Early Findings from a New Approach to Lenders Mortgage Insurance

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1. Historical context

New Zealand's past has shaped its housing landscape. Political and social events such as Polynesian and colonial settlement, the New Zealand wars, the Great Depression, the world wars, the subsequent baby boom, and the urban drift and migratory influxes of the 1960s have all influenced housing policies. Government housing initiatives of the past 150 years have included village settlement schemes, land grants to veterans, the provision of pensioner and workers' housing, the promotion of home ownership through subsidised mortgage finance and deposit assistance and widespread construction of state rental housing.

Government lending to first home buyers began in the late 1890s with a focus on new settlers wishing to establish farming blocks. This was expanded to include general lending for low income workers in the early 1900s. In 1936 the State Advances Corporation (SAC) was established to provide low interest loans for a range of first home buyer groups and to administer State rental housing (with construction overseen by the Ministry of Works). The SAC continued until the establishment of the Housing Corporation of New Zealand (HCNZ) in 1974, which amalgamated the lending, rental and construction arms of the Government into one entity. HCNZ introduced income-related interest rates in the mid-1980s and a range of experimental loan products in the late 1980s. At one point, State lending represented eight per cent of the total market, most of it to first home buyers.

Private sector lending to first home buyers was also supported by HCNZ through a Housing Mortgage Guarantee Scheme (HMGS). This scheme was introduced in the early 1970s and enabled lenders to exceed their normal margins up to 90% of valuation. Despite collecting only a nominal fee from participating lenders, the HMGS was self-sustaining until the late 1980s, when widespread economic restructuring and high interest rates resulted in a substantial increase in claims. This, along with the interest from commercial mortgage insurers in entering the New Zealand market, meant the scheme was to be cancelled as part of the housing reforms (see below).

The economic and social changes of the late 1980s and 1990s introduced significant changes to housing policy, especially the National Government's "Mother of All Budgets" in 1991. This budget greatly curtailed Housing Corporation subsidised lending. These changes also led to:

- the freeing up of financial markets, making capital more accessible;
- the removal of subsidies to local government for pensioner housing;
- the introduction of market rents for State housing tenants;
- the introduction of the Accommodation Supplement as the primary form of government housing assistance;
- the sale of 10,000 units of State housing stock to sitting tenants and investors; and
- the sale of the bulk of the Corporation's loan portfolio of $2.4 billion to private interests.

As part of the changes, the Housing Corporation's functions were split across four entities:

- Housing New Zealand Limited – a State Owned Enterprise established to manage the rental housing stock;
- Community Housing Limited – a subsidiary of Housing New Zealand Limited, set up to manage the portfolio rented to community groups;
- Housing Corporation of New Zealand – a downsized version of the original entity, charged with selling the mortgage portfolio and administering the remaining loans, as well as continuing with some small scale lending programmes;
- Ministry of Social Policy – a pre-existing Government department

that subsumed HCNZ's policy arm, including its Ministerial advisory unit. This move reflected the Government's beliefs that housing problems were fundamentally due to affordability and that policy advice should be kept separate from delivery.

These changes saw the New Zealand Government effectively withdraw from direct lending over the 1992 – 1995 period. Between 1995 and 1999, lending was mainly focussed on two programmes, Low Deposit Rural Lending (LDRL) and HomeBuy. LDRL was aimed at assisting low income people living in rural areas to buy their first home, in part to address substandard housing problems. HomeBuy was a suspensory loan product aimed at assisting HNZC tenants to buy their State rental home.

Housing policy changed direction again with the return of the Labour Government in 1999. The sale of State housing was suspended, and the market rent policy reversed. Housing New Zealand Corporation (HNZC) was established and the different entities brought back under one umbrella. However, changes in the financial markets (discussed below) and the sale of the mortgage portfolio meant a return to large scale lending was neither desirable nor possible.

Interest in home ownership issues was rekindled by the findings of the 2001 census, which showed a decline in the home ownership rate of 6% over the 10 years since 1991.

2. Current market conditions

There have been fundamental changes in the residential lending and consumer credit markets since deregulation in the late 1980s. The easy access to consumer credit has had both positive and negative consequences, with aggressive marketing by banks targeting investors and established home owners. Many consumer items that were once out of reach of the average buyer are now available across the board with no deposit, interest free terms and deferred payment options. Consumers are now more used to getting what they want immediately, rather than saving up to buy it, giving rise to a buy now/pay later mentality. This provides more choice but also more problems by way of unpaid debts and adverse credit records, which paradoxically have a downstream impact on eligibility for loan finance.

Along with easier access to consumer credit, another factor that is affecting the home ownership rate is student loan debt, which has been growing steadily since the student loan scheme was introduced in 1991. As at 30 June 2003 there were 390,000 student loans outstanding, with a combined value of $5.27billion. The average debt was $13,680 per borrower[1]. Given this starting point, many graduates go overseas where they can earn more than in New Zealand, and return some years later to settle down, often with substantial savings.

Increasing debt and an ageing population generally has increased the proportion of older home owners whilst that of younger households has decreased. Even so, the decline in ownership rates has occurred across all age groups[2]. Yet residential mortgage lending continues to grow, reflecting the ongoing preference of New Zealanders to invest in housing rather than the stock market.

Unfortunately, whilst there are no statistics available to confirm this, HNZC believes that this growth is not being directed at first home buyers. Instead, it is made up primarily of loans to existing home owners wishing

[1] Source: Inland Revenue Department
[2] Source: Census statistics 1991 and 2001, Statistics New Zealand

to "trade up", renovators, and investors. The recent popularity of revolving credit loans means that a growing portion of mortgage debt is not necessarily related to housing costs at all, and is being used to refinance credit card and other debts.

Mainstream mortgage lenders remain conservative in their approach to deposit requirements. Typically, loan applicants are expected to be able to demonstrate a savings history and to make up the required deposit from their own resources – gifts from family members for example are not considered acceptable in lieu of savings. This reflects lenders' ongoing adherence to the concept of "hurt money" i.e. home buyers must risk their own capital if the bank is to risk theirs.

Current deposit requirements are still radically more relaxed than 20 years ago. In the early 1980s there was limited access to residential mortgage finance and the market was highly regulated. Deposit requirements of 25% and higher were common, with few lenders in the market. This has changed to the point where the average deposit required is now only 10%, with 5% not uncommon in high growth areas. Having said that, a 5% deposit is still a substantial amount of cash to accumulate; the average entry level house price requires a deposit of around $7,500 (and up to $15,000 in the main urban areas)[3].

These conditions have made it more difficult for people to achieve ownership, and the age at which people can make the transition is much later in life, if it happens at all. In the past 10 years, the proportion of first home buyers who are under 30 in New Zealand has fallen from 48% to 39%[4].

Trends in housing tenure

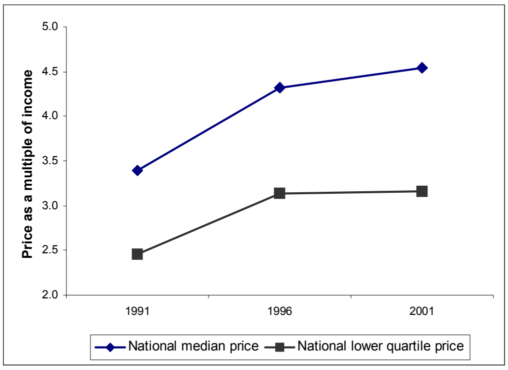
Despite the increased competition amongst residential lenders, and the availability of relatively low interest rates, the ability of first home

[3] Based on a national lower quartile price of approximately $150,000, derived from Quotable NZ statistics as at 30 September 2003. By the same token, higher deposit levels of 10% - 20% are required in provincial and rural areas, effectively negating the advantage of lower prices.

[4] Source: Building the Future: Towards A New Zealand Housing Strategy, Housing New Zealand Corporation, April 2004

buyers to enter the market is becoming increasingly constrained, particularly in the main urban centres. This is underpinned by higher house and land prices compared with wages, and the increasingly higher deposit and borrowing needed to buy a home. Figure 1 below shows how median and lower quartile prices have tracked against median household incomes since 1991. On this basis alone, median house prices are 34% more expensive than they were and lower quartile houses are 28% more expensive.[5]

Figure 1: House prices and median household incomes 1991-2001



As observed, there has been heightened public awareness of home ownership since the 2001 census revealed a 6% decline over the past decade. At 68% the home ownership rate is high by international standards[6], although it has dropped from a peak of 74% a decade ago. Private rental housing has increased from 22% in 1991 to 26%, with some of the remainder accounted for by an increase in people living rent-free in homes owned by family trusts.

Government expectations

The Government is concerned at the declining level of home ownership, but has made it very clear that there will not be a return to large scale direct lending by the state. Any new interventions are expected to leverage off the highly competitive mortgage market wherever possible.

[5] Source: Statistics New Zealand census data from 1991, 1996 and 2001, and Quotable New Zealand data for calendar years 1991, 1996 and 2001 (QNZ data is not publicly available).

[6] e.g. Australia: 69%, USA: 67%, Canada: 66%, France: 55%, Germany: 41%,

3. The importance of Lenders Mortgage Insurance (LMI)

As discussed, commercial lenders mortgage insurers entered the New Zealand market in the 1980s and soon had a major influence on lenders' credit policies. Most lenders take lenders mortgage insurance (LMI) for loans above 80% of loan-to-valuation (LTV), which means mortgage insurers have a major influence on the availability of finance to first home buyers, as these are the people most likely to require high LTV loans[7].

There are only two LMI providers in New Zealand, and one has the lion's share of the market. Criteria are mainly set by the insurers' head offices in other parts of the world and are based on global data. The approach taken to credit assessment is thereby highly conservative and driven by experience unrelated to the New Zealand housing market. Lenders build these criteria into automated processes which, along with conservative credit criteria, produces a system that excludes a large percentage of potential home buyers.

From this picture of the market grew the idea of Government-backed LMI as a way of influencing the market. At the macro level the concept was to underwrite loans that fall outside standard criteria and thereby create new benchmarks for residential lenders and encourage them to look at under-served and under-developed markets.

The HNZC Mortgage Insurance Scheme (MIS) took shape over 12 months between September 2002 and September 2003, when it was introduced. It is being run as a "live" pilot in partnership with one lender so that the concept can be tested before going out to the wider market. The scheme is running as a live pilot until June 2005.

[7] Whilst this is still the case, the high price of premiums and historically low level of claims has lead to two major lenders ceasing to use LMI and self-insuring instead.

4. Features of the MIS pilot

The pilot is designed to test the scheme on three levels:

- Its ability to reach target markets;
- The effect of different credit criteria in terms of making loans more accessible; and
- The effectiveness of associated support strategies.

Target markets

HNZC's target markets are those groups who are unable to obtain housing finance through mainstream lenders. These are defined as:

- First home buyers on modest incomes;
- HNZC market rent tenants wishing to buy a home;
- Multiple income households (such as Pacific Island families) wishing to buy a home; and
- Second chance buyers, such as those who have suffered a relationship breakdown.

Target markets are further defined by way of income and loan caps. Eligibility is limited to households with one or two borrowers with a combined income of NZ$55,000 or less. Where three or more borrowers are party to the loan, the maximum allowable income is NZ$100,000. These caps may be exceeded by up to 5% at the lender's discretion.

The maximum insurable loan is NZ$280,000, reflecting the lower quartile price of homes in the most expensive areas of the country. The lower quartile price range is assumed to be the level of the market that most modest income first home buyers would be happy to buy into. HNZC recognises that buyers in lower-priced areas will be able to buy better quality homes than those in high cost areas.

Credit criteria

To allow greater access to loan finance for aspiring home owners, the MIS allows mainstream lenders more leeway in the areas of **serviceability** and **deposit requirements**.

a. Serviceability

HNZC's servicing ratios are slightly more relaxed than those applied by commercial lenders on the basis that first home buyers on modest incomes do not need the same level of disposable income to live on as other borrowers. HNZC uses the Net Service Ratio (NSR) formula to assess the customer's ability to borrow. NSR must not exceed 95% and is defined as:

$$NSR = \frac{(MC + MLA)}{MNI} \times \frac{100}{1}$$

Where:
MC = Monthly Commitments
MLA = Monthly Living Allowance
MNI = Monthly Net Income

Monthly Commitments include:

- The loan sought calculated at an interest rate of 1.5% above the prevailing variable interest rate, unless fixed rate borrowing for terms of 3 years or more are sought, in which case the actual repayments are to apply for NSR purposes;
- Credit Card repayments calculated at the rate of 3% of the limit;
- All other loan repayments taken at the actual repayment amount.

The monthly living allowance plus loan servicing costs effectively determines loan eligibility relative to net income.

The NSR of 95% is higher than the industry standard of 90%. As an example of the maximum extra borrowing this can allow, with an income of NZ$55,000, a couple with two children is able to borrow an additional NZ$22,000 at current interest rates[8]. At the other end of the continuum, the effect on borrowing power is more limited, but the same family earning NZ$30,000 would still be able to borrow an additional NZ$12,000[9].

b. Deposit requirements

A view prevalent amongst lenders is that homebuyers who do not contribute personal savings to a purchase have less commitment to their homes than those who do. This is a tenet that HNZC wishes to objectively test. The MIS therefore caters for lending up to 100% of a property's value (i.e. no deposit) where the property costs $150,000 or less. For properties over $150,000, a 5% deposit applies, irrespective of location.

Creditworthiness

Eligibility is also determined by the client's credit history. The lender makes the final call on the decision to advance or decline the loan, irrespective of its eligibility for HNZC insurance cover. The reason for this is that the bank needs to be comfortable with the risk first and foremost, as it is the bank that has the relationship with the customer; mortgage insurance is simply the backstop.

Pre-purchase advice

High quality advice and support is to be provided to clients before obtaining mortgage finance. Many aspiring home owners fail to realise their goal due to the lack of useful information and advice available from lenders. This relates to more than just current interest rates and deposit requirements. First time buyers on limited incomes are often unaware of the complexities of finding and buying a home and the obligations associated with owning a home.

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[8] Kiwibank's floating rate at the time of writing is 7.2%.

[9] Note: These scenarios assume no other debts or commitments, which would rarely hold in practice.

HNZC provides a booklet designed especially for the target market. The lender provides advice to applicants by way of a dedicated call centre.

Post-purchase support

The standard approach to loan administration following settlement is to file away the deal (i.e. "set and forget"). Loan accounts are managed on a delinquency basis. For first time buyers, the propensity for problems is greater than normal due to their unfamiliarity with the extra costs of owning a home. HNZC's experience from its own previous and current loan schemes has been that the non-payment of local authority rates in particular is a major cause of default.

Under the MIS, the lender is contracted to closely monitor the status of insured loans, to ensure clients are coping with their commitments. There are dedicated staff keeping in regular contact with the new borrowers, with mechanisms for assisting them to cope with repayment problems. The lender is also expected to make proactive calls to clients in situations where they become aware of local circumstances that might affect borrowers' capacity to pay e.g. a large factory closing in a small rural town. This can be followed up with referral to relevant support in the local community, such as budget advisory services.

5. Choice of lender

The pilot scheme is run in conjunction with Kiwibank, a subsidiary of New Zealand Post Limited, which is a State Owned Enterprise. Kiwibank is a relative newcomer to the mortgage market, having been set up in 2001. The bank commenced operations in February 2002 and has a nation-wide network of outlets. It undertakes to provide the lowest residential mortgage interest rates in the country.

Kiwibank was chosen to work with on the pilot because of their target market, national distribution network and its target market which includes lower income households.

The MIS is governed by a Relationship Agreement rather than the usual Service Level Agreement, to reflect the pilot nature of the scheme. Loans can be issued and insured by the lender under an Open Policy arrangement, with all loans outside of Open Policy referred to HNZC for individual underwriting. Specific criteria are contained in a separate Credit Policy.

Kiwibank have branded the scheme as “Kiwibank In Reach” (KBIR).

6. Demand for the product

Activity since launch date

Given the pressure on Government to come up with "answers" to the problem for low income earners, HNZC officials considered there was potential for overload from any Government announcement about the programme. This proved correct.

The launch of the MIS was by way of Ministerial press release on 1 August 2003. This was followed by wide media coverage and a high degree of enthusiasm by those who had been unable to realise the "kiwi dream" of buying a home.

In the two months following the announcement, over 7,000 people contacted the Kiwibank call centre, causing major overloads. Application processing systems were also overwhelmed, and the average loan processing time stretched out to six weeks. Since then the number of calls has reduced to approximately 600 per week, and has remained steady since.

Figure 2: Level of inquiries and applications – to 30 April 2004

Application packs requested	16,047
Completed applications received	2,487

The MIS has clearly revealed a strong demand for some form of Government assistance for first home buyers.

7. Evaluation of scheme

Formal evaluation process

One of the objectives of the pilot is to assess what barriers people face when trying to access finance to buy a home. This is particularly important in an era when most banks are moving away from the shop front approach and into internet- and phone-based banking. HNZC has therefore engaged a research company to evaluate the pilot over four stages. The main areas of focus of the evaluation have been to identify and describe the experiences of and outcomes for clients (which includes those who just inquired about the scheme through to successful borrowers), and the factors promoting and reducing the scheme's effectiveness. Two of the four evaluations have been completed to date and some of the core findings are presented below.

8. Findings from evaluations[10]

Customers' experiences of banks

Our evaluations showed that the process of buying a home is a complicated and daunting experience for many first time buyers. The complications of the process are more difficult to navigate for people on lower incomes for whom technology-based options are foreign. Banks' systems in particular are designed for people whose loan applications are relatively "easy" to process i.e. higher income earners with clear credit records and a high degree of literacy.

Profile of a typical person wanting to access the MIS

The typical person wanting to buy through the MIS tends to lack financial astuteness, especially in relation to credit management, making them susceptible to private lenders (e.g. "instant cash" companies). They may have little or no experience of house-hunting or maintaining a loan and limited financial goal-setting ability. Some see a mortgage as a potential "millstone", particularly when they have had experience of being unemployed.

First time buyers often have little or no knowledge of the steps towards taking out a mortgage or purchasing a house. Many have often resigned themselves to being renters forever.

These factors contribute to making first home buyers less assertive towards banks, lawyers, real estate agents, vendors, and thereby more likely to miss opportunities through not following up after a set-back. They also have low service expectations, will accept delays and be less likely to ask for reasons or challenge when declined.

Overall, first home buyers are more likely to encounter difficulty in understanding application materials and want assistance to complete their application. In contrast, the research found "second chance" buyers to be more experienced, more assertive and far more able to negotiate the various barriers the process presents.

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[10] Conducted by Pam Oliver, Kate McKegg & Associates for HNZC.

The Kiwibank/customer relationship

Many inquirers identified benefits from having made an approach to Kiwibank. There was a sense of optimism and motivation to canvas potential for owning a home, along with better awareness of their own finances, including banking costs and spending patterns. People were also pleased to be given advice about the constraints they themselves needed to overcome to achieve home ownership, and how to go about it.

Applicants also claimed to have benefited from learning how to make an application, gained an understanding of the process and developed increased confidence in approaching real estate agents and other banks.

Service factors which people particularly appreciated were aspects of the application materials such as a sample application form, an application checklist, calculation table for loan affordability, and use of plain English throughout. Kiwibank personnel also helped with the finer details of the process e.g. calculating likely repayment amounts; advising not to sign an unconditional contract; the importance of consulting a lawyer before signing a contract; items to check when looking at a house; how to manage real estate agents; information to request from vendors, agents and lawyers.

Service levels

The positive aspects of Kiwibank's service were undermined to an extent by the long waiting and processing times caused by the initially high number of callers and applications. These problems have reduced over time as the backlog has been worked through and more efficient processes introduced. Future evaluations will review the service levels to ensure the new processes are working for the customers.

Who is being assisted?

The breakdown of loans advanced through the MIS is shown below. It demonstrates that the scheme is working most effectively for general first home buyers with little or no deposit. It has had least success for HNZC tenants and multiple income households.[11]

Figure 3: Uptake by target group - to 30 April 2004

Target Group	No. of loans	% of total
1a. General first home buyers - nil deposit	105	43%
1b. General first home buyers - deposit provided	137	57%
2. HNZC market rent tenants	3	1%
3. Multiple income households	1	0.4%
4. Second chance buyers	5	2%
All categories	**242**	**100%**

HNZC tenants

A survey by HNZC prior to the launch of the MIS indicated that 92% of its market rent tenants were interested in owning a home. In reality, despite being on an income that can support paying a market level rent, HNZC tenants are like other first time buyers in terms of their unhappy experiences with lenders and lack of self confidence, although to an even greater degree.

All HNZC market rent tenants would have originally qualified for a State rental on the basis of a high level of need. Despite an improvement in

[11] Note: The uptake by second chance buyers was not expected to be significant relative to the other target groups.

their income since then, many of these households have other issues that mitigate against a move out of State housing. Tenants cannot envisage a better situation and appear reluctant to leave that secure environment.

Specific points made to our evaluators by HNZC tenants included:

- A lack of role models – many come from families who have always rented – "It's what we know". These families live amongst other renters and don't know anyone who owns their own home;
- Lack information or education about how to acquire a home – "You're not taught in school about how to get your own home";
- Security of renting from HNZC – providing long-term tenancy, undertaking repairs reasonably quickly, and providing good quality housing;
- Affordable properties are low quality by comparison with State rentals;
- A desire to buy their State rental rather than move;
- Perception that they will never be able to afford their own home, together with a lack of an ethic of saving, resulting in a focus on short term gratification – "We probably could get the deposit, but we just bought our daughter a new computer instead";
- A desire for home ownership counselling courses.

Making home ownership a reality for tenants presents many challenges for HNZC. The aim of State housing is to assist tenants to stabilise their situations in good quality and secure accommodation. By definition, moving into private home ownership involves a leap into the unknown, especially when tenants cannot buy the property they are in, as many wish to[12]. This indicates that other incentives have to be considered to make any significant difference to the number of home loans to HNZC tenants paying a market rent.

[12] A Government moratorium on the sale of State houses has been in place since it took office in 1999, a move designed to halt the decline in the level of State rental stock since 1993.

Multiple income households

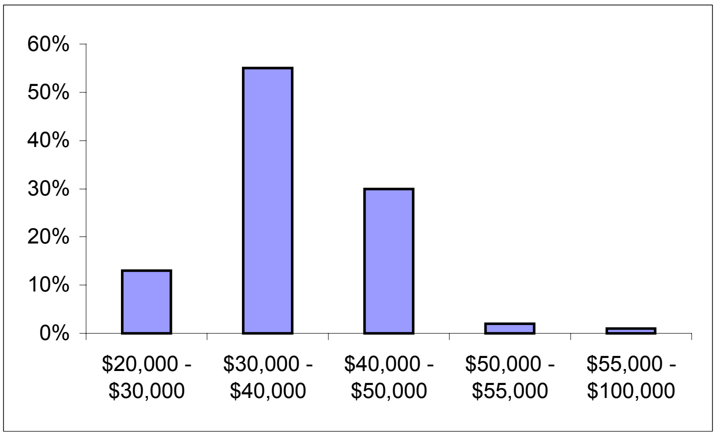
The provision for multiple income households was based on a perception that some cultures may prefer to live "multi-generationally", particularly Pacific Island peoples. This may yet prove unfounded.

Early indications from some Pacific Island people interviewed were that they lived with extended family out of necessity rather than choice. Observations were that Pacific Island families were keen to have more space for extended family, having lived in overcrowded circumstances previously. Many were married to palangi (i.e. Europeans) who preferred not to share a home with extended family. In particular, Pacific (and Mâori) people, together with people who lacked confidence or had literacy issues, said they preferred a face to face service in order to complete an application[13].

Demographics

Other characteristics of the client pool are provided below.

Figure 4: Borrowers by household income



The average income of borrowers under the MIS to date is $38,000. The lowest income recorded is $21,200.

[13] A pilot home ownership workshop programme aimed at Pacific Island peoples recently began in Wellington with this aim in mind. This programme is run by a Pacific Island trust. HNZC is also negotiating with another Pacific Island trust in Auckland to run a similar scheme. Auckland has the highest concentration of Pacific Island peoples in the world.

Figure 5: Household type and age of borrower for loans settled/insured to 30 April 2004

	Number	%
Household type		
▪ single borrowers	140	58%
▪ joint borrowers	101	42%
▪ multiple borrowers	1	<1%
Age of primary earner		
▪ 20 – 29	61	25%
▪ 30 – 39	97	40%
▪ 40 – 49	44	18%
▪ 50 – 59	14	6%
▪ 60 and over	1	<1%
▪ not provided	25	10%

Loans are distributed reasonably evenly around the country, but not in proportion to population density. There is a preponderance of loans in provincial centres.

A Typical MIS Borrower

Steve and Jane are a typical working family in their early 30s with three children. They live in a provincial town, with Steve working and Jane staying home to look after the kids. Steve earns $38,800 per annum.

Unfortunately, the family had been unable to save a deposit due to their limited income and had been renting since they left home.

When Kiwibank In Reach came along and the landlord decided to sell the home, Steve and Jane were given first option. As tenants in the same house for many years, the family had become quite attached to it.

They therefore approached Kiwibank and were approved for 100% finance of $65,000 under the MIS.

Steve says having their own home has provided balance in their lives. The family has gardening, redecorating and landscaping plans and are enjoying the new challenges these bring.

9. Kiwibank and the MIS

The MIS is structured on the same basis as a commercial LMI product, to ensure it can be implemented at minimum cost and inconvenience to the bank. Kiwibank's strategy in managing the MIS has proven extremely informative as a test case for extending the scheme to other lenders.

The high level of interest in the scheme prompted Kiwibank to run the MIS as a separate business group with its own freephone number and credit assessment team. This separation of KBIR customers out from other callers made it easier for Kiwibank to measure the cost of the scheme. It also enabled customers to receive more supportive phone support, while at the same time removing access to the bank's Home Loan Adviser network, and any opportunity for face-to-face advice. (Access to Home Loan Advisers is reserved for high value customers only, a practice common across New Zealand banks, not just Kiwibank).

Profitability

As noted in section 7 above, it has become very apparent that first home buyers require a higher level of support than the more bank-savvy refinance and "top up" clients, who represent the overwhelming majority of residential lending business for banks[14]. The profitability that banks are able to extract from most customers is enhanced by the marketing of credit cards, superannuation schemes and other products. These add-ons are usually not affordable to first time borrowers, many of whom just make the grade for a basic home loan.

The high level of support and lack of opportunity for cross-selling makes the KBIR business unprofitable in the short term, especially when the loan conversion rate per application is currently lower than expected (see Figure 6 below).

[14] There are no statistics captured on the amount of lending to first time buyers. However, anecdotal evidence suggests a figure as low as 5% of residential mortgages per year are to this market.

Figure 6: Activity level and conversion rate - to 30 April 2004

Applications received	2,487
Applications declined	1,291
Loans settled/insured	242
Conversion rate (received to settled)	9.7%

There is now a growing appreciation within Kiwibank that the issues raised through the MIS are not due to any inherent difficulties with the product, but the fact that Kiwibank, like other banks, is simply not used to dealing with first time buyers of modest means.

Recently, with the backlog being cleared and a slow-down in inquiries, the bank has begun incorporating KBIR applications back into its core business and improving its customer support processes. Callers are now pre-qualified more thoroughly by Kiwibank before an application pack is sent out. As a result, loan approval rates have recently started to climb as the quality of applications has improved.

10. Industry perspective

Other lenders have been interested in the scheme from when it started, and took the view that the MIS would provide an unfair advantage for Kiwibank, especially as it is a subsidiary of a State Owned Enterprise. That contention was somewhat misplaced, as the scale of the pilot is very small by comparison with the overall residential mortgage market[15]. Also, it is clear Kiwibank has taken a risk in becoming involved in the pilot, due to the possibility of negative publicity if it should prove to be unviable, something other lenders do not perceive.

HNZC has publicly announced it intends to open the scheme up to other lenders at the end of the pilot period, assuming it is successful and has the support of Government.

[15] HNZC expects to insure approximately $200 million of loans over the 22 months of the pilot. The size of the residential mortgage market in New Zealand is approximately NZD90bn and grew by approximately NZD13bn over the 12 months to April 2004.

Conclusions
11. Is the scheme working?

The MIS is testing a number of assumptions around the practicality of using a Lenders Mortgage Insurance product to improve access to finance for target groups. In doing so, HNZC is negotiating a range of unknowns. There are no absolute ways to define success with something as complex as the MIS. Whilst 242 loans settled over seven months does not look large, this has to be put in the context of a start-up operation and the lessons already learned from the scheme.

Level of interest

The 16,000 inquiries from prospective first home buyers confirms our view that the market does not cater for this customer base. Opportunities to maximise the business represented by this interest were not taken by Kiwibank because they were unprepared for the volume of demand. Calls to Kiwibank are still running at 600 per week, indicating that the MIS is responding to a need.

Administration cost per loan generated

The cost of running the operation can be calculated on a per loan basis. This includes HNZC's one-off set-up costs plus the ongoing administration costs of underwriting (excluding the mortgage insurance premium) and support, pre-purchase advice materials and post-purchase support. Projections are shown below and assume an expansion to other lenders at the end of the pilot period, with a stable throughput of 1,000 loans per annum.

Figure 7: Projections for insured loan uptake and cost

	Sept 03 – June 04	Sept 03 – June 05	Sept 03 – June 09
Number of insured loans	350	1,800	5,000
Average cost per loan	$4,000	$1,200	$900

HNZC believes this cost structure puts the scheme into perspective as an effective way of achieving the Government's objectives. These numbers will become more informative once the scheme has been in place long enough to experience claims. However, the ongoing pre- and post-purchase advice are aimed at minimising the loss ratio of the portfolio.

Premium cost per insured loan

An insurance option was initially approved by the Government as an alternative to direct lending. A comparison of the cost effectiveness of the two approaches is yet to be done in detail, but initial analysis indicates that the 2% premium subsidy per insured loan is substantially less than what might be paid by way of, for example, an equivalent interest rate subsidy.

For example, at present, an MIS premium subsidy based on 2% of the loan amount attracts an average one-off subsidy of $2,100. If an equivalent interest rebate of 2% were to be made available, the cost could be up to $13,650 for the same sized loan[16]. To that extent, the MIS represents an efficient use of funds.

Lender's administration cost per loan

Lower income first home buyers are not as easy for banks to service as existing home owners, and require more support to achieve a successful outcome. An internal review by Kiwibank has concluded that these applications are more costly to process to a successful outcome than standard business[17]. This is partially due to the high

[16] These scenarios assume the same loan size ($105,000) and an average loan life of 6.5 years. The two approaches affect different parts of the supply chain and so are not directly comparable. An interest rate subsidy changes the cost of the product by reducing the interest rate paid, but it doesn't affect eligibility criteria. The insurance option influences the eligibility criteria but does not change the cost of the product. A loan granted with an interest rebate will afford more protection to the borrower in the event of large interest rate increases.
[17] The actual costs are subject to commercial confidentiality.

level of interest in the MIS from people who were not ready to buy a home but who still had to be processed by Kiwibank.

Reaching target markets

Section 8 of this paper discussed the profile of people inquiring about and accessing the scheme. In terms of the types of clients assisted, two of our four main groups are well represented. More work is being done with multiple income households and HNZC tenants.

The relatively low quantity of loans generated is in part due to the size of the eligible population that fall within the income caps. Initially, it was decided to apply relatively tight income caps (i.e. $55,000) to test the market and to ensure the premium subsidy available from Government was not overspent. The income caps have the effect of creating a band within which applicants have to fall to be considered eligible under the scheme.

At the bottom end of the scale, it has meant that households on benefit incomes are mostly unable to borrow enough to buy a home (i.e. those earning less than $25,000 p.a.). However, while the average income of borrowers of $38,000 shows that the scheme is helping some working families, the question being considered at the moment is whether this average is too low, hence the relatively low number of loans. This would require increasing the upper limit to capture more of the target market.

12. Future directions

The MIS live pilot has another 12 months to run. In that time HNZC expects to make more changes to various aspects of the scheme and to complete two more evaluations. Some of the areas we will be looking to enhance are summarised below.

Providing increased support for first home seekers

On the evidence to date, it would appear that first home buyers need more support than is currently made available. Further work is being done on this, including development of home ownership workshops for prospective buyers. These would provide education on budgeting, reducing debt, the obligations of owning a home, and the process of getting a loan and buying a property.

Improving the cost ratio for the lender

This business is expensive for the lender to process, even with a phone-based service. As well as education and support options, addressing this will involve HNZC and Kiwibank co-operating on a combination of strategies:

- Improving the marketing of MIS to reach people who are both in the target groups and either able to, or in a position to, seriously consider buying a home;
- Revising processes at the bank to facilitate applications more effectively;
- Improving the ability of people to self-assess before making an application.

Reviewing client data and credit criteria

The MIS was not originally intended to cater for those living in higher priced markets, such as the large urban areas. Rather it was aimed at people living in provincial and smaller centres where regional deposit requirements discriminated against those with little savings power. There has however been strong demand from first home buyers in the main urban areas. Whilst these households tend to have a higher average income than in other parts of the country, this higher earning power does not make buying a home any easier, especially with the 5% deposit requirement.

In view of this, HNZC is considering the viability of modifying the deposit and income parameters to make the MIS more accessible for those in higher priced areas. Such a move will not be taken lightly, as it entails a change of focus away from assisting those at the margins to subsidising relatively well-off households.

Aside from the long term sustainability of the insured loans, a major test for the pilot will be other lenders' desire to participate in it and the Government's willingness to extend it. The ultimate goal is to bring about a greater focus on first home buyers by lenders and mortgage insurers in general.

Key acronyms

HNZC	Housing New Zealand Corporation
KBIR	Kiwibank In Reach
LMI	Lender’s Mortgage Insurance
MIS	Mortgage Insurance Scheme