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Manager

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The Treasury

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To whom it may concern

**Mortgage broker best interests duty and remuneration reforms**

This is a submission in response to the Exposure Draft of the National Consumer Credit Protection Amendment (Mortgage Brokers) Bill 2019 (the **Draft** **Bill**) and Exposure Draft of the National Consumer Credit Protection Amendment (Mortgage Brokers) Regulations 2019 (the **Draft Regulations**). Connective welcomes the opportunity to comment on this proposed legislation which will have a material impact on the operations of mortgage brokers.

1. **About Connective**

Connective is Australia’s leading home loan aggregator with approximately 3,600 individual mortgage brokers holding Connective membership. This represents approximately 20% of all home loan mortgage brokers in Australia and 1 in 8 home loans being written by a Connective mortgage broker. Membership with Connective provides mortgage brokers with access to approximately 60 lenders Connective has on its panel.

Connective sits in a unique position where we see the daily efforts mortgage brokers take towards providing a valuable service to their customers and achieving good consumer outcomes for these customers, whilst remaining compliant with applicable laws and regulations. The majority of our member brokers are small businesses primarily relying on word of mouth and referrals in order to attract business and remain commercially viable. Considering approximately 56.8% of all home loans in Australia have been arranged through a mortgage broker (based on December 2018 quarter data), it is evident that Australian consumers do value the service mortgage brokers provide and that this service continues to deliver good outcomes for these consumers.

1. **Summary**

Connective is generally supportive of the introduction of a requirement for brokers act in the best interests of customers with regards to residential lending. Many of the concepts introduced by the Draft Bill and Draft Regulations have already been implemented through the Combined Industry Forum (**CIF**), a group established by the mortgage broking industry to drive better customer outcomes through improved governance and remuneration practices in mortgage broking in response to the ASIC Broker Remuneration Review REP 516.

However, it is critical from our perspective that any changes introduced do not adversely impact the benefits mortgage brokers provide consumers. Any changes need to be fair and achievable, and not create negative consequences which either create new conflicts for brokers or hurt the commercial viability of brokers, which in turn detracts from the competition benefits brokers bring to all home loan consumers regardless of whether they go direct to lender or through a broker. In this submission, we will set out areas where further clarification or thought is required in order to avoid creating an unfair or adverse consequence.

1. **Application of new legislation**

As drafted, the operative provisions around best interests duty and conflicted remuneration within the Draft Bill apply to mortgage brokers, which is defined in the Draft Bill to include a licensee or credit representative that “*carries on a business of providing credit assistance in relation to credit contracts secured by mortgages over residential property*”. We disagree with this drafting approach as it fails to capture the true circumstances in which this new legislation should be applied and could exclude the application of a Best Interests Duty applying to some customers when they use a broker to arrange their home loan.

Firstly, what is the threshold for “carries on business”? Although there is a lot of jurisprudence around what this phrase means, this concept introduces uncertainty into the industry around the application of the new provisions. For example, why should a finance broker whose primary business is to arrange commercial equipment finance but decides to assist a customer with their home loan not be subject to the requirements as a mortgage broker who solely arranges home loans? Conversely, for a mortgage broker that arranges a stand-alone consumer car loan secured by a motor vehicle as part of diversifying that broker’s business, why would that mortgage broker be subject to a higher standard when arranging that car loan as compared to a finance broker whose primary business is arranging regulated car loans and does not meet the proposed definition of “mortgage broker”?

Our understanding of the intent of the proposed legislation was to specifically capture residential lending and exclude general finance brokers from the scope of these new provisions. Otherwise, why single out “mortgage brokers” from other finance brokers? Both operate in areas regulated by the National Consumer Credit Protection Act (Cth) 2009 (**NCCPA**).

We strongly recommend the legislation (i.e. application of best interests duty and prohibition on conflicted remuneration) be revised so as to be applicable to circumstances where there is Credit Assistance provided in relation to credit contracts secured by mortgages over residential property for regulated lending purposes, i.e. not for business related purposes and/or to a corporation. The aim is to capture a certain function/service, not the activities of individual that falls within a definition. This interpretation is aligned with Recommendation 1.2 of the Royal Commission’s final report[[1]](#footnote-1) which states that “*when acting in connection with home lending, mortgage brokers must act in the best interests of the intending borrower*”. Our suggested approach removes any uncertainty as to who falls within the scope of these new provisions, whilst ensuring a level playing field amongst all participants in the home lending space.

An alternative approach which would achieve a similar result could be to amend the new section 15B by inserting a new sub-paragraph (3) which states “*The provisions this Act applicable to a* ***mortgage broker*** *will only apply where that licensee or credit representative of a licensee is acting in connection with home lending*”. A similar amendment would be required in section 15C with regards to ***mortgage intermediaries***.

As a minimum, all consumer credit contracts are subject to the NCCPA, including the responsible lending provisions and other protections – the question is when the new best interests duty and conflicted remuneration provisions should also apply. Currently, the Draft Bill goes beyond what was recommended by the Royal Commission due to how the legislation is drafted.

1. **What constitutes “best interests”**

Connective supports the introduction of a best interests duty as we believe the greater majority of brokers act in a manner consistent with the intent of this duty. Although we understand the Government’s approach in choosing a “principle-based standard” to avoid a box ticking approach to compliance which does not necessarily deliver the consumer outcomes sought, some certainty or guidance will be required to allow mortgage brokers to operate in a safe environment, confident they are in compliance of the law.

Certain observations from our perspective which Treasury and ASIC need to take into account include:

* 1. **“Best” does not always mean cheapest price**. Each customer’s circumstances are unique, and many factors need to be taken into account when determining whether a loan is “not unsuitable” for a customer. A loan with a low headline interest rate may not actually deliver what the customer wants. Nor could it be the cheapest over time. Other factors that may be relevant to what is “best” include but are not limited to:
		1. convenience (certain lenders may have platforms, offerings the customer wants);
		2. turnaround time in processing the loan application
		3. lender credit policy and whether the customer can obtain the level of debt they require (and can afford)
		4. product features and other incentives
		5. ability to early exist
		6. financial stability/identity of lender; and
		7. set-up and exist costs.

Provided a mortgage broker can demonstrate they understand their customer’s requirements and objectives and that the credit product suggested meets those requirements and objectives, this should satisfy the best interests duty provided there was not another alternative product available to that mortgage broker which objectively could be seen as obviously superior to the one recommended in light of that customer’s needs.

* 1. **No benefit of hindsight**. Only disclosed facts and circumstances as at the time of providing credit assistance can be considered when determining compliance with the best interests duty. We believe that it is reasonable for a mortgage broker to at least ask their customer whether they foresee any material changes in the future to their current circumstances. A mortgage broker cannot be judged on facts they were not aware of, or future events that were not foreseeable.
	2. **No obligation to conduct further reviews**. We note the exposure draft to the Draft Bill used an example regarding a broker conducting an annual review. Although we would expect mortgage brokers, as part of their business operations, to periodically check in on their customers, this should not be an express obligation by law. Different customers have different circumstances and expectations and the Government should not be excessively prescriptive on this topic.
	3. **Only when credit assistance is provided**. The Draft Bill will impose additional obligations on mortgage brokers – an industry that is already seeing the cost of compliance substantially increase over the past few years. When providing services to their customers, it is critical to ensure that these new provisions only apply when the mortgage broker is actually providing credit assistance to their customer. Examples which we believe should not be caught by the new rules include a broker calling a customer’s existing lender seeking a reduction to that customer’s interest rate and a customer having a high level chat about their current situation (i.e. a loan that broker has placed that customer in) and surveying the current landscape as to whether it is worth exploring a different strategy or switching to another lender. If a broker is required to meet a best interests duty in these and other similar circumstances, the new provisions may dissuade a broker from engaging in services which are highly valuable to their customers as they will feel obliged to conduct a full process which they are highly likely not to be remunerated for before making such recommendations/providing such assistance. Additionally, home loan customers may shy away from mortgage brokers to have these high-level discussions due to the process a mortgage broker must undertake and the time it will take to meet their obligations.
	4. **Product access**. Brokers can only recommend products which they have access to, i.e. lenders who are on their aggregator’s lender panel and to which that broker is accredited with. As part of Connective’s implementation of CIF’s initiatives, our mortgage brokers are obliged to disclose in the Credit Guide they provide their customers the lenders on Connective’s panel, the lenders to which they are accredited with, the top 6 lenders they used in the past financial year and the % flows that went to those top 6 lenders. Mortgage brokers cannot be expected to recommend a product they do not have access to by virtue of not being accredited to that lender or not having access to that lender due to their aggregator – factors that need to be considered when determining compliance to a best interests duty.
	5. **Reasonable comparison**. Following on from the above point, any requirement on a mortgage broker to compare various products to meet a best interests duty needs to be reasonable and recognize that it is impossible for a mortgage broker to be fully across every product offered by the lenders on their aggregator’s panel. Any such comparison needs to be considered based on the facts as at the time of application. For example, interest rates and product features can change from time of application and settlement.

As already stated, we contend that our mortgage brokers already meet a standard that satisfies the best interests duty contemplated by the Draft Bill. It is critical that Treasury and ASIC provide further regulatory guidance in the future as to what compliance with these new provisions looks like. In providing this guidance, Treasury and ASIC must consult extensively with the mortgage broking industry to ensure they fully appreciate and understand exactly what mortgage brokers do, as well as what the experience is for a consumer that goes directly to a lender.

1. **Best Interests Duty – application to mortgage aggregators**

Currently, approximately 1,600 of Connective’s mortgage brokers operate as credit representatives under Connective’s Australian Credit License. The Draft Bill provides that “*the licensee must take reasonable steps to ensure that the credit representative complies*” with the Best Interests Duty. This potentially imposes a significant and unworkable new obligation on mortgage aggregators like Connective as we cannot practically monitor all loans written by those credit representatives.

Currently, in addition to continual training and coaching support, Connective’s compliance department reviews a sample of loan files for each credit representative in detail at least annually. Depending on how those files score will determine the timing and number of that broker’s files we review in their next audit. In addition, our brokers are subject to other supervisory and monitoring activities. These have been described in detail to ASIC in response to their study into loan application fraud in 2018. Connective is happy to share this submission with Treasury upon request.

We seek urgent guidance and clarification from Treasury/ASIC as to what their expectations are as to what “reasonable steps” looks like. Our strong preference is that our existing compliance frameworks are sufficient to meet this requirement. If insufficient, Connective would need to assess the cost of developing new, potentially duplicative, systems and processes to meet these standards – that standards that may not be commercially viable and to possible force Connective and other mortgage aggregators to structurally change their business model towards licensees as opposed to credit representatives.

As a side note, it is important for the government to clarify that compliance with any such obligations on the mortgage aggregator will not create the relationship of employer and employee between the aggregator and the mortgage broker, nor does it suggest that mortgage brokers are conducting the business of the aggregator in order to ensure there are no additional unintended consequences.

1. **Conflict between Best Interests Duty and current clawback structure**

Currently, most lender clawback arrangements are structured to clawback 100% of a broker’s upfront commission if the loan is refinanced in year 1 and 50% in year 2 (as well as in other circumstances). Clawbacks where a loan has been repaid or refinanced early were primarily introduced by lenders for commercial reasons as a way to recoup the costs of entering into the relevant credit contract with that customer. Clawbacks have nothing to do with delivering better customer outcomes.

As an observation, it is highly likely that any post settlement periodic review by a mortgage broker will find there is a better loan (by value or rate) somewhere in the market, especially in a downward or stable interest rate environment. It is critical that the best interests duty include some materiality threshold to prevent a mortgage broker being obliged, in order to comply with this duty, to churn their customer into a different credit product for nominal customer gain (even before taking into account the time and effort required to complete the process and switch lenders).

Separately, where a broker is forced to refinance the consumer within 12 months by operation of the new provisions, that broker will usually suffer a clawback of 100% of upfront commissions earned – remuneration that broker has fairly earned for time expended on that customer’s loan. A broker will be penalized when moving a customer to another loan if the result is to suffer a substantial clawback – a conflict created by the introduction of a best interests duty without corresponding changes to the clawback regime.

In addition to an introduction of a materiality threshold, we would suggest that Treasury needs to introduce some equality into the clawback regime. An option would be to legislate the clawback percentage step down in a more linear manner over the clawback period. Ideally, this step down would be calculated daily (or monthly if not possible) from 100 to zero per cent over the applicable clawback period. Mortgage brokers already consider the current “all or nothing” approach as inequitable and results in an unfair allocation of financial risk from lenders onto brokers. The introduction of a best interests duty may only further exacerbate that sense of inequality. Ultimately, further inequality in how clawbacks and upfront commissions are treated only results in legislation enriching lenders at mortgage brokers’ expense.

1. **Best interests duty - failure to undertake certain activities**

The explanatory materials for the Draft Bill state that a best interests duty requires brokers refrain from making recommendations about a loan if they have not obtained critical information from a customer and there is a consequent risk that the loan will not be in the customer’s interest as a result. As a minimum, Treasury/ASIC needs to provide further guidance around this, including what reasonable steps a broker should take to obtain such “critical information”, what is the meaning of “critical information” and what a broker should do if a customer intentionally withholds information or knowingly provides false information.

1. **Conflicted Remuneration**

The other key element of the Draft Bill as further described in the Draft Regulations is around the prohibition on the payment and receipt of “conflicted remuneration”. In general, Connective is supportive of the need to reduce the potential for conflicts of interest within the mortgage broking industry. However, there are a number of concerns we wish to raise with the proposals.

* 1. **Application of conflicted remuneration provisions**

As a continuation of the point made above in paragraph 3, these new provisions should only apply to the defined activity as opposed to trying to capture a certain class of persons, regardless of what NCCPA regulated activity they engage in. In particular, the conflicted remuneration provisions should only apply to all activity which is related to Credit Assistance provided in relation to credit contracts secured by mortgages over residential property for regulated lending purposes.

* 1. **Inability to pass clawbacks onto customer**

Clause 28VE(2)(c) of the Draft Regulations prevents a mortgage broker passing on the costs of a clawback to their customer. Clawbacks are to the broker’s detriment and, in most cases, benefit the lender financially as they are imposed by lenders on brokers for commercial purposes as a cost recovery exercise. Clawbacks can also indirectly act as a hurdle for a broker to switch their customer into a different loan. Accordingly, how clawbacks are structured needs to be considered further in order to ensure all parties are treated equitably. These suggestions are set out above in paragraph 6.

* 1. **Net of redraw and offset**

The Draft Regulations state that for upfront commissions to be considered as not “conflicted”, these must be based on the drawn amount of the loan net of offset within 90 days of entering into the credit contract. Many of these new provisions have already been introduced to the industry via the CIF reforms. These include a ban on volume based and campaign benefits and limits on soft dollar benefits with a heightened focus on delivering education and training to the industry. Unfortunately, the construct of the Draft Regulations goes beyond this and accordingly, create a number of issues from Connective’s perspective:

* + 1. **When does the 90 days commence?** The Draft Regulations reference 90 days of “entering into the credit contract” – is this the date the credit contract is signed? Date of settlement/first drawdown occurs? Connective strongly supports date of settlement/first drawdown for the purposes of the new legislation.
		2. **Is 90 days sufficient?** We strongly disagree with the 90 day period for calculation of upfront commissions and do not understand the rationale for how this period was determined. The purpose of the Draft Regulations is to drive good consumer outcomes and remove conflicts. Limiting the period in which draw down needs to occur in which to determine upfront commission will lead to a further reduction of already declining mortgage broker income (even before taking into account the increasing cost of compliance) as well as introducing new conflicts in how a broker provides credit assistance.

We recommend this period be aligned with the clawback period of 2 years. Alternatively, can a “top up” concept be introduced where a broker is paid top up commissions as and when a customer draws down further under their loan? Regardless, 90 days, regardless of point in time when the clock starts, is insufficient and unfair for mortgage brokers.

* + 1. **Only the lenders benefit.** Our data indicates that in the last 12 months, clawbacks occurred on 6% of the number of loans settled by Connective brokers, with the actual amount of clawbacks representing about 10% of the amount of commissions received. In addition, our data indicates that the impact of the new CIF requirements that commissions only be paid on the drawn amount net of offset has led to an overall reduction of total upfront commissions paid by lenders to mortgage brokers. Currently, there is no prescribed period by which upfront commissions are to be calculated (i.e. it could be, and usually is, longer than 90 days). It is important to note that none of the savings from this has been passed back to the customer, with the lender primarily benefitting. Would a lender pass on upfront commission savings where a consumer draws down after day 90 of their loan (i.e. drawn amounts which that lender is not obliged to pay the mortgage broker upfront commission on)? This is why we are confused as to the one-sidedness of the Draft Regulations. From our perspective, what would be effective in removing conflicts whilst maintaining an equitable balance is (i) upfronts should continue to be paid as and when draw downs occur (provided they are for the purpose contemplated under the loan) and (ii) applicable clawback % to amortize over clawback period.
		2. **Some loans are not fully drawn within first 90 days.** These include construction loans, lines of credit and loans arranged to finance a large renovation on an existing, family home. In each of these circumstances, the mortgage broker has assisted in obtaining a loan which meets the customer’s goals and requirements. Why should the broker not be fairly remunerated for these efforts just because draw downs do not occur within the first 90 days?
		3. **Trail commissions calculated off “drawdown amount”**. In order for trail commission to be not classified as “conflicted remuneration”, the Draft Regulations require they be calculated on the drawdown amount, which as per clause 28VB, is based on the amount drawn after 90 days on which the credit contract is entered. This is manifestly unfair to a mortgage broker who has complied with its best interests duty and recommended a product which meets the unique needs of their customer. If the genuine requirements of that customer are to draw down amounts after the conclusion of that 90 day period, why should a mortgage broker be prohibited from receiving (and a lender from paying) trail commission on the entire drawn amount.

Again, would such savings be passed on to the consumer or are these rules inadvertently enriching the lender at the broker’s expense? Trail commissions must be paid on whatever the outstanding principal amount of the loan is.

* 1. **Non-monetary benefits**

Connective is generally supportive of the non-monetary benefit provisions set out in the Draft Regulations as they primarily align with initiatives already introduced by the CIF. However, as a mortgage aggregator, we have concerns around the application of these provisions to certain aspects of our operations. These include:

* + 1. Cap of $300 should only apply to lender derived benefits. This cap is designed to remove lender-choice conflicts and therefore should only apply to lenders. We cannot see how extension of this cap to aggregators, other intermediaries and licensees would have similar issues especially as these parties would already be subject to a best interests duty.
		2. Clause 28VF(4)(b) states that in relation to education or training benefits, the participant or the participant’s employer or licensee must pay for the associated costs. This does not work for a mortgage aggregator such as Connective, who has approximately 1,600 credit representatives and 2,000 licensees. We would expect all our brokers have access to various education and training events and functions we run, regardless of whether they operate under our license or another party’s license. Given the importance of continued education and training in the industry and that brokers rely on their aggregator to provide a lot of this through its professional development curriculum, we request Treasury make the necessary amendments to accommodate for this and recognize how mortgage aggregators operate.
		3. Tiered servicing. We note that the Draft Regulations are silent around “tiered servicing”. Following CIF’s reforms, lender tiered servicing models enable lenders provide certain brokers with faster application turnaround times and other benefits which accrue directly to the customer. Eligibility must be assessed on the basis of a balanced scorecard, with volume set at least than 30% of total eligibility. It is critical that “tiered servicing” not fall within the conflicted remuneration prohibition as this would take away a valuable service a high performing broker (from a balanced scorecard perspective) can offer their customers to that customer’s benefit.
1. **Closing**

Connective is supportive of the introduction of a best interests duty in connection with the provision of credit assistance for regulated loans secured by a residential mortgage. Through our efforts within the CIF, Connective has also supported the removal of certain types of conflicted remuneration in this same space.

As set out in this submission, there are potentially significant issues which arise from the drafting of the Draft Bill and Draft Regulations. These issues may potentially have a significant negative impact on the economics of the industry and how it operates. We do not believe this was ever the intention of the legislation and it is critical that the drafting be re-considered to ensure its scope does not extend beyond the original intention of this proposed legislation.

There are also areas where further regulatory guidance will be necessary to ensure the smooth implementation of the proposed legislation. It would be harmful to every consumer seeking regulated credit secured by residential property if the proposed legislation results in mortgage brokers being severely hampered or even paralyzed to provide services to their customers due to fears of potential, unintended liability from the operation of this new legislation. It is absolutely critical that industry be actively involved in the development of any such regulatory guidance to ensure such unintended consequences do not arise.

Connective extends its thanks to Treasury for the opportunity to provide this submission. We are keen to remain involved in the development of this legislation and any associated regulatory guidance. Connective is also happy to make ourselves available to discuss the contents of this submission further with government and regulators.

Yours faithfully

**Connective Credit Services Pty Ltd**

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1. Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Inudstry, Final Report dated 1 February 2019. [↑](#footnote-ref-1)