20 March 2018

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Competition in Australia's Financial System Inquiry
Productivity Commission
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Dear Commissioners,

MFAA Submission to the Productivity Commission Inquiry into Competition in the Australian Financial System – Draft Report

On behalf of the Mortgage & Finance Association of Australia (MFAA), we welcome the opportunity to make a written submission to the Productivity Commission in response to the Draft Report into Competition in the Australian Financial System (the Draft Report). Should the Productivity Commission require further information to supplement this submission, please do not hesitate to contact me on (02) 8905 1300 or by emailing Mike.Felton@mfaa.com.au.

About the MFAA

With over 13,500 members, the MFAA is Australia's leading professional association for the mortgage and finance industry. The stated purpose of the MFAA is to advance the interests of our members through leadership in advocacy, education and promotion. To achieve this aim, the MFAA promotes and advances the broker proposition to a range of external stakeholders including governments, regulators and consumers, and continues to demonstrate the commitment of MFAA professionals to the maintenance of the highest standards of education and development.

Outline of this Submission

This submission seeks to outline the MFAA's position in relation to a number of important issues raised in the Draft Report which relate to the mortgage broking industry. As such, we have structured this submission to address only these key points, and have referenced the Draft Report throughout our discussion.

Yours sincerely

Mike Felton
Chief Executive Officer
Mortgage & Finance Association of Australia

1. Introduction & Summary

Mortgage brokers contribute significantly to competition in the Australian lending market. The c.17,000[1] brokers in the market provide their customers with access to lenders (via their aggregator's panel), which include most Authorised Deposit-taking Institutions (ADIs) as well as finance companies servicing consumers and small business. The mortgage broking industry is supported by franchise and aggregator businesses that employ thousands more staff and bring scale and efficiency benefits to the industry.

The structure, remuneration practices, and governance of the mortgage broking industry have been reviewed twice in the past 18 months: through *Report 516 - Review of Mortgage Broker Remuneration* by the Australian Securities & Investments Commission (ASIC) (**the ASIC Report**)[2] and the *Retail Banking Remuneration Review*, conducted by Mr Stephen Sedgwick AO (**the Sedgwick Review**)[3].

As part of the ASIC Report, ASIC performed its biggest ever data collection exercise, obtaining data from lenders, aggregators, brokers and others in the market to provide a picture of outcomes for residential loans written in both mortgage broking and proprietary lender channels in the years 2012 and 2015.

The ASIC Report 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.

Generally, 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 by stating (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:
  a) match the needs of the consumer with the right home loan product and lender;

[1] MFAA's Quarterly Survey of leading mortgage brokers and aggregators (produced by Comparator which is a CoreLogic company) for July, August and September 2017.
[2] Australian Securities & Investments Commission, *Report 516 - Review of mortgage broker remuneration* (16 March 2017).
[3] Stephen Sedgwick AO, *Retail Banking Remuneration Review - Report* (19 April 2017).

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.

- From a competition perspective, brokers have the potential to:

  a) play a valuable role in providing a distribution channel for lenders - especially smaller lenders without their own distribution network (e.g. branches); and

  b) exert downward pressure on home loan pricing, by forcing lenders to compete more strongly with each other for business.[4]

This data driven review did not present evidence that current remuneration structures are lessening competition or leading to poor consumer outcomes, however the ASIC Report did identify conflicts of interest and the need for change in commission structures. Specifically, ASIC noted that "*remuneration and ownership structures can … inhibit the consumer and competition benefits that can be achieved by brokers.*"[5]

ASIC proposed, the following changes, which form the basis of the Combined Industry Forum (**CIF**) reform package:

1) Changing the standard commission model to reduce the risk of poor customer outcomes.

2) Moving away from bonus commissions & bonus payments which increase the risk of poor customer outcomes.

3) Moving away from soft dollar benefits which increase the risk of poor customer outcomes and can undermine competition.

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.

6) The industry needs to improve the oversight of brokers by lenders and aggregators.

In mid-2017 the mortgage broking industry combined in an unprecedented manner to establish the CIF, to drive better customer outcomes in response to recommendations out of the ASIC Report, and to the third-party recommendations out of the Sedgwick Review.

The CIF is made up of representatives from across the mortgage broking industry including: the Australian Banking Association (ABA), Mortgage & Finance Association of Australia (MFAA), the Finance Brokers Association of Australia Limited (FBAA), the Customer Owned Banking Association (COBA), and the Australian Finance Industry Association (AFIA) plus bank and non-bank lenders, aggregators, referrer groups, and brokers. Consumers are also represented on the CIF through Choice Consumer Group, which also represents the Consumer Action Law Centre, Financial Counselling Australia and the Financial Rights Legal Centre.

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[4] Australian Securities & Investments Commission, *Report 516 - Review of mortgage broker remuneration* (16 March 2017) p 9.
[5] Ibid.

To drive better customer outcomes and manage conflicts of interests raised by the ASIC Report, the CIF released a package of reforms in December 2017. Implementation began immediately, with all proposals to be implemented by 2020.

We believe there is some overlap between ASIC's proposals and the draft Productivity Commission recommendations, and that by addressing ASIC's proposals through the CIF, the industry is also responding to some of the issues identified by the Productivity Commission, particularly in relation to remuneration and disclosure.

The MFAA's response to the draft findings, draft recommendations and information requests of the Productivity Commission in relation to mortgage brokers are summarised below:

- The broker value proposition goes far beyond the provision of lower interest rates as asserted in the draft report. It is also <u>unsurprising</u> that home loans originated by mortgage brokers have only slightly lower interest rates than those originated through direct channels because the majority of lenders follow a policy of pricing parity across all distribution channels.
    - Brokers drive competition to the benefit of all consumers:
        - including those in rural and regional areas where they have filled a significant gap produced by lender branch closures; and
        - by enabling new entrants without large branch networks to operate in the market by providing them with a nation-wide distribution network.
    - Brokers are appropriately licensed and trained to provide a unique combination of choice, convenience, personalised service and credit advice to customers;
    - Bank branch staff are only trained to sell their bank's products;
    - As such, customers often turn to the broker channel for solutions when their primary lender is unable to assist with their given circumstances.
- While the imposition of a clear legal duty on aggregators owned by lenders to act in the consumer's best interests may appear superficially appealing, it fails to take into account that:
    - Brokers already have a strong business incentive to act in the interests of customers, given that a broker's business is based on the relationship model and is contingent on customer referrals, established by a history of good customer outcomes;
    - A requirement to act in the best interests of customers could translate into a legal requirement – that brokers provide the '*best*' or '*most appropriate'* product or advice or to ensure the '*best* outcome' – which is practically impossible for a broker to achieve, and as such would become meaningless;
    - The *National Consumer Credit Protection Act 2009* (Cth) (**the NCCP Act**) already imposes extensive general conduct obligations on brokers, including that they act fairly and honestly, and ensuring that customers are not disadvantaged by any conflict of interest;
    - The CIF has already proposed to apply a definition of a 'Good Customer Outcome' through an industry code, which goes beyond current responsible lending requirements, as follows:

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.

- While cost saving is an important incentive for the lender in using brokers for product distribution, the main reason they are so highly utilised is the specialised service offering brokers provide – above and beyond that provided by lender proprietary channels.
    - There are significant differences between proprietary (branch) and broker channels in terms of the services provided, and therefore a 'like for like' comparison is less useful than one might expect in this context.
    - Brokers provide an efficient variable cost structure to many lenders which lack a branch network, allowing lenders the flexibility to scale up or down in terms of geographic as well as segment coverage, without volatility in infrastructure costs associated with maintaining a branch network.
    - The removal of the broker channel or the imposition of regulation which impacts its desirability to customers would greatly impact small, non-bank lenders, that do not possess an extensive branch network. The cost impact would also be felt by larger lenders, which would have to greatly expand their branch network and staff to service customer demand.
- The suggestion that mortgage brokers could be paid directly by the consumer via a fee-for-service model, in contrast with the commission model currently used that involves payment from lenders, does not fit with current regulatory thinking and remains highly inappropriate for the broker industry. The key problems with such a fee-for-service model are that it:
    - Offers no correlation to the economic value which brokers produce in the loans they originate;
    - Would have a negative impact on competition and consumer outcomes, because:
        - Customers who typically cannot afford to pay an upfront fee, such as first home buyers, could be prevented from securing credit;
        - Customers accessing the broker channel would be charged a fee which would not be charged to those using branch or online direct channels, reducing the value of the broker proposition and forcing brokers to compete on unequal terms.
    - Would not lead to overall savings to customers as bank price parity policies between their channels, and the demands of shareholders, mean it is unlikely to result in any reduction in interest rates to compensate for the increased cost to consumers under a fee-for-service model.
- The current standard commission structure is a reasonable remuneration model that supports a strong and competitive broking industry, and as demonstrated in the ASIC Report and the Sedgwick Review, has not been identified as driving systemic poor customer outcomes.
    - The MFAA and CIF have 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 alternative, impractical models include a consumer-paid fee-for-service model; the standardisation of upfront commission percentage; base commissions paid on the loan to value ratio; a flat lender fee; and the removal of lenders' and brokers' ability to discount interest rates and application fees;
- The MFAA is firmly of the view that payment of trail commissions does not restrict or discourage customer switching or refinancing, as the payments earned via refinancing will generally exceed existing trail, regardless of whether or not it is increasing over time.
  - Trail commissions were originally used to prevent 'churn', however, the focus of trail has shifted in recent years to support brokers in servicing the customer over the life of a loan;
  - The ASIC Remuneration Review did not identify trail commissions as directly leading to poor consumer outcomes;
  - Looking internationally, jurisdictions which do not use trail commissions alternatively have higher upfront commissions;
  - Trail commissions ensure alignment of interests between a lender, aggregator, broker and customer over the life of a loan;
- The MFAA agrees that commission clawback acts as a disincentive to refinance within the clawback period of up to 18 to 24 months, depending on lender arrangements. However, the likelihood of a product being appropriate and competitive for a customer at the outset, and no longer proving competitive within 18 to 24 months, is reasonably slim.

The MFAA's detailed responses to the draft findings, draft recommendations and information requests of the Productivity Commission in relation to the mortgage and finance industry are outlined below.

2. Mortgage Broker Interest Rate Pricing (Draft Finding 8.1)

At Draft Finding 8.1, the Draft Report has stated that "home loans originated by mortgage brokers have only slightly lower interest rates than those originated through direct channels".[6]

The MFAA is unsurprised by this finding, given that lenders generally hold price parity policies between their proprietary and third party channels to prevent channel conflict, which is a matter often raised by brokers. Price parity is also consistent with ASIC's findings, after controlling for demographic differences between channels.

In the majority of cases, rates between channels are broadly aligned, as banks have focused on providing the most competitive price for a consumer, remaining indifferent to channels.

The CIF, of which the MFAA is a member, has committed to additional reporting requirements to ASIC, including lenders providing the weighted average of home loans in the previous financial year across their distribution channels, using standard scenarios. This is consistent with a proposal made in ASIC's

[6] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 216.

Review of mortgage broker remuneration[7] and will ensure greater transparency and more informed decisions.

In looking at relative interest rate pricing achieved between channels, it is also worth noting that the broker channel is often required to deal with a greater degree of complexity of circumstances and credit within each demographic. Effectively managing such complexity is key to the strong value proposition of brokers. Customers often turn to the broker channel for solutions when their primary lender is unable to assist with their given circumstances. In this context, the marginally better pricing being achieved within the broker channel relative to the proprietary channel is a positive outcome.

Although price is a key aspect of the loan, the broker value proposition equates to significantly more than just ensuring that the customer receives a competitive interest rate for their given circumstances. Brokers provide a unique combination of choice, convenience, personalised service and advice with the cost of that customer's introduction paid by the lender.

In an era of increasing product and credit policy complexity, brokers are able to educate and guide customers through the process, reducing the time, stress and administrative burden associated with securing a loan, and assisting the customer to select an appropriate product suited to their financial circumstances and needs. Brokers provide customers with wider choice and access to an increased range of products than they would otherwise likely reach without assistance, thus seeking to ensure customers receive a competitive interest rate for their given circumstances.

Mortgage brokers also provide greater customer relationship continuity and enhanced industry experience, which lenders, in comparison, struggle with on an ongoing basis. A recent survey of close to 1,000 mortgage brokers and broking businesses will reveal that, of those surveyed, brokers on average have between 11 (individual brokers) and 15 years' (broking businesses) industry experience respectively.[8]

Brokers drive competition to the benefit of all consumers, including those in rural and regional areas where they have filled a significant gap produced by lender branch closures. Recent research indicates that 29% of mortgage broker customers are located in regional and rural Australia.[9]

As a result of the strong value proposition offered by brokers, an increasing number of consumers are making use of broker services, with 55.7% of all residential mortgage business being conducted via a broker in the quarter ending September 2017. This figure can be compared with only 46.4% of business conducted via a broker in the same period in 2013.

In addition to the above benefits, we note that mortgage brokers have moderated the dominance of major lenders in the Australian market (namely the influence of ANZ, CBA, NAB and Westpac), with the major banks collectively holding a lower share of the broker channel market than of the overall market.

As seen in Figure 1 below, the major lenders held a share of 58.5% of the broker market in the September 2013 quarter, which declined to 53% by March 2017 versus an overall market share of

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[7] Australian Securities & Investments Commission, 'Proposal 5: A new public reporting regime', *Report 516 - Review of mortgage broker remuneration* (16 March 2017), p 25.

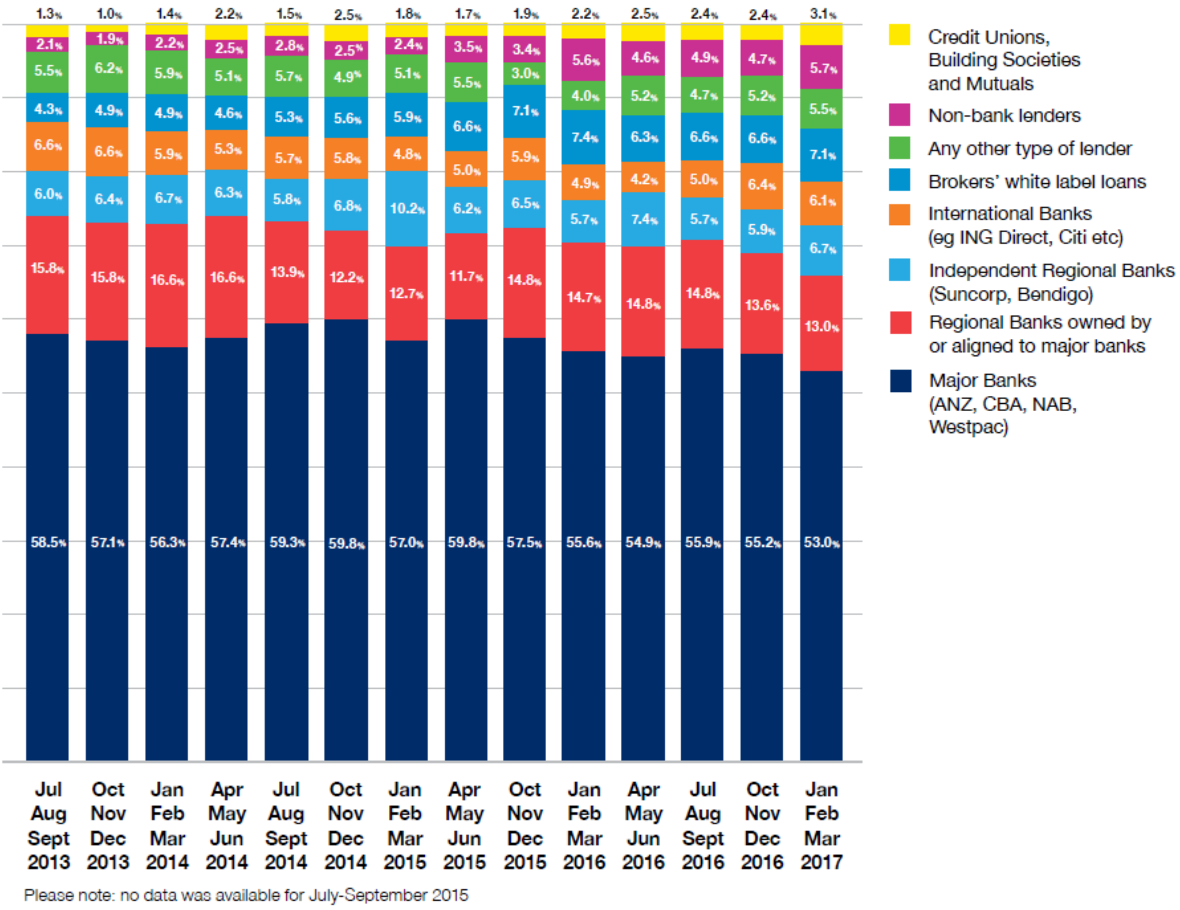
[8] Industry analysis to be released imminently. A copy will be provided to the Productivity Commission upon release.

[9] Industry analysis to be released imminently. A copy will be provided to the Productivity Commission upon release.

73.33%[10]. It is worth noting that during this period, MFAA broker membership expanded from approximately 9,300 to 13,300 members.

When examining the share held by the major lenders combined with regionals aligned to major lenders, the decline in share of business placed by brokers is more pronounced, shifting from 74.3% in September 2013 to 66% in March 2017. It is clear that, without brokers, there would have been less competition, major lenders would have had a greater dominance of the market, and it is likely that net interest margins would be substantially higher.

Figure 1 – Value of new lending originated for each lender segment [11]



3. Mortgage Broker Duty of Care Obligations (Draft Recommendation 8.1; Information Request 8.1)

The Draft Report recommends that that ASIC impose a clear legal duty on mortgage aggregators owned by lenders to act in the consumer's best interests, and calls for information on how obligations for lender-owned aggregators should be implemented.[12]

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[10] APRA Quarterly ADI Property Exposures; ABS 5609.0 Housing Finance Australia total finance for the quarter ending 31 March 2017.

[11] Sourced from Mortgage & Finance Association of Australia, *Industry Intelligence Service - Exclusive Finance Broker Benchmarking Report*, 4th ed, p 18.

[12] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 228.

The MFAA supports ongoing work with ASIC and key industry stakeholders, including consumer groups, to continually improve the standards to which mortgage brokers are held. However, the MFAA has serious concerns with any statutory duty of care imposed on mortgage brokers requiring them to *act in the best interests of customers*, regardless of whether they operate through lender-owned aggregators or aggregators which are not vertically integrated.

The MFAA's reasoning for this position is based on a number of factors. Firstly, brokers already have a strong business incentive to act in the interests of customers, given that a broker's business is based on the relationship model and is contingent on customer referrals, established by a history of good customer outcomes. The imposition of a statutory best interest duty of care would go beyond the duty of care which is reasonable or achievable in the circumstances.

Secondly, under the NCCP Act, brokers and lenders are currently required to provide a loan which is "not unsuitable" to a customer's circumstances. The MFAA is concerned that the proposed legal requirement to act in the best interests of customers has potential to translate into a legal requirement that brokers provide the '*best*' or '*most appropriate'* product or advice or to ensure the '*best* outcome'. Such terms, or those such as '*best available'* product or '*best possible'* loan, outcome or advice, are not only highly subjective descriptions in mortgage broking, but will require an extensive comparison of products which is unrealistic given that there can be up to 1,500 products available across 40 lenders on an aggregator panel, which does not necessarily include all lenders and products in the market.

The MFAA believes that the present "not unsuitable" statutory benchmark provided in the NCCP Act is more than adequate to ensure that brokers act in their customer's interest. This is bolstered by the extensive general conduct obligations in the NCCP Act imposed on licensees, including that they act fairly and honestly, and ensuring that customers are not disadvantaged by any conflict of interest.[13]

Nevertheless, the MFAA supports the continual improvement of standards relating to its industry. In response to the Draft Report's request for information on how obligations for lender-owned aggregators should be implemented, we refer the Productivity Commission to the proposals made by the CIF in late 2017.

The CIF has proposed to apply a definition of a 'Good Customer Outcome' through an industry code, which goes beyond current responsible lending requirements, as follows:

> *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.*

This definition goes to the heart of the CIF reform package, and sets the benchmark which the industry will use to assess behaviour in the future. It holds the industry to a new standard beyond current responsible lending requirements, taking into account whether a loan is appropriate and whether it meets a customer's requirements and objectives. The industry code to be developed through the CIF will apply to mortgage brokers, lenders, aggregators and, where appropriate, referral businesses, and would be subject to all applicable regulatory and competition law approvals. By introducing these new obligations via an industry code, we believe the CIF will successfully address the concerns associated with the current duty of care obligation in a manner which is effective, and which can be implemented more expeditiously than through legislative means.

[13] *National Consumer Credit Protection Act 2009* (Cth) s 47.

4. Home Loan Cost – Broker versus Branch (Draft Finding 8.2)

At Draft Finding 8.2, the Draft Report has stated that "Mortgage brokers enable smaller lenders to gain wider reach, increasing product variety in the home loan market" but also said, "That the providers of half of Australia's home loans were unable to give evidence on how they assess the costs and benefits of using brokers rather than branches to source home loans is surprising".[14]

Brokers provide an efficient variable cost structure to many lenders which lack a branch network, allowing lenders the flexibility to scale up or down in terms of geographic as well as segment coverage, without the volatility in infrastructure costs associated with maintaining a branch network.

There are significant differences between proprietary (branch) and broker channels in terms of the services provided, and therefore a comparison is less useful than one might expect in this context. Indeed, the law recognises this difference in service offering, requiring brokers to be licensed under the relevant provisions of the National Consumer Credit Protection Act 2009 (National Credit Act) and National Consumer Protection Regulations 2010. A lender's branch staff, however, do not hold such licences in their own right.

In addition, brokers are often more experienced; offer different modes of delivery of services (for example, brokers have greater flexibility and can assist customers outside normal working hours); and offer a different service proposition to that provided by bank branch staff. Importantly, brokers provide significant benefit to consumers who are unable to easily access a bank branch, for example, due to their rural or remote location where bank branches have been scaled back or indeed due to their own personal mobility issues. Ensuring rural and remotely-based or mobility restricted consumers have access to credit and product advice is an important benefit provided by mortgage brokers.

The differences in service offering are possibly best highlighted by the divergent Net Promoter Scores (NPS)[15] achieved by the major lenders and those achieved by brokers. Whilst the average NPS of the major lenders tends to range between 0 and -10, data provided by Aggregators Aussie and Advantedge indicate that customers' NPS rating of their broker is +70 or higher.

Comparison between the broker and proprietary channel is also problematic due to the complexities in ascertaining the cost of origination in either the branch or broker networks. Each bank will define and attribute the cost of origination in the relevant channel in a different way. However, we note that banks focus on the value delivered by each channel, rather than between channels. Regardless of the economies of each channel, consumers are choosing, at increasing rates, to use mortgage brokers. In order for lenders to remain competitive, they will elect to distribute loans through mortgage brokers.

While data is not freely available as to the relative costs of the channels, and particularly the cost of the branch channel, the significant reliance of new entrants on the broker channel would suggest it is an efficient, flexible channel that can be scaled as required.

Equally, the removal of the broker channel or the imposition of regulation which impacts its desirability to customers would greatly impact small, non-bank lenders, who do not possess an extensive branch network. The cost impact would also be felt by larger lenders, which would have to greatly expand their branch network and staff to service customer demand.

[14] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 220.
[15] The NPS is an internationally applied measure of customer experience that is used to predict business growth.

5. Mortgage Broker Disclosure Requirements (Draft Recommendation 8.2)

At Draft Recommendation 8.2, the Draft Report has advised that ASIC should require brokers to discuss with consumers, and provide plain-English documentation on, the types of products offered by different lenders; the role and limitations of brokers; broker remuneration arrangements; and ownership relationships between lenders and aggregators, alongside the requirement that brokers are to act in the consumer's interest.[16]

The MFAA supports greater disclosure requirements and enhanced transparency to allow consumers to make more informed decisions. Under the NCCP Act, brokers are currently required to make disclosures to consumers regarding commissions. The CIF has sought to build on this mandate by recommending a number of changes to the disclosure requirements and public reporting model, which will address the bulk of points made at Draft Recommendation 8.2. All such disclosures proposed by the CIF will be consumer tested to ensure they are necessary and effective in achieving the aim of more informed consumer decisions.

Such proposed additional disclosures include brokerage or aggregator ownership arrangements of 20% or greater and potential influence through a Board seat or a 'white label product'. The CIF has also proposed disclosure of issues affecting lender coverage and breadth of choice, such as the number of lenders a broker can access via their aggregator; the number of lenders a broker has used in the previous financial year; and the percentage of business conducted with the top six lenders used over the previous financial year.

Disclosures have also been proposed regarding aggregators, including disclosure of the number of lenders on an aggregator's panel; the percentage of business conducted with each lender in the previous financial year; the spread of lenders used by brokers in the head group over the previous 12 months (i.e. using three or fewer lenders, four to seven lenders, or eight or more lenders); and the weighted average aggregator commission rate in the previous financial year for mortgages (prior to making a broker payment). The CIF has further proposed disclosure of participation in lender tiered servicing arrangements, and disclosure of records of entertainment and hospitality in excess of $100.00, made available to the customer via a register.

6. Consumer Fee-for-service Model (Information Request 8.2)

The Draft Report has sought views on whether mortgage brokers should be paid directly by the consumer via a fee-for-service model, over the commission model currently used that involves payment from lenders.[17]

The question of whether brokers should operate under a fee-for-service model has previously been explored by ASIC, and such a change was not recommended in ASIC's Remuneration Review or in the Sedgwick Report.[18]

The MFAA believes that a fee-for-service model is not appropriate for the broking industry due to the fact that it offers no correlation to the economic value which brokers produce in the loans they originate. Brokers are not employees of lenders; rather, they are suppliers of economic value that

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[16] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 231.
[17] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 229.
[18] Australian Securities & Investments Commission, *Report 516 - Review of mortgage broker remuneration* (16 March 2017); Stephen Sedgwick AO, *Retail Banking Remuneration Review - Report* (19 April 2017).

should be rewarded relative to the benefit produced. Potential rationalisation of broker numbers would serve to increase barriers to entry for new lenders in the market, and disadvantage existing small lenders which lack a branch footprint and therefore rely on brokers to enable and promote customer access.

The MFAA is also of the view that a consumer fee-for-service would have a negative impact on competition and consumer outcomes for a number of reasons including that it would create additional direct costs for the consumer. This is particularly relevant for customers who typically cannot afford to pay an upfront fee such as first home buyers, and who – if pushed towards the proprietary channel – could be prevented from securing credit. This would only serve to strengthen the position of the major banks rather than drive competition. A recent survey of mortgage brokers indicates that 23% of broker customers are first-home buyers, compared with 18%[19] of all Australian housing finance in November 2017.

Under this model, customers would be charged to access the broker channel but not charged to use a branch or online direct channels, reducing the value of the broker proposition and forcing brokers to compete on unequal terms. We expect this would result in a significant contraction in the number of brokers in the industry, and therefore negatively impact competition and the access to credit assistance which brokers currently provide.

Because banks have a price parity policy between their channels, and given the demands of shareholders, there is unlikely to be any reduction in interest rates to compensate for the increased cost to consumers under a fee-for-service model. It is expected that lenders would use such an opportunity to gain greater control of the market by strengthening proprietary channels at the expense of competition.

Therefore, a fee-for-service model would serve to promote the interests of major banks; reduce the number of brokers in the industry; and reduce the number of customers able to access appropriate loans. A diminished broker proposition would result in less competitive tension and poorer overall customer outcomes, while not materially affecting a broker's recommendation of a particular loan product.

In terms of commissions, the MFAA notes that the CIF has recommended adjustments to incentives to ensure a customer is not borrowing more than they will need or use, and to avoid large initial offset balances as per guidance provided by ASIC. To achieve this, the CIF has recommended that commissions are paid on funds drawn down and on the utilised net-of-offset funds. These changes are currently being implemented with the objective of completing the implementation by 31 December 2018.

Finally, in accessing broker remuneration it is worth noting that a broker on average earns an annual income of $87,800 after costs and before tax, which we do not consider to be an excessive figure.[20]

[19] ABS Cat no. 5609.0 Housing Finance, Australia, November 2017, Table 9a and Table 1.
[20] Industry analysis to be released imminently. A copy will be provided to the Productivity Commission upon release.

7. Collection of Home Loan Interest Rate Data from Lenders (Draft Recommendation 8.3)

At Draft Recommendation 8.3, the Draft Report has advised that the Australian Prudential Regulation Authority (APRA) should, on behalf of ASIC, collect monthly data from mortgage lenders (ADIs and non-ADIs) on median interest rates across different categories of new residential home loans.[21]

The MFAA agrees that improvements must be made in the transparency of interest rates achieved in the home loan market. Via the CIF, we have proposed that lenders disclose the weighted average pricing achieved for various standard scenarios (to be defined) across their different distributional channels in the previous financial year. We believe that the median price can be considered in each standard scenario rather than a weighted average, as this would avoid the impact of outliers affecting accuracy in pricing. However, we note that data disclosure must not become over-complicated, jeopardising its efficacy for consumers.

8. Home Loan Interest Rate Transparency (Draft Recommendation 8.4)

At Draft Recommendation 8.4, the Draft Report has advised that the data collected via APRA could be used by ASIC to develop an online tool which allows consumers to select combinations of loan and borrower characteristics; reports the previous month's median loan interest rates by lender with those characteristics; and details specific fees and charges that affect the total loan cost. The Draft Report also recommends that APRA publish the underlying data so that it is accessible to third parties, so that comparator websites can potentially be developed.[22]

The MFAA supports greater transparency of home loan data, and as mentioned under 7 above, supports the CIF proposal requiring lenders to disclose pricing to ASIC, covering various standard scenarios across their different distributional channels in the previous financial year. However, we echo the point above that data disclosure must not become over-complicated, jeopardising its efficacy for consumers. Ultimately, the value of an online tool will rest on the strength of the data entered and the regularity with which it is updated. If this data proves inadequate (for example, it will only cover one previous month), the draft recommendation may not prove beneficial to the consumer.

9. Lenders Mortgage Insurance (LMI) (Draft Recommendation 8.5, Draft Finding 8.3 and Information Request 8.3)

The Draft Report has recommended that the Federal Government "require all lenders to offer home loan customers refunds for the cost of lenders mortgage insurance when customers choose to refinance or pay out their loan" and that the "refund schedule for the remaining life of the loan should be set and made available to the borrower at the time the policy is started."[23] Based on a finding that customers with a loan-to-value ratio (LVR) above 80% are "often required to compensate lenders twice for this risk: by bearing the cost of lenders mortgage insurance, and also by paying a higher

[21] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 237.
[22] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 238.
[23] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 246.

interest rate on their home loan",[24] information has been sought on whether changes are needed to LMI arrangements.[25]

LMI plays an extremely important role in the Australian housing market. It improves access to home ownership; enhances the underlying efficiency in the home lending market; contributes to financial stability and risk diversification; has a smoothing effect on economic cycles; reduces barriers to entry in the home lending market; and increases competition among lenders in the high LVR segment.

In response to Draft Recommendation 8.5, the MFAA suggests that in the interests of transparency and fairness, if LMI providers have taken account of the pricing impact of refunds, and if it is standard practice for the insurer to offer refunds to lenders for loans which have been refinanced or discharged, then we believe that such refunds should be passed on to the customer.

We would also support the LMI refund policy for a particular home loan being clearly disclosed to the borrower by the lender at the point of settlement of the home loan. This may include a disclosure that there are no LMI refunds applicable to the loan, along with full disclosure of any conditions related to any refund (such as the requirement for the loan to never be in arrears). It could be provided along with or part of the LMI fact sheet, which we also support being mandated in some way.

With regard to potentially making a schedule available at the outset to outline the potential refund, it is worth noting that most of the risk associated with LMI occurs in the early years of a loan. With a front-loaded premium, the refund would likely reduce very quickly over the early years of the loan, reducing the practical usefulness of a schedule covering the full term.

It should be noted that any increase in the size of the refund and/or length of time for which LMI refunds are available to borrowers will likely result in an associated increase in premiums for all. Furthermore, it could have the unintended consequence of increasing refinances in the market.

We suggest that, while LMI is arguably too complex to become portable between loans, refunds offered to customers may be appropriate if the industry has priced to reflect such a practice.

The MFAA does not have any evidence to suggest that customers who have loans with LMI are also incurring interest rates that are materially different from those without LMI. However, we note that the Draft Report cites very minor differences in annual interest rates, based on data obtained from ASIC.

We would also add that a move towards risk-based pricing over community-based pricing would be fairer for some, yet reduce home affordability for many others.

10. A Proposed Increased Scope of Financial Advice to Include Some Credit Products (Information Request 12.1)

The Draft Report has sought views on whether ASIC-licensed financial advisers should be able to provide advice on select credit products, such as home loans, personal loans and credit cards.[26]

The MFAA supports initiatives to encourage competition, and the development of services offering both financial and credit services. This said, we note the significant difference between these disciplines. Under the current arrangement, a business providing financial and credit services must

[24] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 246.
[25] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 247.
[26] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 361.

hold both a licence/authorisation under the Australian Financial Service Licence (AFSL) regime and the Australian Credit Licence (ACL) regime. The MFAA believes this is an appropriate arrangement, and contends there is no basis on which to assert that either licence/authorisation is superior or more complex than the other, or that AFSL holders should be entitled to provide credit services without obtaining an ACL.

11. Appropriate Regulator to Advance Competition in the Financial System (Information Request 12.1)

The MFAA is of the belief that the Australian Securities and Investments Commission (ASIC) is the most appropriate regulator to advance competition in the financial system. ASIC is currently working with Government on the details of its new competition mandate, and as such, we believe that reporting on a whole-of-system view on competition should be considered as part of this process.

12. Mortgage Broker Commission Structures (Draft Finding 13.1 and Information Request 13.2)

The Draft Report has stated that trail commissions create “perverse incentives” for brokers by “rewarding them for keeping customers in their existing loan”, thereby skewing broker loyalty towards lenders and discouraging refinancing. Draft Finding 13.1 also states that commission clawbacks act as “a direct disincentive to consumer switching of home loans”.[27] The Draft Report has also sought information on the rationale behind the structure of mortgage broker commissions, including in connection with trail commissions and commission clawback.[28]

The current standard commission model includes upfront commission paid on settlement of the loan, in recognition of economic value created by the broker for the lender, and trail commission paid over the life of a loan, which supports the broker in providing ongoing service to their customer base over time.[29] This model ensures that brokers are rewarded for the economic value they produce and for the ongoing service they provide over the life of a loan.

The standard commission structure is a reasonable remuneration model that supports a strong and competitive broking industry, and, as demonstrated in ASIC’s Review of Mortgage Broker Remuneration and the Sedgwick Review, has not been identified as driving systemic poor customer outcomes.

In conjunction with the CIF, the MFAA has made a rigorous assessment of the potential customer outcomes of a number of remuneration models and their variants, which were deemed to have potential unintended consequences for customers. These alternative, impractical models include a consumer-paid fee-for-service model;[30] the standardisation of upfront commission percentage; base

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[27] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 386.
[28] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 386.
[29] Combined Industry Forum, *Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of mortgage broker remuneration* (2017) p 11.
[30] This submission has outlined the MFAA’s views on a fee-for-service model above, in response to Information Request 8.2.

commissions paid on the loan to value ratio; a flat lender fee; and the removal of lenders' and brokers' ability to discount interest rates and application fees.[31]

12.1 Trail Commissions

The MFAA is firmly of the view that payment of trail commissions does not restrict or discourage customer switching or refinancing. The economic reality is that when a broker refinances a loan, their existing trail flow is replaced with a new trail flow, and the broker also has the possibility of earning an additional new upfront commission if they are refinancing with a different lender. These payments earned via refinancing will generally exceed existing trail, regardless of whether or not it is increasing over time.

Trail is paid on the amortising value of a loan, and therefore declines over time, however certain lenders have scaled their trail to compensate and remain competitive. Accordingly, we do not see any impact that trail would have on refinancing.

Trail commissions were originally used to prevent 'churn', however, for reasons described above, the focus of trail has shifted in recent years to support brokers in servicing the customer over the life of a loan.

The ASIC Remuneration Review did not identify trail commissions as directly leading to poor consumer outcomes. The Review concluded that the payments of ongoing trail commissions typically provides an incentive for aggregators and brokers to put forward higher quality loans under which consumers are less likely to default on their obligations. However, the option to waive trail commissions in favour of an upfront payment removes this incentive, and is likely to increase the risk that aggregators and brokers will be less selective in which loans they put through to the lender.[32]

Looking internationally, jurisdictions which do not use trail commissions alternatively have higher upfront commissions. For example, brokers in Canada earn an upfront commission between 0.90% and 1.40%, with the most common commission being 1.10%.[33] There is a marked absence of commission clawback in the Canadian market, and there is no trail on the vast majority of loans. Overall, domestic broker earnings are comparable with the Canadian market despite being structured differently.

Trail commissions ensure alignment of interests between a lender, aggregator, broker and customer over the life of a loan. For example, if a loan goes into arrears (60+ days); is refinanced for any reason (including if it becomes uncompetitive or inappropriate for the customer's needs); or if fraud is uncovered, the trail commission income flow will cease.

Importantly, trail defers payments of broker income to coincide with the provision of services over time. Considering the broker business model is built on positive customer relationships, with over 70%[34] of business generated directly or indirectly via existing customers, brokers have a strong incentive to maintain contact with their customers over the life of the loan to ensure they have a

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[31] For a more in-depth discussion of the unintended consequences of each alternative model, see Combined Industry Forum, *Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of mortgage broker remuneration* (2017) pp 12-13.
[32] Australian Securities & Investments Commission, *Report 516 - Review of mortgage broker remuneration* (16 March 2017) paras 439 and 432.
[33] Based on information from Mortgage Professionals Canada (March 2018).
[34] Industry analysis to be released imminently. A copy will be provided to the Productivity Commission upon release.

competitive solution that is appropriate to their changing needs. Trail assists in funding such services over time.

12.2 Commission Clawback

The MFAA agrees that commission clawback acts as a disincentive to refinance within the clawback period of 18 to 24 months, depending on lender arrangements. However, the likelihood of a product being appropriate and competitive for a customer at the outset, and no longer proving competitive within 18 to 24 months, is reasonably slim.

The MFAA supports further improvement regarding how the clawback percentage steps down in the first 18 to 24 months of a loan, to result in a fairer and better sharing of economic value between the lender and broker during this early period. However, we do not believe this will have a significant impact on refinancing.

12.3 Commission Rates

The Draft Report makes the following statement:

> Particular concerns are that: commission payments made by lenders to aggregators and brokers are high (compared with other financial services and brokers overseas); and there is a lack of awareness by borrowers about how much their broker is being paid and how the payments are structured to keep borrowers in a loan, even if it is no longer a competitive product. Mortgage brokers receive, on average, an upfront payment from lenders of around 0.6% of the loan value and a trailing commission of just under 0.2% of the loan outstanding per year over the life of the loan. For an average loan value and duration, this amounts to a total fee of around $6000 per loan (compared with $200 to $700 for basic financial advice).[35]

The MFAA respectfully disagrees with the above figures and will outline its reasoning below.

The MFAA has calculated average mortgage broker earnings to total $3,984 over a four-year loan, comprised of $1,992 in upfront commission and $1,992 in trail commission over the period of a four-year average loan term. This figure is reduced to **$3,796** in present value (PV) terms.[36]

The MFAA has used the following factors to calculate average earnings:

- An average loan size of $368,900, being the ABS average owner occupier loan size for the last 24 months (this potentially overstates the average loan size and earnings given that broker business involves a significant proportion of investor lending which tends to have lower loan sizes and which has not been taken into account in calculating the above average loan size);[37]
- An average broker payment of 0.54% upfront, and 0.14% in trail commission;[38] (the figures of .60% and .20% used in the Draft Report do not appear to be the component received by the broker and would appear to include the component retained by the aggregator);
- A four-year average loan term;
- Trail has been calculated on the amortising balance of the loan and not the original loan value);

[35] Productivity Commission, *Competition in the Australian Financial System – Draft Report* (January 2018) p 30.
[36] Total income in PV terms, expressed as a percentage of the original loan amount of $368,900, is 1.03%.
[37] Australian Bureau of Statistics (ABS), data for period 01/01/2016 – 31/12/2017. See: http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5609.0December%202017?OpenDocument.
[38] Australian Securities & Investments Commission, *Report 516 - Review of mortgage broker remuneration* (16 March 2017) para 377.

- A discount of 5% has been used in the trail present value calculation; and
- A 30 year contractual loan term.

We note that, based on a recent survey of close to 1,000 mortgage brokers and broking businesses, it was found that brokers earn an annual income of $87,800 on average, after costs and before tax[39] which we do not believe to be an excessive income.

It is also worth noting that brokers are not employees of banks, but are suppliers of value to lenders and should be paid based on the economic value they produce. Broker commission percentages are lower than observed prior to the Global Financial Crisis, and have not increased in recent years. Broker commissions by value have increased with the rise in house prices in recent years, reflecting the rising economic value of the loans they have originated on behalf of lenders.

We therefore do not believe that broker commissions are high in relation to the economic value they produce, or in comparison to other jurisdictions. Brokers are also not earning excessive incomes, as demonstrated by the average broker earnings figures quoted above.

Mortgage brokers provide a wide distribution network across Australia, often in areas absent of bank branches. This greater distribution enhances customer support and promotes access to financial advice and services, driving competition. Brokers have become strong drivers of competition in the mortgage lending market by providing small lenders and international banks with a 'shop front' to compete against larger bank branch networks. This therefore provides scale and viable channels for different sized lenders in the market. If brokers did not continue to provide these services, we do not anticipate that lenders would be able to sufficiently replace the broker network, but would nonetheless incur considerable costs in widening their branch footprint.

13. Conclusion

Mortgage brokers are drivers of competition in the Australian home lending market. They drive economic value for lenders; promote strong sustainable outcomes for consumers; and enable genuine access to sought-after credit services for many Australians in regional or remote Australia. The growth in the utilisation of brokers by non-traditional lenders versus the big four shows that brokers provide lender with the necessary access to the national market. Continued strong growth in the utilisation of mortgage brokers by customers shows that brokers are delivering the right customer outcomes.

Competition in the home lending market cannot be simply defined in terms of relative interest rate outcomes. To do so misses the true value proposition of brokers to customers. This value proposition has led to strong growth in an interest rate environment governed by major lenders' pricing parity policies.

When we compare the costs associated with operating a proprietary network against commissions earned by mortgage brokers, it becomes clear that the broking channel reduces distribution costs borne by banks. Brokers provide an efficient, variable cost structure to many lenders which lack a branch network, allowing lenders the flexibility to scale up or down in terms of geographic as well as segment coverage, without volatility in infrastructure costs associated with maintaining a branch network.

[39] Industry analysis to be released imminently. A copy will be provided to the Productivity Commission upon release.

The MFAA and members of the CIF have acknowledged conflicts of interest in the remuneration structures for brokers, and in December 2017 announced a package of self-regulatory reforms to address these conflicts. These reforms will be enforced through a self-regulatory code which is currently in development. Implementation began immediately, with all proposals to be implemented by 2020.