RICEWARNER
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Manager
Financial Services Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: consumercredit@treasury.gov.au

The Manager

ASIC Review of Mortgage Broker Remuneration

About Rice Warner

Rice Warner was established in 1987 to support superannuation funds and businesses operating in the financial services industry. It is an Australian business, owned and controlled by its key executives.

Over the last three decades, it has built a strong reputation for insightful commentary. Its independence means clients can be sure the firm always acts in their best interest and provides unbiased advice. Clients include most large superannuation funds as well as many other participants in the industry (service suppliers to funds, regulators and industry bodies).

Through its research and public policy activities, Rice Warner has built an unrivalled reputation for delivering a unique perspective across the superannuation, wealth management and life insurance industries.

Rice Warner has an interest in the operation of the mortgage lending market because:

- Mortgages provide the means by which Australians achieve home ownership. In turn, this has a significant influence on their retirement outcomes.
- Mortgages are also important for direct investment in property by individuals and Self Managed Superannuation Funds (SMSFs) and can be used to support other geared investments.
- Many financial advisers deal in mortgages as part of their solutions for clients.

Background

The ASIC Review of Mortgage Broker Remuneration was released in March 2017 with an invitation to comment on its findings and recommendations. This submission is in respect to that request for comments.

Approved Deposit-taking Institutions (ADIs) – banks, building societies and credit unions – pay mortgage brokers a commission to procure and retain business. As commission is only payable for success, the ADIs have shifted from the fixed costs of bank branches and staff to a variable cost structure which has low risk in times of lower sales.

The structure and operation of the mortgage market is similar to the financial advice market prior to the introduction of the Future of Financial Advice (FoFA) reforms.

Individual brokers generally act as representatives of aggregators that hold the necessary credit licence and are responsible for their representatives. The aggregators operate much like a dealer group licensee and provide access to a set of lenders via a panel and provide systems (platforms) to support the activities of their representatives and to monitor and ensure compliance by those brokers. The major ADI lenders own or have significant shareholdings in many of the bigger aggregators.

Up-front and trail commissions are paid to the aggregators as well as volume bonuses and soft dollar benefits. The aggregators pass a proportion of this remuneration onto the representatives.

Remuneration structures

The issues identified in respect of the remuneration structures of the mortgage market, especially commissions, are strikingly similar to those previously identified with respect to the provision of financial advice. These include:

- The levels of commission.
- The payment of trail commissions, in some instances for many years, when no service is being provided by the broker to the consumer.
- Conflicted remuneration in the form of volume and other bonuses.
- Conflicted remuneration in the form of soft dollar payments.
- The capacity of conflicted remuneration to influence product recommendations including the type and size of loan (Product Strategy Conflict) and choice of lender (Lender Choice Conflict).

We agree that these are all problematic features of the current remuneration system and need to be addressed. A system that rewards brokers for increasing consumers' risks via higher mortgages and interest only mortgages is not in the community interest.

Commission is paid by lenders to procure and retain business which acts to put the consumer's interests behind those of the lender. This conflict is an intrinsic feature of the commission model and cannot be resolved if commission is paid.

ASIC has made three proposals for the reform of remuneration structures:

- Proposal 1: Improving the standard commission model.
- Proposal 2: Moving away from bonus commissions and bonus payments.
- Proposal 3: Moving away from soft dollar benefits.

We support these initiatives, but note that ASIC has made no definitive statements as to what specifically should be done. ASIC defers to the Australian Bankers Association's review into remuneration structures currently underway. We consider that this is insufficient. We recommend that the principles and provisions established by the Future of Financial Advice reforms in respect of remuneration, and especially conflicted remuneration, should be the industry benchmark.

In this regard, we note ASIC's comments at Item 120 that the government's reforms to the life insurance industry will outlaw volume bonuses as part of its moves to bring its remuneration structures in line with the Future of Financial Advice reforms. ASIC should be insisting on the same outcome for mortgage brokers and aggregators.

We also note ASIC's comment at Item 437 that trail commissions are paid in the life insurance advice industry, and that these will continue following reforms currently being implemented. The reasons for the continuation of trail commissions for life insurance do not exist in the mortgage market. The level and form of life insurance cover does require regular review and advisers commonly assist with claims management especially for disability insurance. The features of the life insurance market should not be used to justify a remuneration structure for the mortgage market. We consider that trail commissions should not be paid when no service is being provided.

Consumers' Best Interests

Mortgage brokers nominally operate to provide a benefit in the form of advice to consumers regarding the best mortgage for their circumstances. Brokers therefore owe their primary responsibility to their client, the consumer, and not to lenders, but the ASIC Report makes no specific proposal to entrench and enforce this responsibility.

We recommend that a 'Best Interests' duty equivalent to that imposed on financial advisers by the Corporations Act should also be imposed on mortgage brokers and aggregators. Financial advisers and mortgage brokers give advice that impacts on the long term financial positions of their clients and they should have equal obligations to act in those clients' best interests.

Advice

Mortgages are almost always associated with the acquisition of a long term asset – a residential or business property. In conjunction with their collateral asset, mortgages are equivalent to other long term investments and require equivalent advice especially in relation to long term risks. Mortgages are not simple consumer credit products.

Unlike the situation with consumer credit products, we do not consider that mortgages can be assessed and advice provided as if they are simple consumer credit products if brokers are to act in the best interests of their clients. In this regard, we note ASIC's Finding 7 at Item 59 that lenders *and* [ASIC's emphasis] brokers did not make sufficient inquiries into consumers' expenses. This suggests that even if treated like consumer credit, brokers' level of knowledge of their clients' circumstances is inadequate.

ASIC has made no proposals in respect to the provision of appropriate advice by mortgage brokers, although it has noted at Item 114 that it intends to conduct a review into the advice provided by mortgage brokers starting in 2017. We believe that a more definitive position needs to be taken and note the following items in the report in respect to overseas jurisdictions:

- Item 213: In the United Kingdom non-advised home loans are outlawed.
- Item 220: Home loan products in The Netherlands are fully advised products – although they are almost exclusively sold in conjunction with life insurance.
- Item 225: Mortgage brokers operating in New Zealand must be Registered Financial Advisers or be employed by a Qualifying Financial Entity like a bank.

We believe that the lack of formal 'Know Your Client' obligations that properly recognise the long-term nature of mortgages is a deficiency that should be remedied. Mortgages are long-term financial commitments that impact on all other long term financial plans and need to be recognised as such.

Advice regarding the type, structure and term of a mortgage needs to recognise these other long term financial commitments and aspirations. This is especially the case where the mortgage is used to provide gearing for further investment. To do otherwise would be a failure to serve clients' best interests.

We consider that consumers' interests would be best served by reclassifying mortgages as Financial Products in terms of the Corporations Act. This would immediately and definitively address the issues related to the levels of remuneration and the conflicts of remuneration. It would also address the quality of advice, the qualifications of brokers, the oversight and disclosure regime, and the need to act in consumers' best interests. It would also recognise mortgages for what they are, long term financial instruments, and not simply consumer credit.

We would also consider outlawing commissions as they create a poor alignment of interests. Mortgage Brokers would be able to charge an establishment fee which could be charged at the time of the transaction. Trail commissions make no sense for consumers.

Remuneration would then be transparent and unconflicted and advice would be focused where it should be, on the best long term outcomes for consumers.

If this is not done, equivalent provisions to those imposed on financial advisers and Australian Financial Service Licensees by the Corporations Act should be imposed on mortgage brokers and aggregators. ASIC's proposals to improve governance and oversight would need to be strengthened to accomplish this. These proposals are:

- Proposal 4: Clearer disclosure of ownership structures.
- Proposal 5: A new public reporting regime.
- Proposal 6: Governance and oversight.

In particular, Proposal 6 would need to be strengthened as in its current form it is a list of expectations rather than a set of recommendations.

This submission was prepared and peer reviewed by the following consultants.

Prepared by

A.P. Stevens.

Alun Stevens
Senior Consultant
Telephone: (03) 8621 4105
Email: alun.stevens@ricewarner.com

Peer Reviewed by

Michael J. Rice

Michael Rice
CEO
Telephone: (02) 9293 3700
Email: michael.rice@ricewarner.com