

*Thriving on Change*

**16<sup>th</sup>**

**General  
Insurance  
Seminar**



**9-12th Nov 2008**  
**Hyatt Regency Coolum**

# **What is the future for Lenders Mortgage Insurance?**

**Aaron Cutter & Susie Bowden**



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12th Nov 2008**  
**Hyatt Regency Coolum**

## **Contents**

1. Historical Reasons for LMI
2. Recap of recent LMI experience
3. LMI's place in the sub-prime picture
4. Australia v US Mortgage Market
5. Future Landscape
6. What if?



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolum**

# 1. Historical Reasons for LMI

- Capital
- Risk Transfer
- Product Innovation
- Risk Selection



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolum**

## Capital

- Support ADI return on capital
  - Reduce level of ADI capital
  - LMI providers (arguably) expect a lower return than ADIs
  - LMI providers accept volatile returns
- Facilitate growth in smaller players and entry of non-bank lenders



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolum**

## **Risk Transfer - Diversification**

- Removes volatility from lenders' losses
- Delinquency rates and losses different by lender in the recent benign economic times
- Even in "recent" down-turns LMI providers help smooth losses



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



**Thriving on Change**

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolom**

## **Product Innovation**

- Security for lenders
- Global experience



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



**Thriving on Change**

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolum**

## **Risk Selection**

- Discouraging inappropriate lending
- Providing outsourced expertise to lenders
  - fraud detection models,
  - credit score
  - underwriting standards.



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolom**

## **2. Recap of Recent LMI Experience**

- Australian Experience
- US Experience





Institute of Actuaries of Australia

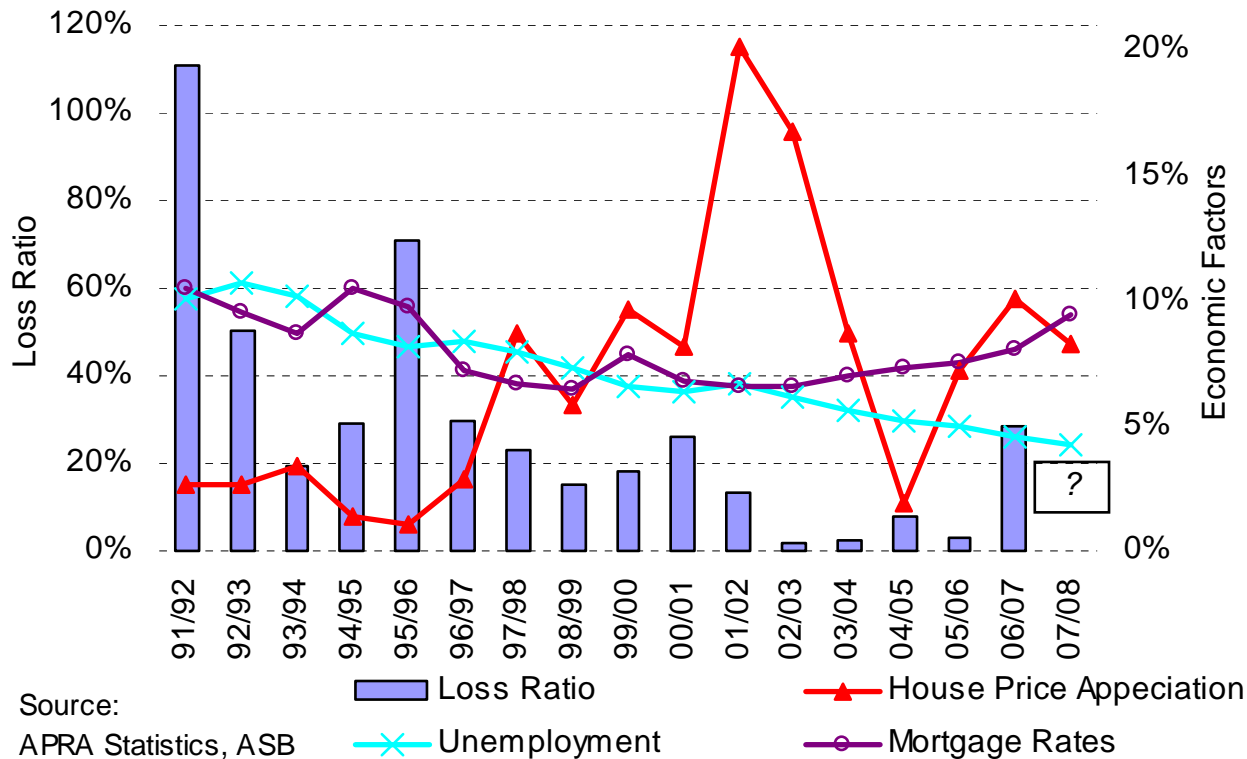
# 16th General Insurance Seminar



Thriving on Change

9-12th Nov 2008  
Hyatt Regency Coolum

## Australia



- Recent LMI losses have been very low (til 2007)
- Favourable national economic environment
- But history shows losses can be large (80s and 90s)
- Where to for 2008 and 09?



Institute of Actuaries of Australia

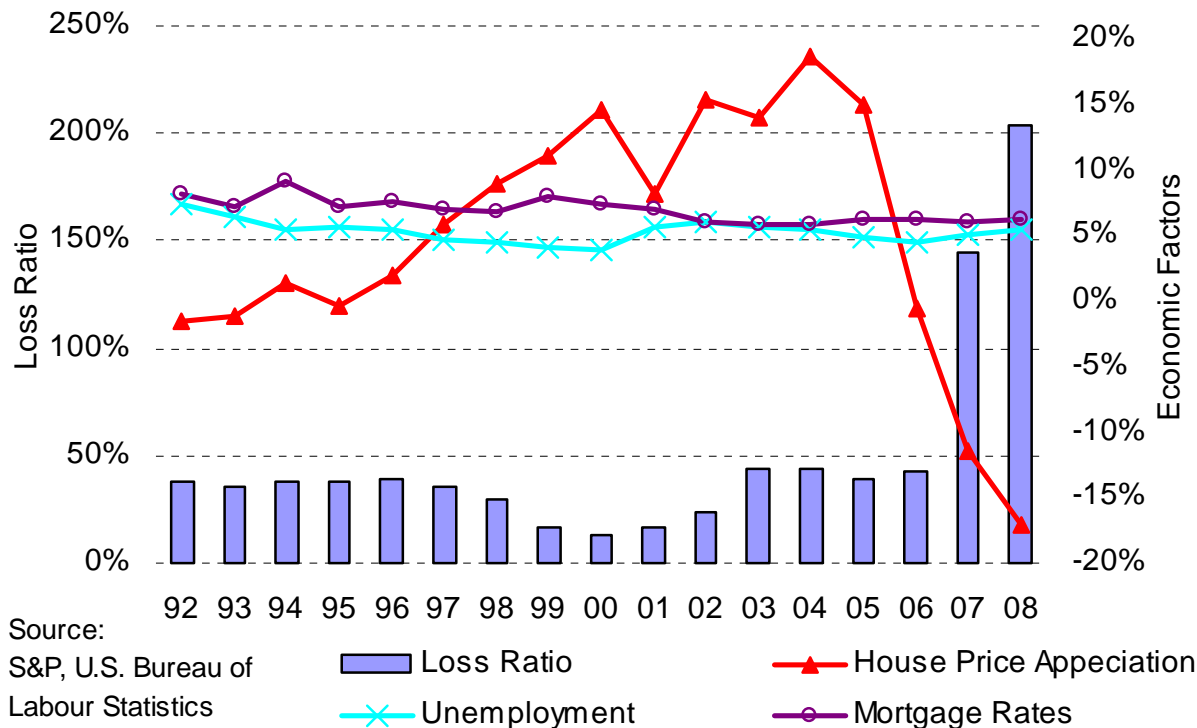
# 16th General Insurance Seminar



Thriving on Change

9-12th Nov 2008  
Hyatt Regency Coolum

## United States of America



- Up until 2006, stable experience
- Then very unfavourable conditions producing loss ratios in the hundreds



Institute of Actuaries of Australia

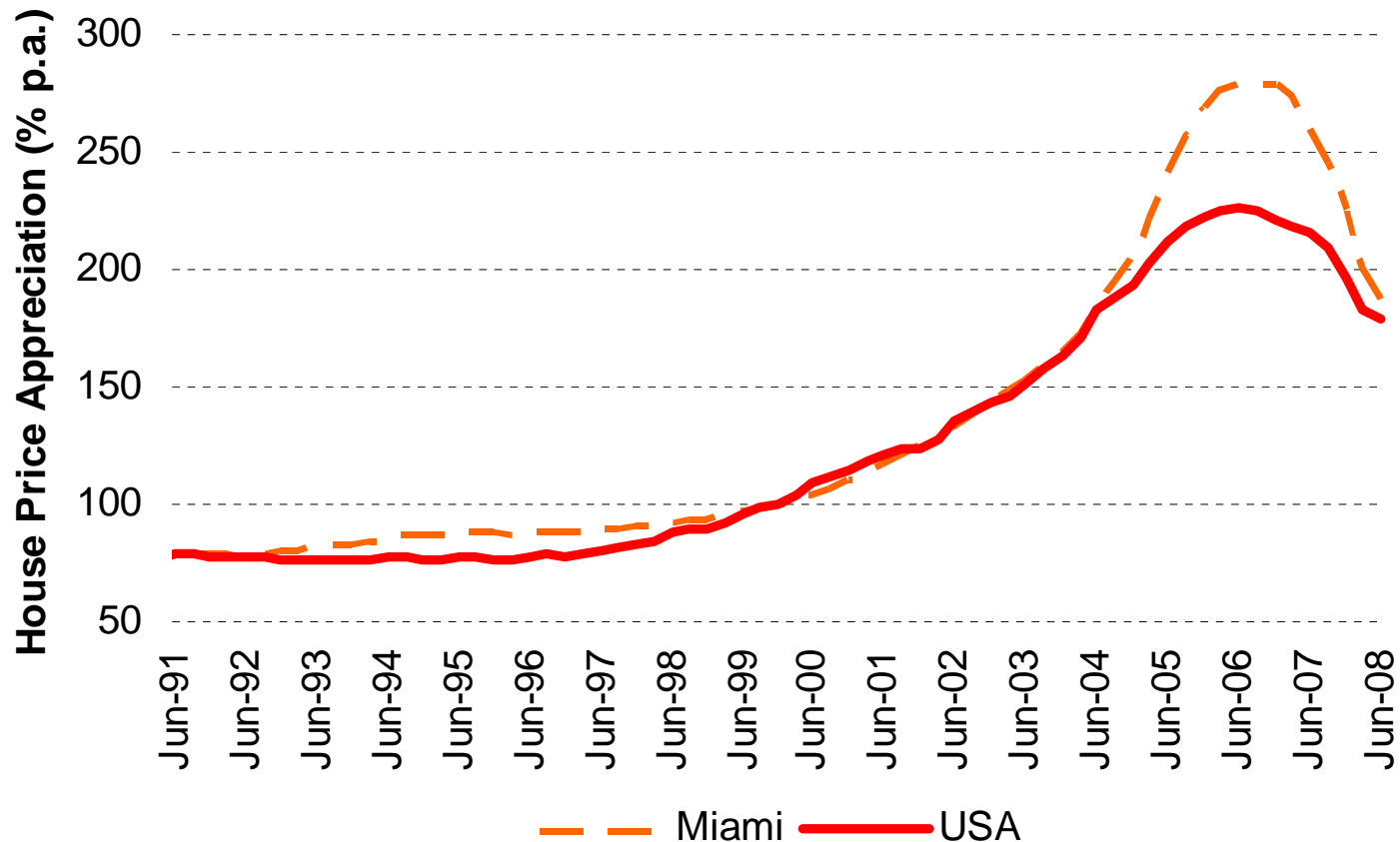
# 16th General Insurance Seminar



Thriving on Change

9-12th Nov 2008  
Hyatt Regency Coolum

## Big falls in US house prices





Institute of Actuaries of Australia

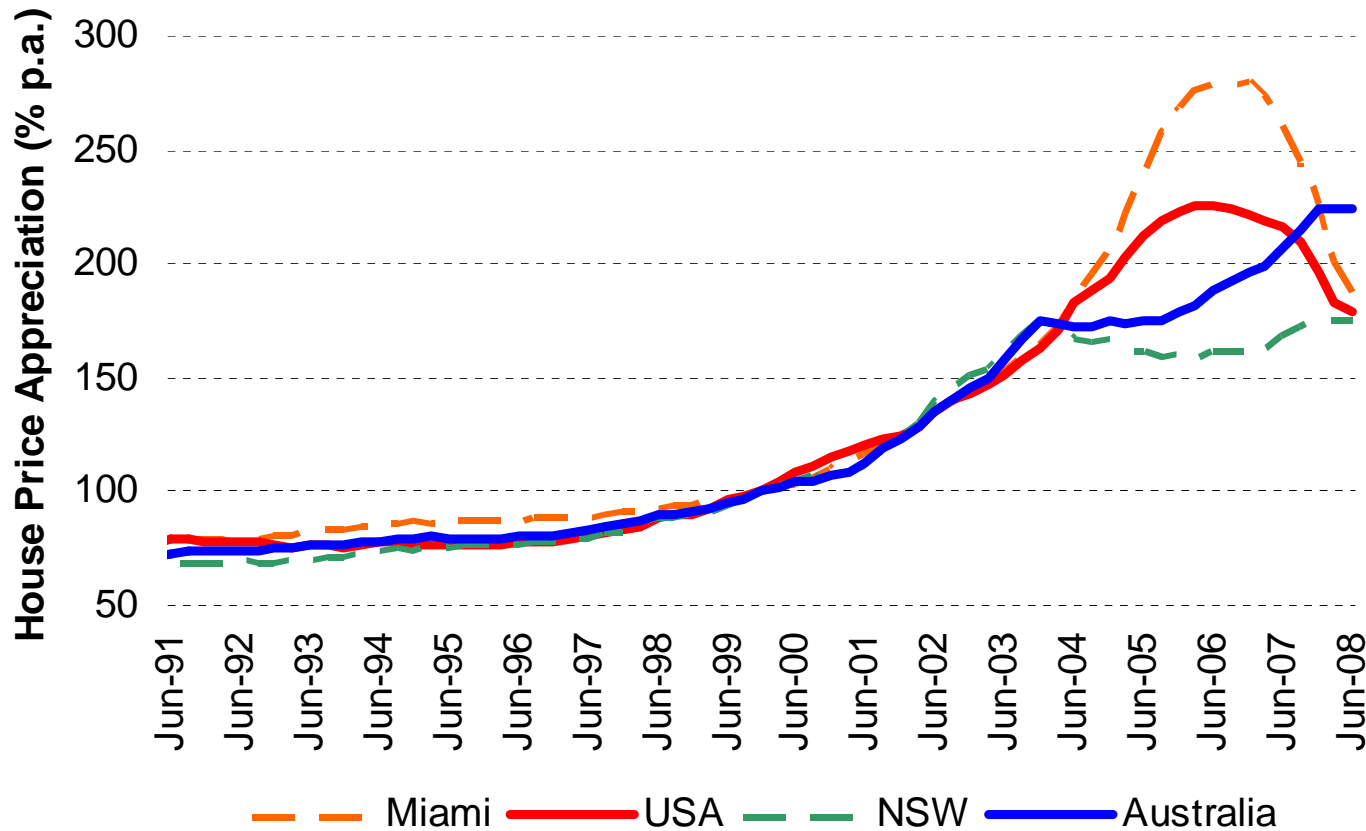
# 16th General Insurance Seminar



Thriving on Change

9-12th Nov 2008  
Hyatt Regency Coolum

## “Small” falls in Aus house prices





Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



**Thriving on Change**

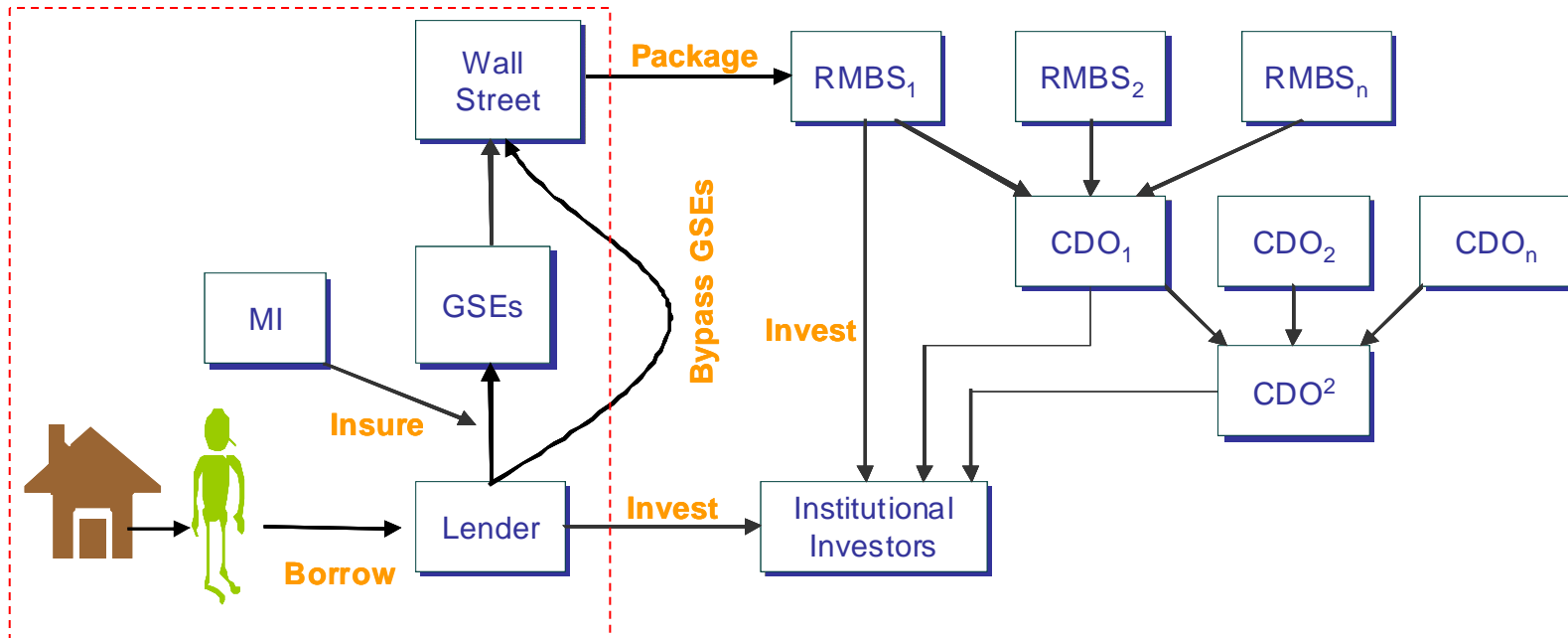
**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolom**

## **3. LMI's Place in the Sub-Prime Crisis**

- Traditional US lending structure
- Traditional securitisation
- Recent departure from tradition

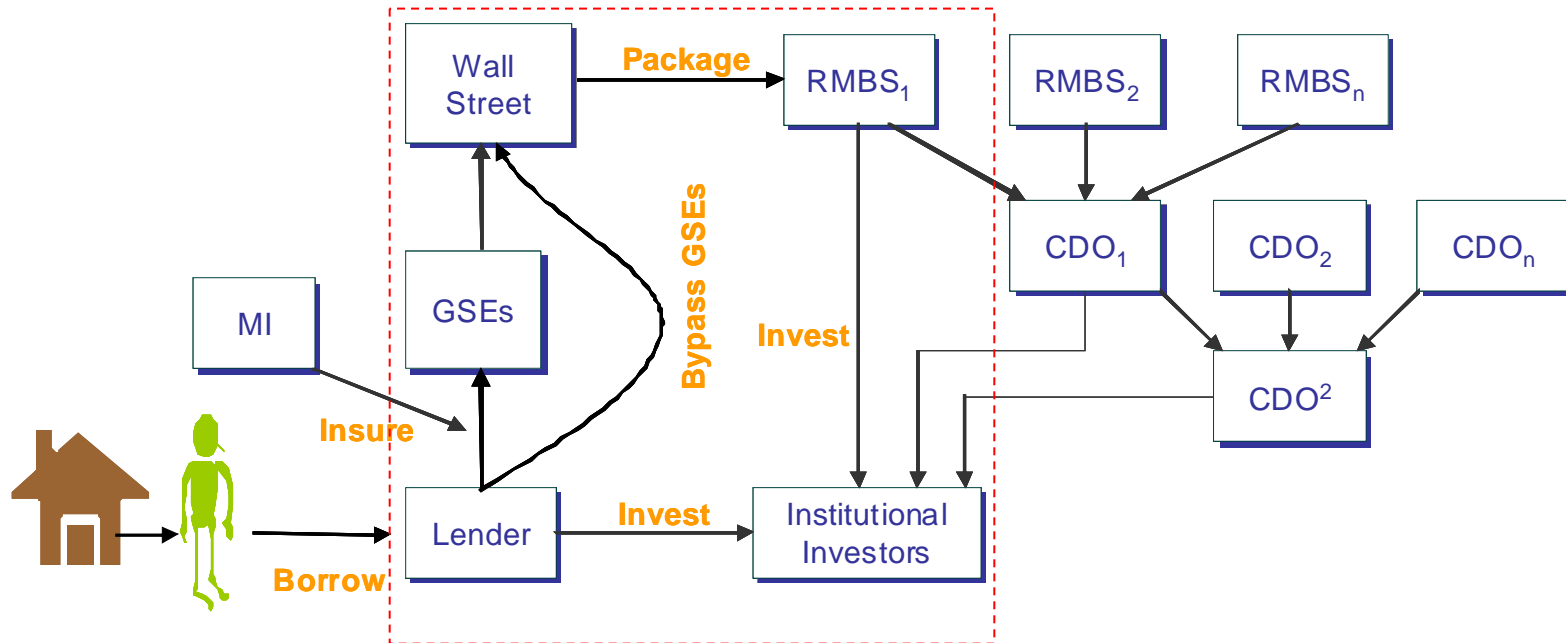


# Traditional Lending Structure



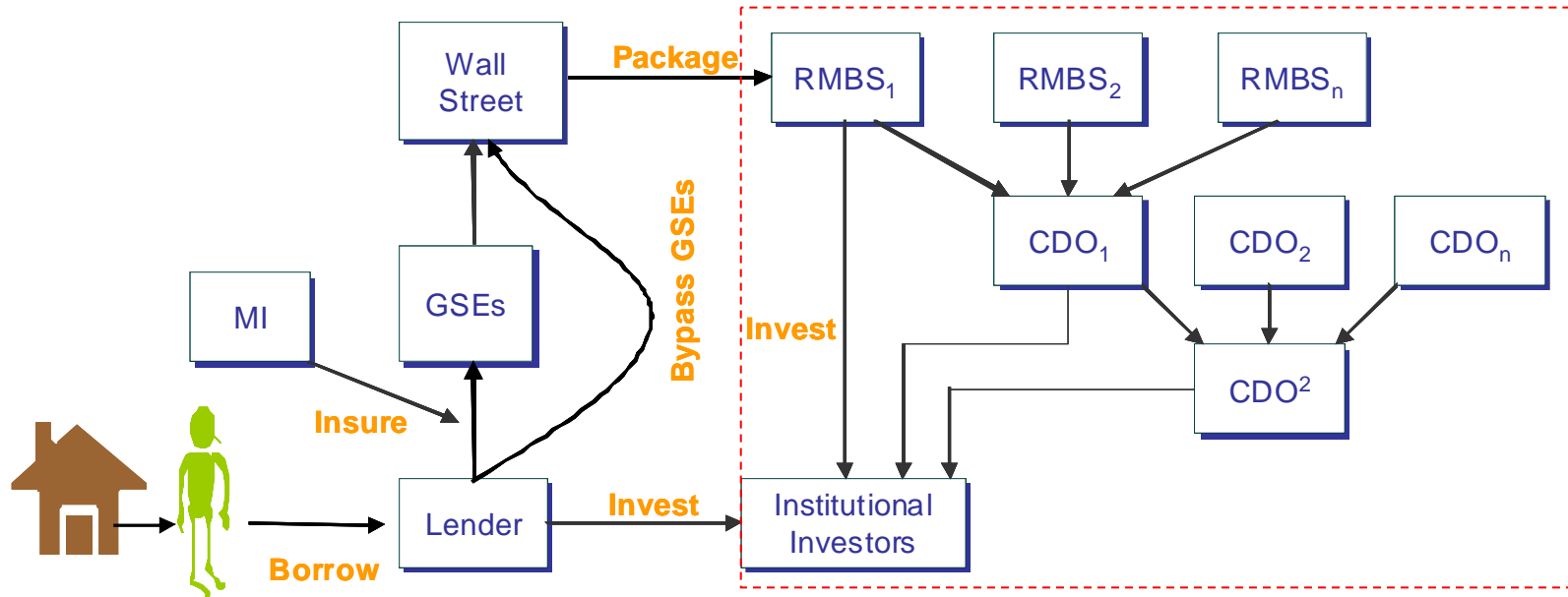


# Traditional Securitisation





# Recent Departure from Tradition







Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolom**

## **4. Australia v US Mortgage Market**

- Mortgage Products
- Lending Practices
- Property Markets



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



**Thriving on Change**

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolum**

# Mortgage Products

- **US**
  - Increase in sub-prime loans (i.e. high risk of default)
  - ARMs with ‘teaser’ rates (3/27s or 2/28s)
  - Sub-prime loans grew “nearly ten-fold in nine years”
  - Negative amortisation loans
- **Australia**
  - Less than 1% non-conforming
  - ARMs with teaser rates not offered in Australia



Institute of Actuaries of Australia

# 16<sup>th</sup> General Insurance Seminar



Thriving on Change

9-12<sup>th</sup> Nov 2008  
Hyatt Regency Coolum

## Lending practices

- US
  - ARM 2/28s offered to those less able to afford the repayments
  - Serviceability calculated on an optimistic basis
  - Lenders by-passing LMI
- Australia
  - serviceability is generally calculated at a buffer over benchmark interest rates
- *But*
  - Australian households are more leveraged
  - Some questionable underwriting has occurred



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



**Thriving on Change**

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolom**

## Property Markets

- **US**
  - Property slumps have been geographically isolated
  - Now, the US has experienced a nationwide downturn
  - Mortgage products and practices led to speculative bubble and its bursting in some states
  - auto-manufacturing sector in trouble at the same time
- **Australia**
  - Property slumps also have been geographically isolated
  - Recently, property market has remained reasonably stable
  - Could a nationwide property downturn occur



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12th Nov 2008**  
**Hyatt Regency Coolom**

## **5. Future Landscape**

- The Mortgage Market
- LMI and Capital
- Risk Selection and Product Innovation
- Risk Transfer



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12th Nov 2008**  
**Hyatt Regency Coolum**

## **The Mortgage Market**

- Consolidation of the LMI providers
- Regional banks will be at a disadvantage to the larger banks
- Assistance with quality control and intellectual support



Institute of Actuaries of Australia

# 16th General Insurance Seminar

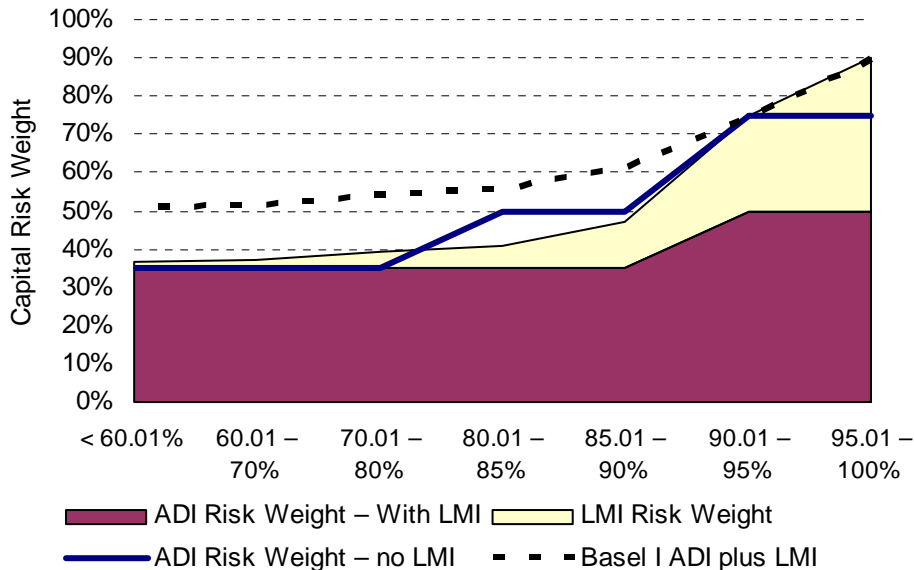


Thriving on Change

9-12th Nov 2008  
Hyatt Regency Coolum

## Capital

Relative capital levels required by LVR



- Capital previously main driver of LMI use
- Capital benefits are lower under Basel II for Standard Approach banks
- Capital position is complex for IRB banks
- Reasons for LMI may move toward true risk assessment and mitigation





Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



*Thriving on Change*

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolum**

## **Risk Selection & Product Innovation**

- LMI providers still facilitate market discipline
- The majority of the LMI business can be expected to be unchanged
- LMI may become the quasi 'gold stamp' of underlying business





Institute of Actuaries of Australia

# 16th General Insurance Seminar

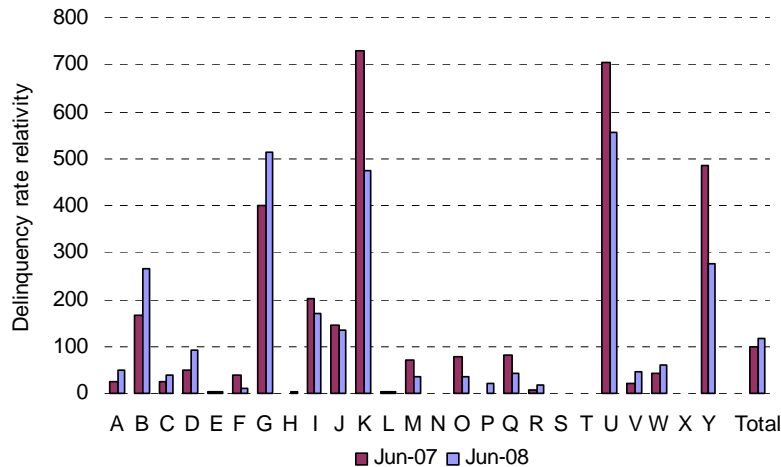


Thriving on Change

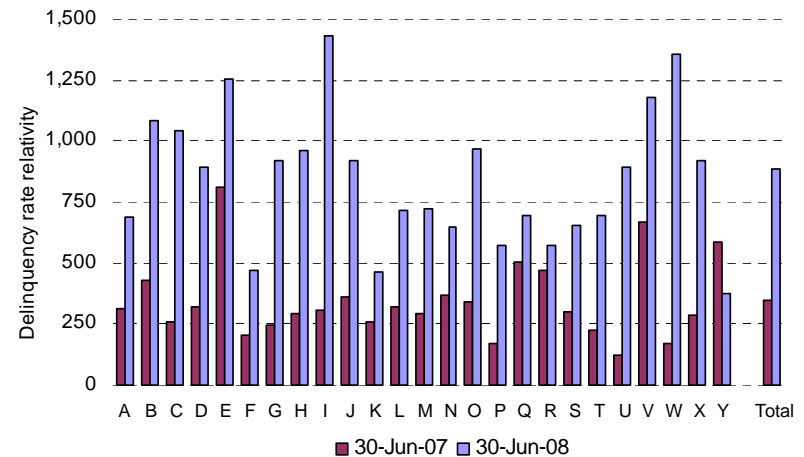
9-12th Nov 2008  
Hyatt Regency Coolum

## Risk Transfer - Diversification

**Delinquency rate (3 months in arrears)  
for Australian lenders as at 30 June  
2007 and 30 June 2008**



**Relative delinquency rate for US  
lenders as at 30 June 2007 and 30  
June 2008 – Prime loans**



- LMI does provide true insurance risk transfer
- In very stressed environments the level of risk transfer is arguably lower
- Maximum benefit provided by global LMI



Institute of Actuaries of Australia

# 16<sup>th</sup> General Insurance Seminar

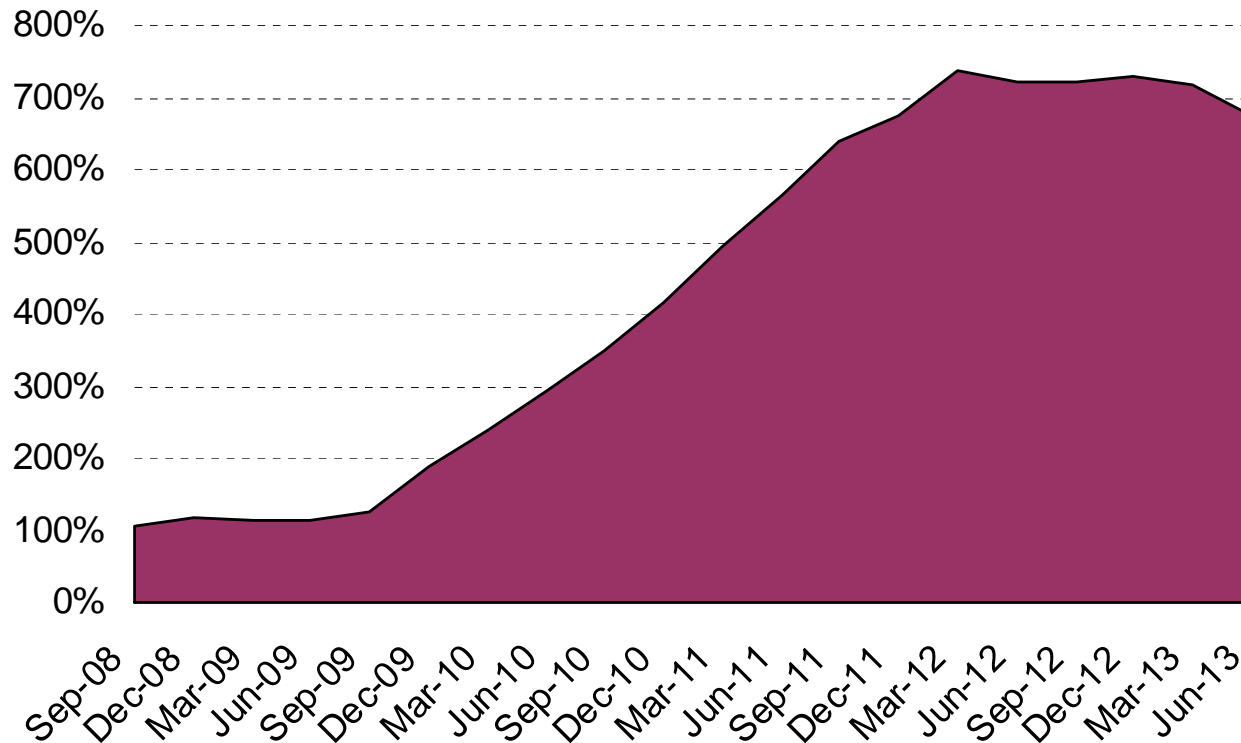


Thriving on Change

9-12<sup>th</sup> Nov 2008  
Hyatt Regency Coolum

## 6. What if?

Future Claim Costs Relativity between “baseline” Australian losses and a US like scenario



- 7 times current level of losses = 200% loss ratio



Institute of Actuaries of Australia

**16<sup>th</sup>**  
**General  
Insurance  
Seminar**



**Thriving on Change**

**9-12<sup>th</sup> Nov 2008**  
**Hyatt Regency Coolum**

## Where will it settle

- Market consolidation and Basel II may lead to a declining LMI industry
- However, risk selection/acceptance and transfer have significant value
- How these opposing forces finally settle will determine whether overall use of LMI becomes less or more...