Competition in the Australian Financial System
Productivity Commission Draft Report
Submission by Australian Finance Group Ltd
20 March 2018

AFG

100 Havelock Street
West Perth WA 6005

PO Box 710
West Perth WA 6872

Phone 08 9420 7888
Fax 08 9420 7856

www.afgonline.com.au

Background

Australian Finance Group Ltd (**AFG**) was founded in 1994, was listed on the Australian Securities Exchange (**ASX**) in 2015 and has grown to become one of Australia's largest mortgage broking groups. Approximately 2,900 brokers arrange residential mortgages, commercial finance and other loan products through AFG.

There is currently an extraordinary level of review and reform of Australia's finance sector. As part of that review, the Productivity Commission (the **Commission**) has been asked to review competition in Australia's financial system. The Commission's work in this regard has necessarily been extremely broad and far reaching and has, in part, considered the role that mortgage brokers play as a force for competition in the home loan market.

In making a final report to Government including recommendations for regulatory reform, AFG asks the Commission to pay particular regard to the Government's existing wide-ranging financial system reform agenda and the extensive work that is already underway that is intended to strengthen competition and improve consumer outcomes particularly with respect to broker commission arrangements.

In particular, in February 2016 the Australian Securities & Investments Commission (**ASIC**) issued the *Review of Mortgage Broker Remuneration Structures Scoping Discussion Paper* (the **Scoping Paper**) which notes that the Government requested ASIC conduct the review to determine the effect of current remuneration structures on *the quality of consumer outcomes*.

Following an unprecedented data collection process over an extended period of time, ASIC released *Report 516: Review of mortgage broker remuneration* in March 2016 (**ASIC Report 516**). That report recognises the important role that mortgage brokers can play in promoting good consumer outcomes and strong competition in the home loan market.[1] It is essential that any actions that follow from ASIC Report 516 do not have the unintended consequences of stifling or inhibiting the mortgage broking industry which will ultimately be to the detriment of all Australian home owners and all Australians who aspire to own their own home.

1 Australian Securities & Investments Commission, *Report 516: Review of mortgage broker remuneration*, March 2017, para 19.

AFG has been a leading contributor to the conversation about mortgage broker remuneration since the Government first requested ASIC to consider the impact of the current structure on the quality of consumer outcomes in November 2015. ASIC has stated that the aims of its proposals are to "strengthen the positive contribution that brokers provide in this sector"[2] while enhancing:

(a) consumer outcomes and competition;
(b) the operation of the home loan market more generally; and
(c) the trust and confidence that consumers have in brokers.[3]

AFG agrees that regulatory change designed to protect consumers is a positive for the industry, however it is vital that the legislative framework focuses on the delivery of a competitive, diverse and sustainable sector that ensures reasonably priced and appropriate products and services for consumers.

Specific Responses

AFG provides the following specific responses to the Commission's draft findings, draft recommendations and information requests which are relevant to AFG's activities as an aggregator.

DRAFT FINDING 8.1 INTEREST RATES FROM BROKERS VS OTHER CHANNELS

Home loans originated by mortgage brokers have only slightly lower interest rates than those originated through direct channels. Further analysis is needed to inform the Commission's view of the sources of such differences and whether they are significant.

AFG would support a proposal for lenders to capture this information. The reported difficulty the Commission encountered with data collection from lenders may be a contributing factor to the opacity of this examination.

DRAFT FINDING 8.2 COST OF HOME LOANS THROUGH BROKERS VS BRANCHES

Mortgage brokers enable smaller lenders to gain wider reach, increasing product variety in the home loan market. Whether brokers are an efficient, lower-cost distribution channel for lenders depends in large part on the way lender branch costs are apportioned between different activities.

That the providers of half of Australia's home loans were unable to give evidence on how they assess the costs and benefits of using brokers rather than branches to source home loans is surprising.

In AFG's opinion, the inability of lenders to provide the Commission with data about the cost of originating loans through branch networks versus the cost of broker originations should be

[2] Ibid, para 23.
[3] Ibid, paras 23-24.

considered to be disingenuous. It is difficult to accept that entities that are sophisticated enough to develop and manage banking products and meet complex legal and regulatory obligations do not have information about product costs that would be needed to price those products. However, absent a willingness to publicise that information, AFG submits that the willingness of lenders to embrace broker distribution should be considered reasonably reliable evidence that brokers provide an efficient and cost-effective means of distributing lending products.

Brokers provide a variable cost base for lenders, with payment only required when a loan is settled and while it remains undischarged and not in default. This means that the risk of non-completion by a prospective borrower is substantially borne by the broker. As a result, lenders using broker distribution (as opposed to fixed cost branch networks) can more easily price loans in a way to ensure that they are profitable

DRAFT RECOMMENDATION 8.1 DUTY OF CARE OBLIGATIONS FOR LENDER-OWNED AGGREGATORS

The Australian Securities and Investments Commission should impose a clear legal duty on mortgage aggregators *owned by lenders* to act in the consumer's best interests. Such a duty should be imposed even if these aggregators operate as independent subsidiaries of their parent lender institution, and should also apply to the mortgage brokers operating under them.

AFG is of the view that the current obligations in the *National Consumer Credit Protection Act 2009* (**NCCP Act**) provide appropriate consumer protections and that the proposed additional regulatory obligation is unlikely to provide any real consumer benefits. This is because there are already extensive obligations under the NCCP Act to disclose commissions and other benefits as well as an obligation for Australian Credit Licensees to:

> have in place adequate arrangements to ensure that clients of the licensee are not disadvantaged by any conflict of interest that may arise wholly or party in relation to credit activities engaged in by the licensee or its representatives[4].

It may be that the publication of further guidance by ASIC about its expectations of how aggregators and brokers that are owned by lenders should manage the conflicts of interest that arise from this relationship, together with surveillance and targeted regulatory action to ensure compliance with that guidance would be a more effective way to deal with the identified area of concern.

AFG is also very concerned about a proposed test that would be applied to only one section of the industry as it is likely to result in market distortions and unintended consequences. For example, lender owned aggregators could suggest that consumers are at risk if they use a broker that is not subject to the same test and assert that the safest course for consumers is to only use brokers that are subject to the additional "best interests duty".

It is also important to consider other work that is already well progressed in this area. In particular, in response to the ASIC Review of Mortgage Broker Remuneration, representatives of Australia's

[4] National Consumer Credit Protection Act 2009, s47(1)(b).

finance industry working together as the *Combined Industry Forum* (**CIF**) have prepared a landmark reform package designed to improve consumer outcomes and confidence in the finance industry.

The reform package developed by the CIF is the result of unprecedented engagement between industry bodies, lenders, mortgage brokers and their representatives, aggregators, introducers, and consumer groups, and follows consultation with regulators and Federal Government.

The package responds to the proposals outlined in ASIC's *Review of Mortgage Broker Remuneration* and takes into account the relevant recommendations of the Australian Bankers' Association's (**ABA**) Retail Banking Remuneration Review.

To date, the CIF have agreed on six principles that will be implemented to ensure better consumer outcomes and improved standards of conduct and culture, while preserving competition in mortgage broking:

- The standard commission model will avoid financial incentives that encourage consumers to borrow more than they need or will use, for example by basing commissions on facility draw down net of offset;
- Volume-based and campaign-based commissions paid by lenders and aggregators are recognised as raising potential conflicts of interest and poor customer outcomes and are expected to cease;
- Non-monetary benefits will only be given based on a balanced scorecard and good customer outcomes, and benefits given by lenders will be capped;
- Ownership models and commercial relationships will be made clear on all marketing materials, including websites, where ownership is greater than 20 per cent, so consumers have the right information to make informed choices;
- ASIC and consumers will be given clearer information on where loans are written, commissions paid and interest rates, to increase transparency and accountability in the industry;
- The industry will introduce an improved Governance Framework that monitors for, and identifies risks, and requires the industry to take action and continuously improve where issues are identified[5].

It is AFG's contention that before considering additional law reform proposals, sufficient time must be allowed for those proposals to be implemented and embedded into the processes, procedures and culture of individual broker businesses. Once that has occurred it will be an appropriate time to again review the extent to which community expectations are met and good consumer outcomes are achieved.

5 Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of mortgage broker remuneration available at: https://www.mfaa.com.au/sites/default/files/users/user130/CIF_Report_Submitted_281117_0.pdf

INFORMATION REQUEST 8.1 HOW SHOULD NEW DUTY OF CARE OBLIGATIONS FOR LENDER-OWNED AGGREGATORS BE IMPLEMENTED?

How should obligations on lender-owned aggregators to act in clients' best interests be imposed? Can such obligations be imposed under the current regulatory and licensing regime (the National Consumer Credit Protection Act 2009 (Cth)), or is there a need for a separate regime for mortgage aggregators and brokers?

AFG has suggested an alternative approach in its response to Draft Recommendation 8.1 above.

INFORMATION REQUEST 8.2 SHOULD CONSUMERS PAY BROKER FEES FOR SERVICE?

Should consumers pay mortgage brokers directly through fees for service (rather than brokers receiving commissions from lenders)? What is the likely effect on consumers' use of brokers and on home loan providers' ability to source home loans through brokers? What is the likely effect on brokers' incentives to recommend loans to consumers?

The introduction of a fee for service payable directly by the consumer would provide a clear disincentive for consumers to use brokers and would inevitably cause a major disruption in the finance industry. The four major banks would be the only beneficiaries of a change of this kind as they would gain an additional competitive advantage over competing lenders that do not have extensive direct distribution channels. This would further entrench the oligopoly powers of the major banks which, coupled with the Commission's observations concerning the regulatory advantage of D-SIBs; have a negative impact on competition in the finance sector; and lead to a loss of the pricing benefits that resulted from the development of the mortgage broking industry.

It is also AFG's view that it is not inevitable that loans would be repriced and consumers would save if lenders did not remunerate brokers for the loan origination services. There are a number of reasons for this. For example, in the absence of brokers, all lenders that currently use broker services to distribute their products would have additional costs. Lenders that do not have direct distribution channels would incur all of the costs of originating their own loans including marketing and distribution costs and additional loan processing costs. Major lenders with extensive branch networks would also need to increase staffing (with associated on-costs) to deal with direct applications that have not been professionally compiled and pre-assessed by a broker to meet the lender's requirements. These costs would be fixed costs for the lenders and would cover unproductive activities (such as rejected consumer inquiries and applications) as well as productive activities that ultimately result in a profitable loan.

There is also no evidence available to support an expectation that the beneficiaries of such a change would pass on any savings to borrowers. This is because the Australian mortgage market is dominated by the four major banks. Similar failures to pass on Reserve Bank cash rate cuts to borrowers has resulted in the ACCC being asked to conduct an inquiry into mortgage pricing.

In fact, the recently released ACCC Residential Mortgage Priced Inquiry Interim Report[6] found that discounting by the major banks is lacking in transparency and the time and effort required for a consumer to obtain interest rate comparisons and negotiate for a discount is very difficult.

It is AFG's contention that the presence of the mortgage broking channel is one of the few drivers of competitive tension in the Australian lending market. A consumer dealing directly with a lender has limited negotiating power or knowledge of the interest rates and lending criteria offered by competitors. A mortgage broker with access to a panel of lenders drives competition between lenders to the benefit of all consumers, not just their own clients.

DRAFT RECOMMENDATION 8.2 MORTGAGE BROKER DISCLOSURE REQUIREMENTS

The Australian Securities and Investments Commission should require that before mortgage brokers recommend loans to consumers, they must have a discussion with consumers about, and provide plain-English documents to consumers on:

- the types of products offered by different lenders (including white-label loans and which lender provides the funding for them) and associated loan features
- the role of 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
- how mortgage brokers are paid (including specific information about their payment arrangements)
- any ownership relationships between lenders and the aggregator, and the requirement for brokers to act in consumers' interest where an ownership relationship exists (draft recommendation 8.1).

Specific details regarding the information provided and the way it is presented should be developed through consumer testing to ensure that consumers understand the information, and the effect of these measures should be reviewed after they have been implemented.

Currently, a credit guide containing specific information must be provided to a consumer as soon as practicable after it becomes apparent to the licensee that it is likely to provide credit assistance.[7] AFG supports the proposition that additional work be done on whether the information currently provided in credit guides could be improved to better meet the needs of consumers. This could be achieved through an ASIC sponsored working group with best practice guidance published by ASIC and would be consistent with work that ASIC has performed in the past.

6 https://www.accc.gov.au/about-us/inquiries/residential-mortgage-products-price-inquiry/interim-report

7 National Consumer Credit Protection Act 2009, s113.

INFORMATION REQUEST 12.1 POTENTIAL TO INCREASE THE SCOPE OF FINANCIAL ADVICE TO INCLUDE SOME CREDIT PRODUCTS

The Commission is considering recommending that ASIC-licensed financial advisers be able to provide advice on some credit products, in particular home loans, personal loans and credit cards. We seek views on:

- *the merits of such a proposal*
- *which credit products should be included in this increased scope to provide advice*
- *the nature of any duty advisers would have to their clients*
- *different licensing approaches including the form of the licence*
- *the regulatory costs and impact on the industry.*

AFG has worked with brokers for 24 years with the aim of providing services and support that enhance the services that those broker businesses can provide to their clients. AFG does not operate a franchise model. Instead AFG operates a flexible model that can accommodate a very wide range of independently owned and operated broker businesses. As a result, AFG works with brokers who run the gamut from sole traders, micro businesses and SMEs to broker businesses that operate as subsidiaries of diversified financial services entities.

There is currently nothing to prevent a financial adviser from obtaining a mortgage broking qualification and acting as an authorised representative of both an Australian Financial Services Licensee and an Australian Credit Licensee. However, this does not typically occur because of the level of complexity inherent in each of these activities. Lender policies and procedures vary greatly and change regularly, and it is extremely difficult to maintain sufficient knowledge and understanding of a wide range of products and to meet lender continuing accreditation requirements as a minor sideline to another professional occupation (such as providing personal financial advice to retail investors). It is AFG's view that there is a risk that consumers would receive an inferior standard of service in these circumstances. This is why there are currently a number of businesses that operate separate financial advice and mortgage broking arms and, for brokers and financial advisers that operate small or medium monoline businesses, well-developed referral arrangements.

DRAFT FINDING 13.1 MORTGAGE BROKER COMMISSION STRUCTURES WEAKEN CONSUMER SWITCHING

The payment of trail commissions creates perverse incentives for mortgage brokers by rewarding them for keeping customers in their existing loan. Broker loyalty appears skewed towards the institution, not the customer, and thus likely discourages refinancing.

The inclusion of commission clawbacks in the remuneration structure for mortgage brokers acts as a direct disincentive to consumer switching of home loans.

AFG agrees that trail incentives that increase over time should not continue to be offered. AFG strongly supports the removal of this form of trail commission. However, AFG does not agree that standard trail commissions operate as a real disincentive to switching. In AFG's experience, brokers generally have a good understanding of the significant cost of acquiring new customers and the consequential importance of retaining existing customers.

Mortgage broking is a professional industry that understands the value of medium-long term client retention. Collecting trail commissions while ignoring the customer is an approach that is likely to result in customer loss when the customer decides to consider refinancing options (as is frequently suggested in the mainstream media) or sell their existing property and obtain a new loan for a new property.

AFG has made a significant investment on a highly successful client retention strategy that is strongly supported by our brokers. The program, SMART, aims to assist AFG brokers to maintain regular and ongoing communication with clients. This communication includes an invitation to revisit the customer's existing loan to evaluate the appropriateness of that loan as requirements do change over time. After receiving the client's agreement to conduct a review the broker examines the customer's current needs and requirements to ensure their current lending solution remains appropriate and recommends appropriate alternatives if it no longer meets the client's needs and requirements.

As has been suggested at the Commission's hearings, when a broker assists a consumer to refinance, trail commissions that cease with respect to the repaid loan will be replaced with the trail commissions payable on the new loan. As a result, it is AFG's view that, in the absence of increasing trail commission rates over time, trail commissions per se are not likely to have a negative impact on broker behaviour.

Commission clawbacks are, in AFG's opinion, a much more complex issue as they require the broker to repay the remuneration received for successfully originating a loan. AFG is of the view that clawbacks can also benefit consumers by providing a financial disincentive to short-termism and encouraging brokers to recommend products that are likely to remain suitable into the reasonably foreseeable future. In the absence of exit fees, borrowers in variable interest rate loans have a real ability to exit a loan product as soon as it ceases to meet their needs with no need to use the same broker for subsequent transactions. AFG also acknowledges that clawbacks allow lenders to recoup costs for loans that have not yet reached the tipping point for profitability. If commissions were not clawed back for unprofitable loans, lenders would be likely to seek to recoup those costs through other means which may well have more significant negative consequences for the broking industry and consumers of loan products.

AFG is also working as part of the CIF to develop additional recommendations relating to trail commissions to improve consumer outcomes and intends to actively support the abolishment of increasing rates of trail commission in its work with CIF.

It is important that any changes should not result in an economic drift away from the broker to the lender as devaluing the service provided by brokers would have significant and long term detrimental effects for consumers by lessening the competitive tensions that currently exist in the credit industry. It is essential that anticompetitive conduct is not permitted to proliferate under the guise of regulatory reform.

INFORMATION REQUEST 13.2 IS THERE A RATIONALE FOR THE STRUCTURE OF MORTGAGE BROKER COMMISSIONS?

The Commission is considering making a recommendation to the Australian Government on the matter of trail commissions and commission clawbacks. We are seeking feedback on the rationale for how mortgage broker commissions are structured. This includes the contractual or other obligations imposed on brokers in connection with:

- *trail commissions*
- *trail commissions that increase over time*
- *commission clawback.*

Please see AFG's response to Draft Finding 13.1 above.

DRAFT RECOMMENDATION 17.1 NEW COMPETITION FUNCTIONS FOR A REGULATOR

To address gaps in the regulatory architecture related to lack of effective consideration of competitive outcomes in financial markets, an existing regulator must be given a mandate to take the lead on matters related to competition in the financial system.

To minimise cost and disruption, this role should be implemented in substantial part through the Council of Financial Regulators (CFR).

There would be no change under this recommendation to the current legislated responsibilities of the regulators. Rather, the Australian Government should include in its Statement of Expectations for all members of the CFR the practice of reviewing, before they are implemented, regulator actions that may have material effects on competition.

The competition-related functions of the designated Council member would include:

- transparent analysis of competition impacts tabled in advance of measures proposed by regulators
- testing of the impacts of competition and community outcomes of additional provider integration.

INFORMATION REQUEST 17.1 WHICH REGULATOR SHOULD ADVANCE COMPETITION IN THE FINANCIAL SYSTEM?

The Commission has presented two possible options for a regulator to advance competition in Australian financial system and ensure robust consideration of competition in the regulatory decision-making processes of the Council of Financial Regulators:

Option 1: that ACCC be afforded new proactive functions to supplement its current reactive role in the financial system

Option 2: that ASIC's existing financial system focus be expanded beyond participant conduct and consumer outcomes to include the advancement of competition.

We welcome feedback on the merits of each option or alternative possibilities.

AFG is of the view that the most efficient and effective approach would be for ASIC's existing focus to be expanded to include the advancement of competition. ASIC has developed a deep understanding of the industries it regulates and is already experienced at effectively balancing competing regulatory objectives. It is AFG's view that it would be a logical extension of ASIC's current remit to expand their regulatory responsibilities to include the advancement of competition.