Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of mortgage broker remuneration

The Hon Kelly O'Dwyer MP

Minister for Revenue and Financial Services

PO Box 6022

House of Representatives

Parliament House

Canberra ACT 2600

Dear Minister,

On behalf of the Combined Industry Forum (CIF), we are pleased to present its first report in response to the Australian Securities and Investments Commission's (**ASIC**) 2016 *Review of Mortgage Broker Remuneration* (**ASIC Report**) and the third party recommendations of the Australian Bankers' Association (**ABA**) 2016/2017 *Retail Banking Remuneration Review* (**Sedgwick Review**).

This report demonstrates a genuine commitment for change from all corners of the mortgage broking industry, and deals directly with the issues of conflicted remuneration, reporting, disclosure and governance outlined in both the ASIC Report and Sedgwick Review. We believe the strength of the proposed package of reforms lies in the integrated nature, with governance at the centre.

Along the way we have received input from many stakeholders, including from consumer groups. We would like to thank them. We look forward to continuing to engage and work together as an industry to implement and review the proposed changes to promote good customer outcomes.

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1. Introduction

The Combined Industry Forum (**CIF**) is pleased to provide this paper to the Federal Government, outlining the mortgage broking industry's commitment to implement a package of reforms to improve customer outcomes in mortgage broking. This paper responds to the proposals outlined in the Australian Securities and Investments Commission's (**ASIC**) 2016 *Review of Mortgage Broker Remuneration* (**ASIC Report**) and takes into account the third party recommendations of the Australian Bankers' Association (**ABA**) 2016/2017 *Retail Banking Remuneration Review* (**Sedgwick Review**).[1]

The mortgage broking industry is committed to taking action to further improve customer outcomes and standards of conduct and culture, while preserving and promoting a vibrant and competitive mortgage broking industry that encourages consumer choice.

Over 50% of residential loan customers choose to find their loan through a mortgage broker and mortgage brokers enjoy trusted relationships with their clients. Mortgage brokers play an essential role in providing strong customer outcomes and enhancing competition in the home loan market.

However, the mortgage broking industry recognises that improvements can be made to manage actual and perceived conflicts of interest, and to improve the governance and oversight of mortgage brokers to identify and rectify issues and ensure continuous improvement.

The measures contained in the industry reform package address each of the six proposals of the ASIC Report and are designed to complement and reinforce each other, to manage the risk of poor customer outcomes and promote better conduct. Central to the reform package are improvements to and standardisation of governance, monitoring and supervision practices across the industry. These improved practices will drive higher standards of conduct, identify bad practices and poor customer outcomes, and contribute to a cycle of continuous improvement in the mortgage broking industry. The governance reforms are complemented by changes to remuneration structures aimed at removing financial incentives that may encourage customers to borrow more than they need or for brokers to direct loans to a particular lender. The package also includes new disclosure requirements so customers will have clearer information to make more informed choices.

Some aspects of the reform package relating to remuneration structures are impacted by Australian competition law. The industry is committed to taking action on these areas, as outlined in this paper, subject to developing an appropriate structure and meeting all competition law requirements. Importantly, some industry participants have already started making individual decisions to improve practices, such as moving away from volume bonus payments.

The package of reforms set out in this paper is an important first step. Implementing the package will require significant work and co-operation across the industry. The CIF will continue to drive the development and implementation of these reforms and will be making further regular progress reports to Government through 2018 and beyond.

[1] This document does not reflect any agreement, understanding or coordinated action except as expressly set out in the document, including without limitation any agreement, understanding or coordinated action in relation to the terms on which individual participants might engage or negotiate with each other or third parties.

2. Executive summary

The industry's reform package has been developed to:

- Ensure better customer outcomes;
- Preserve and promote competition and customer choice; and
- Improve standards of conduct and culture in mortgage broking.

The reform package proposes changes to remuneration to address both the 'product strategy' and 'lender choice' conflicts outlined in the ASIC Report, and will introduce a system of governance, monitoring and reporting to ensure that customer outcomes can be continuously assessed.

Importantly, for the first time, the industry has defined good customer outcomes, and is setting new standards to assess whether the loan is appropriate and whether the loan meets the customer's requirements and objectives. The definition incorporates the existing law and will hold the industry to a new conduct standard, above compliance with responsible lending obligations.

This reform package includes the following key features:

- Implementation of an improved data driven governance framework that is self-assessing, self-correcting and continuously improving;
- Recognition of the potential conflicts of interest and risk of poor customer outcomes as a result of bonus commissions and volume bonus payments;
- Recognition of the potential conflicts of interest and risk of poor customer outcomes as a result of targeted lender campaigns based on increased commissions paid to the mortgage broker, rather than increased value and service for the customer;
- Recognition of the risk of poor customer outcomes as a result of financial incentives that may encourage customers to borrow more than they need. The industry considers that lenders may address this risk by adopting a principle that, to the extent that remuneration relates to loan size, it should relate to the funds drawn down and utilised by a customer. This would be satisfied where, for example, upfront commission was paid on the balance of borrower funds drawn down and utilised by the customer, net of offset accounts or redraw facilities;
- Volume based 'broker clubs' to transform to tiered service models that deliver better standards of service for the customer and do not further reward the broker;
- A new regime for controlling and disclosing non-monetary benefits that manages lender choice conflicts and emphasises professional development and relationship building that promotes competition;
- A clear disclosure regime for ownership structures that takes owner influence into account and provides customers with the information they need to make informed choices; and
- A range of effective and achievable disclosure and public reporting measures to help track customer outcomes, broker behaviour and overall mortgage and finance industry performance.

The industry has committed to implementing this reform package through individual contractual arrangements and changes to internal governance and disclosure frameworks. This commitment enables the industry to take swift action to effect change.

To ensure the ongoing viability of the reforms and equal consumer protections, the reforms will need to be captured in an industry based code that enables enforcement, applies across the industry, and includes new participants over time.

The CIF is considering a number of industry based enforcement mechanisms, such as an ASIC approved industry code, subject to satisfying any regulatory and competition law requirements.

We will be continuously monitoring the effect of these reforms, including the outcomes of the improved governance framework, to ensure their effectiveness and contemplate further changes if required.

3. Background

3.1 Combined Industry Forum

In response to the ASIC Report and the third party recommendations of the Sedgwick Review, and following consultations with Government, the mortgage broking industry established the CIF to drive better customer outcomes through improved governance and remuneration practices in mortgage broking. This forum was tasked to achieve these outcomes through the development of a package of industry led measures to directly address the ASIC Report proposals, taking into account the third party recommendations of the Sedgwick Review. Refer to Appendix 3 for the full Terms of Reference of the CIF (p27).

The work of the CIF has been led by 7 guiding principles:

In responding to proposed changes to remuneration and governance practices in the mortgage industry, the CIF, including industry associations, brokers, aggregators and lenders will:

1) *Support a co-regulatory approach and, to the extent possible, support industry self-regulation;*
2) *Have better consumer outcomes at the centre of its approach;*
3) *Ensure appropriate transparency of process for industry participants, government and consumers;*
4) *Promote competition at all levels of the industry;*
5) *Not aim to change the structure of the industry or unfairly disadvantage any part of the value chain;*
6) *Promote simple and achievable solutions; and*
7) *Seek solutions that can be applied in all jurisdictions and that take account of the needs of metropolitan, regional and country areas.*

The CIF includes mortgage broker practitioners and representatives, aggregators, referrer aggregators, lenders, industry bodies ABA, Mortgage and Finance Association of Australia (**MFAA**), Finance Brokers Association of Australia Limited (**FBAA**), Customer Owned Banking

Association (**COBA**) and the Australian Finance Industry Association (**AFIA**)) and consumer representative groups.[2]

The CIF brings together representatives from across the mortgage broking industry in an unprecedented way. The cross industry commitment means we have been able to move together and at speed to create an initial and powerful package of reforms that demonstrates an industry driven by the desire to build greater trust with customers and deliver good customer outcomes.

The CIF was established in May 2017 and first met on 9 June 2017. The CIF has operated through monthly meetings and five specialist working streams, focussed on developing a package of changes to governance and remuneration in mortgage broking, based on the six proposals of the ASIC Report and the specific recommendations of the Sedgwick Review relating to the remuneration of aggregators and mortgage brokers.

The CIF includes a joint consumer group representative member, and has engaged extensively with ASIC, Treasury, members of the Government and consumer representatives in developing the reform package.

The CIF has played a critical role in identifying common principles and best practices across the industry to form the basis of joint action where appropriate and otherwise guide the decisions of individual participants in implementing the reform package, while preserving competition between them.

All meetings were held with independent legal representation present, to ensure compliance with competition laws.

3.1.1 Preserving competition and consumer choice

The role of mortgage broking

The ASIC Report identified the role that brokers play in the provision of strong customer outcomes and enhancing competition in the home loan market (paragraphs 18 to 22):

> *"Brokers play a very important role in the home loan market. They are responsible for arranging around half of all home loans in Australia. Consumers are increasingly turning to brokers to get help in obtaining a home loan—in 2012 brokers arranged 47.7% of home loans for the lenders in our review. In 2015, this increased to 54.3%.*
>
> *Brokers arranged almost 520,000 new home loans from the lenders in our review in 2015 (compared to 340,000 in 2012).*
>
> *Brokers can play an important role in promoting good consumer outcomes and strong competition in the home loan market.*
>
> *From a consumer outcomes perspective, in a well-performing market brokers can help:*
>
> - *match the needs of the consumer with the right home loan product and lender;*
> - *navigate the home loan application process, which can be daunting for many consumers; and*
> - *improve consumer understanding of home loans and financial literacy.*

[2] see Appendix 1 for full list of participants.

From a competition perspective, brokers have the potential to:

- *play a valuable role in providing a distribution channel for lenders—especially smaller lenders— without their own distribution network (e.g. branches);*
- *exert downward pressure on home loan pricing, by forcing lenders to compete more strongly with each other for business."*[3]

Competition law

As set out in CIF guiding principle four, the design of the industry response must preserve competition.

The CIF has taken strong steps to respect and comply with all Australian competition law requirements, in all forums, meetings and written materials. We have sought advice from independent external counsel on the preparation of reports and external counsel has been present at all forums and all meetings that address monetary and non-monetary incentives.

3.1.2 ASIC Report proposals and Sedgwick Review recommendations

The six ASIC Report proposals and relevant Sedgwick Review recommendations were the main drivers of the CIF's work. The CIF believes it is important to integrate both the ASIC Report proposals and Sedgwick Review recommendations to ensure a simpler and more sustainable response that has all voices at the table. An overview of the ASIC Report proposals and related Sedgwick Review recommendations is set out in Appendix 4.

3.2 Current regulatory framework and recent changes to practice

Mortgage broking is already regulated through the *National Consumer Credit Protection Act 2009 (Cth)* and related regulations and regulatory guidance. This regime sets out significant conduct and disclosure obligations that are intended to better protect customers and manage conflicts.

The ASIC Report and Sedgwick Review have been important triggers for industry action. However, the industry has been working on significant industry led changes since the review of mortgage broking remuneration was referred to ASIC by the Minister for Revenue and Financial Services in November 2015. These industry led changes include:

- Ongoing improvements to broker monitoring and supervision and increased oversight by lenders of aggregator monitoring and supervision arrangements;
- Work between lenders to agree and establish a standardised format for documenting customers' requirements and objectives;
- Changes to the location of, and the proportion of educational content provided at, industry conferences; and
- Individual decisions to move away from volume bonuses.

[3] ASIC Report 516, 'Review of mortgage broker remuneration', section 22, p.8.

4. Proposed reform package

In explaining the proposed reforms we have listed the changes against each of the ASIC Report's individual proposals. However, many of the reforms are important in addressing more than one of the ASIC Report proposals, and equally contribute to responding to the Sedgwick Review recommendations. Accordingly, they should be read together as a package of integrated reforms rather than individual changes.

4.1 Scope

The reform package applies to loans regulated through the National Consumer Credit regime. The remuneration principles applied to arrangements for mortgage brokers are expected to be equally applied in arrangements for introducers and referrers.

4.2 Implementation and timing

The CIF has followed a work plan and established five specialist working streams to ensure that momentum was not lost and that the ambitious timeline for self-regulatory reform could be met.

Subject to meeting regulatory and competition law requirements, the industry commits to having the reform package implemented by end 2020. However, the industry has committed to earlier milestone steps, including:

- Changes to commissions structures **by end 2018**;
- Addressing bonus commissions and volume bonus based payments **by end 2017**;
- Implementing changes to tiered service models and eligibility of non-monetary benefits **by end 2018**;
- Implementing the new ownership disclosure and public reporting framework **by end 2018**;
- Commencing work on an industry code **by mid-2018**; and
- Completion of governance frameworks **by end 2020**.

The work of the CIF will be ongoing, encompassing the development of an industry code, monitoring of industry implementation, assessment of improvement to consumer outcomes, and considering further work and reforms. The CIF will report on implementation to Government, Treasury and ASIC on a semi-annual basis.

4.3 Industry code and enforcement

The proposed reforms will be industry led, and individual industry participants have committed to taking immediate steps (having regard to competition law requirements) to implement the reform package. However, to ensure the ongoing viability of the reforms and equal consumer protections, the reforms will need to be captured in an industry code that enables enforcement, applies across the industry, and includes new participants over time.

The CIF is considering a number of approaches, including working with ASIC on establishing an ASIC-approved code for all participants in the mortgage industry, and / or repurposing current industry codes to include these reforms, and to house the appropriate monitoring and compliance functions.

The CIF's position on the mechanism for developing an industry code will take into account the outcomes of the ASIC Enforcement Review's assessment of ASIC's code approval powers, and any new obligation for industry participants to subscribe to an approved industry code. A 'mortgage broking industry code' would apply to mortgage brokers, lenders, aggregators and, where appropriate, referral businesses and would be subject to all applicable regulatory and competition law approvals.

4.4 Defining 'Good Customer Outcomes'

ASIC noted in their report that brokers can contribute to positive customer outcomes, as they:

> *a) "match the needs of the consumer with the right home loan product and lender;*
>
> *b) navigate the home loan application process, which can be daunting for many consumers; and*
>
> *c) improve consumer understanding of home loans and financial literacy.[4]"*

ASIC also noted the competition brokers drive in the home loan market, exerting downward pressure on pricing.

> At the heart of ASIC's work was enhancing customer outcomes. In responding to the ASIC Report proposals, the CIF has worked to define a 'Good Customer Outcome' and, as an industry, have agreed to a new definition that is set above the law and that we believe will improve customer outcomes. We defined a 'Good Customer Outcome' as:
>
> *"The customer has obtained a loan which is appropriate (in terms of size and structure), is affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan."*

A 'Good Customer Outcome' is at the centre of what we are striving to achieve whether lender, aggregator, mortgage broker or other industry participant. The above definition sets out four key measures that need to be satisfied to determine a 'Good Customer Outcome':

- Appropriate size and structure of the loan;
- Meeting the customer's stated requirements and objectives;
- Affordability for the customer; and
- Applied for in a compliant manner (meeting all responsible lending requirements).

The definition incorporates the existing law, and holds the industry to a new standard, above compliance with responsible lending, to take into account whether the loan is appropriate and whether the loan meets the customer's requirements and objectives. Where changes in disclosure and communications are proposed, the CIF will engage customers for feedback to ensure we are enabling more informed and better customer outcomes.

[4] ASIC Report 516, 'Review of mortgage broker remuneration', section 21, p.8.

4.5 Remuneration changes - Managing product strategy and lender choice conflicts

The CIF has proposed changes that taken together, will manage and reduce the potential for conflicts of interest that pose risks to customers. The ASIC Report identified and defined potential conflicts, including[5]:

1. *Product strategy conflict: when a broker could recommend a product or strategy to maximise their commission payment, for example, by recommending a loan that is larger than a customer needs, or can afford.*
2. *Lender choice conflict: when a broker is incentivised to recommend a loan from a particular lender over another.*

4.6 Governance, conduct and culture

The CIF believes that improvements to the governance of mortgage broking, and strengthening conduct obligations through industry led reform, will be one of the greatest drivers for improvements in customer outcomes.

Changes to governance, oversight and reporting will mean that poor behaviour or poor customer outcomes will be more readily identified and addressed, and feed into a cycle of continuous improvement in mortgage broking.

[5] ASIC Report 516, 'Review of mortgage broker remuneration', section 29, p.10.

4.7 Industry's reforms to improve customer outcomes

The following table outlines the package of reforms as it relates to ASIC's specific proposals (see Appendix 4 for interaction between the ASIC Report proposals and Sedgwick Review recommendations):

ASIC's Proposals	Reforms	Impact
1. **Changing the standard commission model** to reduce the risk of poor customer outcomes [Sedgwick recommendation 18]	The industry recognises the potential for financial incentives to put good customer outcomes at risk where they encourage customers to borrow more than they need. The CIF considers that industry participants may address this risk by adopting the following remuneration principle: "To the extent that remuneration relates to loan size, remuneration should relate to the funds drawn down and utilised by a customer". The industry considers that this principle would be satisfied where, for example: • Upfront commission is paid on a utilisation basis, that is: - based on facility limit drawn down by the customer; and - in cases where the loan has an offset account, on the amount drawn down net of offset account balances, • Trail commission is paid on the amortised drawn down amount net of offset account	The current standard commission model includes upfront commission paid on settlement of the loan, as recognition of economic value created by the broker for the lender, and trail commission paid over the life of the loan, which supports the broker to provide ongoing service to their customer base over time. ASIC "found it common for remuneration structures to pay commissions on the total amount of borrowing approved, rather than the amount of funds drawn down"[6]. We believe the principle to pay commissions based on the funds being utilised by the customer directly addresses the biggest risk to consumers arising from product strategy conflict. Mortgage brokers will no longer be paid on facility limits or have a financial incentive to recommend larger loans that initially have large offset balances. The CIF have proposed this principle to promote good customer outcomes, specifically to ensure the appropriate size of the loan for customers and to discourage large initial offset balances. When coupled with the governance framework proposed, this is a significant step forward.

[6] ASIC Report 516, 'Review of mortgage broker remuneration', section 30, p.10.

	balances or based on facility utilised, and • Clawbacks remain part of the standard commission structure. Generally, funds drawn down would be measured and commission paid on initial settlement and at a later point in time for subsequent drawn down amounts, up to the maximum facility limit. The CIF recognises that this approach to funds drawn down and utilised may require further consideration in certain limited circumstances, such as residential construction lending. As long as this principle is satisfied, there should be no restrictions placed on lenders adopting additional methodologies of calculating commission payments. Additional arrangements for the eligibility of trail commission based on customer outcomes are set out in proposal six. **Implementation by end 2018**	The CIF made a rigorous assessment of the potential customer outcomes of a number of remuneration models and their variants, which were deemed to have potential unintentional consequences for customers. These identified unintended consequences generally affected first home buyers most. The models and their variants could largely be placed into five main categories. The models were all evaluated by the CIF based on the schedule contained in the MFAA submission (MFAA Submission), and were all found to have unintended consequences some of which are detailed below. The main categories and their potential unintended consequences include: • Consumer paid fee for service (in lieu of commissions): While consumer paid fee for service may reduce lender choice and product strategy conflicts, it will negatively impact competition and customer outcomes; result in additional direct costs to consumers to access the broker channel; diminish the broker value proposition to the customer; put brokers at a significant disadvantage to the lender branch channel (who do not charge direct fees); likely result in rationalisation of broker numbers, increasing barriers to entry for new lenders, whilst disadvantage smaller lenders and those without a branch footprint; is unlikely to correlate to economic value produced by the broker; and could result in brokers servicing a much narrower band of customers. • Standardisation of upfront commission percentage: while it may reduce lender choice conflict, by itself, it would not reduce product strategy conflict. Further, this method does not differentiate for complex products and

		may raise competition law issues if implemented by industry agreement. • Base commissions paid on Loan Value Ratio (**LVR**): may exclude high LVR lending, for example to first time home owners and could encourage the greater use of guarantees from related parties to reduce LVRs. • Flat lender fee: could result in brokers servicing a narrow band of customers, for example, those with simple needs. It may not reduce product strategy conflict in the case of tiered fees. It has no correlation to economic value produced. Also, it could negatively impact pricing on smaller loans. Finally, it may result in split loans for customers if ‘gamed’. • Removing lenders’ and brokers’ ability to discount interest rates and application fees: this may limit loan size as it could remove incentives to recommend larger loan sizes to hit the discount rate hurdle but also reduce direct customer benefits. Adopting this principle is a first step for the industry. The industry intends to use the improved governance framework to closely monitor customer outcomes and the impact of the reforms. Where remuneration structures are found to be driving poor behaviours and customer outcomes, the industry will consider further changes to remuneration structures.
2. Moving away from bonus commissions and bonus payments	The industry recognises the potential for volume-based bonus commissions, campaign-based commissions and	ASIC noted that volume-based and campaign-based commissions that supplement the standard commission

which increase the risk of poor customer outcomes [Sedgwick recommendations 16. a) and 16. c)]	volume-based bonus payments paid by lenders and aggregators to brokers or by lenders to aggregators to put good customer outcomes at risk. The industry also recognises ASIC's expectation that the industry moves away from these commission and payment structures. All industry participants should respond to ASIC's recommendation by 31 December 2017. In practice, many industry participants have already taken individual decisions to cease these payments. The industry recognises that volume-based payments from lenders to aggregators can also raise conflicts. Financial support, provided by lenders to aggregators, for compliance education and training that lead to better customer outcomes is not likely to raise conflicts as long as such support is not based on volume of loans written with any particular lender and do not form a condition of being on the aggregator's panel of lenders. Discounted or free aggregation as a result of writing aggregator white label loans, or any specific lender's loans, has been removed from the industry, and the industry does not support the return of this practice. While not a change specifically proposed by the ASIC Report or the Sedgwick Review, this move demonstrates the intent of the industry to address areas of potential conflict that may not result in	model can create potential conflicts of interest and "higher risk that brokers will place customers with lenders for the wrong reasons"[7]. The changes proposed are considered to reduce this risk of lender choice conflict. From a customer perspective, this provides a clearer pathway for brokers to "match [their needs] with the right home loan product and lender"[8]. Again, the change to broker conduct and culture from this proposal will be supported through changes to the governance framework. We also note that ABA member banks are addressing bonus payments to their staff through commitment to implementing the Sedgwick Review recommendations.

[7] ASIC Report 516, 'Review of mortgage broker remuneration', section 119, p.24.

[8] ASIC Report 516, 'Review of mortgage broker remuneration', section 21, p.8.

	good customer outcomes. **Implementation by end 2017**	
3. Moving away from soft dollar benefits which increase the risk of poor customer outcomes and can undermine competition Specific areas considered: • Tiered servicing (Broker Clubs) • Conferences/Professional development events • Entertainment and Hospitality [Sedgwick recommendation 16. b)]	<u>Tiered servicing</u> Access to a Lender or Aggregator's tiered service model should be determined using a balanced scorecard, with a maximum 30% volume component, as a proxy for productivity, as well as other criteria aligned to 'Good Customer Outcomes'. Access to a tiered service model will be disclosed by the broker where they are recommending a product from that particular lender. Such programs should not entitle brokers to preferential customer discounts or to additional payments or commissions. Instead, these programs should provide preferential service which can assist customers in achieving better outcomes. <u>Conferences and Professional Development</u> Professional development and most education is available to all brokers to ensure ongoing competency and professional development. All conferences and professional development events must be educationally focussed (with a minimum of 80% identified education content) and aimed at continually improving customer outcomes. Minimum education and professional development for brokers is not considered a reward but as driving a level of competency to improve customer outcomes. Locations for conferences and professional development must be business appropriate and not likely to cause	The industry intends to reduce potential for both lender choice conflict and product strategy conflict through these changes. These changes are expected to continue to improve customer outcomes through promoting a strong base level of competency across brokers in the industry and a risk and regulatory focus through use of balanced scorecards. Disclosure of conflicts of interest registers to customers, combined with disclosure changes under proposal five, will help increase transparency and reduce potential for lender choice conflict. Removal of volume from eligibility scorecards directly manages strategy conflicts by removing incentives to write larger loans that are not utilised by the customer. Again, combined with changes under proposals five and six, implementation is intended to lead to improved conduct and culture.

	reputational harm to the industry. In some circumstances, additional education opportunities are offered. Broker access to these additional opportunities should be based on a balanced scorecard, which does not include volume. <u>Entertainment and hospitality</u> The industry recognises that the provision of high-value entertainment and hospitality may raise the risk of lender choice conflicts. The industry considers that this risk may be addressed by ensuring that lenders do not provide entertainment or hospitality to mortgage brokers that has a value of more than $350 per person, per event and is not based on the volume of loans written by the broker. This value was chosen to align with Fringe Benefit Tax (**FBT**) reporting, which enables lenders and aggregators to use existing reporting for better monitoring and supervision. Aggregators will not determine eligibility for entertainment or hospitality, wholly or partly, on the volume of loans written with any one lender or white label loan product. For entertainment or hospitality above $100, lenders, aggregators and brokers will be required to maintain their own register of entertainment and hospitality benefits (given or received) on a rolling 12 month basis, with records kept for three years. ‘Entertainment and hospitality’ does not include professional development and education events, that have more than 80% identified education content and are offered in a business appropriate location. This register should be kept current, advertised in the Credit	

	Guide provided to customers and monitored by aggregators and details provided on request. <u>Lender Sponsorship of Aggregators and Events</u> Sponsorship opportunities to an aggregator event should be made available to the aggregator's entire lender panel. As above, the aim of any event is to increase education. Further, the ability to join an aggregator's panel should not be contingent on the level of sponsorship provided. **Implementation by end 2018**	
4. Clearer disclosure of ownership structures within the home loan market to improve competition	To reduce the potential impact of ownership structures on competition in the home loan market, we propose that participants in the industry more clearly disclose their ownership structures and other circumstances in which they may have the ability to exert influence. • Disclosure of ownership structures will be required if 'Significant Influence', as guided by the definition in Australian Accounting Standard 128 (AASB 128), is deemed to be exerted over a participant in the industry. Disclosure of ownerships structures would be required where, for example: - Ownership is 20% or greater; or, - Where ownership is less than 20%, a board seat is held or a white label product is offered by a substantial shareholder (as defined); • Disclosure of ownership structures should extend beyond mortgage brokers and apply to all players in the home loan distribution chain,	The disclosure of ownership structures, combined with the proposed changes under the public reporting regime, is expected to better inform customers and improve competition in the industry.

	- including lenders and aggregators; and - Disclosure of ownership structures should be included in marketing material, digital formats and at all distribution points (e.g. websites and at physical premises). The CIF suggests carrying out customer testing of disclosure formats and standards (once designed) to ensure clarity and maximum benefit. **Implementation by end 2018**	

5. Establishing a new public reporting regime of customer outcomes and competition in the home loan market
 	
[Sedgwick recommendation 19]
	Below, the CIF proposes providing particular information to ASIC and would like to work with ASIC on approaches to de - identify and aggregate the information, for publication.
	
	Aggregators to publish and provide to ASIC:
	
	- List of all lenders available on panel and percentage share of business written with each over the previous financial year,
	- Spread of number of lenders being used by brokers in the group/aggregator (in the last 12 months):
	  - % brokers using < 3 lenders;
	  - % brokers using 4 – 7 lenders;
	  - % brokers using 8+ lenders; and
	- Weighted average commission rate percentage earned in the previous financial year for mortgages.
	
	Lenders to provide to ASIC:
	
	- Weighted average pricing of home loans in the
		The proposed disclosures and measures are to be tested with consumers and ASIC to evaluate whether they make a meaningful difference to reducing the potential for lender choice conflict and increasing financial literacy.
		
		Once clear disclosures are developed, the CIF believes that the proposed disclosures will help customers when navigating the home loan process. By providing them with transparency around the lenders used by brokers, it enables a customer to question whether they have been matched to the right home loan product and lender.
		
		Again, when combined with other proposals, the changes are expected to improve broker conduct and culture through providing transparency of use of lenders on an aggregator panel.

	previous financial year across their different distribution channels using various standard scenarios (to be defined). Further work is required with ASIC and the industry to agree a standard model to analyse and present the pricing information, particularly taking into account variables such as the effect of interest rate movements. Brokers to publish to customers: • List of lenders available to the customer via the broker's aggregator; • Number of lenders used in the previous financial year; and • Top six lenders and % of business written in the previous financial year (Note: if the individual broker has not been in business for 12 months then this would be N/A). **Implementation by end 2018**	
6. The industry needs to improve the governance and oversight of brokers by lenders and aggregators [Sedgwick recommendation 17]	The industry proposes introducing an improved Governance Framework under which the industry would self-assess, self-correct and continuously improve. This framework would comprise: • Key Risk Indicators, which would act as triggers/flags for potential poor customer outcomes; • Unique identifiers, to allow for more complete reference checking and identification of poor	The proposed changes are expected to improve conduct and culture across the industry, and hence improve customer outcomes. Prioritisation of elements of this model is the next step for the CIF, to ensure continuous improvement does not stall. The industry is committed to the change and is continuing to work together around how and when this can be implemented given the materiality of the change and constraints of individual technology and systems. The Governance Framework has the following features:

	performers; • Annual reviews of individual aggregator and broker governance frameworks; • Data based broker monitoring; • Customer feedback and shadow shopping to ensure reforms are ensuring good customer outcomes; • Reporting and ongoing review of remuneration structures, including upfront, trail and clawbacks, to the extent they negatively impact customer outcomes; and • Remediation, such as training, education, and recognition. This work is already underway and will be ongoing. *Key Risk Indicators* Key Risk Indicators would need to be reported from Lender to Aggregator/Broker around the potential for a poor customer outcome. These indicators provide data based direction to the allocation of oversight effort and resources and could/would include the following relative to the industry average: • % of portfolio in Interest Only, as an example of a product and whether for investment or owner occupier purposes; • Arrears (60+ days or average weighted arrears in the first 12 months); • "Switching" in the first 12 months of settlement;	• The governance changes underpin all the entire reform package; • The changes will focus on better understanding of the broker – customer conversation and needs analysis, including the customer interview guide, to drive a higher and consistent level of practice; • The changes improve data driven information sharing between lenders and brokers to improve monitoring, supervision and identification of poor customer outcomes; and • Identified issues will feed into Professional Development and education plans.

	• Elevated level of customer complaints; • Poor post settlement customer survey results of the broker experience; and • The quality of the loan, identified through any deficiencies found in Requirements and Objectives (**R&O**) documentation which would include moving to a more robust capture of the R&O by the lender as a separate initiative (potentially through establishment of an Industry Guide for capturing such information). *Unique Identifiers* The industry intends to work with Government to implement a unique identifier for each broker and introducer/referrer to lender, noting there is investigation required around how this can be implemented. The unique identifier should be held on a 'register' of brokers maintained as a reference checking protocol for credit professionals moving between aggregators or moving from working with a lender to an aggregator. Ideally this identifier would be maintained throughout a person's career across financial services industries, such as financial planning, mortgage broking, referring / introducing and as a lender employed banker, and be managed centrally by ASIC. Once fully implemented this identifier would be used by aggregators, lenders, associations and ASIC, and be held against all loans lodged at the lender level to assist with data analytics. *Customer Feedback* There should be ongoing customer feedback gathered to	

	review whether a 'Good Customer Outcome' has been achieved. An industry standard to obtain this feedback needs to be designed but would become integral to the aggregators' monitoring of brokers, creating a 'test and learn' environment. *Remediation* In conjunction with proposal one, and along with training, education and recognition, the industry considers that good customer outcomes are promoted by withholding the **trail** commission if: • A loan is 60+ days in arrears; and/or • A loan is found to have been calculated using inaccurate information allowing a customer to receive a larger loan (trail not paid if any fraud found in the application); and/or • A loan is refinanced or restructured, which may be potential evidence of not being fit for purpose. **Implementation end 2020**	

In addition to the package of reforms outlined in this paper, the CIF recommends to the Government that ASIC should establish an ongoing shadow shopping program to feed back to the industry the impact of the recommended changes and to assess if they believe there are any other shortcomings that the industry should action.

4.8 Further work

The CIF believes that this paper is an important first step in the self-regulatory process designed to improve governance and remuneration practices to ensure better outcomes for customers.

As a first step, and in many cases as an articulation of intent, there will be further work to be done to implement the required changes. Implementing the above reforms will require significant work and co-operation across the industry. The industry welcomes this opportunity as it believes implementation of the proposed changes will improve customer outcomes, and enhance the sustainability of the mortgage and finance industry.

The work of the CIF will be ongoing through 2018 and beyond, including:

- Developing further detail of the improved governance framework;
- Developing the industry code;
- Monitoring of industry implementation;
- Assessing improvement to consumer outcomes; and
- Considering further work and reforms.

The CIF will report on implementation to Government, Treasury and ASIC on a semi-annual basis.

The CIF was established to develop a package of reforms in response to the ASIC Report proposals, and the Sedgwick Review recommendations. However, the Industry sees the need to maintain the momentum generated during this time, and so the CIF will continue until all proposed reforms are successfully implemented, and potentially thereafter to drive continual improvement.

Progress reports will continue to be provided to ASIC, Treasury & Government by the CIF and industry bodies on a quarterly basis.

5. Concluding remarks

The CIF is pleased to provide this report to the Government, and grateful for the Minister's public commitment to take this paper into account when finalising the Government's response to the ASIC Report. We look forward to continued engagement with the Government on these important proposals.

Appendix 1 – CIF members

Industry stakeholders who participated in the Combined Industry Forum:

Company Name	**Group**
ABA	Industry Association
AFIA	Industry Association
Australian Finance Group (**AFG**)	Aggregator
AMP Bank	Lender
Australia and New Zealand Bank (**ANZ**)	Lender
Astute	Aggregator
Bendigo and Adelaide Bank	Lender
BeckMitch Consulting	Broker
Bank Of Queensland	Lender
Commonwealth Bank of Australia	Lender
CHOICE	Consumer Advocacy Group
Choice Aggregation Services	Aggregator
COBA	Industry Association
Credit Union Australia (**CUA**)	Lender
Connective	Aggregator
Divitis Finance	Broker
FAST Group	Aggregator
FBAA	Industry Association
Foster Finance	Broker
GRACosway	Consultants
Gilbert + Tobin Lawyers	Independent Legal Advisors
Heritage Bank	Lender
ING	Lender
Lendi	Broker

Liberty Financial	Lender
Loan Market	Aggregator
ME Bank	Lender
MFAA	Industry Association
Mortgage Choice	Aggregator
National Australia Bank	Lender
Nexus Partners	Referral Aggregator
NMB	Aggregator
PLAN Australia	Aggregator
SmartMove	Broker
Suncorp	Lender
Tailored Lending	Broker
Westpac	Lender

Appendix 2 - Glossary

Term	Definition
Consumers or customers	Used interchangeably in this paper to refer to individuals in the market who have the potential to, or have already, applied for a regulated home lending product.
Commissions	Payment provided to mortgage brokers as: • An upfront commission to remunerate as a recognition of economic value created by the broker for the lender. • A trail commission paid over the life of the loan, which supports the broker to provide ongoing service to their customer base over time. Introducers also receive an upfront commission for referring a customer to a lender.
Introducer or referrer	A trusted professional (e.g. financial planner, lawyer, accountant, etc.) who refers customers to a lender for the purposes of securing a home loan.
Volume-based Bonus Commissions and Bonus Payments	The industry has previously allowed the payment of bonus commissions based on volumes written from lenders/aggregators to brokers. This practice has ceased and will not continue. Likewise, volume-based bonus payments have previously been allowed to be paid from lenders/aggregators to brokers. This practice has ceased and will not continue. Payments provided from lenders to aggregators for the purpose of education and training of mortgage brokers will be allowable on a negotiated commercial terms basis to ensure continued.

Appendix 3 - Combined Industry Forum Terms of Reference

Objective

1) The Combined Industry Forum's (CIF) objective is to work with Government, ASIC and consumer representatives to develop a co-regulatory solution to design and implement changes to remuneration and governance practices in the mortgage industry.

Guiding principles

2) In responding to proposed changes to remuneration and governance practices in the mortgage industry, the CIF, including industry associations, brokers, aggregators and lenders will:

1. Support a co-regulatory approach and, to the extent possible, support industry self-regulation;
2. Have better consumer outcomes at the centre of its approach;
3. Ensure appropriate transparency of process for industry participants, government and consumers;
4. Promote competition at all levels of the industry;
5. Not aim to change the structure of the industry or unfairly disadvantage any part of the value chain;
6. Promote simple and achievable solutions; and
7. Seek solutions that can be applied in all jurisdictions and that take account of the needs of metropolitan, regional and country areas.

Scope

3) The CIF will develop industry based responses to the ASIC Report proposals[9], and have regard to the third party recommendations of the Sedgwick Review[10]. These industry based responses will be presented to the Government and ASIC to help inform the Government's response to the ASIC Report proposals.

4) The response will be developed in accordance with the Work Plan, approved by the Forum.

Timing

5) The Forum will provide regular updates to ASIC and Treasury, and a formal interim response outlining progress to the Government by Monday 13 November.

Consultation

6) The Forum will consult and engage regularly with Government, ASIC and consumer representatives.

Resources

7) The CIF will be supported by a Secretariat within the associations, technical resources provided CIF participants, and by external legal and technical resources as approved by the CIF.

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[9] ASIC Report 516, 'Review of mortgage broker remuneration', pp.23-27.
[10] Recommendations 16, 17, 18(a), 20(a), 21 of the *Final report of the Retail Banking Remuneration Review.*

Appendix 4 – ASIC proposals and Sedgwick recommendations

ASIC's Report 516, "Review of mortgage broker remuneration", made 13 key findings and six specific recommendations. The findings focused on commission structures; soft-dollar benefits; key characteristics of the broker channel; value chain ownership structures; governance and oversight; and data quality and public reporting. These findings framed ASIC's key recommendations which painted a picture of potential conflicts of interest in current remuneration practices; and assessed the relative 'health' of the mortgage and finance broking industry.

Importantly, the ASIC Report endorsed the role that brokers can play in the provision of strong consumer outcomes and enhancing competition in the home loan market (paragraphs 18 to 22):

> Brokers play a very important role in the home loan market. They are responsible for arranging around half of all home loans in Australia. Consumers are increasingly turning to brokers to get help in obtaining a home loan—in 2012 brokers arranged 47.7% of home loans for the lenders in our review. In 2015, this increased to 54.3%.
>
> Brokers arranged almost 520,000 new home loans from the lenders in our review in 2015 (compared to 340,000 in 2012).
>
> Brokers can play an important role in promoting good consumer outcomes and strong competition in the home loan market.
>
> From a consumer outcomes perspective, in a well-performing market brokers can help:
>
> - match the needs of the consumer with the right home loan product and lender;
> - navigate the home loan application process, which can be daunting for many consumers; and
> - improve consumer understanding of home loans and financial literacy.
>
> From a competition perspective, brokers have the potential to:
>
> - play a valuable role in providing a distribution channel for lenders—especially smaller lenders— without their own distribution network (e.g. branches);
> - exert downward pressure on home loan pricing, by forcing lenders to compete more strongly with each other for business.

However, the report raised concerns that "remuneration and ownership structures can … inhibit the consumer and competition benefits that can be achieved by brokers."

The report also focused on two key conflicts of interest it identified in the current broker remuneration model – "Product strategy conflict" & "Lender Choice Conflict". The product strategy conflict is where a broker could recommend a loan that is larger than the consumer needs or can afford to maximise their commission payment; and the lender choice conflict, where a broker could be incentivised to recommend a loan from a particular lender because the broker will receive a higher commission, even though that loan may not be the best loan for the consumer.

In focusing on the product strategy conflict, ASIC states in paragraph 115 of its report: "To reduce the risk of this occurring, we propose that lenders change their standard commission arrangements so that brokers are not incentivised purely on the size of the loan." It also states in paragraph 116 that "lenders should not structure their incentives in a way that encourages the creation of larger loans that initially have large offset balances".

From these key findings, ASIC specifically developed six proposals, aimed at improving consumer outcomes and competition, for further consultation:

1) Improving the standard commission model;
2) Moving away from bonus commissions and bonus payments;
3) Moving away from soft dollar benefits;
4) Clearer disclosure of ownership structures;
5) A new public reporting regime; and
6) Governance and oversight.

The Sedgwick Review also made similar recommendations to that contained in the ASIC Report, however in Sedgwick's case they were framed at tackling the "significant risks of mis-selling" attached to current arrangements to remunerate Mortgage Brokers. The evidence provided by Sedgwick included:

- That banks seeking to increase market share through a sales campaign often improve both the terms and conditions they offer the borrower and the commission they pay the Mortgage Broker;
- That some banks told me during consultations that they believe they need to offer volume based incentives to Mortgage Brokers over and above the upfront and trail commissions to remain competitive;
- That, similarly, many banks said they need to offer significant 'soft dollar' payments to Mortgage Brokers;
- That data presented to the Sedgwick Review during the consultation process (and confirmed in the ASIC Report72) show that mortgages arranged through the broker channel are likely to be larger, paid off more slowly, and more likely to be interest-only loans than those provided to equivalent customers who dealt directly with bank staff; and
- A few banks reported during consultations that they had changed (or were intending to change) trail commission arrangements because some customers draw down a larger loan amount than they need, with the surplus being deposited in an offset account or a loan account (i.e. as a redraw amount).[11]

The Sedgwick Review made four key recommendations to remedy the risk of mis-selling:

Recommendation 16

In respect of remuneration of Mortgage Brokers:

a. Banks cease the practice of providing volume based incentives that are additional to upfront and trail commissions;

b. Banks cease non-transparent soft dollar payments in favour of more transparent methods to support training etc.; and

[11] Sedgwick, Retail Banking Remuneration Review, April 2017, p 34

c. Banks cease the practice of increasing the incentives payable to brokers when engaging in sales campaigns

Recommendation 17

Banks adopt, through negotiation with their commercial partners, an 'end to end' approach to the governance of Mortgage Brokers that approximates as closely as possible a holistic approach broadly equivalent to that proposed for the performance management of equivalent retail bank staff

Recommendation 18

Banks adopt approaches to the remuneration of Aggregators and Mortgage Brokers that do not directly link payments to loan size and reflects a holistic approach to performance management (see Recommendation 17):

a. To establish in a timely fashion how best to address Recommendations 17 and 18, banks with a significant recourse to the Mortgage Broker channel, but at least the four major banks, each report regularly to ASIC on their progress; and

b. With enhanced oversight by ASIC (and other regulators as necessary) to monitor market responses

Recommendation 19

The independent review proposed under Recommendation 15 or, at the latest, any post implementation review of the operations of the proposed product intervention power for ASIC, examine whether the government should legislate to extend ASIC's intervention powers to address conflicted remuneration in circumstances in which the industry cannot or does not address Recommendations 16, 17 and 18 adequately without such an intervention

The six recommendations from the ASIC Report and the four from the Sedgwick Review form the basis of this report from the CIF. The CIF believes that all recommendations are addressed through our responses, and that they provide an important first step in the self-regulatory process designed at removing conflicted remuneration and improving outcomes for customers.

Interaction between ASIC's proposals and Sedgwick's recommendations:

ASIC's review of mortgage broker remuneration Reviewed over 1.4 million home loans across 19 lenders, 14 aggregators, 44 broker businesses, referrers and aggregators to understand the customer outcomes resulting from loans originated through lenders and brokers.	**Retail Banking Remuneration Review** The Review related to bank staff and third parties who receive payments for selling bank products such as mortgages. This Independent Review was commissioned by the Australian Bankers' Association.
1. Changing the standard commission model to reduce the risk of poor customer outcomes	Recommendation 18: **Banks adopt approaches to remuneration of Aggregators and Mortgage Brokers that do not directly link payments to loan size and reflects a holistic approach to performance management**…
2. Moving away from bonus commissions	Recommendation 16: In respect of Mortgage

& bonus payments which increase the risk of poor customer outcomes	Brokers: Banks **cease the practice of providing volume based incentives** that are additional to upfront and trail commissions; Banks **cease the practice of increasing the incentives payable to brokers** when engaging in sales campaigns.
3. Moving away from soft dollar benefits which increase the risk of poor customer outcomes and can undermine competition	Recommendation 16: In respect of Mortgage Brokers: **Banks cease non-transparent soft dollar payments** in favour of more transparent methods to support training etc.
4. Clearer disclosure of ownership structures within the home loan market to improve competition	
5. Establishing a new public reporting regime of customer outcomes and competition in the home loan market	Recommendation 19: …examine whether the government should **legislate to extend ASIC's intervention powers to address conflicted remuneration**…
6. The industry needs to improve the oversight of brokers by lenders and aggregators	Recommendation 17: **Banks adopt**, … , **an 'end to end' approach to the governance of mortgage Brokers** that approximates as closely as possible a holistic approach to that proposed for the performance management of equivalent retail bank staff.
	Recommendation 20: In respect of **Introducers and Referrers**: **Banks examine their governance** of these arrangements to ensure that existing practices are appropriate; and **ASIC**, in due course, **investigate whether the upfront commission paid to Introducers and Referrers is justified**.