



31 March 2014

David Murray AO
Financial System Inquiry
GPO Box 89
Sydney
NSW, 2001

QBE Insurance (Australia) Limited

ABN 78 003 191 035
Level 06
85 Harrington Street
SYDNEY NSW 2000
Australia

Postal Address
GPO Box 82
Sydney NSW 2001

QBE Insurance Group - Financial system inquiry submission

QBE is one of the few domestic Australian-based financial institutions operating on a truly international landscape with a presence in all major regions around the globe. QBE welcomes the Inquiry as an important opportunity to consider how our financial system can position Australia to participate and compete in an increasingly converging and interdependent global market.

QBE is pleased to provide this submission for the Panel's consideration. It outlines in detail our observations on the important role of insurance, the emerging opportunities and challenges for the industry, and the need to take stock of our regulatory framework that QBE considers is curbing Australia's economic growth.

There are three specific matters that we particularly wish to bring to the Panel's attention:

Deregulation and harmonisation of federal and state regulation

Overlapping, duplicative and inconsistent regulation creates inefficiencies and, in some instances, inequities and adds considerably to the cost of doing business in Australia. Additionally, although consistent international regulation will remain important to Australia's reputation as a politically and financially stable location for investment, QBE believes it is not in Australia's best interests for Australia to 'lead the pack' on regulation. If we create a regulatory regime that is more onerous than the rest of the world this will impact on our international competitiveness in a highly contested global market for investment.

QBE is very supportive of the Australian Government's deregulation agenda. QBE also recommends Government consider initiating a regulatory harmonisation program (as outlined in our submission) giving due weight to the need to promote productivity and competitiveness in a dynamic global economy and maintain insurance affordability for our customers.

State taxes and levies on insurance

Numerous reviews, including the recent Henry Tax Review, have unanimously found that state taxes, duties and levies on insurance are very inefficient and in fact counterproductive. We estimate these imposts alone add on average \$93 to each QBE policy (totalling \$455 million in 2013 for Australian consumers). Given the importance of affordability of insurance and the potential implications of non or under-insurance on the public purse, we believe it is time to act to remove all these specific imposts on insurance as has previously been recommended. Further, State and Territory governments should be actively encouraged by the Australian Government to implement this reform within 3 years.

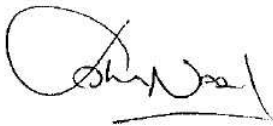
Lenders mortgage insurance

Lenders mortgage insurance (**LMI**) has been a critical component of the housing market since 1965, facilitating home ownership and accessibility to credit for millions of borrowers. LMI enables those who would otherwise have difficulty obtaining a home loan (particularly borrowers with low incomes or low levels of equity), to satisfy responsible lending criteria and purchase a home. Currently internal ratings based (**IRB**) lenders receive no capital benefit for the use of LMI, despite the fact that the LMI providers are required to, and do hold, significant capital for the risk that is transferred.

QBE believes the Inquiry should consider the important role that LMI plays in the financial system and recommends that capital relief be provided to IRB lenders that utilise LMI. This would ensure that LMI continues to benefit the housing industry and its customers, and continues to facilitate increased competition between lenders. It would bolster financial and economic stability and importantly improve access to affordable home ownership.

QBE welcomes this Inquiry as an opportunity for Government and market participants to take into active consideration the need for a more productive, innovative and competitive economy. The costs of doing business in Australia should be a paramount concern in this Inquiry, now and into the future. We have submitted a seven-point plan in the attached submission for the Panel's consideration and look forward to participating in the Inquiry.

Yours sincerely



John Neal
Group Chief Executive Officer
QBE Group Limited



Colin Fagen
Chief Executive Officer
QBE Australia & New Zealand



**QBE Lenders' Mortgage Insurance Limited
Submission to the Federal Government's
Financial System Inquiry**

March 2014

Contents

Lenders' mortgage insurance	3
Background	3
Benefits of LMI	3
Regulation of LMI and capital relief for lenders	4
Capital relief for lenders	4
Viability of LMI product	5
Financial system stability	5
Monoline versus multiline licensing	6
Conclusion	7

Lenders' mortgage insurance

QBE Lenders' Mortgage Insurance Limited, as part of the QBE Insurance Group (**QBE**), welcomes this Inquiry into the Australian financial system as an important opportunity for the Australian Government and market participants to take stock of our financial system and consider how it has and can operate to best support our country's economic growth and meet Australia's evolving needs in the coming decades.

Lenders' mortgage insurance (**LMI**) currently plays an extremely important role in the Australian housing market - it enhances the underlying efficiency in the market for housing loans, improves access to home ownership, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), increases competition and innovation among lenders and reduces barriers to entry in the home lending market.

There is currently little capital incentive for the home lending market to use LMI because of the increasing dominance of Internal Ratings Based (**IRB**) lenders, together with a lack of regulatory recognition for IRB lenders use of LMI when modelling reduction in credit losses.

In the absence of such regulatory or structural incentives, QBE is concerned about the ongoing viability of LMI as a product. This in turn may place at risk both the accessibility to home ownership and affordability of homes within the Australian housing market.

Background

LMI is a wholesale insurance product that protects the lender in the event a borrower defaults on a loan and there is a shortfall on the sale of the property. It is the insurance of the credit default risk of a specific loan provided by a specific lender at a specific time in relation to a particular mortgage (borrower, loan characteristics, property and lender or origination attributes).

The lender is the beneficiary under the policy, not the borrower. In insurance terms, the borrower is actually the "risk" against which the LMI policy provides protection.

LMI is generally required by lenders where a borrower has saved less than 20% of the purchase price as a deposit. The once only up front premium is paid directly by the lender to the LMI provider for the provision of LMI. That premium covers the lender for the entire life of the loan (up to 30 years).

Typically (but not always), the cost of the LMI premium is passed on by the lender to the borrower as a fee (similar to other fees incurred by the lender in the mortgage origination process, e.g. valuation fees).

As a wholesale (or business to business) product (i.e. not a retail insurance policy protecting a borrower) protecting the lender, it cannot be "transferred" by the borrower if the borrower wishes to refinance their mortgage with another lender.

Benefits of LMI

The main benefits of LMI are set out in more detail in Attachment 1 but in summary, LMI providers:

- make a significant contribution to the community by facilitating home ownership. Since 1965 (when it was first introduced), LMI has helped over 2 million people who have not had at least a 20% deposit purchase their own home;
- contribute to systemic risk diversification across mortgage lenders (by the pooling of risk across geographies and distribution sources);
- play an important role in assisting to maintain credit standards within the financial system by providing a 'second set of eyes' in the mortgage origination process;
- are active in detecting and monitoring potential fraudulent activity within the mortgage industry;
- make their expertise and resources available to assist mortgage lenders improve their mortgage origination processes and service to borrowers; and

- support capital markets by credit enhancing mortgage backed securities, increasing their appeal and reducing wholesale funding costs for some lenders.

The value of LMI is widely recognised by the financial authorities - the 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% LTV¹

Regulation of LMI and capital relief for lenders

The provision of LMI in Australia is highly regulated. LMI providers are regulated by APRA and LMI is a general insurance product offered in Australia by providers operating under a monoline licence. LMI operates under the Insurance Contracts Act 1984. As a wholesale or business to business product, LMI is not governed by Chapter 7 of the Corporations Act 2001 (consequently retail disclosure requirements such as for a Product Disclosure Statement do not apply).

LMI is a very capital intensive business. LMI providers are typically highly rated by independent ratings agencies, underpinned by substantial capital strength, both through APRA's local regulatory requirements and through rating agency capital requirements. LMI capital in Australia is typically invested in conservative, highly liquid non-correlated assets and is used as an independent layer of capital or buffer to pool credit default risk and the costs associated with default across time, geography and a large group of borrowers and lenders.

Capital relief for lenders

Under the existing Basel II arrangements, there is no capital incentive for IRB lenders to use LMI on residential mortgages.

The Basel II based APRA rules replaced the Basel I equivalent in 2008. They include:

- a 'standardised approach' with updated risk weightings applicable to residential mortgages;
- an alternative regime being the Internal Ratings Based (IRB) approach. This approach allows Authorised Deposit-taking Institutions (**ADIs**) to use their own models, subject to APRA approval, to determine the credit risk component of regulatory capital.

The standardised approach reflects more granular risk weightings for residential mortgages and a reduced level of capital incentive (compared to Basel I) for ADIs to use LMI.

Following the implementation of Basel, APRA has required all IRB lenders to maintain a floor of 20% for the Loss Given Default (**LGD**) on residential mortgages. This floor has been the adopted assumption for LGD for mortgages with and without LMI protection, giving no recognition for the use of LMI by lenders and effectively negating any capital benefits for LMI.

Prior to 2008, however, under Basel 1, there was a significant capital incentive for the use of LMI. In particular, it enabled ADIs to apply a 50% risk weighting (rather than 100%) to 'standard' loans with greater than 80% Loan to Valuation Ratio (**LVR**) and 'non-standard' loans (primarily low-doc loans) with greater than 60% LVR. This incentive, which halved the capital usage for the lender, reinforced the practice by lenders of insuring high LVR loans.

The current IRB approach has proven to yield a lower regulatory capital requirement for residential mortgages than the standardised approach. At present, all of the 'Big 4' Australian banks have had their IRB status approved by APRA; a number of 2nd tier ADIs have

¹ The Joint Forum, *Review of the Differentiated Nature & Scope of Financial Regulation*, January 2010, p.17. The Joint Forum was established under the aegis of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors.

achieved or are seeking IRB status; and smaller ADIs (such as credit unions, building societies and various smaller lenders) will continue to apply the standardised approach.

In practice, the vast majority of residential mortgages originated by ADIs are subject to the IRB approach. It is anticipated that this proportion will increase further due to the market dominance of the large IRB lenders and anticipating that further ADIs will achieve IRB status over time.

A key element in determining regulatory capital for IRB lenders is to ascertain LGD, being the estimated loss in the event that a loan defaults. APRA has set the minimum LGD for residential mortgages at 20%. This is based on its views of potential losses that would occur in a severe economic downturn.

Individual banks and the LMI and banking industries, through the ICA and the ABA, have submitted extensive claims data, modelling and analysis to APRA on the effect of using LMI in the context of the LGD floor in the event of a severe downturn. Similarly, extensive representations have been made to APRA on the important role of LMI in the Australian market and the need to recognise the use and value of LMI from a capital perspective for lenders in the IRB's LGD model. To date, this has been unsuccessful.

The effect of this is that:

- to the extent that mortgage insurance reduces credit losses, LGD must still be no lower than 20%;
- in determining regulatory capital, there is no incentive for IRB lenders to separately model the benefit of LMI; and

IRB lenders do not therefore currently receive any regulatory capital benefit for insuring mortgages.

Viability of LMI product

APRA has developed a specific regulatory capital regime applicable to LMI. This requirement is very high due to APRA's view of potential losses arising from mortgage defaults in a severe economic downturn. The largest component/driver of LMI premium rates is therefore the high level of regulatory capital that LMI's must hold.

There is significant tension between the following objectives:

- keeping LMI premiums affordable for homebuyers who need it to buy a home (typically those who cannot afford a home loan deposit of greater than 20%);
- holding a high level of regulatory capital to fund claims in a severe economic downturn;
- providing adequate returns to LMI shareholders; and
- satisfying lenders that it is worthwhile to insure mortgages. The alternative would be for lenders to leave loans uninsured and charge borrowers additional fees and interest to compensate for the higher risk retained by lenders.

In the absence of any regulatory or structural incentives for using LMI, market forces (reflected in the points above) may drive LMI as a product out of the market. This is the case in New Zealand where LMI is no longer available.

Financial system stability

From a financial system stability perspective, the LMI providers hold significant capital in Australia that provides an additional independent layer of capital that assists in diversifying risk across lenders, across time and across geography. LMI has contributed significantly in ensuring a stable and competitive residential mortgage market during the last 45 years.

The consequences of there not being a strong independent LMI regime (in addition to loss of the benefits referred to in Attachment 1) include the following:

- ***The capital in the financial system would be reduced unless held by the lenders.*** APRA has indicated that it is reluctant to see any capital reduction within the financial system. This suggests that any withdrawal of LMI would necessitate a change in regulations to compel mortgage lenders to carry the additional capital currently held by LMI providers.

- ***The charging by lenders of a low equity fee in lieu of LMI may have adverse consequences for the financial system if it threatens the viability of LMI as a product.***

Whilst it is difficult to be definitive, the New Zealand experience (where LMI has been progressively replaced by a low equity fee charged by lenders), suggests the following consequences. Competitive pressures and the drive for market share, especially in a low growth environment, can lead lenders to under price the risk or arbitrage the low risk fee away altogether, e.g. through fee waiver.

Following the GFC and a softening of the New Zealand residential market, apart from Kiwi Bank (which retained LMI over that period), all the major banks withdrew from high LVR lending, requiring at least a 20% deposit for new loans. Such an approach in Australia would have a calamitous impact on the property market, which in turn would be highly detrimental for mortgage lenders.

The recognition of income/reserving and loss provisioning for LMI providers is generally much more conservative than the treatment of a low equity fee by mortgage lenders.

Because LMI providers are separately capitalised to carry the mortgage risk and need to make an adequate return on that capital, they are better placed than mortgage lenders to adequately price for the associated risks.

An emerging trend in Australia is the selective charging of a low equity fee in lieu of LMI by some lenders (e.g. CBA and ING) on lower risk loans with an LVR >80% at origination. This results in potential adverse selection for LMI providers (i.e. proportionally higher risk lending insured than previously) - this skews the distribution of risk (as lenders bring more good/low risk in-house- holding premiums constant, claims paid will be on average greater than premiums charged), and LMIs may face default risk².

While Australian banks subject to the IRB capital approach receive no capital offset for LMI and, allowing for competitive pressures referred to above, in QBE's view, there is a real risk they will under-price the low equity fee. On the other hand, LMI providers will be constrained by competitive pressures in adequately pricing LMI up for the increased risk in their adversely selected LMI book.

- ***There is likely to be an increased volatility for lenders in economic cycles in relation to residential mortgage risk that will likely impact on the broader housing market.***

For example, during times of downturn, lenders appetite for higher risk lending reduces. LMI operates to smooth these cycles enabling credit to flow during periods of downturns. The role LMI plays in this respect was critical during the Federal government's first home buyers stimulation of the economy in 2009 which would not have occurred without LMI.

- ***At the economy-wide level, economic efficiency (value-add) and stability throughout the business cycle may be compromised by¹:***
 - › lowered risk-pooling benefits (including lost fungible capital);
 - › information asymmetries returning at the cost of economic efficiency;
 - › incentives skewing (with potential impacts to capital sufficiency);
 - › competition between lenders reduced, at the cost to economic efficiency;
 - › reduced counter-cyclical benefits of insurance; and
 - › added cost to the public sector finances (at the cost of policy initiatives).

Monoline versus multiline licensing

There may be efficiencies in allowing LMI to operate as part of a multiline insurance entity. In jurisdictions where mortgage insurance operates, the regulatory regime typically includes:

² As noted by Deloitte Access Economics discussion paper 2010, *Economic Value of Lenders Mortgage Insurance*, p. 24.

- specific regulatory capital requirements reflecting the need to hold a high level of capital. This is designed to ensure claims are funded in the event that a severe economic downturn generates a catastrophic level of mortgage defaults and claims; and
- the requirement to operate LMI in a separate licensed entity so as to quarantine the LMI product from other lines of general insurance.

Within a broad based, multiline insurance group, the risk profile (and capital requirement) at the group level is likely to benefit from the diversification that arises from insuring many uncorrelated risks. The same is true of reinsurers who cover diverse risks.

The same argument may be made at the insurance entity level. On that basis, the ability to write LMI business from a multiline insurer (i.e. one licence for many products) as opposed to a monoline (i.e. one licence for one product) may bring benefits, including the following:

- risk diversification at the operating entity level;
- potential capital relief at the operating entity level;
- simplified regulatory oversight and governance; and
- simplified processes and reduced costs.

Conclusion

Lenders mortgage insurance has been a critical component of the housing market since 1965, facilitating home ownership and accessibility to credit for millions of borrowers. LMI enables those who would otherwise have difficulty obtaining a home loan (particularly borrowers with low incomes or low levels of equity), to satisfy responsible lending criteria and purchase a home. Currently IRB lenders receive no capital benefit for the use of LMI, despite the fact that the LMI providers are required to, and do hold, significant capital for the risk that is transferred.

QBE believes the Inquiry should consider the important role that LMI plays in the financial system and recommend that capital relief be provided to IRB lenders that utilise LMI. This would ensure that LMI continues to benefit the housing industry and its customers, and continue to facilitate increased competition between lenders. It would bolster financial and economic stability and importantly improve access to affordable home ownership.



QBE