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Ms Rosalyn Bell
Assistant Commissioner
Productivity Commission
4 National Circuit
BARTON ACT 2600

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

Dear Ms Bell,

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

Genworth Mortgage Insurance Australia Limited (**"Genworth"**) welcomes the Productivity Commission's "Inquiry into Competition in the Australian Financial System" **(the Inquiry)**, and the opportunity to make this submission.

Genworth is the leading provider of Lenders Mortgage Insurance **(LMI)** in Australia. LMI is an important component of Australia's mortgage market and financial system, and we are proud of the contribution we have made to Australia's high levels of home ownership since our foundation in 1965.

Genworth considers the Productivity Commission inquiry into competition to be an important opportunity to both explain the important role that LMI plays in stimulating competition between mortgage lenders, and its contribution to the stability of the wider Australian financial system. Additionally, we outline some policy solutions for the consideration of Commissioners.

We are confident that our global experience and our unique standing in Australia position us well to help with this inquiry, and would be pleased to assist Commissioners further, if they wish. If so, please contact Alexander Drake, Head of Government and Industry Affairs

Yours sincerely

Georgette Nicholas
Chief Executive Officer and Managing Director

Executive Summary

Genworth is the leading LMI provider in Australia. LMI was established by the federal government in 1965 to assist first homebuyers get into homes more quickly without having a 20% deposit, thereby bridging the deposit gap. Housing finance is a critical part of the financial system and helps foster the Australian dream of home ownership. With $376 billion of new loans originated in 2016 and close to a quarter 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.

This submission:

- gives a broad overview of the nature and role of LMI in Australia, and the role of Genworth in that market;
- considers the ways that LMI enhances competition between lenders in the Australian mortgage market;
- gives an overview of the reinforcing support that LMI gives to the Australian financial system through the capital that it secures in it; and
- makes various policy recommendations to enhance the ability of LMI to contribute these strengths to the Australian financial system.

Overview of LMI and Genworth

The key value proposition of LMI to the Australian financial system is that it helps home loan lenders to manage the risk of issuing high LVR loans – that is, loans where the borrower's deposit is between 5% and 20% of the value of the property being purchased. This enables mortgage lenders to safely handle the risk associated with writing a loan for a borrower unable to provide a 20% deposit when buying a home. These borrowers are seen to have a greater risk of default than other borrowers, so having confidence to manage this additional risk is important.

Managing this risk successfully in turn helps play a significant role in making home ownership more accessible for more Australians who are creditworthy but without a larger deposit. In particular, LMI helps first home buyers, as they are able to enter the market sooner than if they had to keep saving for a 20% deposit. With Sydney house prices now

[1] APRA, 29 August 2017, *Quarterly Authorised Deposit-Taking Property Exposures*, page 9. Available at: http://apra.gov.au/adi/Publications/Documents/QPEX_June_2017.pdf

averaging over $1.1 million[2], and with saving for a deposit still a major challenge in many other regions, LMI is more important for first home buyers than ever before.

LMI was introduced by the Australian Government in 1965 with the aim of making home ownership more affordable and accessible to more Australians. The government-owned Housing Loans Insurance Corporation (HLIC) was later privatised and was purchased by GE Mortgage Insurance (now part of Genworth Financial, Inc.). Genworth Financial conducted an Initial Public Offering for 48% of the shares in its Australian operations in 2014, and it now trades as Genworth Mortgage Insurance Australia Limited on the Australian Securities Exchange (ASX).

Because of the importance of the role they play, Australian LMI providers are regulated by APRA as monoline insurers. Consequently, LMI is the only line of insurance Genworth is authorised by APRA to issue, meaning we are exclusively focused on the Australian housing market, its risks and opportunities, and how lenders service the market.

Collaborating with over 100 lenders across Australia, Genworth has built a reputation for being an expert in understanding issues across the residential mortgage market. We have insured over $600 billion of residential mortgage loans since 1965 and issued over 4 million policies. Our expertise is built on data and trends we have observed in the residential property market in Australia over the last 52 years.

LMI is also available in many countries around the world, through both public and private providers. It is extensively used in Australia, Canada, the United States, the United Kingdom, France, the Netherlands, Spain, Mexico and Hong Kong. Its prudent use is encouraged by global regulatory standard-setters and by public policy. Whilst LMI supports government housing initiatives in other countries, the application of LMI and the relationship with the government differ depending on location. This reflects differences in regulatory requirements and the extent of government involvement in the global LMI market. LMI is generally either mandatory on all loans above a specified LVR or incentivised through relief on capital reserve requirements for the underlying mortgages.

[2] "Sydney house prices climb more than 10 percent to record $1.1 million: Doman Group", 24 January 2017, available here: https://www.domain.com.au/news/sydney-house-prices-climb-more-than-10-per-cent-to-record-11-million-domain-group-20170123-gtryjd/

How LMI helps to make the Australian financial system more competitive

LMI helps newer and smaller mortgage market entrants compete with bigger, more established lenders, and works to help more Australians achieve a core personal financial and social goal – home ownership.

LMI also helps smaller mortgage lenders, such as smaller banks, credit unions, building societies and non-bank lenders, compete with larger banks by:

a) helping smaller lenders overcome more stringent capital requirements set by regulators for writing high LVR loans that do not apply to larger banks in the same way; and
b) diversifying the handling of risks associated with writing high LVR loans that the bigger banks find easier to handle.

With the consumer focus of the Inquiry, it is worth noting the presence of LMI in the financial system helps borrowers, because helping smaller lenders compete more vigorously with bigger lenders results in:

a) downward pressure on mortgage interest rates;
b) keeping mortgage lending competition alive in regional areas; and
c) lower prices and more innovative product features.

More detailed consideration of these points follows.

Using LMI helps smaller lenders manage their capital requirements under Basel II

Under the rules agreed to by the Basel Committee for Banking Supervision[3] **(BCBS)**, and administered by APRA, banks can be distinguished by the type of ratios, known as risk weights, used to calculate how much capital they need to retain, in order to write high LVR mortgages. The two main categories are "Advanced Internal Ratings Based" (better known as **IRB)** lenders, and "standardised" lenders.

The policy package known as "Basel II" that the BCBS agreed to in 2004, finalised in 2006 and came into effect in 2008, was intended to ensure that banks can absorb shocks arising from financial and economic stress, such as higher mortgage delinquency rates. Under Basel II, and the Basel III package thereafter, when standardised lenders use LMI to transfer

[3] More on the BCBS can be found here: http://www.bis.org/bcbs/about.htm?m=3%7C14%7C573

the risks associated with writing high LVR loans, they are given some relief from retaining the extra capital that IRB lenders are not required to retain.

Because of their size and more sophisticated risk operations, IRB banks are given more flexibility to determine their own capital levels for writing these loans, subject to approval by APRA. The capital levels are determined as a function of the probability of default **(PD)** and loss given default **(LGD)** of each segment. IRB lenders in this category in Australia are the Commonwealth Bank of Australia (CBA), the National Australia Bank (NAB), Westpac, the Australia and New Zealand Banking Group (ANZ), and Macquarie.

By comparison, banks following the standardised model comprise the other banks operating in Australia, as well as credit unions, building societies and other lenders. These lenders, because are they are smaller, are held to have less sophisticated modelling capabilities and are therefore required by APRA to retain more capital to write the same mortgage loans as IRB lenders.

For smaller lenders, it gives them confidence to engage in the high LVR market space, because they know they have the ability and extra support to handle a possible mortgage default. More competitors in the market puts downward pressure on prices (including interest rates), making home ownership more affordable for consumers.

LMI encourages more competition in the mortgage market, benefiting the consumer

For standardised lenders, LMI helps them to diversify their high LVR risk across the whole financial system. Before the GFC, Australia had a highly competitive, financial system that encouraged competition and diversified risks. Since the GFC, market consolidation amongst banks (also known as authorised deposit-taking institutions, or **ADIs**) has meant that credit risk associated with the home lending market is more concentrated in the IRB banks. Currently, IRB lenders have over 80% of market share in residential lending. This concentration makes the presence of continuing standardised lenders in the market all the more important for both healthy competition, and good consumer outcomes.

LMI helps to increase competition in the home lending market, in particular though the credit enhancement support it has offered standardised lenders. Thanks to LMI, smaller lenders have been able to cost-effectively access the capital markets (particularly between 1990 and 2008). This in turn, enabled these lenders to place competitive pressure on the larger banks, helping to reduce margins on mortgages and offering increased choice for consumers. This would not have been possible without the support LMI providers gave to standardised lenders. Although their total market share (under 20%) is now smaller than before the GFC, standardised lenders continue to play a critical role in providing competition in the Australian mortgage market.

Standardised lenders are also often concentrated in specific regional areas, such as their home state or region. Because of Australia's size and diversity, it is rare that an economic downturn will affect the entire country uniformly, making it harder for a smaller lender to allow for geographically concentrated risk on their own. By pooling these risks via the LMI industry, smaller lenders are able to afford the costs associated with high LVR lending that arise from operating in one part of the country, and so compete in the same space as much larger lenders.

LMI helps facilitate lending in the Australian mortgage market by transferring risk from lenders to LMI providers predominantly for high LVR residential mortgage loans (being loans above 80% LVR). LMI allows those borrowers to access residential mortgage loans on similar terms to borrowers with lower LVR residential mortgage loans.

Importantly, LMI helps smaller players (e.g. standardised and non-bank financial institutions) compete in the home lending market and to diversify risk across the whole financial system. Pre-GFC, Australia had a highly competitive, robust financial system that encouraged competition and diversified risks. Post-GFC, market consolidation amongst ADIs has meant that credit risk associated with the home lending market is more concentrated in the IRB banks.

By helping lenders manage risk, LMI increases competition between lenders. Competition between lenders provides choice and innovation for borrowers and assists affordability. Whilst major trading banks, smaller banks, mutuals and non-authorised deposit taking institutions (non-ADIs) all use LMI, it is heavily relied upon by small and regional ADIs for high LVR lending. They cannot carry as much risk on their smaller balance sheets and need the credit enhancement of LMI to access additional capital and compete with the ADIs in the high LVR lending space. This fosters a more competitive environment by providing more choice and reducing prices for borrowers.

LMI fosters competition between lenders because it helps smaller lenders who cannot maintain large risks on their balance sheets and supports securitisation, a key source of funds for non-bank lenders.

Securing the future of LMI and its benefits for the financial system

The Basel II model currently gives no capital recognition to IRB lenders for using LMI. This means IRB lenders can waive LMI with no marginal capital consequences unlike the smaller, standardised lenders. This can lead to undesirable policy outcomes.

First, IRB lenders under no obligation to use LMI can 'cherry pick' the loans that are a better risk and waive charging an LMI premium on them, often by charging fee or higher interest rates instead. These monies go straight to the lenders are not retained with an LMI, meaning that less capital is being held in reserve in the financial system.

Second, it leaves IRB banks open to significant exposures it an extreme stress scenario results in unexpected losses. By comparison, the standardised approach's more prescriptive approach to retaining capital does not allow smaller lenders to segment beyond LVR.

While smaller standardised lenders obtain capital relief for using LMI with high loan to value ratio mortgages, the capital levels are still higher than the advanced accredited major trading banks. The advanced accredited major trading banks determine their own capital levels but do not receive explicit capital relief for using LMI. This then results in very different capital for the same risk across ADIs governed by the same regulator depending on their accreditation status, as well as impacting non-bank lenders. This impedes the ability of smaller lenders to compete on a level playing field with larger lenders.

In addition to the differences in capital requirements between standardised and IRB lenders, there is the additional issue of how APRA interprets the rules agreed to by the BCBS.

The Basel regime provides credit risk management expertise to standardised lenders with a minimum LGD floor of 10% without recognition for LMI cover. As stated earlier, the benefits of LMI are traditionally recognised as reducing the LGD for lenders, as claims paid by LMI providers reduce the loss that would otherwise be incurred by the lender. However, in applying the Basel II rules to Australia, instead of adopting the Basel II requirements, APRA increased the minimum LGD floor for IRB banks to 20%, which does not recognise the loss absorption of LMI.

As a result, the changes by APRA to the LGD floor of 20% for IRB lenders means that those banks lose their incentive to manage their risks, via the use of LMI. The effect of this is that IRB banks no longer derive any capital benefits from using LMI, and compete at a distinct advantage over standardised lenders because its costs less to write and sell a high LVR mortgage loan.

Policy recommendations

The consultation paper shows interest in whether benefits from competition are being passed on to consumers. By helping to diversify risks associated with high LVR lending for both IRB and standardised lenders, more lenders can compete for business in the Australian mortgage market, putting downward pressure on prices for consumers. In order to help sustain that competition, a number of policy solutions to give support to LMI should be considered by the Inquiry.

- The mortgage loss absorption provided by LMI cover could be explicitly recognised by IRB lenders taking into account the impact of the minimum LGD floor APRA chooses to adopt. Genworth believes the actual LGD for LMI insured loans in Australia should be reduced since it is a first loss insurance that is both well-regulated and well-capitalised. While a zero LGD is unrealistic, the minimum permissible in the Basel framework, or a staggered series of floors based on the LVR of the loan, should be could be considered for adoption by APRA.
- Alternatively, APRA could adopt the standardised approach for IRB lenders when writing high LVR loans. This would level the playing field between standardised and IRB banks as they would be following the same requirements and this more accurately reflects the unexpected risk.

  The final report of the Financial System Inquiry **(FSI)** acknowledged that there was merit in this approach, by recommending that APRA should *"...raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for... IRB risk-weight models and those using standardised risk weights"*[4]

[4] FSI final report available at:
http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

- The securitisation market is a key source of funds for non-bank lenders and helps to enable them to compete. In order to help keep non-bank lenders in the market and competing with larger lenders, the credit risk transfer of LMI should be explicitly recognised in APRA's APS 120. Part of what made the pre-GFC securitisation market more efficient was the widespread use of LMI.

Conclusion

In again quoting the FSI final report, its Panel recommended:

> *"APRA should seek to maintain as much risk sensitivity in the capital framework as possible* ***and recognise lenders mortgage insurance where appropriate****".*[5]

The key to ensuring that LMI can continue to help consumers enter the mortgage market via high LVR loans, lies in making it more attractive to IRB lenders as a provider of capital and risk management solutions in residential mortgage markets. Ultimately the decision on how to do that, lies with APRA.

It is acknowledged that this Inquiry is being conducted by the Productivity Commission, not APRA, and that APRA is a statutory body that operates entirely at arm's length from both the Productivity Commission, and the Government of the day. Moreover, financial issues are also covered by other regulators with an interest in the financial system.

However, if the Inquiry agrees that improved consumer outcomes via the provision and use of LMI is advantageous, then Commissioners should urge APRA to change its capital requirements to encourage IRB lenders to use LMI as part of their capital and risk management solutions.

LMI was introduced in Australia over 50 years ago to help consumers that needed additional help to successfully realise the dream of home ownership. Genworth believes that it successfully continues to do that today – but that further action by regulators and lenders is needed to secure that help into the future.

[5] FSI final report, page 66, available here:
http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf