



Prudential supervision of lenders mortgage insurance

Proposed reforms - discussion paper

AUGUST 2004

PREAMBLE

One of APRA's goals is to apply prudential supervision across our regulated entities equally and consistently. Wherever possible, similar economic risks should attract similar prudential treatment, irrespective of the institutional structure through which the activities are conducted. The process of achieving such a system of prudential regulation is ongoing and dynamic.

The proposed reforms outlined in this paper address the capital framework for lenders mortgage insurers (LMIs), and inconsistencies in regulation across LMIs and between LMIs and authorised deposit-taking institutions (ADIs). In part, these inconsistencies are a legacy of the supervisory framework that existed prior to the formation of APRA in July 1998.

APRA proposes to strengthen and standardise the capital and reporting requirements for LMIs. APRA also proposes to modify the conditions under which ADIs will be able to claim the 50 per cent concessional risk weight on certain loans that are mortgage-insured with an 'acceptable' LMI. The changes in this area centre on the definition of 'acceptable' mortgage insurance.

These changes will strengthen the LMI prudential regime and reduce regulatory inconsistencies within the industry, and between ADIs and LMIs.

Written submissions on the proposals contained in this discussion paper should be forwarded by 11 October 2004 to:

Mr Ilanko Sellathurai
Policy, Research and Statistics
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001
Or email: lmi@apra.gov.au



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GLOSSARY

| | |
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| ADI | Authorised Deposit-taking Institution under the <i>Banking Act 1959</i> |
| AGN 112.1 | Guidance Note AGN 112.1 - Risk-Weighted On-Balance Sheet Credit Exposures |
| APRA | Australian Prudential Regulation Authority |
| APS 112 | Prudential Standard APS 112 - Capital Adequacy: Credit Risk |
| Collection of Data Act | <i>Financial Sector (Collection of Data) Act 2001</i> |
| GGN 110.1 | Guidance Note GGN 110.1 - Measurement of Capital Base |
| GGN 110.5 | Guidance Note GGN 110.5 - Concentration Risk Capital Charge |
| GPS 110 | Prudential Standard GPS 110 - Capital Adequacy for General Insurers |
| GRF 170.0 | Reporting Form GRF 170.0 - Maximum Event Retention and Risk Charge |
| GRS 170.0 | Reporting Standard GRS 170.0 - Maximum Event Retention and Risk Charge |
| Insurance Act | <i>Insurance Act 1973</i> |
| Insurer or general insurer | General insurer authorised under the Insurance Act |
| LGD | Loss-Given-Default |
| LMI | Lenders Mortgage Insurer |
| LVR | Loan-to-Valuation Ratio |
| MCR | Minimum Capital Requirement |
| MER | Maximum Event Retention |
| PD | Probability of Default |
| PML | Probable Maximum Loss |
| REMS | Reinsurance Management Strategy |

INTRODUCTION

APRA seeks comment on proposed reforms to the prudential framework for LMIs, and the definition of 'acceptable' mortgage insurance for ADIs claiming a capital concession on mortgage-insured loans. This paper examines the existing requirements and outlines proposals to strengthen the current framework. These proposals focus on the capital and prudential reporting requirements for LMIs. The proposals also amend the definition of 'acceptable' mortgage insurance, thereby amending the conditions under which ADIs may claim a 50 per cent capital concession on certain loans that are mortgage-insured. The proposed reforms aim to enhance APRA's supervision of LMIs, strengthen the LMI industry and the Australian financial system, and provide greater protection to the beneficiaries of APRA-regulated institutions.

Industry overview

LMIs are mono-line insurers¹ that protect lenders from losses in the event of borrower default on loans secured by mortgages. There are currently 15 LMIs operating in the Australian market. Of the 13 LMIs domiciled in Australia, six LMIs are captive insurers² of ADIs. The remaining two are captive LMIs domiciled in Singapore and regulated by the Monetary Authority of Singapore. LMIs insure more than \$200 billion worth of loans, including loans made and retained by ADIs and lenders that are not regulated by APRA, and securitised loans.

LMIs play a significant role in the Australian financial system: they accept credit risk-transfers from ADIs and other lenders; they facilitate access to wholesale funding through the securitisation market by providing credit enhancement on mortgage-backed securities; and they allow ADIs to claim a concessional risk weight of 50 per cent on mortgage-insured loans for capital adequacy purposes.

LMIs are regulated under the general insurance framework, comprising the *Insurance Act 1973* (the Insurance Act), prudential standards and guidance notes. LMIs are also required to comply with reporting standards made under the *Financial Sector (Collection of Data) Act 2001* (the Collection of Data Act).

Background

During 2003, APRA conducted a housing loan stress test involving 120 ADIs. The results demonstrated that, as a group, ADIs could withstand a substantial increase in housing loan defaults and losses without a material deterioration in their prudential soundness. It also indicated that a significant proportion of ADI counterparty default risk for housing loans is transferred to LMIs. This raised the question of how LMIs themselves would fare in a severe housing downturn, given the higher risk of their portfolios. Hence, in late 2003, APRA extended the stress test to LMIs and conducted a broader review of the LMI industry including reinsurance arrangements, parental support, reporting requirements and relationships with ADIs.

¹ The issue of whether mortgage insurance business should continue to be restricted to mono-line insurers is being considered in stage two of APRA's general insurance reforms.

² A captive insurer provides insurance to companies within the same corporate group and does not solicit business from third parties.

The stress test and the review of the LMI industry identified inadequacies in the current LMI capital and reporting framework, inconsistencies in the prudential supervision of LMIs and ADIs, and some potentially ineffective risk-transfer arrangements between LMIs and ADIs. The reforms proposed in this paper address these key risk issues.

Scope and objectives of the proposals

The first of the three proposals set out in this paper addresses the capital framework for LMIs, focusing on the concentration risk or maximum event retention (MER) charge that forms a large component (approximately 70 per cent) of the insurer's minimum capital requirement (MCR). The MER charge reflects the risk associated with the accumulation of exposures to a single catastrophic event. APRA proposes to make amendments to the model currently used by LMIs under the Prescribed Method to calculate this risk charge. These amendments will increase the level of the MER and standardise the method of calculation across the industry. This proposal will apply to all APRA-regulated LMIs that use the Prescribed Method to calculate the MCR.

The second proposal relates to reporting of the MER by LMIs. It proposes additional reporting on risk profiles and reinsurance arrangements by LMIs on a quarterly basis. Again, this proposal will apply to all APRA-regulated LMIs.

The final proposal details the conditions under which ADIs will be granted a 50 per cent concessional risk weight on loans that are mortgage-insured. APRA proposes to modify the definition of 'acceptable' mortgage insurance. These amendments aim to ensure that capital savings to ADIs are matched by appropriate risk-transfer and will apply to all ADIs that claim capital concessions on mortgage-insured loans.

The objectives of the proposals are to:

- increase the protection provided to policyholders and other beneficiaries of mortgage insurance policies;
- ensure that LMI capital requirements are more risk-sensitive than is the case in the existing prudential framework;
- reduce inconsistencies in the prudential supervision of LMIs and ADIs;
- clarify existing prudential requirements and provide additional guidance for LMIs and ADIs; and
- increase the transparency of LMI prudential requirements to market participants.

Industry consultation

In January 2004, APRA obtained feedback from LMIs on the results of the stress test and the existing prudential framework. APRA has considered these views in formulating the current proposals. Formal consultation with the industry on the proposed reforms will commence with the release of this discussion paper, and will be followed by the release of amended prudential standards, reporting standards and guidance notes for consultation.

Implementation

It is intended that the proposals set out in this paper will be implemented on 1 July 2005. Where appropriate, transitional arrangements may be agreed upon. APRA will consider these requests on a case-by-case basis.

Structure of this paper

This paper is divided into three chapters. Chapter 1 provides an overview of the proposed changes to the capital framework for LMIs and the rationale for strengthening this framework. Chapter 2 outlines the proposed requirements for LMIs to report on the MER. Chapter 3 discusses changes to the mortgage insurance requirements for ADIs claiming capital concessions, and the basis for tightening the existing requirements. The proposed MER reporting form for LMIs is set out in the appendix.

CHAPTER 1 - MAXIMUM EVENT RETENTION (MER) MODEL FOR LMIs

This chapter outlines the current capital framework for LMIs and proposed reforms to the framework.

Current capital framework for LMIs

The current capital framework for LMIs and other general insurers consists of prudential standard GPS 110 - Capital Adequacy for General Insurers and associated guidance notes made under the Insurance Act.

The MCR for LMIs and other general insurers, set out in GPS 110, takes into account a range of risk factors that may threaten the ability of the insurer to meet policyholder obligations. Insurers may choose to use an in-house capital measurement model (Internal Model Based Method) to calculate the MCR or alternatively, the Prescribed Method. Under the Prescribed Method, the MCR is comprised of an insurance risk charge, investment risk charge³ and MER charge.

The minimum capital level for LMIs differs from other general insurers in that the MER charge accounts for around 70 per cent of the MCR. Guidance note GGN 110.5 - Concentration Risk Capital Charge defines the MER as the largest loss to which a general insurer expects to be exposed (over a 250-year period) due to a concentration of policies, after netting out any reinsurance recoveries. LMIs that currently follow the Prescribed Method use a model specified by APRA to calculate the MER. In this model, standard frequency, severity and seasoning factors are applied to the LMI's risk exposures to determine the Probable Maximum Loss (PML). Reinsurance protection is deducted from this to obtain the MER. An overview of the current MER model is provided in Table 1.

³ The insurance risk charge reflects the risk that the true value of net insurance liabilities could be greater than provisioned for, and the investment risk charge captures the risk of an adverse movement in the value of assets and off-balance sheet exposures.

Table 1 - Current MER model for LMIs

MER = PML - reinsurance
 where PML = sum insured x PD x LGD x seasoning

| Event | One-year scenario |
|------------------|---|
| PD by LVR | |
| 0 - 60% | 0.09% |
| 60.01 - 70% | 0.15% |
| 70.01 - 80% | 0.27% |
| 80.01 - 85% | 0.39% |
| 85.01 - 90% | 0.81% |
| 90.01% + | 2.32% |
| LGD | 42% for all LVR bands |
| Seasoning | |
| ≤ 5 years | 100% |
| 5 < years ≤ 10 | 25% |
| > 10 years | 10% |
| Pool insurance | 3.75% factor applied to sum insured |
| Commercial loans | 4.75% factor applied to sum insured |
| Reinsurance | Reinsurance recoveries over one year |
| Capital base | As defined in guidance note GGN 110.1 - Measurement of Capital Base |

Inadequacies in the current MER model

As the MER charge accounts for the majority of an LMI's MCR, the standard APRA MER model is a key determinant of overall capital requirements. At present, most LMIs hold capital well in excess of minimum APRA requirements. However, the results of the stress test indicate that if the MER model is not strengthened, LMIs operating close to the current APRA minimum capital requirements may have inadequate levels of capital to support the risks associated with their business.

Under current capital requirements, there is a discrepancy between the level of capital that ADIs and LMIs are required to hold for the same risk. This has created an incentive for ADIs to transfer risk to LMIs and possibly to take an ownership interest in LMIs through captive insurers.

Finally, in recent years there has been significant demand for riskier and more innovative loan products, such as low-doc loans and high-leverage loans. This may have increased the overall riskiness of loan books and has led to APRA proposing tighter capital requirements for these exposures within ADIs. However, the current MER charge for LMIs does not differentiate loans by product type and hence does not adequately reflect the risks associated with the new loan products.

Proposed changes to the MER model

This section outlines the proposed changes to the standard MER model for LMIs under the Prescribed Method. A summary of the model is provided in Table 2.

Table 2 - Proposed MER model for LMIs

MER = PML - reinsurance

where PML = sum insured x PD x LGD x seasoning

| Event | Three-year scenario | |
|--------------------|---|--------|
| Sum insured* | Original loan balance | |
| PD by LVR | Years 1, 3 | Year 2 |
| 0 - 60% | 0.05% | 0.1% |
| 60.01 - 70% | 0.1% | 0.2% |
| 70.01 - 80% | 0.2% | 0.4% |
| 80.01 - 85% | 0.4% | 0.8% |
| 85.01 - 90% | 0.8% | 1.6% |
| 90.01 - 95% | 1.25% | 2.5% |
| 95.01 - 100% | 2.0% | 4.0% |
| 100.01%+ | 3.5% | 7.0% |
| LGD by LVR** | | |
| 0 - 60% | 20% | |
| 60.01 - 70% | 20% | |
| 70.01 - 80% | 30% | |
| 80.01 - 85% | 30% | |
| 85.01 - 90% | 30% | |
| 90.01 - 95% | 40% | |
| 95.01 - 100% | 40% | |
| 100.01%+ | 40% | |
| Seasoning | | |
| ≤ 5 years | 100% | |
| > 5 years | 20% | |
| Non-standard loans | Two-notch LVR penalty*** | |
| Pool cover | PD and seasoning factor corresponding to the weighted-average LVR and age of the pool, and 100% LGD | |
| Commercial loans | 8% applied to sum insured | |
| Reinsurance | Reinsurance recoveries over each of the three years | |
| Capital base | As defined in GGN 110.1 | |

* For top-up cover and pool cover, sum insured is the original loan balance multiplied by the coverage amount. For example, the sum insured for top 20 per cent cover, is 20 per cent of the original loan balance.

** Where total sum insured is less than 100 per cent of the mortgage (for example, top-up cover), the LGD factor will be adjusted according to the amount covered by the insurance.

*** For example, a non-standard loan with an 80 to 85 per cent LVR will be treated for capital adequacy purposes as a 90 to 95 per cent LVR loan.

Event

The proposed MER model is based on a hypothetical three-year downturn in the housing market, where 25 per cent of losses occur in years one and three and 50 per cent in year two. This 'head-and-shoulders' type stress scenario is similar to that observed during stress periods, both domestically and internationally.

The model parameters are calibrated to ensure that LMIs meeting the minimum APRA requirements could manage a nationwide housing downturn that is more severe than worst-case historical Australian experience. The overall loss rate in the proposed model corresponds to a historical default probability of approximately one in 250 years, consistent with GGN 110.5.

Probability of default

In the proposed MER model, the probabilities of default (PDs) in years one and three are half those assumed in year two. The base case default rates are modelled on the worst Australian claim year frequencies experienced by LMIs from 1980 to 2000. In order to calibrate the stress case default probabilities to the one-in-250-year probability, the base case default rates have, on a weighted-average basis, been multiplied by a factor of 10 (when aggregated over three years). This factor also takes into account several limitations associated with relying purely on historical data to model a severe downturn, such as:

- the sample period does not include a nationwide downturn in the housing market;
- the historical performance of some LMIs will be worse than the aggregate industry performance;
- structural change in the housing market, as evidenced by the growth of mortgage originators and mortgage brokers, and the introduction of higher-risk loan products, has reduced the applicability of the historical data; and
- the rapid growth in house prices and housing credit over the past seven years, which is unlikely to be sustainable.

Compared to the current model, the PDs have increased significantly and will enhance the ability of LMIs to manage a severe housing downturn, particularly those LMIs operating close to the current minimum APRA requirements. These higher PDs will also significantly reduce, though not eliminate, the difference in capital requirements applied to LMIs and ADIs for bearing the same risk.

The relative riskiness of the LVR buckets is consistent with historical default rates. The proposed model also has greater granularity for loans with an LVR exceeding 90 per cent. This increases the model's, and hence the capital requirement's, sensitivity to risk.

Loss-given-default

Loss-given-default (LGD) in the proposed MER model is based on the long-run average LGD of 20 per cent reported by LMIs, across all LVR buckets, from 1980 to 2000.

Consistent with economic intuition, the proposed model allows LGD to vary with LVR. This increases the model's sensitivity to risk compared with the current model, which has a flat LGD across all LVR buckets.

Where the total sum insured is less than 100 per cent of the total mortgage (for example, top-up cover), the LGD factor will be adjusted according to the amount covered by the insurance. For example, an LGD of 100 per cent would apply to top 20 per cent mortgage insurance.

Seasoning

The proposed MER model has two age buckets, less than or equal to five years and greater than five years, with seasoning factors of 100 per cent and 20 per cent respectively. This is based on the actual claims experience of LMIs, where over 90 per cent of claims occur in the first five years after a loan is originated. The proposed model has only two age buckets as the benefit of greater granularity in the seasoning factors does not compensate for the additional complexity associated with introducing further seasoning buckets.

Loan product type

The proposed MER model introduces sensitivity in LMI capital requirements to risks associated with different types of loan products, including non-standard mortgage loans, commercial loans and mortgage pool cover.

In the proposed model, a non-standard mortgage loan is defined as a loan that does not meet the criteria set out in draft guidance note AGN 112.1 - Risk-Weighted On-Balance Sheet Credit Exposures⁴. It includes, for example, low-doc loans, which are considered to be higher risk loans because they do not meet standard income verification requirements.

Non-standard loans receive a two-notch LVR penalty. That is, a non-standard loan with an 80 to 85 per cent LVR is treated, for capital purposes, as a 90 to 95 per cent LVR loan. Hence, an 80 to 85 per cent LVR, non-standard loan will have an aggregate PD of 5.0 per cent over three years and an LGD of 40 per cent, rather than a PD of 1.6 per cent and an LGD of 30 per cent. This approach is consistent with market practice where loan products that are judged to be higher risk than standard loans (such as low-doc loans) are charged an additional risk premium.

⁴ This is part of the proposed changes to the risk-weighting of residential mortgage lending for ADIs. Refer to paragraphs 2, 3, 6, 7 and 8 of Attachment C (Eligible Residential Mortgages), which is available on APRA's website: <http://www.apra.gov.au/ADI/Other-Information-for-ADIs.cfm>

Table 3 - Comparison of PDs and LGDs for standard and non-standard loans (per cent)

| LVR | Standard loan | | Non-standard loan | |
|-------------|---------------|-----|-------------------|-----|
| | PD* | LGD | PD* | LGD |
| 0 - 60 | 0.2 | 20 | 0.8 | 30 |
| 60.01 - 70 | 0.4 | 20 | 1.6 | 30 |
| 70.01 - 80 | 0.8 | 30 | 3.2 | 30 |
| 80.01 - 85 | 1.6 | 30 | 5.0 | 40 |
| 85.01 - 90 | 3.2 | 30 | 8.0 | 40 |
| 90.01 - 95 | 5.0 | 40 | 14.0 | 40 |
| 95.01 - 100 | 8.0 | 40 | 14.0 | 40 |
| 100.01+ | 14.0 | 40 | 14.0 | 40 |

* For illustrative purposes, the PDs are aggregated over three years

In the proposed MER model, commercial loans are defined as all loans that are secured by non-residential properties. The overall capital and reinsurance requirement for commercial loans is eight per cent. This is similar to the capital requirement applying to commercial loans for ADIs.

The model proposes that the PD and seasoning factor for pool cover should correspond to the weighted-average LVR and seasoning of the pool. An LGD of 100 per cent is to be applied. Typically, pool insurance covers one to two per cent of the pool; hence, the treatment of LGD for pool insurance is consistent with top-up cover.

Reinsurance

In the proposed model, available reinsurance recoveries are recognised. When calculating available reinsurance cover, LMI should account for the fact that the model is based on a three-year event. Appropriate assumptions about new business written and earned premiums over three years will need to be made if the available reinsurance cover is based on earned or written premiums.

In addition, LMIs must include the cost of reinstatement of reinsurance to cover the three-year scenario, where applicable. Specifically, if the existing contract is valid over the next three years but could be exhausted at any time during that period due to the model-specified losses, the relevant reinstatement costs should be included in the MER charge so that the remaining reinsurance cover can be recognised. However, if the existing arrangement does not permit reinstatement or the reinsurance cover is not in place for the next three years then reinsurance recoveries for the non-contracted period should not be claimed.

It should also be noted that, as part of the stage two reforms of the prudential framework for general insurers, APRA has proposed that the Reinsurance Management Strategy (REMS) will include details of how the existing reinsurance program is applied to the PML in determining the MER.

Conclusion

The proposed MER model addresses weaknesses in the current capital framework for LMIs, by ensuring that minimum capital requirements are at an appropriate level and are more risk-sensitive. It will also reduce inconsistencies in capital requirements between LMIs and ADIs.

If adopted, the proposed model will be detailed in a new guidance note for LMIs on the concentration risk charge that will form part of GPS 110. This is intended to increase the transparency of LMI prudential requirements for market participants and formalise the requirements. Finally, it should be noted that, subject to approval by APRA, LMIs may use the Internal Model Based Method to calculate the MCR⁵.

⁵ As required under the Insurance Act, APRA will modify the relevant standards and guidance notes so that the insurer's model may be implemented. Such modification, however, will require the Commonwealth Treasurer's approval.

CHAPTER 2 - MER REPORTING REQUIREMENTS FOR LMIs

This chapter discusses the proposal to extend the MER reporting framework for LMIs to incorporate reporting to APRA on overall risk profiles and allowable reinsurance.

Current MER reporting requirements

The current MER reporting framework for LMIs and other general insurers consists of reporting standard GRS 170.0 - Maximum Event Retention and Risk Charge, including reporting form GRF 170.0 - Maximum Event Retention and Risk Charge, and associated instructions, made under the Collection of Data Act.

GRF 170.0 requires LMIs to report to APRA, generally on a quarterly basis, in relation to their maximum event retention and risk charge. Specifically, they must provide the MER and the cost of one reinstatement premium for the insurer's catastrophe insurance, which sum to the total MER charge. This is included in the calculation of the minimum capital requirement for the insurer.

The data collected in GRF 170.0 is used by APRA for the purpose of prudential supervision, including assessing a general insurer's compliance with capital adequacy requirements under GPS 110.

Inadequacies in the current MER reporting requirements

APRA's existing reporting requirements for LMIs have not produced the appropriate quality and frequency of reporting on risk profiles and reinsurance arrangements that determine the MER. In particular, LMIs are not required to provide the total value of risk exposures, the break-up of their book by key drivers of claims, such as age, LVR and product type, and the nature and level of reinsurance cover on an ongoing basis. This has impacted on APRA's ability to assess LMIs' compliance with applicable prudential requirements.

As LMIs are not required to report the risk exposures that are used to calculate the MER, the current reporting framework has led to inconsistencies in the way that the standard MER model is applied by LMIs to their portfolios. These include:

- the use of current loan balances rather than sum insured to measure exposures;
- the categorisation of loans by an estimate of current LVR rather than LVR at origination; and
- insufficient recognition of risk exposures arising from inwards reinsurance.

For the most part, LMIs have adopted appropriate practices: loans are generally categorised by original LVR, loan exposures are based on original loan amounts, and inwards reinsurance exposures are included in their calculations. There are, however, a few LMIs that do not follow these practices, leading to a potential understatement of their relative risk and minimum capital requirements.

Proposed changes to the MER reporting requirements

APRA is proposing to determine a new reporting standard for the maximum event retention and risk charge for LMIs under the Collection of Data Act. The proposed reporting standard, including a new reporting form and instruction guide, will

require additional reporting by LMIs on risk profiles that determine their MER charge. LMIs should calculate and report the MER charge on a quarterly basis. An outline of the proposed reporting form is provided in Appendix 1.

The proposed MER reporting form will require LMIs to provide details of risk exposures underlying their PML. These exposures will be divided into risk categories, which may include:

- LVR
- age
- loans originated by ADIs and by lenders that are not regulated by APRA
- securitised loans
- non-standard loans (for example, low-doc loans)
- commercial loans
- top-up cover
- pool cover
- inwards reinsurance exposures
- percentage of business that is written under open policy and directly underwritten respectively
- large exposures to lenders

Some of these data do not directly affect the MER calculation, but are useful for prudential supervision.

In addition, LMIs will be required to report the level of reinsurance cover that can be used to cover the PML under the maximum event.

The proposed reporting form and instruction guide will also provide additional guidance to LMIs on determining and reporting the MER charge. For example, it will specify that LMIs should use original LVR to categorise loans and sum insured to report exposures.

Public disclosure of these data, at both the individual LMI and aggregate industry level, has yet to be determined.

Conclusion

The proposed changes to MER reporting requirements for LMIs will allow APRA to better control and standardise the approach to calculating the MER. It will also reduce the need for APRA to seek additional clarification from LMIs via *ad hoc* data requests.

CHAPTER 3 - MORTGAGE INSURANCE REQUIREMENTS FOR ADIs CLAIMING CAPITAL CONCESSIONS

This chapter provides an overview of proposed changes to the criteria under which ADIs will be able to claim the 50 per cent concessional risk weight on certain loans that are mortgage-insured.

Concessional risk weight on mortgage-insured loans: current requirements

Under prudential standard APS 112 - Capital Adequacy: Credit Risk and associated guidance notes, ADIs qualify for a 50 per cent concessional risk weight on loans above 80 per cent LVR that are fully secured by registered mortgage over a residential property, and 100 per cent mortgage-insured through an 'acceptable' LMI. Without mortgage insurance, high-LVR loans attract a 100 per cent risk weight⁶. The capital concession for ADIs recognises that the credit risk of borrower default on mortgage-insured loans is transferred to LMIs.

AGN 112.1 defines an 'acceptable' LMI as an LMI that has a minimum 'A' credit rating and is subject to supervision by an approved insurance regulator. An unrated captive LMI may also qualify as an acceptable LMI where it is able to demonstrate claims-paying ability rated 'A' or higher; APRA considers this on a case-by-case basis.

Inconsistencies in the recognition of risk-transfer for capital concessions

The existing requirements for capital concessions on mortgage-insured loans have created regulatory inconsistencies in the treatment of non-captive LMIs (which are mostly rated) and captive LMIs (which are mostly unrated). In particular, the 'A' rating requirement has proven difficult to apply consistently and, as a result, mortgage insurance with an unrated LMI still allows an ADI to qualify for capital concessions.

Moreover, the concessional treatment has created the incentive for ADIs to set up off-shore LMIs. Off-shore LMIs are subject to different and, in some cases, less stringent regulation that is not consistent with APRA's prudential requirements. Nonetheless, ADIs that insure with off-shore LMIs still qualify for the 50 per cent concessional risk weight.

Finally, ADIs still qualify for the 50 per cent concessional risk weight on mortgage insurance arrangements that may not involve the complete transfer of risk. In such arrangements, LMIs may have potential recourse to the ADI parent through their reinsurance programs. For example, the ADI could be required to make payments to the reinsurer if the ADI's captive LMI does not meet minimum premium requirements, or the ADI could be required to make payments to its captive LMI if the LMI's reinsurance is exhausted. Such arrangements are clearly contrary to the policy intent of the capital concession granted to ADIs for transferring risk to LMIs.

⁶ For non-standard loans, proposed amendments will require mortgage insurance on loans with an LVR in excess of 60 per cent for ADIs to claim the capital concession.

Proposed changes to capital concessions on mortgage-insured loans

APRA proposes to strengthen the eligibility requirements for ADIs claiming the 50 per cent concessional risk weight on certain loans that are mortgage-insured.

The proposal will amend the definition of ‘acceptable’ mortgage insurance to require insurance to be provided by an LMI that:

- is authorised by APRA; or
- is domiciled in a country APRA considers to have comparable prudential regulation⁷.

APRA proposes to remove the ‘A’ rating requirement in the existing standard. The primary reason for taking this approach is that the rating requirement has led to inconsistencies, as APRA and rating agency requirements are not directly comparable. Moreover, with the proposed strengthening of the LMI prudential capital and reporting framework, the need for an external rating requirement is substantially diminished.

Finally, where the insurer or any reinsurer has contractual recourse to the ADI, or a member of the ADI’s consolidated group (excluding the captive LMI), the ADI will not be eligible for capital concessions.

Conclusion

The proposed changes will ensure that the concessional treatment of mortgage-insured loans for capital adequacy purposes is consistent and appropriate. It will also ensure that ADIs have adequate risk-transfer arrangements in place.

⁷ In principle, this is consistent with “Key Findings of the Review of Discretionary Mutual Funds and Direct Off-shore Foreign Insurers”, which is available at:
http://dmfreview.treasury.gov.au/content/_report/key_report.asp

APPENDIX - PROPOSED MER REPORTING FORM

Standard Loans - 5 years and under

100% Cover

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | PML |
|--------------|-------|-----|------------------------------------|-------------|---------------------|-------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | |
| > 100% | 14.0% | 40% | | | | | |
| 95.01 - 100% | 8.0% | 40% | | | | | |
| 90.01 - 95% | 5.0% | 40% | | | | | |
| 85.01 - 90% | 3.2% | 30% | | | | | |
| 80.01 - 85% | 1.6% | 30% | | | | | |
| 70.01 - 80% | 0.8% | 30% | | | | | |
| 60.01 - 70% | 0.4% | 20% | | | | | |
| 0 - 60% | 0.2% | 20% | | | | | |
| Total | | | | | | | |

Top-up Cover (e.g. Top 20%)

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | PML |
|--------------|-------|------|------------------------------------|-------------|---------------------|-------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | |
| > 100% | 14.0% | 100% | | | | | |
| 95.01 - 100% | 8.0% | 100% | | | | | |
| 90.01 - 95% | 5.0% | 100% | | | | | |
| 85.01 - 90% | 3.2% | 100% | | | | | |
| 80.01 - 85% | 1.6% | 100% | | | | | |
| 70.01 - 80% | 0.8% | 100% | | | | | |
| 60.01 - 70% | 0.4% | 100% | | | | | |
| 0 - 60% | 0.2% | 100% | | | | | |
| Total | | | | | | | |

Pool Cover

| Weighted Average LVR | Equivalent PD | LGD | Sum Insured by Origination Channel | | | | PML |
|----------------------|---------------|------|------------------------------------|-------------|---------------------|-------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | |
| | | 100% | | | | | |

| | |
|---|------|
| Standard Loans - 5 years and under Seasoning Factor Seasoned Loss | 100% |
|---|------|

Standard Loans - over 5 years

100% Cover

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | PML |
|--------------|-------|-----|------------------------------------|-------------|---------------------|-------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | |
| > 100% | 14.0% | 40% | | | | | |
| 95.01 - 100% | 8.0% | 40% | | | | | |
| 90.01 - 95% | 5.0% | 40% | | | | | |
| 85.01 - 90% | 3.2% | 30% | | | | | |
| 80.01 - 85% | 1.6% | 30% | | | | | |
| 70.01 - 80% | 0.8% | 30% | | | | | |
| 60.01 - 70% | 0.4% | 20% | | | | | |
| 0 - 60% | 0.2% | 20% | | | | | |
| Total | | | | | | | |

Top-up Cover (e.g. Top 20%)

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | PML |
|--------------|-------|------|------------------------------------|-------------|---------------------|-------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | |
| > 100% | 14.0% | 100% | | | | | |
| 95.01 - 100% | 8.0% | 100% | | | | | |
| 90.01 - 95% | 5.0% | 100% | | | | | |
| 85.01 - 90% | 3.2% | 100% | | | | | |
| 80.01 - 85% | 1.6% | 100% | | | | | |
| 70.01 - 80% | 0.8% | 100% | | | | | |
| 60.01 - 70% | 0.4% | 100% | | | | | |
| 0 - 60% | 0.2% | 100% | | | | | |
| Total | | | | | | | |

Pool Cover

| Weighted Average LVR | Equivalent PD | LGD | Sum Insured by Origination Channel | | | | PML |
|----------------------|---------------|------|------------------------------------|-------------|---------------------|-------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | |
| | | 100% | | | | | |

| | |
|--|-----|
| Standard Loans - over 5 years Seasoning Factor Seasoned Loss | 20% |
|--|-----|

Non-standard Loans - 5 years and under

100% Cover

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | | PML |
|--------------|-------|-----|------------------------------------|-------------|---------------------|-------------------|----------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | Of which Securitized | |
| > 100% | 14.0% | 40% | | | | | | |
| 95.01 - 100% | 14.0% | 40% | | | | | | |
| 90.01 - 95% | 14.0% | 40% | | | | | | |
| 85.01 - 90% | 8.0% | 40% | | | | | | |
| 80.01 - 85% | 5.0% | 40% | | | | | | |
| 70.01 - 80% | 3.2% | 30% | | | | | | |
| 60.01 - 70% | 1.6% | 30% | | | | | | |
| 0 - 60% | 0.8% | 30% | | | | | | |
| Total | | | | | | | | |

Top-up Cover (e.g. Top 20%)

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | | PML |
|--------------|-------|------|------------------------------------|-------------|---------------------|-------------------|----------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | Of which Securitized | |
| > 100% | 14.0% | 100% | | | | | | |
| 95.01 - 100% | 14.0% | 100% | | | | | | |
| 90.01 - 95% | 14.0% | 100% | | | | | | |
| 85.01 - 90% | 8.0% | 100% | | | | | | |
| 80.01 - 85% | 5.0% | 100% | | | | | | |
| 70.01 - 80% | 3.2% | 100% | | | | | | |
| 60.01 - 70% | 1.6% | 100% | | | | | | |
| 0 - 60% | 0.8% | 100% | | | | | | |
| Total | | | | | | | | |

Pool Cover

| Weighted Average LVR | Equivalent PD | LGD | Sum Insured by Origination Channel | | | | | PML |
|----------------------|---------------|------|------------------------------------|-------------|---------------------|-------------------|----------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | Of which Securitized | |
| | | 100% | | | | | | |

| | |
|---|------|
| Non-standard Loans - 5 years and under Seasoning Factor Seasoned Loss | 100% |
|---|------|

Non-standard Loans - over 5 years

100% Cover

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | | PML |
|--------------|-------|-----|------------------------------------|-------------|---------------------|-------------------|----------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | Of which Securitized | |
| > 100% | 14.0% | 40% | | | | | | |
| 95.01 - 100% | 14.0% | 40% | | | | | | |
| 90.01 - 95% | 14.0% | 40% | | | | | | |
| 85.01 - 90% | 8.0% | 40% | | | | | | |
| 80.01 - 85% | 5.0% | 40% | | | | | | |
| 70.01 - 80% | 3.2% | 30% | | | | | | |
| 60.01 - 70% | 1.6% | 30% | | | | | | |
| 0 - 60% | 0.8% | 30% | | | | | | |
| Total | | | | | | | | |

Top-up Cover (e.g. Top 20%)

| LVR | PD | LGD | Sum Insured by Origination Channel | | | | | PML |
|--------------|-------|------|------------------------------------|-------------|---------------------|-------------------|----------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | Of which Securitized | |
| > 100% | 14.0% | 100% | | | | | | |
| 95.01 - 100% | 14.0% | 100% | | | | | | |
| 90.01 - 95% | 14.0% | 100% | | | | | | |
| 85.01 - 90% | 8.0% | 100% | | | | | | |
| 80.01 - 85% | 5.0% | 100% | | | | | | |
| 70.01 - 80% | 3.2% | 100% | | | | | | |
| 60.01 - 70% | 1.6% | 100% | | | | | | |
| 0 - 60% | 0.8% | 100% | | | | | | |
| Total | | | | | | | | |

Pool Cover

| Weighted Average LVR | Equivalent PD | LGD | Sum Insured by Origination Channel | | | | | PML |
|----------------------|---------------|------|------------------------------------|-------------|---------------------|-------------------|----------------------|-----|
| | | | ADIs | Unregulated | Inwards Reinsurance | Total Sum Insured | Of which Securitized | |
| | | 100% | | | | | | |

| | |
|--|-----|
| Non-standard Loans - over 5 years Seasoning Factor Seasoned Loss | 20% |
|--|-----|

Commercial Loans

| LVR | Factor | Sum Insured by Origination Channel | | | | PML |
|--------------|--------|------------------------------------|-------------|---------------------|----------------------|-----|
| | | ADIs | Unregulated | Inwards Reinsurance | Of which Securitised | |
| Total | 8% | | | | | |

| | |
|------------------|--|
| Total PML | |
|------------------|--|

PML by Year

| | Year 1 25% | Year 2 50% | Year 3 25% |
|----------------------|---------------|---------------|---------------|
| PML per year | | | |
| Eligible Reinsurance | | | |
| MER per year | | | |

| MER | |
|-------------------------|--|
| Reinstatement Costs | |
| Total MER Charge | |

Large Liability Exposures by Originator

| Largest Exposure | Originator | Sum Insured | Open Policy (%) |
|------------------|------------|-------------|-----------------|
| 1 | | | |
| 2 | | | |
| 3 | | | |
| 4 | | | |
| 5 | | | |