Getting better results for consumers: An economic perspective from a discount mortgage broker

Submission in response to the Discussion Paper on national finance broking regulation

On behalf of

peach HOME LOANS

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Executive Summary

It is easy to identify things that are not perfect in the world. It is easy to propose regulation. When the regulatory net was last extended in Australia, to require the industry to publish ‘comparison rates’ the body that implemented the regulation, the Ministerial Council of Consumer Affairs (MCCA), did not comply with the regulatory regime on regulation making to which it is itself subject.[1]

Despite repeated requests and reminders from the Federal regulatory watchdog the Office of Regulation Review (ORR), no Regulatory Impact Statement was prepared. In the publication of the latest Discussion Paper Australian Government’s regulatory policy is so far being followed at least in form. However our submission argues that the procedure is not being followed in substance.

Peach Home Loans proposes that there be national regulation of mortgage broking and that a regulatory regime that was consistent with all Australian Government’s policies to implement ‘minimum effective regulation’ should:

1 Ensure consumers are as well informed as possible

With a simple statement to be presented to all clients of mortgage brokers explaining that brokers are effectively sales agents of lenders and not independent advisors and suggesting that consumers stay in charge by ‘shopping around’ and also search for loan products on the internet. Other possible disclosure including commission rates and lenders within a broker’s panel could accompany this statement.

Regulation must choose between having consumers *well informed* and *fully informed,* as attempting the latter risks compromising the former. Whilst consumers must have *access* to all information of relevance to them including information about the operations of their broker, if they are provided with all this information in an unstructured manner, most consumers will either be confused or ignore the information altogether.

2 Resolve disputes cost effectively

This can be done with an effective ombudsman scheme. The scheme should be as structured as it is currently but with small deposits for consumers to access the service – refundable on succeeding in their

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[1] In 1995 the Council of Australian Governments (COAG) agreed that all regulation imposed by Australian governments would be compliant with a statement of *Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard-Setting Bodies* at http://www.pc.gov.au/orr/reports/external/coag/. These were endorsed by COAG April 1995 and have been reaffirmed and amended twice since then. When it last regulated to make ‘comparison rates’ compulsory in 2002-3 the regulation was one of just three pieces of regulation identified by the Federal regulatory watchdog, the Office of Regulation Review, for it's complete disregard for complying with the principles.

case. This would deter frivolous actions which appear to be quite frequent. In addition there should be some scope to require consumers to meet some of the costs of their actions on consumers where the Ombudsman considers their action to be vexatious. Without this the Ombudsman scheme will be a powerful obstruction to innovation and cost reduction.

3 Remove unscrupulous operators

Where operators have been found to be unscrupulous in their dealings with consumers, they should be removed from the industry through a system of negative licensing.

It is very hard to justify regulation beyond this.

Our submission explains why existing regulation adds cost with few benefits for consumers. Further, most regulation is counterproductive in various ways. Thus:

- The regulation requiring mandatory comparison rates actually confuses and misleads consumers.

- Existing requirements for brokers to agree to a Finance Broking Contract (FBC) with their clients in NSW seem farcical to us. They spring from a desire to 'do something' about certain problems. But even a little reflection, let alone experience with the working model in NSW, shows that getting vulnerable consumers to sign yet another document which is drafted by the very broker it is intended to discipline is unlikely to protect the consumers.

  In our experience the FBC is vexing and confusing to the diligent consumer and broker alike. But we would expect it would add to the ease with which the less scrupulous broker could bamboozle a less sophisticated consumer.

- Despite this, the Discussion Paper proposes to generalise the FBC procedure and then to add the requirement that the broker "provide the consumer with a statement of reasons setting out why the credit product recommended by the broker is the most appropriate product for the consumer's circumstances (p. 74)".

  If required, this advice would be provided as it generally is by 'financial advisors' as slabs of text generically drafted by sales executives, vetted by lawyers and disgorged from software that 'wows' the customers with its wizardry in their living rooms but is promoted as 'sales technology' within the industry.

  In addition to other shortcomings outlined below, the 'advice' will neither identify loans outside the brokers' panel nor their existence. Thus the regulation fits neatly into the sales strategy of inviting the client to view the broker as an 'advisor' – suggesting a fiduciary relationship where none does or can exist.

- The greatest costs of the regulation are the hidden ones, and the ways in which it is actively counterproductive. This regulation imposes substantial costs on consumers, not just in the direct – and relatively small – costs it imposes on the industry but in its obstruction of innovation and cost reduction in the industry.
- Our inability to charge even a small and refundable deposit for our time prevents us from paying substantially higher rebates and from selling special low margin products. We find it hard to believe that the regulators meant to foreclose such options but that is the effect of their regulation.
- While bemoaning the incentives on sales agents in the industry, and trying to wave a regulatory wand to make them act like the fiduciaries they are not, the complete prohibition of charging before obtaining credit actually prevents the emergence of an economic model in which brokers could be true fiduciaries. Peach is interested in establishing a fiduciary broking service that would charge clients by the hour – in the way an accountant would.
- If we did so we could also experiment with offering our own low cost loans direct from funding wholesalers without an interest rate margin - saving clients around 0.25% or more off their interest rate, or $50 per month on a $250,000 loan or over $50 per month. Against this borrowers would occasionally parting with a fee charged on an hourly basis if they wanted to change some detail of their account.

  But in addition to prohibitions on charging before obtaining credit, charging by the hour would upset consumer expectations – even if we told consumers the rules beforehand raising the risk of consumer action against us with the Ombudsman.

  We support and indeed agitated for the Ombudsman before one existed. But because it was designed to appease consumer groups, it is wide open for vexatious and malicious abuse. In five years we have never had a case brought against us with the Ombudsman. But if we were, we'd face costs of over $7,000 just to successfully defend ourselves without so much as a $10 deposit from the consumer or any risk to the consumer of having to bear some of our costs up to whatever stage of proceedings it took if his or her complaint were be found vexatious. It is hard to imagine anything better calculated to obstruct cost reducing innovation.

Introduction

I founded Peach Home Loans, Australia's first national discount mortgage broker, in April 2000.

We provide the same service to clients as other mortgage brokers. We help our clients identify loans that suit their circumstances. Someone with detailed knowledge of a wide range of product offerings discusses their needs with them. If necessary research is performed using the internet and networks within the industry to identify products that meet specific needs.

Clients are then sent detailed product information and then we assist them through the process of application with any one of a wide range of lenders. Home visits are frequently arranged, though, where lenders' policies permit, we also allow clients to apply at a distance using phone, fax and internet communication such as e-mail.

Peach then provides a rebate to its clients reflecting its lower margins. The normal level of rebate paid is provided in the accompanying table.

Loan Amount	Peach Rebate
$120,000 – $149,999	**$350**
$150,000 – $249,999	**$500**
$250,000 - $499,999	**$1,000**
$500,000+	**$1,500**
We pay an additional $1,000 for each additional $250,000 in the loan above $500,000. However to qualify for rebates over $1,500 you must check with Peach.	

Peach also provides a range of free benefits to people, whether or not they are clients of ours. We send out monthly newsletters on lending and financial matters to those who have subscribed, 'savers' newsletters to those who are still saving for a deposit.

We operate a free property sale website - http://property.peachhomeloans.com.au – and also distribute free of charge sophisticated property investment software that allows people to model the financial impact of property investment scenarios – available at http://www.peachhomeloans.com.au/ez_rent_investment_software.htm. We know of no way of obtaining comparable software other than paying between $80 and $400 for it.

The need for regulation

Graham Samuel, Chairman of the Federal consumer watchdog the Australian Competition and Consumer Commission, has recently commented that consumer regulation can hurt consumers.[2] He argues that consumer regulation should seek to ensure that consumers get accurate information and then generally leave them to make their own choices.

> Where competition is able to operate effectively and efficiently, the disciplines of competition will result in consumers receiving the benefits of lower prices, of greater choice. What that means then is that consumer protection primarily is directed towards ensuring that businesses are honest, that the information they provide to consumers to enable them to make their choice is honest, is not misleading and deceptive.

Samuel argues that that is the “broad tenor of the Consumer Protection Provisions to the Trade Practices Act” and that accordingly a clear case must be made out for going beyond its provisions.

As we see it there are two problems in the industry which might warrant going beyond the Trade Practices Act. The first is that there are what the Discussion Paper calls ‘fringe players’ who employ all sorts of highly dubious tactics and prey off people’s vulnerabilities. The second is the ambiguity of the role played by mortgage brokers. These issues are tackled in turn.

Fringe players

On the unscrupulous fringe of mortgage broking, consumers are lured and/or pressured into unsuitable credit contracts. These are frequently of much greater financial significance for customers than a faulty consumer good.

There is a substantial industry that involves some or all of the following practices.

- cold calling;
- ‘pressure’ sales on home visits;
- compelling but frequently dubious demonstrations of how consumers can save money by ‘consolidating’ existing debt; with
- consumers being asked to sign to make an immediate payment of a substantial sum – usually by signing credit card authorisation.

Following this, the customer is refinanced into an expensive ‘line of credit’ type of service which is often neither suitable for the customers given their level of financial sophistication, nor is the product competitively priced.

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[2] The World Today - Tuesday, 18 January , 2005 12:10:00, http://www.abc.net.au/worldtoday/content/2005/s1284013.htm,

It may be appropriate to impose some regulatory regime on this industry. We do not know much about it, so we cannot propose regulatory solutions. However we would hope that customers' basic choices are respected. The regulatory task is to try to alleviate the 'horror stories' at the same time as allowing people to make legitimate choices. We expect most people's choices will reflect their interests and regulation should only seek to help them be informed consumers and perhaps address the question of sales pressure with 'cooling off' periods etc.

More important from our perspective is the need to come up with a means of addressing the issues thrown up by this kind of lending that does not impose costs on those in the industry who are operating in a quite different manner. For example, as argued below, restrictions on unreasonable charges at a home visit may be appropriate, but the outlawing of any deposit taking whatever is one of a number of practices which prevent service providers such as Peach from cutting their margins further.

The mainstream

As the Discussion Paper acknowledges, the bulk of the industry operates in a very different manner to the fringe. The problem with mainstream brokers is quite different.

Like its cousin, 'financial planning' or 'investment advice' mortgage broking operates in a netherworld.

Within the industry, brokers are treated and thought of as a "sales channel" and remunerated as such. Thus brokers are paid commission by lenders for selling loans, they are paid bonuses for volume sales, and lenders conduct sales campaigns amongst brokers with bonuses and various benefits in kind.

For all these reasons we encourage our customers to see us as sales people – and the closest analogy is selling consumer goods like fridges in a department store. We are not ashamed of being straightforward about this relationship. Salespeople are usually honest and good sources of advice because of their extensive product knowledge. And where a salesperson can offer products from many different providers – as salespeople in department stores can – there are obvious efficiencies and savings for customers.

So long as they think they're operating in a competitive market, salespeople also have strong incentives to try to find the best product for their customers. If they don't, another salesperson will beat them to the punch.

Not only is this analogy an accurate reflection of the realities of mortgage broking, it is one that customers are familiar with, and so it is a very direct way of ensuring that they are empowered. In department stores, customers understand that they should 'shop around' and stay in charge because salespeople only offer access to some brands and not others and salespeople are there to make a sale.

In broking as in 'financial advice' there are hefty rewards for practitioners who can get their customers to think that, despite their remuneration as sales agents, they act as fiduciaries – that is on behalf of their customers, the way a good doctor or accountant would.

Thus, though we wonder what took it so long, we support the increased vigilance ASIC is showing towards misleading claims being made in the industry, particularly claims of 'independence' and 'impartiality' from people who are in fact sales agents.

A regulatory regime that meets Australian government's commitments to 'minimum effective regulation'.

The process by which we arrive at any national regulation of mortgage broking is governed by the *Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard-Setting Bodies*.[3]

When the regulatory net was last extended in Australia, requiring the publication of 'comparison rates', the body implementing the regulation, the Ministerial Council of Consumer Affairs (MCCA), did not comply with the regulatory regime on regulation making to which it is itself subject.

Preeminent amongst the principles of good regulation set out in that document is this principle.

> **Legislation should entail the minimum necessary amount of regulation to achieve [its] objectives.**

Because of the unusual importance of what brokers do, and because of the ambiguity of their role in the marketplace, we think there is a case for regulation to go beyond simple reliance on the Trade Practices Act. It should encompass three objectives

1. the provision of simple, useful information to consumers to ensure they understand what brokers are;
2. the provision of cost effective dispute resolution for consumers to seek relief against service providers; and
3. removal from the industry of unscrupulous operators

1 Ensuring consumers are well informed

The ambiguity of the role of the broker should be addressed by simply requiring brokers to make a short simple statement to borrowers to the effect that they are sales agents, that they do not cover the whole market. They should also be

[3] at http://www.pc.gov.au/orr/reports/external/coag/.

required to advise borrowers to consider ‘shopping around’ by consulting more than one broker as well as searching the internet for available options.

Peach has processes in place for ensuring that its brokers are not financially motivated to sell one product ahead of another. However we believe the concern about this matter in the community arises from the ambiguity in the way in which brokers are conceived of within the community as ‘advisors’. If it is understood that they are salespeople and people understand that this is their role, and if there are sanctions for dishonesty, then whether they are paid additional commission for some loans or not becomes secondary, as indeed do ‘soft dollar’ commissions.

There are two pronounced problems with excessive concern for differential commission structures. Firstly the idea of constraining differentials in remuneration between products implies that the consumer should put themselves in the hands of the broker and seek his ‘recommendation’.

The idea that brokers ‘recommend’ loans is a major theme of the discussion in the Discussion Paper and a foundation for proposed regulation.

If we instead strive to ensure that the consumer understands the need to stay in control, that he or she should ultimately use service providers to assist in *his or her* search for a product, then commissions are incidental.

Perhaps more importantly, focusing on the issue of equality of commission distracts attention from a range of other conflicts of interest that brokers have. Most particularly, brokers are remunerated by the extent of their sales. So a broker generally has a financial incentive to maximise the borrowing of the consumer. We don’t believe the answer is to outlaw this kind of conflict of interest. One could argue that it should be disclosed. We have no real problem with it being disclosed and frequently disclose it ourselves. But it is also imperative that **consumer information should be simple and brief**. If it is not, consumers will not read it, and so their attention will be diverted from the most important issue.

There is a terrible tendency in regulation to simply add one piece of information disclosure after another.

The resulting ‘information overload’ is well known from the tabloid press to academic studies. Excessive information disclosure often produces the same result as no disclosure. It leads consumers to simply skim or even skip it altogether. The Discussion Paper shows very little regard for the importance of simplicity in conveying information to consumers, despite its crucial importance in ensuring that consumers are well informed.

This lies behind our own suggestion of a very simple disclosure of the nature of what brokers do, how they’re remunerated and some simple steps consumers need to take to stay in charge. Given that it is virtually inevitable that this review will recommend disclosure of commissions and perhaps the panel of lenders that the broker represents, we believe that it is important that this information be structured so that the consumer is able to browse it in order of importance. We suggest detailed matters such as this form an annex to the more simple statement of disclosure of the broker's role.

2 Resolving disputes cost effectively

Our legal system is a scandalously inadequate means of resolving disputes in our community. It requires people to wager literally tens of thousands of dollars to solve even quite small disputes. It would be most appropriate to address this dysfunction directly by reviewing the way in which the legal system manages small claims between consumers and their suppliers and service providers. However, presuming that this is outside the scope of review, an industry ombudsman is an excellent next best option.

While we endorse the idea that the industry funds the ombudsman, we think it is sad that consumers may use the ombudsman without bearing any cost whatever or any risk of cost, however vexatious their conduct.

What anecdotal evidence we have suggests that this imbalance is leading to substantial inefficiencies already. But it seems likely that the scope it provides for vexatious and malicious behaviour will attract greater abuse over time. The imbalance involved discredits what is otherwise a worthy initiative.

3 Removing unscrupulous operators

A by-product of the Ombudsman's dispute resolution is information about poor practice amongst brokers. Where brokers are discovered by the Ombudsman or others to be engaged in fraud, misconduct or other impropriety they could be excluded from the industry with *negative* licensing.

Upon receiving notice from the relevant regulatory official, a person or persons served with such notice would not be permitted to practice as brokers (or in any other field requiring a high degree of trustworthiness). This saves the time and money of the vast majority of brokers who do not engage in such conduct, it prevents their trading on the professional mystique of being 'licensed' brokers and it is otherwise consistent with the policy of 'minimum effective' regulation.

The distinction between negative and positive licensing is not a big one for us, so it is not a major point in this submission. However we do contest the observation in the Discussion Paper that "Negative licensing cannot prevent the entry of undesirable elements, nor can it provide access to industry participants (p. 66)". It can do so very effectively. For instance the Discussion Paper calls for a licensing regime that imposes probity checks to cover a range of concerns such as convictions for offences involving dishonesty, the cancellation of licences, registration or permission to trade in a regulated occupation, profession or business, undischarged bankruptcy and so on. It would be perfectly feasible to regulate to prevent people with such blemishes on their records to practice as brokers without explicit authorisation by the regulator.

Beyond these three proposals – a simple disclosure of the role of brokers, effective dispute resolution and removal of the unscrupulous – we believe that industry regulation will harm consumer interests rather than promote them. The rest of this submission seeks to outline why we believe this.

Keeping it complex: Why existing and proposed regulation is inefficient

This section argues that existing regulation, such as it is, performs its stated functions poorly if at all and that the proposed extensions to existing regulation will do likewise. In this regard the argument is that the regulation is inefficient, in the sense that it imposes greater costs than is necessary and/or that it does so without commensurate benefits. The following section argues that the regulation is in fact counter-productive in that it promotes and further legitimates the idea that brokers are ‘advisors’ to their customers with the implication that they owe quasi-fiduciary duties to them.

We believe that regulation beyond what we have proposed above is unlikely to be cost effective. In this section we point out a range of ways in which the regulation we already have confuses people and also prevents us from cutting our margins and providing better products to our customers. Subsequent sections argue that much existing and proposed regulation is actively counterproductive. As Graham Samuel suggests, it actively harms consumers.

Providing information

Recent NSW regulation requires us to sign a Finance Broking Contract with our clients. There are valuable aspects to this requirement. It requires brokers to inform their clients that they only cover a part of the market. Unfortunately the regulation is a grab bag of ideas that have been poorly thought through. The FBC arises from the call for greater disclosure by brokers.

This starting point is benign enough, but as we have discovered in our own business, the task of conveying information to consumers is not a straightforward one. It requires us to consider carefully what it is we need to convey to them, and how important issues can be highlighted for their attention. And we’re always improving the process as we discover problems.

By contrast regulated information provision seems invariably to simply add more and more disclosure requirements. Even within single instruments this is regardless of the consumers’ capacity to take in the information. And we are unaware of any monitoring of the success or otherwise of the regulations in meeting their objective. The FBC regulation has been in force in NSW now for a sufficiently long period of time for the regulators to have investigated its success or otherwise in achieving its objectives. We know of no such activity. Perhaps we are mistaken. After all we don't have the time to scrutinise all the activities of regulators. But the impression we have is that the regulator, having regulated, moves on.

The problem is of course compounded by the fact that there are umpteen other regulatory initiatives. When confronted by political agitation, it is relatively easy for politicians and officials to call for further information disclosure. It ensures nothing too dramatic occurs and has the merit of being seen to do something.

But the initiatives mount up. Here are some initiatives that we must comply with.

- The comparison interest rates we must quote, that bamboozle and mislead consumers so much more than the industry methodology they replaced.
- Finance Broking contract regulation
- Disclosure of commissions, 'soft dollar' commissions
- Privacy regulation.
- The Uniform Consumer Credit Code (UCCC)
- Bank account identify regulation
- Anti-Spam regulation

Each of these pieces of regulation has a compelling rationale. We accept that government action is appropriate in some or all of these areas. Yet the initiatives operate in a summative manner and their costs are mostly hidden from view.

- This is true almost by definition if governments are not seeking to measure the success or otherwise of their regulation.
- When we entered the industry our goal was to provide services from a distance – to allow application over the phone, fax and internet. We still do so where we can operate consistently with lenders' requirements. But we find many consumers are so intimidated by the amount of material that they receive and that is required to successfully complete an application that they request a home visit. Naturally this drives up costs and so reduces the rebates we can pay.
- Each bit of regulation adds to the compliance burden, and none are written so that one can be confident that one is not in breach simply by acting in an ethical manner. One must try to learn the rules and regulations, and then, if one proposes to do something new in one's business, one needs to employ the services of lawyers to find out if one can and if so how. This means that innovation is riskier, and puts an important floor under margins. We provide an example of this below.

Despite our best efforts to condense it, our standard disclaimer is now nearly 1,000 words long and we doubt it is read by many of our clients. We are required to convey such gems as this "Variable rates vary over time".

Box 1: Comparison rates

The rationale behind comparison rates, like that of its earlier, simpler and much better Annualised Average Percentage Rate (AAPR), is compelling. The comparison rate and the AAPR calculate the total range of costs in addition to interest payments. (The main costs are application and other up front costs and account keeping costs). They then produce a single interest rate that is intended to 'take into account' all unavoidable costs in the loan – like application and loan maintenance fees.

When we heard of the intention to regulate for comparison rates we thought it would be a good step to help consumers. We had imagined regulators would simply require all lenders to supply AAPR information. If they had done so it would have helped consumers at negligible cost. The AAPR assumed that borrowers held their loan for 7 years (approximately the average time before paying off or refinancing loans at the time it was introduced. This has now fallen to around 5 years today). It also assumed that loans were $250,000, though the lender could use some other figure.

The AAPR was simple and effective though, as with any simplification, it could mislead to the extent that a client's situation deviated from the one it modelled. However it exposed some of the most misleading practices of lenders, such as selling 'honeymoon' loans to snare people into a loan that was more expensive in the long run than normally priced loans. Peach also provided an AAPR that clients could tailor to their own circumstances. It made the calculation period as long as the loan term - 25 or 30 years - or as short as 1 year and added whatever costs they thought appropriate to their situation – whether it be additional costs of expected redraws or deferred establishment fees if they expected they may incur them.

Where a simple number helped clients work out what was important for them, Comparison Rates make this more complicated. They must be provided in large schedules of 15 loan sizes from $10,000 to $300,000. Although of course it is nonsensical to produce figures for a home loan of $10,000, the lenders of Australia are now doing just that. Against this the lenders have many different products. So their Comparison Rate schedules make mobile phone plans look like a paragon of simplicity! When it had to comply with the new regulation St George released a Comparison Rate Schedule with around 460 different interest rates on it! All this to help simplify loan selection! The system couldn't be better designed to swamp borrowers in information if it tried!

One of the first reactions to this has simply been the removal of interest rate information from advertisements. We don't have the money to get lawyer's advice on what we can and can't do and it’s not at all simple. So, following general advice by lawyers to the industry, we now advertise without interest rates. Lots of other lenders have chosen to do the same thing. So now customers get less information, not more, as a result of the new regulation.

And there are lots of grey areas. Lines of credit don't require comparison rates, so lenders don't publish them - yet many of the biggest rip-offs occur with lines of credit. Also the new regulation doesn't seem to require comparison rates for 'professional packages', though a very large proportion of loans are arranged under professional packages.

Comparison rates are also calculated over notional periods simulating actual loan terms. But doing this goes against the spirit of the new legislation because it dramatically reduces the relative weighting given to up front fees - after all what's $600 or even $1,000 if you're getting a loan for 30 years. A $600 fee increased the AAPR on a $150,000 loan by around 0.07% whereas it increases the comparative rate by just a little over half that amount. Yet almost everyone will refinance or pay off the loan well before the loan term expires.

If this seems like quibbling, consider the situation with fixed rates. After the fixed rate period is over your loan typically reverts to the standard variable rate - yet most people who fix will review their loan at the end of the fixed rate. They may fix again, revert to the standard variable rate or refinance elsewhere. Yet the Comparison Rate is calculated over the entire original loan term. So the standard variable rate to which the fixed rate reverts can dominate the comparison rate rather than the fixed rate that really matters – to consumers.

Not only does the comparison rate mislead. At most times fixed rates are above variable rates, and so the comparison rate grossly underestimates the true cost of the loan. If, for instance, fixed rates were, say, 1% above variable rates – a frequent occurrence - the comparison rate on a fixed rate loan would *underestimate* the cost of the loan during the fixed rate period.

Finance broking contracts

NSW regulation already provides for 'Finance Broking Contracts' (FBCs). FBC's seek to address some of the abuses in the industry, but the attempt is so poorly executed that the best that can be said for it is that it adds costs. In all probability it makes things worse for those consumers it is supposed to protect, but we are aware of no research into its costs or effects.

The FBC does not just bury important disclosure amidst a mass of less important information. Much more importantly, the process of agreeing to the FBC is vexing and confusing to the diligent consumer and broker alike and adds to the ease with which the less scrupulous broker can bamboozle a less diligent or sophisticated consumer.

FBC outlines the services that will be provided – before they're provided. If this were a tender document for a major project one could understand the logic. But consumers are often already highly stressed when they are applying for a loan. They are suspicious – as is reasonable – of being taken for a ride. So they need a process with simplicity, flexibility and integrity. If one cannot be devised, it is better to do nothing and rely on other mechanisms, particularly the Ombudsman to detect and deal with problems.

The whole idea of being able to agree to an FBC specifying a range of parameters about the loan before engaging the broker is paradoxical for, usually, the borrower relies on the broker to supply the details.

For instance, the FBC specifies both the interest rate and the amount the client seeks to borrow. Now clients often don't know the right interest rate band to aim for until we tell them. If they rely on us to specify the rate of interest they are looking for, the FBC doesn't provide them with much protection. If they know the rate they want to get, they don't need the protection of the FBC!

The same can be said for the amount of the loan. A client is likely to notice the size of the loan they're applying for when they fill out the application form! But just to make sure, this must also be specified in the FBC! It is actually very hard to think of a scenario in which the FBC offers any protection whatever with regard to loan size. This is not to say that clients are not talked into larger loans than they had first intended by brokers, but if they are this is the stage at which the FBC will be filled out and signed. And if an earlier FBC specifies another loan, it will be amended or replaced with a new one.

The FBC also requires the specification of loan features clients require. Similar considerations apply. If they specify the features they think they want, this can constrain their broker from discussing options outside that specification. If they know what they want they don't need the protection of the FBC. They can go to the ombudsman if they are misled. If they don't know what they want, they will get advice on it from the broker, who will then be the author of the terms of the document that is supposed to hold them to account!

However limited its use as a document of account for consumer protection purposes, it actively adds to clients' confusion and anxiety at a time that's already confusing and stressful for them.

Let's say that the client wants a loan of $450,000. We might suggest that we express this as a loan that is "$500,000 or less" to ensure that we are covered if the loan needs to be larger than the client initially anticipated, or to enable the consumer to qualify for discounts that some lenders make available at the threshold of $500,000. The client need not draw down more than they need and so need not be charged for any excess lending unless it was necessary – and they agreed to it in their loan application. (We do not seek to increase our clients' loans for our own convenience.)

Accordingly our own FBC contains the following clause. "Note: You should nominate an indicative loan amount, repayments and preferred interest rate a little above the level you are hoping for – and the level at which we will aim. This enables us to put several options to you – though of course you should choose the loan that best suits your circumstances".

It's hard to know what this process contributes in the way of consumer protection, but it certainly confuses a lot of consumers.

They wonder why we are writing a little more into their FBC than they think they will need to borrow at a rate a little higher than they think they'll have to pay. The same can be said about loan features. Let's say the client doesn't want fees – who does? Or they want an offset account. If we write those requirements into the client's FBC, then we can't suggest they consider products with fees or which have different features, because that would violate the contract. We can't suggest that they take note of how much an offset account is effectively costing them compared with a simpler loan with a redraw.

Yet if we write the possibility of fees or don't write their desire for an offset account into the FBC the consumer will often wonder if they're being 'fitted up' with a product they don't want.

For all its inconvenience to good brokers, unscrupulous brokers will be licking their chops at the Kafkaesque ritual it requires. It is the perfect beginning to the nightmare of documents, which the broker explains one by one until that sweet moment when, through a long sigh, the customer offers up his wearied and complete capitulation. Just sign here. And here. And here.

Keeping to the script: Why existing and proposed regulation promotes and further legitimates the ambiguity of the broker's role

So far most of our criticisms of existing regulation are of its efficiency. The extent to which it enhances consumer protection is minimal, and the costs it imposes on both brokers and their clients is substantial. But the most important objection to regulation beyond what we have suggested is 'minimum effective regulation', relates not to the costs it imposes.

Rather, the regulation that exists and the regulation anticipated in the Discussion Paper are counterproductive. Both make things worse for consumers. They do so in the following ways.

- The confusion and additional anxiety they create undermines consumers' capacity to stay in control of the process.
- They reinforce and legitimate the idea that brokers are fiduciaries or quasi-fiduciaries rather than sales agents
- They raise costs for consumers. The direct costs they impose on brokers are not cost beneficial, but they are nevertheless not large. By contrast the extent to which they restrict cost reducing innovation in the industry *is* substantial and over time will cost consumers a substantial amount.

The first of these points was explored in the previous section. The second is explored in this section, whilst the third is explored in the subsequent section.

The idea of close supervision of the quality of brokers' advice ultimately reinforces the ambiguity that has dogged the industry since its inception. Brokers are sales agents for the lenders and no amount of regulation or moralising can change that fact – though it can serve to disguise it with false expectations. Licensing and regulation of the quality of brokers' service and their advice strongly suggests to consumers something that many brokers are only too happy to have them assume – that brokers' relationships to their clients go beyond the ethical and legal requirements upon a salesperson to be straightforward and honest; that instead the relationship is fiduciary or quasi-fiduciary.

The regulation proposed entrenches the idea that brokers are 'advisors' to their clients. Early on (p 10), the Discussion Paper moots three central possibilities about the way a broker operates. (See Box 2).

Box 2: From the Discussion paper: Three different approaches.

A key issue in this area is that there are vastly different views of the role and responsibilities of the broker. Possible variations of the role of the broker are:

- To advise the consumer about the best option or options available, from a broad range of products, following a careful analysis of their personal circumstances;
- To present a range of options (with no express or implied recommendation) and allowing the consumer to select the product they consider most appropriate for their own circumstances; or
- To simply arrange credit for the borrower (usually from a preferred lender), without regard to whether a cheaper or more appropriate product is available.

At a practical level these views translate into significantly different methods of operating.

Yet from this promising beginning the Discussion Paper loses sight of these different approaches, effectively ending up recommending a regulatory approach to those brokers who invite their clients to think of them as advisors. The regulation proposed will assist these brokers. It will permit them to represent themselves to clients as 'licensed' brokers. It will require clients to read and sign yet more paperwork, giving a further air of legitimacy and faux professionalism to what is effectively a sales relationship.

Comments on the bizarre ritual of the FBC are set out above. It is quite unclear what the FBC arrangements have contributed to consumer protection in NSW. One would imagine that, with their having been in place in NSW, it would be appropriate to commission research to determine their costs and benefits. Australian governments' policy requires this to be done *before* regulation is introduced but better late than never.

Alas we know of no such research, and it is not in evidence in the Discussion Paper. Yet rather than wait for any research results, the Discussion Paper proposes to generalise the FBC procedure and then to add the requirement that the broker "provide the consumer with a statement of reasons setting out why the credit product recommended by the broker is the most appropriate product for the consumer's circumstances (p. 74)".

One can imagine the form such advice would take. The 'licensed' brokers providing what is, by implication, licensed advice will generate a set of reasons for recommending the product.

To streamline the process, as is currently the case amongst financial advisors, the advice will be provided as slabs of text generically drafted by sales executives, vetted by lawyers and disgorged from software that 'wows' the customers with its wizardry in their living rooms but is promoted as 'sales technology' within the industry.

The ‘advice’ will neither identify loans outside the brokers’ panel nor their existence. In all probability it will not identify;

- the costs of the various options the client has, in their innocence, indicated they would like. Thus if a client indicates that they would like an offset account, the advice will not stipulate that the client could save $x thousands per year by electing to use a simpler system.
- the kinds of ‘mix and match’ strategies that we point out to our own clients, enabling them to enjoy the benefits of one product – for instance a honeymoon loan – before switching to a discounted rate loan with the same lender after the honeymoon.

Thus the regulation dovetails with the sales strategy of many brokers whose software to graphically rank the competitiveness of various loans – using comparison rate methodology. As they emphasise in ’sales seminars’ promoting their software – ‘seeing is believing’.

Indeed much of the expertise provided can thus be automated in the software program. The client is asked a series of questions about what they want (often without advice about the opportunity cost of the various options chosen) and then a button is pressed. Voila – the ‘right loan’ is nicely displayed at the top of a graph for the customer’s edification as the best value loan that meets their specifications.

Another mouse-click and the appropriate application form appears already populated with the client’s details. Another mouse-click and the ‘reasons for selecting a loan’ statement is generated. Please sign here.

We have nothing against this method of sales. though we believe our own approach is more thorough. But our own approach would be far more costly if we were required to provide our reasons for drawing the attention of our clients to some loans and (by implication) not to others. Being required to generate reasons for the loans we select to highlight is likely to drive us towards a more standard methodology which is oriented towards compliance with regulation *rather than and at the direct expense of* serving our customers’ needs.

The costs of the consumer script: Raising costs, obstructing innovation

Brokers do a great deal of research work on their clients’ behalf. This is as it should be. We are happy to do this, as it is our job. However we sometimes get the impression that this work is unlikely to lead anywhere.

As a discounter we seem to attract lots of those known in the industry as ‘shoppers’ and ‘tyre kickers’. On persevering with them it turns out they are not serious in their interest or that they’ve applied with several other brokers amongst whom they then hold an auction. And then we get ‘shy types’, who conceal various skeletons in their family cupboard like a former bankruptcy. In each case we waste much of our time – which we can only fund from higher margins on successful loans.

The obvious solution to our problem is to say to clients that we will continue to do research for them but to charge them a deposit for such work – refundable upon settlement, with their rebate. Often the amount of deposit can be quite small – for instance $20. It enables us to put some onus on the consumer to disclose to us how serious they are. It also allows us to impose some risk on a customer if we suspect that they may not be being entirely frank with us about some matter that may affect their credit worthiness.

This course of action is now closed to us in NSW as a result of regulation. This restriction and other difficulties with the regulation now prevent us charging any deposit for our time – unless we obtain finance for the client. Often the matter does not get that far. Or finance falls through because the client's bad credit record (which they concealed from us) is discovered.

We find it hard to believe that the regulators meant to foreclose such options, for they directly affect our profit and so the rebate we can afford to pay clients. When the new regulation was introduced in NSW we reduced the level of rebates we paid, and we will probably have to do so again if national regulation imposes further obligations on us.

If this looks like a minor problem for consumers, it is not. For small obstacles like this prevent the emergence of new means of doing business.

Box 3: The Ombudsman: An anecdote and some implications

In five years of operation we are aware of one call having been made to the Ombudsman about us. A client demanded that we deliver his rebate in cash to his door within two days. We were able to pay his bank account on that day to avoid the hassle, but he did not accept this. It was physically impossible for us to get cash to him that week, as the broker who was going to visit him and pay him was on leave until the next week. We were rung by the Ombudsman's office within 20 minutes of the client ringing them. We explained the situation and the Ombudsman's office said that it would discuss the matter further with the client, and no further action was taken. We delivered the rebate to the client the next week as we had offered.

I asked the person at the Ombudsman's office if our case was typical. She said that it was, that there were a large number of similarly minor complaints to it and that in fact they were typical.

We think the office operated effectively in this situation. We are not sure why the more reasonable borrowers in the country should subsidise this kind of activity by the Ombudsman's office, but given that it is not a large cost, perhaps it performed a useful 'peacekeeping' role in this case. However a system that can impose costs of over $7,000 on a service provider without imposing any risk of bearing the costs of a vexatious claim on a complainant is one-sided in a way that is not only inefficient but is also unjust. It invites abuse.

As discussed below, the existence of these rules has prevented us experimenting in the marketplace with radically lower margin products

Fee for service lending

Ironically, at the same time as bemoaning the incentives on sales agents in the industry, and trying to regulate them into being the fiduciaries they are not, existing regulation such as that in NSW actually prevents the emergence of an economic model in which brokers could be true fiduciaries.

Peach is interested in establishing a fiduciary broking service that would charge clients by the hour – in the way an accountant would.

If we did so we could also experiment with offering loans without an interest rate margin. Then, genuine borrowers would save on interest – perhaps up to half a percent – throughout the whole term of their loan, occasionally parting with a fee charged on an hourly basis if they wanted to change some detail of their account.

But regulation prevents us charging before we get someone a loan – though this is where most of our time is spent. It prevents us from recovering at all from someone who lies to us about their circumstances and who therefore wastes our time in applying for one. And charging by the hour would upset a lot of people – even if we told them the rules beforehand.

That raises the risk that some clients would take us to the industry Ombudsman.

We support the idea of having an ombudsman, having agitated for one before it existed. But because it was designed to appease consumer groups, its costs are met by those businesses consumers bring before it. In nearly five years we've never been taken to the Ombudsman. But if we were, we'd be charged $200 for the initial referral, a further $2,000 for conciliation and then another $5,000 for the Ombudsman to rule! That's even if we successfully defended ourselves!

It is plain to see, therefore, why we're not falling over ourselves to rock the boat as a true 'fee for service' fiduciary broker. Most consumers are very reasonable people. But given that, even if we *win* all our cases, each unreasonable consumer can cost us over $7,000, we won't be taking any chances by upsetting the apple cart.