



Finance Brokers Association
of Australia Ltd
Ph: 1300 130 514
National Office: (07) 3847 8119

To:

Financial System Inquiry
GPO Box 89
Sydney NSW 2001

By email: fsi@fsi.gov.au

Submission to Financial Systems Inquiry by FBAA

This is a submission made on behalf of the Finance Brokers Association of Australia Limited (**FBAA**) in response to the Terms of Reference (**TOR**) released by the Federal Treasurer, Hon Joe Hockey MP, on 20 December 2013 for the Financial System Inquiry.

The FBAA

The FBAA is a not-for-profit organisation that represents finance and mortgage loan writers throughout Australia. The FBAA was established in 1992 and is run by members for members. The FBAA currently reaches approximately 9,500 finance brokers across Australia through its membership, and approximately 14,500 industry stakeholders. The FBAA seeks to promote best practice throughout the finance brokering profession, represent its member's interests and seek to ensure the financial sector operates in fair and open manner. The FBAA is committed to ensure that the practical implications and effect on both consumers and brokers of financial legislation, policy and industry practice are known, understood and regulated appropriately.

This submission is in response to -

TOR 1.3: "the consequences of developments in the Australian Financial System since the 1997 Financial Inquiry and the global financial , including implications for the current cost, quality, safety and availability of financial services, products and capital for uses"; and

TOR 2.3: “refresh the philosophy, principles and objectives underpinning the development of a well functioning financial system, including assessing the effectiveness and need for financial regulation, including its impact on costs, flexibility, innovation, industry and amount users.

However, the issues raised in this submission will have wider ramifications for the finance industry and so the panel may find its contents of use when considering other TOR’s.

Lenders Mortgage Insurance

The focus of this submission is Lender’s Mortgage Insurance (**LMI**). LMI is designed to protect lenders in the event the consumer borrower defaults on their home loan obligations. LMI is not a statutorily required insurance but rather an insurance imposed by lenders on their consumer borrowers, dependent on the value of the loan taken out by the consumer borrower. Most lenders require a consumer borrower to pay, usually as part of the total loan amount, the LMI premium if the consumer borrower is seeking to borrow 80% or more of the property value, that is, where the loan value ratio (**‘LVR’**) is more than 80%.

It is estimated by the Reserve Bank of Australia that over one quarter of housing loans in Australia are subject to LMI.¹ In the financial year ending 30 June 2013, banks made an estimated 761,880 home loans, totalling \$247.9 billion in lending.² Those figures alone suggest that approximately 190,470 loans created in the financial year ending 30 June 2013 were subject to LMI. LMI is clearly a significant factor in assisting consumer borrowers to enter into the housing market and also to provide lenders with greater security and comfort in lending.

The FBAA, through this submission, seeks to highlight the practical issues that arise from the LMI regime. Further, the FBAA submits that issues raised herein will oblige the Federal Government to investigate these issues further, seek transparency and disclosure from both lenders and LMI insurers and put in place a regulatory framework to promote competition, flexibility, cost effectiveness and affordability for consumers.

The FBAA submits that there is a need for greater transparency and disclosure on behalf of lenders and LMI insurers in respect of LMI. The need for greater transparency is due to the information available to consumer borrowers being inadequate, resulting in consumers being unaware of the

¹ Reserve Bank of Australia - Financial Stability Review - September 2013
<http://www.rba.gov.au/publications/fsr/2013/sep/html/box-c.html>

² Australian Bankers Association Inc, Facts and Figures - Housing Loans, September 2013
<http://www.bankers.asn.au/Banks-in-Australia/Facts---Figures/Banking-Facts-and-Figures>

ramifications of LMI and the rights that may arise in relation to LMI. At the conclusion of this submission, the FBAA urges the Inquiry to take up several specific recommendations.

Need for Disclosure: Terms of LMI Arrangement / Commissions Paid

Consumer borrowers are paying for LMI insurance for the lender, but they are not provided with the LMI product disclosure statements, including any details regarding any commissions payable to the lender. Privity of contract is the apparent reason for this non-disclosure, as LMI essentially is a contract between the LMI provider and the lender, but it is contended that the consumer borrower has an interest in this insurance arrangement as they have paid for it, at the insistence of the lender. As such, there should be some sort of disclosure made.

Further, as with most insurance, it is believed³ that there is a commission payable to the entity brokering/selling the insurance on behalf of the insurer. Details of any commission earned by a lender, for the sale of particular a LMI provider's products, should be disclosed to the consumer borrower. Further, any such commissions should form part of both the LMI provider's and lender's annual reporting.

Lack of Choice: Inability for the consumer to choose LMI provider or negotiate LMI rate

Consumer borrowers are not provided with the option to choose which LMI insurer would provide the best LMI rate for their loan. LMI rates and therefore LMI premiums are not standardised throughout the country. As is noted in material from one of the leading LMI providers (Genworth):

*“Premium quotes may vary for a number of reasons including the personal circumstances of the borrower and the LMI product selected and may be dependant on a range of factors including the type and location of the property”.*⁴

It is submitted that consumer borrowers should be made aware of all variables that affect the calculation of LMI premium, as well as all LMI product types available and the LMI providers should be making publically available their base LMI rates.

As the consumer borrower is unable to choose which LMI provider insurer to cover their loan and currently has no way of cutting through the mystery of how the LMI rate will be assessed for their

³ The basis of this belief is that one of the main providers of LMI in Australia has disclosed on their website that when calculating refunds that may be paid (discussed later in this submission), the refund is calculated on the amount of the premium paid less the rebate paid to the lender. See <http://www.genworth.com.au/underwriting-policy/policy-variations/7.2-loan-discharges---cancellations>

⁴ Genworth, Loan Management <http://www.genworth.com.au/underwriting-policy/loan-management/8.3-default-management>

loan, there should be reform to place a positive obligation on the lender, whose LMI premium is being paid by the consumer borrower, to broker or seek out the best value LMI for the particular loan risk.

Recovery of Refunds: LMI Premium Refund? Yes, no, maybe?

It seems, from the material publically available from LMI providers that lenders are entitled, in certain circumstances and instances, to a refund of the LMI premium. However, this process appears uncertain and from an LMI provider's position, the responsibility of the lender. The consumer borrower has no role to play in seeking or compelling a refund of LMI premium. In the LMI information material of a major LMI provider (Genworth) the following are the requirements for loan discharges:

The Lender should advise Genworth as soon as the loan has been fully repaid so that the policy can be cancelled in our system and any refund due calculated. Please include your loan number, Genworth reference number, the borrower name and the date of the final payment.

No refund is payable where:

- *separate arrangements are in place with the Lender for a reduced premium rate in lieu of taking premium refunds*
- *the loan is repaid within one year of the maturity date of the mortgage; or*
- *the notification of cancellation of the policy is received by Genworth more than 3 months after repayment of the insured loan; or*
- *the refund amount is less than \$150.00; or*
- *a loss has eventuated; or*
- *the loan has been reported to Genworth to have had arrears.⁵*

Any enquiries made to Genworth from borrowers regarding refunds will be forwarded to the Lender to address.

The current Genworth premium refund payable for a loan that has been repaid in full is:

- if the loan has been repaid within 1 year or less = 40% refund of LMI premium*;
- if the loan is repaid over 1 year to 2 years = 20% refund of LMI premium*.

***Based on the total LMI premium paid and less any rebate paid to the lender (emphasis added)**⁶

Based on Genworth's documentation, a lender is entitled to a percentage refund of the LMI premium if, the loan is repaid in full within the stipulated time periods and the lender, not the borrower, advises Genworth that the loan has been repaid in full within the specified period.

⁵ Genworth LMI Underwriting Policy and Product Parameters - <http://genworth.com.au/docs/underwriting-policy/lmi-underwriting-policy-australia-jan2012.pdf?Sta>

⁶ Genworth- 7.2 Loan Discharges - Cancellations - <http://www.genworth.com.au/underwriting-policy/policy-variations/7.2-loan-discharges---cancellations>

As a matter of legal principle, if the consumer borrower has paid for the LMI on the insistence of the lender to protect the lender, then if the cost of that LMI is rebated or refunded, then the lender will be legally obliged to make restitution to the consumer borrower for the cost saving.

A major issue arising from this potential refund is that a consumer borrower is only in a position to receive a refund on the LMI premium they paid IF they ask their lender to request the refund within a specific time period. Unfortunately, the practice seems to be that consumer borrowers are not advised by their lenders that they can request such a refund as there is no documentation provided by lenders to consumer borrowers about this. A consumer borrower has no relationship with the insurer and so is not directly informed of any rights the lender may have.

Further, no details are available regarding the ‘*reduced premium rate*’ referred to as a reason for refunds not being available in some cases. This is at odds with rate guides from LMI providers as these demonstrate, particularly those of QBE that LMI premiums have in fact increased. For example, the QBE LMI rate for a LVR of 80% has increased 0.16%⁷ in a period of 4 years.⁸

A lack of disclosed information regarding this area raises the concern that lenders may be advising LMI providers of loans being repaid in full within the relevant time periods and are receiving both the LMI premium refund and lenders rebate but may not be taking that refund amount into consideration in the loan payout figure or refunding it to the consumer borrower.⁹

As there is limited information available from both lenders and LMI providers regarding the number of loans, subject to LMI, being paid out within the relevant period, it is only possible to guess the amount of refunds that may be or should be available based on historical data.

Historical data from APRA, collected from a survey of 44 Australian ADI’s of loans approved in September 2006 being 112,206 loans reported that almost 20% (approx 22,400) of those loans had a

⁷ Difference in QBE LMI Rates 2009 - 2013, based on the rate applicable for LMI on an 80% loan.

⁸ Difference in QBE LMI Rates 2009 - 2013, based on the rate applicable for LMI on an 80% loan.

⁹ It is arguable that this concern is consistent with the concerns identified by the Australian Securities and Investment Commission in its Report 300 which led to its Recommendation 8: “*Lenders generally did not provide any additional disclosure for more complex early termination fee structures than for simpler fee structures, increasing the likelihood of having their early termination fees declared unfair.*” See [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Report300-published-18-September-2012.pdf/\\$file/Report300-published-18-September-2012.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Report300-published-18-September-2012.pdf/$file/Report300-published-18-September-2012.pdf)

¹⁰ APRA Insight, ADI Housing lending, Issue One 2008.

total LVR ratio above 80% and requiring LMI.¹⁰ For the purpose of this example, an average loan amount of \$250,000¹¹ was used and this would give rise to an average LMI premium was \$1,600.¹²

If, conservatively speaking, 10%¹³ or 2,240 of those 22,400 loans were paid out or refinanced within 24 months with an LMI refund of 20% or \$320 per loan, that equates to \$716,800 in refunds that were available to lenders (which it is submitted should have been passed on to the consumer borrowers). *This is a conservative view and based on only one month's worth of approved loans in September 2006.*

Lenders and LMI providers are operating in a way that is not transparent and not in the best interests of consumers. This lack of transparency gives rise to the possibility of lenders seeking to take advantage of consumers who are uninformed and unaware to seek refunds. The FBAA urges the Federal Government to take action and inquire into the LMI regime and seek to require better disclosure, better reporting and to make changes to the current industry practice. Unfortunately, without some further investigation under the imprimatur of the Inquiry, it is difficult to see how the true size of the problem may be, and to ascertain how much money has not been returned to consumer borrowers.

Need of Competition: Anticompetitive Market

There are essentially only two LMI insurers in the Australian market, being Genworth and QBE. APRA heavily regulate the LMI industry as it requires that LMI providers to only write LMI and no other products.¹⁴ It appears that Genworth and QBE seek to discourage any competition in the LMI market by seeking to have lenders align themselves solely with one of those LMI insurers through the negotiation of 'Master Policies', being specific sets of terms that will apply between the LMI provider and the specific lender. With Master Policies in place, lenders do not seek to find a competitive LMI rate with an alternative provider. Further, as noted above, it appears that lenders receive a lender's rebate for choosing a particular LMI provider. As a result, the unrated captive LMI market continues to be dominated by the two major LMI providers, Genworth and QBE.

Whilst the LMI provider market is restricted by APRA, the market is further restricted by LMI providers paying commission, through Master Policies, to lenders in exchange for the lender referring loans subject to LMI.

¹¹ Based on a property purchase price of \$300,000, which is considered to be an extremely conservative figure in the current market.

¹² \$1,600 LMI premium. As per a loan of \$250,000 on a \$300,000 purchase price calculated on www.yourmortgage.com.au. Of course, this assumes that such a calculator is of universal application, but as noted elsewhere in this submission, the finer details of how LMI premiums are calculated in specific cases are difficult or impossible to verify independently.

¹³ Based on the opinion and knowledge of finance brokers in the industry and on a conservative basis.

¹⁴ Reserve Bank of Australia Lenders Mortgage Insurance <http://www.rba.gov.au/publications/fsr/2013/sep/html/box-c.html>

This practice needs to be investigated and further information provided by LMI providers and lenders as to why such arrangements should not be considered anticompetitive behaviour.

Transferability: Need to Avoid Double Dipping

LMI attaches to the lender rather than the borrower, despite the borrower paying the insurance premium. If the borrower refinances within 12 months on the same property, they are generally required to pay LMI again if the LVR is still 80% or more. When the first loan is taken out, the amount of the LMI premium is added to the amount having to be borrowed. So unless there are some extraordinary loan repayments in the 12 months, it is quite understandable that the LVR may still exceed 80% when the loan is renegotiated.

Material available from LMI providers demonstrated that if a consumer borrower wishes to refinance a loan already subject to LMI, a refund might be claimable by the lender, but a new LMI premium will still be payable.¹⁵ Leaving aside the question as to whether the consumer receives the percentage refund and whether the lender receives the applicable lender's fees, the issue is whether entering into a new policy is the most cost effective for the consumer borrower who will be obliged to pay the LMI premium, or should there simply be an adjustment? Given that there are essentially only two insurers in the market, a consumer borrower who refinances their loan may change lenders but still have the new loan covered by the same insurer.

The current system can lead to the lender and the insurer 'double dipping' in that the consumer borrower is forced to pay for insurance again that is essentially for the same risk.

The obvious solution which would save consumer borrowers a substantial amount would be to introduce portability so that the LMI policy is in fact owned by the consumer borrower but that, upon a refinance, a different beneficiary of the policy (i.e. the new lender) is substituted.

¹⁵ Genworth, Policy Variation, 7.1.1 substitution of security <http://genworth.com.au/docs/underwriting-policy/lmi-underwriting-policy-australia-jan2012.pdf?Sta>

Recommendations:

It will become apparent from the above submission that the only way that the issues outlined above can be properly addressed is if there is more information made available to see how substantial the problem is and how much consumer borrowers have suffered financially by not receiving refunds of LMI premiums.

The FBAA recommends that the Federal Government pursue further inquiry into lenders and LMI providers to seek to answers and information of the following:

- o Details of the master policies between lenders and LMI providers so that the precise terms of LMI that may apply in respect of loans made to consumer borrowers can be ascertained;
- o Details of the LMI rates and premiums, how they are calculated and applied;
- o Details of the benefits received by the lender for writing LMI through the insurer (i.e. any lender commissions or incentives that may be paid by the LMI provider);
- o The frequency with which consumer borrowers may be entitled to request refunds from their lenders when loans have been repaid, especially when no loss or claim has been made on the LMI provider.

It is noted that the Inquiry intends publishing an interim report towards the middle of 2014, with a final report due by November 2014. It is therefore submitted that the above recommended inquiries be pursued by the Inquiry urgently so that more information is available for comment by the time the interim report is delivered.

For further comment, queries can be directed to:

Mr Peter White

CEO

Finance Brokers Association of Australia Ltd ABN 22 094 784 040

Level 1, 386 Logan Road, Stones Corner Qld 4120

PO Box 234, Stones Corner Qld 4120

Tel: (07) 3847 8119

Fax: (07) 3041 0350

Email: pwhite@fbaa.com.au

Web: www.fbaa.com.au