



Australian Banking
Association

Mortgage broker best interests duty and remuneration reforms

ABA response to Treasury consultation

8 October 2019





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Financial Services Reform Taskforce
The Treasury
Langton Crescent
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Via email: consumercredit@treasury.gov.au

Dear Ms Moore

ABA submission: Mortgage broker best interests duty and remuneration reforms

The Australian Banking Association (**ABA**) welcomes the opportunity to provide our response to Treasury's exposure draft of the National Consumer Credit Protection Amendment (Mortgage Brokers) Bill 2019 (**'the Bill'**) and the National Consumer Credit Protection Amendment (Mortgage Brokers) Regulations 2019 (**'the Regulations'**).

The ABA is committed to the implementation of the recommendations of the Royal Commission into Misconduct in the Banking and Financial Services Industry (**Royal Commission**) and welcomes the Government's progress on legislating these important reforms.

Key points

- The ABA supports the implementation of recommendation 1.2 of the Royal Commission, a best interest duty for mortgage brokers, and the Government's announced reforms to mortgage broker remuneration.
- To achieve these aims, the ABA believes that the Bill and Regulations should reflect and fully implement the best interest duty as recommended by Commissioner Hayne, including the duty applies to mortgage brokers when acting in connection with home lending.
- The Bill and Regulations should give full effect to the Government's announced reforms to mortgage broker remuneration and the new obligations should:
 - Regulate the activity of providing credit assistance in relation to credit contracts secured by mortgages over residential property
 - Exclude credit providers (or their related entities) where they are providing credit assistance in relation to their own products (or products of the brand they operate under) rather than providing broking or intermediary services
 - Apply the ban on conflicted remuneration with respect to credit assistance in relation to credit contracts secured by mortgages over residential property
 - Define the 'drawdown amount' with reference to drawdowns up to the facility limit that are drawn down for any use, other than being held in an offset account, if drawn down within 12 months
 - Allow for remuneration to be paid in relation to additional borrowings beyond the current facility limit (i.e., that involve a variation to the credit contract, but do not



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- involve writing a new credit contract or refinancing the whole loan) ('top ups') where the top up is:
- obtained after the initial draw down period, and
 - for any use, other than being held in an offset account.
- Apply to 'up front' payments relating to the initial credit contract and any 'top ups'.

Mortgage brokers play an important role in supporting competition in the home loan lending market, and the banking industry supports implementing these important reforms in a way that preserves competition and maintains customer choice. The ABA looks forward to working with the Government on the finalisation of this legislation and the implementation of these important reforms.

Please contact me on (02) 8298 0450 if you would like to discuss any aspects of this submission.

Yours sincerely

Justin Mining
Policy Director



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1. Introduction

The ABA supports the strengthening of protections for customers who deal with mortgage brokers, including:

- the introduction of a duty for mortgage brokers to act in the best interests of customers when acting in connection with home lending, in line with recommendation 1.2 of the Final Report of the Royal Commission
- reforming mortgage broker remuneration in line with the Commonwealth Government's response to recommendation 1.3 of the Royal Commission
- legislating against certain non-monetary or 'soft dollar' benefits that increase the risk of poor customer outcomes and can undermine competition.

1.1 Best interests duty

The ABA supports the introduction of a duty for mortgage brokers to act in the best interests of customers when acting in connection with home lending in line with recommendation 1.2 of the Royal Commission:

Recommendation 1.2 – Best interests duty

The law should be amended to provide that, when acting in connection with home lending, mortgage brokers must act in the best interests of the intending borrower.

The introduction of this duty is an important step towards better protecting customers who use mortgage brokers when seeking a home loan and is consistent with what customers expect from mortgage brokers.

We support the Royal Commission's recommendation that the duty be developed on the following basis:

- the duty applies when a mortgage broker is "acting in connection with home lending"
- the content of the duty is best expressed "as a broad statement of principle"
- "it is not an obligation that should affect the practices of lenders" nor should it "apply to aggregators, who have no direct relationship with the borrower", and
- the duty should be enforceable and enforceable by civil penalty.¹

1.2 Reforms to mortgage broker remuneration

The ABA supports reforms on remuneration structures in the mortgage broking industry aimed at removing financial incentives that may encourage customers to borrow more than they need or for brokers to direct loans to a particular lender.

The ABA supports the policy adopted by the Government in its response to the Royal Commission released in February 2019² and the subsequent announcement by the Treasurer in March 2019.³ It committed to a number of measures to be in force from 1 July 2020, including:

- requiring the value of upfront commissions be linked to the amount drawn down by borrowers and not the loan amount

¹ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report: Volume One, 1 February 2019, pages 72 – 73 available at: <https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf>

² The Australian Government the Treasury, 'Restoring trust in Australia's financial system: the Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry', February 2019 at p 7 available at: <http://treasury.gov.au/sites/default/files/2019-03/FSRC-Government-Response-1.pdf> (FSRC Response)

³ Treasurer, the Hon Josh Frydenberg MP, 'Media Release: Review of mortgage broking trail commissions', 12 March 2019, available at: <http://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/040-2019>



- banning campaign and volume-based commissions and payments
- limiting the period over which commissions can be clawed back from aggregators and brokers to two years, and
- prohibiting the cost of clawbacks being passed on to consumers, and
- a review by Council of Financial Regulators (COFR) and the Australian Competition and Consumer Commission (ACCC) of the impact of the above changes, and remuneration structures for mortgage brokers, including upfront and trail commissions.

We note that in developing its policy, the Government had regard to the commitments implemented by members of the Combined Industry Forum (CIF), which includes ABA members, to ban volume based and campaign based payments and adopt the principle that “to the extent that remuneration relates to loan size, remuneration should relate to the funds drawn down and utilised by a customer”.

In June 2019, the ABA Council formally agreed to accept the Government’s announced policy on mortgage broker remuneration from 1 July 2020 and to fully participate in the COFR and ACCC review in three years’ time. Therefore, we submit that the drafting of the mortgage broking legislation should be in line with the Government’s announced policy.

1.3 Non-monetary benefits

The ABA also supports measures in the proposed legislation that limit certain non-monetary or ‘soft dollar’ benefits that increase the risk of poor customer outcomes and can undermine competition, including:

- limiting infrequent benefits, such as entertainment and hospitality, to less than \$300 for each credit licensee or representative and identical or similar benefits are not given on a frequent or regular basis, and
- limiting education or training benefits to those with a genuine purpose, activities that take up 75% of the course time or 6 hours per day and where the participant’s employer or licensee is paying for the participant’s travel, accommodation and cost of attending any events or functions (such as dinners).

We note that the Government’s decision to legislate these limitations takes into account the work done by members of the CIF to move most of the industry away from these ‘soft dollar’ benefits.

2. Aspects of the Bill

2.1 Regulation of activity not participant

The introduction of the best interest duty for mortgage brokers and reforms to mortgage broker remuneration are intended to apply in relation to home lending. Recommendation 1.2 of the Royal Commission states that the duty should apply in connection with home lending. The Government announced its policy on reforms to mortgage broker remuneration in the context of the home lending market.

To ensure that these aims are fully achieved, the ABA proposes that the new obligations (both best interests duty and remuneration reforms) apply to the provision of credit assistance in relation to credit contracts secured by mortgages over residential property.

Drafting the obligations in this way will ensure that all credit assistance in relation to credit contracts secured by mortgages over residential property is captured, and the application of the obligations is not based on whether the provider meets the threshold of ‘carrying on a business of providing credit assistance in relation to credit contracts secured by mortgages over residential property’.

The ABA further submits that the Bill’s current intention of excluding credit providers (or their related entities) where they are providing credit assistance in relation to their own products (or products of the



brand they operate under) should be maintained. In particular, the legislation should not inadvertently impose the best interest duty obligation on franchisee and other similar models where they are distributing their own branded loans.

ABA proposal: That the Bill and Regulations are drafted to ensure the new obligations apply to the activity of providing credit assistance in relation to credit contracts secured by mortgages over residential property. Consistent with the stated intent of the Bill (see paragraph 1.16 of the Explanatory Memorandum) the new obligations should not apply to credit providers (or their related entities) where they are providing credit assistance in relation to their own products (or products of the brand they operate under) rather than providing broking or intermediary services.

2.2 Scope of ‘conflicted remuneration’

The ABA supports the Government’s policy of reforming mortgage broker remuneration. To align the drafting of the Bill with the Government’s policy we propose the ban on conflicted apply with reference to credit assistance in relation to credit contracts secured by mortgages over residential property.

Scoping the Bill in this way will ensure that the reforms apply to payments made to all brokers providing credit assistance in relation to credit contracts secured by mortgages over residential property and does not rely on the recipient meeting the activity threshold currently proposed in the Bill.

ABA proposal: That the definition of conflicted remuneration is drafted with reference to credit assistance in relation to credit contracts secured by mortgages over residential property.

2.3 Definition of drawdown amount

The ABA supports the Government’s policy commitment to require the value of upfront commissions be linked to the amount drawn down by borrowers and not the loan amount.⁴ This commitment will help to address the risk of brokers being paid on facility limits or the financial incentive of recommending larger loans with high offset balances.

To achieve this objective, the definition of ‘drawdown amount’ should enable upfront payments to brokers based on the funds drawn down and utilised by a customer for any use, other than being held in an offset account, within a 12 month period.

Drafting the legislation in this way will reflect the way that customers use borrowed amounts, often with subsequent drawdowns up to the facility limit over a number of months and for purposes beyond the purchase or refinance of residential property.

ABA proposal: That the legislation be drafted to limit the payment of commissions to brokers based on funds drawn down and utilised by a customer and to allow payment of commissions on funds drawn down for any purpose other than being held in an offset account, if drawn down within 12 months.

2.4 Remuneration relating to additional borrowings

The ABA proposes that the legislation be drafted to allow brokers to be paid upfront commissions for loan ‘top ups’ under the existing credit contract (i.e., that involve a variation to the credit contract, but do not involve writing a new credit contract or refinancing the whole loan). Consistent with the proposed approach for the ‘draw down amount’, remuneration for additional borrowings should be permitted where the funds are used for any purpose other than being held in an offset account.

ABA proposal: That the legislation be drafted to allow upfront commissions to be paid for loan “top ups” under an existing credit contract.

⁴ FSRC Response.



2.5 Application to ‘upfront’ remuneration

The Government’s announced policy relates to the value of upfront commissions being linked to the amount drawn and utilised by the customer. Consistent with this policy the new obligations and reforms to mortgage broker remuneration should apply to upfront commission.

The ABA supports the review in three years’ time by Council of Financial Regulators (COFR) and the Australian Competition and Consumer Commission (ACCC) of the impact of the above changes, and remuneration structures for mortgage brokers, including upfront and trail commissions.

3. Other aspects

3.1 Timing of drawdowns

The ABA supports upfront commissions being calculated on the amount drawn down from the date of the initial draw down of the loan (i.e., settlement, not the contract date). This should also be the date for the commencement of the relevant clawback period.

This will align the legislation with the current and predominant industry practice.

3.2 Non-monetary benefits – ‘tiered servicing’

The ABA notes that credit providers often have arrangements in place with mortgage brokers to provide certain non-monetary benefits, such as providing preferential service (e.g., faster turnaround times for loan approvals and settlements). In the past, these models have potentially raised the perception of a conflict of interest from models that have been linked to broker remuneration and could be seen as potentially influencing a broker recommendation on a loan product.

However, much of the industry involved in the CIF has already moved towards models that recognise the importance of placing customers’ interests first with lenders providing preferential service level offerings to brokers based primarily on the quality of their loan submissions. This can assist customers in achieving better outcomes through:

- faster turnaround times for loan approvals and settlements
- direct access to loan assessors
- access to upfront valuations.

In addition, brokers are required to disclose their access to a tiered service model to a customer when recommending a product from that lender and aggregators monitor broker compliance with the disclosure requirement.

The ABA believes there is a risk that these tiered service models could be deemed “conflicted remuneration” and prohibited under the proposed legislation. Given that much of industry has already addressed the conflict issues through the work of the CIF and the fact that brokers will also now be subject to a best interests duty, we submit that it would be a poor outcome if consumers lost the benefits that these models can deliver.

4. Best interests duty

The Bill establishes that once a person is deemed a mortgage broker or intermediary, the best interests duty covers them in relation to all credit contracts (e.g., personal loans, car finance and credit cards).

This is beyond the scope of the duty proposed in recommendation 1.2 of the final report of the Royal Commission, which stipulated that it should apply when a mortgage broker is “acting in connection with home lending”.



The ABA submits that consistent with section 2.4 above, the Bill should be drafted so that a duty only applies to any credit assistance provided by a mortgage broker on a loan secured by a mortgage on residential property. The current effect of the Bill not including credit providers should be maintained.

5. Current Treasury proposal

The ABA provides feedback below on the current drafting of the legislation in the event that the Government does not accept our proposed changes as outlined above.

5.1 Transition for pre-1 July 2020 contracts

The current draft legislation applies to both upfront and trail commissions. As noted at section 2.5 above, the ABA submits that the obligations should only apply to upfront remuneration and that this is consistent with the announced policy of the Government.

Impact on trail

In the event that the obligations apply to trail, the payment of trail commissions will only be permitted where the credit contracts relate to the provision of credit wholly or predominantly for the purpose of purchasing residential property or refinancing credit wholly or predominantly for that purpose, provided that the commission is a fixed fee or the calculation meets the drawdown requirements (e.g., it is calculated as a percentage on an amount not exceeding the portion used within 90 days of customer contract entry for purchasing residential property or refinancing such credit).

The legislation is proposed to take effect on 1 July 2020 and will apply to benefits given or paid after that date regardless of whether the arrangements were in place prior to then. As a result, the legislation has retrospective application to trail.

Trail commissions are currently paid on the loan balance, which may be more than the amount drawn down in the first 90 days of the loan for the purpose of purchasing the property (due to progressive draw downs, loan variations and/or top-ups). Accordingly, unless the legislation has a different drawdown definition for existing trail, these commissions will need to be adjusted particularly where they provide for benefits greater than that permitted by the Bill.

Retrospectivity

The retrospective impact on trail presents a significant challenge for credit providers given the difficulty of identifying the amount and purpose of funds drawn down in the first 90 days for old loans (which will be the maximum amount on which trail can be paid). Lenders may no longer hold information about the purpose for which individual parts of the loan proceeds on their back book were used, or it may not be easily accessed by the broker payment systems. In these cases, it will either be impossible or very difficult to calculate commission as percentage of the draw down amount for loans in existence as at 1 July 2020. Where it is possible, it is likely to be a complex manual process and involve the review of millions of broker-arranged loans which are currently held in our member bank's Australian mortgage portfolios.

Further, it would be very difficult for lenders to attribute any repayments that have been made in the past, or interest charged on a loan, between 'trailable' portions (e.g., relating to draw down within first 90 days for a permitted purpose) and 'non-trailable' portions of the loan balance and to calculate which part of the trail commission should cease.

Due to the potential significant impact on the industry and complexity of implementation, we believe how the legislation applies to existing trail needs to be reconsidered. Consistent with the Treasurer's announcement of 12 March 2019, we would suggest that the trail commissions on loans established before 1 July 2020 be permitted to continue to be paid under existing arrangements, with the review of mortgage broker remuneration by the Council of Financial Regulators in 2022 to review the operation of trail commissions, including whether any action is required to bring past trail commission into line with the current regime.



We believe this can be dealt with by adding a regulation to the effect that, for monetary benefits given in respect of credit contracts secured by residential property settled prior to 1 July 2020, regulation 28VB is modified so that the draw down amount is the amount outstanding under the credit contract.

Customer impact

The ABA does not believe this approach is inconsistent with good customer outcomes for a number of reasons, including:

- the loans for which they relate are already on foot
- the commissions are not paid by the customer and were factored into the original price of the loan
- there is not a strong incentive for brokers to seek to keep customers in existing contracts but rather they are likely to assist customers to find a better loan in order to earn a new upfront commission.

5.2 Scope and definition of ‘mortgage broker’ and ‘mortgage intermediary’

The ABA’s observations on the operation of s15B and 15C would be addressed by adopting the approach of regulating the activity rather than the participant as outlined at 2.1 above. If the Government retains the current approach of regulating participants (based on an activity test) the Bill should apply to all participants (who are not credit providers such as banks, mutuals, alternative lenders etc) that provide credit assistance in relation to a mortgage secured by residential property, not just those participants that meet the threshold of carrying on a business of providing such credit assistance.

Any changes to the drafting should not affect the intention of the Bill (noted at paragraph 1.16 of the Explanatory Memorandum) that the regime not extend to credit providers (or their related entities) where they are providing credit assistance in relation to their own products (or products of the brand they operate under) rather than providing broking or intermediary services.

5.3 Definition of drawdown amount

Under the conflicted remuneration, the limitation on commissions linked to drawdown amounts applies "for a credit contract that relates to:

- the provision of credit wholly or predominantly for the purpose of purchasing residential property;*
- the provision of credit wholly or predominantly for the purpose of refinancing credit that was provided wholly or predominantly for that purpose."*

This drafting raises two significant issues that may lead to poor customer outcomes:

- limiting payment of commissions to credit for the purpose of purchase or refinancing of residential property, and
- operation of ‘relates to’ and impact on payment of commissions on subsequent credit contracts secured by the same residential property.

Purpose

The ABA submits that the definition of “drawdown amount” in Regulation 28VB should be expanded to incorporate a wider range of purposes than is currently proposed for the payment of commissions to brokers. This should at least cover funds drawn down for construction and renovation purposes.

Limiting the purpose to the purchase or refinancing of residential property may make it more difficult for customers to access products that seek to simplify the lending process by including the purchase of the property and construction or renovation funds. It may also incentivise brokers to propose multiple loans for a customer.



Further, as long as the purpose test remains, it should apply in the context of the loan as a whole and not against each individual drawdown (i.e., drawdown of a small amount on a large loan).

‘Relates to...’

Regulation 28VA(3)(d) stipulates that the limitation on commissions applies to a credit contract that ‘relates to’ the provision of credit wholly or predominantly for the purpose or purchasing or refinancing of a residential property.

The fact the words "that relates to" have been used (rather than words such as "under which credit is provided wholly or predominantly for the purpose of....") suggests that the ambit is intended to be wider than just the contract to purchase residential property and it would also apply to contracts for other purposes. For example, if a debtor obtained credit service in relation to two credit contracts at the same time, one to purchase residential property and the other to fund renovations to that property or construct a new house on the property, it is likely both contracts "relate to" the provision of credit for the purpose to purchase the residential property.

The impact of this would be that a broker could earn commission for the loan to purchase the residential property but not for another loan arranged at the same time. However, if a mortgage broker provided the credit assistance in relation to a single loan (and only that loan) the sole purpose of which is, for example, to renovate a property (e.g. put in a pool or renovate a kitchen), construct a home or purchase a car or holiday, and that was documented as a stand-alone credit contract, then that loan would likely not be subject to the limitation on commission linked to drawdown. We believe this could lead to poor customer outcomes where they may be encouraged to take out multiple loans over a period to achieve the same outcome.

5.4 Scope of best interests duty (credit products)

As noted in section 4 above, the Bill establishes that once a person is deemed a mortgage broker or intermediary, the best interests duty applies in relation to all credit contracts (e.g., personal loans, car finance and credit cards).

This is confirmed in relation to the duty by paragraph 1.19 of the Explanatory Memorandum, which stipulates that:

- the duty applies in relation to credit assistance provided by mortgage brokers in relation to any credit contract, and
- it ensures that mortgage brokers dealing with consumers in relation to mortgages must comply with duty not only in relation to the mortgage, but also in relation to any other credit contract for which they provide credit assistance (e.g., credit cards and personal loans that are packaged with the mortgage as well as unsecured credit for home renovations).

The ABA submits that the Bill should be drafted so that the duty explicitly only applies to any credit assistance provided by a mortgage broker on a loan secured by a mortgage on residential property. However, if this change is not made, we submit that a broker should only be required to consider other types of credit products within the context of the duty as part of the package related to the mortgage. It would be extremely difficult for a broker to be able to satisfy the duty for a product that is often packaged with a mortgage, such as a credit card, on an individual basis.



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About the ABA

With the active participation of 23 member banks in Australia, the Australian Bankers' Association provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services.

The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.