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Take cover
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Buying your first home is a steep learning curve. One of the biggest shocks is often the realisation that lenders' mortgage insurance is there to protect the lender, not you.

A recent survey by direct home lender MyRate found that one in six people believe lenders' mortgage insurance will cover their repayments if they become unemployed. That is not the case. Such policies are designed to ensure lenders get some or all of their money back if for any reason you default on your loan.

Kevin Sherman, managing director of MyRate, says: "If you can't make the repayments, the lender can claim on the insurance if your repossessed home fails to recover the full amount owed when it's finally sold. It does not cover the borrower in any way if they are unable to meet their repayments due to ill health or being out of a job."

With loan defaults on the rise, he says some people could be in for a surprise.

Ian Graham, the chief executive of PMI Mortgage Insurance, reports that a higher percentage of loans in default now lead to a claim by mortgage lenders. "In a forced sale situation the average claim is $80,000 but at the low point about four years ago [they] were running at $20,000 a claim."

Home buyers are typically required to take out insurance if their deposit is less than 20 per cent of the property's purchase price, even if you have a good credit history. If you have a poor credit history you may be required to get cover regardless of your deposit amount. Graham says the premiums are determined by the loan-to-valuation ratio, the size and type of loan and the borrowers' credit worthiness.

For example, someone borrowing $300,000 for a house valued at $330,000, giving a loan-to-valuation ratio of roughly 90 per cent, would pay a premium of 1 per cent, or $3000 plus stamp duty.

You pay more if you take a low-doc loan, usually available to self-employed people who are unable to provide up-to-date financial information, because they represent a bigger risk for the mortgage provider.

Unlike other insurance premiums, the lenders' cover is paid for in full at the time of purchase and is typically added to the loan amount and paid with your regular mortgage payments. But as with all other insurance, you won't get any of your premiums back, even if you make all your loan repayments.

Sherman has noticed an increase in the number of home loan applications knocked back because the borrower is unable to obtain lenders' cover, indicating that insurers are tightening their criteria.

Graham says PMI has done some "fine-tuning" of its pricing. "We've been looking closely at the type of business offered. Three per cent of the lowest quality loans contribute 30 per cent of claims, so we've made changes to our underwriting," he says.

Hence, low-doc loans with a 70 to 80 per cent valuation have seen a premium increase of 30 per cent. Cover is not available for low-doc loans with a ratio of more than 80 per cent. There has been no change in pricing for standard loans or for low-doc loans with ratios below 70 per cent.

Despite the increase in home loan defaults, and a higher proportion of defaults leading to repossession and sales, Graham says the numbers are still about the long-term average.

"With two interest rate increases this year, we expect to see further increases in defaults and claims," he says. Even so, PMI has more than a million loans insured in Australian and New Zealand, with only 0.3 per cent, or 3000 loans, being 60 days or more in arrears.

"That is a satisfactory level of defaults," Graham says.

In comparison, defaults in the US are 10 to 12 times higher on standard loans and 30 to 40 times higher on low-documentation loans.

INSURANCE PRODUCTS TO PROTECT YOU

With home affordability at record lows and interest rates on the rise, financially stretched home buyers may decide they need to protect themselves against any future loss of income.

Income protection insurance will cover mortgage repayments if you become ill or injured and can't work for a time but the cost is generally out of the reach of the people who need it most.

There are other insurance products for people taking out mortgages.

Australian Life Insurance has three products that provide mortgage protection, sold through a network of 4000 mortgage brokers.

Its head of distribution, Brian Pillemer, says the three products are essentially a life insurance product that you can take out as part of the home loan application process but they are not tied directly to your mortgage. So when you make a claim, the payout does not have to go towards your loan.

For example, the Loan Protection Plan covers you for serious cases such as cancer, stroke and heart bypass as well as terminal illness and death. You designate the amount of cover you want and you remain protected as long as you continue to pay the monthly premiums. You are not covered for unemployment.

The cost will depend on your age, gender and whether you are a smoker. For example, a non-smoking 35-year-old male pays a monthly premium of $16.70 for each $100,000 of cover, while a smoker would pay $29.03. A 35-year-old female would pay $13.98 and $20.42 a month respectively. If you become seriously ill, you can claim up to one-third of the policy amount, while the remainder is payable on death. If you become terminally ill, you can claim the full amount.

Most of the big bank and insurance company lenders have some form of mortgage protection insurance but the type of coverage and the cost vary.

Some policies will cover you for unemployment but there are lots of exclusions and they can be expensive.

For example, many building societies and smaller lenders have consumer credit insurance linked to your mortgage. These typically pay out in the event of death or make payments for a few months if you are made redundant or disabled.

Most provide only five years' cover with five years of premiums added to your loan at the outset, attracting interest for the full term of your loan. This can prove costly if you have a 20- or 30-year loan.