

Mr John Lonsdale
Head of Secretariat
Financial System Inquiry
GPO Box 89
Sydney NSW 2001
Via Email: fsi@fsi.gov.au

Tuesday 26 August 2014

Dear Mr Lonsdale,

RE: Genworth Response to Interim Report of the Financial System Inquiry

Genworth welcomes the opportunity to respond to issues raised in the Interim Report of the Inquiry into Australia's financial system.

Genworth is the leading provider of Lenders Mortgage Insurance (**LMI**) in Australia. LMI has been a fundamental factor in home ownership since 1965 and we are proud of our contribution to the financial system, the housing market and the great Australian dream of home ownership.

Genworth's business is at a strategic nexus between housing finance, housing accessibility and housing affordability which gives us a strong presence in the financial system assisting lenders manage residential mortgage default risk. With \$306 billion insurance in force, we are a key contributor to the stability of the Australian financial system. We have a unique insight into the health and dynamics of the Australian residential housing market as both a provider of LMI and as an industry leader that regularly surveys the market.

Given Genworth's experience, we are keen to assist the Inquiry explore potential policy options to address competition and stability concerns that the LMI and residential mortgage industries face through regulation and the interpretation of global capital standards as highlighted in the Interim Report. We here-in provide a submission commenting on key policy options, providing the Inquiry with further evidence to assist it in its deliberations.

Genworth's submission is supported by the attached report by Deloitte Access Economics on the 'Socioeconomic Impact of LMI in Australia' (**Appendix A**), which Genworth recently commissioned. Additionally, we have actively contributed to the LMI Industry Submission via the ICA. We welcome any opportunity to assist the Financial System Inquiry further.

Yours sincerely,



Ellie Comerford
CEO & Managing Director

Genworth Mortgage Insurance Australia Limited
Second Round Submission to the Financial System Inquiry

1. Executive Summary

The key value proposition of Lenders Mortgage Insurance (**LMI**) to the Australian financial system is that it helps home loan lenders to manage the risk of issuing high loan to value ratio (**LVR**) loans – that is, loans where the borrower's deposit is less than 20% of the value of the property being purchased. This enables mortgage lenders to safely handle the risk of writing a loan to someone unable to provide a 20% deposit when they want to buy their home. This in turn helps play a significant role in making home ownership more accessible for more Australians – especially first home buyers, and the self-employed. The significance of this can be seen by the fact that in 2013, approximately one third of all new mortgage loans were above 80% LVR¹. Given the high cost of housing in Australia, LMI has played a vital role since 1965 in not only ensuring accessibility of housing, but also in ensuring financial system stability in the high LVR segment. Additionally, LMI has supported the Australian RMBS market.

Our response to the Interim Report of the Financial System Inquiry (**Interim Report**) provides evidence to support our argument that the regulations underpinning the Australian mortgage market need reform in order to increase competition and level the playing field between larger and smaller lenders. The changes we recommend will help to make the system more stress-resistant and stable over the long term, ensuring the long term viability of the LMI industry. This in turn helps strengthen the financial system and supports underlying social policy on housing.

Inaction will weaken the Australian mortgage market

If no change is made we believe there will be the real possibility of less competition, an increase in systemic risk and reduction in system capital as follows:

- **System Capital - Less capital to absorb an unexpected crisis:**

The Basel II advanced internal ratings based approach (**AIRB**) currently affords no capital recognition for using LMI. Therefore, major banks, which are accredited to use AIRB – being Westpac Banking Corporation (**Westpac**), National Australia Bank (**NAB**), the Commonwealth Bank of Australia (**CBA**), the Australia and New Zealand Banking Group (**ANZ**) and Macquarie² - can waive LMI with no marginal capital consequences unlike the smaller standardised approach lenders. If the bigger banks do not receive any capital benefit from using LMI, this can lead to their 'cherry picking' better risk borrowers and waiving LMI, typically charging a fee or higher interest rate instead. In doing so overall system capital is reduced, as the major banks do not hold the additional capital that would otherwise have been held by the LMI provider had LMI not been foregone.

This is further exacerbated by the AIRB models which allow AIRB banks to segment their mortgage portfolios by factors other than simple LVR in determining their mortgage capital requirements. Whilst these other factors may be relevant in benign times, in an extreme stress scenario it is our view that they underestimate the unexpected losses. The standardised approach does not allow smaller lenders to segment beyond LVR. The result is very different capital requirements for essentially the same mortgage risks - less capital for the AIRB banks but relatively more for the standard approach banks in respect to mortgages with similar risk characteristics.

¹ APRA, (25 February 2014) Quarterly Authorised Deposit-taking Institution Property Exposures December 2013 at page 8, available at <http://www.apra.gov.au/adi/Publications/Documents/Quarterly%20ADI%20Property%20Exposures%20-%20December%202013.pdf>.

² Macquarie has foundation IRB accreditation

- **Competition – Indirect subsidisation for bigger banks:**

The different capital requirements, if allowed to persist, will continue to make it harder for smaller lenders, such as the regional banks, building societies and credit unions, to compete with the major banks in offering high LVR loans. Traditionally LMI has allowed smaller lenders to at least compete with larger lenders in the high LVR lending segment as smaller standardised lenders obtain capital relief for using LMI for high LVR loans. As the non AIRB lenders have to hold relatively higher levels of capital, despite capital relief from LMI, it is still not a level playing field, hence impacting competition. Further, the non-recognition of LMI for AIRB and the disparity in capital calculation encourages the AIRB banks to adopt Bank Risk Retention (**BRR**) programs / policies to ‘cherry pick’ high LVR loans, waiving LMI and typically charging a fee or a higher interest rate to the borrower. They are essentially able to retain the additional risk while not holding the same level of combined capital the LMI providers and smaller standardised lenders are required to hold between them. Further, depending on the particular BRR program any fees charged may have an up to 11% beneficial tax treatment over LMI premium taxation (GST and Stamp Duty).

These headwinds to competition are in addition to the cost of funds advantage the ‘too big to fail’ banks already receive from an implied government guarantee.

- **Concentration Risk – Deterioration of average mortgage risk across industry:**

With a different methodology no effective capital recognition for LMI usage and AIRB capital being calculated, AIRB banks are understandably incentivised to ‘cherry pick’ more high LVR mortgages on a non-LMI basis. In our view, this increases their susceptibility to significant stress events in the face of increasingly less risk diversification. LMI on the other hand is designed as a shock absorber with LMI providers holding specific capital - for the benefit of lenders - for such stress events. It is our fear that BRR programs/policies will, over time, lead to a deterioration of the average mortgage risk for both the AIRB banks and the LMI providers with less overall system capital to deal with the outcomes of a significant stress event.

Since the Global Financial Crisis (**GFC**), it has become especially important for Australia to strengthen its financial system so that Australia is better placed to face any future domestic and international economic or financial crises.

Recommended solutions to these problems

To address these problems we believe that high LVR loans need to be treated as a separate segment within AIRB bank capital modelling with increased minimum risk weights and explicit recognition for LMI. More specifically our recommended solutions involve:

Recognising LMI in AIRB bank models by reducing loss given default (LGD) factors to their lowest percentage permissible by the regulator (according to BIS this should be 10%) where LMI is protecting a mortgage;

AND

Increasing the capital requirements for high LVR loans for AIRB banks by segmenting their mortgage portfolios between high and low LVR and introducing either / both of:

- minimum risk weights by LVR for high LVR lending irrespective of the probability of default (PD) segmentation assessed by the major banks in benign times;
- increasing the correlation factor in the AIRB model for high LVR lending (as was instituted in more recent times by the Reserve Bank of New Zealand (RBNZ)).

Other alternatives that we believe could mitigate risks identified in the Interim Report include:

- **Introduce policy to discourage AIRBs ability to ‘cherry pick’ the ‘better’ risks from high LVR loan segments.**

In deciding which mortgages require LMI, AIRB banks should be prevented from ‘cherry picking’ the lower risk mortgages that they identify due to their PD segmentation. The portfolio of high LVR loans secured by mortgages an AIRB bank retains without LMI should have broadly the same risk characteristics as a portfolio with the benefit of LMI.

- **Development of a catastrophic reinsurance pool for LMI policyholders.**

We propose a government-sponsored reinsurance arrangement for LMI policyholders which would only trigger if the financial system fails due to an unexpected major catastrophe that would be more than a 1 in 200 year event. Such a policy would help protect the system against catastrophic tail credit risks, making the system more stable and enhancing competition for all residential mortgage lenders, as they would share access to the pool. It would effectively introduce explicit government support for the Australian residential mortgage loan market in place of the implicit government support that exists today in respect of the ‘too big to fail’ banks. This would not be a government guarantee but rather a reinsurance program funded progressively by the LMI industry and hence would not place a burden on the government or taxpayers in an extreme stress scenario.

- **Recognition of LMI as a credit risk mitigant in Securitisation.**

Traditionally LMI has been an integral form of credit enhancement for the securitisation market. Before the GFC, almost all residential mortgages loans underlying transactions of residential mortgage backed securities (RMBS) were covered by LMI policies. To help manage the risk of writing high LVR loans, the recent move away from LMI should be stemmed by recognising its role in APRA’s APS 120 standard.

Ultimately, all these proposals seek to make the Australian residential mortgage lending market better placed to:

- Level the playing field and improve competition between lenders, putting downward pressure on the costs of many Australians to buy their own home;
- Create greater financial stability for the Australian financial system as a whole;
- Increase the liquidity in the residential mortgage loan market; and
- Continue to meet the social needs of ensuring accessibility to housing for all Australians.
- Cement the position of LMI which has supported the mortgage industry and financial system since 1965.

2. About Lenders Mortgage Insurance

LMI has been an important part of the Australian residential mortgage lending market since 1965 when it was introduced by the Australian Government with the aim of increasing and enabling more affordable and accessible home ownership. 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 Mortgage Insurance Pty Limited is an APRA regulated specialist mortgage insurance provider. Its parent, Genworth Mortgage Insurance Australia Limited, is listed on the Australian Securities Exchange. Genworth is the leading provider of LMI in Australia.

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 50 years.

LMI provides protection (typically for the life of the loan) to financial institutions against losses arising from borrower default on residential mortgage loans. It works by insuring the credit worthiness of qualified borrowers, thus allowing consumers to borrow up to 95% of a property's value. This in turn enables a borrower to purchase a house without a 20% deposit, providing greater accessibility for prospective home owners.

LMI providers drive market discipline, help maintain prudent capital, governance and underwriting standards and apply advanced risk management expertise and monitoring tools to enforce disciplined risk taking. LMI providers have been described as the mortgage industry's "second set of eyes" with a core focus on responsible lending. More importantly, LMI provides an opportunity for borrowers to accelerate the Australian dream of home ownership.

3. The Value of LMI to the Financial System

LMI provides risk transfer and diversification to lenders, especially with respect to high LVR lending. When a residential mortgage lender uses LMI to manage the risk of issuing a high LVR loan, it enables the lender to lend to the borrower at a higher LVR. So when a lender uses LMI, it means a borrower will find it easier to access the housing market. Additionally, it bolsters competition and stability within the wider financial system. LMI allows all lenders - large and small - to compete within the residential mortgage lending market and diversify their risks.

LMI providers, such as Genworth, are prudentially regulated and proscriptively required to maintain specific designated capital designed to withstand housing market and economic downturns based on a 1 in 200 year stress event. This capital promotes stability across the wider financial system. In summary, LMI:

- **Improves access to home ownership.** LMI is available to help credit worthy borrowers access home purchases on an accelerated basis without necessarily having to save a 20% deposit. Because of LMI, the lender's risk of lending to these high LVR borrowers is transferred to the LMI provider, with the LMI provider having the expertise necessary to evaluate the risk.
- **Increases competition between lenders.** Competition between lenders provides choice and innovative products for borrowers and assists affordability. Lenders adopting the standardised approach to credit risk (APS 112) (**Standardised Lenders**), who are typically smaller lenders, receive an explicit capital benefit from purchasing LMI in respect of residential mortgage loans for which the LVR is 80% or greater (**HLVR**). LMI is also particularly important to smaller lenders as a credit enhancement tool to access additional capital which allows them to compete with larger lenders in offering home loans to borrowers with smaller deposits.
- **Helps with financial and economic stability.** LMI helps with the stability of the financial system by allowing a greater spread of risk and diversification of lenders' exposures. It also increases the total amount of capital held within the wider Australian financial system.
- **Provides a bird's eye view of the mortgage market, through LMI providers' data.** Importantly, LMI providers act as 'a second set of eyes' assessing residential mortgage lending policy, underwriting processes and performance data at an economy-wide level leading to an increased quality of risk assessment. Some of the benefits LMI brings to prudent lending in this regard are explicitly recognised in APRA's draft Prudential Practice Guide, APG 223, on Residential Mortgage Lending³.

³ See <http://www.apra.gov.au/adi/Documents/Draft-PPG-APG223.pdf>

4. Views on the policy options raised in the Interim Report

The issues affecting LMI and the residential mortgage lending industry are directly addressed in the 'Competition' section of the Interim Report. The purpose of this submission is to address the issues raised and provide potential solutions for the Inquiry to consider. Our submission specifically tackles the issues raised in the following sections of the Interim Report:

- Growth and Consolidation – Competition - Lenders Mortgage Insurance (2-21 to 2-23)
- Growth and Consolidation – Competition - Regulatory Capital Requirements (2-8 to 2-12)

In considering the above issues, our submission also makes reference to the Inquiry's observations with respect to:

- Growth and Consolidation – Competition - Residential Mortgage-Backed Securities (2-15 to 2-16)
- Post-GFC Regulatory Response – Stability - Too-big-to-fail and Moral Hazard (3-8 to 3-12)

We also include our views on the dangers of making no change and offer some positive solutions to improve the current system.

4.1 Comparing risk weights for residential mortgage loans

In the Interim Report, the Inquiry specifically requests views on regulatory capital requirements and the determination of risk weights. Before responding to each of the options raised in the Interim Report, we set out in the section below an explanation as to how the 'big four' banks calculate their risk weights and the capital attributable to residential mortgage loans under the AIRB formula.

To ascertain the system capital and competition consequences that may have been unintended, these AIRB risk weights need to be compared to risk weights of other participants in the financial sector; other participants include lenders such as the regional banks, credit unions and building societies (**Standardised Lenders**) as well as LMI providers.

AIRB banks

Banks adopting the AIRB approach to credit risk (APS 113) use a formula set by APRA, which in turn largely follows the formula published in the Basel Framework documents by the Bank of International Settlements (**BIS**) providing their own estimates for key variables. The purpose of this formula is to determine risk weights and ultimately the amount of capital required to protect the lender in an unexpected extreme catastrophic event (1 in 1000 according to the formula's 0.999 level stated).

The formula is outlined below in Chart 1:

Chart 1: IRB Formula for Credit Risk Capital

Capital requirement (K) = $[LGD * N [(1 - R)^{-0.5} * G(PD) + (R / (1 - R))^{0.5} * G(0.999)] - PD * LGD] * (1 - 1.5 * b(PD))^{-1} * (1 + (M - 2.5) * b(PD))$

Where:

N denotes a normal distribution

G is the inverse of a standard normal distribution (0.999 represents a 1 in 1000 scenario)

R is the correlation factor (fixed at 0.15 for retail portfolios)

PD is the probability of default (3 full payments in arrears)

LGD means loss given default and is the discounted cash flow loss of defaulted loans

EAD is the exposure at default

Converting this formula to determine risk weighted assets, the formula becomes:

$$RWA = K \times 12.5 \times EAD$$

The expected loss is:

$$EL = PD \times LGD \times EAD$$

PD and LGD estimates (as stated in bank Pillar 3 disclosures) are applied to the BIS formula to determine bank risk weights for different mortgage loan segments.

Pillar 3 disclosures contain AIRB banks' probability of default or PD segments and loss given default or LGD estimates. For illustration purposes, a range of PD segments combined with different LGD levels has been applied through the AIRB capital formula to determine estimated AIRB banks' Credit Capital Risk Weights (**RW**) and are shown in Chart 2 below:

Chart 2: Capital Credit Risk Weights

Segment Descriptions*	PD	LGD	RW
i. "Outstanding Quality" Risk Segment Example. A borrower who has a good long history with the lender in other products (credit cards, personal loans, etc.) and has a strong capacity to pay (high income against their borrowing commitments).	0.05%	10%	1.5%
	0.05%	20%	2.9%
	0.05%	30%	4.4%
	0.05%	40%	5.9%
	0.10%	10%	2.5%
	0.10%	20%	5.0%
	0.10%	30%	7.6%
	0.10%	40%	10.1%
ii. "Very Strong Quality" Risk Segment Example. A borrower with a good history with the lender and who meets all the other requirements to have their residential mortgage loan approved.	0.20%	10%	4.3%
	0.20%	20%	8.5%
	0.20%	30%	12.8%
	0.20%	40%	17.0%

Segment Descriptions*	PD	LGD	RW
iii. “Good Quality” Risk Segment Example. A borrower, who is new to the lender and meets the lender’s minimum servicing requirements, has been a long term saver with a modest income and has been doing their banking with another institution but wants to get a residential mortgage loan from a major bank.	0.50%	10%	8.3%
	0.50%	20%	16.5%
	0.50%	30%	24.8%
	0.50%	40%	33.1%
iv. “Moderate Quality” Risk Segment Example. A borrower who meets the minimum requirements of the lender to have their residential mortgage loan approved.	1.00%	10%	13.3%
	1.00%	20%	26.6%
	1.00%	30%	39.9%
	1.00%	40%	53.1%

* Whilst the segmentation level varies by AIRB lender, generally, lenders will have many segments within their residential mortgage portfolio (the Risk Segment names indicated above are illustrative and not taken from the lenders but indicate what they represent)

Chart 2 demonstrates that a residential mortgage loan with a low PD and a high LGD (a high LGD is usually associated with high LVR lending) will still have a relatively low RW. An example of this is, say a borrower who is a professional recently graduated from tertiary education more than meets the minimum servicing requirement but has to accumulate the minimum deposit required to obtain a home loan. This borrower might have no (or limited) other assets as they have been paying their credit card debt and personal loans whilst working and studying demonstrating a strong saving and repayment behaviour.

The LGD is an estimate of the amount of loss on a particular residential mortgage loan once a borrower is in default (meaning they have missed more than three full mortgage loan repayments). While the Basel floor LGD is 10%, APRA uses a minimum LGD average of 20%. AIRB banks develop their own internal LGD estimates for particular borrowers/residential mortgage loans.

Chart 2 also shows that the Risk Weighted Asset percentage varies significantly for a residential mortgage in a 1 in a 1000 year unexpected event. While APRA has introduced a minimum LGD average of 20%, the capital varies quite significantly for a residential mortgage loan depending on which risk segment it falls within. Whilst PD is based on borrower history and capacity to repay in a benign environment, capital requirements are imposed to protect a lender when an unexpected extreme event occurs (e.g. both unemployment rising and house prices falling substantially). Considering this extreme scenario, high levels of equity in the home and other assets are the key buffer to avoid loss emanating from mortgage default.

While sophisticated banks can segment their loans in considerable detail, the segmentation for PD does not require segmentation based on LVR. When considering that a 95% LVR stand-alone loan without mortgage insurance for an outstanding quality risk with a PD set at 0.05% and a 20% LGD, would only require 2.9% RW credit capital – whereas a 1.00% PD segmented risk would require 26.6% (almost 10 times the credit risk capital) – this benefit can be considerable. The obvious statement is that the PD credit risk is one twentieth of the other, the PD segmentation being based on the performance under an expected loss scenario in benign times. The lender receives the mathematical benefit of actual lower losses (based on actual experience or provisioning) in a benign environment. But, the issue is that they should hold enough capital to cover an extreme catastrophic scenario.

This incentive to hold lower capital, coupled with lower expected loss for AIRB banks, is further exacerbated by being able to underwrite high quality loans but at high LVRs where the bigger banks can also charge a premium or a higher interest rate due to the borrower’s lack of a deposit.

The LMI Industry

The capital that LMI providers are required to hold is determined based on frequency and severity factors, which vary by LVR segments, with:

- *frequency* being the probability that a default under the loan will result in a claim in a 1 in 200 year scenario; and
- *severity* being the loss expected as a percentage of the original loan amount.

These factors are then multiplied to determine the capital rate under APRA General Insurance Prudential Standard (GPS) 116. LMI providers tend to hold at least 30% more capital than the regulatory minimums, as seen in Chart 3 below.

Chart 3: LMI Capital Calculation

Total LVR (includes premium capitalised)	Frequency	Severity	GPS 116 Capital	Risk Weight Equivalent	Increase by 30% for capital loading
95.01 – 100%	8.2%	40%	3.280%	41.0%	53%
90.01 – 95%	5.1%	40%	2.040%	25.5%	33%
85.01 – 90%	3.2%	40%	1.280%	16.0%	21%
80.01 – 85%	2.0%	30%	0.600%	7.5%	10%

Standardised Lenders

The formula for Standardised Lenders is very simple for high LVR loans and can be seen in the following chart (Chart 4):

Chart 4: Standardised Lenders HLVR Formula

LVR	Standard eligible mortgages	
	Risk-weight (no LMI)	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI policy)
90.01% – 100%	75%	50%
80.01% – 90%	50%	35%

Whilst smaller Standardised Lenders obtain capital relief for using LMI with high LVR residential mortgage loans, the level of capital Standardised Lenders are required to hold is still higher than the AIRB banks⁴.

Why the difference is important?

Although Standardised Lenders and AIRB banks are all governed by APRA as Authorised Deposit –taking Institutions (**ADIs**), depending on their accreditation status they could have

⁴ See page 43 of COBA submission to FSI <http://fsi.gov.au/files/2014/04/COBA.pdf>

very different capital requirements for essentially the same risk. This lessens competition, making it more difficult for Standardised Lenders to compete with the AIRB banks in the high LVR residential lending market. This significantly impacts Standardised Lenders, given that high LVR represents a substantial segment (approximately one third) of the residential mortgage lending market.

4.2 Genworth’s views on the costs, benefits and trade-offs of policy options identified in the Interim Report

Having highlighted issues associated with risk weighting, the submission turns now to specifically address the Interim Report. The Inquiry has requested views on the costs, benefits and trade-offs of a number of policy options regarding bank capital. The table below sets out the policy options which are addressed:

Interim Report topic(s)	Policy option	Submission section
Lenders Mortgage Insurance (2-21 to 2-23)	No change to current arrangements	4.2.1
	Decrease the risk weights for insured loans	4.2.2
Regulatory Capital Requirements (2-8 to 2-12)	No change to current arrangements	4.2.1
	Increase minimum IRB risk weights	4.2.3
	Other alternatives	4.2.4

Our views outlined below include recommendations focused on levelling the playing field and ensuring that the financial system avoids systemic risks in the future arising from unintended consequences of regulation.

4.2.1 No Change to Current Arrangements

It is our view that making ‘no change to current arrangements’ is not a viable option. Change is critical to ensuring the ongoing stability of the residential mortgage lending market.

The residential mortgage market landscape has changed significantly since the GFC. Whilst Australia performed well during the GFC, it is important to address issues identified and better position the financial system for any future domestic and international economic or financial crises.

Regulations have been put in place aiming to enhance prudential standards and raise capital ratios to provide a better safety net for the financial system in economic downturns or stressed events. Capital protects banking institutions which, if they fail, puts the entire financial system and/or the Australian taxpayers at risk. System capital is critical to absorb losses in stressed scenarios and ensuring the right level of capital is held at institution level is paramount.

LMI vs Bank Risk Retention (BRR)

However, the consequences of these regulations have meant that there is reduced competition, less risk diversification, reduced levels of system capital and the use of BRR programs / policies which result in lower levels of LMI - potentially adversely affecting long term accessibility to home ownership. BRR describes the situation where lenders decide not to obtain LMI in respect of high LVR loans but instead retain the credit risk of residential mortgage loans for a fee or higher effective interest rates.

There are examples in the current market of BRR programs / policies where banks charge borrowers either fees or potentially higher interest rates in lieu of taking out LMI and charging the borrower the cost of the LMI premium. Furthermore, mortgage originator and broker groups also advertise similar products for medical professionals where LMI is waived⁵.

It is our experience that lenders generally use BRR to retain the risk in respect of borrowers in higher quality risk segments. The remaining risks which require higher AIRB capital are then typically insured through lenders taking out LMI.

Such BRR programs / policies erode the efficiency of the residential mortgage lending market by arbitraging the differing levels of capital required to be held by AIRB banks, Standardised Lenders and LMI providers. Essentially AIRB banks charge a fee or higher effective interest rates without the requirement of holding the same level of capital that an LMI provider would. This segment of loans has lower levels of capital relative to Standardised Lenders and residential mortgage loans supported by LMI but fees, or higher effective interest rates, received. In other words the AIRB banks benefit through a high return on equity for these loans due to lower capital charges.

New Zealand serves as a cautionary example of the threat that this arbitrage creates for the financial system and access to home ownership for the average Australian.

Chart 5 below shows the impact on system capital when LMI is taken out for a 90-95% LVR loan in comparison to when LMI is waived and/or a fee or higher effective interest rate is charged in lieu of LMI. It is assumed that a loan with LMI has a 10% LGD whereas a loan without LMI has an LGD of 40%. A higher LGD with LMI or a lower level without LMI exacerbates the amount of system capital lost (so these are minimum levels of system capital being lost).

⁵ <http://www.mortgagechoice.com.au/home-loans/home-buying-advice/tips-and-tools/lenders-mortgage-insurance-lmi.aspx>

Chart 5: System capital lost by not using LMI

For a 90-95% LVR Loan	Lender Capital Capital*	LMI Capital	Total System (Credit Capital)	System Capital (% of RWA) lost by not using LMI*
For Standardised Lenders				
LMI Insured Standardised Lender loan	50.0%	25.5%	75.5%	
Uninsured Standardised lender loan	75.0%	0.0%	75.0%	-0.5%
For the AIRB banks				
LMI Insured Outstanding Risk Quality (0.05% PD) (Assume LGD is 10%)	1.5%	25.5%	27.0%	
Uninsured Outstanding Risk Quality (0.05% PD) (Assume LGD is 40%)	5.9%	0.0%	5.9%	-21.1%
LMI Insured Very Strong Risk (0.10% PD) (Assume LGD is 10%)	2.5%	25.5%	28.0%	
Uninsured Very Strong Risk (0.10% PD) (Assume LGD is 40%)	10.1%	0.0%	10.1%	-17.9%
LMI Insured Strong Risk (0.50% PD) (Assume LGD is 10%)	8.3%	25.5%	33.8%	
Uninsured Strong Risk (0.50% PD) (Assume LGD is 40%)	33.1%	0.0%	33.1%	-0.7%
LMI Insured Moderate Risk Quality (1.00% PD) (Assume LGD is 10%)	13.3%	25.5%	38.8%	
Uninsured Moderate Risk Quality (1.00% PD) (Assume LGD is 40%)	53.1%	0.0%	53.1%	14.3%

* While lenders hold capital for other risk types, the system capital comparison above highlights the difference between a loan that is covered by LMI compared to one which is not.

It can be clearly seen that there is a competitive disadvantage between the Standardised Lenders and LMI providers when compared to what the AIRB banks can arbitrage by waiving LMI. It can also be seen that the amount of capital required at higher PDs results in banks being incentivised to seek LMI in respect of these loans.

In other words, the BRR fees charged by AIRB banks in lieu of LMI do not have any marginal additional regulatory capital costs. The banks may not account for these fees in the same way that LMIs are required to earn premium and could recognise revenues sooner. This inequity is further exacerbated by the differential tax treatment of LMI premiums compared to BRR fees or higher effective interest rates. Essentially LMI being a premium for insurance attracts both GST and Stamp Duty where as BRR fees do not.

No change to current arrangements

Recommendation

By failing to do anything, arguably this will not result in the status quo being maintained. While the uneven playing field exists regarding capital treatment for AIRB vs. standardised, there will be the real possibility of an increase in systemic risk, a reduction in system capital and a reduction in competition, which unless corrected, will see the AIRB banks potentially continue to increase low-capital, high LVR non LMI lending. A change to the treatment of high LVR loans is required to address these issues.

Specific recommendations in respect of policy options that may effect this change are set out below in sections 4.2.2 and 4.2.3 of this submission.

4.2.2 Decrease the risk weights for insured loans

Residential mortgage loans covered by LMI should have the lowest LGD permissible by the regulator and be excluded from the minimum average 20% LGD calculated at the portfolio level.

Remaining within the BIS framework, this should be 10%. The regulator however, can deviate from this level and allow the AIRB lenders to calculate this at levels below this.

Lenders would then be required to hold capital for other risk classes (e.g. Operational Risk, Market Risk) but receive a clear credit risk capital incentive consistent with the residual risk that remains.

Decrease the risk weights for insured loans

Recommendation

The RW floor for LMI insured loans should be set by using an LGD at the lowest level permissible from the regulator and excluded from the average 20% LGD level calculated at the portfolio level.

This capital relief can then be calculated to offset the capital increase impact posed in section 4.2.2.

4.2.3 Increase minimum IRB risk weights

The LMI industry has been working to have LMI explicitly recognised within the LGD models of the AIRB banks.

While this is a step in the right direction, in the example above (a PD segment with an expected default rate at 0.05%), the LGD could move from 20% to 30% or maybe 40% if the lender chooses to waive LMI and this would move this 2.9% RW level to 4.4% or 5.9% respectively. This would be well short of the 1% PD rate levels of 39.9% and 53.3% respectively. As an extreme comparison, increasing the LGD to 90% for this PD level results in a RW level of 13.2%.

So increasing the LGD in isolation would not be sufficient to level the statutory capital for like mortgages. On a comparative basis, a LMI provider would hold 41% RW for that loan (the

LVR on the loan includes premium capitalisation so with a 95% LVR loan enters the 95.01 – 100% LVR capital category).

Using Chart 5, the capital level for a 90-95% LVR loan shows that the ‘break even’ point from a system capital perspective is when the PD is at 0.5%

Chart 6: System Capital Lost when not using LMI for a HLVR Loan

For a 90-95% LVR Loan	Lender Credit Capital*	LMI Capital	Total System (Credit Capital)	System Capital (as % of RWA) lost by not using LMI
LMI Insured Standardised Lender loan	50.0%	25.5%	75.5%	
Uninsured Standardised Lender loan	75.0%	0.0%	75.0%	- 0.5%
LMI Insured Strong Risk (0.50% PD) (Assume LGD is 10%)	8.3%	25.5%	33.8%	
Uninsured Strong Risk (0.50% PD) (Assume LGD is 40%)	33.1%	0.0%	33.1%	- 0.7%

* While lenders hold capital for other risk types, the system capital comparison above highlights the difference between a loan that is covered by LMI compared to one which is not.

The Basel formula is calibrated so that AIRB banks are required to hold capital at the 99.9% level (cover for a 1 in 1000 year event) whereas the LMI regulatory formula is set at the 99.5% (cover for a 1 in 200 year event) so arguably it is reasonable to use the LMI RW levels as the minimum RW for AIRB banks when they underwrite an uninsured high LVR loan. This ensures that there is no arbitrage opportunity and that there is no leakage in system capital.

Increase the minimum IRB risk weights

Recommendation

High LVR loans should be treated as a separate segment for AIRB banks and have minimum RW floors by graduated LVR bands whether LMI insured or not. Those floors should be calibrated to no less than the equivalent capital required of LMI providers.

4.2.3.1 Separate Correlation factor for High LVR Loans

An alternative / supplement to increasing the minimum IRB risk weights is to revisit the correlation factor and have a separate level for loans above 80% LVR in accordance with Genworth’s 2010 submission to the Basel Committee⁶ where it was shown that:

“The IRB formulas assume that the relationship between stress conditions and expected conditions can be estimated using a single equation, using a differentiating correlation factor to adjust the results for certain asset classes that demonstrate specific response rates to stress changes. In the case of residential mortgage loans the single 15% correlation factor assumes that HLTV response rates will be similar to that of low LTV loans. The implied assumption is that the cure rates on all residential loans from 90 day delinquency status are the same, regardless of LTV or other segmentation. However, historical data suggests that

⁶ See <http://www.bis.org/publ/bcbs165/genworthfinanci.pdf>.

under stress, the cure rates on 90 day delinquent HLTV loans can change drastically compared to the cure rates of delinquent low LTV loans, reflecting the loss of borrower net equity when there is a severe drop in property prices.”

New Zealand, in part due to adverse selection by the banks against using LMI (given that the Australian-owned New Zealand major banks received no capital incentive to use LMI), has had increased volatility in its housing finance sector which has had a system wide impact on the financial system and the average consumer. One of the responses by the RBNZ was to increase the capital requirements for high LVR loans consistent with this recommendation. As of 30 September 2013, the banks in New Zealand had to use the following LTR sensitive correlations:

Chart 7: New Zealand Correlations (30 September 2013)

	Current	New
Correlation for LVR under 80%	15%	15%
Correlation for LVR 80-89%	15%	20%
Correlation for LVR 90% and over	15%	21%

(Source: RBNZ, The Reserve Bank’s Banking Supervision Handbook, Capital Adequacy Framework (Internal Models Based Approach) BS2B, Table 4.11A)

See further, the RBNZ consultative paper, laying out its rationale for the increased capital tied to the LTR,⁷ and the final RBNZ impact study.⁸

Chart 8: Impact of using a correlation factor of 0.25

	Lender Capital*	LMI Capital	Total System (Credit Capital)	System Capital (as % of RWA) lost by not using LMI
For a 90-95% LVR Loan				
LMI Insured Standardised Lender loan	50.0%	25.5%	75.5%	
Uninsured Standardised Lender loan	75.0%	0.0%	75.0%	- 0.5%
LMI Insured Strong Risk (0.50% PD) (Assume LGD is 10%)	14.8%	25.5%	40.3%	
Uninsured Strong Risk (0.50% PD) (Assume LGD is 40%)	59.4%	0.0%	59.4%	19.1%

4.2.4 Other Alternatives – Create a policy for AIRB banks to avoid anti selection

If a risk weight solution is not implemented within a relatively short period of time, an ‘anti-cherry picking’ policy should be established for lenders choosing to waive LMI for high LVR loans.

This would be implemented utilising prudential standards to ensure that AIRB banks maintain a representative sample of high risk loans whether the risk is retained or LMI is obtained. Australian financial regulators have already suggested that type of arrangement to prevent ‘cherry picking’ in securitisation transactions and covered bond issuances to

⁷ See http://www.rbnz.govt.nz/regulation_and_supervision/banks/policy/5199878.pdf

⁸ See http://www.rbnz.govt.nz/regulation_and_supervision/banks/policy/5253294.pdf

increase investor protections and to ensure that a lender still has 'skin in the game' in proportion to its lending book. This approach ensures that the LMI risk pool is not adversely affected, home ownership and affordability social policy goals remain in focus, and overall system capital is not reduced.

A prudential policy aimed at ensuring that AIRB banks do not adversely select the risk pool for LMI providers will also ensure that the LMI market operates at its optimum and risks insured by LMI are priced appropriately. Accordingly, it is critical that LMI providers have a broad distribution of risks, including lower-risk borrowers.

LMI pricing is predominately based on both LVR and the loan size, rather than borrower characteristics. As discussed above, if AIRB banks adversely select certain loans and only leave lower quality loans that still fit within the underwriting parameters, the availability of LMI could be decreased and the cost increased as a result both negating the benefit of LMI for the Australian market.

Additionally, AIRB banks can use more criteria in selecting which risks to retain, whereas the Standardised Lenders are limited to LVR as the selection criteria. Accordingly, to promote competition, if the asymmetry in capital between lenders is not resolved as above, then this additional competition issue also needs to be addressed.

5. Too-big-to-fail and moral hazard (Sections 3-8 to 3-12 of the Interim Report)

Develop catastrophic reinsurance for LMI policyholders

Complementing the recommended policy changes in section 4, Genworth proposes the development of a government sponsored catastrophe reinsurance arrangement for LMI providers in the case of catastrophic financial system failure due to exceeding claim payment capability from an extreme macroeconomic event. As Australia's LMI providers, including the captive LMI providers of several of the AIRB banks, insure almost all residential mortgage loan originators in Australia, such a policy would accrue to protect the system against catastrophic tail credit risks, simultaneously enhancing stability and enhancing competition for all residential mortgage loan originators, at the same time giving APRA greater comfort in respect of residential mortgage lending market concentration risk.

The proposed reinsurance is in effect taking 'tail risk' out of the high LVR residential mortgage lending market that currently exists. The proposal is designed to smooth any excessive pricing of such tail event residential mortgage loan risk by introducing explicit government support for the Australian residential mortgage lending market in place of the implicit government support that exists today in respect of the 'too big to fail' banks. The purpose of the reinsurance would be to protect the LMI beneficiaries, not the LMI providers, as the claims paying ability of the LMI providers would be expended before the reinsurance would be available. For the avoidance of doubt, as described below, the first step for the policyholders' recovery would be in insolvency of the LMI provider, making it impossible for either the LMI provider's shareholders or management to benefit. If such a 1 in 200 year event were to occur and LMI providers became insolvent as a result, any additional loss would need to be borne by the banking industry, with the government almost certain to step in to prevent the financial system becoming unstable. Instead of the Australian taxpayer having an unfunded potential liability, the financial system would be bolstered and protected with commercially reasonable fees being paid by the LMI providers for the reinsurance.

It would pool for unforeseeable catastrophic risk in the event of a more than 1 in 200 year stress scenario and would give greater financial stability and increased liquidity in the residential mortgage lending market, by covering extreme events and could increase the LMI extreme event coverage to be consistent with the Basel level of 1 in 1000. This would be enacted if the LMI provider exceeded claims payment capability due to a macroeconomic event and a Minister declared that a catastrophic economic event had occurred.

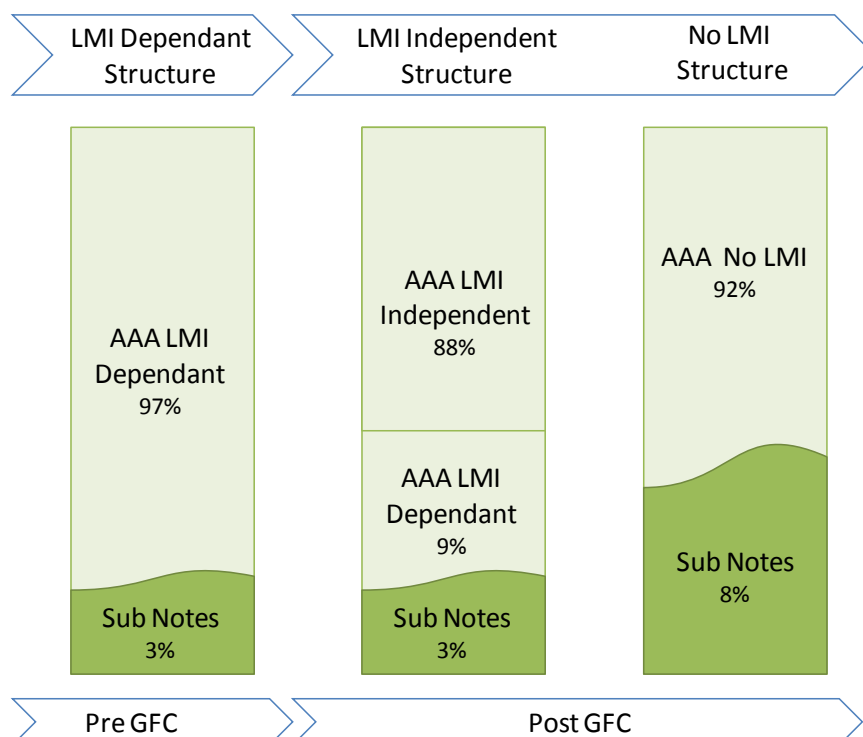
This would also improve competition by providing greater financial stability and increased liquidity in the residential mortgage lending market by covering these extreme tail events. Markets would still freely price the counterparty risk of LMI providers on their operational and market risks. The additional stability should provide additional prudential assurance.

6. Residential Mortgage-Backed Securities (Sections 2-15 to 2-16 in the Interim Report)

Recognise LMI as a credit risk mitigant within any securitisation reform

Further to our recommendations in section 4 and 5, Genworth supports the recognition of LMI within any proposed securitisation reform. Since the inception of RMBS in Australia, LMI has been an integral form of credit enhancement. Prior to the GFC almost all residential mortgages loans underlying outstanding Australian RMBS transactions were covered by LMI policies. A succession of LMI-related rating events during the GFC, changes in rating agency methodology for the credit enhancement afforded by LMI in RMBS, and changes in APRA's securitisation framework all spurred originators to address such concerns. The trend has been a structural change in RMBS and a move away from LMI dependency in the structures.

Chart 9: RMBS Evolution



* Illustrative example only. Break down will depend upon actual level of subordination in individual RMBS transactions.

Pre GFC, RMBS were issued as AAA and subordinated notes without indicating what proportion of the AAA tranche achieved the rating of AAA due to LMI credit enhancement in respect of the structure (i.e. 'LMI Dependant Structure'). This meant that if the LMI provider's ratings were downgraded the entire AAA tranche was at risk of downgrade.

LMI-Independent Structure

Post GFC such LMI downgrade risk concerned investors, given the volatility of LMI in the US and other jurisdictions. This was compounded by changes to the rating agencies' models and methodologies in reducing the credit enhancement afforded by LMI. To address this issue, the RMBS market created 'LMI-independent structures'.

Under, this structure the AAA tranche was segregated into:

- the most senior AAA tranche the rating of which is independent of LMI; and

- a less senior AAA tranche the rating of which is dependent on the creditworthiness of the LMI provider.

Non-LMI Structure

Due to changes in APRA's securitisation framework, the AIRB banks further evolved to using a non-LMI structure. Under APRA regulatory framework (APS 120) an originating ADI must assess the extent to which expected losses on the pool of securitised mortgages will be borne by its retained positions, including any notes held, prior to being absorbed by credit enhancements provided by third parties. APRA in August 2010 clarified APS 120, that an originating ADI holding the most subordinated tranches of an RMBS (even if rated) is to be treated as having retained a substantial majority of the credit risk in the transaction and as such would not qualify for capital relief.

Utilising LMI on the underlying loans was not considered adequate justification that significant credit risk had indeed been transferred to third parties. In such instances, the originating ADI cannot exclude the securitised assets from its calculation of regulatory capital for credit risk under Prudential Standard APS 112 (Standardised Approach) nor APS 113 (Internal Ratings-based Approach). As the AIRB bank models do not recognise LMI, it is more capital effective for AIRB banks eliminate the cost of LMI altogether where they have retained subordinated notes in an RMBS. Under this structure the RMBS have no benefits from LMI but rather rely on greater subordination to enable the senior tranches to achieve an AAA rating.

In our view, LMI is a vital component of a strong RMBS market adding strong risk management discipline to individual transactions.

Appropriately, it is recommended that the credit risk transfer of LMI should be explicitly recognised in APS 120. A reason why the pre-GFC securitisation market was so efficient was the widespread use of LMI. Should the Inquiry decide to recommend reforms in the securitisation market, the benefits of LMI need to be preserved, particularly around reducing subordination with a market based risk mitigant.

7. Conclusion

As outlined in this submission, LMI plays a key role in the financial system:

- LMI ameliorates information asymmetry that would otherwise lead to credit rationing and higher prices (interest rates) for mortgages. This **improves access to housing**, by allowing more, and a wider range of, borrowers to get a mortgage earlier than otherwise.
- LMI **increases financial stability**; it mitigates default risk for lenders, provides an extra check on the creditworthiness of borrowers and helps support the housing market in downturns. LMI provides a second set of eyes, ensuring prudent lending practices. With LMI providers being regulated by APRA and having to hold significant designated capital, this adds capital to the financial system.
- 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.

The existing residential mortgage market has concerns which require action to remove volatility and ensure lasting stability across the system. As an industry participant, Genworth is focused on developing solutions to assist the wellbeing of the system into the future.

Our proposed solutions of treating high LVR loans as a separate segment with minimum risk weights of uninsured loans and giving explicit capital credit for loans that are mortgage insured are aimed at levelling the playing field for all lenders and ensuring Australia remains within international regulatory parameters.

We complement our proposed solutions by recommending the creation of a separate correlation factor for high LVR loans, the development of a catastrophic reinsurance for LMI policyholders and the development of a prudential anti-selection policy.

Together, our recommendation is aimed at encouraging competition and enhancing the stability and overall strength of the financial system in the event of a crisis. Change is critical to ensure the system is well placed to face the challenges that the future will undoubtedly hold.

DISCLAIMER

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