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20 March 2018

Competition in Australia's Financial System inquiry
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

To the Commission,

Home Loan Experts is specialist mortgage broker that focused on assisting good borrowers who for whatever reason are not well-serviced by our industry. Typically, this is because their situation is complex and requires more expertise or because the major lenders don't work with that type of customer. The majority of our customers are Australians living overseas and first home buyers.

Being a specialist mortgage broker, we deal with a wider range of lenders than other brokers. As such, we're required to keep our finger on the pulse when it comes to changes in our industry and the impact that these changes will have on our customers. Our submission has been written with input from customer-facing staff to give the Commission a different point of view when compared to other submissions.

Where we can see that others in our industry have covered an issue well, we've kept our submission brief or added additional examples to assist the Commission.

We've focused on the Commission's role to "help government make better policies in the long term interests of the Australian community" and, as such, some areas of our submission may be out of the scope of the draft report.

Similarly, some topics and areas of discussion were not included in the draft report that we believe should have been because they're important if the Commission's purpose is to be achieved.

Broker remuneration

On the PC's suggestions that trail commission provides "perverse incentives for mortgage brokers by rewarding them for keeping customers in their existing loans", this is incorrect.

The purpose of trail is to incentivise brokers to stay in contact with their customers and to service their needs for many years after the mortgage is set up. We note that several other companies have already discussed this issue in depth so we will provide examples of what we do for our customers in return for our trail income.

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- Post-settlement follow up to make sure offset accounts are set up, internet banking is set up and the customer knows when their first repayment is.
- Six month follow-up to inform the customer of how much they can save by making extra repayments and how to increase their repayments.
- One year follow-up to see how they are going and if they have any queries.
- Two year follow-up to check the price of their loan and renegotiate their rate if required. If their loan is not competitive and their lender refuses to negotiate then we recommend that they refinance.
- Three year follow-up with an e-valuation and to check if they have future plans that require our assistance.
- Four year follow-up to again reprice their loan. This continues every two years.
- Fixed rate and interest only expiry follow-up to ensure that the customer's needs are met. In particular, fixed rates often roll to a high variable rate if we do not reprice the loan.
- Product switches, discharges, loan increases and other loan maintenance.
- Monitor if our customer's properties are put on the market for sale and, if so, contact the customer to see if they require our assistance.
- Irregular communications where something occurs that affects them. For example, if a particular bank was to increase its rates then we would contact all of these customers.
- We have a team of eight people working full time to assist settled customers.

It's actually short-term incentives, such as upfront commission, that promotes churning, which is often unnecessary when a customer's interest rate can simply be renegotiated without refinancing.

Mortgage brokers that do not remain in contact with their past customers are likely to lose those customers and, therefore, lose their trailing commission.

Hence, there is a strong incentive to provide post-settlement customer service. Trail supports long-term mortgage brokers rather than people who just it try for a few years and then change careers.

Clawback

The PC said that clawback acts "as a direct disincentive to consumer switching of home loans" and to move to a fee for service model instead.

In the past year, we had an unusual event where actions taken by the Australian Prudential Regulation Authority (APRA) put various restrictions on banks which resulted in changes to their pricing for investment and interest only loans.

The result of this was that many loans approved just six months prior to this were no longer competitive. There was an unusually high level of clawback in this period and we have not seen this happen before or since.

It is rare in normal market conditions that a customer should need to change their loan in the first two years.

If clawback were to be abolished, the flow on effects would first need to be considered:

- Without exit fees on loans, lenders would make a significant loss where they have paid an up front commission and the costs of setting up a loan and then it only lasts a few months.
- Lenders would likely reduce mortgage broker up front commissions to compensate for this.
- Lenders would likely introduce high entry fees where a particular product had a risk of being used for the short term.
- Some lenders may try to avoid legislation by using a 'rebateable establishment fee' where a fee is charged to the borrower at origination and is later rebated to them if they stay for a certain period of time.
- Some mortgage brokers may churn customers between loans with no benefit to the customer. This would likely be a minority of brokers.

Overall, careful consideration must be given to the flow on effects which can only be achieved with input from industry stakeholders.

We, as a mortgage broker, would benefit from clawback being abolished, however, we can see there is the potential for new problems to be created and so we urge caution.

The current system is working well

Change is difficult, risky and has unintended consequences so there must be a strong benefit to justify any change. Otherwise, we risk going backwards.

The result of more legal restrictions or requirements placed on mortgage brokers will invariably see the cost of being a mortgage broker increase.

This will result in fewer people taking up the profession or for existing brokers to remain in the industry: the cost of compliance and meeting customer demand would simply be too high for a broker to remain viable.

Any additional legislation must be well thought out, have industry input and have a strong benefit to all stakeholders.

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Disclosure, choice and transparency

The PC said that vertical integration of brokers carries the "risk that consumers have an illusion of choice rather than genuine choice in the market" so they could be missing out on "products that are better for them".

We are privately-owned and are not vertically-integrated with any lenders but we regularly compete against mortgage brokers who are.

We do see *some* of our competitors offering white label products which are provided by a vertically-integrated bank. However, we have not seen poor customer outcomes as a result of this.

We believe that disclosure is important but, aside from this, the market is competitive and, so, were any lender to try to take advantage of this, they would likely lose customers.

Mortgage brokers, on the whole, will seek to recommend customers a home loan that suits their needs above other potential influencing factors such as ownership or commission rates.

Legal standards for brokers and aggregators

The PC suggests an alternative to removing trail: impose a legal duty to act in the interests of consumers, including requiring "brokers to continue to act in the interests of their clients so long as they continue to receive commission payments from lenders".

They said this should extend to lender-owned aggregators.

We believe that if there were to be a legal duty of care requirement, commissions would need to increase to account for the increase in compliance costs.

We estimate that the time taken to process a loan has more than doubled in the last three years due to APRA's influence on the banks.

These additional costs have not been offset by increases in commissions and have only partially been offset by increases in average loan sizes.

The goal should be having the right level of regulation, which we believe we are at now, not to overregulate so as to stifle an effective market. We see no evidence of an actual problem that needs to be fixed and, so, the best course of action is to do nothing.

Besides all that, again, customers will be the ones to suffer by having to pay some upfront fee for service model or higher interest rates.

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Brokers as negotiators

On the finding that brokers only get slightly better deals and that growth in the broker market "does not appear to have increased price competition", there is a lot the PC has overlooked.

Many factors affect the pricing of home loans. If the PC is to address this factor then it should refer to data from 1995 - 2003 when mortgage broking was just becoming a mainstream industry.

It is during these times that we saw Aussie Home Loans compete with the major banks, which resulted in a significant reduction in the net interest margin received by the banks.

In more recent times, pricing has more been a matter of maintaining that level of competition and the changes have been relatively small. If any lender was to offer pricing that isn't competitive, they would lose significant market share, and so, given this, we can say competition is working.

The real risk to competition is inefficiency causing borrowers to see refinancing as too difficult to the point that they don't change to a cheaper home loan.

This in turn means that it is easy for a major lender to use various tactics to take advantage of complacent clients and slowly find ways to earn a higher margin from them.

If getting a new home loan was a simple and painless process then many more customers would switch. Customers can't be bothered to switch unless the benefit is substantial.

It's for this reason that complexity is the main barrier to achieving good customer outcomes.

LMI

Apart from interest rates and fees, another aspect of pricing is Lender Mortgage Insurance (LMI).

Responding to suggestions that the LMI market is "highly concentrated" and banks should do a better job at tendering to increase competition, ANZ chief executive Shayne Elliott said that pricing isn't that simple.

He said to "slice and dice" a home loan, breaking up each individual funding component is not "reasonable" and that mortgage insurance is simply a part of the home loan package.

He compared it to buying a car.

"I don't go through and say, 'I'd like to understand who all the possible providers of the airbags are [and] I'd like to know who are the possible providers of the steering wheel, and the seats and all those bits and prices' — it's a package," he said.

Home Loan Experts agrees with this because lenders have their own commercial agreements with LMI providers.

The LMI premium and loan are effectively one product as the fee is passed on by the lender and not charged directly to the customer by the mortgage insurer.

On that basis, if the customer wants a different LMI premium, they can certainly shop around by choosing another lender.

As mortgage brokers, we're already helping our customers to do this because we consider the LMI premium as part of our recommendation.

Insurance is a necessary reality for many industries and a highly-specialised area.

There have been new entrants into the market like Arch Capital and we would certainly welcome more new entrants to shake things up.

However, LMI companies do not appear to be making substantial profits and we are currently in the good times with few defaults and a relatively strong economy.

Any changes may cause them to become unprofitable which would cause an increase in LMI premiums which significantly affects first home buyers.

Allow skilled migrants to become mortgage brokers

We believe the industry is experiencing a squeeze where increased complexity, regulations and work for each loan application have not been offset by increased income.

The level of complexity has changed mortgage broking from a sales type job more towards a professional line of work like accounting or law. However our industry struggles to attract quality talent and the percentage of mortgage brokers who make it through the first year is as low as 30% - 50%.

Currently, finance broker is an occupation that can be considered for a 2-year 457 visa plus a 2-year term.

However, there is no pathway to Permanent Residency. A simple change which allows for finance brokers to become Permanent Residents will attract quality people to our industry.

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For example, we have a team of 65 people based in Nepal, the majority of which have over 2 years' experience working in the Australian mortgage industry and have MBAs or BBAs.

They are highly intelligent, driven, customer-focused and have great values.

They are exactly the type of people that our industry needs to attract and retain yet we are unable to give our top performers a long term stable career as a mortgage broker because if we were to sponsor them they would need to return to Nepal within four years.

Experienced mortgage brokers are needed to help customers with unique needs such as Australians living overseas or complex loan products such as guarantor loans.

Comparison rates provide no decision-making value

ASIC recently told the PC that comparison rates are "not a very good guide" because they don't compare apples with apples, that is, rates "based on different loan and borrower characteristics".

This includes considering the size of the loan and loan term, the LVR, loan fees, the borrower profile/risk profile, the repayment type (interest only versus principal and interest) and the type of interest rate, and more.

We have not seen a customer use comparison rates or one that understands them. They are largely ignored by the industry and customers alike. For this reason, we recommend scrapping them altogether.

Questioning the research from UBS and Choice

The Adviser editor Annie Kane cast doubt on the reliability of the PC's draft report because it sources both UBS and Choice.

She said that both research houses didn't have a good track record in understanding how trail actually helps deliver good customer outcomes.

Frankly, we agree: both "research houses" are out of touch with the market, appear heavily biased and their research should be taken with a grain of salt.

Combined Industry Forum

The formation of the CIF was unprecedented, consisting of representatives from the Australian Bankers' Association (ABA), the Mortgage and Finance Association of Australia (MFAA), the Finance Brokers Association of Australia (FBAA), the Customer Owned Banking Association (COBA) and the Australian Finance Industry Association (AFIA).

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It's proof that the industry can agree on a direction forward to continually improve the customer experience.

Self-regulation is surely a better solution than costly legislation that tends to cause more confusion and greater costs to the customer.

We strongly recommend that the PC consider any recommendations made by the CIF as it is the most reliable source of information and thought leadership in our industry.

APRA's involvement in the mortgage industry

APRA has a somewhat myopic focus on making the banks unquestionably strong.

They've no doubt been very effective at achieving this goal and quite possibly they have averted a bubble from occurring in the property market.

As their scope is limited, we see their actions causing problems for society as a whole and so a review of their mandate is needed to at least include "with a consideration of the impacts on society as a whole".

The constant regulatory changes and ineffective lending policies that follow are the largest cause of poor consumer outcomes that we can see.

There were several changes that we consider to be ineffective and were pushed through with little consultation with lenders and no consultation with mortgage brokers.

This has caused considerable inefficiencies and problems for our industry and poor customer outcomes as a whole.

Examples of changes that had unintended consequences

We find that the customer's self-assessment of living expenses is very time-consuming and, in most cases, does not result in a better outcome.

The cases where we see an assessment of their living expenses being helpful is where they have something exceptional about their circumstances such as private school fees, large religious donations or they are living outside of Australia.

In some cases, we see customers being conservative and overestimating their living expenses which means we are unable to help them to buy a home.

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The correct approach is to focus on what is the minimum investigation that can be completed into living expenses without creating inefficiencies that cause higher prices for customers and complacency because switching loans is too hard.

Another example was the change in the assessment of interest only loans. We believe that this is very beneficial over the long-term and we think that most customers were not aware of the increased cost of an interest only loan, particularly where it was used for owner-occupied purposes.

However, many customers with current interest only repayments were expecting to be able to extend their interest only period or refinance to a new interest only period.

Now many of these people are unable to do so and may face financial hardship as a result. The effect of this will only be felt in the coming years.

The correct approach for this should have involved consultation with the banks and consideration of these customers that will be affected.

The calculation of borrowing power is another example where borrowers have been negatively affected by a change made by APRA. The changes occurred quickly, without consultation and with no communication to borrowers.

Many customers who purchased off the plan were pre-assessed only to have the rules change and then they are unable to complete the contract several years later.

Any proposed changes should consider some form of leniency or grandfathering where someone who has already committed to a property should not be held to *new* lending standards.

As a result, thousands of customers will lose their deposits because an arbitrary benchmark has changed. It's hard to see how this is a good customer outcome.

Social equality has fallen by the wayside

Ensuring that banks are strong is important but we must also consider social equality, which can be affected by changes in lending policy or pricing.

The ability of first home buyers to get into the market is as much driven by LVRs offered by the mortgage market as it is by house prices and first home benefits.

Putting up more barriers to qualifying for a loan prevents new entrants from entering the market and building their wealth.

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This, in turn, creates a highly-stratified society, which has proven to cause major problems such as a higher level of crime and increased unhappiness. This is one of the key differences between Australia and the United States of America.

In their study, *Income Inequality Explains Why Economic Growth Does Not Always Translate to an Increase in Happiness*, Shigehiro Oishi (University of Virginia) and Selin Kesebir (London Business School) looked at happiness across 34 nations.

They found that the percentage of respondents who said they were very happy was inversely correlated with income inequality (with a negative correlation of −.618).

First home buyers are being locked out by overly strict policies

Several years ago, APRA was focused on the risks that high Loan to Value Ratio (LVR) loans caused to banks and how this would affect the banking system in a crisis.

However, we believe more consideration should have been given to the effects this would have on first home buyers and society as a whole.

The fact is, property prices are still high in comparison to the rate of wage increases and the overall cost of living. Wages simply aren't growing at the same rate.

In the past, you could borrow up to 100% of the property value without a guarantor because there were stricter lending policies in place. In fact, one lender offered 106% LVR loans.

Mortgage arrears was actually lower than a borrower who was able to provide a 5-10% deposit.

The reason?

Lenders were tougher on these applicants and asked for more documents and required them to meet stronger servicing benchmarks in order to qualify.

This type of lending should not be “off the table” as long as it is limited in scale, is only available to first home buyers and has strict lending criteria.

Where we can enable home ownership for more Australians then, *everybody wins*.

Considering that the government regularly talks about affordable housing, it makes sense for APRA to consider this if it finds that the changes it makes are negatively affecting first home buyers.

As soon as this is identified at a macro level, this strategy of locking first home buyers out of the market should be scrapped and *quickly*.

Common sense is no longer common

People's lives rarely fit in the boxes of an application form so common sense is a crucial part of credit assessment.

The problem is that APRA has put pressure on lenders to stop making exceptions to their lending policy. As a result, common sense has been removed from the industry, frustrating customers and stifling innovation.

We can understand declining loans within policy that don't meet a common sense test. A good mortgage broker should be doing this already and we encourage our team to do so.

The problem is a lack of common sense that's preventing the approval of applications outside of policy where there is a good reason to do so. Lending policy should be a guide and not a hard and fast rule.

We have heard anecdotal reports that one major bank had 24% of their loans approved with some exception to policy and due to pressure from APRA this has been reduced to 2%.

This estimate matches our experiences in the past year in which we have seen all ADIs tighten the way that they apply their policy.

We are unsure of what problem APRA is trying to fix with these changes but we can see a clear negative impact on borrowers who are in good positions yet unable to qualify for a loan.

Why don't referrers fall under the same regulations as brokers?

We agree with ASIC's comments on referrers including financial planners, solicitors, accountants, real estate agents and other professionals who are escaping the regulations that affect mortgage brokers yet are paid similar commissions.

These referrers are trusted advisers to clients and many clients assume that there was a reason they were recommended to apply with a particular lender.

In actual fact, no fact find, verification or preliminary assessment is completed so the customer's trust is misplaced.

Secondly, there is very little oversight over who these referrers are. If a mortgage broker or banker is banned from the industry then they often turn up somewhere as a referrer.

Their name doesn't appear on any application to the lender and so the lender may be aware that that person is banned but is not aware that they are the source of that application.

We're suggesting that Australian credit licence (ACL) holders have clauses in their referral agreements that require the referrer to disclose any previous experience in the mortgage industry, criminal history or other misconduct.

ASIC would likely be able to assist with specific suggestions of what should be investigated about a potential referrer.

Lastly, documents should not be obtained directly from the referrer but should be obtained from the client.

It is reasonable to obtain a client's tax returns from an accountant who is also a referrer but it is *not* reasonable to obtain them from a real estate agent who has sold the customer a property and then has referred them to a bank or mortgage broker. The risk of fraud in these instances is high.

Overall, standards for referrers is an area that requires a small amount of additional legislation in order to improve customer outcomes and close loopholes that enable unscrupulous operators.

Why are mortgage industry inefficiencies out-of-scope?

Adding more checks and balances has to be carefully considered as there isn't an unlimited capacity for our industry to just do more work for each file and this goes totally in the opposite direction to LEAN / Six Sigma methodology.

Where the checks and balances are ineffective then it is a new waste that is introduced in the process which, again, increases prices for borrowers.

A final thought

The complexity and documentation required to obtain a home loan is now at a level that is *maddeningly inefficient*.

This causes cost increases for lenders and mortgage brokers as well as frustration for customers.

This is the root cause of many other issues such as new brokers failing to last more than a year in the industry and customers refusing to switch loans despite seeing constant advertising for lower rates.

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A focus on why getting a home loan is now so difficult and if the reasons behind these barriers are genuine or not should be the true purpose of the PC.

We believe that this is the number one problem faced by the industry and borrowers and yet it is not addressed in the draft report.

The recommendations made to government need to consider what should be eliminated, such as comparison rates, and this should in fact be *the* main focus of the report.

The industry is extremely well-run with very few problems so adding more regulations is likely to do more harm than good unless it is very well-considered.

We would like to offer an open invitation to the PC, ASIC and APRA should they wish to get involved in our mortgage broking training to get a better understanding of what our industry is like and the challenges that we face in originating mortgages.

We believe this “grass roots” exposure is required to make an effective recommendation to government.

Lastly, a root cause analysis is required as many problems covered in the report are symptoms of the real problem: unnecessary complexity and limitations from regulators.

Sincerely,

Otto Dargan
Managing Director
Home Loan Experts