The Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Australian Finance Group Ltd - Submission
26 October 2018

Introduction

Thank you for the opportunity to respond to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The Commission's questions concern the conduct, culture, governance and regulation of the financial services sector. The Commissioner has specifically asked why misconduct has occurred and what can be done to stop it from happening again.

Australian Finance Group Ltd (**AFG**), as a mortgage aggregator affiliated with 2,950 mortgage brokers, has responded to the Commission's questions about the mortgage broking industry through this prism.

WHY DID IT HAPPEN?

The impact of market power on conduct

The global financial crisis led to a significant reduction in competition in the Australian lending market. The exit of many foreign banks, the Government guarantee for wholesale funding and subsequent risk rating advantages held by the major banks all resulted in an uneven and preferential playing field.

The approval of mergers and acquisitions during this period, in particular the acquisition of Bankwest by CBA and of St George and Bank of Melbourne by Westpac, cemented the lack of competition.

The major banks' market share rose from 78.8% in July 2007 to 92.4% in March 2012.

The 2011 Senate Economics References Committee, Competition in the Australian banking sector inquiry found the same:

…the Committee believes that, in general, competition rather than regulation will generate improved outcomes for customers. It agrees with Treasury that: Competition is the cornerstone of efficiency and productivity in any market. It promotes fair prices, enhances living standards and ensures that scarce resources are allocated to their highest value uses.[1]

It is AFG's concern that the erosion of public confidence in the major banks and their failure to meet community expectations is inextricably linked to the immense market power that they have inherited coming out of the 'too big to fail' concept, and which they now wield.

Remuneration

The Commission's Interim Report asks if the commission structure of remuneration for mortgage brokers is consistent with acting in the interests of the client.

ASIC's extensive, data-driven review of the current commission model for mortgage brokers highlighted the risks that bonus commissions and campaign-based commissions paid by lenders and aggregators pose to good customer outcomes. In addition, ASIC recommended a move away from soft dollar benefits which increase the risk of poor customer outcomes and can undermine competition. However, ASIC did not recommend the removal of commission remuneration for mortgage brokers.

In recognition of these issues the industry, through the work of the Combined Industry Forum (**CIF**), has already moved away from these commission and payment structures. These changes, together with other CIF initiated changes designed to remove incentives to recommend loans larger than required by a customer, which are currently being implemented, will reduce the risk that the customer's interest is not placed first.

The Productivity Commission has also recognised that a move to a consumer pays model would result in weaker competition in the home loan market and noted:

> *The [Productivity] Commission agrees that fees-for-service paid by consumers are unlikely to be pro-competitive, because a lack of willingness to pay is likely to result in a smaller mortgage broking industry, and the greater damage would be to the lenders without branch networks. Given that many mid-size and smaller lenders rely on brokers to compete (section 11.3), competition in the home loan market would likely be weaker as a result.*[2]

[1] The Senate Economic References Committee, *Competition Within the Australian Banking Sector*, May 2011, pp xv-xvi.
[2] Productivity Commission, *Competition I the Australian Financial System – Productivity Commission Inquiry Report No. 89*, 29 June 2018, p 333.

Consistent with the concerns expressed by the Productivity Commission, it is AFG's fear that a fees-for-service model paid for by consumers would result in the major banks with large branch networks increasing their oligopoly powers to the detriment of all Australian borrowers.

AFG recognises that there have been circumstances where lenders have sought to use commissions as a tool to influence brokers to prefer their products instead of focusing on providing products and services that better meet consumers' needs.

The commencement of industry funding of ASIC, new regulatory tools such as the Product Intervention Power and enhanced enforcement powers as proposed by the ASIC Enforcement Review will equip the regulator with the resources needed to provide effective regulation and act more quickly to stop practices that are detrimental to the interests of consumers.

As Treasury noted in their submission to the Royal Commission:

> *The Product Intervention Power, once implemented, will enable ASIC to intervene in this area to target aspects of remuneration structures where ASIC is satisfied that there has been or is likely to be significant consumer detriment.*[3]

Another change that could be considered to prevent lenders from competing for brokers rather than competing for consumers by providing better products and services, would be to legislate for the provision of standardised commission rates. Such an approach would go a long way towards eliminating the 'lender choice conflict' identified by ASIC.[4]

WHAT CAN BE DONE TO STOP IT HAPPENING AGAIN?

Customer first

We recognise the Commission has questioned the need for, and structure of, a 'best interests' duty to apply to mortgage brokers.

The services provided by mortgage brokers have both similarities to and differences from the services provided by financial advisers. In considering the type of regulatory reform that may be most appropriate for the mortgage broking industry, Treasury has provided the following analysis:

[3] The Treasury, *Financial Services Royal Commission Submission on Key Policy Issues*, 13 July 2018, para 265.
[4] Australian Securities & Investments Commission, *Report 516 Review of Mortgage Broker Remuneration*, at para 29, p 10.

> *For mortgage broking, the regulatory framework is less interventionist, with no direct regulatory restrictions on conflicted remuneration or positive duty on brokers to act in consumers' interests. In part, this reflects the fact that the broker's role is a narrower and well-defined one, and that mortgage broking represents a distribution channel for a specific financial product.*
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> *As a key distribution channel for mortgages, and by assisting consumers' search for a better deal, mortgage broking also has a vital role in facilitating effective competition and better outcomes for consumers that needs to be taken into account in assessing reform options.*
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> *Following a comprehensive report by ASIC in 2017 on mortgage broker remuneration, the industry is progressing reforms that could address the most significant misconduct with the current remuneration model, and ASIC is to obtain powers to intervene when satisfied that there has been, or is likely to be, significant consumer detriment. The adoption of a positive duty on brokers to act in consumers' interests may also merit consideration if it can be achieved without adding undue compliance costs.* [5]

ASIC has also expressed similar views in its submission to the Productivity Commission:

> *At this stage, we think that determining which legal model will best improve mortgage broker standards and outcomes for consumers obtaining home loans will require further analysis. This might depend on whether the mechanism of any new best interest duty involves:*
>
> *(a) changing the process for mortgage broking—for example, by mandating additional inquiries or steps that need to be taken before recommending or arranging a loan; or*
>
> *(b) setting standards for the quality of the outcome for consumers—for example, by specifying circumstances in which a mortgage broker recommends a loan from a related company will be acceptable or not be acceptable.*
>
> *It may be preferable to enhance the existing responsible lending obligations for mortgage brokers by focussing on obtaining specific, positive outcomes for consumers.*[6]

[5] The Treasury, *Financial Services Royal Commission Submission on Key Policy Issues*, 13 July 2018, at paras 160-162, p36.
[6] Australian Securities & Investments Commission, *Productivity Commission Inquiry into competition in the Australian financial system: Draft report – Submission by the Australian Securities and Investments Commission*, March 2018, at paras 21-22, p 8.

The work that the mortgage broking industry is currently actively engaged in through CIF is consistent with the approach suggested by both Treasury and ASIC and, together with ASIC's new regulatory powers, needs time to become entrenched.

CIF's work to date has necessarily reflected the specific issues that were raised in the reviews that were conducted immediately prior to the inception of CIF. More recently, CIF has added a *Customer First* duty to the package of industry led reforms that it is developing. That proposal will combine with the *Good Customer Outcomes* measure and sit under the umbrella of an enforceable industry code. We would encourage both ASIC and Treasury to now work with CIF to ensure that the industry led work will provide timely solutions that meet regulatory expectations.

Governance

The Interim Report has also questioned the confusion of roles and responsibilities of brokers and aggregators and whether there is effective communication with customers.

Mortgage brokers must disclose commissions at various stages when providing credit assistance to a consumer. First, the credit guide must contain information about any remuneration likely to be received by the mortgage broker, directly or indirectly, from the credit provider as a result of providing credit assistance. Later, the credit proposal, which is provided to a client when a recommendation is made, must contain more information about fees, charges and commissions.

CIF has proposed a number of disclosure enhancements for the mortgage broking industry that, when combined with the *Customer First* duty, the *Good Customer Outcomes* measure and an enforceable industry code (as well as ASIC's enhanced enforcement toolkit and product intervention powers), should assist consumers to better understand the available service.

The Customer First duty will work with the Good Customer Outcomes measure to require the appropriate management of potential conflicts of interest and drive positive behaviour in the mortgage broking industry.

In addition, CIF propose that brokers should be obliged to advise their customers about the number of lenders available to the broker, the number of lenders that the broker has actually used in the previous financial year, the top 6 lenders used, and the percentage of business concluded with each in the previous financial year, as well as information about ownership by product providers.

AFG also supports clear disclosure of ownership structures. ASIC's Broker Remuneration Review proposal to require clear disclosure of the ownership structures of vertically integrated businesses should be implemented in a way that consumers can easily understand.[7] This change is also advocated by CIF.[8]

Complaints as an indicator

AFG agrees that complaints are a reliable indicator of problems within the industry. The Credit & Investments Ombudsman (**CIO**) Annual Report on Operations, reported that 364 complaints were received about brokers and aggregators in the 2017/18 financial year.[9]

The Financial Ombudsman Service (**FOS**) Annual Review 2017-18 reported that it accepted:

- 10,021 consumer credit disputes in 2017-18.[10] Of these, 71% involved banks while 1% involved finance brokers and an additional 2% involved a broad "other" category which included mortgage brokers and aggregators.[11]
- 1,016 business finance disputes in 2017-18. Of these 70% involved banks while 1% involved finance brokers.[12]
- Financial difficulty disputes in 2017-18. Of these 72% involved banks while 2% involved a broad other category which include finance brokers.[13]

Further developments to improve access to redress for consumers

The existence of compulsory internal dispute resolution (**IDR**) and external dispute resolution (**EDR**) processes provides consumers with access to a free and fair mechanism for the resolution of complaints. The recent establishment of the Australian Financial Complaints Authority (**AFCA**), which will replace CIO and FOS as the single EDR for financial products and services, consumer credit products and services and superannuation from 1 November 2018, is expected to lead to additional improvements in the handling and remediation of consumer complaints.

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[7] Australian Securities & Investments Commission, *Report 516 Review of Mortgage Broker Remuneration*, at para 125, p 25.
[8] Combined Industry Forum, *Combined Industry Forum Progress Report: Working Towards a Better Mortgage Broking Industry for Customers*, July 2018, p9.
[9] Credit & Investments Ombudsman, *Annual Report on Operations 2018*, p6.
[10] Financial Ombudsman Service Australia, *Annual Review 2017-18*, p 74.
[11] Ibid, p74. The other category is comprised of "FinTech, administration services provider, product distributor, MIS operator/fund manager, general insurer, trustee, ***mortgage broker***, mortgage manager, non-cash payment system provider, building society, financial advisor/planner, life insurer, ***mortgage aggregator***, general insurance broker, accountant, clearing/settlement house, custodial and depository services, foreign exchange dealer, friendly society, product issuer, stockbroker, superannuation fund trustee/advisor, underwriting agency, not yet determined [emphasis added]".
[12] Ibid, p75.
[13] Ibid, p107.

Higher monetary limits and compensation caps will give more consumers and small businesses access to a free and independent forum to resolve their complaints.

Unintended consequences

The development of the mortgage broking industry has increased competition amongst lenders and provides an effective distribution network for lenders without a large branch network. It is AFG's view that a viable mortgage broking sector is crucial for retaining an element of competitive pressure in the Australian mortgage market. This is evidenced by the fact that AFG has 40 residential lenders on its panel with more than 40% of applications going to lenders other than the four major banks.

Brokers also provide a variable cost base to institutions and many of Australia's smaller lenders rely on mortgage brokers to distribute their products. Without access to the network of mortgage brokers provided by the likes of AFG, these lenders would simply not have the resources to get their products to market. This competitive tension is needed to help limit oligopoly behaviour in an industry that is dominated by the four major banks.

Just as importantly, without the diversity of the underlying mortgage asset portfolio (particularly in terms of customer type and their location) that a mortgage broking industry provides, the ability of these smaller financial institutions to attract ongoing funding at commercially competitive terms would be hindered. This would also inevitably lead to a reduction in competition in the market place.

AFG agrees that regulatory change designed to protect consumers is a positive for the industry, however it is vital that the legislative framework focuses on the delivery of a competitive, diverse and sustainable sector that ensures reasonably priced and appropriate services are available to all Australian homebuyers (including remote and first homebuyers) and does not result in an economic drift towards the major banks.

Conclusion

The mortgage broking industry contributes $2.9 billion to the Australian economy each year, supporting more than 27,100 (full-time equivalent) jobs.[14] This is additional to the downward pressure on interest rates (and interest margins earned by all lenders) that mortgage brokers have contributed to over recent decades.[15]

[14] Deloitte Access Economics, *The Value of Mortgage Broking*, July 2018, p 21.
[15] Ibid p 18-19.

The 2014 Financial System Inquiry recognised the fundamental importance of an efficient, resilient and fair financial system. By facilitating effective consumer choice and increasing competition between lenders, Australia's mortgage brokers play an important positive role in achieving this goal.

The overwhelming majority of brokers operate small businesses with customer service at their core. Without the delivery of good consumer outcomes, they would not have sustainable businesses. If Australian consumers did not believe this to be the case, broker market share would not have continued to grow to now exceed 1 in 2 home loans.

If any participant in the mortgage and finance industry engages in conduct that falls below their legal obligations and community expectations, it is important that the right regulatory tools exist to enable appropriate and commensurate action to be taken. ASIC is the industry regulator charged with this task and the additional enforcement powers that are expected to flow from the ASIC Enforcement Review together with the new Product Intervention Power should provide a more effective regulatory toolkit to deal with such circumstances.

The investigations and regulatory and legal reforms that have recently been completed or are currently in train (which are to be implemented in the short and near term) are extensive and require a reasonable period to become embedded into the processes, procedures and culture of individual broker businesses. Once that has occurred, it will be an appropriate time to again review the extent to which community expectations are met and good consumer outcomes are achieved.