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Royal Commission into Miscount in the Banking,
Superannuation and Financial Services Industry

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FBAA Draft Preliminary Submission for the Royal Commission (RC)

The FBAA, as the leading national professional industry association to finance and mortgage brokers which represents over 8,000 members and in excess of an additional 12,000 industry stakeholders, welcomes the invitation to make a submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

This submission is made in response to the letter dated 15 December 2017 inviting the FBAA as a representative body to provide an early written submission. The submission is based around a discreet set of questions framed in the letter. As far as possible, we have endeavoured to follow the framework provided, however we also believe it is necessary to introduce some additional matters for consideration which the framework may not have otherwise elicited.

We are also proceeding on the basis that this submission is a preliminary submission and that the FBAA will be provided with the opportunity to make a further submission on other material matters at a future time.

The structure of this submission
The FBAA offers an opening statement in which we provide our views on a range of issues that relate to the structure of the Australian Banking system and the dynamics that shape behaviours and issues.

Responses to the question posed in the invitation letter
Secondly, the submission provides our responses to the questions posed in the invitation letter of 15 December 2017.

Other issues and concerns
The third and final part of our submission identifies other issues and concerns that we believe must be taken into account as part of the Royal Commission. This third part only introduces these issues at a high level on the understanding that there will be further opportunities to make submissions to this Royal Commission.

Opening Statement
The FBAA recognises that Australia has a strong banking system which in no small part has come about because of the rigorous controls and barriers to entry surrounding banking services in Australia. However, the four pillars policy, while providing strength and stability in Australia, has also supported the evolution of models, practices and attitudes that may no longer be serving mainstream consumers' best interests.

The models, practices and attitudes which concern the FBAA include:
- Vertical integration
- Sales before service mentality
- Cross-selling and upselling
- Volume and target-based remuneration
- Disproportionate spending on compliance relative to business development and sales;
- Power imbalance between product development and sales and compliance
- Abrogation of responsibility by banks – shifting regulatory obligations onto intermediaries
- Pressuring intermediaries to follow specific practices imposed by lenders

Vertical Integration
Banks are the most well-capitalised entities in the Australian economy. As banks have grown and strengthened their position, largely free from competition, they have expanded their activities into other areas including provision of financial advice and other products.

A significant difference between bank and non-bank providers is that bank providers exist primarily as a distribution channel for their own products.

Banks have been able to ignore competitor products when providing credit and financial advice to consumers under the guise of risk management, claiming a restricted/approved product list that only includes its own products limits the risk of poor advice or must be maintained in order to adequately monitor its large network of representatives. In actuality, this is an entrenched conflict of interest that ensures consumers cannot receive the best advice (unless the relevant provider just happens to have the best or most suitable product for the consumer's needs).

The approach taken by regulators until now has been to accept this entrenched conflict of interest and instead focus on the activities of smaller independent licensees. This has placed additional pressure on non-bank licensees which escalates their compliance costs and increases the regulatory burden around providing advice, disclosure to consumers and

record keeping. Where a bank can recommend a single product from its limited suite of products using highly formulaic disclosure and advice documents, non-bank providers are required to research the market, maintain copious records to justify the advice provided and face regular criticism over conflicts of interest.

We see this most clearly in the consumer credit marketplace where a major bank will only ever offer a consumer its own products, will never inform a consumer about better alternative products offered by other issuers and will never contact an existing customer to renegotiate an existing contract. If that same set of behaviours were modelled by a non-bank broker, they would be accused of breaching the conflicts of interest provisions or failing to act in the client's best interests. The cost of defending such charges even if successful, is very high on small businesses.

The other less frequently acknowledged impact on non-bank licensees is that they are required to obtain more information from consumers before recommending particular products to support the recommendation. Banks typically request less information. Banks claim to have sophisticated processes and access to data which reduces the amount of information they must seek from a consumer before processing a loan application. In many cases this is not true. Banks are not undertaking the level of inquiries that non-bank providers are expected to undertake.

This creates a perception at consumer level that direct channels are easier to deal with because they ask for less information upfront. This exacerbates the impact of the higher regulatory burden borne by non-banks.

The required response for this is that regulation of licensees must be more consistent across the entire marketplace. Consideration should be given to whether the lack of prescription in the legislation has allowed banks to exploit their size and market position which impacts consumers and diminishes competition.

Sales mentality and cross-selling
For many years banks have operated remuneration models based on volume of sales and cross-sales. They have maintained these models despite all of the work being undertaken by regulatory authorities and Government to limit adverse consumer impacts of volume-based sales practices, cross-selling and upselling.

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Where an independent financial planning licensee recommends a similar investment methodology and group of products to numerous clients they are accused of running a cookie-cutter model. The implications being that the licensee will recommend their products or strategies to all clients regardless of suitability[1]. Banks are able to institutionalise this approach and profit from it.

Treatment of third parties with which banks deal and from which banks derive significant benefit

Brokers and other service entities that work with banks provide an invaluable service to consumers. Whilst is it true that brokers could not exist without banks, brokers also provide a valuable service for banks by being the frontline face the consumer deals with. In exchange for upfront remuneration and a moderate on-going trail, banks receive increased volumes of consumer business in products that pay them substantially more than it pays the brokers. It is therefore in their interests to continue with the broker model. Brokers increase exposure of bank products to consumers outside of the direct marketing channels.

Because brokers are so dependent on bank permission to submit deals, banks dictate the terms on which brokers and other service providers engage in their activities.

For structural reasons we identify in this submission, banks have historically avoided the consequences of others breaching legislation even where such breaches are incentivised and/or dictated by the banks.

Our submission mentions abrogation of responsibility. We provide two examples in support of this notion.

A typical response from the banks when ASIC emerges with new guidance about the expected behaviours and conduct of licensees is to impose additional requirements on brokers. A recent example is the Government and regulator's focus on interest only lending. Banks were forced to reweight their exposure because of changes to the capital adequacy rules for interest only loans. Some lenders also introduced additional obligations on brokers such as a requirement to complete detailed questionnaires to accompany interest only loan applications which amounted to a broker being required to "certify" that the consumer fully understood the implications of an interest only loan and the long-term impact of it.

Consumers reported finding the questions intrusive and impractical. Brokers report having to fill out yet another piece of paper solely to discharge the lenders' perceived obligation to

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[1] 14-154MR ASIC suspends AFS licence of Financial Technology Securities Pty Ltd. Only a small percentage of clients received the advice that was the subject of this action.

have something on file to justify the basis of the lending decision. Brokers already have detailed discussions with clients about their needs and objectives and note it in the consumer files however banks direct brokers to exclude this information from the applications. The banks' knee-jerk reaction to areas of concern noted by ASIC usually translate through to banks loading further obligations onto brokers.

Another example was a lender demanding a broker certify the mental fitness of a consumer applicant after the consumer claimed to have been heavily medicated and receiving treatment for mental disorders at the time of applying for a loan which caused them to have diminished understanding of their obligations under the mortgage. The broker duly notified the lender who promptly stated it would withdraw the offer of finance unless the broker would certify mental fitness of the consumer. The broker was not qualified to do this and the lender cancelled the offer of finance through the broker. The consumer went directly to the lender several weeks later and successfully applied for a mortgage. The lender excluded the broker from the deal.

Our submission also identifies as another practice, lenders imposing rules and requirements on brokers where meeting such requirements potentially causes other entities to fall short of full NCCP Act compliance as it is enforced by ASIC. An example of this is banks and their loan application portals. Each bank portal is different and requires brokers to submit different information, in different formats for each lender. Some lender portals artificially restrict the amount of information that brokers can lodge with an application which can include limitation the amount of financial information about the consumers, redacting certain information from financial records where the lender only wants proof of address or proof of income but not information about expenses. Brokers cannot submit a deal unless they comply with the conditions. ASIC has assessed the completeness of broker applications by taking the information from lenders - failing to recognise that the lender application may only contain a portion of the information collected and assessed by the broker. In such cases, ASIC generally imposes tougher sanctions on brokers than they do on the lenders that cause the behaviour.

Clawbacks are used excessively. Brokers cannot be accountable for the choices a consumer makes after they have provided their services and assisted them to find a loan. We recognise that credit providers need to protect themselves from unscrupulous practices but clawbacks are currently wielded as a front-end tool where as soon as a consumer takes action within a

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certain timeframe, any remuneration paid to a broker for work previously undertaken is stripped away from them.

This practice is uncommercial and creates a dynamic within the marketplace where the behaviour of intermediaries is modified by fear of clawbacks – performing a lot of work and ultimately not being paid.

The relationship between banks and broker
Anecdotally, the relationship between banks and other third-party service providers is likely to be similarly imbalanced. Not all of these relationships are broken or need to be examined however we believe it is critically important the Royal Commission is receptive to submissions from third party service providers and the impacts the power imbalance has on their ability to offer goods and services to consumers free of undue influence from the product providers. The additional pressures of regulation of service providers independent from the regulation of the banks places third party providers in a position where they face difficulties complying with expectations of regulations and demands of banks. Faced with choosing between the two, third parties ultimately choose to stay in business and acquiesce to the demands of the banks while running the risk of possible regulatory intervention if they are unfortunate enough to be identified by ASIC for audit and if at that time they are unable to satisfy the regulator that they are complying with their obligations.

The Commission will also have regard to the fact that some third-party providers may be uncomfortable providing full and frank information to the Commission for fear of repercussions. No amount of protection will provide reassurance to providers who recognise that providing information to the Commission may cut off their pipeline of work.

Bank Accountability
Perhaps one of the most relevant issues is to whom the banks are accountable.

It is clear banks believe that first and foremost they are accountable to shareholders. This of itself leads to behaviours that impact their integrity and cornerstone position within the economy and community. The growth and profit mentality overrides the good corporate citizen and model behaviours.

The degree to which previously principles-based legislation such as the Corporations Act and NCCP Act has become increasingly prescriptive is largely as a result of large organisations behaving in ways that produce consumer outcomes that are inconsistent with the principles

of consumer protection frameworks. Our banks should be first to comply with the spirit and intent of the law and yet they are often the last and most reluctant to move. Banks often deflect attention away from themselves by shifting blame to other entities where they create the environments that cause others to behave in certain ways.

Banks are very slow to change their approach. They will claim to regulators and public they are moving quickly but take years to move away from poor practices. We cite, as examples, the ASIC action against BOQ in 2015 for failure to comply with rules introduced in 2010, large institutions are still not making reasonable inquiries into consumers' financial position despite litany of outcomes by ASIC against smaller participants over responsible lending breaches from 2012. Banks continue to manipulate the prohibition against automatic credit card limit increase offers where it has been clear for significant time that such offers are not in consumers best interests and must cease.

Industry would like to see greater accountability of banks for their conduct. Banks should be at the forefront of change and the most well-informed about their regulatory obligations and yet they continue to engage in questionable behaviour so long as it is profitable and until pressure builds to the point of making them act. The inconsistency of regulation and imposition of penalties against large versus small to medium entities exacerbates problems with a competitively neutral market – and consumers interests are best served in a competitively neutral market.

Often when banks relinquish ground, they will claim accolades for the behavioural change. Several examples we provide in support include dropping ATM fees and ceasing to fund payday lenders back several years ago. Banks were content to conduct business with the sector but then, as a collective, moved to cut ties with the payday lending industry as it became maligned, such decision being run in the media headlines as banks exercising social conscience.

Banks are able to intimidate regulators – for example claiming to be able to acquire detailed information about a consumer's financial circumstances that exceed their NCCP Act obligations and allow them to make lending decisions with little apparent inquiry, refusing to disclose the specifics on the grounds of claiming commercial sensitivity. Meanwhile smaller players are required to obtain large amounts of information to demonstrate compliance with the law and cannot pretend to have sophisticated systems and access to data that is not available to others.

This of itself creates impressions with consumers that it is easier to deal with the big banks because they don't ask for as much information. In many cases the banks are merely shirking their regulatory obligations but have little fear of it being uncovered. This ability to intimidate regulators gives banks a genuine commercial advantage even though it is often based on non-compliance with obligations that all other licensees are required to follow and aggressively punished for non-compliance.

Even where standards are found to be below what's expected, banks have been able to head off significant regulatory outcomes and costly compensation programs by changing their practices[2]. Even recent outcomes against one major bank suggest this is still occurring[3].

The proportionality of financial penalties should be reviewed. It is rare that banks face financial penalties as large as much smaller businesses however, even the largest financial penalties are insignificant to large financial institutions whereas small penalties hurt small businesses. The penalty regime should be revisited to ensure small businesses that make mistakes can learn from their mistakes, pay their penalties and continue to operate. Large institutions can wear large penalties. We point to the recent CBA share price recovery despite the fact they are facing a fine that could exceed one billion dollars. The market clearly anticipates the penalty will be much lower than the maximum and that it will have negligible impact on CBA. Such outcomes provide no disincentive to major banks from engaging in such conduct. In contrast, fines and remediation programs for smaller licensees can often amount to proportionately significant amounts. The recent action against Thorn group appears to have resulted in fines and compensation that equates to approximately 15% of its total market capitalisation.

FBAA Product Concerns
The FBAA has long held concerns with offerings of lenders mortgage insurance ("LMI") and credit cards.
LMI

There are only two LMI providers in Australia. They are highly reliant on their relationship with banks since banks require consumers takeout LMI over certain lending thresholds. LMI is insurance for the lender and not the consumer, although it is regularly mis-sold or misunderstood as consumer insurance.

Next to stamp duty, LMI often represents the largest cost to consumers when purchasing a property and taking out a mortgage. LMI is anchored to the credit facility and not the

[2] 15-125MR ASIC concerns prompt Bank of Queensland to improve lending practices

[3] 18-013MR ASIC acts against ANZ for breaching responsible lending laws in its former Esanda car finance business. In contrast to BMW's $70+m compensation program and other outcomes against Cash Converters and Thorn Group (Radio Rentals), the ANZ outcome appears extremely small.

property or the consumer. Issuers claim that LMI has no portability, meaning that if a consumer wishes to refinance their existing property into a more competitive product, they must re-purchase LMI. This eliminates any benefit they might receive from switching products and diminishes real competition since issuers are well aware that many consumers cannot afford to switch products because of the LMI impact. LMI may also contribute to reckless lending decisions where an issuer knows any shortfall between the equity in a property and the loan will be covered by LMI.

LMI is the single largest reason consumers are not free to refinance on a regular basis. Home loan exit fees which the banks ceased charging some years ago with much fanfare from ASIC as a victory for consumers were only a few hundred dollars whereas LMI runs into the thousands.

LMI is a product created by closed-shop relationships between banks and LMI issuers. It offers no benefit to consumers, is mis-sold, diminishes consumer flexibility and competition.

We support eliminating LMI altogether. Credit providers are adequately capitalised to self-insure. LMI, paid for by the consumer, should not be used as free gap-cover for excessive LVR lending.

In the alternative to eliminating LMI, the product should be made portable and the cover should have strict controls around the speed with which the insurance loses value. For example an issuer should not be able to claim a large percentage of the cover is lost in the first 12 months such that a consumer looking to refinance to a more competitive loan is told the residual value of their LMI policy is negligible therefore a refinance will see them incur almost 100% repurchase cost.

This issue intrudes into the current Royal Commission because the product is created by the power imbalance of banks, adversely impacts consumers and the housing market and we submit would not exist in a fair marketplace.

Credit Cards
The information considered by card issuers prior to making a lending decision still appears to sit largely outside the scope of responsible lending in the issuers ask for very little and in some cases no information about a consumer's needs and objectives or their financial situation before making a credit decision although they are subject to the same obligations as other credit products.

Cards are issued with minimal inquiries. Credit limits are never reviewed downwards and many consumers are in deep financial difficulty because of it.

The fees and rates of interest charged on credit cards are egregious. Interest rates have no correlation with cost of credit which is evident from the fact of rates not moving when official cash rates do. Rather than limit charges or put pressure on issuers to constrain credit card lending, issuers were required to include additional disclosure on card statements telling consumers how long it would take to pay off the card if they only pay the minimum each month. This is an example of where the behaviour of charging excessive rates has been recognised as causing consumer harm but rather than stop it, issuers have been able to continue and simply disclose to consumers how much they are hurting them - knowing that this type of disclosure has minimal impact on consumer behaviour.

Conclusion of structures causing poor quality outcomes for consumers and intermediaries
The effect of the behaviours identified above is that large institutions operate in an environment where they are able to:

- risk poor behaviour because the financial risks of penalties is not material;
- push many of their obligations onto other parties who are dependent on a positive relationship – such as brokers
- offer small concessions to quieten down regulatory scrutiny and public backlash (e.g. ATM fees and home loan exit fees)

These dynamics lead to poor quality products and poor practices. Until the penalties for non- compliance are material, banks will continue to game the system, push the boundaries of product innovation and deliver less than ideal consumer outcomes in return for maximising growth and shareholder returns.

Part 2

FBAA's response to the invitation to make an early written submission to the Commission on certain matters.

We repeat the Royal Commission's questions below. Rather than answer each individually, we provide a response at the end that responds to each of the questions.

1. Excluding cases of theft from member entities, has the body identified or become aware of any misconduct by member entities (including directors, officers or employees, or by anyone otherwise acting on their behalf) which occurred at any time since 1 January 2008?

2. Has the body identified or become aware of any conduct, practice, behaviour or business activity engaged in by member entities (including directors, officers or employees, or by anyone otherwise acting on their behalf) since 1 January 2008? If so, what was the nature, extent and effect of that misconduct?

3. If yes to either or both of questions one and two:
   (a) *Is the identified conduct, practice, behaviour or activity the subject of another inquiry or investigation, or a criminal or civil proceeding?*
   (b) *Does the body attribute any of the identified conduct, practice, activity or behaviour to broader cultural or governance practices in the relevant industry or sector of the relevant industry? If so, describe those cultural or governance practices.*
   (c) *Does the body consider that the identified conduct, practice, behaviour or activity results from other practice (including risk management, recruitment or remuneration practices)? If so, describe those practices.*

FBAA response
The FBAA has an internal professional standards committee and a ACCC approved Disciplinary Tribunal. Very few matters of misconduct are brought to the FBAA and the number of cases brought to the committee for all issues including professional standards and disputes is between two and six each year. The low number and broad variety of issues that come before the professional standards committee do not lead us to conclude that there are any systemic practices, behaviours or business activities engaged in by member entities which we are able to report. Most matters which come before the professional standards committee relate to fee or interest rate disputes or breaches of our code of conduct.

The FBAA works closely with ASIC and refers matters to the regulator where appropriate. One of the rare examples of this happening in recent years was the referral of a matter which involved a member entity engaging in activity which we suspected was phoenix activity. This matter was referred to ASIC for further investigation.

In most cases, the FBAA becomes aware of misconduct matters involving members only after ASIC has taken action and the outcome of that action becomes public. In addition to other sanctions imposed by the regulator or the courts, the FBAA takes steps to expel such members from the association.

As a consequence of not being aware of misconduct or poor conduct, practices, behaviours or business activities engaged in by member entities except in very isolated instances, we have little direct information to provide in response to the questions put by the Royal Commission.

The FBAA can point to practices that existed prior to the commencement of the National Consumer Credit Protection Act and which ceased in the years following its implementation as examples of the types of practices we would have raised in response to these questions. Whilst they continued beyond 1 January 2008 it has been a number of years since they were an issue.

Broker Accreditation Practices

Banks require mortgage brokers to be “accredited” before they can recommend the bank’s products and submit deals. To be accredited, banks required brokers to participate in an accreditation program for which brokers were usually charged a fee. To maintain accreditation with a particular bank, brokers would need to submit a minimum number of loan deals in each quarter. Each time a broker did not submit enough deals, their accreditation was suspended and they would be required to be re-accredited and pay another fee. In some cases, re-accreditation involved nothing more than paying another fee to the bank.

For some issuers, the number of deals required to be submitted was significant. The issuers knew that brokers that only submit a small number of deals each month would struggle to submit enough deals with each major lender to maintain their accreditation with each, therefore the practice ultimately caused some brokers to have to choose which lenders to submit deals to. Alternately, brokers on the threshold of meeting a quota to retain accreditation would have been influenced to remit their next loan deals to that particular lender to preserve their accreditation. This practice created a conflict of interest and was anti-competitive. It diminished the ability of affected brokers to be truly independent.

Bans were aware of the practice and of the position it put brokers in. Banks were also aware the NCCP prohibited the conduct yet the practices continued well beyond the introduction of the NCCP. The brokers bore the brunt of the regulatory risk in that they were powerless to defend a challenge by ASIC if ever accused of being conflicted. Banks were able to deflect regulatory action by claiming the accreditation practice was necessary to ensure brokers had adequate product knowledge of their products to be able to recommend them to consumers. This was a thinly veiled argument.

The scope of the questions in this invitation to make an early written submission potentially excludes other information we consider relevant for consideration as part of the Royal Commission which is why the bulk of our submission is included in the first part of this paper.

Issue relating to limitation of scope of the Royal Commission

We note the inquiries to be made by the Royal Commission relate to financial services entities. We are concerned that the definition of financial services entity in the Terms of Reference excludes credit licensees. The definition includes entities that hold an Australian Financial Services Licence and also includes a person or entity that acts or holds itself out as acting as an intermediary between borrowers and lenders (i.e. mortgage brokers). Excluding credit licensees potentially excludes some large, second-tier (non-bank) lenders that play an important role in the financial services industry.

We feel it is important at this early stage to question the scope and encourage the Commission to consider whether excluding credit licensees has potential to unreasonably limit the scope of the Royal Commission or exclude potentially relevant and important parties in the non-bank lending sector.

End

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We look forward to providing further input into the matters for consideration before the Royal Commission during the year.

Yours faithfully

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