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26 October 2018

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

Dear Commissioner Hayne

Re: **Submission to the Interim Report prepared by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry**

1. This is a submission in response to the Interim Report (the **Interim Report**) prepared by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the **Commission**) dated 28 September 2018.

2. Connective is Australia's leading home loan aggregator with approximately 3,500 individual mortgage brokers holding Connective membership. This represents approximately 20% of all home loan mortgage brokers in Australia with 1 in 9 home loans being written by a Connective mortgage broker. Membership with Connective provides mortgage brokers with access to the 56 lenders Connective has on its panel.

3. Connective sits in a unique position where we see the daily efforts mortgage brokers take towards providing a valuable service to their customers and achieving good consumer outcomes for these customers, whilst remaining compliant with applicable laws and regulations and individual lender requirements. We also see the remuneration they earn, understand how hard mortgage brokers work for a customer in order to earn that remuneration, the relatively low levels of misconduct within the industry and that the existing value-based remuneration structure is not the main reason behind the cases of mortgage broker misconduct we identify.

4. This submission will only respond to the issues raised in the sections of the Interim Report regarding mortgage brokers and aggregators in Consumer Lending.

The importance of the mortgage broking industry

5. Mortgage brokers play a critical role in the Australian home loan market with 55.7% of all residential home loans in the September quarter 2017 being settled by a mortgage broker. This represents substantial growth from the market share of 33% in 2012 (based off industry surveys). Of those residential home loans settled by mortgage brokers:

   - 3 out of 10 were arranged for consumers in regional and rural areas;
   - 9 out of 10 customers were satisfied with the services provided; and
   - 23% were first home buyers.[1]

6. In 2016-17, the average mortgage broker had access to loan products from 34 different lenders and used on average 10 lenders on their panel to settle loans based on a customer's choice, financial circumstances, needs and preferences.[2] This has driven

[1] Deloitte Access Economics report "The Value of Mortgage broking" dated July 2018.
[2] Deloitte Access Economics report "The Value of Mortgage broking" dated July 2018

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competition in the home loan market, allowing new participants to compete with the incumbents who previously relied on an extensive physical branch network.

7. Consumers have benefitted from this increased competition through greater product selection and more competitive pricing. Net interest margins for banks have fallen by over three percentage points over the past three decades with the greater competition generated by mortgage brokers a key contributor.[3] The Productivity Commission noted the distribution of home loans through brokers has, on average, increased smaller lenders' market shares by 1.55% points. *"If mortgage broker services were not available, these [smaller] lenders would on average, need to have an additional 118 branches each in order to maintain their current market shares."*[4]

8. With their market share continuing to increase, it is evident that the service mortgage brokers provide customers is valued and that, at least in the eyes of the customer, and the way mortgage brokers are remunerated is not adversely impacting the service they are providing. Any fundamental change to the structure of mortgage broker remuneration could substantially affect the viability of many mortgage brokers, which in turn would destroy a lot of the benefits they have brought to consumers and the home loan industry.

Mortgage brokers are not introducers

9. The commentary in the Interim Report refers to the term "intermediaries" which includes both mortgage brokers and introducers. It is important that the Commission appreciates the distinction between the two.

10. Introducers are what their name suggest – they refer a home loan customer to a lender and are paid a commission if that customer settles a loan with that lender. They do not provide any service to the customer and are not required to be licensed with ASIC.

11. The function of a mortgage broker is entirely different. Mortgage brokers provide an actual service to customers. A mortgage broker must understand their customer's needs and requirements, recommend a product that is not unsuitable for that customer and prepare a preliminary assessment regarding that recommendation.[5] As part of its preliminary assessment, Connective requires its mortgage brokers objectively compare at least three different lenders/products, where possible, before making their recommendation.

12. Other key services a mortgage broker provides include assistance with customers who are time poor; financial literacy (navigation through what can be seen as a complex process) and knowledge of products and lender policy which the customer may be unaware of.

For whom does the mortgage broker act?

13. Connective is surprised that the Commission believes there is uncertainty as to who a mortgage broker acts for. We cannot understand how the Commission believed that there is a possibility that the mortgage broker represents, or is seen to represent, the lender.

14. From a mortgage broker's or an aggregator's perspective, a mortgage broker acts for the

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[3] Reserve Bank of Australia (2017), Submission to the Productivity Commission inquiry, September 2017, p 14.
[4] Productivity Commission, Competition in the Australian Financial System – Inquiry Report, pp 312-313
[5] Section 115, *National Credit Consumer Protection Act 2009* (Cth)

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customer. We believe lenders would give the same answer. We struggle to see how a mortgage broker with the ability to submit loan applications to numerous lenders could be seen by a consumer to be "*the face of the lender*" – as opposed to an introducer, who has an arrangement with only one lender.

15. This position is further reinforced by the documentation a mortgage broker provides its customers – these clearly identify that the broker is working for that customer. To eliminate any possible doubt in a customer's mind, Connective will be updating its template Credit Guide (NCCP prescribed document) to expressly state this.

16. Regarding the evidence around CBA's broker accreditation program and that a broker was required to settle a certain number of loans with CBA in order to retain their accreditation, we strongly disagree with the inference the Commission made in the Interim Report that "*in the eyes of at least some lenders, the broker's task is to sell that lender's products*".

17. We commonly see lenders require brokers undertake regular training to remain current with their policies and procedures. It is fair for a lender to assume that a mortgage broker who has not submitted loans for a period of time would not be proficient with that lender's current policies. Many lenders will turn a broker's accreditation to inactive until refresher training is completed. We see this as the reason behind CBA's approach, with their fault being a failure to communicate this message as opposed to an attempt to drive more loans.

What sort of duty should a mortgage broker owe the customer?

18. Connective believes that the statutory requirement of arranging a not unsuitable loan remains the appropriate standard. Each customer's needs and requirements are unique and this standard takes this into account. However, we do believe that greater supervision and oversight by regulators, lenders and aggregators is required to ensure responsible lending obligations are being complied with. We also recognize that the industry can always improve especially in response to the findings of ASIC's Report 516: Review of Mortgage Broker Remuneration, March 2017 (**ASIC Review**).

19. Connective is an active participant of the Combined Industry Forum (**CIF**), a body made up of key participants in the industry to address the issues raised in the ASIC Review. Connective strongly endorses the CIF's proposed reforms. In relation to applying a new standard for mortgage brokers, the CIF has developed a definition for "good customer outcome", being "*the customer has obtained a loan which is appropriate (in terms of size and structure), if affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan.*"

20. CIF is also developing a "customer first duty", which builds on the good customer outcome definition and, amongst other things, incorporates a "conflicts priority rule" where a customer's interests are to be placed above the mortgage broker's. This duty will be encapsulated in an enforceable industry code which the CIF is currently developing. We believe our mortgage brokers already meet these standards and as such, Connective supports its application as the new standard for mortgage brokers.

21. In order to assist lenders and aggregators better supervise mortgage brokers, including the supervision of this customer first duty, the CIF is developing a set of key risk indicators related to the loans brokers submit which lenders will share data with aggregators to

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support this broader governance framework.

Complaints data

22. We appreciate certain case studies of mortgage broker misconduct were considered during the Commissions' hearings into consumer lending. However, it is critical that these be considered in context. For FY 2017/18[6], the Credit and Investments Ombudsman (CIO) (which virtually all but a small group of our mortgage brokers are a member of) received 6,293 complaints, of which only 364 (5.8%) related to brokers and aggregators.

23. External dispute resolution (EDR) schemes such as CIO and the Financial Ombudsman Service (FOS), provide accessible and fair dispute resolution services for customers. We see complaint levels to these EDR schemes as a good barometer for the level of misconduct and "bad customer outcomes" attributed to mortgage brokers. Compared to the 5.8% of all CIO received complaints relating to brokers and aggregators, residential mortgage lenders and managers accounted for 647 complaints (10.3%). In addition, most mortgage lenders are primarily members of FOS, so when taking into account FOS complaints, lender complaint numbers would be substantially higher than those of brokers and aggregators. The CIO statistics for FY 2016/17 complaints were virtually identical (residential mortgage lenders and managers – 655 complaints (11.1%), brokers and aggregators – 357 (6.1%)).

24. Approximately 1,400 mortgage brokers operate as credit representatives under Connective's Australian Credit Licence (the rest operate under their own licence). We are responsible for customer complaints against those brokers. In FY 16/17, only 4 customer complaints could not be resolved by Connective and had to be escalated to CIO for dispute resolution (all of which were resolved or dismissed as unsubstantiated)[7]. In FY 17/18, there were 7 such complaints (of which, 6 remain unresolved)[8]. Considering Connective credit representatives settled 22,726 home loans in FY 16/17 and 30,167 home loans in FY 17/18, such low complaint numbers show that there is no systemic misconduct in the mortgage broker industry and bad consumer experiences are rare. If value-based remuneration were such an important contributor to misconduct, why are customer complaints against mortgage brokers and aggregators so low?

25. Similarly, in the circumstances where we have observed mortgage broker misconduct (whether internally identified or complaints through an EDR scheme), we do not believe that these cases arose due to the value-based remuneration structure. As the Commission has identified, these cases of misconduct are driven by greed, but we are of the view that these cases would have arisen regardless of how mortgage brokers are remunerated.

[6] Credit & Investments Ombudsman Annual Report on Operations 2017/18 (https://www.cio.org.au/assets/36897397/ARO2018.pdf)

[7] Page 7, Credit & Investments Ombudsman FSP Complaint Statistics FY 2016/17 (https://www.cio.org.au/assets/27886550/CIO%202016-17%20FSP%20Complaint%20Statistics.pdf)

[8] Brokers and aggregators data, Credit & Investments Ombudsman Complaint Statistics FY 2017/18 (https://www.cio.org.au/assets/36897397/Brokers%20and%20aggregators%20-%20complaint%20contact.pdf)

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Mortgage broker remuneration

26. Connective is extremely disappointed that the Commission has stated, in the context of mortgage broker remuneration, that "*value- and volume-based remuneration for intermediaries in the home loan industry has been an important contributor to misconduct and conduct falling short of community standards and expectations and poor customer outcomes.*" What is most concerning is that this conclusion has been reached based on two submissions, (i) data selectively used from the ASIC Review and (ii) commentary from a confidential letter submitted by CBA's then CEO, Mr. Ian Narev, to Mr. Sedgwick (who was conducting a broad review in the bank remuneration at the time).

27. The Commission points to commentary in the ASIC Review which stated "*broker loans were reliably associated with have being higher leverage, even for customers with an identical estimate of risk*", and then concluding "*Over time, higher leverage means broker customers have an increased likelihood of falling into arrears, pay down their loans more slowly and on average pay more interest than customers who dealt directly with the bank*".[9] These observations were based on the ASIC Review, which you concluded that "*there is no reason to doubt the accuracy of these findings.*"

Over-reliance on stale data

28. There are a number of flaws to this approach. The data being relied upon was from home loans settled between 2012-2015. This data is now stale and may not represent the actual reality today, especially considering the evolution and maturation of the industry as well as the industry's proactive response following the release of the ASIC Review.

29. We also query how effective ASIC's methodology to "control" the data was in order to reliably and fairly compare data of home loans settled through mortgage brokers against lenders' proprietary channel. ASIC controlled their data by comparing customers with the same age, income, expenses, employment status, property value, occupation, unemployment rate, marital status, housing status, property purpose, and state or territory.[10]

30. What this "controlling" did not do was to consider qualitative factors such as that different types of investors are more likely to utilize the broker channel as opposed to going direct to lender. First home buyers and investors are more likely to use mortgage brokers which may explain the higher LVR and greater number of interest only loans. Customers who are unable to successfully source a loan direct from a lender often turn to mortgage brokers for aid. ASIC's attempt to control the data did not recognize that within a demographic group, those with more complex or difficult needs usually gravitate towards mortgage brokers.

31. Treasury's views on this data were that "*[t]hese average differences are prima facie not so significant that they provide compelling evidence of major problems that require a wholesale change to the existing standard commission structure given the industry reforms currently underway ... though it is possible that looking at averages masks a subset of consumers for whom there should be concern. The differences may also reflect the difficulties in statistically controlling for differences between brokered and direct channels, as well as*

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[9] Interim Report, page 60, section 6.1.2

[10] ASIC, Report 516: Review of Mortgage Broker Remuneration, March 2017, paragraph 827.

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brokers achieving outcomes actively sought by customers."[11] This aligns with the fact that ASIC did not recommend any fundamental change to the remuneration structure of mortgage brokers as they had not identified cases of systemic misconduct or behavior which did not meet community standards and expectations. This is supported by the CIO complaints data quoted above.

32. With neither ASIC nor Treasury advocating fundamental change, it is difficult to accept the Commission's views regarding the structure of mortgage broker remuneration driving certain negative outcomes, especially when the data relied on for this conclusion is arguably flawed. ASIC themselves qualified their findings by noting they cannot conclude if these characteristics actually lead to a poor consumer outcome without an understanding of whether that loan met the customer's requirements and objectives.

Combined Industry Forum reforms

33. The Commission states in the Interim Report that it considers the reforms announced by the CIF to be "*limited*". It is important to understand the mandate of the CIF was primarily driven by the six recommendations outlined in the ASIC Review, with regards to Mr. Sedgwick's findings. The work of the CIF represents a concerted effort by key players in the mortgage broking industry (comprising of lenders, aggregators, mortgage brokers, industry bodies and consumer groups, whilst maintaining a regular line of communication with regulators and government) to proactively self-regulate itself and work towards improving areas identified by the ASIC Review.

34. ASIC stated "*we consider that changes could be made to the standard commission model to reduce the risk of brokers seeking to inappropriately maximize their commissions. We recommend that a further review is conducted in three to four years to determine whether further (and more fundamental) changes to the standard model are required.*" ASIC goes on to recommend refinement – not fundamental change - to the commission model to reduce the risk of brokers placing consumers in larger loans when this is not in the interests of that consumer.

35. As such, CIF's reforms regarding the structure of remuneration were:

    a. Volume-based remuneration ceased by the end of 2017. We were surprised that the Commission made this comments regarding volume-based commissions when the industry stopped paying this remuneration before the commencement of the Commission.

    b. By the end of 2018, upfront commissions paid to mortgage brokers will be calculated on the actual utilized amount net of any amounts placed in an offset account. This removes an incentive for a mortgage broker to encourage a customer to borrow more than actually required.

36. ASIC and Treasury have each recognized that although there are potential conflicts in the current commission model, changing to alternative models which may remove these potential conflicts have their own drawbacks. There is a danger with these alternative models that a number of unintended, negative consequences may arise if such a

[11] Paragraph 243, The Treasury, Australian Government, *Financial Services Royal Commission – Submission on key policy issues*, 13 July 2018.

fundamental change is mandated.[12]

37. We acknowledge that the above changes only go part of the way towards responding to the Commission's concerns. We believe a combination of a customer-first duty (discussed above) enforced through an industry-wide code and more active supervision and monitoring by all industry participants will mitigate remaining concerns around the existing remuneration structure. The CIF is making strong progress on this with further reforms.

38. Finally, we wish to point out the following existing safeguards that discourage poor mortgage broker behavior:

    a. Clawbacks: all or part of a mortgage broker's upfront commission must be repaid to the lender if the loan is repaid or refinanced within a certain period after settlement. This acts as a strong deterrent to placing a customer in an unsuitable loan or not placing that customer's interests first.

    b. Trail commissions only paid if loan is performing: trail commission is paid on the loan amount outstanding and subject to the loan not being in arrears. This discourages the mortgage broker recommending a loan that the customer cannot afford.

39. The greater majority of mortgage brokers are small businesses. They do not advertise or market broadly, relying on word of mouth, referrals and repeat business. This business model requires them to act in a customer's best interests. The most successful mortgage brokers are those who provide outstanding service to their customers. We find brokers who do not have their customers' interests at heart do not remain in the industry for long.

40. When viewed as a total package, the changes to remuneration coupled with increased governance and supervision, already move the industry substantially from what was in place between 2012-2015 (the period of data used for the ASIC Review, and which the Interim Report relies on). To address whatever remaining conflicts may still exist in the structure for mortgage broker remuneration, the industry is working towards voluntarily adopting a customer-first duty, which is a higher standard than the current legislative requirement of "not unsuitable" and a genuine attempt by the industry to further drive good consumer outcomes and avoid the identified concerns of the Commission.

41. These actions and reforms need to be considered in the broader context of an industry which has already been under significant scrutiny over the past several years. What this scrutiny has not found is evidence of systemic consumer harm nor has any of the reviews recommended fundamental changes to its remuneration structure. Accordingly, we urge the Commission follow ASIC's recommendation of reviewing the data in 3-4 years' time after implementation of these reforms and their effect can be appropriately measured before determining whether more change is required.

Other issues and questions raised by the Interim Report regarding mortgage brokers

What should be disclosed to borrowers about a mortgage broker's remuneration

42. The NCCP requires mortgage brokers, at the same time as providing credit assistance (i.e.

[12] Treasury examines alternatives in paragraphs 254-265, The Treasury, Australian Government, *Financial Services Royal Commission – Submission on key policy issues*, 13 July 2018

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suggesting a customer apply for, assist that customer to apply for or recommend that customer remain in, a loan product), to give that customer a Credit Proposal Disclosure document (CPD).[13] The CPD must contain a reasonable estimate of the total fees the mortgage broker will be paid (and who pays that fee) in relation to that loan product and the method used in determining that amount. Checking for issuance of the CPD in a timely manner is a part of Connective's audit process of its mortgage brokers. As full disclosure of mortgage brokers' remuneration is already mandated by law and occurring today, we do not see any need for further consideration of this point.

Should a mortgage aggregator owe any duty to the borrower?

43. By the nature of its operations, Connective does not have any contact with customers except where a customer complaint arises against one of our mortgage brokers. In such circumstances, Connective assumes an active role in resolving the relevant dispute (and avoid the EDR scheme and courts having to get involved). As referenced above, the number of these complaints are extremely low relative to the number of loan applications submitted by our mortgage brokers. Most customers of our mortgage brokers do not now who Connective is, nor the function an aggregator plays.

44. Connective owes contractual obligations under its lender head agreements with each of the lenders on its panel. We expect these obligations to grow as part of the CIF reforms which will expand our obligation to supervise and monitor our mortgage brokers. We also provide services to our mortgage brokers in accordance with the terms of the member agreement these brokers sign with us.

45. Connective believes that the customers mortgage brokers deal with belong to them, not Connective and as such, we do not believe any additional duty imposed on an aggregator in favor of borrowers is necessary, or would lead to improved consumer outcomes.

Connective appreciates the opportunity to respond to a number of issues the Commission has identified in the Interim Report. We are strong advocates of the work the greater majority of mortgage brokers do to service and assist Australian consumers in navigating what possibly is the biggest financial decision in their lives. The benefits mortgage brokers bring to the home loan industry are extensive and any fundamental change to how they are remunerated is likely to have negative unintended consequences which could potentially destroy the livelihood of a number of honest, small businesses in Australia whilst hurting consumers by removing the competition benefits mortgage brokers provide and the general service increasing numbers of Australians are choosing to use.

We are happy to make ourselves available to discuss this submission further if required.

Yours faithfully

For

Daniel Oh
Group Legal Counsel, Connective
[redacted]

[13] Section 121, National Consumer Credit Protection Act 2009 (Cth)