INSURANCE COUNCIL OF AUSTRALIA

11 November 2019

Ms Heidi Richards
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
Level 12, 1 Martin Place
SYDNEY NSW 2000

Dear Ms Richards

Capital Treatment of Mortgages under the First Home Loan Deposit Scheme

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to comment on APRA's proposed capital treatment of mortgages under the First Home Loan Deposit Scheme (the FHLDS). While we agree with APRA's view that "the Government guarantee is a valuable form of credit risk mitigation"[2], we are concerned that the specific approach proposed by APRA:

(i) does not adequately reflect the risk associated with the FHLDS;

(ii) is inconsistent with APRA's current (and proposed[3]) approach to capital adequacy; and

(iii) is inconsistent with the capital treatment for LMI.

Does not adequately reflect the risk associated with the FHLDS

APRA "proposes to allow ADIs to treat eligible FHLDS loans in a comparable manner to mortgages with a loan-to-valuation ratio of 80 per cent. This would allow eligible FHLDS loans to be risk-weighted at 35 per cent under APRA's current capital requirements".

However, a loan under the FHLDS is not equivalent to a mortgage with an LVR of 80 per cent. In particular, a loan with an LVR in excess of 80 per cent under the FHLDS has a higher probability of default. This translates into significantly higher losses under a stress scenario. While the Government guarantee under the FHLDS offers some degree of

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent approximately 95 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. June 2019 Australian Prudential Regulation Authority statistics show that the general insurance industry generates gross written premium of $48.4 billion per annum and has total assets of $128.4 billion. The industry employs approximately 60,000 people and on average pays out about $151.4 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as lenders' mortgage insurance, product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

[2] APRA *Consultation on the capital treatment of mortgages under the First Home Loan Deposit Scheme* (letter dated 28 October 2019)

[3] as set out in APRA's *Response to Submissions: Revisions to the capital framework for authorised deposit-taking institutions* (12 June 2019)

protection, it is limited to 5-15 per cent of the property value, and the guarantee ceases when the balance of the loan becomes less than 80 per cent of the value of the residential property.[4] By way of contrast, LMI covers the principal and interest for the duration of the loan.

Inconsistent with APRA's approach to capital adequacy and the treatment of LMI

Table 1 compares APRA's current risk weights for residential mortgages[5] with the proposed risk weights for loans under the FHLDS:

Table 1: Risk weights for standard eligible mortgages

LVR (%)	Risk weight (no mortgage insurance)	Risk weight (with at least 40% of the mortgage insured by an acceptable LMI)	*Risk weight (under FHLDS)*
80.01 - 90	50	35	*35*
90.01 - 100	75	50	*35* *(up to 95% LVR)*
> 100.01	100	75	*n/a*

For loans with an LVR greater than 90 per cent, the proposed capital treatment is more favourable under the FHLDS than for LMI. Consequently, this undermines the Government's intent that:

> The development of the Scheme has prioritised the maintenance of a viable and profitable LMI industry, as LMI enables high-LVR lending and benefits the financial system more broadly. LMI allows potential home buyers the ability to enter the property market sooner than they would otherwise be able to.[6]

Further, we are concerned that the different capital treatment of loans under the FHLDS relative to LMI may create a regulatory imbalance and may be contrary to APRA's mandate to balance competition with other factors in financial markets.

We note that APRA has not outlined its proposed treatment of the FHLDS to reflect Basel III. Under Basel III, which includes an additional buffer for high LVR loans, if APRA were to retain its current proposed approach, this may create even further inconsistency in future.

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[4] s29H(3) Exposure Draft *National Housing Finance and Investment Corporation Investment Mandate Amendment (First Home Loan Deposit Scheme) Direction 2019*

[5] APRA Prudential Standard *APS 112 Capital Adequacy: Standardised Approach to Credit Risk*

[6] Paragraph 2.32 *Explanatory Memorandum* to the *National Housing Finance and Investment Corporation Amendment Act 2019*

If you have any questions or comments in relation to our feedback, please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on tel: [redacted] or email: [redacted].

Yours sincerely

[redacted]

for

Robert Whelan
Executive Director and CEO