GPO Box 144
Sydney NSW 2001
1300 554 817
enquiries@mfaa.com.au

10 February 2017

Mr. Stephen Sedgwick AO
Retail Remuneration Review

Email: submissions@retailbankingremunerationreview.com.au

Dear Mr Sedgwick

MFAA Response to the Retail Remuneration Review Issues Paper, 17 January 2017

On behalf of the Mortgage & Finance Association of Australia (MFAA), we welcome the opportunity to respond to your Retail Remuneration Review Issues Paper released on 17 January 2017, and we commend the Australian Bankers' Association for commissioning this important work.

The MFAA also welcomes the contribution the Retail Remuneration Review (the Review) is making in defining current remuneration practices, and the potential link between these remuneration practices and the behaviour of both bank staff and third parties. The MFAA sees this work as an important input to the Federal Government's current review of Mortgage Broker remuneration, and indeed, as complimentary to the work being undertaken by ASIC in that review.

This submission seeks not only to address the relevant questions raised in the Issues paper, but to also provide the Review with an outline of the relevant organisational and commission structures throughout the residential mortgage market value chain. The focus of our response is on the remuneration of third party channels (Chapter 4), and the specific questions raised in the third party section of chapter 6.

The MFAA strongly supports the retention of the current remuneration structures and believes that there is no evidence of systemic mis-selling in the third party channel. The most important and relevant remuneration structures to the retail Mortgage Broker remain the 'upfront' and 'trail' commissions. These commissions are typically paid by the lender to a broker's aggregator, who deducts servicing costs, and then passes them on to the Mortgage Broker. Importantly, these commissions are also subject to control mechanisms such as 'clawback', whereby proportions of the commission need to be paid back should a customer refinance their loan within a particular timeframe. Retail Mortgage Brokers do not receive any volume-based incentive payments, nor on the whole are their commissions paid directly from lenders.

That said, the MFAA is always prepared to consider ways in which compliance can be improved, and customer outcomes enhanced. The focus of such a review should be on the actual customer interaction practices of brokers, rather than on the remuneration structures. Measures to enhance customer follow-up after a loan is written are worth considering and could become standardised across MFAA members.

At the aggregator level, some lenders make payments of sponsorship or contributions to development programs based on the volume of loans written (volume bonuses or volume-based incentives). These payments are not passed directly through to brokers and therefore do not constitute an incentive for brokers to direct more business through to the lender. Instead, they are made in recognition of the investment that larger aggregators have made in developing platforms which have enhanced distribution of the lenders' products, in acknowledgement of enhanced compliance processes and in ensuring that brokers have an opportunity to receive subsidised ongoing professional development and information about emerging business trends.

Licensed brokers, aggregators and credit representatives are heavily regulated under the *National Consumer Credit Protection Act 2009* (National Credit Act) and are monitored by ASIC. In addition, Mortgage Brokers have to comply strictly with the wider lending policies and compliance standards set by their aggregator and the relevant panel lending institutions with whom they deal.

In stark contrast, introducers and referrers who often receive the same or similar incentive payments for introductions, are not holders of an Australian Credit Licence (ACL) or a Credit Representative appointment. As a result, they avoid substantial regulation and the scrutiny of regulators, and have no 'best interest duty' towards the customer they are referring. The MFAA believes that the review should consider recommending the re-examination of the regulation of these unlicensed referrers and introducers, investigate ways that payments to 'introducers and referrers' are made and can be better disclosed to customers and how compliance with current disclosure requirements can be enforced.

1. Background to the MFAA

With over 12,500 members, the MFAA is Australia's leading professional association for mortgage and finance brokers. The aim of the MFAA is to help MFAA members to be recognised as trusted professionals and to be their client's first choice. To achieve this aim, the MFAA promotes and advances the broker proposition to consumers as well as external stakeholders including governments and regulators, and continues to demonstrate the commitment of MFAA professionals to the maintenance of the highest standards of education and development.

It is estimated that around 17,000 mortgage and finance brokers operate in Australia.[1] In September 2016, *Comparator Business Benchmarking* found that local brokers' market share then stood at 53.6 per cent for home loans written compared with 70 per cent for the UK (in 2016)[2], 27 per cent for Canada, less than 40 per cent in the US and 25 per cent in New Zealand. Industry participants[3] agree

[1] IBISWorld, *Mortgage Brokers in Australia: Market Research Report*, August 2016, p. 1, http://www.ibisworld.com.au/industry/default.aspx?indid=1821.

[2] IRESS, *Intermediary Mortgage Survey 2016*, p. 7, https://www.iress.com/files/1214/5995/3077/UK_IRESS_IMS_2016_FINAL.pdf.

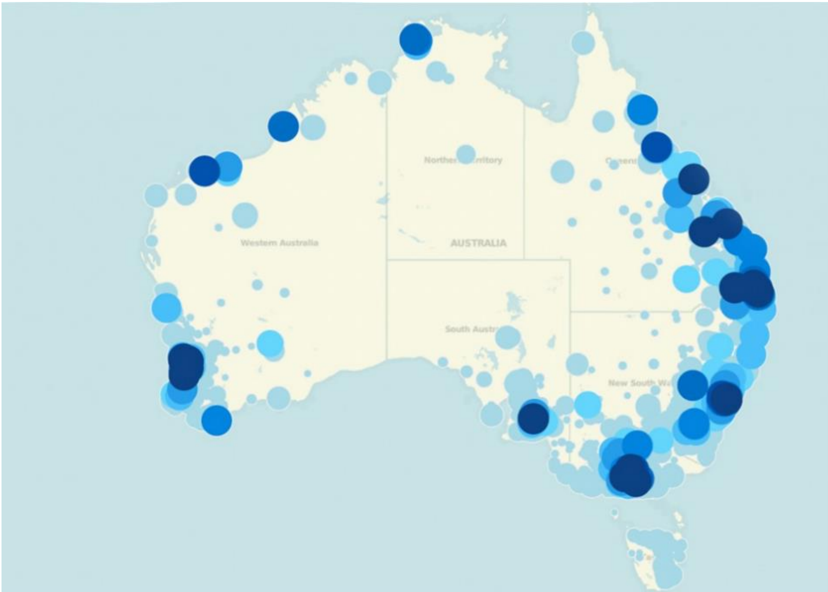
[3] Ernst & Young, *Observations on the Value of Mortgage Broking*, May 2015, p. 2, https://www.mfaa.com.au/IndustryInformation/Documents/1527742_MFAA_Broker%2020Study_final_email.pdf#search=observations%20on%20the%20value.

that within five years, Mortgage Brokers will account for 60 per cent of home loans in Australia based on prevailing growth trends.

2. Mortgage Broker Industry Overview

The Mortgage Broker industry is relatively new but continues to demonstrate growth. Mortgage Brokers have filled a clear gap in the market, being viewed as providers of comprehensive convenient and personalised advice to clients. Representing a panel of lenders, they offer customers a range of products and tailor mortgages to specific needs. Generally, these factors have contributed to demand growth in the industry.

Mortgage Brokers provide a distribution network right across the country, often in areas where there are no bank branches.



As mainly small businesses or sole operators, Mortgage Brokers access on average 1,000 customers per year. As a result, it is conservatively estimated that the industry as a whole directly engages with over 1.9 million customers per year. Mortgage Brokers are strong drivers of competition in the mortgage lending market, providing many small lenders and originators with a 'shop front' to compete against the larger bank branch networks.

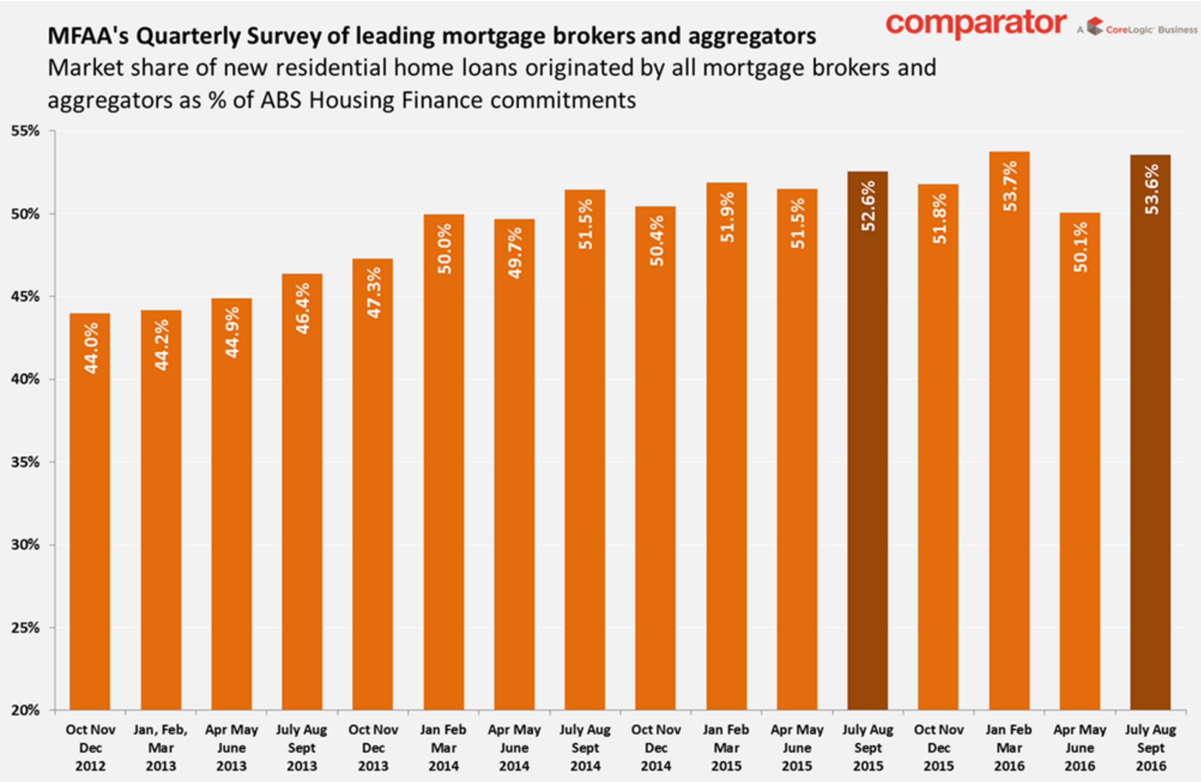
Industry revenue is forecast to grow by at least 4 per cent annually, principally on the back of favourable credit conditions and rising house prices. Competition and industry employment are also expected to increase due to favourable conditions. It is anticipated that the supply of finance will rise and more lenders will enter the market. As lenders continue to turn to the broking channel to distribute products, demand for broking services is therefore expected to increase.

The industry responds to several primary drivers including residential housing loan rates; the household savings ratio; residential housing prices; and the number of households in Australia. In this context, the contribution of the 'broker', as a distribution channel, is enhanced. Loan originators recognise the value-add provided by the broker through a combination of factors, including:

- geographic presence;
- convenience through flexibility and availability to meet consumers;

- independence; and
- provision of quality advice in addition to loan access.

Mortgage originators consider brokers as an efficient model to increase brand recognition. As competition has increased, the range of products offered by brokers has widened, delivering a more thorough and customised service to clients.



As the industry is considered to be approaching maturity, challenges for the industry as a whole are likely to come from pressure on housing affordability; increasing use of technology by lenders to provide access to loans; changing legislation; and competition and consolidation within the industry. Industry concentration is considered medium with the four largest players controlling around 52 per cent of market flows.

3. Mortgage Broking Industry and Remuneration Structures

The Review places the mortgage broking industry into the "third party" category alongside introducers and referrers. Whilst this was clearly done for convenience and to distinguish third parties from bank staff channels, the MFAA argues that it is an inappropriate categorisation of introducers and referrers. Whilst licensed brokers, aggregators and credit representatives are closely regulated under the *National Consumer Credit Protection Act 2009* (National Credit Act) and monitored by ASIC, introducers and referrers are neither ACL holders nor appointed Credit Representatives. Equally, Mortgage Brokers also have to comply strictly with the wider lending policies and compliance standards set by their aggregator and lending institutions.

This is an extremely important distinction, as brokers must comply with not only the National Credit Act but also industry-based lender and aggregator compliance obligations. These enhanced compliance standards form a key pillar of the mortgage and finance broking industry. The Review correctly points out that compliance standards are set both directly on the industry by its regulatory body, ASIC, and indirectly by the compliance standards set out in the contractual arrangements with lenders.

Unlicensed introducers and referrers must not engage in any 'credit activities' described in the National Credit Act, and as such have few compliance obligations and limited regulatory oversight. This distinction is often lost on the customer who is to some degree relying on the knowledge and status of the referrer when seeking their referral advice. This situation is even worse for referrers who have no status, other than a link with the customer (for example, family members or friends), and may undertake referrals and receive a benefit from the lender in an entirely unregulated manner.

When assessing the remuneration practices as they relate to the mortgage broking industry, it is important to understand the structure of the industry, as well as the role which Mortgage Brokers play.

The Australian mortgage industry is dominated by the four major banks, being the traditional lenders that cover the full mortgage value chain from funding to distribution. Regional banks, non-major lenders, credit unions, building societies and other non-bank lenders have comparatively smaller market share.

Participants in the mortgage industry primarily fit into three categories, each of which represents a particular part of the Australian mortgage industry value chain. These categories are origination, servicing and funding.

Origination: The process by which a borrower submits an application to enter into a loan with a lender, typically through a Mortgage Broker or directly at a bank or building society. Mortgage Brokers have become an effective and popular method of originating loans for lenders as they provide a convenient service that assists borrowers to find a mortgage product that meets their needs from the range of products available.

Approximately $356 billion in residential loans were settled in the 12 months to June 2016 with 53.6 per cent originated by Mortgage Brokers and the balance by lender staff. Lenders typically pay around 0.65 per cent of the loan amount in upfront commission which represents the origination cost of their own channel. Australia's 17,761[4] brokers received approximately $1.2 billion in upfront commission – equivalent to less than $68,000 per broker before costs.

Aggregators (Wholesale mortgage broking groups and franchise models) sit between lenders and Mortgage Brokers to provide the critical infrastructure and back office functions required by Mortgage Brokers to support their businesses. Aggregators typically provide access to a range of mortgage

[4] IBIS World, *Mortgage Brokers in Australia: Market Research Report*, August 2016.

products provided by a broad lending panel in addition to back office infrastructure to facilitate transactions, improve the customer experience and meet legal and regulatory obligations.

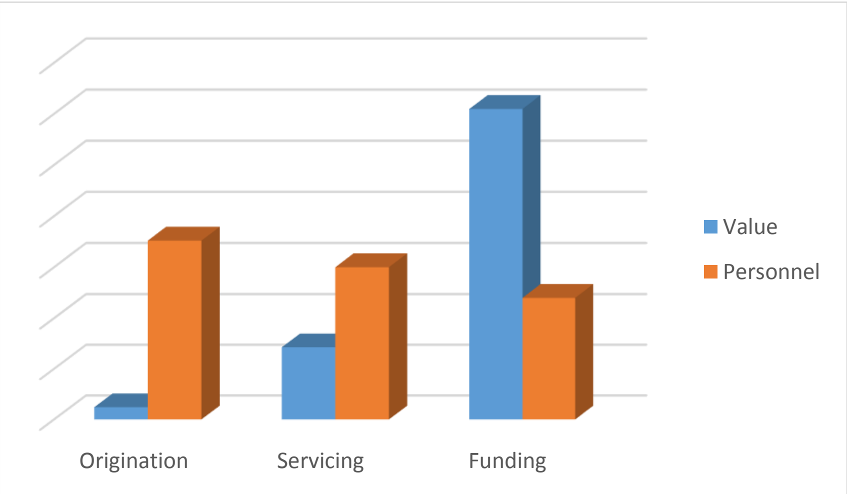
Servicing: Relates to the ongoing provision of services to the borrower and management of the mortgage for the term of the loan. These include services such as the provision of statements, receipt and disbursement of loan repayments and the ongoing credit management of the mortgage. Servicing is generally carried out by the lender or provider of the mortgage product.

With the majority of mortgagors meeting their loan commitments in a timely fashion, most mortgage servicing activity is automated and requires less customer contact than origination. Industry servicing costs can be in the region of 0.40 per cent of the loan value per annum. With $1.523 trillion in residential loans outstanding, the mortgage servicing part of the value chain is estimated at around $6.1 billion per annum. Mortgage Brokers also receive approximately 0.15 per cent of the value of loans which they originated for providing ongoing advice to their clients while the loan remains in place. Servicing provided by brokers represents another $1.02 billion in value.

Funding: Bank lenders have traditionally funded their assets using a combination of retail deposits, wholesale funding (lending by one financial institution to another) and through a process known as 'Securitisation'. Securitisation involves building up a large portfolio of residential mortgages and then selling the right to receive the future cash flow from those mortgages to other investors through capital markets. Non-bank lenders are not authorised to take deposits and are therefore reliant on either wholesale funding or securitisation to fund their loans.

The profits of Australian lenders and, particularly, the major banks are driven by mortgage lending. With average Net Interest Margins of over 2 per cent, funding comprises approximately $30.5 billion or 78 per cent of the mortgage value chain. As retail depositors continue to migrate to digital bank channels, banks are reducing their branch networks and transforming them into channels for the sale of more complex products. The number of staff involved in facilitating funding therefore continues to reduce and is relatively small in relation to the revenues earned.

The diagram below reflects the size of the respective sectors of the value chain in terms of value of employment.



3.1 Mortgage Brokers

The Australian mortgage broking industry was developed as a result of financial deregulation in the 1980s. Prior to this, banks and building societies provided the vast majority of any residential mortgage lending. From its inception in the early 1990s and through the early 2000s, the lending market became significantly more sophisticated and competitive.

Deregulation also led to a significant increase in the number of mortgage products available and the sophistication and complexity of such products. Large broking groups (including Aggregators) typically offer over 1,400 products to their customers, highlighting why borrowers increasingly seek advice to help choose an appropriate product.

There are a number of different operating models within the mortgage broking industry as outlined below:

Model	Description	Examples
Wholesale Mortgage Broker Model	Wholesale Mortgage Brokers secure mortgage products from their lending panel and provide the support for Mortgage Brokers to distribute under their own name	AFG PLAN* Vow Financial** Choice* Connective FAST*
Franchisor Model	A franchisor assigns franchisees the right to market and distribute the franchisor's branded service and to use the business name for a fixed period of time	Mortgage Choice Aussie Home Loans*** Loan Market
Licensee Model	Similar to the franchise model, loan writers are employed or licensed by a single branded employer, which generally pays a mix of salary and commissions to licensees	Yellow Brick Road
Sole Trader	The owner and broker are one and the same with no group affiliation	

* 100% owned by NAB
** 100% owned by Yellow Brick Road
*** Controlled by CBA

The services of Mortgage Brokers and wholesale Mortgage Brokers (third party distribution) are increasingly important in the Australian mortgage landscape.

Mortgage Brokers are becoming the distribution method of choice for many smaller lenders as these entities do not possess the branch footprint of larger banks, nor can they afford such an investment. Additionally, third party distribution is an important distribution channel for major banks. It has assisted them to maintain and grow their market shares, especially after the substantial major bank branch closures in the 1990s.

The current level of Mortgage Broker penetration has grown significantly over the past 15 years, with Mortgage Brokers accounting for 53.6% of residential mortgage loan originations in CY2016 (to

September 2016) up 7.2 percentage points from 46.4% in the three year period since CY2013. This has been facilitated by a combination of factors, including:

- a recognition by lenders that Mortgage Brokers are a viable and cost effective means of accessing and assisting customers in the mortgage market;
- the growing complexity of mortgage products, which has driven consumers to increasingly seek advice on suitable products; and
- an overall increase in demand for residential mortgage loans by banks, given the preferred capital treatment of residential mortgages for the purposes of capital adequacy rules affecting banks.

The Review makes a number of assertions about the difference in nature and repayment profile of third party mortgages in comparison to those sold through a bank branch:

> …data was presented to the Review that suggested that third-party mortgages 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. Noting that all such mortgages need to satisfy the relevant bank's credit assessment and responsible lending requirements, this evidence is suggestive rather than conclusive.[5]

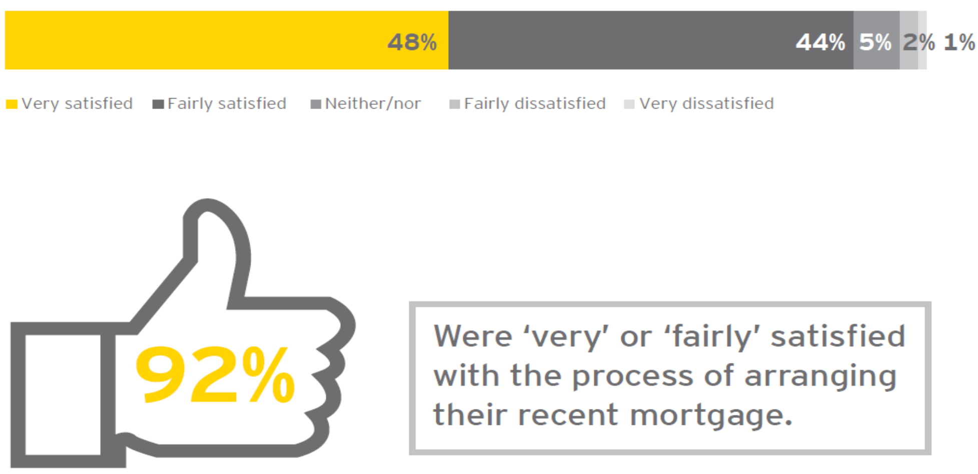
Whilst the review quite rightly characterises this evidence as 'suggestive' rather than 'conclusive', it does not go further to evaluate the data. There are a number of factors which lead to this slightly different profile of third party mortgages, including the demographics of customers of brokers versus bank branches, and the higher proportion of investment loans sold through the third party channel. The only valid way to assess the relative appropriateness of loans written by brokers and the appropriateness of their remuneration structures is to assess customer outcomes and determine whether the remuneration structures are positively or negatively impacting these outcomes.

The Review makes the following comments on the difficulty in defining customer outcomes:

> It is perhaps surprising that there is no commonly accepted definition in Australia of a poor customer outcome. In the UK context the FSA uses the term mis-selling as a proxy for poor customer outcomes. Mis-selling is defined by the FSA as a "failure to deliver fair outcomes for consumers". They go on to list fair outcomes as including:
>
> - Customers are treated fairly;
> - Customers understand the key features of the product or service and whether or not they are being given advice or information;
> - Customers are given information that is clear, fair and not misleading – information that enables them to make an informed decision before purchasing a product or service or before trading; and
> - Customers buying on an advised basis are recommended suitable products.[6]

Question 32 of the Issues Paper asks specifically whether the Australian industry should adopt this definition when assessing customer outcomes. This definition is already reflected in the obligations placed on licensed brokers and credit representatives under the National Credit Act. The only difference is that under the Act, Mortgage Brokers are required to offer a "not unsuitable product". This to the MFAA is in the spirit of the final FSA definition.

[5] Sedgwick, S, *Retail Remuneration Review – Issues Paper*, Retail Banking Remuneration Review, 17 January 2017, p. 54.
[6] Sedgwick, p. 55-56, citing, FSA, *Final Guidance: Risks to customers from financial incentives*, January 2013, p 9.



Source: EY report to the MFAA: Observations on the value of mortgage broking, May 2015

Customer outcomes in the mortgage broking sector are overwhelmingly positive. A 2015 Ernst & Young study revealed a broker satisfaction rating of 92% of customers either 'very satisfied' (48%) or 'fairly satisfied' (44%) with their broker's services.[7] There is no suggestion that the current review by the Federal Government into Mortgage Broker remuneration is being driven by any customer dissatisfaction or detriment. This can be best demonstrated through the analysis of dispute resolution data. Most Mortgage Brokers are members of the Credit and Investments Ombudsman (CIO) service, and in turn make up the vast majority of CIO members. However, only around 6.1 per cent of complaints received by the CIO relate to Mortgage Brokers or aggregators.[8]

Customer outcomes can also be assessed by comparing mortgage default rates of mortgages sold in a branch versus third-party mortgages. The MFAA is not aware of any significant difference in such default rates across channels, and recommends that the Review further analyse such metrics before making assessments of the appropriateness of the third party channel.

Question 33 asks if there is *"evidence that the risks of mis-selling are currently significant, not sufficiently mitigated by existing strategies, and systemically important?"*[9]. The MFAA believes that in light of the strong customer satisfaction scores, adherence to the obligations of the National Credit Act, and low customer default rates, mis-selling is neither significant nor systemic in the third party channel. That said, the MFAA is always prepared to consider ways in which compliance can be improved, and customer outcomes enhanced. The focus of such a review should be on the actual customer interaction practices of brokers, rather than on the remuneration structures. Measures to enhance customer follow-up after a loan is written are worth considering and could become standardised across MFAA members. Such measures would help to ensure that the loan a customer has is still in line with their needs.

---

[7] Ernst & Young, p. 10.
[8] CIO, *Annual Report on Operations* 2015, http://www.cio.org.au/publications/annual-report-on-operations/.
[9] Sedgwick, p. 56.

3.1.1 Broker value proposition to borrowers

The growth in the Mortgage Broker channel over the past 15 years has been overwhelmingly driven by the value which they provide to their customers. A mortgage is a long-term commitment often spanning 20-30 years and many home buyers prefer to be reassured by a Mortgage Broker who is independent of any one lender that the mortgage product they choose is right for them. Many customers of Mortgage Brokers are also repeat customers, who are pleased with the services brokers provide above and beyond that which they receive in a bank branch.

These benefits make up the mortgage broking industry's customer value proposition and include:

- a single point of contact in the loan origination process, saving time and reducing the administrative burden;
- large Mortgage Broker networks that create leverage to extract competitive loan pricing and terms from lenders;
- a customised approach to satisfy each individual borrower's needs;
- flexibility and convenience in being able to talk to a Mortgage Broker outside bank opening hours;
- easy access to a range of loan products for consumers in remote/country locations, particularly where no lender representation exists; and
- credit advice on a wide range of lending products providing choice to borrowers.

Additionally, as lenders generally pay upfront and/or trail commissions in respect of the loans Mortgage Brokers originate, the vast majority of residential Mortgage Brokers do not charge borrowers an upfront service fee.

3.1.2 Broker value proposition to lenders

In addition to a strong customer value proposition, Mortgage Brokers also provide benefit to lenders. Whilst all lenders who utilise the Mortgage Broker channel accrue benefits, by far the strongest benefits are achieved by smaller lenders. Put simply, the Mortgage Broker channel allows smaller lenders to compete on even terms with the big four banks. Through the broker channel, small lenders can compete equally with the large lenders on important product attributes, rather than being entirely discounted due to the lack of a national, physical footprint. The broker channel also saves smaller lenders from excessive marketing and distribution costs, enabling them to compete strongly on price.

This is not to say that the broker channel does not benefit the larger banks also. The mortgage broking industry's strong customer value proposition has led to all of the major lenders also making their products available for distribution through the third party channel.

The key value proposition to lenders include:

- providing a national distribution network without lenders having to invest in branches and other physical infrastructure, which is particularly important following industry-wide branch closures and rationalisation;

- allowing lenders to differentiate their products to capture a different segment of the mortgage market; and

- in the case of wholesale Mortgage Brokers, managing a large volume of Mortgage Brokers on a day-to-day basis and therefore reducing the lender's fixed costs. Management of a

Mortgage Broker may encompass compliance, training and distribution of revised and new product details and also payment of remuneration for all settled loans.

3.1.3 Remuneration structures for brokers

The most important and relevant remuneration structures to the mortgage broking industry remain the upfront and trail commissions. These commissions are paid by the lender to the Mortgage Broker via their aggregator and are subject to control mechanisms such as 'clawback'. This basic commission structure is vital to the continued viability of the industry as it ensures that a customer can access the broker channel at no greater financial cost than walking into a bank branch. Given that Mortgage Brokers are the 'shop front' of smaller lenders, and those without a national branch presence, to place them at a competitive disadvantage would only serve to further dampen competition in financial services.

Question 29 of the Issues Paper specifically asks whether *"there is sufficient evidence to support a case for banks to discontinue the practice of paying volume based commissions to third parties in respect of new and increased mortgages"?*[10] Retail Mortgage Brokers no longer receive volume based commissions from banks, and as such this is not an issue which relates to retail Mortgage Broker remuneration. Such payments are sometimes made to aggregators and wholesale Mortgage Brokers, and as such further commentary on their role, structure and importance are made later in this submission. The same applies to ***Question 30*** which discusses 'accelerator arrangements'.

In terms of ***Question 31***, which asks if there is any *"evidence that the contractually based risk mitigation devices available to banks in respect of third parties are deficient in avoiding poor customer outcomes"?*[11] The MFAA is of the view that whilst all evidence points to the fact that customer outcomes in the third party channel are overwhelmingly strong, compliance practices are, and should be regularly reviewed by lenders. Retail Mortgage Brokers are by and large compliance standard 'takers'. It is the lenders who set out the customer information required by way of their application forms, and set the risk appetite for lending. That said, the general processes and customer needs analysis undertaken by a Mortgage Broker, including loan affordability, must align with the customer's objectives and, we believe, goes much further than for a loan sold in a bank branch.

The Review also makes a number of claims based on the evidence it has received so far. For instance it correctly identifies that *"the use of upfront and trailing commissions incentivise sales"*.[12] It then goes on to say *"Where a Broker can earn a significantly higher commission to sell one product over another, they are incentivised to sell that product, which may not be the most suitable for the customer, potentially leading to poor customer outcomes"*.[13] While this is technically correct, this statement ignores the fact that in the vast majority of cases, commissions are standard across all products, especially where a broker is associated with an aggregator or dealer group.

The MFAA disagrees with the assessment of the Review that "the risk of commission-related mis-selling is not insignificant in this market".[14] This assertion is not supported by the facts. The upfront remuneration offered by lenders is fairly uniform at approximately 0.65 per cent, and trail remuneration also relatively uniform at approximately 0.15 per cent for the life of the loan. Broker remuneration provided by lenders has reduced over the past ten (10) years from a mostly uniform

[10] Sedgwick , p. 55.
[11] Sedgwick, p 55.
[12] Sedgwick, p 54.
[13] Sedgwick, p 54.
[14] Sedgwick, p 54.

offering of 0.70 per cent and 0.25 per cent for upfront and trail commissions respectively. In parallel, broker costs, compliance requirements and client engagement per file have all increased.

Trail commissions in the mortgage broking sector are an important component of the overall remuneration structure as they promote continued engagement with customers. Post sale customer contact includes annual check-ins with customers to ensure that their financial circumstances and/or plans have not changed significantly and that the mortgage servicing and management functions are satisfactory.

It is important to remember that any sale of a product by a Mortgage Broker is subject to up to a 100 per cent 'clawback' of the commission made by the Mortgage Broker, ranging for periods up to 24 months of a settled loan's life if the consumer is dissatisfied and chooses to refinance. It is therefore not in a broker's best interests to place a customer with the wrong product. Just as importantly, a broker's business is built on referrals, and dissatisfied customers will impact a broker's ability to build a long term sustainable business.

It is also worth noting that 'exit fees' have been abolished. This also minimises the potential for a consumer to be disadvantaged if they are not happy with the lending solution a broker has helped them acquire. If this is the case, they have a simple exit strategy, and the broker will be subject to "clawback" of commissions.

In addition, any broker who provides a loan that is 'unsuitable' is directly in breach of their obligations under the National Credit Act, as well as the MFAA Code of Practice. A broker spends approximately 12-16 hours (client inquiry, lodgement, settlement) on each settled file and if the average loan size of $350,000 (Australian Bureau of Statistics) is used, a broker is likely to earn, prior to costs, about $2,275 in upfront commissions.

An unsuitable loan (in this case a loan which is larger in value than a customer can afford or needs) will directly put at risk a broker's Australian Credit Licence or Representative appointment and therefore the viability of their overall broker business and ongoing income. The behaviour also exposes the broker to clawback, or at the very least, a loss of trail due to the loan entering arrears or defaulting.

The Review also mentions the regulatory situation in the Netherlands, where *"commission payments have been banned for mortgage broking activities".* [15] The review fails to mention that this has led to significant consolidation in the mortgage broking industry, with branch loans now dominating the mortgage market. If this were to occur in Australia, it would remove the competitive pressure on the major banks and reduce easy access to finance for thousands of customers, particularly in remote and regional Australia.

The MFAA believes that the current structure of remuneration and incentives remains fit for purpose, driving appropriate broker behaviours and leading to positive customer outcomes. The current remuneration structures contain the necessary controls to ensure they are not misused; controls which for the most part remain in place after the original loan transaction is complete.

[15] Sedgwick, p. 54.

3.2 Aggregators (Wholesale Mortgage Brokers)

Wholesale Mortgage Brokers and franchisors provide the link between Mortgage Brokers and lenders. Both wholesale Mortgage Brokers and franchisors provide a panel of lenders from which to choose a loan that is appropriate for the borrower. They also provide technology, marketing, compliance and administration services in return for a portion of the remuneration paid by lenders. Wholesale Mortgage Brokers (such as AFG, Fast, Plan and Connective) and franchisors are able to offer their Mortgage Brokers competitive rates and a selection of products that they would not necessarily be able to access without the scale and purchasing power of a wholesale mortgage broking group.

Generally, wholesale Mortgage Brokers and franchisors both act as the intermediaries between lenders and Mortgage Brokers. They may provide varying levels of service to their Mortgage Brokers and franchisees that directly service borrowers and tend to occupy more of a wholesale role than franchisors generally do. Wholesale Mortgage Brokers' end customers are Mortgage Brokers who usually trade under their own brand name. Due to this broker-centric focus, wholesale Mortgage Brokers only require brand recognition amongst lenders and Mortgage Brokers. Mortgage Choice, which is listed on the ASX, is an example of a franchisor model. Franchisors seek higher retail brand recognition amongst residential mortgage borrowers.

Lenders deal with wholesale Mortgage Brokers and franchisors for the administrative convenience of dealing with one party and gaining access to a wide distribution network. The mortgage broking channel has proven to represent a predominantly variable cost structure, as compared to a branch network, for mortgage product distribution.

Wholesale mortgage broking service providers, such as wholesale Mortgage Brokers and franchisors directly compete with each other. These businesses provide various levels of technology, back office, compliance and administration functions, training, and lender relationships to Mortgage Brokers. Some wholesale Mortgage Brokers have adopted a full service model to obtain a competitive advantage. The cost of providing all of these services can create a barrier to new entrants to the market.

The competing businesses include franchisors such as Mortgage Choice and Aussie Home Loans (the latter controlled by CBA), and other wholesale Mortgage Brokers such as Vow Financial (acquired by Yellow Brick Road in May 2014), PLAN, FAST and Choice (wholesale Mortgage Brokers owned by NAB), ASX listed AFG and Connective. The mortgage broking market is dynamic and there is ongoing competition for market share from the existing and newer participants operating under a range of business models.

Through their Brokers, wholesale mortgage broking service providers indirectly compete with other Mortgage Brokers, tied broking businesses of mortgage providers (or funders) and the distribution networks of the various banks and other mortgage providers within the mortgage industry (through their own branches or other in-house distribution platforms, such as mobile lending services).

In addition to the strong outlook for the residential mortgage market, the Mortgage Broker share of the Australian market will continue to increase.

Factors influencing increasing Mortgage Broker originations include:

- Increasing positive awareness of the Mortgage Broker channel: A result of a greater number of consumers becoming aware of the value and services that Mortgage Brokers can deliver, and the broad range of products that they can access

- Convenience: Mortgage Brokers will often visit borrowers at home or work and outside office hours, and will also provide the borrower with a more thorough understanding of how mortgage products work
- Industry consolidation: Scale through recent industry consolidation among Mortgage Brokers is a major driver of Mortgage Broker strength and profitability as larger mortgage broking groups are able to provide greater market leverage as well as better services and platforms to their sales force, and
- Competition: Competition amongst lenders continues to increase which in turn has resulted in improved pricing, service standards, product innovation and investment in more efficient systems to support the mortgage broking industry.

3.2.1 Aggregator value proposition

Aggregator broking groups are built on a mutually beneficial relationship with their Brokers. In most circumstances, Brokers are contracted to exclusively originate mortgage products of the broking group's lending panel. The general value proposition for many broking groups is summarised below:

Aggregator value proposition

Scale efficiencies	The typical size of the aggregator loan book attracts new Mortgage Brokers, who in turn originate more loans and revenues. The loan book size also delivers improved efficiencies in supplying support functions.
Access to Information technology	Many Aggregators invest heavily in the latest information technology systems which assist Brokers to enhance the customer experience and meet legal and regulatory obligations.
Access to a diverse lending panel	Aggregators provide Brokers with access to a diverse panel of lenders, including the big four banks and smaller bank and non-bank lenders, delivering access to a vast number of products on competitive terms. Individual Mortgage Brokers would not be able to access this range of products on similar terms without the support of an Aggregator.
Greater Mortgage Broker buying power	Many Aggregators generate a significant quantity and quality of loans to lenders, placing them in a strong position to negotiate preferred origination terms and conditions. The strong market share of many of these groups means they are relevant to all financial institutions operating in Australia that seek to distribute mortgage products.
Business development and sales support	Typically, Aggregators offer a diverse range of sales support services to Brokers often including: • business development and marketing support including lead generation campaigns, development of local, personalised marketing campaigns, public relations and field support, together with customer retention campaigns;

Aggregator value proposition

	• training services, including mentoring, lender accreditation and relationship building; • business establishment support; and • sales offices and support teams which facilitate responsive support for Brokers ensuring they are aware of all the latest mortgage industry products, developments and initiatives.
Comprehensive administration and support systems	Aggregators typically offer a diverse range of back office support services to its Brokers including: • efficient, accurate and timely payment and mortgage processing systems; • commission payment certainty due to its size and reputation; • administration services such as policy training and loan submission quality training; • business establishment support; • regular communications with other Brokers; and • assistance with meeting regulatory requirements.
Compliance	Brokers can often apply to become Credit Representatives under the Aggregator's ACL or operate under their own ACL. In either case, Brokers are offered support by the Aggregator's compliance team such as access to online training and education resources.

3.2.2 Aggregator investment in infrastructure

At the aggregator level, some lenders make payments of sponsorship or contributions to development programs based on the volume of loans written (volume bonuses or volume-based incentives). <u>These payments are not passed directly through to brokers and therefore do not constitute an incentive for brokers to direct more business through to the lender</u>. Instead, they are made in recognition of the investment that larger aggregators have made in developing platforms which have enhanced distribution of the lenders' products and ensuring brokers have an opportunity to receive subsidised ongoing professional development and information about emerging business trends.

As such ***Question 29*** of the Issues Paper, which asks whether *there is sufficient evidence to support a case for banks to discontinue the practice of paying volume based commissions to third parties in respect of new and increased mortgages,* can only be answered in the negative. If volume-based incentives were in fact passed on to retail Mortgage Brokers, then there could be a case made for their abolition. Without the link between the bonuses paid and those actually selling the loan, no mis-selling can be incentivised through their payment. Therefore, the cessation of volume-based incentives will only serve to deprive aggregators and wholesale Mortgage Brokers of a vital income stream, resulting in lower levels of investment in broker group infrastructure, training and compliance.

Continued investment in broker group infrastructure is required to ensure that brokers who use the infrastructure increase efficiency and maximise positive customer outcomes. AFG, for example, has invested over $70 million into technology to support the broker sector since 1994. AFG's end-to-end technology platform is a single access point for all customer data and products, eliminating the need to run multiple programs to perform different tasks. It ensures that AFG brokers maintain regular communication with customers for the life of a loan thereby promoting customer retention. AFG employs 68 staff in IT and support roles to maintain technology development and provide technical support to contracted brokers.

In addition to an upfront investment, aggregators also spend considerable amounts on maintaining and upgrading this infrastructure. For example, AFG spends more than $5 million per year on IT. This includes:

- around $500,000 per annum on IT Security to ensure customer and broker data is protected;
- approximately 60 per cent of annual IT expenditure is in ongoing innovation to the benefit of brokers and customers;
- investment in mobile applications, websites and functionality that improves the broker and customer experience, helps align the customer with the right finance, reduces risk and ensures compliance; and
- in addition to technological investment, aggregators commonly offer brokers tailored marketing materials including brochure copy, web copy, scripts, templates, social media guides, social media content and artwork, webinars, business development guides, presentation templates and further email templates.

3.2.3 Remuneration structures for aggregators

Aggregator staff members are generally rewarded and remunerated with base salary and reward structures tied to contracted brokers' business growth.

Such a model incentivises aggregator staff to assist the broker to maximise positive customer outcomes. As with a Mortgage Broker, this model ensures that staff members are invested in the outcome of a lending proposition for a consumer. With a commission-based model of remuneration, a broker is remunerated based on the placement and ongoing suitability of the product. The removal of a broker commission-based model would result in a 'salaried' aggregator workforce with no incentive to ensure a proper broker comparison across lenders or products.

Alternatively, it would result in a fee-for-service model in which customers pay the broker directly for services received. Such a model would significantly reduce the desirability of using a Mortgage Broker, leading to mass customer attrition and significantly undermining the competitive landscape in mortgage lending. It would also remove the incentive for aggregator staff to assist in customer management over the life of a loan.

3.2.4 Volume Based Incentives

As mentioned in the Issues Paper, some lenders make payments to aggregators over and above the upfront and commission payments made to brokers. These help fund the above mentioned services.

Known as Volume Based Incentives (VBI), these payments are driven by volume, yet also contain quality measures such as conversion rate, assistance with access to brokers who are strong in the lenders preferred segments, arrears rates and application quality.

VBI recognises the aggregator's role in facilitating lower marginal costs for the lender as a result of higher volumes and better quality applications.

As previously mentioned, VBI is not passed on to brokers as payment and is therefore not an incentive for brokers to recommend particular products or lenders to their clients.

3.2.5 Soft dollar rewards

The payment of non-monetary rewards to high performing brokers is relatively common across aggregators. Whilst the type and level of such reward varies significantly, they are seen as an important method of rewarding high performing brokers. The provision of such incentives helps to lift the overall performance of the broker group, and is the only way in which high performance can effectively be recognised.

The MFAA is aware of public and media opinion of the 'extravagance' of some rewards and is keen to see that these reward structures are proportional to the success levels they are rewarding. The MFAA does not support their abolition, but believes that further control and reporting standards should be considered. Equally, the MFAA does not support such rewards being linked to the sale of an individual product, or the suite of products offered by a single lender. Rather, such incentives should be linked to the overall performance of the broker across the aggregator's entire lender panel.

3.2.6 Aggregator-Lender Relationships

Aggregators facilitate a low (variable) cost channel for lenders to access customers for their products. This channel is effective for all lenders, but in the case of many small lenders, is the only viable way for them to achieve a national footprint for their products. This has greatly enhanced competition in the home mortgage market and has led to significant downward pressure on prices. An important factor in fostering this competition is ensuring fair access to the aggregator's lender panel. Whilst an entirely 'open architecture' approach to panel membership may seem superficially appealing, it would greatly reduce the aggregator's ability to control the quality of products on its system. This would lead to poorer customer outcomes in many cases.

Therefore, all aggregators have stringent assessment process for selecting a lender for their aggregator panel. These processes will generally take into account the following factors:

- strength of the lender balance sheet:
  - *To ensure the financial viability of the lender to protect the customer from potential lender failure;*
- member and public demand for its products:
  - *To ensure that the lender actually offers products which are saleable, and in-line with the needs of customers;*
- competitiveness and quality of the product range:
  - *To ensure that the products are offered at a competitive rate, and that the features of the product meet the needs of customers;*
- agreement terms:

- *To ensure that the terms of business are commercially viable, and not punitive towards the aggregator;*

- reputation and history of the lender:
  - *To ensure they have a reputation reflective of strong customer outcomes;*

- ability to service members and the end customer:
  - *To ensure that levels of support will be maintained;*

- channel parity:
  - *To ensure that the loan is being offered through the broker channel at a competitive rate to other channels;*

- electronic application capability:
  - *This is a requirement of many aggregators and ensures compatibility with selection software etc; and*

- reporting capability:
  - *To ensure that it is compatible with the aggregator controls and standards.*

3.2.7 Aggregator-broker relationships

As previously mentioned, the upfront and trail commission model is almost the only remuneration model used by brokers. The upfront remuneration offered by lenders is fairly uniform at approximately 0.65 per cent, and trail remuneration also fairly uniform at approximately 0.15 per cent for the life of the loan. Broker remuneration provided by lenders has reduced over the past ten (10) years from a mostly uniform offering of approximately 0.70 per cent and 0.25 per cent for upfront and trail commissions respectively. In parallel, broker costs, compliance requirements and client engagement per file have all increased.

The proportion of commission paid by the lender that is passed through from aggregator to broker is negotiated on a case-by-case basis in conjunction with fees payable for services provided by the aggregator, such as access to the loan platform, compliance and marketing support.

The level of service provided by different aggregators varies as does the level of support required by each broker. These differences may affect the proportion of the commissions paid to the broker and the proportion retained by the aggregator. Brokers originating high volumes are usually able to negotiate higher pass-through rates.

Aggregators generally provide technology, compliance, licensing, training and professional development, file audits, marketing and in some instances advertising support to their contracted brokers.

The compliance function of one aggregator group, AFG, incurs costs of more than $1 million per annum to operate. Without revenue streams to supply the service, the responsibility to carry out these actions would in all likelihood shift from aggregator to the regulator. ASIC would therefore need to perform around 15,000 audits and fulfil similar relevant compliance functions. We imagine these responsibilities would be cost prohibitive, may well be ineffective and would require significant additional government funding.

4. Referrers and introducers

The Issues Paper fails to tackle the issue of 'referrers and introducers' adequately nor does it make any specific findings on their behaviour, conduct or impact on customer outcomes. Whilst it is true that referrers and introducers are not able to undertake any credit activities and cannot sell products, this is an extremely opaque area and their activities in referring customers to individual banks remain relatively unregulated.

Private referrals, for example, from a friend or family member, are unregulated and quite legitimate. However, under what is referred to as the Referrer Exemption, the National Consumer Credit Protection Regulations (see in particular Regulation 25) impose a number of obligations on those individuals who are in 'a business' and do not hold a credit licence but perform tasks to introduce or refer customers to brokers or lenders on condition that they do not provide 'credit assistance'. These obligations include requirements to not charge a fee to the customer for the referral, to disclose remuneration that will be paid and to refer the customer within a certain time to a lender. There are also obligations on that lender to ensure that the referral process meets obligations for introductions from unlicensed business entities.

The MFAA is concerned that the level of compliance with these regulations is likely to be low and that many referrals are occurring without the required disclosure and documentation occurring. The act of referring carries with it considerable weight – and is something for which banks are happy to pay handsomely. Referrers use their existing relationships with customers as leverage, and are often seen by these customers as trusted advisers. At no point are they required (under NCCP provisions) to act in the best interest of the customers they are referring, nor is the disclosure requirement of their financial relationship with the organisation to which they have referred the customer effectively policed.

By way of example, an unlicensed individual could refer a customer to a bank branch and receive payment of 0.50% on the loan amount – just for providing a name and number. On a loan value of $500,000 that would represent a payment of $2,500. If the referrer undertakes one such referral per week, this would theoretically provide an annual income of $130,000 (nearly double what the average broker earns).

For some, the referring of customers is potentially big business, and the fact that it is acceptable to refer to institutions that may not have products suitable to a customer's needs, should be of concern to regulators. In addition, there appears to be little if any regulatory scrutiny on high-volume unlicensed referrers which may leave relevant customers unable to lodge no-cost complaints with a dispute resolution scheme other than a complaint about the lender. These referrers are also likely to not have relevant professional indemnity insurance – a statutory requirement for licensees and their representatives.

5. Conclusion

The MFAA again welcomes the contribution the Retail Remuneration Review (the Review) is making in defining current remuneration practices and the potential link between these remuneration practices and the behaviour of bank staff and third parties.

The MFAA believes that the current remuneration practices for the Mortgage Broker channel remain fit for purpose and have the appropriate controls to ensure that the levels of mis-selling remain at their current very low levels. We also believe that the remuneration and regulation of 'referrers and introducers' needs to be entirely overhauled. At the very least, regulatory oversight should ensure that commissions are disclosed to customers and that consideration be given to a review of those engaged in the activities of 'referrers and introducers' and whether they should be licensed and subject to EDR membership and ASIC oversight. The MFAA recommends that a system which aims to ensure that the customer achieves appropriately beneficial outcomes is the objective of all industry participants.

Yours sincerely

Mike Felton
CEO

Cynthia Grisbrook
Chairman