

## **Lenders mortgage insurance doesn't protect the borrower, so who is covered by it and how does it work?**

Most people know that if they default on their mortgage repayments, they'll find themselves in a rather uncomfortable position that can result in their property being repossessed by the lender. The lender will then sell the property to recover the costs associated with the foreclosed loan, but what if this doesn't cover their costs?

This is when lenders mortgage insurance, or LMI, kicks in. If the defaulted mortgage is insured by an LMI policy, the mortgage insurer will pay any amount still not recovered by the lender after the sale of the property.

First introduced in the early 1990s, LMI doesn't exist to cover the mortgagee in case they can't make their repayments; rather LMI exists to protect the mortgage lender should the forced sale of a property fall below the outstanding loan amount.

Although designed with the lender in mind, the product has helped borrowers by allowing loans with loan-to-value ratios (LVR) that are higher than the traditionally accepted 80 per cent mark. This has been very useful for both homebuyers and investors alike, as it has opened the market for people with smaller deposits and allowed investors to reserve some of their capital by not placing so much initial equity in a property. It's this lower initial equity that assists investors in making the most of the tax benefits of negative gearing through interest payments.

### The F word: Finance

Despite LMI opening doors for more flexible finance requirements, organising a mortgage for the purchase of a property is still quite a complicated matter, especially given the time constraints of contract finance clauses. Borrowers have to provide proof of employment, pay slips, demonstrate that their expenses for both living and other liabilities are in check and then, depending on the size of the deposit, the lender may require them to pay LMI.

If you're in a position to provide at least a 20 per cent deposit, thus making your LVR 80 per cent or less, many lenders won't take an LMI policy over the loan. However there are lenders that will still take insurance, sometimes down to an LVR of 60 or 50 per cent. If this is the case then they usually won't charge you the premium for the insurance and you probably won't even know that the loan has been insured. The two key reasons for this are that by providing a 20 per cent or more deposit you have satisfied the traditionally acceptable criteria for obtaining a loan and with an LVR of less than 80 per cent the LMI premiums are greatly reduced given the reduced risk to the insurer of having to pay out on the policy.

### The personal impact

So, aside from allowing borrowers and lenders to have smaller deposits to enter the market, what does LMI mean for you as an investor?

In the early years of home buying and investing then LMI probably means very little to borrowers. Yes, it affords greater loan flexibility on the lender's part and you will be required to pay any necessary premium but the overall impact of the insurance is probably minimal.

New investors are likely to have loan sizes that are relatively lower and the total debt or risk of the portfolio is also going to be quite small compared to more experienced investors. This can all change, however, when the size of the portfolio and the associated total risk starts to increase.

There are two insurers offering LMI in Australia: Genworth Financial and PMI. Given that there are only two insurers and the nature of the product whereby the risk primarily is based on the size and LVR of the loan, figures which are quite indisputable, the premium prices for both are quite similar.

There's no "cut-price" mortgage insurer in the market.

As a further point of similarity, both lenders have the same maximum individual loan amount and similar maximum total exposure limits for an individual borrower.

Both Genworth Financial and PMI won't cover a single loan risk that's greater than \$1 million, however loans smaller than this may still not be accepted.

The LVR obviously impacts on this maximum loan size but other factors which are considered by the insurer as to how much risk they'll cover are the location of the property and whether the purchase is a house, unit, land or construction.

Typically loans for houses can be insured up to higher loan amounts than just vacant land.

These variables will become more noticeable as they compound within a portfolio of several loans so that although Genworth Financial states that it accepts a maximum risk per borrower of \$2.5 million and PMI a maximum of \$3 million, the likelihood of your total risk portfolio reaching these levels and being accepted for LMI is reasonably remote.

#### The consequences of the fine print

When the time comes to have your loan approved by your lender, it may be able to approve the finance and authorise any necessary LMI policy up to a certain risk amount. However once your portfolio exceeds this amount, the mortgage insurer will be required to make the decision on whether to accept the risk.

You could find yourself in the situation where, even though your finance provider is prepared to lend you the money with insurance, the mortgage insurer could reject the loan.

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