26 October 2018

By online submission: https://royalcommissioninterimreportwebform.lawinorder.com.au

Dear The Honourable Kenneth Madison Hayne AC QC,

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

Mortgage Choice appreciates the opportunity to provide its comments on the Interim Report released on 28 September 2018 by the Commissioner in respect of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Our feedback is mainly in relation to Consumer Lending, Financial Advice and Entities: Causes of Misconduct with a specific focus on Mortgage Broking and Financial Advice.

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1. An Introduction to Mortgage Choice

Mortgage Choice Limited is a public company listed on the ASX. It holds an Australian Credit License to act as a credit intermediary and a wholly owned subsidiary holds an Australian Financial Services Licence that allows its authorised representatives to provide advice to consumers on Tier 1 products. Mortgage Choice is also a franchisor operating under the Franchising Code of Conduct.

Mortgage Choice is a lending aggregator. Aggregators are intermediary organisations that connect lenders with mortgage brokers. Brokers may act as credit representatives under an aggregator's credit licence and be provided with differing levels of infrastructure and support to operate, such as technology systems, regulatory and compliance assistance, software, marketing and professional

^ MFAA Quarterly Survey of leading Mortgage Brokers and Aggregators June 2018 completed by Comparator
** Deloitte - The Value of Mortgage Broking July 2018.*

development depending on the aggregator offering. Some aggregators allow brokers to hold their own license and provide a different level of service.

Mortgage Choice distributes credit advice, primarily on residential lending, and financial planning advice services to consumers through a franchise network of 458 independently owned small businesses across Australia, 422 of which are Mortgage franchises and 36 Financial Planning franchises. The company has 601 credit representatives and 38 authorised financial representatives and is considered a major aggregation business in Australia.

Mortgage Choice represents a strong financial brand that is well respected in the market, delivering quality service to consumers for over 26 years and helping over 600,000 people with their home loans.

2. The Mortgage Broking Channel – A Valuable Partner and Advocate for Customers

Market forces created the broker channel and have sustained the industry over the last 3 decades. Australian borrowers have become increasingly aware of the benefits associated with using a mortgage broker. This awareness has been a driving factor behind the significant growth in broker market share, with an estimated 55.3% of new residential home loans originated through the broker channel in the March quarter 2018^. This share continues to increase year on year indicating consumers are continuing to see value in the service mortgage brokers provide.

The broker channel provides consumers with access to specialist knowledge of mortgage products, pricing and features independent of the manufacturers and providers of those products. By providing an independent source of comparison of lending products and their suitability to the customer's needs, mortgage broking has contributed to;

- Forcing Australia's lenders to become more innovative in terms of home loan products and mortgage features.
- Increasing lender competition, which leads to more competitive home loan interest rates for consumers across small, large and regional lenders and banks. Recent research by Deloitte showed that, as a result of competition from the broker channel, net interest margins for banks fell by over 3% over the last 3 decades.
- Providing professional, comprehensive expert advice, particularly for home loans, which is one of the most important financial decisions in a person's life. Brokers help customers navigate a complex range of products available across a diverse range of lenders. They have in depth conversations with their clients to understand their needs and financial position, undertake product and lender research, educate customers thereby increasing their financial literacy, assist in structuring the deal and completing the application process. Brokers are particularly valuable when it comes to structuring complex deals. 9 out of 10 customers are satisfied with the services provided by their broker*. Brokers provide price discovery in a system where the advertised standard variable rate is not the rate paid by the majority of customers. Brokers provide choice, expertise and convenience.

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- Mortgage Brokers not only reduce the search costs for customers but are also more likely to negotiate better deals saving money for customers. The broker serves as an advocate for the customer in the lending process.
- Increased lender choice and advice for regional and rural customers. Deloitte's research indicates that 3 in 10 mortgages arranged by mortgage brokers are for customers in regional and rural areas*.

The broker channel contributes to the financial services market by acting as an independent distribution channel for lender products. This is particularly relevant for small to medium banks and lenders where it is not economically viable to open retail branches. The Mortgage Broking Industry provides a distribution channel for small to medium lenders equivalent to 118 branches each*. It enables a lender to increase its distribution footprint, particularly into geographic areas that are unlikely to be serviced otherwise.

Without brokers, the number of banks and lenders in the market would reduce, thereby reducing competition and forcing consumer lending to be concentrated in the hands of a smaller number of banks and lenders, mainly the 4 major banks. Our own analysis shows that the percentage of Mortgage Choice residential settlements with the 4 major banks (excluding St George and Bankwest) was 42% in FY18, accounting for both St George and Bankwest it was 57% (which dropped from 62% in FY17). We believe this drop was due to the tighter lending criteria at the majors, which allowed increased opportunity for smaller lenders and niche players.

3. Questions to be Considered

If we believe the mortgage broking channel is an important source of information and advice to customers and a valuable contributor to the Australian Financial Services industry, and should be maintained (which Mortgage Choice strongly believes) then the main questions are:

- How do we address the issues the Royal Commission and ASIC believe may contribute to poor customer outcomes and reduce the likelihood and risk of them occurring; and
- If policy changes are made in respect of the channel, it is important to understand the ramifications of those changes on the customer, industry and the individual businesses that support the channel (mostly small businesses). In particular, it is important to ensure that any policy changes do not have unintended consequences that may potentially dilute the outcome for the consumer and the market participants.

4. Mortgage Choice Executive Summary

The Royal Commission Interim Report (including case studies) questions whether the broker channel is one of the main sources of misrepresentation and a driver of bad customer outcomes. It indicates that this is a result of misaligned incentives and the mortgage broker putting their own interests ahead of that of the customer.

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Like all industries, there will be some individuals that do the wrong thing and commit acts that constitute misconduct such as committing fraud. We do not believe however that there is enough evidence to suggest a widespread problem in the broking channel. Further, we do not believe the remuneration model in the broker channel is the cause of such behaviour, although we do accept that in some circumstances volume-based bonuses and rewards could cause a conflict of interest and support the removal of such incentives.

We do not believe that value-based remuneration contributes to misconduct or poor customer outcomes. The purported higher incidence of interest only loans, higher LVRs and larger loan sizes in the broker channel compared to other channels is, in our view, a result of the difference in the demographics of the customers who choose to use a broker and their more complex needs. It is also the result of customer dynamics that would send a customer to a broker versus a bank branch (ie, you seek your initial home loan from a broker to obtain the best price, but approach your branch or phone your bank for a small top-up, reducing the average loan size through the bank channel). Our day-to-day interaction with brokers leaves us confident that they place loans with the intent of providing the best outcome they can for their customers. This adds value to their business – the customer returns and provides a referral. Arranging a loan for a customer that they cannot repay does not add commercial value to their business.

We believe that many of the issues the Royal Commission and ASIC are seeking to address, would be best addressed through lender credit policy and lender pricing. High LVR loans and interest only loans are excellent products for subsets of the consumer population – first home buyers (high LVR) and sophisticated borrowers that can afford and choose to manage their cash flow on their own terms (interest only). These are classic consumers that seek to use a broker as finding the best interest rate is particularly important in those circumstances.

The standard remuneration model, which together includes upfront, trail and clawbacks based on funds utilised, whilst not perfect, is a very good model and provides a good customer outcome. There are enough checks and balances in the model and the system to ensure a broker does the right thing by the customer. This includes clawback of upfront commission, cessation of trail commission, loss of a portfolio of trail commission from a lender, loss of credit representative status, personal reputational impacts and, under our model, loss of business.

Further, we believe that the current standard model provides an appropriate mechanism for a simple profit share between the lender, aggregator and broker for upfront and ongoing servicing of the customer. Other model structures, as laid out in the CIF response to the ASIC Broker Remuneration Review, disadvantage different customer segments by leaving them under serviced depending on the model.

We believe that making significant changes to the standard model will not in itself address the misconduct alluded to in the report and may in fact have unintended consequences that far outweigh those of the current model.

We are fully supportive of mortgage brokers providing a higher duty of care than “not unsuitable” but we do believe there are practical pitfalls to achieving this change. Any change to the duty of

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care would need to be considered in consultation with the industry to ensure it works in a lending scenario. It should not be assumed that the "best interest duty" from financial planning should just be applied to another process.

We provide further information in respect of these views below.

In respect of Financial Advice, we support the removal of grandfathered exceptions to the conflicted remuneration provisions as there is a risk that financial advisers do not move customers to more appropriate solutions in order to maintain the grandfathered provisions. Further, we believe that product manufacturers and product sellers that also provide financial advice, should be required to offer a full panel of options outside their own products to avoid the potential for a preference to sell their own products.

5. High Level Themes for Discussion

We provide comment on some of the high-level themes we believe are critical in this discussion:

1. Who does the mortgage broker act for?
2. Approach to broker remuneration.
3. Value-based remuneration vs utilisation of lender policy to influence necessary changes.
4. Self-regulation and the Combined Industry Forum.

a) Who does the mortgage broker act for?

It is important to discuss for whom intermediaries in the home loan market act. Here we specifically focus on the role of the mortgage broker.

We believe brokers act for the customer in the first instance, but are clearly obligated by law to provide a lender with a compliant application and to carry on their business in a compliant manner. Brokers must first understand a borrower's credit needs and goals and then seek out the most appropriate solutions to meet those needs, and educate the customer on the lending process and available solutions. They are also responsible for ensuring they take reasonable steps to identify and verify the customer's financial position to ensure the solutions suggested are 'not unsuitable', as per their credit representative conduct obligations which are outlined in the NCCP Act 2009.

Customers rely on brokers to navigate through the very large number of products and lenders available in the market, each with their own features, rates and policies. Our systems currently list over 1,500 products, which includes approximately 3,000 pricing points that are based on combinations of LVR, loan type repayment and other options. The broker removes the complexity in the process by using his/her expertise to find the most suitable solutions for the customer and by doing so reduces the search costs faced by the customer. Brokers provide price discovery across the lender landscape in a pricing system that is opaque and based on loan size, LVR and loan type as well as negotiation. This is particularly true for customers who are less financially savvy or would likely remain with their current lender at potentially higher interest rates or in less relevant products if

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they didn't seek broker assistance. This is also true for customers with more complex financial situations, such as small business owners or more complex financial requirements. The Deloitte research into the Value of Mortgage Broking (July 2018), shows that on average there are 34 lenders on a panel and brokers use on average 10, providing a wider choice to the customer than if they were to search themselves or go direct to a branch where they will be limited to the products sold solely by that lender. It is difficult to see how a limited product selection will translate to a regime with a higher level of care due to the consumer.

While brokers primarily act for the customer and advocate for those customers, they also have a responsibility to the entities with which they are associated (mortgage aggregators), the lenders to which they introduce customers and the general public by complying with the laws of the industry in which they operate.

The table below seeks to summarise our view on the broker's responsibilities to each stakeholder:

Customer	Mortgage Aggregator	Lender	Regulator
• Understand credit needs of the customer • Understand and verify the customer's financial position • Provide the customer with access to a range of mortgage product features and pricing options available based on their personal circumstances • Customer education on lending process and available solutions • Submit application and relevant documentation on behalf of the customer • Disclose all relevant information including any fees, commissions and any other remuneration they may receive in respect of the loan application	• Comply with Aggregator's compliance policies and processes • Comply with all regulatory requirements as an Authorised Representative of the Aggregator	• Understand and accurately represent the organisation and product offering to a customer • Comply with lending policies and application requirements	• Take reasonable steps to identify the customer's requirements, identify and verify the customer's financial position to ensure solutions suggested are 'not unsuitable' • Comply with NCCP Act 2009 including providing customer with Credit Guide and Preliminary Assessment • Referral fee disclosure

b) Approach to Remuneration

Current standard remuneration is fair payment for value provided

Under the current remuneration structure, mortgage brokers are paid an upfront fee, subject to clawback, together with a monthly trailing commission only after the customer has settled his/her loan. At Mortgage Choice, we believe the current remuneration structure is fair and reflective of the value delivered by the broker to the customer, as well as the other stakeholders. It is structured in such a way as to provide a significant proportion upfront to offset initial activity but still defer much

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of the remuneration to confirm value has been provided and remunerate the broker for ongoing service to the customer.

The deferred nature of the income is consistent with the methodology of the Banking Executive Accountability Regime (BEAR) in that it seeks to defer payment to hold brokers accountable for meeting appropriate standards of behaviour, which are in line with community expectations. Trail commission also compensates the mortgage broker for the post-settlement service they deliver to their client database including re-pricing and refinancing services which are estimated to account for 18% of loan volumes handled*

We believe that the combination of an upfront fee, clawback and ongoing trail appropriately matches the customer's interests with the broker. The broker is rewarded for the upfront effort in mortgage selection and application whilst the trail incentivises the broker to select the most appropriate loan for the customer, that is, that the customer can afford and serves their needs for the long term.

The payment of trail commission is contingent on the customer not defaulting on the loan. Trail is also not paid if the customer decides to refinance the loan with another lender, pay out the loan or the loan reaches a certain level of arrears. There are also fraud protections that reach beyond the loan in question to the entire portfolio of a broker. Consequently, the remuneration structure incentivises a broker to place the customer in a loan that meets the structural requirements of the customer, is affordable and is compliant. The remuneration structure also incentivises the broker to maintain a relationship with the customer and continue to keep the customer in an appropriate loan. If a customer's needs change and the broker does not meet those needs, they potentially lose the customer. Deloitte's research indicated that 99% of mortgage brokers follow up customers post settlement in some form or another be it by email, newsletter, social media or direct.

The Productivity Commission findings questioned whether trail disincentivised a broker to "churn" a customer when it might be in the best interest of the customer to move and say, pay a lower interest rate. Our experience is that customers are smart and will move. If the broker does not help that customer then someone else will and the broker loses a customer. Brokers are much more interested in customers that believe their financial needs are being well met. Keeping the customer is more valuable than maintaining the trail. Also should the broker move a customer to a better product with either the same lender or a new lender, they may lose trail on the old product but will receive trail on the new product.

Over the last few years, there have been a large number of lender and regulatory changes that have resulted in an increase in broker workload during the application to settlement phase. This includes:

- The implementation of the *National Consumer Credit Protection Act* which has significantly increased broker workload especially at the front end of the home loan process.
- Under the legislation, significant changes were made to mortgage brokers' disclosure requirements, causing workloads to increase.
- The movement to macro prudential controls and greater prudential oversight at the bank level has translated into a longer more complex application process causing workloads to increase.
- Some tasks are now performed at a broker level that were previously performed at the bank level for some lending institutions such as ordering valuations and completing credit checks.

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Given that broker workload has significantly increased for various reasons, it makes commercial sense for brokers to be compensated fairly for the services they provide.

It is important to note that not all of the broker's efforts are compensated. At times brokers invest time and effort to assist in educating, researching and negotiating a deal for the customer and maybe even submitting the application, but the customer does not progress with the loan at that point in time, or the information is used to go directly to the recommended lender. Some customers may not be able to proceed because they are unable to qualify for the mortgage product they are seeking due to their personal financial circumstances. Commission is therefore at risk right up until settlement.

While this is the case, brokers understand the value of educating customers and providing a great service experience. Some of these customers may not take a loan at that time, but may return at a later date or refer the broker to family, friends or colleagues. This is one reason why we believe that brokers do act in the interests of their customers, ahead of their own.

In fact, most of a broker's business is derived from repeat customers and customer referrals. As outlined earlier, Deloitte research indicates that '70% of a broker's business comes directly or indirectly from existing customers, demonstrating high levels of customer satisfaction.' The only way this repeat business can occur is through the delivery of a good financial result for the customer, a great initial service experience but more importantly ongoing contact and support of the customer. This is rewarded through trailing commission.

As part of the Royal Commission, NAB indicated that the average life of a loan in the broker channel is less than that of those written in their retail channel, supporting the position that brokers are motivated to continually service customers and move clients to more competitive offers. In contrast, there is no incentive for the retail channel to swap customers into cheaper offerings and where this does occur, customers are limited to the lender's products.

If trailing commission were to be reduced or removed, it would:

- Be uneconomical for Brokers to maintain active contact with customers to review their position and if applicable, offer more relevant or competitive products in the market. There would be a shift away from servicing of customers towards transactional relationships where brokers would simply look to write new business.
- Reduce the incentive for brokers to provide education and price discovery for those consumers that are underserviced by banks or who are not yet ready for a transaction.
- Reduce competition in the market as there would be less movement between products and lenders. The customer would have the unintended consequence of not moving to a potentially better offer, and through reduced competition likely higher prices. In particular this has the potential for a greater divergence between pricing for new customers (front book pricing) and rates charged to existing customers (back book) as the broker would be removed from providing valuable insight to the customer on this differential.
- Cause an instant reduction in the value and viability of mortgage broking businesses, as most are small businesses who rely on trail commission to operate. As seen in the WA market, the value of property has fallen so significantly that valuations are impacting loan assessment

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making it difficult for customers to refinance loans or submit applications. These businesses have relied heavily on trailing commission to keep their businesses afloat during the market downturn.

It is important to note that commissions are paid by lenders to mortgage brokers (through aggregators), it is not the customer that pays the mortgage broker directly. We do not believe that by removing or reducing trailing commission, lenders would use this to reduce interest rates for customers, particularly for existing customers. To maintain their market share and distribution footprint from a contraction in the broker channel, lenders would need to funnel this expense reduction into alternate forms of distribution to close the gap left by the broker channel. This could include opening additional branches or recruiting additional sales staff to service customers and areas previously covered by brokers.. This would be particular expensive for those institutions that do not have a historical branch network.

Lender Commission Clawbacks

Mortgage Brokers are subject to lender claw-backs. The threat of having commissions clawed-back seeks to ensure brokers deliver the right product and service to a customer in the first instance and for the longer term. Refinancing is only appropriate when the customer's needs change or economic changes arise, making the current product no longer the ideal home loan solution.

Lender claw-backs remove the threat of broker/customer churning in the short term and ensure a broker is held accountable for their professional mortgage advice for a period of time after a home loan has settled.

Fee for Service – an alternate method of remuneration

There are a number of alternate methods of remunerating brokers, a number of which have been reviewed as part of the CIF. Fee for service is one considered option that has generated much attention, and while we do not believe it is a better option than the current standard model, we would like to comment on it here.

In our opinion:

- Fee for service would act to disincentivise brokers unless the quantum of that fee is sufficient to remunerate the broker for their efforts. At a non-commensurate 'fee for service' level, brokers may seek customers that require less time and effort to service. This will affect first home buyers and regional borrowers. It will likely lead to a reduced willingness to assist and educate customers in the process and focus solely on completing the loan process as quickly as possible.
- If there is no fair compensation for structuring complex deals as compared to simple, plain vanilla deals, these customers (such as small business owners or self-employed customers) will likely find it difficult to find broker assistance. If the 'fee for service' varies based on complexity, there will need to be clear criteria to differentiate between the various levels.
- Currently a broker customer is not charged a direct fee for the broker's service. The lender pays the aggregator an upfront and trail commission based on the size of the loan, which is then passed onto the mortgage broker. In an environment where the fee is expected to be

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paid by the customer, it is unlikely that the same number of customers will use a broker. It will be seen as additional upfront cash, along with a deposit, stamp duty and LMI needed to buy a home that is already expensive. This will result in more customers moving back to the banks with existing branch networks.

- The 'fee for service' model is likely to reduce the number of mortgage brokers in the industry. Shrinkage in this channel will ultimately have a flow-on effect of reducing competition and consolidating mortgage lending back into the banks with existing distribution networks. Lenders that rely on mortgage brokers as an effective distribution channel for their products currently will find themselves having to increase their fixed costs to create distribution capabilities. Currently, the broker channel provides a variable cost distribution channel that is only paid for when utilised. This leads to more effective use of bank capital and more competitive interest rates .

In conclusion, it is likely that a change to a 'fee for service' model will have its own complexities and potential for conflicts of interest when compared to the current revenue sharing model.

Conflicted Remuneration

We do not agree that commission in itself incentivises a mortgage broker to make a recommendation or referral to a customer to maximise their commission. That is, we do not believe brokers prioritise the selling of home loans over the proper assessment of the customer's requirements and objectives for the purpose of identifying and recommending a loan product that is not unsuitable for the customer.

There are a number of reasons why we do not believe this to be true:

- We believe the four key components that ultimately drive broker lending decisions are:
  - customer needs,
  - product flexibility/suitability,
  - lender turnaround times; and
  - interest rates.
- We strongly believe there is insufficient difference between lender commissions to dictate and direct a mortgage broker's lending recommendations. Since the introduction of the *National Consumer Credit Protection Act*, we have witnessed a certain degree of convergence in lender commissions with ASIC estimating that lenders pay aggregators an upfront commission in the vicinity of 0.61% and a trailing commission of 0.175%.
- Deloitte's research indicates that 70% of a broker's business comes directly or indirectly from existing customers. Essentially, 40% of the broker's business is repeat business from existing customers and 30% are referrals from existing customers. It is not in the broker's interest to deceive the customer or put them in an unsuitable product. They have a reputation and business to maintain, along with regulatory obligations to meet.
- Mortgage Choice analysed the lender mix between July 09 and Jun 14 (a period during which the rates were much more widely spread), without adjusting for our 'paid the same' policy, to establish whether increases in upfront commission payments had an impact on the

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volume of sales to a particular lender and therefore influence the overall revenue rate. The analysis shows they did not.

- In the analysis, even when lenders did increase their payment rates for promotional periods (or permanently), our research strongly indicates that these changes did not affect lender volumes. Importantly, these promotions are no longer paid.

While we do not believe brokers seek solutions to maximise their commission ahead of the customers's interests, we do accept that in some circumstances volume based bonus commissions, campaign based commissions and volume based payments could cause a conflict of interest. We therefore support the industry's removal of these incentives this year.

We also support the industry's move to base commission on the drawn down amount by the customer (that is, the loan amount net of offset) as this could be incentivise for a broker to recommend a larger loan than required by the customer. Once the roll out of this change is completed (1 January 2019), a broker will only be paid for the funds a customer utilises, not unutilised credit limits.

Paid the same

At Mortgage Choice, our brokers operate under our unique 'Paid the Same' Policy.

Under the 'Paid the Same' Policy, our mortgage brokers are paid the same rate of commission regardless of which lender the customer chooses from the Mortgage Choice residential lender panel, remove the incentive to place a customer with one lender over another on the basis of commissions.

c) Value-based remuneration vs utilisation of lender policy to influence necessary changes

The Interim Report contemplates the removal of value-based remuneration on the basis that the Commissioner believes it contributes to misconduct and conduct falling short of community standards and expectations and has the consequence of poor customer outcomes. It suggests the consequence of this volume-based remuneration is a higher incidence of interest only loans, higher LVRs, larger loan sizes with an increased likelihood of borrowers falling into arrears.

We believe the difference in portfolio characteristics between the broker channel and other channels is due to the demographics of the customers who choose to use a broker and the more complex needs they bring to the table, as well as brokers actively looking for solutions that meet their customer's long term needs. For instance, a broker may ask a customer what the long-term strategy is for the property they are looking to purchase and will seek to structure the loan with that in mind, which could result in an interest only period being the most appropriate long term option for the customer.

The broker channel tends to introduce new customers with larger loan values whereas branches frequently perform top-ups for existing customers so it is logical to expect the branch channel to have smaller average loan sizes.

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We are therefore not surprised that the demographics of broker customers skew the size of the LVRs, the number of interest only loans and the higher borrowings in the broker channel. We do not believe that brokers, in general, place loans with the sole intent and purpose of receiving additional commission nor do they encourage customers to borrow more than they need.

We believe that the issues the Royal Commission and ASIC are seeking to address, that is the number of interest only loans, higher LVRs and larger loan sizes, would be best addressed through two significant levers:

- **Lender Credit Policy and Responsible Lending:** Influencing lender credit policy can ensure borrowing levels are appropriate based on servicing, LVR and repayment restructure (IO vs P&I). By influencing lender policy, the regulator can essentially adjust the loan portfolio characteristics. Tighter responsible lending procedures as have now been implemented in the last six months will ensure loan sizes remain appropriate at the individual consumer level.
- **Lender Pricing:** Pricing to consumers already does influence the shape and nature of mortgage lending. Differential pricing based on lender preferences and lender risk is already prevalent in the market. Lender pricing of loans may vary in an LVR band of 90% as compared to those at 75%. This drives consumer behaviours to seek lower LVRs and the associated discounts. Lenders also vary pricing offered to consumers according to the loan amount applied for, with larger loans often attracting a higher interest rate discount. This in itself may drive a customer to borrow a higher amount in order to reach a nominated threshold qualifying them for a better interest rate.

In our opinion the concerns regarding the profile of lending, for example LVR and repayment structure, through broker is significantly influenced by the business the lenders are seeking to accept through their pricing and policy approach. Drawing a line between these portfolio characteristics and broker remuneration structure, is not irrefutable, however remuneration is not the prominent driver.

The pricing lever is almost universal at this point and the recent tightening of lender credit policies and Responsible Lending procedures appear to be gaining traction. Brokers can only offer solutions that meet regulatory requirements and lender credit policy.

d) Self-regulation and the Combined Industry Forum

We believe that the proposals put forward by the Combined Industry Forum (CIF) go a long way to addressing the concerns raised in the ASIC Broker Remuneration Review and the Royal Commission interim report. The proposals put forward to date have been a result of extensive discussions and much consideration of various options under the key areas outlined in the ASIC review. Each option reviewed had its issues, biases and conflicts of interest. The CIF agreed that the current structure of upfront and trail was the best option with the least conflict of interest, subject to some adjustments to improve the model and remove potential areas where it could lead to brokers prioritising their remuneration over the interests of customers.

The interests of multiple stakeholders were taken into account, with industry groups, lenders, aggregators, brokers and consumer groups working together to develop proposals that are in the

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best interests of the industry. The proposals therefore take into account the need to maintain competition in the industry whilst reducing the likelihood of poor customer outcomes.

6. Closing Remarks

The mortgage broking channel is a significant contributor to the financial services market providing customers financial education, price discovery, lender choice as well as a valuable, practical service, whilst maintaining competition. It is in the best interests of the consumer at both an individual level and at the general public, industry wide level that we work to maintain and strengthen the channel.

We recommend the retention of the current standard remuneration model (upfront, trail and clawbacks) as a sound model that incentivises a broker to put the customer in an appropriate long term solution and defers remuneration to ensure this is the case. Whilst not perfect, we believe it will produce better customer outcomes in the long run than fee for service, which as discussed earlier raises conflicts for different groups of consumers.

Further, we believe that the changes being made in the industry such as removal of volume based commissions, commissions based on utilised funds removes combined with tighter responsible lending processes and tighter credit policy and pricing around LVRs and interest only lending, will have a more targeted effect on the borrowers having access to borrowing more than they cannot afford to repay.

ASIC confirmed that wholesale changes to the standard commission structure paid to brokers are not required. This view is also supported by Treasury in its submission to The Royal Commission dated 13 July 2018. ASIC did not recommend the removal of trailing commission but suggested a number of changes to the standard commission model could be made to reduce any risks of brokers maximising commissions, which the Combined Industry Forum are addressing. ASIC noted it would review the structure of commissions again in 3-4 years after the proposed changes have been embedded. We support ASIC's orderly approach to the review of broker remuneration. The ASIC review to date has been based on factual information rather than opinions and sensational headlines.

Regards

Susan Mitchell
CEO, Mortgage Choice

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Appendix

Responses to Key Questions Raised in the Royal Commission Interim Report

Below we provide our thoughts on a range of questions raised in the Interim Report. We have not sought to comment on all questions raised, only those where we have strong opinions or where we believe we can add value.

a) Responsible Lending

The issues that emerged in connection with consumer lending relate to:

- intermediaries, and confusion of roles;
- communication with customers; and
- responsible lending.

Here we specifically focus on the role of the broker.

What duties does an intermediary owe to a borrower?

We believe a broker owes the following duty to a customer:

- Assess the the particular needs and financial situation of that borrower in a professional, competent manner;
- Offer solutions across the lender market that suit the particular situation of that borrower.
- Accurately represent the different lending products as to their risks and benefits.
- Accurately represent the specific lending solution chosen for that borrower.
- Be clear upfront what remuneration you will receive as a broker and any fees that you may pay out/ receive for a referral.
- Guide and educate that borrower through the application and settlement process in a compliant and transparent manner to ensure that a borrower does not lose an opportunity through inexperience.
- Translate the borrower's story or situation into the language of the prospective lender to ensure the borrower has an honest chance to qualify for a loan if appropriate.
- Ensure the borrower's information is presented fairly in a compliant manner to ensure the Bank can make a decision on the most accurate data available in a timely manner.
- Follow up with the borrower to ensure the resulting lending situation remains appropriate over time.

The main duty owed to a borrower is to put the customer's needs and interests at the forefrontand act with honesty and integrity.

What duties should an intermediary owe to a borrower?

A broker should have access to a broad, unbiased panel of product solutions that provide competitive pricing and product features to suit a wide variety of customers. The broker should be

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knowledgeable and competent. As much the broker must put the customers' interests first in the process, the broker owes an obligation to the lender and to the public to act with integrity and in a compliant manner.

An aggregator owes the lender and the public a governance structure that means a customer can approach a broker with confidence that that broker is knowledgeable and competent; that the broker has access to a broad, unbiased panel of product solutions that provide competitive pricing and product features to suit a wide variety of customers, and that the broker acts with integrity.

How can entities' systems be improved to detect and prevent breaches of responsible lending obligations by intermediaries?

We believe greater sharing of information between the lender and aggregator is critical to detecting and preventing breaches. This includes having a unique identifier for each intermediary in the financial services industry, which follows that intermediary wherever they go. This is currently in scope and discussion with the CIF in its work on reporting and governance.

To enable a mortgage aggregator to effectively review broker portfolios and detect and prevent breaches, it is essential that lenders provide mortgage aggregators more detailed information in respect of loans submitted by the broker. Information would be in respect of key risk indicators which act as triggers for poor customer outcomes. These would include the current interest rate,), arrears, customer complaint information and any loan changes since settlement.

It is important to note that when it comes to review and verification, the broker channel provides 3 filters which increase the likelihood of picking up any discrepancies in customer data or financial position thereby reducing the risk of breaching responsible lending obligations. This isn't available in the retail channel.

- The broker reviews customer documentation, structures the deal and submits the application on behalf of the customer. The broker is responsible for taking reasonable steps to verify the information provided by the customer. These details are included in a statement of financial position, which is signed by both the customer and the broker.
- A percentage of applications submitted by the broker network is reviewed by the aggregator as part of their compliance review program. Mortgage Choice undertakes a sample based systematic process of reviewing applications submitted to lenders. The aim being to understand how brokers are performing against compliance and regulatory standards, determine if there are gaps and to identify any systemic issues. File rectification and broker training arethe outcome of any issues or gaps identified.
- The lender, independent of the broker, reviews applications submitted including verifying customer documentation against the application and completing a credit assessment before the loan is approved. A broker has no delegated authority as in a bank branch.

This structure provides additional levels of protection, reducing the risk of fraudulent or inappropriate lending to consumers.

The Mortgage Choice compliance framework includes additional steps to reduce breach instances:

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- Level 1 support which is aimed at assisting new brokers with meeting all lender and compliance requirements, and structuring deals. It acts as a review mechanism before deals are submitted during the early phases of the broker's career with Mortgage Choice.
- Lender Updates which outline changes in lender interest rates, policies and processes are communicated to brokers as they are received by the lender. These changes are also updated in our proprietary software used by brokers to determine customer options.
- Compliance training is provided via online learning modules, face-to-face training sessions and Professional Development days.

Are 'introducer' programs compatible with responsible lending obligations?

We believe there is a gap in disclosure to consumers of fees received by an introducer in exchange for their referral. For example hairdressers, solicitors, real estate agents are not obliged to advise clients that they may receive a fee for passing on their details to an intermediary. In essence, whilst a broker is obligated by law to disclose any referral fees it may receive from a referrer such as an accountant or financial adviser, such introducers are not obliged to do so. We believe this gap should be addressed.

What should be disclosed to borrowers about an intermediary's obligations to the lender and to the borrower?

Disclosure should include a clear description of the role of the broker in the lending process, and importantly that their purpose is to act primarily for the customer in scanning the market to find the most appropriate solution to meet the customer's individual needs. It is also important to explain the functions the broker performs in relation to the lender. Essentially, that the broker is independent of the lender (unless there is some form of vertical integration) but still has an obligation to ensure the lender's products are accurately represented to the customer and the loan application complies with lender policies. Further, it is obligated to make reasonable enquiries to verify the accuracy of the customer's information before submitting the application in accordance with lender requirements. This could be included in the Broker Credit Guide.

What should be disclosed to borrowers about an intermediary's remuneration?

We support disclosure of all fees paid and received at the aggregator and broker level with respect to the lending transaction completed and any referral arrangement as well as any other form of remuneration that might be received by the broker. The fees should be disclosed as an expected or maximum $ amount. Most of this requirement is already included in the National Consumer Credit Protection (NCCP) Act 2009 and is in practice today. Mortgage Choice requires this level of disclosure today.

What steps, consistent with responsible lending obligations, should a lender take to verify a borrower's expenses?

We believe borrower declared expenses should be measured against income adjusted/ location adjusted benchmarks for standard non-discretionary expenses such as utilities. Discretionary expenses should be detailed by the borrower and reviewed for reasonableness based on the

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spending patterns as evidenced by the borrowers actual activity. Major discretionary expenditure such as school fees should be specifically reviewed.

Having said this, borrowers do change their spending habits to attain property ownership. A borrower should have the opportunity to do this.

Should the HEM continue to be used as a benchmark for borrowers' living expenses?

We believe the use of the HEM benchmark is an appropriate way to deal with situations where it is difficult to obtain an accurate assessment of living expenses from a customer, but this should be the exception not the norm. Further, it should be used as a tool to check reasonableness of what has been provided by the customer. The HEM calculation should be revisited to ensure it is truly reflective of the population is purports to represent.   If the tool is properly used, it can lower the cost of the application process which a benefit for borrowers and investors.

When an employee or intermediary is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?

We do not believe this is appropriate unless the customer has been specifically impacted by the fraud or the misconduct . However, we do believe there should be a national register that financial institutions and aggregators can access to ensure the individual does NOT seek employment in another organisation in the industry. For example a banker who has committed fraud cannot then seek a role as a broker in the financial services industry. We would expect protections to be built around this so that an individual is not unjustly maligned.

When an employee or intermediary is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidence of misconduct?

Should the fraud or misconduct be found to be the fault of the broker (not the customer), a sample of other settled applications should be reviewed to determine if the activity was isolated or systemic. Appropriate steps should be taken once this information has been ascertained to compensate any customers that have suffered loss as a result of the activities of that broker. This can be a very difficult assessment to make as borrower circumstances changes as do economic circumstances. Loss may have occurred that is unrelated to the broker's actions. Referral of these cases to an external dispute resolution process may be appropriate if the answer is not clear cut.

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b) Financial Advice

The issues that emerged in connection with financial advice related to:

- culture and incentives;
- conflicts of interest and duty, and confusion of roles; and
- regulator effectiveness.

How does a financial adviser's employer encourage provision of sound advice (including, where appropriate, telling the client to do nothing)?

We believe there are three ways to encourage financial advisers to provide sound advice, which also signals the importance of such advice and the employer's commitment to doing so:

a) The employer should 'walk the talk' and always act in accordance with the principles of providing sound advice. They should ensure each adviser within the business lives up to the same standards – acknowledging the right behaviours and ensuring any contrary behaviours are called out;

b) Holding financial adviser's accountable by provision of a balanced scorecard, that considers both client outcomes and satisfaction, and encourages and rewards said behaviours; and

c) Put in place formal audit programs with independent quality review of advice.

Can conflicts of interest and duty be managed?

Potential conflicts of duty can be managed through disclosure to clients and through appropriate separation of advice businesses from manufacturers of financial products.

How far can, and how far should, there be separation between providing financial advice and manufacture or sale of financial products?

We believe there should be complete separation, as we believe it is not possible for a commercially focused organisation to adequately manage this conflict of interest on a sustained basis.

Should financial product manufacturers be permitted to provide financial advice?

- ***At all?***

No, we believe it is too difficult to manage this conflict of interest where there is a direct financial benefit for the product manufacturer to maximise sales of their own products. We also believe there should be no product subsidisation of advice, such as through subsidised / discounted licensee fees to advisers within the networks aligned to a product manufacturer.

- ***To retail clients?***

Please see response above.

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Should financial product sellers be permitted to provide financial advice?

- ***At all?***
- ***To retail clients?***

While we do not believe this is an optimum position or approach, there may be instances where this might be appropriate. In these circumstances, an effective level of disclosure and client acknowledgement of the limitation of the advice received would be required. There should be a clear governance structure that ensures there a broad selection of product available for a wide variety of clients and there is no bias towards a particular class of products. This structure may work well for a particular group of customers (such as stock selections for knowledgeable clients.

Should an authorised representative be permitted to recommend a financial product manufactured or sold by the advice licensee (or a related entity of the licensee) with which the representative is associated?

- ***At all?***

We do not believe this should be allowed where the financial product is manufactured by the advice licensee (or a related party) for the reasons noted above.

- ***Only on written demonstration that the product is better for the client than comparable third party products?***

We consider this appropriate but written demonstration would need to refer to an independent party or benchmark for it to be acceptable in removing this perceived conflict.

- ***Should the grandfathered exceptions to the conflicted remuneration provisions now be changed?***

  - ***How far should they be changed?***

We believe that grandfathered exceptions should be removed and any benefit passed back to the customer in full. Grandfathered arrangements may encourage financial advisers to leave clients in existing products in order to retain their grandfathered remuneration arrangements, when it may actually be more beneficial for the client to switch products (for reduced fees for example).

Should grandfathered exceptions not be removed, then there could possibly be an obligation placed on the financial adviser to let customers know they are on grandfathered arrangements and provide them with alternatives. Practically this could be difficult to implement.

- ***If they should be changed, when should the change or changes take effect?***

We understand that removing grandfathered exceptions may have a significant impact on a number of small business owners at a time of significant industry change. However, we believe the industry needs greater encouragement to implement these changes. While there will most certainly be implementation challenges that need to be considered including impacts on technology systems, we

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believe the timeframe for removal of the exceptions could follow a similar timeline to the LIF changes.

Importantly, before these exceptions are removed there needs to be certainty that any removal of the grandfathered benefits results in a positive gain for the client (or at least the client is no worse off) given the practical challenges of changing products. This means there needs to be surety that the benefits are passed back to the client by the product provider in the form of reduced fees.

Should the life risk exceptions to the conflicted remuneration provisions now be changed?

- ***How far should they be changed?***

We believe there should be no change at this point in time. Underinsurance remains a significant problem in Australia. If the industry moves to charging fully costed advice fees for risk insurance we believe this will discourage a significant proportion of Australians from seeking insurance advice, which will exacerbate the underinsurance problem.

There is no guarantee that insurance providers will pass on any benefits from removing these commissions, and to date we have not witnessed any (significant) decreases in average premiums passed through to consumers following the introduction of LIF, which capped the commissions payable to advisers.

- ***If they should be changed, when should the change or changes take effect?***

LIF has only just come into effect, and ASIC is scheduled to conduct a post-implementation review in 2021 to assess the impact of the reforms. We believe the question of life risk exceptions to commissions should be left until ASIC's completes its review in 2021.

Should all financial advisers (including those who now act as authorised representatives of an advice licensee) be licensed by ASIC?

Whilst we are in favour of reducing the administrative burden on licensees by moving to single licensing, as well as holding individual representatives more directly accountable to ASIC, we do have some concerns about financial advisers being licenced by ASIC.

As a branded network, we would be concerned that any dealing ASIC might have with a representative under our brand might take place without our knowledge, potentially placing our clients and brand at risk. We would want to have clear obligations on ASIC to alert us (the dealer group) of any concerns prior to taking any action.

The question also lies with ASIC and whether they have the capability to adequately monitor and supervise the number of advisers with individual licensing. In general, we believe a more efficient system is created by ASIC dealing with adviser issues trough a dealer group. It adds a second layer of accountability to the system.

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When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?

The files of the adviser would need to be reviewed to understand the impact on the client base as to whether the misconduct was isolated or systemic. Clients who require remediation would clearly need to understand the need for remediation. We believe that it is important to provide some level of information to clients of advisers terminated for fraud or misconduct, with an offer for them to speak to another of the licensee's authorised representatives at no charge if they have ongoing concerns. If a client is on an active ongoing service arrangement with that authorised representative, then the client should be informed of the misconduct/fraud regardless of whether they have been impacted or not.

Importantly, and it goes without saying, there would need to be absolute certainty that the fraud/misconduct has taken place with proof to support this (for example a banning order) before there is any communication with the client in respect of the misconduct/fraud.

When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidents of misconduct?

We believe it may be impractical to review every file or client in such a circumstance. Where concerns have been raised or identified, we believe it would be appropriate to take a broad representative sample of the remaining client files, and if any further incidents or concerns are identified, then it would be important to review all files/clients for that adviser.

Should self-reported breaches of the Corporations Act generally attract legal sanctions unless some special circumstances exist?

Consideration to the positive learnings and identification that comes from encouraging self reporting of breaches should be at the forefront. Special circumstances should be allowed for in any changes to sanctions to encourage correct behaviour and allow for ambiguous or unusual circumstances.

Should ASIC make more use of its Section 916G power to give a licensee information about a person who is or will be a representative of the licensee?

Yes we believe ASIC should make more use of its Section 916G power particularly when breaches have been reported to ASIC in regards to an adviser, but the matter hasn't progressed to banning or disqualifying the individual. Unless the current licensee provides this information, which can be tricky under privacy laws, there is no way for a new licensee to become aware of the concerns raised with ASIC.

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c) Entities – Causes of Misconduct

7.2 Remuneration

What more should be done to implement the recommendations of the Sedgwick Review?

The Combined Industry Forum has a clear plan in place to address the issues raised by the ASIC Review into Broker Remuneration, Sedgwick Review (in respect of Brokers), Productivity Commission and Royal Commission interim report. The plan is currently in progress, with some elements already implemented by participants.

Our firm belief is that we should allow the CIF to work through these issues as a group to find the best solution for the industry. The group is adequately represented by all parts of the industry – lenders, aggregators, brokers, industry and consumer groups and this should enable the group to come to an appropriate solution. We do not believe anything further is required at this point.

We believe with regard to mortgage brokers, the ASIC review is based on collected data and input from both lenders and brokers and we are supportive of the recommendations. ASIC has suggested a path that is incremental with review of the results before moving forward. Some of the suggested changes from other forums are extreme and thrown out with little consideration of the consequences to the system as a whole and therefore in the end – the customer.

The Sedgwick review was commissioned by the ABA without reference or input from the mortgage broking industry. The recommendations made in the Sedgwick with regard to brokers are in part referenced to the ASIC review but are also the result of commentary from lenders only, who have a vested interest in seeing broker remuneration changes implemented at a regulatory level. Should the banking industry support remuneration reforms in that industry that are believed to achieve better consumer outcomes, this is very much to be commended. But to dictate to another industry without consultation when an intensive review has already be conducted by ASIC, is not to be encouraged and the particular recommendation regarding mortgage broking should be dropped from the Sedgwick implementation in deference to the review by ASIC.

6.4 Intermediaries

Questions in this section have been answered earlier in this paper.

7.5 Business structures

Do the events that have happened raise any issue about business structures?

It is important to provide clarity and potential additional disclosure to ensure transparency of business structures. Clearly defined rules would be required and there would be practical challenges in how this disclosure could work beyond the time of settlement and who should or would be responsible for these disclosures.

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Do the events that have happened suggest that manufacturers of financial products should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures?

We believe it is impossible to manage this conflict of interest, that is where there is a direct financial benefit for the product manufacturer to maximise sales of their own products. We also believe there should be no product subsidisation, such as differential interest rates to authorised representatives within the networks aligned to the product manufacturer.

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