4 October 2019

Manager
Financial Services Reform Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

ConsumerCredit@treasury.gov.au

Dear Sir/Madam

AFG

100 Havelock Street
West Perth WA 6005

PO Box 710
West Perth WA 6872

Phone 08 9420 7888
Fax 08 9420 7856

www.afgonline.com.au

The Treasury Consultation – Mortgage broker best interests duty and remuneration reforms
Submission by Australian Finance Group Ltd ACN 066 385 822

Australian Finance Group Ltd (**AFG**) was founded in 1994, was listed on the Australian Securities Exchange in 2015, and has grown to become one of Australia's largest mortgage broking groups. Approximately 2,950 brokers (of which 1320 are credit representatives of AFG) arrange residential mortgages, commercial finance and other loan products through AFG.

AFG welcomes the opportunity to respond to the exposure draft *National Consumer Credit Protection Amendment (Mortgage Brokers) Bill 2019* (the **Bill**) and the draft *National Consumer Credit Protection Amendment (Mortgage Brokers) Regulations 2019* (the **Regulations**) issued by the Australian Government on 26 August 2019 and the draft explanatory material accompanying these reforms. For the purposes of this submission, AFG's response is limited to providing some key observations below.

1. The mortgage broker best interests duty and remuneration reforms generally

AFG agrees in principle with the majority of the provisions set out in the exposure draft Bill and Regulations and concurs that requiring mortgage brokers to act in the best interests of consumers and addressing conflicted remuneration will strengthen existing protections for consumers who deal with mortgage brokers.

AFG is a founding member of the Combined Industry Forum (**CIF**), which has been considering how to best address customer interests since its inception in 2017. AFG has already adopted and implemented many of the proposals set out in the Bill and Regulations to address conflicted remuneration.

As an industry, we believe that operating in the best interests of customers is central to ensuring customer satisfaction. With referrals playing such as important role for mortgage brokers, the business model of all successful mortgage brokers is built on satisfied customers. The interests of mortgage brokers and the Government are therefore aligned on the importance of making customer interests a priority.

2. *The definition of 'best interests'*

The Act and the Regulations currently do not include a definition of 'best interests'. Paragraph 1.20 of the Exposure Draft Explanatory Materials to the Bill (**Explanatory Materials**), notes that "*The duty to act in the best interests of the consumer in relation to credit assistance is a principle-based standard of conduct …*" and that "*… what conduct satisfies the duty will depend on the individual circumstances*" and "*… the duty does not prescribe conduct that will be taken to satisfy the duty in specific circumstances*".

AFG agrees with the principles-based approach to define what conduct will constitute acting in the best interests of a consumer. The CIF has already developed a working definition and recommended approach to 'good customer outcomes' which could form the basis of guidance for the mortgage broking industry. This definition is tested by whether "*a reasonable mortgage broker would believe that the product recommended would satisfy the best interests duty and has met the customer's needs and objectives*".

It should be recognised that 'best' does not always mean 'lowest rate'. The services provided by a particular lender form an important part of why a mortgage broker recommends them, based on the stated needs and objectives of the customer. These include:

(a) **Approval time**. Many property transactions are time sensitive. A customer may wish to bid at auction or need to meet a settlement date after already having paid a deposit to a seller. A deposit will be at risk of forfeit if the lender cannot meet the required date.

(b) **Credit policy and risk appetite**. Particular customers, or the proposed property, may be outside a prime lenders' policy, so the available alternative products may not have the lowest rate.

(c) **Customers do not always prioritise rate over the choice of lender**. Many customers want to use a non-big four bank, as evidenced in the shift to non-majors following the release of the Final Recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry[1]. Other customers prefer services such as sophisticated mobile banking apps that larger lenders offer ahead of lower rates at non-majors.

(d) **Customers may self-select or refuse a lender for other reasons**. Customers may have a strongly held belief about a lender and may not wish to consider that lender regardless of their offering. For example, they may have personal experience with a lender or may be looking for a lender aligned to their views on environmental (such as climate change), sustainability and governance (ESG) issues.

---

[1] See AFG's Mortgage Index for Q42019 at https://www.afgonline.com.au/wp-content/uploads/2019/07/afg-index-q42019.pdf which shows non-major lender market share of lodgments increasing to 42.3% from 35.5% in Q42017 and 28.3% in Q42015.

AFG also considers that it is important that the best interests duty is tested at a point in time. We suggest the duty is tested as at the time the credit assistance is provided to assist the borrower to apply for the residential loan. Lenders regularly change loan conditions, pricing and product offers, such a change may in fact happen the day after a loan has been applied for. It is unworkable for a broker to monitor all clients, every day.

AFG strongly suggests regulatory guidance on the definition of best interests be developed by the Australian Securities and Investments Commission (**ASIC**) in close consultation with the industry and other stakeholders in order to provide certainty to mortgage brokers and consistency on the application of the duty across the industry. Consultation on the regulatory guidance would be the best time for industry to constructively engage with the Government on this definition to develop a workable and fair outcome for consumers and mortgage brokers. We appreciate time is of the essence here but trust this will not prevent meaningful consultation from taking place.

3. Education or training exemption from conflicted remuneration

The Regulations state that a non-monetary benefit given to a licensee, or a representative of a licensee, who provides credit services to consumers is not conflicted remuneration if the benefit has a genuine education or training purpose and:

(a) education or training activities for the professional development of the participants in the course must take up, the lesser of, at least 75 per cent of the time spent on the course or six hours a day; and

(b) the participant, or the participant's employer or licensee, must pay for the costs of the travel and accommodation relating to the course and attendance at events and functions held in conduction with the course.[2]

AFG submits that limiting the travel and accommodation benefits a mortgage broker can receive in connection with a training course may have the unintended consequence of making the decision for mortgage brokers about whether to undertake additional education and training activities, an economic decision. The vast majority of mortgage brokers are small business operators, often working alone, and many are located in regional areas with little or no opportunities for comprehensive face-to-face education or training. A lack of training opportunities puts them at a competitive disadvantage and risks negatively impacting their customers.

Minimum education and professional development for mortgage brokers is not considered a reward but as driving a level of competency to improve customer outcomes. We submit that the greater the education and training of mortgage brokers, the better the outcomes for consumers. If mortgage brokers are forced to make an economic decision about whether to attend a training course, as the travel and accommodation costs will have to be self-funded or funded by the mortgage broker's licensee (if it is a credit representative), the most likely outcome is a reduction in the level of attendance by mortgage brokers at these education and training activities.

---

[2] See Regulation 28VF(3) and (4).

A more equitable outcome, and one that is less likely to lead to poor consumer outcomes, is that a subsidisation of education and training activities is allowed.

4. Drawdown amount period

The Government has provided clear guidance in Regulation 28VA(4) and Regulation 28VB on the exclusion from conflicted remuneration for a benefit provided or received by a mortgage broker which is calculated by reference to the 'drawdown amount' for a credit contract. AFG believes that as this will be applied consistently across the industry it will reduce any perception of lender choice conflicts that mortgage brokers may face.

However, we caution that the period of 90 days to assess the 'drawdown amount' is not sufficient and consistent with market practice. AFG submits that a period of 12 months is a more reasonable period for consumers to draw down funds from a credit contract and would be more consistent with the experience of our mortgage brokers, especially in dealing with things such as home renovations which often take considerable time to fully finalise. We suggest that the Government requests clear data from lenders as to the usual period in which a residential property credit contract is drawn down so that this Regulation can be substantiated with evidence of current market practices. Data from our own lending business AFG Securities, indicates that 89.7 percent of the loan amount is drawn initially, 91.3 per cent after 90 days, 93.8 per cent after 180 days and 95.5 per cent after 365 days.

The drafting of the regulation also appears to prohibit the payment of trail commission on amounts drawn after the initial 90 day period. This compounds the issue and will play havoc with lenders commission systems. As well as extending the assessment period for the drawdown amount to 365 days from the initial drawdown, AFG submits that the drafting should be revised so as to exclude trail commission from being captured under this regulation.

We also believe that in relation to a particular credit contract, the calculation period 'clock' should restart each time credit advice is provided.

AFG also submits that construction loans should be excluded from the application of Regulation 28VA(4) and Regulation 28VB. A drawdown period of 90 days, or even 365 days, is not appropriate for credit contracts used for the purchase of vacant land and to fund the construction of a residential dwelling given the length of time a dwelling takes to be constructed, that there are often delays to construction due to inclement weather or changes made to building contracts, and that all advanced loan funds are usually fully utilised on the construction and purchase of land and are, in the majority of cases, tied to a fixed price contract.

5. ***Wholly or predominantly for the purpose of purchasing residential property***

Regulation 28VA(3) exempts a monetary benefit given in the following circumstances from being prohibited conflicted remuneration:

"(3) A monetary benefit given (whether directly or indirectly) to a licensee, or a representative of a licensee, is not conflicted remuneration if:

...

(d) for a credit contract that relates to:

(i) the provision of credit wholly or predominantly for the purpose of purchasing residential property; or

(ii) the provision of credit wholly or predominantly for the purpose of refinancing credit that was provided wholly or predominantly for the purpose of purchasing residential property;

the benefit is of the kind referred to in sub regulation (4);"

Sub-regulation (4) of Regulation 28VA goes on to provide that the benefit must be an amount given without reference to a particular amount of a credit contract (i.e. flat fee) or a benefit calculated as a percentage of an amount limited to the amount of credit provided or drawn down for the credit contract (i.e. percentage commission) or a combination of the two methods.

The reference to '*wholly or predominantly for the purpose of purchasing residential property*' could be interpreted narrowly to mean that any amount borrowed by a consumer to construct a residential property or for a renovation to a residential property would not fall within the exemption. Further, even where a credit contract was entered into to partly to purchase residential property and partly to renovate or construct a residential property, on a strict interpretation of this Regulation, a lender would be required to work out if the amount borrowed for the purchase was the predominant purpose or whether the renovation or construction was the predominant purpose. Lenders and mortgage brokers do not currently have processes in place to determine the proportion that would be used for these other purposes and consumers may not always use the funds borrowed in the proportions originally anticipated.

The issue is further compounded by the fact that where a credit contract has been refinanced by a different lender that the original credit contract, the subsequent lender is not likely to be able to calculate whether the original credit contract was predominantly for the purpose of the purchase of the residential property or whether some of the original credit contract was used to renovate the property.

Further, as the Bill and Regulations appear to apply retrospectively, for any trail commissions payable by lenders, they would be required to know the proportions of the purpose of the original credit contract, which may go back several decades. This information may not be available.

AFG submits that there should be no policy distinction between a consumer borrowing funds to purchase a residential property and to borrow funds to renovate or construct a residential property, provided the security for that credit contract is the residential property.

To provide clarity on this point it would be preferable if Regulation 28VA(3)(d)(i) and (ii) added the words "*constructing, renovating or any other legal purpose*" after the word "*purchasing*". Alternatively, ASIC regulatory guidance could specify that the intention of this exemption is to include any regulated credit contracts which are secured by mortgages over residential property and that a mortgage broker and lender will not have to determine whether those purposes are the predominant purposes of the credit contract.

6. Clawback period

Regulation 28VE(2)(a) provides that where there is a 'clawback' repayment obligation under a credit contract, this repayment obligation must not apply for more than two years after the day on which the credit contract is entered into by the consumer.

This Regulation does not specify whether the full amount of the benefit given to the licensee or representative must be available for clawback for two years or whether the benefit may be paid back in a graduated way based on the amount of time elapsed over the maximum two-year clawback period.

Regulation 28VE(2)(c) makes it clear that the consumer must not be subject to an obligation to pay any clawback amount, so this is purely a commercial arrangement between the lender and the licensee or representative. AFG believes it is a fairer position for licensees and representatives if the repayment amount, which the lenders can clawback, decreases over the clawback period as the lender has extracted fees and interest payments and has therefore financially benefited from having the loan in place over that time.

The current clawback system applied by lenders to mortgage brokers is blunt in its application. The majority of lenders have a maximum clawback term of 18 months with 100 per cent of the upfront commission clawed back if the loan is repaid in full within the first 12 months and 50 per cent of the upfront commission clawed back if the loan is repaid in months 13 -18. This system has the potential to disadvantage a mortgage broker reviewing a customer's arrangements within the clawback period of a loan term.

The interaction of a periodic review (as suggested in paragraph 1.21 of the Exposure Draft Explanatory Materials to the Bill) with the clawback regime brings to light the potential disadvantage to a mortgage broker if they suggest during that periodic review, acting in the best interests of the customer, that the customer switch to a new credit contract within the clawback period of the credit contract. In these circumstances, the mortgage broker would be required to repay all, or a portion, of its commission received. However, if the clawback requirements are implemented as a sliding scale over the clawback period, the disadvantage to mortgage brokers can be reduced and leads to a fairer outcome.

To provide clarity to the industry it would be preferable if ASIC regulatory guidance specifies that the repayment obligation can be on a sliding scale with the amount of the benefit to be repaid decreasing over the clawback period pro rata with the time elapsed.

7. *Conflicted remuneration applying to all credit cards and personal loans*

Regulation 28VA(3) refers to a monetary benefit given (whether directly or indirectly) to a licensee, or a representative of a licence, not being considered conflicted remuneration if the credit contract relates to the provision of credit wholly or predominantly for the purpose of purchasing residential property or refinancing credit for the purpose of purchasing residential property.[3] Therefore, on the current drafting, it is arguable that a credit contract that is not wholly or predominantly for the purpose of purchasing or refinancing residential property would be caught by the prohibitions on providing or receiving conflicted remuneration i.e. a non-National Consumer Credit Protection Act 2009 (Cth) regulated commercial loan or a credit card or personal loan not related to a residential property purchase.

It does not appear that this is the intention of the Bill or the Regulations and therefore it would be helpful if the Bill and the Regulations included a positive statement that this legislation only applies to regulated credit contracts secured by mortgages over residential property or packaged as part of advice provided in relation to finance secured by mortgages over residential property.

Please do not hesitate to contact AFG if you require any further detail about the matters raised in this submission or if AFG can provide any further assistance in the development of alternative proposals.

Yours sincerely

Mark Hewitt
General Manager Industry & Partnership Development

---

[3] See Regulation 28VA(3)(d).