

7 February 2025

Council of Financial Regulators

Via email: CFRReview@treasury.gov.au

Dear Council

Review into Small and Medium-sized Banks

The Insurance Council of Australia (Insurance Council) welcomes the opportunity to provide a submission to the Council of Financial Regulators (CFR) and the Australian Competition and Consumer Commission's Review into Small and Medium-sized Banks (the Review).¹

The Insurance Council is the representative body of the general insurance industry in Australia and represents approximately 89% of private sector general insurers. As a foundational component of the Australian economy, the general insurance industry employs approximately 46,000 people, generates gross written premium of \$66 billion per annum and on average pays out \$159 million in claims each working day (\$39.4 billion paid out per year).

We wish to provide information on the role of lenders' mortgage insurance (LMI) in supporting lending by small and medium-sized banks.

LMI supports increased competition among lenders by assisting smaller lenders, such as non-banks, customer owned, and regional banks, to manage risk. LMI helps these cohorts of lenders manage the risks associated with lending to higher loan-to-value ratio (LVR) borrowers.

As the Review notes, non-banks, regional banks and customer owned banks have active Residential Mortgage-Backed Security (RMBS) programs. These programs are a vital part of the funding mechanisms for these lending institutions and LMI is an important input for RMBS programs. As Reserve Bank of Australia research has stated "LMI on the mortgage pool is the main type of credit enhancement used in Australian RMBS."²

LMI can be distinguished from the Australian Government's Home Guarantee Scheme (HGS), which offers less financial protections to lending institutions. We note that small and medium lenders use both the HGS and LMI to support their customer bases.

Where a mortgage has LMI and the property must be sold for less than the mortgage value, the LMI provider guarantees to cover the shortfall, for the life of the loan. Comparatively, when a mortgage is guaranteed under the HGS and the property must be sold for less than the value of mortgage, the Government guarantees to covers at most 15 per cent of the mortgage value.

This creates a risk for lenders and the broader financial system, which LMI would otherwise protect against. If lenders do not accept the greater risk associated with high LVR lending back by the HGS,

¹ Council of Financial Regulators. 2024. [Review into Small and Medium-sized Banks](#).

² Ivailo Arsov, In Song Kim and Karl Stacey. 2015. *Reserve Bank of Australia Bulletin*, [Structural Features of Australian Residential Mortgage-backed Securities](#).

they are required to self-exclude from a significant cohort of first home buyers. This decision would be particularly difficult for smaller lenders.

LMI and mortgages guaranteed by the HGS attract different capital recognition under the Australian Prudential Regulation Authority's (APRA) capital requirements for lenders. This can cause first home buyers who use LMI because they are ineligible for the HGS and have no access to a parental guarantee, to pay higher borrowing costs. The larger borrowing costs can be in the form of higher interest rates, as lenders are required to hold more capital against these loans.

The below table demonstrates the discrepancy between different forms of guarantees a first home buyer may be able to access.

	No Lenders Mortgage Insurance	Lenders Mortgage Insurance	With First Home Guarantee	With Parental Guarantee
Variance to standard risk weight (70%):	0%	-15%	-35%	-35%
Risk weight:	70%	55%	35%	35%

Table 1: APRA risk weightings.³

The Insurance Council believes that LMI's weighting is not appropriate given its comparative risk protection. This disadvantages lenders who may prefer their customer utilise LMI.

Should Australia's economy and housing markets see a significant downturn, we believe there may be significant difficulty for lenders to call on limited government guarantees or parental guarantees (where guarantors may be experiencing their own financial difficulties and house values losses in that economic context) if. The reputational damage for lenders calling on parental guarantees on a large-scale could also carry financial implications for individual lenders and the wider financial system. We note that LMI providers, who hold capital against their risk, would not encounter these issues.

LMI is priced risk mitigation while the HGS carries no cost to end users (lenders and borrowers). The HGS involves taxpayers funding the housing market access for borrowers who could potentially afford the cost of LMI. The Insurance Council commissioned research by Deloitte Access Economics (please see **attached document**) which demonstrates the extent to which borrowers who would have otherwise accessed LMI, are now using the HGS in its place.

This combination of different levels of financial protection and unequal risk, creates a commercial disadvantage which can create risks for the availability of LMI. We note that any impacts on the availability of LMI could have implications for first time borrowers outside the eligibility criteria of the HGS and with no access to parental guarantees, as well as other high LVR borrowers. There would likely impact small and medium-sized lenders' use of RMBS programs to assist their funding.

We note the Senate Economics Reference Committee's *Inquiry into Financial regulatory framework and home ownership* recommended that prudential guidelines allow "authorised deposit-taking

³ Helia. 2024. Submission to the Senate Standing Committee on Economics' Inquiry into Financial regulatory framework and home ownership.

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