3 April 2018

Misconduct in the Banking, Superannuation and Financial Services Industry

Submission to the Royal Commission

ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia"s largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

To find out more about CHOICE"s campaign work visit www.choice.com.au/campaigns

CONTENTS

INTRODUCTION 3

- Unacceptable risk created by conflicted incentive structures 4
- Inadequate self-regulation 5
- A best interest duty for brokers 7
- Disclosure – only a partial solution 8
- Risks of outsourcing the sales process 9
- Risks of outsourcing – indications of improper financial advice 10
- Policy recommendation 10

INTRODUCTION

CHOICE welcomes the opportunity to provide a written submission to the Royal Commission on the first round hearings. Given our experience over the years assessing the mortgage broking market we have confined our response to this portion of the hearings. We are aware of Consumer Action Law Centre‟s written submission and we support the findings it has made in relation to broader consumer lending questions.

Australians have been let down by a number of players in the home lending market. Purchasing a mortgage is the largest financial decision most people will make. However, the importance of this decision is not matched by adequate protections for consumers. Instead, people are faced with mortgage brokers who do not act in their best interest, are motivated by perverse commission structures and in some cases have breached the law. They are also let down by banks who are increasingly outsourcing their responsibilities to third parties and failing to take adequate steps to assess for themselves a customer‟s ability to repay. The end result is that consumers pay too much for poor quality information, which all too often leads them into financial difficulty.

Industry is well aware of the problems that exist in this market but have failed to act to address the root causes. Instead they have preferred to leave customers vulnerable rather than risk easy profits. This sales first culture is most clear in Commonwealth Bank‟s failure to act alone on known problems due to a fear of loss of market share.

Attempts to self-regulate have been piecemeal, delayed and woefully inadequate. The sector has made much of its package of reforms developed through the Combined Industry Forum (CIF). However, the failure to address the most harmful commission structures is indicative of an industry that ultimately is seeking to continue business as usual.

CHOICE maintains that the only way to turn the tide on misconduct and behaviour falling below community standards is to phase out conflicted commission based incentives and move to a transparent „fee for service‟ model. This must be bolstered by the introduction of a „best interest duty‟ for mortgage brokers to ensure consumers are adequately protected.

Unacceptable risk created by conflicted incentive structures

Based on the evidence presented before the Commission and CHOICE‟s years of experience analysing this market and working with industry on self-regulatory measures, we consistently find that commission-based structures pose an unacceptable risk to consumers.

The evidence provided by Commonwealth Bank showed that current remuneration structure incentivises mortgage brokers to arrange loans with:

- higher leverage,
- a higher incidence of which are interest only,
- higher debt to income ratios, and
- as a result, a higher incidence of people falling behind on payments and getting into financial difficulty.[1]

This echoed CHOICE‟s own findings in its 2015 shadow shopping exercise, where we sent five customers looking for a home loan to three brokers each (15 brokers in total). We found:

- Risky borrowing suggestions – one broker advised a home owner who wanted to refinance her home loan and was in an unsecure employment situation to use the equity in her home to invest in new property or go on a holiday. Another broker advised a couple to borrow $1 million against their home when they only needed $600,000 to buy an investment property.
- Recommendations weren‟t always based on quality – one broker pushed his own company‟s product even while acknowledging that other lenders offered a cheaper loan.
- Poor disclosure - only two of the fifteen brokers explained unprompted that they received commissions and which lenders they dealt with.
- Little discussion of long-term risk - no broker had a conversation about capacity to pay should interest rates rise.[2]

This shadow shop indicates that there are problems for consumers, likely stemming from broker commission arrangements or institutional ownership.

These findings were confirmed by the regulator, the Australian Securities and Investments Commission (ASIC) in its review of mortgage broker remuneration.[3]

---

[1] Royal Commission, 2018, 'Royal Commission Transcript' 15/03/2018, p.241, pars. 10-30
[2] CHOICE, 2015, 'Mortgage broker investigation', https://www.choice.com.au/money/property/buying/articles/mortgage-broker-shadow-shop

ASIC found that current upfront and trail commission arrangements create two kinds of conflicts of interest. First, because brokers are paid by percentage-based commissions, a conflict arises as the broker earns more if the client borrows more. ASIC calls this a “product-strategy conflict” and recognises that “a broker could recommend a loan that is larger than the consumer needs or can afford to maximise their commission payment.” It is particularly concerning that in some cases brokers earn more if they recommend risky products, like interest-only loans, that maximise the amount the customer can borrow. Overall, ASIC found that loans provided through brokers were larger than those from direct online or direct with lender channels and loans arranged through a broker had a higher loan-to-value ratio.

The second kind of conflict ASIC identified was lender-choice conflict, where a broker is incentivised to recommend a loan that may not be the best option for the customer because they will get a higher commission. There was a 0.68% difference between commissions with one aggregator – that could mean broker receives up to $3,400 more for arranging an average loan with a certain lender.[4] Again, ASIC identified some commission structures that indicated that broker remuneration incentivised riskier borrowing strategies. For example, one lender paid higher commissions for loans with higher credit risks which attracted higher interest rates.[5] These incentives are not only leading to demonstrable harm to people, but can contribute to economy wide prudential risk.

Inadequate self-regulation

Industry, through the Combined Industry Forum (CIF), has attempted to cast the conflicted remuneration problem as one that can be resolved by removing explicit volume-based incentives, such as bonuses for reaching specific sales targets. CHOICE is a member of the CIF governance committee, acting as an independent consumer advocate. CHOICE and other consumer groups welcomed parts the reform package put forward by the CIF in December 2017.[6] However, we have consistently noted that the package of reforms proposed by industry falls short when dealing with commission structures and the duty brokers owe to clients.

The CIF has resolved to remove some volume-based incentives in an attempt to improve consumer outcomes. However, this response fails to capture the full scope of volume based

---

[3] ASIC, 2017, ‘Review of mortgage broker remuneration’ p.10.
[4] ASIC, 2017, ‘Review of mortgage broker remuneration’, para 379.
[5] Ibid, para 419(d)
[6] Combined Industry Forum, December 2017, https://www.ausbanking.org.au/images/uploads/CIF_Report_Submitted_281117.pdf

incentives. As the ASIC report found percentage based up-front and trail based commissions are both geared towards driving increased loan values, which are the self-confessed root cause of poor consumer outcomes.

Under the industry"s proposed reforms a broker or aggregator still stands to gain a higher dollar value in commissions if a consumer borrows more money. For example, a loan of $400,000 with an upfront commission of 0.6% and a trail of 0.15% p.a. would earn a broker $2,400 upfront and $600 p.a. in trail, by contrast a loan of $600,000 with the same commissions would earn a broker $3,600 upfront and $900 p.a. in trail. Industry has tinkered around the edges in attempt to deflect attention from its conflicted incentive structure, but so long as commissions exist consumer harm will remain.

The CIF program failed to rectify the inherent problems associated with trail commissions. It noted that trail commissions, which are paid over the entire life of the loan, allow a broker to "provide ongoing support to their customer base".[7] However, the exact nature of this support remains unclear. Clients who require no additional advice are still charged trail for „support" they do not draw upon nor require. If a broker wishes to provide additional support to a customer, then they should charge a fee for the service, rather than receive opaque and high-cost trail commissions.

The mortgage broking industry has also claimed that trail commissions prevent „churning" of loans.[8] This is the practice of a broker recommending a consumer switch loans in order to gain a new up-front commission, rather than basing a recommendation on the consumer"s needs and objectives.[9] Firstly, this highlights that brokers are incentivised to recommend loans to maximise commission payments, whether in a consumers best interests or not. Secondly, this assumes that preventing churn is a desirable outcome for a consumer. In fact, The Reserve Bank of Australia (RBA) found that variable interest rates of existing home loan customers average around 0.3 to 0.4% points higher than rates on new home loans.[10] Therefore, promoting regular product switching is likely to save consumers a significant sum of money, yet trail commissions create a disincentive to this type of switching. Trail commissions are better suited to minimising the loss of customers for incumbent lenders, this gives further weight to the finding that mortgage brokers are indeed the agents of the lenders.

---

[7] Combined Industry Forum 2017, Improving customer outcomes: the Combined Industry Forum (CIF) response to ASIC Report 516: review of mortgage broker remuneration

[8] For example, see FBAA, 2017, https://www.fbaa.com.au/wp-content/uploads/2017/04/2017-FBAA-Global-Research-Paper-Broker-Home-Loan-Commissions-general.pdf

[9] ASIC, 2017, 'Review of mortgage broker remuneration', p.237

[10] RBA, 2017, 'Competition in the Financial System', p.25

A best interest duty for brokers

Customers need to be able to have certainty that the person providing them advice is acting for them and putting their interests above all others. Right now, brokers have no obligation to act in the customers‟ best interests and can put their own or a lenders‟ needs first.

While brokers may act in their interests, customers are led to believe that a broker will look out for them. Advertising for mortgage brokers services claim that brokers will find customers a good quality or even the best loan, even though there is no obligation to do so. CHOICE conducted a brief review of online claims made by mortgage brokers and we found advertisements in which they stated that brokers would:

- "Fight to Get You a Great Home Loan Deal."[11]
- "choose the best loan for your needs – all free of charge!"[12]
- "choose the perfect loan for their personal financial situation"[13]
- "help you navigate through the array of options in the home loan market to find the loan that best suits your needs."[14]

In all of these statements, there is an implication that brokers act for the customer and help them get a good quality loan based on their individual needs, or even the "perfect loan". With advertising like this, it‟s no surprise that consumers think brokers will get them a good quality loan or act in their interests. What‟s needed is a tangible, legal obligation to make brokers live up to the promises they make to their customers.

CHOICE notes that industry groups have collectively defined „good consumer outcomes‟ that should be delivered by mortgage brokers through the CIF process. While we have welcomed an industry proposal that would see brokers lift standards, we do not think it goes far enough. The CIF proposal is that mortgage brokers would need to ensure that they arrange loans that:

- are an appropriate size and structure;
- meet the customer‟s stated requirements and objectives;
- are affordable for the customer;
- are applied for in a compliant manner.

---

[11] Google advertisement from mortgagechoice.com.au All images sourced on 18 March 2018.
[12] Yourmortgage.com.au/brokers
[13] Claims about eChoice made on finder.com.au/mortgage-brokers/echoice-mortgage-brokers
[14] Claims about Finsure Mortgage Brokers made on finder.com.au/mortgage-brokers/finsure

If thoroughly implemented, this requirement would see brokers having to meet higher requirements than currently set out in the law as they would arrange loans that are affordable (as opposed to not unaffordable) and that meet the customer"s stated requirements and objectives. However, it still remains unclear in whose interest the broker is acting. Notably, the CIF test does not require a broker to place a customer"s interest ahead of their own or a lender"s interest.

CHOICE maintains that a „best interest" duty should be imposed on mortgage brokers. Customers need to be able to have certainty that the person providing them advice is acting for them and putting their interests above all others. The best interest duty can be included in the current legal regime through amendment of the *National Consumer Protect Act 2009* (Cth). This duty should mirror obligations financial advisers are subject to under the *Corporations Act.* Additional requirements should be legislated and ASIC should prepare regulatory guidance on the application of the new law.

Disclosure – only a partial solution

The reforms proposed by the CIF also seek to improve disclosure requirements for lender-owned aggregators. However, it is important to note that disclosure of a conflict does not remove a conflict. Research by the Federal Trade Commission found that mortgage broker disclosure of commissions can actually increase trust in a broker, when it should have led customers to be more critical about the advice.[15] Solutions which rely on disclosure are very unlikely to address the conflicts leading to poor consumer outcomes. There is a long history of ineffective disclosure in financial services that have done little to protect consumers but added significant regulatory cost.

These examples of from the CIF reform package serves to further illustrate the point that industry resists and delays real consumer protections, and then minimises its impact through disappointing self-regulatory responses. After years of resistance by the broker industry to any suggestion that commission structures might be causing poor consumer outcomes, it took the ASIC report and threat of government intervention for the industry to act. And so far, the self-regulatory response has failed to adequately address the problems of conflicted remuneration and giving the interests of customers" priority.

---

[15] James Lacko and Janis Pappalardo, 2004, 'The effect of mortgage broker compensation disclosures on consumers and competition: a controlled experiment", Federal Trade Commission, https://www.ftc.gov/reports/effect-mortgage-broker-compensation-disclosures-consumers-competition-controlled-experiment

Risks of outsourcing the sales process

CHOICE was particularly concerned by the evidence presented before the Commission of outsourced sales and referral processes. By its nature outsourcing makes adequate monitoring significantly more difficult. A lender is unable to see inside another business and root out poor practice in the same way it can over its own business. Combined with a conflicted remuneration structure, which incentivises the sale of large and in some cases unaffordable loans, we are concerned that this is a deliberate strategy to avoid responsibility for sales practices which at best do not meet community standards and at worse breach the law.

Introducer program

Given the significant volume of commissions (approximately $144 million) involved and the significant volume of loans written ($24 billion between 2013-2016)[16] the NAB Introducer program was clearly a lucrative sales channel. In exchange for these commissions NAB claimed introducers were only supposed to provide the name and contact details of potential lenders.[17] Introducers were forbidden from giving advice or representing themselves as an agent of the bank. However, on the evidence introducers went far beyond these limitations and the incentive structure seemed designed to encourage this behaviour.

Offering a percentage of loan value as an incentive is ill suited to remunerate a person for simply introducing a potential lender to the bank. As discussed already, percentage based commissions are designed to incentivise the sale of larger loans. Coupled with NAB"s requirement for introducers to meet volume based sales targets, the bank created a significant risk that introducers would attempt to convince potential borrowers to take larger, less affordable loans.

There were also examples of introducers going well beyond simple referrals and sending home loan applications and supporting documentation to the bank. In total this lead to the approval of loans in circumstances where a person did not have the capacity to repay. By February 2016, NAB had identified 90 customers with $50 million in loans where the bank was concerned about the customer"s ability to continue to afford repayments.

---

[16] Royal Commission into misconduct in the banking, superannuation and financial services industry, transcript p.46 par 20

[17] Royal Commission into misconduct in the banking, superannuation and financial services industry, transcript p.74 par 10

There was also evidence that NAB failed to build adequate protections and monitoring into the introducer program. There were piecemeal attempts to remedy these problems, but the fundamental point remains that commission based incentives drive behaviour which is likely to lead to breaches of responsible lending laws.

Risks of outsourcing – indications of improper financial advice

This risk of improper advice is also evident in the mortgage broking market more generally. In July 2016, CHOICE asked a nationally representative sample of Australians if they had seen a mortgage broker in the last six years. We asked those people who had seen a broker about their experience.[18] We note that the sample size of this research is relatively small: 280 people had seen a broker in the last six years, the majority (170) had seen a broker in the last two years. Given this, the findings should be taken as an indication of likely behaviour from brokers but not representative percentages of the activity.

The results are concerning. Many people appear to have been given limited information. About a third of people said a broker did not tell them how they were paid. Some brokers appeared to have a financial advice-style relationship with their clients – they were discussing non-property investments (24%), long-term investment strategies (33%) and helping people make financial decisions linked to superannuation (20%) and retirement (30%).

Unless a broker is also a qualified financial adviser they should only be arranging a loan for consumers; they are not able to provide financial advice on or related to other financial products. We are concerned that a reliance on mortgage brokers as an outsourced sales channel for loans potentially exposes consumers to unlicensed financial advice. Once again the outsourced nature of these practices means the banks have little ability to monitor sales practices and prevent advice that may lead to risky lending.

Policy recommendation

CHOICE recommends that fee for service remuneration for mortgage brokers would eliminate the consumer detriment caused by commissions. This fee could be either a lump sum payment

[18] This question was asked as part of CHOICE's Consumer Pulse study. Consumer Pulse is a study conducted by CHOICE among a sample of 1025 respondents aged 18-75 years. The sample is a nationally representative of the Australian population, based on the 2011 ABS Census data. The study was conducted via an online self-complete survey in partnership with The ORU. The ORU is an ISO 20252 / ISO 26362 accredited panel provider and full AMSRO member. Fieldwork was undertaken from 21 to 29 July 2016.

or rates based on hours of work required to arrange a loan. Under this transparent system, consumers would be aware of the real cost of the service. This would remove opaque commissions and resolve the agency issue highlighted by the Commissioner throughout hearings.

CHOICE maintains that a „best interest" duty should also be imposed on mortgage brokers. Customers need to be able to have certainty that the person providing them advice is acting for them and putting their interests above all others.