

TREASURY EXECUTIVE MINUTE

Minute No.

16 June 2011

Deputy Prime Minister and Treasurer

BANKING PACKAGE – RECOMMENDATIONS ON LMI

Timing: At your discretion.

Recommendation:

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Agreed/Not Agreed

Signature:

...../...../2011

You may also wish to:

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Agreed/Not Agreed

Signature:

...../...../2011

KEY POINTS

- As part of its *Competitive and Sustainable Banking System* package the Government announced that it would accelerate its development of frameworks to transfer lenders mortgage insurance (LMI) between lenders.
 - The goal was to reduce the extent to which LMI can be a barrier to switching lenders.

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- LMI portability would be expensive and extremely complex to implement and administer and would benefit less than one per cent of all borrowers. At the time a loan is refinanced, the majority of borrowers' circumstances will have changed. Further, many borrowers will increase their loan amount to upgrade or renovate their property.

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Contact Officer:

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ADDITIONAL INFORMATION

WHAT IS LENDERS MORTGAGE INSURANCE?

- LMI protects lenders from the risk that a borrower defaults on their mortgage and the bank is unable to recover the full debt by selling the mortgaged property. Even though the contract is between the LMI provider and the lender, and the lender is the beneficiary of the policy, the cost of the insurance premium is in most cases passed onto the borrower.
- The LMI premium is a one-off payment, paid at the time the loan is established. Borrowers may pay the upfront amount, but in many cases they have the option to add the amount of the LMI onto their loan.
- The cost of an LMI premium is based on the loan to value ratio (LVR) of the mortgage and increases with the size of the loan. Generally, LMI only applies to mortgages with LVR's of greater than 80 per cent, or 60 per cent in the case of low-doc loans (low-doc loans are provided to borrowers who cannot provide sufficient evidence of future income – they are more widely used for small business borrowers where future incomes may be uncertain.)
- LMI premiums can be very substantial ranging from a few hundred dollars for an 80 per cent LVR loan, to tens of thousands of dollars for a mortgage with an LVR of more than 95 per cent. According to the Insurance Council of Australia, the average LMI premium is around \$3,000. See the following table for indicative premiums.

Indicative LMI Premiums*

House Price	LVR (percentage of house price)			
	80%	85%	90%	95%
200000	\$ 400	\$ 1,309	\$ 1,926	\$ 2,142
300000	\$ 400	\$ 1,963	\$ 2,889	\$ 5,985
400000	\$ 730	\$ 3,400	\$ 5,580	\$ 10,412
500000	\$ 730	\$ 4,250	\$ 6,300	\$ 13,015
600000	\$ 730	\$ 6,375	\$ 9,558	\$ 21,432

* based on Genworth's indicative LMI calculator

- The pricing of LMI premiums is based on a portfolio approach so that LMI costs are consistent across loans and only depend on the amount of the loan and the LVR. LMI providers generally do not take into account a customer's capacity to pay, this is left to the bank to determine. The borrower's default risk is implied from the LVR and the amount they borrow. In this way, borrowers with a lower default risk subsidise borrowers with higher default risk so that insurance premiums are consistent.
 - Changing the way that LMI is priced would substantially increase LMI costs for some borrowers.
- There are two major stand-alone LMI providers operating in Australia: Genworth and QBE LMI. ANZ and Westpac also operate their own 'captive' LMI providers that write LMI only over their own bank's loans.

LOSS OF LMI VALUE AND SWITCHING

- LMI may affect a decision to switch lenders in the early years of a mortgage or where a borrower increases the size of their loan.
 - As a loan matures, the LVR is likely to decrease because the borrower pays back some of the principal and/or because the underlying property value has increased. Ultimately, this depends on how quickly the underlying principle on the mortgage is being repaid. If the LVR has fallen below 80 per cent, then in most cases no further LMI is required when the borrower switches lenders.
 - : This barrier is likely to be most acute for first home buyers and small businesses given that they are the types of borrowers that generally require LMI over their loans.
- Industry has provided some data on the impact of LMI on refinanced mortgages.
 - Around 20 per cent of all mortgages require LMI and approximately 30 per cent of these are refinances (around six per cent of all mortgages).
 - 90 per cent of the borrowers who refinance and require additional LMI also choose to borrow an additional amount on top of their existing loan with their new lender, or roll other debts into their home loan (for example, credit card debts and personal loans). Only 10 per cent of borrowers who refinance their mortgage and require an additional LMI premium refinance dollar for dollar (that is, with no additional borrowing on top of their mortgage). In total this amounts to less than one per cent of all borrowers.
 - When a borrower refinances with a new lender and requires a new LMI premium because they have borrowed an additional amount or rolled other debts in to their loan, the new loan represents an entirely different risk to the old loan and therefore the LMI provider will re-evaluate their LMI premium accordingly. In many cases this could mean an additional LMI premium.

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ATTACHMENT B - OPTIONS TO RETAIN VALUE OF LMI IN A REFINANCE

Options	Description	Costs	Benefits	Sensitivities
<i>Full portability</i>	LMI premiums can be transferred between lenders.	<ul style="list-style-type: none"> • Substantial increases in up-front premiums for all borrowers. • Increases in regulatory capital for LMI providers. 	<ul style="list-style-type: none"> • A small number of borrowers who want to switch (without borrowing an additional amount). 	<ul style="list-style-type: none"> • Could encourage lenders to self-insure rather than use LMI. LMI has benefits for prudential stability and for reducing costs for some lenders.

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