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Mortgage broker best interests duty and remuneration reforms

The FBAA welcomes the opportunity to make a submission in relation to the proposed best interests duty and ban on conflicted remuneration as introduced by the *National Consumer Credit Protection Amendment (Mortgage Brokers) Bill* 2019.

Recognising the inevitability of the reform, the FBAA wishes to ensure the best interests duty is clearly defined and fairly administered. The greatest challenges with the best interests duty lie in its administration rather than its introduction into the mortgage broking industry.

The consultation around the introduction of the best interests duty presents some challenges. The draft legislation is broad and principles-based and will rely heavily on ASIC regulatory guidance to provide more granular detail. The regulatory guidance will not be consulted on or released until well after the legislation is passed. Further, the consultation process itself does not provide a great deal of structure, yet it marks a fundamental change to the way credit assistance will be regulated in the future.

Our paper will address each of the concepts introduced by the best interests duty and ban on conflicted remuneration in the same order they are raised in the bill and Explanatory Memorandum.

As a further general position, we recognise that imposing a best interests duty on credit assistance providers that provide credit assistance in relation to credit contracts secured by residential mortgages will further widen the gap between the obligations placed on credit assistance providers and those that apply to lenders for engaging in a substantially identical activity.

Accepting that a best interests duty is intended to deliver better outcomes for consumers, why is it that lenders are not subject to similar obligations? Where the true goal is to achieve greater transparency and better outcomes for consumers who are choosing a home loan, then it makes no sense not to impose parallel obligations on lenders to demonstrate that the provision of services or products direct to consumers is done in a manner consistent with achieving the best outcomes for the consumer.

The FBAA is also concerned that the draft legislation marks a potential departure from the Government's undertakings provided earlier in 2019 with respect to mortgage broker remuneration. We refer to the media release from the office of the Honorable Josh Frydenberg MP on 12 March 2019 wherein the Government gave this undertaking:

"Following consultation with the mortgage broking industry and smaller lenders, the Coalition Government has decided to not prohibit trail commissions on new loans, but rather review their operation in three years' time.

The review will be conducted by the Council of Financial Regulators and the Australian Competition and Consumer Commission (ACCC) – a review which will also consider the continuation of upfront commissions and which has already been announced.[1]”

Owing to the lack of specificity in the draft legislation, members are uncomfortable about whether the draft bill inadvertently captures or impacts upfront or trail commissions. We call on Treasury to provide unequivocal clarification that these are not impacted through making specific reference to this in the Explanatory Memorandum and further considering improving the drafting around the definition of conflicted remuneration.

Related to the point above, of genuine concern is the wording in Schedule 9, section 3 regarding the commencement of the conflicted remuneration provisions. The section is copied below:

3 Application of ban on conflicted remuneration

(1) Subject to subitem (2), Division 4 of Part 3-5A of the National Credit Act, as inserted by item 5 of Schedule 1 to the amending Act, applies to a benefit given on or after 1 July 2020 to a licensee, or a representative of a licensee, if the benefit is given under an arrangement entered into before, on or after 1 July 2020.

(2) The regulations may prescribe circumstances in which that Division applies, or does not apply, to a benefit given to a licensee or a representative of a licensee.

Subsection 1 makes reference to the relevant provisions applying to a benefit given under an arrangement entered into *before*, on or after 1 July 2020. We submit that the word *before* must be removed from the bill. Otherwise the legislation retrospectively impacts existing arrangements.

This also introduces a raft of potentially unworkable consequences of having to review existing remuneration arrangements against the purpose of the credit taken out prior to 1 July 2020 and any remuneration still being paid against those facilities.

We further seek positive assurances from Treasury that the draft bill and regulations do not apply to any arrangement established prior to the commencement of the new provisions.

Yours faithfully

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[1] http://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/040-2019

1. Best Interests Duty

1.1 Our general view at this time is that the legislation is lacking detail and creates potential for inconsistency and direct conflict between obligations on credit assistance providers.

1.2 Sections 158LA and 158LE of the bill introduce the notion of a best interests duty. The bill does not define what it means to act in the best interests of a consumer yet carries extremely high penalties for non-compliance. We are concerned with the lack of detail in the current bill.

1.3 The legislation should define what it means to act in a consumer's best interests. We acknowledge the discussions during the Royal Commission regarding the financial adviser's best interests duty and the safe harbour provisions. Notwithstanding reservations expressed about the efficacy of a safe harbour we hold the view that the legislation must provide greater clarity around the elements of a best interests duty and how it can be met.

1.4 We also maintain that the legislation should prescribe steps which, if met, will go some way to demonstrating compliance with the best interests duty requirement.

1.5 Paragraph 1.4 of the Explanatory Memorandum explains "requiring mortgage brokers to act in the best interests of consumers and addressing conflicted remuneration are intended to strengthen existing protections for consumers who deal with mortgage brokers. In particular, they bring the law into line with what consumers expect – that any advice provided by a mortgage broker serves the consumer's interests first and foremost."

1.6 As lenders remain immune from any similar obligations, we would appreciate clarification around whether:

a. Government believes that lenders already and unequivocally act in the consumer's best interests; or

b. Customers do not have the same expectation of lenders as they allegedly do of brokers to serve their interests first; or

c. Government does not believe consumers need the same protection against lenders as they do against intermediaries.

1.7 We acknowledge the objectives stated in the Explanatory Memorandum insofar as they relate to brokers but also want to see the Explanatory Memorandum address why lenders are not also included. It is essential to have clearly articulated objectives for this legislation since its administration and enforcement will be developed around the objectives. We see the current Explanatory Memorandum falling short of providing a complete explanation.

1.8 Paragraph 1.21 of the Explanatory Memorandum further highlights the inconsistency in thinking underpinning the regulation of lenders and brokers.

"1.21 By way of illustration, a consumer could be provided with credit assistance by a mortgage broker in a variety of ways. For example, the credit assistance could consist of a broker recommending one or more home loan products out of a selection of home loan products and then assisting the consumer to apply for the product the consumer selects.

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The content of the duty ultimately depends on the circumstances in which such credit assistance is provided and would include a failure to do certain things. Examples of such content that might arise under certain circumstances are:

prior to recommending any home loan product or other credit contract to a consumer based on consideration of that consumer's particular circumstances, it could be expected that the mortgage broker consider a range of such products (including the features of those products) and inform the consumer of that range and the options it contains;

1.9 How does this paragraph reconcile with the objectives of consumers getting better outcomes with respect to their choice of a home loan where a lender can recommend its own product without considering the current product the consumer is in or considering the broader marketplace?

1.10 Were a broker to not recommend a lender's product to a consumer on the basis that it was not in the consumer's best interests, that lender could recommend that same product to a consumer directly without any risk of breaching its obligations. This cannot be an outcome of this legislation that Government is seeking.

1.11 We contend that mortgage brokers already undertake extensive product research and consider a range of products before making a recommendation to the consumer. A broker quickly eliminates unsuitable products whilst determining a consumer's relevant needs and objectives and from information pertaining to their financial situation (looking for markers that indicate the consumer will not meet the credit criteria of particular lenders). What we do not want to see is the introduction of a requirement for brokers to explain to a consumer what products were rejected or why, or to create records to demonstrate this process to a regulatory authority or EDR scheme. This would impose a significant record keeping burden on brokers for no real gain to consumers. Other professions do not provide explanations to consumers about all of the options they considered and rejected prior to arriving at the recommendation which, in their professional opinion, meets the consumer's needs and objectives and we do not support this becoming an obligation for brokers.

2. Application of the BID to non-mortgage broking activities

2.1 On the current drafting of the bill it would appear that a best interests duty applies to all credit assistance provided by an entity once they fall within the definition of mortgage broker regardless of whether they are providing credit assistance in relation to a home loan or other forms of finance (for example asset finance or personal loans).

2.2 Clearly it is not acceptable to have a best interests duty apply to some credit assistance providers because they also provide credit assistance in relation to home loans (and are by definition mortgage brokers) whilst others who are not mortgage brokers and provide the very same service are not subject to a best interests duty.

2.3 This needs to be addressed in the drafting. If the intention is for the best interests duty to only apply when a mortgage broker is providing credit assistance in relation to a home loan, then the drafting must change to reflect this.

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3. Burden of Proof

3.1 The best interests duty must not be administered on a 'reverse onus of proof' basis. It must be encumbent on the party alleging a breach to prove the duty has not been met.

3.2 We hold reservations that this duty may be enforced on a reverse onus basis – essentially concluding the best interests duty has not been met unless the broker's records clearly demonstrate that it has. Such an approach would require brokers to create additional records producing a complex audit trail to enable a regulator or EDR scheme to understand all steps taken by the broker to arrive at their recommendation.

3.3 If this is the approach adopted, it will not be possible to assess a particular transaction against the notion of a best outcome without the assessor knowing all of the other products in the marketplace at the time and the specific instructions given to a broker by the consumer. These are not always recorded in broker files. ASIC does not always obtain complete broker files when undertaking its reviews (brokers do not provide all of their working documents to lenders with an application – only the specific documents requested by the lender) so it is difficult to retrospectively reconstruct a file to put oneself in the situation the broker was in at the time of giving the assistance. If an enforcement mentality is developed where a broker fails the best interests duty test unless it can prove that it didn't, brokers will be unfairly put at risk of breaching the best interests duty with potentially very high penalties for failing to keep records to a particular standard.

3.4 We recognise this element of the best interests duty will be developed through ASIC guidance however the current legislative draft includes nothing relating to a defence to a charge of breaching the best interests duty.

4. Price cannot be the sole or primary determinant

4.1 Much of the discussion around broker conflict and acting in a consumer's best interests is interwoven with notions of there being a "best product" and a cheapest product. Discussions around where a best interests duty may not be met are supported by giving examples of consumers being encouraged to apply for a particular loan where there are other, cheaper products in the market[2].

4.2 We need to see greater recognition of the other factors that go to product recommendation including whether a particular lender would accept the application based on the consumer's particular circumstances, product features, flexibility, timeframes to settlement and consumer biases. Understanding how a regulator might weight the various factors when undertaking assessments for compliance with the best interests duty is one of the areas causing concern for the industry as it tries to understand how a best interests duty will be administered.

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[2] See as an example Explanatory Memorandum paragraph 1.21 – fourth bullet point which gives the example of a broker recommending a more expensive white label product.

5. Materiality

5.1 The best interests duty applies not only to home loans but to all other credit contracts impacted by the transaction where the home loan is the primary transaction.

5.2 The best interests duty must be administered by recognising materiality thresholds. The best interests test must be applied to the transaction as a whole and cannot be applied to each credit contract individually under the services provided by a broker. It is not uncommon to assist a consumer with a refinance of multiple products where the overall outcome places the consumer in a better position but one or more of the products that are refinanced as part of the package may be less competitive than the existing product. Establishing a credit card with a new mortgage and a new credit provider is one example of where this can happen.

6. Transition Period

6.1 The FBAA submits that there should be a lengthy transition period for the enforcement of the best interests duty. We recognise the compressed timeframes for the implementation of the legislation. As with other elements of the new requirements introduced by this bill, a no action position or a facilitative attitude by ASIC with the implementation is sought.

6.2 We advocate for a 12-month transition period during which ASIC may issue Media Releases and other guidance to explain where they have observed outcomes where they believe the best interests duty would not have been complied with. ASIC could also provide specific direction to individual licensees.

6.3 Feedback from our members indicates that a 12-month period is necessary for licensees to make changes to their systems for record production and retention and for monitoring and supervision of representatives.

6.4 ASIC has ample power under the existing provisions of the NCCP Act to address any serious misconduct.

7. Conflicted Remuneration

7.1 The conflicted remuneration provisions have raised a number of issues we wish to address including:

a. The Regulation 28VA(3)(d) carve out of conflicted remuneration and its interaction with regulation 28VB;
b. Clawbacks;
c. Applicability of conflicted provisions to aggregators.

7.2 The structure of the conflicted remuneration provisions is unclear. The definition of conflicted remuneration in section 158N of the bill is very broad and non-specific. It defines ***Conflicted remuneration*** as:

a. any benefit, whether monetary or non-monetary, that:
(i) is given to a licensee, or a representative of a licensee, who provides credit assistance to consumers; and
(ii) because of the nature of the benefit or the circumstances in which it is given, could reasonably be expected to influence the credit assistance provided to consumers

ABN: 22 094 784 040

7.3 The first point made under this heading is that the interpretation of the wording in (a)(ii) remains very broad. The phrase "because of the nature of the benefit or the circumstances in which it is given, could reasonably be expected to influence the credit assistance provided to consumers" provides little clarification to assist licensees to understand what is, and is not, conflicted remuneration.

7.4 The second concern with the drafting relates to the interaction between the bill and draft regulations.

7.5 Section 158NA of the bill says that the regulations may provide circumstances where remuneration is and is not conflicted however there is no baseline definition of what conflicted remuneration is. The drafting creates uncertainty about remuneration paid in circumstances that are not addressed in the bill or regulations.

7.6 Members report hearing multiple interpretations of the same provisions from different sources and have reached conflicting positions with respect to how the regulations apply. This indicates to us that the drafting requires further clarity.

7.7 It is our understanding that:

a. For all credit assistance providers and intermediaries, regulation 28VA(2) exempts benefits paid directly by the consumer to the licensee or rep (i.e. fee for service).

b. The remainder of Regulation 28VA appears to be intended to be limited to mortgage brokers and mortgage intermediaries as it is drafted under the subheading above regulation 28VA(3) which reads *Other mortgage broker and mortgage intermediary remuneration*.

c. If this is correct then the effect of s158N and Reg 28VA is that it bans all credit assistance provider remuneration that could be regarded to influence the credit assistance and which is not paid directly by the consumer to the credit assistance provider. There are some additional provisions that then apply to mortgage brokers and mortgage intermediaries under Reg 28VA(3).

d. For mortgage brokers and mortgage intermediaries, a benefit is not conflicted if it relates to a credit service and is not volume-based, campaign-based and meets the clawback requirements of not more than 2 years.

e. Subsection 28VA(3)(d) applies only to credit contracts that relate to the purchase or refinance of residential property[3]. These are not conflicted if they meet the drawdown provisions in subsection 4.

If any of these interpretations are not aligned with Treasury's intentions we say this highlights the needs for further consultation before the bill and regulations are finalised.

7.8 We provide a number of examples to further illustrate the point:

[3] This also being a correct interpretation, any finance arranged for residential property that is not related to the purchase or refinance of the purchase of residential property is not impacted by 28VA(3)(d). Whether all other finance related to residential property is conflicted or not will be determined solely by s158N and Reg 28VA(2), 28VA(3)(a)(b)(c) and (e).

Example 1 – Finance for renovations

Finance for the renovation of an existing property is specifically referenced under the definition of credit to which the Code applies in section 5 of the National Credit Code ("to purchase, renovate or improve residential property for investment purposes) however it is not replicated in the regulations. How is payment of commission on a loan taken out to improve residential property treated under the existing draft? Is it conflicted remuneration because of the definition of s158N? If it is conflicted by reason of s158N, then we must turn to the regulations to understand if it is exempt. Regulation 28VA(3) would appear to be the relevant provision. Benefits paid to a licensee or representative for a credit service that are not volume-based (28VA(3b), campaign-based (28VA(3c))and conform to the clawback arrangements (28VA(3)(e) are exempt from the conflicted remuneration provisions therefore a benefit paid for this activity is not conflicted remuneration. We understand 28VA(3)(d) does not apply because even though the finance is arranged in respect of residential property, it does not relate to the purchase or refinance of the purchase.

Example 2 – Change of plans causing delay in drawdown of funds

A consumer uses a broker to obtain finance in anticipation of a particular venture but then that venture falls through for reasons unrelated to the work performed by the broker. The consumer may take considerably longer than 90 days to find another purpose for the funds. Alternately settlement on the venture is delayed more than 90 days. The consumer receives the full benefit of the facility being approved and the lender receives the full benefit of the facility being established and will earn revenue from the facility when the consumer draws down against it. The only person in this scenario who is carved out of the transaction is the broker.

If the venture described above does not relate to the purchase of residential property then the 90 day drawdown would appear to be irrelevant[4].

Clearly an outcome such as this is manifestly unfair and is not an intended outcome of this reform.

Example 3 - Construction loans

Construction loans are not specifically recognised under the bill or regulations and it is unclear whether remuneration paid under a construction loan is treated as given in circumstances where *because of the nature of the benefit or the circumstances in which it is given, could reasonably be expected to influence the credit assistance provided to consumers* (s158N).

Working on the basis that a loan arranged for the construction of a residential property is intended to be covered by the new legislation (in which case we support amendments to the bill and regulations to more clearly reflect this), we have further concerns with how this interacts with s28VA(3)(d) of the regulations.

[4] Regulation 28VB only applies if the benefit is paid on a credit service provided in relation to the purchase of a residential property or the refinance of a residential property (28VB(3)(d).

There are two interpretations that can be applied to construction loans and regulation 28VA(3)(d). This regulation essentially says that a monetary benefit paid on a credit contract or refinance of a credit contract that is for the primary purpose of purchasing residential property is not conflicted remuneration where the benefit paid complies with regulation 28VB. Regulation 28VB specifies the benefit must be paid on the drawn down amount of the finance and defines the ***drawdown amount*** as "so much of the amount of credit as is used for that purpose within 90 days after the day on which the credit contract is entered into by the consumer".

On the first interpretation, a construction loan does not fall within the 28VA(3(d) definition as it is confined to credit contracts for the primary purpose of purchasing or refinancing a residential property. If this is correct then:

- The drawdown provisions do not apply; and
- We recommend the Explanatory Memorandum be amended to clarify the reach of regulation 28(3)(d).

If construction loans are caught by the regulation 28(3)(d) provision then there is an issue. Construction loans are typically funded for the entire cost of the construction. Builders invoice customers at various development milestones such as pouring of foundations, first fix, second fix, lockup and finalisation. Consumers progressively draw down against the construction loan to make payments as they fall due and these are staggered over the life of the build which can exceed 12 months.

It cannot be the intention of the legislation to limit commission payment to brokers arranging construction loans to the amount only drawn down in the first 90 days of the loan.

More broadly, as demonstrated in Example 2 above, the 90-day drawdown rule may still adversely impact brokers where settlement is delayed or where the purchase of a particular residential property might fall through and the facility is later accessed to purchase a replacement property later than 90 days from the loan settlement date. This highlights the difficulty of setting a specific timeframe against the expectations of those drafting the legislation without regard to the practical realities that brokers deal with on a daily basis which includes the fact that delays can be caused for any number of reasons outside the broker's control.

There needs to be a mechanism whereby the 90 day period is reset or the drawdown provisions are voided. The most efficient way is to remove the time limitation and permit lenders to pay commission to brokers on the full value of the loan. Alternately remove the 90 day period that applies to drawdowns. Brokers should not shoulder the blowback from delays beyond their control or a consumer changing their mind on a property after obtaining a finance facility.

We recognise that the intention behind aligning commission paid with the drawn down amount is to ensure brokers only receive remuneration on the portion of a loan that is actually utilised - presumably to ensure a broker could not seek to augment their remuneration on a loan by encouraging the consumers to obtain a facility for significantly more than they required then draw down only a portion of that amount.

As we have stated in earlier submissions, this is not a common practice engaged in by brokers and the risks of attempting this strategy substantially outweigh any potential benefit said to exist. Thus, the regulation attempts to prevent conduct that is not occurring in practice and in the course of doing so making a straightforward concept (that a broker should only be paid on the 'genuine' part of the loan they assist a consumer to obtain) very complex.

There is a marked difference between a broker encouraging a consumer to take out a facility larger than they require with no present intention to utilize the funds and the myriad of situations where consumers obtain the facility in anticipation of legitimate future activity which may occur more than 90 days from settlement.

8. Clawbacks

8.1 There are several issues that arise with respect to clawbacks.

8.2 The FBAA has long advocated for clawbacks to be abolished. We maintain that this is the most appropriate way forward. Failing that, we recommend that clawbacks be limited to less than 12 months. This would align with annual reviews for brokers that adopt a practice of regularly reviewing their clients' circumstances.

Interaction between best interests duty, annual reviews and clawbacks

8.3 We will require greater clarity around how the best interests duty interacts with annual reviews.

8.4 Paragraph 1.21 of the EM recognises the best interests duty would apply to annual reviews where it says, "*during an annual review, a broker would not suggest that the consumer remain in a credit contract without considering whether this would be in the consumer's best interests*".

8.5 Clawbacks are proposed to operate for 2 years. A broker may conduct an annual review with a client and identify that a better outcome is available to the consumer by switching away from the current product that the broker assisted the consumer into 12 months ago. The current framing of the operation of the best interests duty would be that a broker would be obligated to recommend the switch (on the basis that a recommendation to remain in the existing product is subject to the best interests test and in this scenario may fail that test). This recommendation would trigger the clawback when the broker has done nothing to bring about the circumstances whereby the current lender's product is not as competitive as another at a given point in time.

8.6 Our suggested solution to this issue is to modify Regulation 28VE to restrict the timeframe for remuneration paid under an arrangement carrying clawback provisions to be capped at 11 months.

8.7 Our understanding is that more than 85% of clawbacks occur within the first 12 months.

8.8 A further issue relating to clawbacks is the drafting of Regulation 28VC(2)(c). This regulation currently requires that the consumer must not be subject to an obligation to pay an amount as a result of an amount being required to be repaid under the repayment obligation.

8.9 Whilst not a common practice, some brokers defer charging fees for service but reserve the right to charge fees for service if the consumer does anything to trigger the clawback. We see no reason this practice should not be allowed to continue.

8.10 Consistent with other parts of this submission, we submit that the clawback provisions and best interests duty unfairly target brokers and note that lenders:

a. Do not regularly review existing clients and recognise that consumer apathy leads to high retention rates notwithstanding unfavorable changes to terms and conditions, fees and rates; and

b. Would be under no obligation to consider competitor products or consider whether telling a consumer to remain in their existing product is in their best interests or not.

9. Aggregators

9.1 Concerns have been raised that the current drafting of the regulations risks inadvertently capturing payment structures in aggregator groups as conflicted remuneration.

9.2 Certain fees are payable by licensees to be part of aggregator groups. These fees are influenced by overall volume written by a particular licensee or broker but are not influenced by where the specific deals are placed. These rewards essentially operate to recognise high volume business writing licensees and representatives by reducing their annual fees. They are potentially captured by regulation 28VC and should be excluded.

9.3 There is scope to make the drafting of the bill and regulations clearer to ensure it does not fall to aggregators and brokers to have to seek clarification through the courts as to the proper construction of the provisions.

9.4 It is our understanding that aggregator fees will not be caught by the conflicted remuneration provisions because these fees do not fall within the s158N definition of conflicted remuneration, however if there is any ambiguity around our understanding then the bill should be amended to clarify that they are exempt.

10. Mortgage Managers

10.1 A further point of clarification consistent with the concerns cited above, it is the FBAA's understanding that mortgage managers and servicers are excluded from the best interests duty and conflicted remuneration provisions.

10.2 Discussions between members has highlighted that the provisions are open to interpretation with some members believing mortgage managers are exempt and others believing the drafting of the bill is unclear and leaves the way open for mortgage managers to be swept up in the reforms.

10.3 To resolve any ambiguity we advocate for an express provision to be included in the bill identifying the status of mortgage managers as exempt from these provisions.