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Dear Senior Advisor

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

Genworth appreciates the opportunity to respond to the recommendations contained in the Final Report of the Financial System Inquiry into Australia's financial system dated 7 December 2014 (**Final Report**).

In the Final Report, the Financial System Inquiry (**Inquiry**) recognises the importance of housing to the Australian economy. With the total market for residential mortgage lending being approximately $1.3 trillion, housing finance is an integral part of the financial system. In the intervening years since the Wallis Report, Australia has seen the global financial crisis pressuring the banking system and mortgage lending, increased regulatory requirements, rising house prices and the introduction of global regulations by the Bank of International Settlements' Basel Committee on Banking Supervision (**Basel Committee**), which have had the unintended consequence of creating an un-level playing field between the larger and smaller lenders. All those factors have impacted on accessibility to home ownership.

In recognising the importance of housing to the financial system, in Chapter 1 of the Final Report, "Resilience", the Inquiry makes a number of key recommendations designed to ensure improved access to housing and housing finance which are efficient, resilient, fair and competitive

In this submission, we highlight the Inquiry's recommendations as they relate to housing, setting out a number of reasons as to why we believe that those recommendations should be implemented.

As the leading provider of Lenders Mortgage Insurance (**LMI**) in Australia, Genworth strongly supports the Inquiry's recommendations. LMI has been critical to growing levels of home ownership in Australia since 1965 and we are proud of our contribution to the financial system and the housing market. For the past 50 years LMI has continued to help Australians realise their dream of home ownership by getting people into homes sooner. According to ABS census data, the percentage of private dwellings owned or being purchased grew from 52.6% in 1947 to 70.8% in 1966. As at the date of the last census, the rate of home ownership has remained at approximately 70%, being one of the largest proportions of any nation, with LMI being a contributing factor. With over $300 billion of new loans originated in 2014 and a third of those loans being over 80% loan to value ratio (**LVR**) loans, the high LVR segment is an important segment in which LMI plays a crucial role. This is recognised by the Inquiry in its recommendations, where in discussing risk weights, it recommended that APRA, "*recognize lenders mortgage insurance where appropriate"*.[1]

In taking up the Treasury's invitation to respond to the Final Report, we acknowledge that many of the Inquiry's recommendations are the responsibility of the financial regulators – APRA, ASIC and the RBA - and rest within their current regulatory mandates. While these regulators will have the primary responsibility for acting on recommendations within their mandates, we are pleased that the Government has offered to receive submissions on the Final Report's recommendations.

In our submissions to the Final Report and the Inquiry's Interim Report, we articulated that the regulations underpinning the Australian mortgage market need reform in order to continue to promote financial stability, increase competition, level the playing field between larger and smaller lenders and assist with first home buyers accessing housing. The key issues are:

- **Competition - Very different capital requirements for the same risk.** The Basel Committee's "Basel II" regulations introduced in 2008 have caused unfair competition between lenders adopting the Advanced Internal Risk Based (**AIRB**) approach and standardised lenders. This is because AIRB lenders are allowed to segment their portfolio by factors other than simple LVR in determining capital requirements, whereas standardised lenders can only segment by LVR. This results in competition issues which include that the larger AIRB lenders can "cherry pick" lower risk borrowers in the high LVR segment and waive LMI or charge a lower fee, arguably exposing the standardised lenders to higher risk borrowers as they cannot compete evenly with the AIRB lenders. This was recognised by the Inquiry as a key area of concern.[2]

- **System Capital - Less system capital to absorb an unexpected crisis.** As set out by the Inquiry[3], prior to Basel II being introduced in 2008, all ADIs were required to operate with the same risk-weight model, which resulted in the same capital for a given asset, including loans, with explicit recognition for LMI. Following Basel II, regulations for AIRB lenders afford no explicit capital recognition for using LMI. This allows these AIRB lenders to waive LMI with no marginal capital consequences and/or "cherry-pick" the better risks and charge a fee or higher interest rate or waive LMI. In these instances, AIRB lenders do not hold the additional capital that would otherwise have been held by the LMI provider. In a housing market downturn, without this capital, additional stress is unduly placed on the financial system.

- **Concentration Risk – Deterioration of average mortgage risk across the industry.** LMI acts as a shock absorber in stress events. With AIRB lenders retaining more risk without LMI, there is potential that this will lead to a deterioration

[1] Final Report, page 66
[2] Final Report, page 61
[3] Final Report, page 61

of the average mortgage risk for both the AIRB lenders and LMI providers with less overall system capital to deal with any stress events.

- **Lending Standards – Deterioration of credit quality across the industry.** LMI provides a second set of eyes in the loan assessment process and monitors the industry for trends. With AIRB lenders retaining more risk without LMI, there is potential that this will lead to a reduction in lending standards and overall credit quality. For example, Genworth has robust credit criteria for investment loans which are highlighted by our current insurance in force exposure of 25%[4].

We believe that these issues present a major challenge to the residential mortgage market and to ensuring an efficient, resilient, fair and competitive financial system. Left unchecked, this could lead to deteriorating lending standards, with regulators already voicing concern about lenders' exposure to investment lending in recent times.

In order to address this, our submission to the Final Report called for the need for high LVR loans to be treated as a separate segment within AIRB lenders' capital modelling with increased minimum risk weights and explicit recognition for LMI. More specifically our recommended solutions included:

- Recognising LMI in AIRB lenders' models by reducing loss given default (**LGD**) factors to the lowest percentage permissible by APRA, where LMI is protecting a mortgage; and

- Increasing the capital requirements for high LVR loans for AIRB lenders by segmenting their mortgage portfolios between high and low LVR loans and introducing minimum risk weights by LVR for high LVR lending [above 80% for standard loans and above 60% for non-standard loans].

We were encouraged to see that the Final Report identified the key theme of competition being the primary means of supporting the financial system's stability and efficiency. In balancing resilience and competition, the Inquiry made some helpful comments and recommendations in line with our submission on both the treatment of LMI and AIRB lenders.

Recommendation 2 in Chapter 1 of the Final Report recommends that APRA should:

"Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights."

Primarily for reasons of competitive neutrality and increasing competition, the Final Report recommends narrowing the average risk weight gap between the risk weights used by AIRB lenders and those used by the standardised banks. A range of between 25% and 30% for the AIRB lenders is considered to be appropriate, compared with the current average AIRB lenders and standardised lenders mortgage risk weights of 18% and 39% respectively. We endorse this recommendation.

[4] Source: Genworth internal data

We note that the Final Report comments that increasing risk weights for AIRB lenders has a specific benefit, being to "*reduce the likelihood of the IRB approach underestimating risk, or being subject to model risk or outright manipulation. A minimum average risk weight prevents very low risk weights being assigned in a manner that may not reflect the true risk of an asset. The Inquiry notes that models based on individual borrower characteristics rarely capture the systemic risks that can become the primary driver at the portfolio level*".

These comments very much align to Genworth's submission on probability of default (**PD**) segmentation, and we endorse this recommendation. Our concern is that loans with a low PD and a high loss given default under the current AIRB models can still have relatively low risk weights. High LVR lending is typical of this scenario. PD is based on borrower history and capacity to repay in a benign environment whilst capital requirements are designed to protect a lender when an unexpected extreme event occurs. In these scenarios, this results in low levels of capital being held to cover stress events.

The role of LMI in managing differences in risk weights between smaller and larger lenders is also mentioned in the Final Report. The Final Report recognised that the Basel II AIRB approach extends no capital recognition for the use of LMI. AIRB lenders can waive LMI with no marginal capital consequences unlike the smaller standardised lenders. Genworth highlighted the concern that if the larger AIRB lenders do not receive any capital benefit from using LMI, this can lead to their "cherry picking" better quality loans and waiving LMI, typically charging a fee or higher interest rate instead. In cases where LMI is waived, standardised lenders are at a competitive disadvantage to the AIRB lenders. It is harder for them to compete on pricing and exposes them to higher risk borrowers.

In discussing how the risk weight gap between AIRB and standardised lenders could be narrowed, the Final Report recommended that, "*APRA should seek to maintain as much risk sensitivity in the capital framework as possible and* ***recognise lenders mortgage insurance where appropriate***" (emphasis added).

Given that the standardised banks already receive explicit capital recognition of LMI, this comment is more relevant to the AIRB lenders if and when average risk weights for residential mortgages are increased by APRA. We would strongly encourage APRA to adopt this recommendation, and would argue that it should apply to all loans over 80% LVR and in addition non-standard loans over 60% LVR. LMI brings both capital benefits and claims expertise in a downturn scenario.

A recent US study completed by the Urban Institute[5] dated February 2015 titled 'Loss Severity on Residential Mortgages - Evidence from Freddie Mac's Newest Data' supports our view. This study utilises 13 years of data (1999 to 2013) including 17 million loans reviewing loss severity (the percentage lost in the event of default). The study concludes:

"*The relationship between loss severities and LTV* [loan to value] *categories is particularly interesting. Severities for loans with LTVs over 80 are much lower than for loans with LTVs between 60 and 80. In fact, the severities for the over-80-LTV loans are even lower than severities for the 60-or-under-LTV loans. The reason is simple. Loans with LTVs over 80 are*

[5] Refer to page 7 of the paper, published at http://www.urban.org/UploadedPDF/2000092-Loss-Severity-on-Residential-Mortgages.pdf.

required to have mortgage insurance, which covers the first loss; this coverage is usually deep enough that Freddie is not exposed unless the market value of the home drops far more than 20 percent. For example, standard practice is to bring down an 85 LTV mortgage to 73 LTV, a 90 or 95 LTV mortgage to 65 LTV, and a 97 LTV mortgage to 63 LTV. These results would indicate that mortgage insurance is more effective at protecting the GSEs against losses than is commonly assumed."

This study supports our view that high LVR loans need to be treated as a separate segment within AIRB lenders' capital modelling with increased minimum risk weights and explicit recognition for LMI. With LMI, these higher risk loans have 100% cover for the life of the loan and in Australia this has been proven over 50 years of continuous service.

Mortgage insurance has existed as a government program in the US since 1934 and private mortgage insurance has been continuously in the market since 1957. As noted previously, the product served its economic role in the US during the global financial crisis by reducing the losses to creditors. The product also protected the US taxpayers. Since the onset of the housing crisis in the US, private mortgage insurers have covered over 44 billion USD in claims. Three US MI companies did exit the business, but they all continue paying claims under their prudentially supervised resolution regimes. Markets have responded to this success with the US industry attracting approximately 10 billion USD in new capital during this time, with three new regulated insurance companies entering the business since 2008. (Gupta 2015). Private mortgage insurers have acted as countercyclical capital sources for the banks and other creditors and that has helped creditworthy borrowers get into homes sooner.[6]

As this illustrates, LMI providers drive market discipline, help maintain system capital, governance and underwriting standards and apply advanced risk management expertise and monitoring tools to enforce disciplined risk taking.

Whilst we are extremely heartened by the recommendations of the Final Report, we firmly believe that there is much more to be done by mortgage lenders, government, regulators and other stakeholders. Encouraging greater competition between lenders through changes to risk weights and extending recognition to the use of LMI will mean that the Australian residential mortgage lending market will be better placed to:

- put 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 making housing more accessible for all Australians.

We also note that APRA will be looking to the Basel Committee and is likely to be guided by any new regulations as to capital requirements and risk weights, particularly in light of recent consultation papers the Basel Committee has called for responses on. Given the unintended consequences and impact on competition that Basel II has contributed to and

[6] In these respects, MI plays a similar economic role for one of the largest banking asset classes to the to the "Capital Insurance" proposed at the 2008 Reserve Bank of Kansas City symposium on "Maintaining Stability in a Changing Financial System," held at Jackson Hole, Wyoming. (Kashyap, Rajan and Stein 2008)

that the Inquiry has thoroughly investigated the issues relevant to the Australian financial system in making its recommendations, we would encourage future Basel regulations to be carefully considered before being adopted into Australia.

Given Genworth's experience and position in the residential mortgage lending industry, we are keen to assist Treasury and the regulators explore further the Inquiry's recommendations. We are committed to levelling the playing field for our customers and supporting the Australian dream of home ownership.

We are available to discuss our submission and the Inquiry's recommendations in more detail at your convenience.

Yours faithfully

Ellie Comerford

CEO & Managing Director