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

Aussie Home Loans

Round 1 Hearing - Consumer Lending Closing Submissions

Part B

3 April 2018

Remuneration Structures

1. In response to the additional questions posed to all parties with leave to appear at T986.36-.44, AHL further submits that remuneration structures that reward mortgage brokers for volume of sales of loans do not create an unacceptable risk that mortgage brokers will prioritise the sales of loan products over their other statutory obligations.

2. The standard upfront and trail commission model enhanced by the program of reforms proposed by the Combined Industry Forum[1] (**CIF reforms**) and the early moves of individual participants (such as cessation of volume based incentives by the majority of credit providers), strikes the right balance between ensuring good customer outcomes and preservation of the mortgage broking industry.

3. The value of the mortgage broking industry was recognised by ASIC,[2] and includes delivery of benefits to customers by:

    (a) assisting customers navigate the many home loan product market and application process;

    (b) improving customer understanding of home loan products and financial literacy; and

    (c) providing access to finance (including specialist, small and regional credit providers) and therefore facilitating a more competitive home loan market.

4. Aussie Brokers operate across all states and territories in Australia including rural and regional Australia,[3] providing a wide distribution network across the country including in areas where there are no or few major credit provider branches. This accessibility for customers and non-bank lenders alike is a *positive* customer outcome, as it facilitates enhanced access to pre and post settlement credit services enhancing the support of customers (particularly in the face of

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[1] *Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of mortgage broker remuneration* (December 2017).

[2] ASIC Report 516 at [18] to [22].

[3] D Smith [Ex 1.78] [AHL.0011.0001.0001] at [9], and DS-1 [AHL.0011.0001.0001].

increasingly smaller branch networks) and drives competition among credit providers by providing scale and viable channel for smaller lenders that do not have branch structures.

5. AHL submits that standard commission model, which universally includes clawback arrangements, cessation of trail commission on defaulting/hardship loans, and calculation of trail commission on loan balances net of any offset account balances and which is augmented by measures to garnish benefits received from misconduct or poor practices, appropriately incentivises small business mortgage brokers to:

   (a) develop long term relationships with customers, including prospective customers, with regular contact over extended periods of time by such things as developing and monitoring savings plans for first home buyers and offering periodic home loan health checks to customers with existing loans;

   (b) write good quality performing loans which meet the customers' needs and requirements and do not become defaulting loans; [4]

   (c) leave customers in performing loans which remain suitable for their needs and requirements after a home loan health check (by continued receipt of trail commissions) or assist customers apply for a different loan which is suitable to their changed needs and requirements (by receipt of upfront).

6. With the standard commission model, AHL's experience is that loans submitted by Aussie Brokers:

   - do not have a higher than market incidence of interest only loans;[5] and
   - have default rates no different from the default rates of most banks.[6]

7. ASIC itself found that based on its data driven analysis it *"did not identify trail commissions directly leading to poor consumer outcomes"*.[7] The strength of this conclusion is bolstered by ASIC's acknowledgement that changes in industry behaviour in relation to, among other things, interest only loans following ASIC Report 445 and ASIC Report 493 would *"not be reflected in the data collected "* and relied upon for the purposes of ASIC Report 516.[8]

8. AHL also submits that conflict of interest risks are further moderated in the context of a branded or franchised aggregator model. In a franchised aggregator model, like AHL's, mortgage brokers

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[4] ASIC Report 516 at [432].

[5] T426.34 – T426.45.

[6] T427.13 – T427.16.

[7] ASIC Report 516 at [439].

[8] ASIC Report 516 at [6].

operate as small businesses in defined geographical locations, which is usually linked to the mortgage broker's local community. Like any other small business, mortgage brokers operating in a franchised aggregator model continue and grow their business by delivering good customer outcomes and securing repeat and referral business from satisfied customers. As AHL's CFO described based on his own observations, Aussie Brokers *"are extremely customer focused"… "they are running small businesses"* and are *"focused on their customers and building their customer base"*.[9] In the branded or franchised aggregator model, mortgage brokers have a direct incentive to act in the best interests of customers such that there is a coincidence of interests in a well performing market.

9. The current commission model does not separately or specifically remunerate mortgage brokers for services provided to customers *before* a loan becomes a settled loan or *after* a loan becomes a settled loan, other than through the upfront and trail commissions received on settled loans.

10. By way of example, the services provided *before* settlement are illustrated by the work mortgage brokers do for first home buyers to obtain pre-approval. As pre-approvals last, generally, no more than 90 days, it is not uncommon for mortgage brokers to undertake the work to obtain pre-approval for the same first home buyers more than once and over extended periods of time before a settlement of the loan. The customers are not charged for these services upfront or through loading of the commissions into the delivery rate to the customer. [10]

11. In addition to the pre-settlement services which result in a settled loan and post settlement services for which mortgage brokers are not specifically or separately remunerated, AHL submits that mortgage brokers provide the following credit assistance to customers, which is not remunerated:

    - suggesting a customer remain in a particular credit contract not originated through the mortgage broker;
    - suggesting that a consumer apply for a particular credit contract but no credit application eventuates through the mortgage broker; and
    - assisting a customer to apply for a particular credit contract which application is subsequently refused or withdrawn.

12. The involvement of mortgage brokers in providing all of these services to customers can itself be a positive customer outcome as it promotes access to credit advice and services increasing the sophistication and financial literacy of customers generally and facilitates competition among

[9] T416.4 – T416.7.

[10] This is evident from Finding 6 in ASIC Report 516 that mortgage broker originated loans are not consistently cheaper or more expensive loans.

credit providers in terms of product range offering and robust pre and post settlement service levels to customers. AHL submits that a fee for service model would not incentivise the provision of these services, nor would it be likely to correlate to the economic value produced by mortgage brokers.

13. By way of example, AHL submits that the services provided by mortgage brokers to customers *after* settlement include:

    - loan management services such as dealing with the credit provider to effect change of address, updated contact details, ensuring correct direct debit details/authorities, setting up loan account operating authorities, obtaining lender consents for security property alterations, reviewing loan statement;
    - assistance with product feature, technology or account change queries such as use of internet banking, setting up or linking of offset accounts, debit card applications;
    - loan variations such as substitution of security properties, partial release of securities, small top-ups, change loan type (fixed to variable, interest only to principle and interest and *vice versa*), change loan purpose (investment to owner occupier and *vice versa*), loan splits;
    - making retention pricing (discounted pricing) requests of existing lender;
    - customer education by regular notification of changes in market or industry conditions such as movements in major bank lenders standard variable rates, RBA official interest rate changes, changes in security property/postcode values and provision of market insights from industry experts;
    - home loan health checks to ensure the existing loan competitive and still meets the customers', needs, requirements and objectives and/or changed circumstances;
    - construction loan draw down support over construction period including assisting customers with submissions of required periodic documentation to facilitate draw down.

14. These post settlement services can be of particular value to customers who have limited access to, or ability to attend, traditional branch based credit providers, or smaller credit providers without a branch footprint, and to first time home buyers who have a developing financial literacy.

15. The involvement of mortgage brokers in post settlement service can also facilitate positive customer outcomes at the front end of a credit application as the service level of a credit provider as experienced by a mortgage broker is one of the qualitative consideration in a preliminary assessment of loan suitability.[11] This involvement of mortgage brokers in post settlement service can itself be a positive customer outcome as it facilitates competition among credit providers in

[11] D Smith Exhibit [1.78] [AHL.0011.0001.0001] at [34].

terms of robust post settlement service delivery to customers. AHL submits that a fee for service model would not incentivise the provision of these post settlement services nor would it be likely to correlate to the economic value produced by mortgage brokers.

16. Further, the fact that mortgage broker originated loans are neither cheaper, nor more expensive, than proprietary channel loans highlights the competitive pressure the mortgage broker industry experts on the home loan market. This conclusion is reinforced by the following observations:

    (a) commissions are a cost to the credit provider, in that commissions affect the profit of the credit provider and are not loaded into the delivery rate to the customer;

    (b) major bank lenders have aggressively reduced cost to income ratios for loans originated through the proprietary channel.[12]

17. Before recommending an abandonment of the current commission model, AHL submits that the Commission would need to grapple with the risk that, if left unchecked by the competitive pressure of the mortgage broking industry, and the viable distribution channel it provides to small, regional/rural and specialist lenders major lenders may be required to stand up additional branches and/or employ other additional resources to deal with the volume of applications which would flow form the mortgage broking channel to the proprietary channel and:

    (a) the costs of the additional resources needed to support the higher volumes may negate any cost savings resulting from the abolition of trail commission resulting in no reduction in the interest rate paid by the customer;

    (b) the cost of additional resources needed to support the higher volumes may be greater than the cost savings resulting from the abolition of trail commissions which costs may be passed on the customer via higher interest rates;

    (c) the costs of the additional resources needed to support the higher volumes may be less than the cost savings from the abolition of trail commission which costs savings may not be passed onto customers but instead added to the profit of the major lenders.

18. AHL submits that the Commission ought to be concerned not to make recommendations which would reduce the competitive pressure able to be exerted by the mortgage broking industry on the basis of an assumption that there would be cost savings from abolition of trail commissions and/or that any cost savings would be passed on to the consumer.

19. AHL further submits that the Commission ought not make recommendations which would adversely affect the viability of the mortgage broking industry or which would reduce the competitive pressure able to be exerted by the mortgage broking industry without first

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[12] T234.25-.30.

undertaking a proper economic analysis of the market consequences. In this regard, the Commission ought note that in response to the Financial System Inquiry, the Federal Government introduced new laws in 2017 which will mean ASIC's regulatory and supervisory costs in relation to credit activities will be funded by the Australian Credit Licensees. The industry funding regime took effect on 1 July 2017 and should enhance ASIC's ability to focus its resources and collect data on activities in the credit sector that are creating the need for most regulation. In this way, the industry funding model will allow for data driven recommendations rather than recommendations based on a small number of case studies or anecdotal evidence; and provide market-based incentives for credit licensees to self-regulate.

20. However, the industry funding model is at an early stage of implementation. Changes to the standard commission model should not be considered until after sufficient time has elapsed to allow the data driven and industry-wide reviews the industry funding model that it is designed to facilitate.

21. AHL submits that the risk of the standard commission model being abused by misconduct of individual brokers and delivering poor customer outcomes will be further mitigated and managed by adoption of the CIF Reforms which:

    (a) will deliver improved monitoring, supervision and reporting practices across the industry by data driven governance frameworks. AHL is already leading the mortgage broking industry with the development of its "Aussie Broker Dashboard" which was deployed in AHL's operations in early March 2018;[13] and

    (b) requires out a clear disclosure regime for ownership structures. AHL's ownership by CBA (including when partly owned) was disclosed in marketing material, digital formats and at distribution points. In addition, CBA's ownership of Residential Mortgage Group Pty Ltd (lender of record on an AHL white label product) is disclosed in AHL's Credit Guide.[14]

22. "Fee for service", as an alternative to the standard commission model, risks unintended consequences for customers and so not deliver better customer outcomes, including:

    (a) imposition of direct costs on customers where the fee for service is customer paid. For the types of customers utilising the services of mortgage brokers (being younger, lower

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[13] G Boddy [Ex 1.73] [AHL 0008.0020.0053] at [11] to [24]. The recent CBA internal audit report noted that comparatively few aggregators utilised data analytics: see Exhibit 1.74 [CBA.0506.0001.0014] at [CBA.0506.0001.0035]. Out of the six (6) aggregators used to compare to AHL, four (4) aggregators did not use analytics of broker behaviour, and two (2) aggregators systems required improvement.

[14] D Smith [Ex. 1.78] [AHL.0011.0001.0001] at Exhibit DS-11 [AHL.0008.0014.2233] at [AHL.0008.0014.2234]. RMG's relationship with CBA is also disclosed in the Credit Proposal: see DS-12, [AHL.0008.0014.2235] at [AHL.0008.0014.2236].

income consumer)[15], such an imposition would more likely than not impact customers who could least afford it;

(b) rationalisation of mortgage broker numbers:

i. this would tend to disadvantage regional and rural customers, already affected by major bank branch closures, and introduce further competitive pressure on smaller lenders (mutual banks, credit unions and building societies) and specialist lenders which do not have the distribution channels established by major bank lenders;

ii. abolishing trail commissions puts at risk the viability of the many small business mortgage broking operators across all states and territories in Australia, including rural and regional areas. Trail commissions provide a level of certainty of income for such small businesses, and in particular franchised brokers who have fixed overheads and small businesses to operate (T429.15-.23);

(c) mortgage brokers servicing a narrower band of customers (for example, those with simple needs), reflecting an absence of correlation between the economic value produced by the mortgage broker (including to the credit provider) and the quantum of the fee.

Adequate systems and processes to prevent fraud

23. In response to the question posed at T986.46- T987.03, AHL further submits that credit licensees are obliged by the NCCCPA to comply with licensing requirements, general conduct obligations and responsible lending obligations. In relation to general conduct obligations, credit licensees are legislatively obliged to have in place adequate systems and process to comply with the obligations in section 47 of the NCCPA.

24. There is no obligation in section 47 of the NCCPA to have "*systems and processes to prevent, detect and respond to fraud*". The actual obligation on credit licensees is to "*do all things necessary to ensure that the credit activities authorised by the licence are engaged in efficiently, honestly and fairly*".[16]

25. The fact that adequacy of systems and processes to ensure that credit activities are engaged in efficiently, honestly and fairly is to be determined by reference to "*the nature, scale and complexity of the credit activities engaged in by the licensee*" is expressly recognised in the terms

[15] Recognised in ASIC Report 516 at [47].

[16] Section 47(1)(a) of the NCCPA.

of the NCCPA17 and by ASIC in its guidance on general conduct obligations[18] and on responsible lending where it provides the following guidance:

> *"We expect that the compliance processes a credit licensee puts in place will depend on the business model, product type and credit activities that the licensee undertakes or offers".*[19]

26. The nature and complexity of the credit activities engaged in by mortgage brokers is vastly different to the nature and complexity of the credit activities engaged in by credit providers. This difference is recognised by the NCCPA obligation on mortgage brokers (as credit assistance providers) to make *"preliminary assessment"* and the NCCPA obligation on credit providers to make a *"final assessment"* about whether the particular credit contract will not be unsuitable.

27. Both assessments are to be made after making reasonable inquiries and taking reasonable steps to verify information. However, what constitutes reasonable inquiries and steps to verify information is different for credit assistance providers and credit providers.

28. In light of the:

    (a) differences in what constitutes reasonable inquiries and steps to verify for the purposes of preliminary assessment as opposed to final assessment; and

    (b) the vastly different nature of credit assistance services and the provision of credit,

    credit assistance providers are, and ought not be, required to maintain ADI or credit provider standard processes and systems for the prevention and detection of fraud.

29. This is not to diminish the obligation that credit assistance providers have in ensuring that the credit assistance provided by mortgage brokers is engaged in efficiently, honestly and fairly. In this regard, that obligation is adequately satisfied by systems and processes like those maintained by AHL which include systems and processes:

    (a) which provide for responsible lending compliance and training tailored to the actual credit activity engaged in by the licensee;

    (b) which monitor the ongoing eligibility of persons to be authorised as credit representatives;

    (c) ensure the electronic collection and storage of mortgage broker files including documents which evidence a needs analysis, preliminary assessment and any documents relied upon for the purposes of the preliminary assessment;

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[17] Section 47(2) of the NCCPA.

[18] ASIC Regulatory Guide 205 *Credit licensing: General conduct obligations* [205.22] – [205.23].

[19] ASIC Regulatory Guide 209 *Credit licensing: Responsible lending conduct* [209.9].

(d) which record data about the volume and nature of the credit assistance provided by mortgage brokers by reference to key risk indicators;

(e) which provide for line 2 compliance reviews, where the files to be reviewed are chosen at random and in light of key risk indicators and require consideration of whether the information collected for the loan application actually support the financial circumstances used by the mortgage broker to support the preliminary assessment;

(f) which address adverse file review findings through additional training of individual mortgage brokers and broader training programs for all authorised credit representatives of the licensee;

(g) notification of the termination of credit representatives under adverse circumstances to panel lenders and industry bodies.

30. There is a risk that, notwithstanding having been banned by ASIC from acting as a credit representative or being terminated for fraud or dishonest conduct, former mortgage brokers continue to operate in the industry or broader financial services industry.

31. To deal with this risk, the Commission might consider recommendations which requires:

(a) all authorised credit representatives of a licensee to be members of an industry body;

(b) the maintenance of a single register of credit representatives including details of current and past authorisations as well as terminations for adverse circumstances; and

(c) the industry to develop a standard and agreed definition of what constitutes “adverse circumstances”.

Dated: 3 April 2018