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3 February 2017

Mr Stephen Sedgwick AO
ABA Retail Banking Remuneration Review

For public release

By email: submissions@retailbankingremunerationreview.com.au

Dear Mr Sedgwick,

ABA sponsored review of commissions and payments in retail banking

Australian Finance Group Ltd (**AFG**) was established in 1994 as an aggregator, providing brokers with access to a broad range of credit products. AFG has grown to become one of the largest providers of mortgage broking services in the country. Through our network of 2,650 finance brokers, AFG processes around $4.5 billion of finance every month.

AFG has reviewed the Issues Paper dated 17 January 2017 (**Issues Paper**) issued in connection with the Australian Bankers' Association (**ABA**) sponsored review of commissions and payments in retail banking (the **Review**) and provides the following information and commentary for your assistance. AFG provides this submission to you and the ABA as part of AFG's continuing commitment to strengthening trust in the finance broking industry.

Scope of the Review

Reduction in public confidence

It is noted in the Issues Paper that the Review is one of a number of initiatives of the ABA that aim to build public trust and restore public confidence in the banking industry. Public confidence is clearly at a low point at present as evidenced by repeated calls for a Royal Commission to investigate the banking sector.

AFG agrees that irrespective of whether there are further governmental inquiries, it is appropriate for the banking sector to consider how it does business and the factors that have led to the loss of public confidence. Examples that may have contributed to negative consumer perceptions may include the Four Corners exposé of CommInsure, "Money for Nothing" which was aired on 7 March 2016[1] and the remediation activities and reports that have flowed from the Australian Securities and Investments Commission's (**ASIC**) Wealth Management Project which focused on the conduct of the largest financial advice firms, including the advice arms of ANZ, CBA, NAB and Westpac groups[2].

Impact of corporate culture

However, it is AFG's contention that focusing on remuneration puts the cart before the horse. Remuneration structure is a result of the culture and strategy of the relevant bank and is set by the Board and executed by the senior executives. The importance of good corporate culture has recently been raised by ASIC in a number of fora, including by ASIC's Chairman Greg Medcraft who stated in a

[1] See also ASIC Report 498 *Life Insurance Claims an Industry Review*.

[2] See also individual examples of compliance failures by banks such as ASIC Media Release 16-009 *Westpac pays $1 million following ASIC's concerns about credit card limit increase practices* and ASIC Report 445 *Review of interest only home loans* which was issued following a review of the practices of 11 home loan lenders.

speech to launch of the Governance Institute's inaugural Ethics Index:

> ASIC is concerned about culture because it is a key driver of conduct within the financial industry. By focusing more on culture, we expect to get early warning signs where things might be going wrong to help us disrupt bad behaviour before it happens and catch misconduct early.
>
> We also think it will help us with identifying not just individual instances of misconduct, but broader, more pervasive problems.
>
> Poor culture often leads to poor outcomes for investors and consumers, impacts on the integrity of the Australian financial markets, and can erode investor and financial consumer trust and confidence.
>
> Domestically, the ongoing issues within Australia's financial advice industry – along with continuing media reports relating to bank culture, misreporting of profits and the manipulation of the bank bill swap rate (BBSW) – undermine investor and financial consumer trust and confidence in the system.[3]

By failing to focus on the issue of corporate culture it may be that changes to remuneration models for bank staff will not have the desired effect on bank conduct and may not lead to better outcomes for consumers and improved confidence in the banking industry.

Third party remuneration

Issues for other fora

The remuneration of the third party broker distribution channel is currently the subject of an extensive review that is being conducted by ASIC (the **ASIC Remuneration Review**) independent of both banks and brokers. This review was requested by the Government in its response to the recommendations of the Murray Financial System Inquiry Final Report. In conducting the review ASIC has exercised its powers to gather a large amount of data which is currently being analysed by ASIC.

In view of the work currently being undertaken by ASIC it seems inappropriate and misguided to seek to include broker remuneration within the scope of this Review. The Review does not have information gathering powers or resources equivalent to ASIC and should not risk reducing confidence in its findings by referring to, or basing recommendations on, isolated anecdotal statements. This is even more important where information has not been gathered in the same way from all relevant industry participants and leaves the Review open to allegations of bias or partisanship.

We note that a number of other issues have been excluded from the Review and the following statement is included at page 7 of the Issues Paper:

> Importantly the Terms of Reference exclude issues that have been, or are currently, subject to detailed examination in other fora.

Clearly, this is also the appropriate approach for issues relating to broker remuneration and any relevant information obtained during the Review should not be used as the basis for any "findings" but should be passed on to ASIC for consideration as part of the ASIC Remuneration Review.

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[3] *Good corporate culture, values and ethics***,** A speech by Greg Medcraft, Chairman, Australian Securities and Investments Commission at the launch of Governance Institute of Australia's inaugural Ethics Index (Sydney, New South Wales) 20 July 2016.

Incorrect assumptions

There is also a significant risk of the Review drawing false conclusions with respect to broker remuneration due to the limited and one-sided nature of the investigations that the Review has undertaken with respect to broker commissions.

For example, the Issues Paper states that:

> In consultations more than one bank acknowledged that if a bank wishes to conduct a campaign to increase sales of its mortgage product, for example, it would typically increase the commission rate available on such sales for a period. This appears to be an industry practice from which few banks are prepared to depart, at least on a unilateral basis.[4]

Unfortunately, this statement fails to consider the combination of incentives that a bank might provide when seeking to expand its market share for a particular product. Those other incentives might typically include (in addition to a temporary increase in broker commissions) a consumer incentive such as a reduced interest rate or fee waiver. These consumer benefits must be considered by brokers when fulfilling their responsible lending obligations under the *National Consumer Credit Protection Act 2009* (**NCCP Act**) together with negative factors that may arise during a special offer such as substantial delays in processing loan applications due to the spike in demand. The suggestion that a broker will chase higher commission at the risk of recommending something unsuitable or risk clawback and damage their reputation and therefore their business for a few dollars more is ludicrous. In fact, AFG has provided extensive empirical information to ASIC for the purposes of the ASIC Remuneration Review that indicates that there is no real correlation between the commission rate offered and the market share of a lender.

The Issues Paper also includes the statement that:

> The fact that many banks are reluctant to defy industry practice and move away from commission-based arrangements and the success of campaigns based on increased commission deals suggest that the risk of commission-related mis-selling is not insignificant in this market. Indeed, data was presented to the Review that suggested that third-party mortgages are likely to be larger, paid off more slowly, and more likely to be interest only loans than those provided to equivalent customers who dealt directly with bank staff. Noting that all such mortgages need to satisfy the relevant bank's credit assessment and responsible lending requirements, this evidence is suggestive rather than conclusive.

It is extremely disappointing that the above statement was included in the Issues Paper, albeit with the final acknowledge that the information that was considered is ***not*** conclusive. It is clearly not possible to draw any conclusions about the risk of broker misconduct or "commission-related mis-selling" from the information referred to in the Issues Paper.

It is an undeniable fact that the attributes of loans introduced to banks through the broker channel directly relate to the attributes of the consumers who seek the assistance of mortgage brokers. For example, consumers seeking larger loans may seek the assistance of a broker in order to maximise potential savings.

In fact, we note that ASIC has found that:

- The average value of interest-only home loans was substantially higher than principal-and-interest home loans for both owner-occupiers and investors and that this was especially so for loans provided through **direct channels** in comparison with third-party

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4 *Issues Paper* p30.

channels.[5]

- Consumers with interest-only home loans were, on average, further ahead in reducing the balance of their loan when including funds held in offset accounts related to the home loan than those with principal-and interest home loan.[6]

Different roles, responsibilities, risks and regulation

Another danger that the Review should seek to avoid is treating the roles, responsibilities and risks associated with credit assistance providers (mortgage brokers) as equivalent to those of providers of personal financial product advice (financial planners). It is important to remember that the Government intentionally excluded mortgage brokers from the Future of Financial Advice reforms (**FOFA**). This approach recognises that the regulatory failures that the Government sought to address with FOFA did not include residential mortgages and that mortgage brokers were already subject to an appropriate protective regulatory regime under the NCCP Act, including the responsible lending obligations.

It is also pertinent to note that lenders conduct their own monitoring of mortgage brokers who they permit to introduce loans in a number of ways including accreditation assessments, reviews, audits of aggregators and brokers and performance reporting.

Ultimately, each home loan submitted by a mortgage broker is assessed by the lender's credit team and it is their responsibility to ensure they complete the 'final' assessment of the loan from a responsible lending perspective each time.

Proposal for ASIC Product Intervention Power

Finally we note that the proposal to introduce a new product intervention power exercisable by ASIC may also result in significant changes to the way in which banking products are developed and sold.

The Government's Proposals Paper includes the following summary of the product intervention power:

> ASIC can make interventions in relation to the product (or product feature), the types of consumers that can access the product or the circumstances in which consumers access the product. Examples of possible interventions include additional disclosure obligations, mandating warning statements, amendments to advertising documents, restricting or banning the distribution of the product.[7]

This proposal also flows from the recommendations made in the Murray Financial System Inquiry (FSI) Final Report and would give ASIC an effective tool to address market practices (whether widespread or individual) that have the potential to cause significant consumer detriment.

Conclusion

The mortgage broking industry plays a critical role in maintaining choice for Australian consumers. For many rural and regional Australians, mortgage brokers are the only ones in their local communities. In addition, many of Australia's smaller lenders rely on mortgage brokers to act as a distribution network for their products. The loss of the broker based distribution network would put these lenders at a major

[5] *ASIC Report 445: Review of interest-only home loans (August 2015), Page 27, Section 82*

[6] *ASIC Report 445: Review of interest-only home loans (August 2015), Page 36, Section 112*
Available from: http://download.asic.gov.au/media/3329474/rep445-published-20-august-2015.pdf

[7] *Design and Distribution Obligations and Product Intervention Power Proposals Paper*, The Australian Government, December 2016, p30.

disadvantage to the large banks and result in a significant reduction in competition in the mortgage sector, to the detriment of consumers. Every mortgage customer would pay for reduced competition throughout the life of their loan.

We trust that you will give this submission due consideration as the restoration of public faith in the banking industry is a goal that AFG supports.

Yours sincerely,

Brett McKeon
Managing Director
Australian Finance Group Ltd