# Submission to the Productivity Commission

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## First Homeownership

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## Introduction

The Insurance Council of Australia (ICA) is the representative body of the general insurance industry in Australia. ICA members account for over 90 per cent of total premium income written by private sector general insurers.

ICA members, both insurance and reinsurance companies, are a significant part of the financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates direct premium revenue of $19.8 billion per annum and has assets of $66.6 billion. The industry employs about 25,000 people.

ICA members issue some 37.8 million insurance policies annually and deal with 3.5 million claims each year.

## Executive Summary

ICA believes there are two specific insurance related areas that should be drawn to the attention of the Productivity Commission inquiry into the affordability and availability of housing for first home buyers:

1. Insurance taxes are a disincentive for first home buyers. For example, home insurance premiums are subject to the cascading effects of a fire services levy, the GST and then State stamp duty. Refer Appendix A.

   ICA believes that the removal of these taxes and their cascading effect should improve the maintenance of a prudent level of insurance by first homeowners.

> ICA believes the recommendations of the HIH Royal Commission as they relate to taxes on insurance, should be implemented by all Australian Governments.
>
> For the first home buyer, implementation of these proposals will significantly reduce ongoing costs associated with first homeownership while also having broader application to the community.
>
> While first homeowners are required to take out insurance over the home if it is purchased with the support of monies from a financial institution there appears to be nothing to stop the homeowner from not renewing this policy once the period of cover expires, as policing of this area by financial institutions may have become more limited in recent times. The high cost of insurance, fuelled by penal taxes, could play a role in the making of these risky decisions so the removal of such taxes should improve the maintenance of prudent insurance by first homeowners.

2. Lenders Mortgage Insurance (LMI) is a significant support to first homeownership.

LMI is an integral part of the funding and capital equation for ADI's and non-banks, which translates to greater finance opportunities for first home buyers. It facilitates entry to homeownership at an early stage. It also provides significant structural and systemic protection to the banking industry. LMIs will continue to provide the security and confidence to facilitate the growth and development of a competitive residential mortgage market. This will deliver significant benefits to first home buyers, mortgage lenders and investors in the Australian market.

# 1. Insurance Taxes – A Disincentive to First Home Buyers

A significant impost on first home buyers is the high level of tax applied to property insurance on the home.

The purchase of the first home can often occur only if the purchaser borrows money from a financial institution. In order to ensure that the financial institution's monies are protected in the event that some man-made or natural peril impacts on the house, approval for housing loans can be subject to the purchasing of adequate insurance cover for the property by the borrower.

In making home insurance less of a discretionary purchase, first home buyers are rightly required to protect both their financial institution and themselves from unforseen incidents that could destroy the house as an asset. However the more mandatory nature of the insurance also locks the first home buyer into penal levels of tax on the insurance product. This could see the home buyer paying taxes on insurance for property for the term of the loan agreement, which could span up to 30 years.

Property insurance can be subject to the cascading effect of up to three separate taxes on the basic insurance premium, a fire levy (to fund State Fire Services) then the GST followed by Stamp duty. The impost of a 'tax on a tax on a tax' on general insurance products remains in the two key States of Victoria and NSW while other jurisdictions continue to maintain stamp duty on insurance policies that add to and amplify the impact of the GST on basic premiums.

Enclosed at Appendix A is an ICA table showing the impact of State and Federal taxes on household insurance. A hypothetical basic premium of $100 is used to demonstrate the point. Lenders Mortgage insurance is also subject to GST and stamp duty.

## HIH Royal Commission Tax Reform Recommendations

The HIH Royal Commission, as part of its terms of reference from Government, inquired into the impact of taxation on insurance products.

When considering the tax issue the Royal Commission considered "the impact of taxes that are specific to the insurance sector and the detrimental effects that such taxes may have on the solvency of general insurers and the overall strength and competitiveness of the general insurance industry in Australia".[1]

The insurance tax issue was also assessed by:

- Good tax design principles, such as efficiency, simplicity and equity
- Comparisons with the taxation imposts on other industries

[1] Page 273 The Failure of HIH Insurance Volume I A corporate Collapse and its lessons

- The uniformity, or otherwise, of the application of taxes on insurance across the country and

- Evaluating the impact of insurance taxes in discouraging people from prudently managing risk through insurance and whether these same taxes penalise those who do insure.

In his final report, the Royal Commissioner, Justice Owen, made several recommendations on the insurance taxation in recognition of the important role that affordable insurance plays in the community.

Justice Owen's key recommendations pertaining to insurance tax reform are:

## 1 Recommendation 55

I recommend that state and territory governments abolish stamp duty on general insurance products. It would be appropriate for this process to be coordinated through the proposed ministerial council with responsibility for general insurance.

## 2 Recommendation 56

I recommend that those states that have not already done so abolish fire services levies on insurers.

## 3 Recommendation 57

I recommend that state and territory governments exclude the cost of the GST for the purposes of calculating stamp duties or any other state or territory levies that are imposed on insurance premiums.

## 4 Recommendation 58

I recommend that governments avoid imposing on insurers levies and other taxes that cannot be passed on to policyholders.

With respect to the impact on insureds generally, these unequivocal recommendations were supported by arguments that high insurance taxes do lead to consumers making decisions to underinsure or to not insure at all. These taxes, according to the Commissioner, may also encourage consumers to source alternative cheaper forms of insurance from foreign insurers that are not licensed by APRA – and therefore subject to higher risk of failure compared with licensed insurers. It was also noted that the maintenance of taxes that penalise those who prudently insure will only continue to discourage people from adequately insuring their assets, placing ongoing strains on government budgets in times of disaster.

In years past ICA has put the same case to Governments with respect to insurance tax reform, pointing out the:

- Penal levels of insurance taxes that apply in Australia, with our country imposing world record levels of tax that put some insurance products in the same category as the 'sin' taxes that apply to cigarettes and alcohol

- Inequities of funding State fire services from a levy on insureds only when clearly the whole community benefits from the existence of fire services

- High incidence of under and non insurance in the community, fuelled by high insurance taxes, with house structures affected by disaster situations being found to be underinsured, on average, by 40 percent of the replacement cost and

- The negative impacts on Government budgets in times of disaster from having to assist people who have lost their assets and are uninsured.

Despite the urgings of ICA and the report of the HIH Royal Commission, which both support the abolition of insurance taxes, limited action has been taken by Governments to reduce the insurance tax impost.

## Government Response to the HIH Royal Commission

Following the handing down of the HIH Royal Commission report in April this year, only two Governments have taken action in support of the Commissioner's recommendations relating to tax reform.

The NSW Government responded to the report by announcing a public inquiry into current and future methods for funding that State's fire services, responding to the Commissioner's recommendation relating to the imposition of fire service levies on insurance products. That Parliamentary Inquiry is currently underway.

The Commonwealth also wrote to the States and Territories to encourage them to embrace the Commission's recommendations as they relate to their individual jurisdictions. It is understood that most of the jurisdictions have provided negative responses to the recommendations that support reform of insurance taxes.

## House of Representatives Select Committee into the Recent Australian Bushfires

More recently an inquiry by the House of Representatives Select Committee into the Recent Australian Bushfires recommended that all States and Territories that apply fire service levies on insurance policies to fund fire services remove them in favour of alternative property based systems. Queensland, South Australia and Western Australia operate systems of this type while the ACT and the Northern Territory fund their fire services from consolidated revenue.

The All Party Committee also recommended that taxes on insurance premiums be calculated only on the basic premium in order to eliminate the current cascading cost.

## ICA Recommendations

ICA believes the recommendations of the HIH Royal Commission as they relate to taxes on insurance, should be implemented by all Australian Governments.

For the first home buyer, implementation of these proposals will significantly reduce ongoing costs associated with first homeownership while also having broader application to the community.

While first homeowners are required to take out insurance over the home if it is purchased with the support of monies from a financial institution there appears to be nothing to stop the homeowner from not renewing this policy once the period of cover expires, as policing of this area by financial institutions may have become more limited in recent times. The high cost of insurance, fuelled by penal taxes, could play a role in the making of these risky decisions so the removal of such taxes should improve the maintenance of prudent insurance by first homeowners.

# 2. Lenders Mortgage Insurance – Supports First Homeownership

## What is Lender's Mortgage insurance (LMI)?

LMI was introduced into Australia in 1965 to enable first home buyers to "bridge the deposit gap" which was at that time a significant impediment to achieving their dream of homeownership.

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

## LMI Industry

There are two privately owned LMI companies in Australia that are writing new business, GE Mortgage Insurance Services and the PMI Group. Royal & Sun Alliance ceased writing new LMI business in April 2003 and is currently in run-off. CGU's LMI business was acquired by PMI in 2001.

In additional to these two privately owned LMI companies, there are approximately half a dozen 'captive' LMI companies, which are owned by or affiliated with several of Australia's lending institutions.

Customers of the privately owned LMI companies include major banks, mortgage originators, regional banks, building societies and credit unions. LMI cover is generally for 100% of the loan amount. The full premium is paid at the time of loan advance and cover is for the life of the loan.

## History of LMI - the early years

The LMI industry has played a key role in the development of Australia's retail financial services industry. This is evidenced below.

### 1965 to 1985

Australian building societies, with the support of the LMI industry, expanded their credit policies to enable first home buyers to get first mortgage finance with a minimum 5% deposit. Building societies, in conjunction with the LMI industry, also worked together to support a first homeowners government assistance program during the period 1983 – 1985. This program enabled a significant number of first home buyers to achieve a home of their own sooner than would otherwise have been the case.

### 1986 to 1993

Following the deregulation of bank mortgage interest rates in 1986, the four major banks, with the support of the LMI industry, entered the high loan to value 95% segment of the home lending market. Prior to this time, first home buyers were restricted to borrowing up to 80% of the value of the property from the savings bank, and then borrow the remainder from either the trading bank arm of the bank, or from another finance company – generally at much higher rates than the loan obtained from the savings bank. The major banks account for approximately 50% of all high LVR lending today.

During this period also, the credit union movement expanded its product offering from pure consumer lending to include mortgage lending for their members. This included high LVR lending, again undertaken with the support of the LMI industry.

## LMI Industry's Current Role in the Banking System

Historically, housing finance has been provided by banks, building societies and credit unions. These entities are regulated by APRA and are referred to as approved deposit taking institutions (ADI's). Prudential standards administered by APRA govern their activities, including capital adequacy requirements.

ADI's obtain LMI for two principal reasons. First, they can obtain a 50% capital benefit for housing loans over 80% loan to value ratio ("LVR"), provided such loans have been insured with an APRA regulated LMI company that has a financial strength rating of A or better. Secondly ADI's, particularly the smaller building societies and credit unions, also obtain LMI so as to transfer credit risk to the LMI company. Having regard to the fact that housing loans make up in excess of 50% of the assets of most ADI's, the LMI industry therefore plays an important and significant role in facilitating the efficient management of capital in the banking system. It also provides systemic housing loan risk protection for the Australian banking system by enabling such credit risk to be transferred outside of the banking system.

## What impact does LMI have on first Home Buyers?

Prior to the introduction of LMI in Australia, first home buyers in a regulated bank interest rate environment were required to provide a deposit equal to 25-30% of the purchase price if they were to get their loan approved. First home buyers were confronted with two options:

Defer purchase of their home (at a time when property prices were rising), while they continue to save the minimum deposit for a period of time, at a time when they had rent commitments or

Proceed with the purchase of their home with recourse to higher interest/short-term second mortgage loan to "bridge the deposit gap", with the additional mortgage repayment burden that imposed.

LMI has facilitated higher levels of homeownership in Australia as it enables a lender to advance a higher portion of the purchase price towards a residential property. That is because ADI's, for the capital and risk reasons mentioned previously, generally do not agree to advance more than 80% of the value of the security property, <u>unless</u> the loan has been insured with an LMI company.

Accordingly, the LMI industry has played an important role in enabling first home buyers (with equity in range 5% to 20%) to purchase a home sooner than would otherwise be the case, had they been forced to save a 20% deposit before being able to obtain a loan from an ADI. A large portion of this high LVR market segment is first home buyers.

## LMIs Role in Increasing Availability of Non-Bank Finance

While there was some non-bank mortgage lending activity in the late 80s, the real development and growth of the non-bank segment occurred during the 90s. Non-bank lenders were able to offer lower mortgage rates to first and other home buyers by accessing investors in domestic and international capital markets through the issue of residential mortgage backed securities. Non-bank mortgage managers and originators have been able to enter the market and offer competitive rates because of securitisation.

The LMI companies play a vital role in this process by ensuring that issuer's borrowing costs are minimised (in effect the mortgage originators have leveraged the superior balance sheets of the LMI entities so as to ensure the securities instruments used to raise the funds are optimally priced, hence minimising their borrowing costs and enabling them to offer extremely competitive lending rates to borrowers). The non-bank mortgage managers and originators insure all loans irrespective of the LVR, for the credit enhancement reasons described above. Generally for those loans with LVRs of 80% or above, the LMI premium is passed onto the borrower, whereas for those loans under 80% the non-bank manager or originator pays the premium.

The growth of the non-bank lending sector, with the support of the LMI companies, has been an extremely important factor in the increased level of competition and product innovation in the housing finance industry. This increased level of competition has generally led to lower lending margins throughout the entire industry, resulting in benefits to all borrowers, but particularly first home buyers.

In the latter period of the 90s ADIs showed interest in securitising some of their on balance sheet residential mortgage loans. Their motivations were to manage overall credit risk, release capital and manage shareholder return on investment. For those uninsured loans less than 80% LVR, the LMI companies were able to credit enhance the loans so as to enable the ADI to achieve the rating required by investors. ADIs are increasingly accessing capital markets to fund the demand for home loans. As a result, their cost of funds are reduced and first home buyers have a greater number of competitive options offered by the ADIs from which to obtain housing finance.

## LMIs Role in First Homeowners Grant (FHOG) Scheme

LMI credit parameters normally require that the borrower have at least 3% – 5% genuine equity to contribute towards the purchase. This means funds that have been saved over time as opposed to gifts or grants, so as to evidence genuine saving capabilities.

When the FHOG scheme was introduced by the Federal Government in 2000, each of the LMI companies, consistent with the Government's policy objectives and the approach generally taken by the lending industry, agreed to recognise the FHOG as genuine equity for the purposes of their credit parameters. There is little doubt that had the LMI industry not adopted this approach, the number of people using the FHOG to purchase a new home would have been much less, given it is unlikely that the ADI's would have agreed to advance these (predominantly) high LVR loans without LMI.

During the period from July 2000 – June 2002, the proportion of new business represented by first home buyers and FHOG recipients written by GE Mortgage Insurance Services (one of the privately owned LMI companies) peaked at 40%. As at August 2003, the corresponding percentage for the same company was less than 15%.

These figures help demonstrate the fact that the FHOG Scheme brought forward a number of first home buyers, who, if not for the grant, would not have been able to enter the housing market for a number of years. Consequently, this "bring forward" of first home buyer demand has meant that the portion of first home buyer business for the LMI companies has since declined.

Clearly the FHOG Scheme acted as a significant stimulus for high LVR lending during the first two years or so following its introduction. This is evidenced by an analysis of the high LVR business written by the LMI industry since the Scheme's introduction. It is however difficult for the LMI industry to comment on what impact the Scheme has had on the housing market and first homeownership affordability generally, given such factors are impacted by so many other factors, other than just the availability of finance.

## Benefits of LMI to First Home Buyers

A cost to consider for first home buyers looking to enter the market and purchase a home is the opportunity cost of not entering an appreciating market at the earliest possible opportunity. In this situation the first home buyer needs to carefully assess his or her own financial circumstances, personal goals and level of borrowing with which he or she is comfortable.

If the first home buyer seeks to enter the market, LMI plays an important role in facilitating this entry. LMI can be the difference between a lender advancing funds today equal to 95% of the purchase price (with LMI) and a first home buyer having to save for a longer period of time (possibly a number of years) until they have a deposit equal to at least 20% of the purchase price (assuming no LMI). When viewed in this context LMI plays an important role in enabling first home buyers to enter the market sooner than they otherwise may have been able to. Refer to Example 1, which illustrates this point.

Assume a home in Melbourne with a Purchase Price of $250,000 and 85% Loan to Value Ratio (LVR) for all examples.

Example 1: Home Price Appreciation

| | |
|---|---|
| Base June 2001 | $250,000 |
| 19% increase | $ 47,500 |
| Price June 2002 | $297,500 |
| 10% increase | $ 29,750 |

(Source: ABS publication 6416.0)

Price at June 2003 $327,250

Overall increase of $77,250, 31% over 2 years

In this situation the benefit obtained from LMI in facilitating early entry into the housing market far outweighs the cost of LMI.

A one-off payment is made to the LMI provider at or soon after the time of settlement of the loan. The premium is assessed as a percentage of the loan amount as per the example below.

Example 2: LMI Calculation

| | | |
|---|---|---|
| A | Loan amount | $212,500 |
| B | LVR | 85% |
| C | Premium rate | 0.75% |
| D | Premium (incl GST) | $1594 (AxC) |
| E | Stamp duty @ 10% | $160 |

Total LMI cost $1,754 (D+E)

The LMI provider's contract of insurance is with the lending institution. The lender can choose to pass the cost on to the borrower, or can choose to fund the cost itself. Lending institutions nearly always pass on the full premium to the borrower as a cost of providing the loan. If the LMI premium is passed on to the borrower, the borrower may have the option of either paying the LMI premium from his or her own funds, or capitalising the premium to the loan amount. The LMI premium is then amortised, along with the principal, and is paid over the life of the loan. This is an attractive option for some borrowers, who prefer to use their funds for other loan costs.

When purchasing a home there are a number of decisions and costs that arise. LMI, if required by the lending institution, is one such cost. The majority of these costs are basically taxes and fees, whereas a distinguishing feature of LMI is that is for the payment in lieu of the credit risk assumed. It is a value add component and provides benefit to the purchaser. However, when analysing all of the costs associated with purchasing a home, the LMI component is relatively insignificant.

Example 3: Purchase Costs

| Category | Estimated Cost | % |
|---|---|---|
| Title Transfer Fee | $705 | 5% |
| Stamp Duty on Loan | $816 | 5% |
| Stamp Duty on Property | $10,6606 | 7% |
| Mortgage Insurance | $1,757 | 11% |
| Other | $1,859 | 12% |
| Total | $15,797 | 100% |

## Industry Product Innovation/Market Trends

As discussed earlier the housing market has expanded over the past ten years. This significant growth of the housing finance market over the past ten years has led to more product innovation as the mortgage managers and originators look to carve out their niche and compete with the ADIs. The ADIs in turn have fought back and are continually looking at ways to regain and maintain market share. The LMI industry has developed innovative LMI products, in conjunction with mortgage lenders, which are more flexible to meet the changing needs and circumstances of first home buyers.

As a result of this we have seen new LMI products at higher LVR's than ever before (97% and 100%), changes in credit parameters to keep up with changing borrower characteristics and demographics ie: increase in contractors, casual workers, more movement from one job to the next. These products are aimed at people who have not previously been able to obtain finance before, ie: first home buyers who have clear credit background and income to service the debt but may not have been able to save the required amount of deposit.

LMIs are continually looking for new ways in which to assist first home buyers.

## LMI Assessment Criteria

When setting credit criteria and underwriting loans for LMI purposes, the LMI companies assess loans to first home buyers on exactly the same terms as other borrowers. That is, first home buyers are treated no differently to any other borrower for LMI purposes. The fact that they are a first home buyer is captured for portfolio analysis and reporting purposes. However this plays no part in the overall LMI underwriting decision process.

One item that is taken into account when setting criteria is that the LMI companies do not want to see people overstretched and have them purchase a home today and default after the purchase. Accordingly serviceability criterion are used to determine whether, based on the information available, the borrower has the ability to meet the loan commitments, as well as existing commitments, based on the current interest rate, after allowing for a minor surplus to cover any increase in interest rates. The serviceability model employed by all LMI companies, whilst differing amongst the industry, does not in any way discriminate between first home buyers and other purchasers.

LMIs adopt responsible practices, operate in a disciplined manner and display prudent risk management, which add to the overall stability of the home buyer market.

## Conclusion

LMI is an integral part of the funding and capital equation for ADI's and non-banks, which translates to greater finance opportunities for first home buyers. It facilitates entry to homeownership at an early stage. It also provides significant structural and systemic protection to the banking industry. LMIs will continue to provide the security and confidence to facilitate the growth and development of a competitive residential mortgage market. This will deliver significant benefits to first home buyers, mortgage lenders and investors in the Australian market.