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Submission - Productivity Commissions draft report Competition in the Australian Financial System

Thank you for the opportunity to comment on the draft report of the Productivity Commission's Inquiry into Competition in the Australian Financial System (Inquiry).

My name is Marty McDonald, I am the owner operator of small mortgage brokerage with 3 staff. I hold a ACL (391230) in my own name and authorise my company as a credit representative (444479).

My submission will be brief as I am solely focussed on comments and recommendations made in regard to the residential home loan market and specifically mortgage brokers.

I have made several observations below and provided conclusions and some recommendation for the commission to consider.

1) Switching levels in the mortgage market is a key indicator of a competitive market:

I refer to the draft report which concludes the level of switching within a product segment by consumers is a good indicator of the level of competition in that market. The published data in the report shows there is a much higher level of switching in the mortgage market than any of the other product markets observed, namely transaction accounts and credit cards. It can therefore be concluded that competition is strong in the mortgage market relative to other segments.

Mortgage brokers play very little role in the origination of credit card and transaction accounts, while they play a significant role in the mortgage market. Current levels of new mortgage inflows via brokers sits at > 50% of the total inflows. The market segments with no broker involvement show limited switching activity and we can assume therefore that they lack competitive tension. The opposite is evident in the mortgage market which shows high levels of switching.

I also point to Nab's submission to the PC in which they noted *"refinance out rates for NAB's mortgage broker originated loans was more than double the rate of direct channels in FY17".* While we have no data around whether these borrowers were utilising the same broker again to assist with the refinance it seems highly likely that there would be a strong correlation.

Summary:

The level of switching indicates a healthy competitive mortgage market.

In product segments with no brokers, switching is much less prevalent.

Mortgage brokers appear to be the main conduit to assist consumers in refinancing.

There are currently no signs of brokers being an impediment to competition in the mortgage market.

2) The borrower is in no way tied to the broker ongoing:

The assumption is made that there is a perverse incentive for the borrower to remain in their current loan due to trail income being received by the broker and or the threat of a commission claw back in the first few years of the loan.

I contest these assumptions as the borrower is not tied to the broker in any binding manner. There is no perverse impediment in the mind of the borrower.

Borrowers who use a broker are free to refinance to another lender at any time whether this is through their current broker, a lenders direct branch channel, a lenders online channel, over the phone to a lender or via another broker. The only real impediment to consumers refinancing is the administrative burden.

If the borrower does remain loyal to the broker and that same broker assists with a refinance this is income positive to the broker in all cases for that broker. There is a new upfront commission paid, the trail from one lender is replaced by the trail from the new lender.

Clawbacks:

In the event of a clawback of upfront commission from a lender this is effectively repaid by the new lenders upfront payment (assuming the same broker is utilised). I will grant that no one is particularly incentivised to do twice the work for the same income but retaining the customer would remain paramount. Therefore, it could be concluded that "clawbacks" provide only a slight impediment on competition.

LMI and Fixed Rate Break Costs:

I do take the commissioners points on LMI. I add fixed rate break costs to that discussion.

Fixed rate break costs or early repayment adjustment fees as they are sometimes known are an impediment to refinancing and competition. Over the last few years fixed rates have not moved much in general yet when a borrower breaks a fixed rate loan they are still penalised with a large break cost. As market fixed rates have not materially changed in the last few years this indicates that break costs in their current form are not a true representation of the cost to the lenders who could re-lend these funds at similar rates as to what they initially lent them at.

Summary:

There is no perverse impediment in the mind of the consumer who is free to refinance at any time (assuming no LMI and no fixed rate break costs are in play).

The retention of trail commission by the broker is not a perverse impediment to refinancing for the broker as it is replaced by the new lenders trail payment and importantly another upfront commission in most cases.

3) Mortgage broker trail commissions - Their role in the market:

The commission seems to focus at the transactional level rather than the relationship level when looking at commission earned by brokers. I believe the views formed on trail incomes are clouded by this thinking.

Brokers run a relationship business based on customer satisfaction, repeat business and referrals. After a loan settles all mortgage brokers provide ongoing advice to borrowers on an ad-hoc basis when they require it and on a diarised review basis.

For their client's mortgage brokers run detailed and accurate hypothetical serviceability scenarios based on changing family circumstances or potential investment opportunities as they arise. They do regular loan reviews and reprice existing loans with existing lenders. They offer options to refinance if the current loan is no longer competitive. They do variations to existing loans with the current lender such as switches to different products, switches to interest only or principal and interest repayments, substitutions of security, partial discharges, consents to subdivide….the list goes on. These variations can be as much work as a full application in some cases, but brokers receive no direct payment for this work performed. This "unpaid" work would not be sustainable without the current level of trail income to support the mortgage broker businesses.

As a mortgage broker business grows, their client base increases and the amount of "non-paid" work increases along with business overheads such as the requirement for more staff and more office space.

I estimate this non-core or non-paid work for want of a better term currently takes up around 60% of my time. I don't think I am unique for the industry. Without trail commissions I could not support my client base to the level they are accustomed to.

Summary:

Rather than trail commissions being an impediment for customers to switch loans evidence suggests it is the opposite. Trail income provides the borrower (if they so choose) a stable mortgage broking business that knows their financial affairs intimately and which can be called upon to answer their queries promptly and professionally.

The broker performs ongoing "unpaid" administrative work that was traditionally done by bank branches. The broker acts as an agent of change and can ultimately assist the borrower to refinance to a more competitive loan / banking arrangement if their incumbent lender isn't looking after their interests as they should.

4) Assessing the cost of the broker channel

As the commissioner has noted there is very limited data on whether branch or broker is the cheaper distribution channel. There is conjecture as the banks themselves have either not provided the data or they have not presented it in a uniform manner.

The CBA's outgoing CEO's comments recently that the direct channel is the cheaper distribution option did not mention if this was based on a marginal or fixed cost basis. During the royal commission hearing recently we heard from the CBA's Executive General Manager of Home Buying. He stated that when he looked at costs of the two channels he considered the proprietary channel on a marginal cost basis, effectively ignoring some or all of the fixed costs that already exist in the branch network.

Summary:

There is currently no evidence that broker commissions are adding to the overall cost of distribution of home loans and therefore to the costs of home loans in general.

It appears unlikely to me that lenders with large branch networks will be able to extract the data around the costs of the two channels in a way that doesn't have a bias regarding their point of views on fixed versus marginal costs of their own networks.

5) Interest rates lower through brokers:

The draft report notes that interest rates for broker introduced customers were lower than direct customers across all loan sizes. Somewhat puzzling to me is the report notes that they are only "marginally" lower and this requires further investigation.

The channels have loan pricing parity most of the time, a recommend retail price if you will. So why do broker loans consistently have lower rates especially for lower value loans?

My experience tells me the reasons are:

a) Lender panel – Brokers have a choice of lenders and some lenders rates on offer will of course be lower than others at any point in time. Brokers are very good at utilising special offers for their clients benefit.
b) No advantage for brokers to offer higher rate products – There is no advantage for a broker to assist a client into a higher interest rate product. The same cannot be said for the direct channel as they have a conflict of interest to maximise their employer's profits.
c) Discounting – An employed loan officer has no incentive to offer a customer their maximum discount if not asked for it. A mortgage broker has no incentive NOT to offer it.
d) Repricing of old loans – Brokers keep in contact with their clients and reprice uncompetitive loans. This can be via the current lender or by refinancing to another lender.

Why are broker introduced loans only "marginally" lower?

The answer is brokers can only offer what the lenders offer. Hypothetically if a new lender entered the market and was pricing their loans at 1% pa less than the incumbent lenders and they had scale to manage new inflows, systems in place to manage customer expectations post settlement and all the other considerations that go into recommending a loan provider then brokers would use this lender en masse.

In reality brokers are so good at rewarding lenders who offer cheaper rates that lenders cannot manage to offer lower rates than their competitors for any extended period of amount of time due to their processing constraints. Case in point is currently Westpac who after offering significantly lower investment, interest only fixed interest rates for a period of 3 months now has a 15-working day turn around in their processing centre.

Summary:

Broker introduced loans have overall lower interest rates than branch introduced loans. This indicates brokers provide competition in an efficient price discovery market.

Competition would be increased if lenders had more scale to handle inflows from brokers when they offered lower than market rates.

6) Fee for service:

It has been proposed that brokers should move to a fee for service proposition. My colleagues and I just can't see this working for any of the stakeholders besides the 4 major banks.

While existing customers of brokers value their service, new customers when faced with the prospect of paying a large upfront fee to a broker or walking down the road to a big 4 branch with no fee will likely chose the latter. Brokers market share would of course plummet.

All things being equal if 10,000 or more active mortgage brokers disappeared the lenders direct channels would have to employ thousands more staff to cope with their customer facing needs not to mention that other fixed costs that would increase. Would these increased costs be more or less than the cost of the current broker commissions? No one can reliably say for sure as we don't have that data. What we can say is the end consumer would not be advantaged by increased competition as many lenders rely almost entirely on the broker channel.

Summary:

There is no evidence to suggest a change to the current commission model would be beneficial to competition.

A fee for service in place of the current commission model would be detrimental to competition.

<u>CONCLUSSIONS</u>

1) Competition is alive and well in the home loan market. It is the most competitive of all financial service markets. Brokers play an integral role in promoting competition.

2) There is no evidence that the current commission model in particular trail commissions provide an impediment to competition.

3) Commission claw backs are not an impediment directly to the borrower but are a minor impediment to brokers.

4) LMI and fixed rate break costs (in their current form) are an impediment to competition.

5) Trail commissions allows mortgage broker customers to be provided with ongoing after sales service by respected professionals that was traditionally supplied by the branch network.

6) There is no evidence that broker commissions add to the overall cost of housing loans. There is no evidence that broker commission are an expensive method of distribution. For large branch network lenders, the cost of using brokers may be higher than their own channels but only when comparing on a marginal cost basis. The savings made by smaller lenders and potential new entrants and what this offers to competition outweigh any concerns.

7) Fees for service in place of commissions would decimate the mortgage brokering industry and would not have a positive outcome for competition.

RECOMMENDATIONS TO CONSIDER:

1) I don't recommend any material change to the current standard commission model as I don't believe it would be beneficial for competition.

2) All brokers not just those under lender owned aggregators to adopt a duty of care to act in their customers best interest.

   A limited liability scheme similar to what is afforded to legal and accounting professionals should be considered.

3) LMI should be refundable to the borrower during the first 2 years of the loan on a sliding scale.

   For example:

   Year 0 - 1 = 75% refund
   Year 1 – 2 = 50% refund
   Year 2 onwards = 0% refund

4) All lenders should have their fixed rate break costs formulae approved by ASIC. As they stand currently most are in favour of the lenders and do not represent the true cost of breaking the loan. The break costs formulae should reference current market home loan rates at the time of the break and not cost of funds rates which are opaque and too easily manipulated to favour the lender.

5) Lender clawback to be retained but the time they are in force should be reduced to a 6-month maximum period. This would ensure there was no impediment to refinance if the loan became unsuitable or uncompetitive. It would also ensure no over payment of upfront commissions to a broker in a bridging or temporary loan scenario.

Regards,

Marty McDonald