connective

22 March 2018

Commissioners
Productivity Commission

By email: financial.system@pc.gov.au

Dear Commissioners

Re: Competition in the Australian Financial System – Productivity Commission Draft Report (January 2018)

1. This is a submission in response to the draft report prepared by the Productivity Commission in relation to '*Competition in the Australian Financial System*' dated January 2018 (the **Report**).

2. Connective is Australia's leading home loan aggregator, with approximately 20% of all home loan brokers in Australia utilizing our services and 1 in 10 home loans being written by a Connective broker. This places Connective in a unique position where we see both the daily efforts mortgage brokers take towards servicing the needs of consumers within the requirements lenders prescribe, and the substantial benefit these mortgage brokers provide to consumers in the home loan market.

3. Considering the area Connective operates in, this submission will only respond to the sections of the Report referencing the mortgage broking industry, primarily Section 8 "The residential home loan market".

General observations

4. We would like to acknowledge the detailed review of mortgage broker remuneration completed by ASIC in 2017 (Report 516 '*Review of mortgage broker remuneration*' dated March 2017 (the **ASIC Review**)). In preparing this report, ASIC performed its biggest ever data collection exercise, obtaining data from key stakeholders in the industry, including Connective. We were also an active participant following the release of the ASIC Review in formulating the response to its findings.

5. ASIC expressly recognizes, both in the ASIC Review and in subsequent public statements, the very important role mortgage brokers play in the home loan market.

6. In response to the ASIC Review, the Combined Industry Forum (the **CIF**), which is referenced in Box 8.1 of the Report, was formed as a proactive step towards generally lifting standard of mortgage brokers. Connective was an active participant in the CIF including Mark Haron, one of our directors, acting as Deputy Chair.

7. The CIF included representatives from all corners of the home loan industry, including the various industry bodies and associations, aggregator groups, broker businesses and home loan lenders (ranging from the Big 4 banks to smaller, specialized lenders), with ASIC and Treasury regularly consulted. In addition, consumers were represented through the involvement of Choice Consumer Group, Consumer Action Law Centre, Financial Counselling Australia and Financial Rights Legal Centre. Working together, the CIF has

recommended reforms be implemented by lenders, aggregators and brokers in response to the ASIC Review, some of which are already occurring. We understand that the CIF is separately making a submission in response to the Report. Accordingly, we will not set out each of the CIF's proposed reforms on the basis that these will already be part of CIF's own submission.

8. As a general response to the Report's comments regarding the mortgage broking industry, Connective strongly believes that the proposed reforms recommended by the CIF more than adequately respond to any concerns the Productivity Commission raise regarding mortgage brokers. This is on the basis that the CIF was formed in response to the ASIC Review and the Retail Banking Remuneration Review conducted by Mr Stephen Sedgwick AO (the **Sedgwick Review**), both reviews covering similar issues as the Report regarding mortgage brokers (particularly around remuneration and disclosure obligations).

9. What we would caution the Productivity Commission against is making recommendations which may negatively impact the feasibility of mortgage brokers to continue to operate in the industry as that may result in the opposite effect of what this Report is trying to achieve. As we set out below, we disagree with certain findings set out in the Report. In addition, there are areas which require further investigation before conclusions can and should be made.

Findings, Recommendations and Information Requests

Draft Finding 8.1 Interest rates from brokers vs other channels

10. The Report states on page 7 "*while enabling ready comparisons between a selection of home loan providers and reducing consumer search costs, mortgage brokers do not consistently get lower home loan interest rates for consumers than would be available to the consumer by going directly to the provider*". This statement cannot be made without at least further investigation by the Productivity Commission.

11. From our perspective, it fails to appreciate that consumers who use mortgage brokers are generally different from those that go direct to branch and that such factors may explain why this may be the case. Otherwise, comparisons the Productivity Commission make in arriving at its conclusions may not be accurate and, in our view, may undersell the value mortgage brokers provide consumers generally.

12. As acknowledged by the Report, a mortgage broker's value to the consumer should not solely be linked to their ability to negotiate the cheapest interest rate pricing. The advice and assistance during what can be a daunting process for a consumer cannot be quantified and as evidenced by your findings.

13. Finally, the impact of mortgage brokers to home loan interest rates cannot solely be quantified by comparing the rates obtained from brokers vs. other channels based on current data. The Productivity Commission must also appreciate the role mortgage brokers have played in applying downward pressure on pricing in the home loan industry generally over time. Mortgage brokers have helped facilitate greater competition in the home loan market, through providing a national distribution channel for certain lenders (whether new entrants or those without large branch networks) as well as offering consumers access to, and information of, products offered by multiple lenders to facilitate switching, which could only lead to all home loan consumers enjoying the benefit of more favorable interest rates.

14. We set out in Schedule 1 to this submission a graph of the distribution of settlements arranged by Connective mortgage brokers amongst lenders between 2015-2017. As seen from Schedule 1, the Big 4 major banks' share has progressively fallen from 64.32% of all Connective mortgage broker settlements in 2015, down to 54.4% in 2017. In comparison, the other lender categories have each progressively seen their share of settlements increase in the equivalent period. This evidences mortgage brokers facilitating greater competition in the market and allowing new or smaller entrants to compete against larger lenders on a national level.

Draft Finding 8.2 Cost of home loans through brokers vs branches

15. The Report notes that distributing loans through mortgage brokers has, on average, increased smaller lenders' market share by 1.55%. Without mortgage brokers, these lenders would, on average, need to have an additional 118 branches each to maintain their current market share in the home loan market. The Productivity Commission must consider what the cost to the customer would be without mortgage brokers – both from increased costs these smaller lenders would need to pass on to their customer and generally, the lessening of competition in the market.

16. It is disappointing to note that the Productivity Commission was unable to fully recognize the value of mortgage brokers to lenders due to an inability of certain lenders to give evidence on how they assess the costs and benefits of using mortgage brokers rather than branches to source home loans. It is easy to point to the measurable upfront commission paid to a mortgage broker as a "large" amount for the service that a mortgage broker provides. Such services range from recommending possible loan products suitable for the customer, managing the loan process from start to finish, collating supporting documentation for the application to liaising with the customer's lawyers to ensure settlement occurs. What is often not appreciated is the number of hours that mortgage broker has expended on these services to achieve settlement of a home loan for their customer.

17. Connective sees the time and effort mortgage brokers put in helping their consumers obtain a home loan. From our perspective, it is difficult to fathom that one could conclude that mortgage brokers are not cost efficient for lenders especially when the lender only incurs such cost if a home loan is settled as compared to the sunk costs of running a physical branch and staffing it accordingly.

18. We object to the statement on page 220 of the Report that "*Lenders have spent large amounts of money remunerating brokers…*" as this would indicate that the Productivity Commission is of the view that mortgage brokers are remunerated too much. Without any evidence that an effort has been made to appreciate the time and effort mortgage brokers expend in servicing their consumer, and how that consumer values the mortgage broker, it is concerning that a value judgment is being made as to what a mortgage broker's service is actually worth.

19. This trend continues on page 221 of the Report, quoting UBS's commentary that mortgage broker commissions were '*relatively high*' when compared to 'simple financial advice'? Many in the industry have strongly disagreed with UBS' publications on the mortgage broking industry and queried on what basis UBS has made certain conclusions. It is extremely disappointing that the Productivity Commission has quoted from UBS's

publications without independently investigating how valid such assertions are in the first place. Home loans are often the biggest financial decision in a consumer's life and it is difficult to accept that the service a mortgage broker provides is equal to "*simple financial advice*", which UBS uses to support its conclusion that broker commission costs are high.

20. Separately, we need to appreciate that brokers usually are self-employed small businesses (often sole proprietors), with commissions they receive being their sole revenue to cover the costs of their business. They are not employees with a regular wage, and commissions cannot be equated to that when observing whether they are "high".

21. The Report's statement that "*Consumers ultimately pay for brokers*" is correct but we are unsure as to the purpose of this statement considering this is no different than if a consumer went directly to a lender. Is not the cost of running the lender branch also passed on to the consumer?

22. Similarly, what is the value of referencing UBS's estimate that broker commissions increased home loan interest rates by 16 basis points per year (page 221 of the Report) when the Report also acknowledges that this estimate does not take into account any cost savings that may flow from the broker distribution channel? If brokers were not paid commission by the lenders, does the Productivity Commission genuinely believe that consumers would enjoy lower interest rates?

Draft Recommendation 8.1 Duty of care obligations for lender-owned aggregators

23. Macquarie Bank Limited (**MBL**) owns a 25% stake in Connective. MBL does not have a representative on Connective's board, nor does it have any influence or involvement in the day to day operations of Connective. On this basis, we do not believe that this draft recommendation would apply to us.

24. However, in response to this recommendation, we do not believe that such a duty is required considering the various laws and regulations, including responsible lending obligations, mortgage brokers are already subject to. We also refer to the CIF proposed reforms which include applying the following definition of "*good consumer outcome*" in response to the findings of the ASIC Review:

    "*The customer has obtained a loan which is appropriate (in terms of size and structure), if affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan.*"

25. We believe that this definition of "*good consumer outcome*", which will be the focus of lenders, aggregators, mortgage brokers and other industry participants moving forward, coupled with the other CIF proposed reforms will provide an equivalent, and more relevant, duty on mortgage brokers than that suggested in the draft recommendation without the need to introduce another layer of regulation.

26. From a practical perspective, introducing one standard for certain brokers (those who are connected with a lender-owned aggregators), and a different set for other brokers will lead to confusion and regulatory uncertainty.

Information Request 8.2 Should consumers pay broker fees for service?

27. We would strongly recommend that the commission structure for mortgage brokers remain as is, subject to the changes recommended by the CIF. The proposed reform requires commissions be paid on the net utilized amount of the loan, as opposed to the total loan amount, so as to eliminate the potential conflict of a broker recommending a loan larger than consumer requires. As per our submission to the ASIC Review, although there are potential conflicts of interests due to the current commission structure, alternative structures would raise similar issues or perceived conflicts.

28. Moving to a consumer pay fee for service structure would severely damage the mortgage broking industry, if not kill the industry. This would also unfairly benefit lenders with physical branches, where a consumer would not be charged if they obtained a home loan directly from lender.

29. There is also unfairness to customers who use mortgage brokers with this proposal on the basis that:

    - Customers who typically cannot afford to pay an upfront fee, such as first home buyers, could be prevented from obtaining the assistance and advice they require; and

    - Customers using brokers would be charged a fee which would not be charged to those going direct to lender, hurting a mortgage broker's value proposition and ability to compete on equal terms.

30. It is critical that the focus be on rewarding behavior which drives positive consumer outcomes as opposed to shrinking the funding available to pay mortgage brokers for their efforts. As discussed above, this would equate to measuring a mortgage broker's performance against their responsible lending obligations. Considering the benefits mortgage brokers provide the home loan industry generally, we must be very careful to ensure any changes do not hurt the industry which in turn results in a less competitive market for consumers resulting in a less positive outcomes for them.

Draft Recommendation 8.2 Mortgage Broker disclosure requirements

31. Connective does acknowledge that consumers could benefit from receiving more information from mortgage brokers. However, we believe that the proposed reforms recommended by the CIF already adequately cover this. Ultimately, a balance needs to be struck to ensure that a consumer is appropriate informed but not so overwhelmed with information to be unhelpful.

32. In relation to the Commission's specific recommendations:

    - *The types of products offered by different lenders (including white-label loans and which lender provides the funding for them) and associated loan features*:

      We understand the value some of this information may provide for a consumer. However, we query whether this will actually be helpful to consumers or just result in confusion. The consumer may not be eligible for all the products accessible through that mortgage broker, nor are many of these products suitable for that consumer's needs. Often, consumers use brokers as they have lower financial literacy or are time poor. On this basis, we disagree with this recommendation on the basis that a broker is already subject to responsible lending obligations and working towards a good consumer outcome, which should drive the level of information provided. In our view, the right of level of information involves a summary of a small range of products available from more than one lender, where suitable, who the mortgage broker believes suits the consumer's needs. This information would only be provided after that mortgage broker has understood that consumer's requirements and objectives.

- *The role mortgage brokers in matching borrowers with home loan providers, including how brokers are limited in their ability to help consumers apply for loans from all lenders because not all lenders are on the aggregator's panel or the broker is not accredited with a particular lender.*

  We agree that a mortgage broker should disclose to a consumer which lenders they are accredited with. This is in line with the CIF's proposed reforms. These proposals also include providing the consumer with data as to the which lenders the broker had placed loans with over the prior 12 months and the percentage spread.

- *How mortgage brokers are paid (including specific information about their payment arrangement)*

  This is already communicated to consumers by Connective's brokers in the credit proposal document (which the Report describes in Box 8.3).

- *Any ownership relationships between lenders and the aggregator, and the requirement for brokers to act in consumers' interest where an ownership relationship exists*

  We agree with this recommendation (bearing in mind our response to Draft Recommendation 8.1 above) and note that it is already covered in the CIF's proposed reforms.

Draft Finding 13.1 Mortgage Broker commission structures weaken consumer switching

33. We strongly disagree with this finding and believe that the Productivity Commission has incorrectly interpreted what the true purpose and effect of trail commissions and commission clawbacks are.

34. We are unsure as to how the conclusion was reached on page 385 of the Report that "*trail commissions weaken the incentive for mortgage brokers to help their customers switch home loans. This is especially true when the commission increases over time, as brokers stand to lose the higher trail commission rate …*". Where a mortgage broker facilitates a consumer to switch from one lender to another, it is true that the mortgage broker will lose the trail commission payable on that original home loan (usually 0.15% p.a. although this can increase to around 0.30% p.a. for certain lenders). However, what the Productivity Commission has not appreciated is that the mortgage broker would earn a new upfront commission (approximately 0.65% on the loan amount) when that consumer switches, which is a far greater incentive than the existing trail commission. In addition, that new loan would also pay a trail commission to the broker.

35. Trail commission also does not prevent a mortgage broker approaching the incumbent lender to a consumer seeking to renegotiate for improved terms and conditions as part of

the mortgage broker's ongoing service to its client.

36. From a lender's perspective, they do not recoup the upfront commission they pay to a mortgage broker until the home loan has been performing for a period of time. This is why lenders introduced 'clawbacks' in order to recoup some or all the upfront commission if the home loan was prepaid or refinanced within a short period of time.

37. Mortgage brokers have often argued against clawbacks, pointing towards the unfairness of being required to repay some or all the upfront commission earned on a loan due to circumstances entirely outside of their control (e.g. the customer sells the property shortly after the loan is arranged). From a mortgage broker's perspective, the same amount of time and effort has gone in to obtaining that home loan regardless of when it is repaid.

38. Mortgage brokers would happily support the removal of clawbacks from the commission structure, however not for the reasons stated in the Report.

39. We believe that the Productivity Commission has drawn the wrong conclusion in its statement that clawbacks create "*a direct disincentive for mortgage brokers to help their customers to switch within that time period*" on page 385 of the Report. As part of performing their responsible lending obligations, a mortgage broker takes great effort in ensuring the consumer is in a home loan which should meet that consumer's needs and objectives at least for the near future. Home loans are not a product that can be easily switched, and the time and costs associated with entering a home loan need to be considered. If the mortgage broker has done their job correctly, the home loan should be suitable for that consumer at least for the period to which clawbacks would apply.

40. Finally, if a mortgage broker did facilitate a consumer to switch home loans during a clawback period, any clawback suffered by that mortgage broker would be offset by the upfront commission received as part of the new loan, so query whether such a disincentive genuinely exists.

Information request 13.2 – Is there a rationale for the structure of mortgage broker commissions?

41. In our opinion, the current commission structure for mortgage brokers (comprising of upfront and trail commission) provides a great balance between paying the mortgage broker for their efforts in assisting the consumer obtain the home loan, whilst continuing to remunerate the mortgage broker for providing service to the consumer during the life of that home loan.

Trail commissions generally

42. Connective sees trail commissions as deferred consideration paid by lenders to mortgage brokers for their services. In other countries where mortgage brokers only receive an upfront commission and no trail, the quantum of upfront commission is much higher than in Australia (upfront commissions in Canada range from 0.90% to 1.40% with no clawbacks).

43. Connective's expectations of its mortgage brokers will be, as a minimum, that they should endeavor to contact the consumer at least once a year to justify the continued payment of trail commission. As with any home loan customer, whether through a mortgage broker or direct to lender, some require regular and extensive assistance, others very little. Trail

commission is critical in ensuring that mortgage brokers continue to provide this invaluable assistance during the life of the home loan.

44. As per our response above to Draft Finding 13.1, we strongly disagree that the current structure of trail commission actually creates a perverse incentive for mortgage brokers to keep customers in their existing loan. In addition, is there any evidence that the removal of trail commission will result in a cheaper rate for mortgage broker consumers? Lender practice is for pricing to be agnostic between its distribution channels, making it unlikely that the saving from abolishing trail commissions would actually benefit the consumer.

Trail commissions that increase over time

45. The longer a consumer remains in their home loan, the more profitable the home loan is from a lender's perspective. Certain lenders have chosen to share this with mortgage brokers by increasing the trail commission.

46. At the end of the day, this is a commercial decision taken by each lender in their sole discretion. Connective sees no reason why this option of a lender should be removed on the basis that it does not actually create the perverse incentives the Report has identified in Draft Finding 13.1.

Commission clawback

47. We would support the removal of commission clawback. This is on the basis that clawbacks are unfair to a mortgage broker who has provided the assistance and spent the time and effort in assisting a consumer obtain a home loan that has been repaid within a certain period of time outside of that mortgage broker's control. As discussed above, we do not see clawbacks as a reason for a mortgage broker keeping a consumer in their existing loan when the mortgage broker can switch the consumer to a superior option.

Closing comments

48. Connective is appreciative of the time and effort the Productivity Commission has undertaken in preparing the Report and for offering the opportunity to make a submission in response.

49. We firmly believe, as confirmed by both the Report and findings in the ASIC Review, that mortgage brokers provide great value to their customers. Mortgage brokers have also facilitated greater competition in the home loan market which has led to lower interest rates for consumers generally. In certain areas such as rural areas unsupported by lender branches, small lenders having access to a national distribution channel without the need to set up branches and customers requiring that additional level of support in connection with their homes loans, mortgage brokers fill a critical gap.

50. Interest rates for home loans should also not be the sole measure for competition in the home loan market, nor the true value mortgage brokers provide their customers. Your findings show that without brokers, certain groups in the market may not be adequately serviced.

51. The industry recognizes through the work of the CIF that there were areas which could be improved and as a group, we can strive to do better. The CIF's proposed reforms are a

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proactive step in this direction. At Connective, our focus is ensuring we continue supporting our mortgage brokers to focus on helping their customers achieve great outcomes.

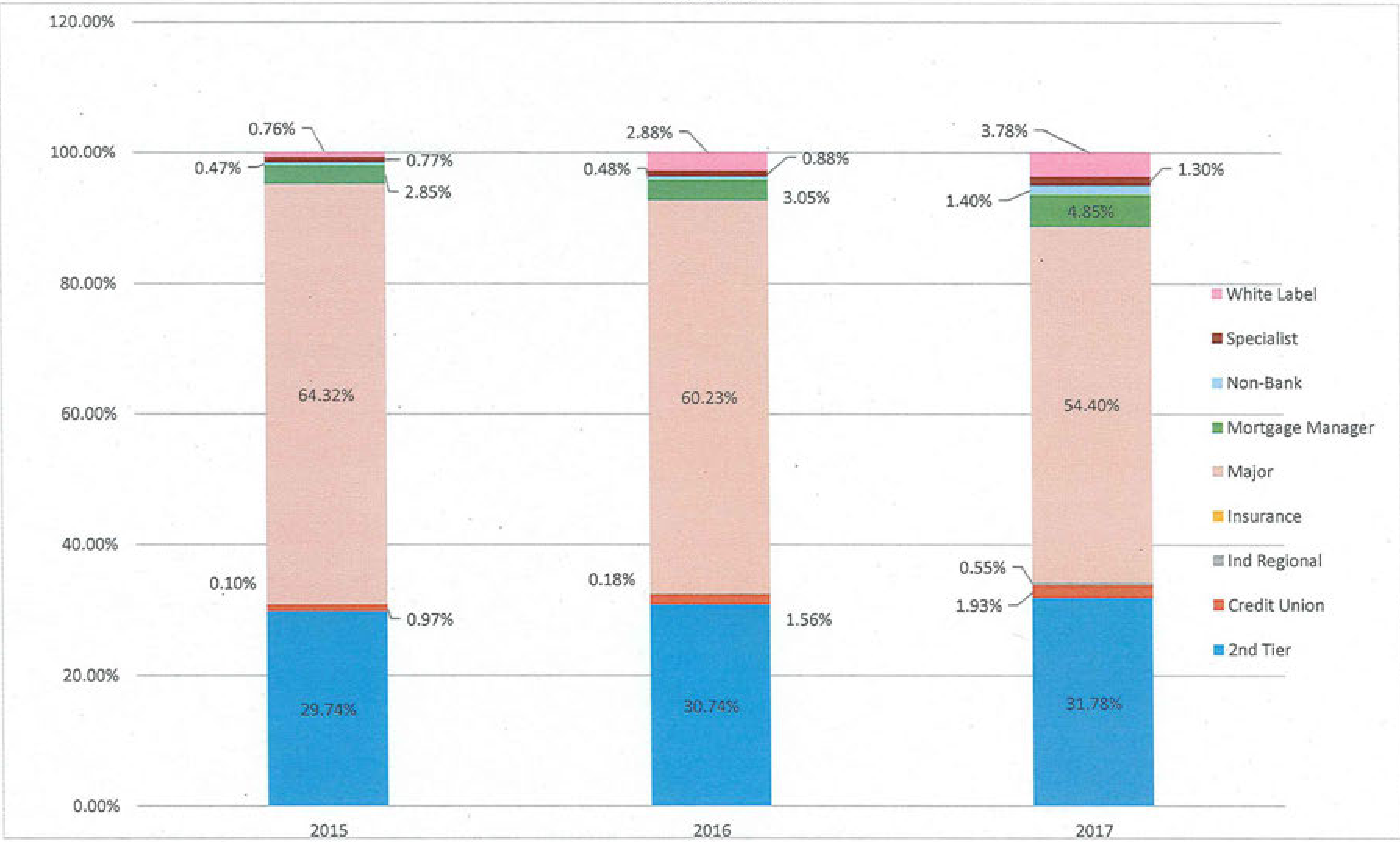
52. As we have expressed above, we do not necessarily agree with all of the Productivity Commission's findings and recommendations. From Connective's perspective, we believe the current regulatory framework applicable to the industry supported by the reforms proposed by CIF are sufficient to ensure mortgage brokers provide their customers with good consumer outcomes and that healthy competition is maintained within the home loan market.

We are happy to make ourselves available to discuss this submission further if required.

Yours faithfully

Daniel Zon
Group Legal Counsel, Connective

Schedule 1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Insurance
Ind Regional
Credit Union
2nd Tier

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Adelaide Bank	2nd Tier	Suncorp Bank (Commercial)	Ind Regional	Auswide Bank	Non-Bank
AMP	2nd Tier	Allianz Insurance	Insurance	Better Mortgage Management	Non-Bank
Bankwest	2nd Tier	Australian Life Insurance	Insurance	Bluebay Home Loans	Non-Bank
Citibank	2nd Tier	BT Financial Group (House and contents Insurance)	Insurance	Deposit Bond	Non-Bank
Heritage Bank	2nd Tier	ANZ	Major	Deposit Power (Deposit bonds)	Non-Bank
ING	2nd Tier	Commonwealth Bank	Major	HomeStart Finance	Non-Bank
Macquarie Bank Pty Ltd	2nd Tier	National Australia Bank	Major	Lifebroker	Non-Bank
ME Bank	2nd Tier	Westpac	Major	Merchant Mortgages (Commercial)	Non-Bank
St George Bank	2nd Tier	Better Choice Home Loans	Mortgage Manager	RAMS	Non-Bank
Suncorp Bank	2nd Tier	Australian First Mortgage	Mortgage Manager	Real Estate Investar Australia	Non-Bank
Circle Credit Union	Credit Union	BMC Mortgage Corporation Pty Ltd	Mortgage Manager	Virgin Money	Non-Bank
Gateway Bank	Credit Union	Connective Home Loans	Mortgage Manager	Bluestone	Specialist
IMB Bank (Commercial)	Credit Union	Firstmac	Mortgage Manager	Liberty Financial	Specialist
Keystart Home Loans	Credit Union	Homeloans	Mortgage Manager	MKM Capital	Specialist
Newcastle Permanent Building Society	Credit Union	La Trobe Financial	Mortgage Manager	Pepper Money	Specialist
P & N Bank	Credit Union	Loan Ave	Mortgage Manager	Connective HL Essentials by Advantedge	White Label
Teachers Mutual Bank	Credit Union	Paramount Mortgage Services	Mortgage Manager	Connective HL Smart Options by Macquarie	White Label
The Rock	Credit Union	Scottish Pacific Debtor Finance	Mortgage Manager	IC Financial	White Label
Bank Of Queensland	Ind Regional	AMRO	Non-Bank		

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