanism for high LVR risk.

For borrowers, we believe LMI is currently the most efficient and equitable way we have of giving less wealthy borrowers access to home ownership while maintaining capital system stability.

We hope the information that we have provided assists the Productivity Commission with its consideration of the important role that LMI plays in the financial system, particularly in relation to supporting competition in the Australian home lending market.

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