ASIC Broker Remuneration Review – AFG response to Scoping Document

The Home Lending Market

Scoping Considerations

Participants and their roles

History of regulation
Mortgage brokers have been regulated in Western Australia since 1975 through the *Finance Brokers Control Act 1975*. National regulation was introduced with the *National Consumer Credit Protection Act 2009* (NCCP) which includes the National Credit Code. The introduction of NCCP has improved both the level of disclosure and lending standards within the residential lending industry.

Primary distribution channel for smaller lenders
Over the last 20 years mortgage brokers have become an essential distribution channel for lenders and now account for over 50% of all originations to become the primary distribution channel for many smaller lenders, without whom there would be less competition.

Referrers
It has come to our attention that some larger lenders are seeking to increase originations by focusing on referrals from unlicensed sources. We have been made aware that some lenders are offering commission of up to 60 basis points (bp) on settlements resulting from referrals from real estate agents, community groups, solicitors, accountants, financial advisors, property developers, wealth creation specialists, builders, charity foundations, clubs and association. We believe ASIC's review should extend to these unlicensed referrers and focus on how these services are provided and what disclosures are being made to consumers (eg in accordance with *NCCP Regulation* 25).

Distribution channels

Impact of channel on loan performance
Loan performance can be interpreted according to a number of criteria including prepayments, arrears, defaults and complaints. While there will be variations in loan performance between channels, the existence of such differences does not prove that a particular distribution channel results in riskier loans or leads to poorer performing loans.

Different types of borrowers may prefer different distribution channels. For example, borrowers who

- expect to have difficulty meeting the lending criteria of some lenders;
- have complex finances; or
- require more specialised or have multiple lending arrangements,

may be more inclined to use the services of a broker.

Irrespective of the distribution channel, lending to such borrowers may be of inherently higher risk, even when responsible lending criteria have been satisfied. Higher risk lending should be priced accordingly by the lender and meet applicable prudential standards in order to safeguard Australia's financial system. However, it is not correct to attribute the higher risk of such loans to the broker distribution channel.

Growth of the online channel
The online channel has become a major source of lead generation and many website owners have taken advantage of their penetration by negotiating referral fees with lenders and aggregators. Lenders themselves use their own websites to qualify mortgage enquiries but the application and approval process cannot currently be undertaken completely online.

Products

Broker access to a broad range of products
Mortgage brokers can arrange the complete range of residential mortgage products including owner occupier, investor and refinance arrangements as well as a range of commercial and personal debt products.

Reverse mortgages
Brokers can also originate more complex products, such as reverse mortgages and loans to Self Managed Superannuation Funds (SMSFs) although it is fair to say that the broker channel has not entirely embraced these products. The Deloitte Reverse Mortgage Report for 2015 stated that only 31% of reverse mortgages were originated by the broker channel. At $3.7 billion, the reverse mortgage market is a fraction of the size of the $1.4 trillion residential mortgage market.

SMSF lending
In December 2014, the Final Report to the Financial System Inquiry (FSI) recommended a ban on self managed superannuation fund (SMSF) borrowing using Limited Recourse Borrowing Arrangements (LRBAs) – see Recommendation 8. This recommendation was the only one not to be accepted by the Government but it commissioned the ATO to monitor borrowing and report back in 2018. The total value of LRBAs was $18.7 billion in December 2015 - approximately 1.3% of the $1,406 billion in housing lending at the same time. The rate of LRBA growth has reduced, largely as a result of ongoing uncertainty about the future of the product. It remains a product that is only of interest to a very small sector of the market.

Construction loans
Construction loans should be considered as a separate category due to the variance in the ways a broker is remunerated. Some lenders will pay the broker commission on settlement, others pay when the first drawdown is made by the borrower and others pay periodically as the loan is drawn down.

Panel of lenders
Aggregators consider a range of criteria before including a lender on their panel, including demand for their products, product quality, ability to service the whole market, availability of ongoing funding and balance sheet strength. Once a lender is included on an aggregator's panel of lenders the aggregator typically makes available most non-revolving debt products that are offered by that lender. Some lenders decline the opportunity to be included on the lending panel of all or particular aggregators. Reasons for this may include pressure from existing distributors who are in competition with those aggregators, the lender's capacity to cope with additional volume or geographical constraints.

Ownership structures

Franchisees and subcontractors
All mortgage brokers are affiliated with an aggregator that provides access to a panel of lenders and facilitates the lodgement of loan applications. In some cases, these brokers may be associated with the aggregator through a franchising agreement (eg Aussie, Yellow Brick Road and Mortgage Choice) while others are separate business entities with a contractual arrangement with the aggregator (such as AFG, Connective and the Advantedge brands).

Ownership of aggregators
These aggregators may, in turn, have a relationship with a lender ranging from 100% ownership (Advantedge/NAB) to 80% (Aussie/CBA) down to a minority equity interest. There is little doubt that those aggregators that are majority-owned by a lender have the potential to be influenced by that lender and that the lender has a vested interest in maximising its market share. This potential conflict of interest diminishes as the level of common ownership decreases. Our view is that the threshold level of interest that should be disclosed to consumers is 20% (consistent with section 606 of the *Corporations Act 2001*.

Multiple lender trading names
There have been a number of lender mergers in the Australian market. Often, the consolidated entity continues to trade using both names (under a single banking licence). This means that consumers may believe that they are considering competitor's products when this is not the case. For example, we have been made aware of applicants choosing to refinance a loan from Westpac to Bank of Melbourne without being made aware that the Bank of Melbourne is a wholly-owned subsidiary of Westpac.

Anti-competitive conduct and sub-economic pricing of aggregator services
Distortion of the market by bank-owned aggregators is a risk as they are in a position to forego earning any profit margin on their aggregator services in order to increase the distribution of their lending products for which they earn significantly greater profits. The same risk arises if a fee for service model is introduced as the parent lender would be in a position to absorb the cost of their brokers, whereas non-aligned brokers would need to charge the consumer a fee. Similar issues arose in the Netherlands after commissions were banned.

Scoping Questions

1. **Should we consider the remuneration structures associated with products other than residential mortgages? e.g. review non-residential mortgages products (such as commercial or personal loans) in circumstances where the remuneration structures are linked to the sale of residential mortgages**

   The value of residential mortgages is substantially greater than the sum of all other loan products originated by brokers and should therefore be the focus of the review. Commercial, debtor and inventory finance are all distributed, by definition, to commercial clients who have a greater level of sophistication and knowledge of the products and are therefore better prepared to assess the risks of these products.

2. **Have all types of relevant industry participants been identified as a part of the scoping considerations above? Are there any home lending market participants that you consider should or should not be examined as a part of this review? e.g. real estate agents, accountants and multi-disciplinary practice referrers**

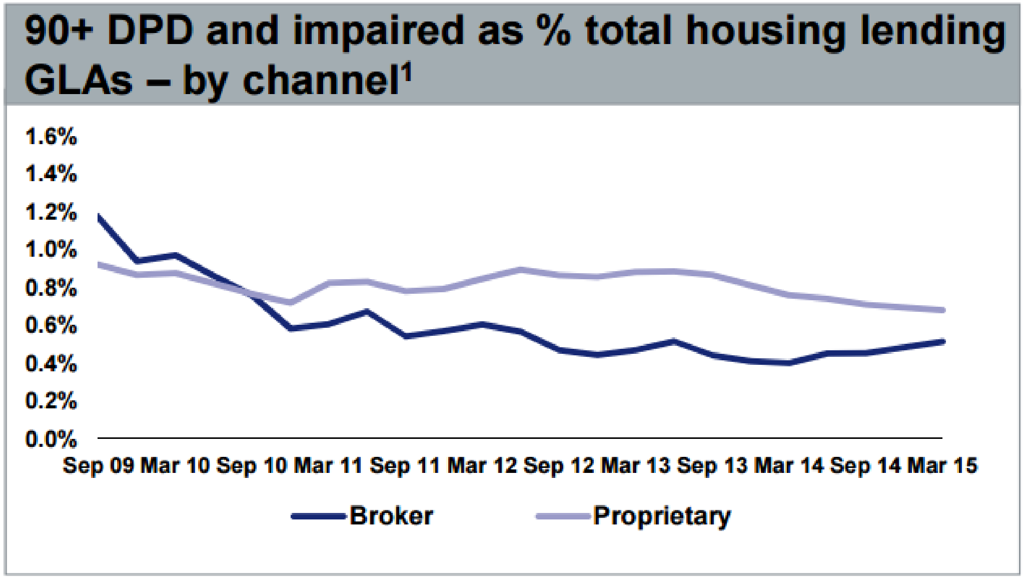
   Brokers are usually independent of the property selection process and are generally approached once the client has identified a property that they wish to purchase. There are a range of parties, including real estate agents, community groups, solicitors, accountants, financial advisers, property developers, wealth creation specialists, builders, charity foundations, clubs and associations, that have entered arrangements with lenders whereby they receive a commission of up to 60bp on any settled loan resulting from a referral. The impact of these arrangements and the level of compliance with licensing exemption disclosure requirements (eg regulation 25 *NCCP Regulations*) should be considered as part of ASIC's review.

3. **Which home lending product distribution channels do you consider should or should not be included in the review for consideration and comparison**

   All channels should be considered as part of the review, especially the direct lender channel. And it is important to ensure a like-for-like comparison of proprietary to third party originated loans is conducted.

   The preference for using a mortgage broker varies according to the type or situation of the borrower. If there is a higher risk of default for any particular category of borrower, the overall performance of the channel that originates a higher proportion of these loans will display a greater impact.

   A review of NAB's 1st half 2015 results (see below) shows the robustness of the overall loan quality originated through the broker channel. The home loan impairment rate is lower through their broker channels than through their proprietary channels. At this stage, no other lender has disclosed or volunteered to provide this level of data.



(1) Excludes Asia

Source: National Australia Bank 1H2015 Presentation dated 7 May 2015

http://www.nab.com.au/content/dam/nabrwd/legacy/about-us/shareholder-centre/financial-results/documents/2015-half-year-results-investor-presentation.pdf

While online is a major source of lead generation, it is not currently a self-contained distribution channel due to the requirement to confirm the identity of the client and the process involved in meeting responsible lending requirements, determining the client's requirements and objectives, verifying the client's financial situation and making recommendations.

4. What do you view as the emerging and potential future trends in the distribution of home lending products? e.g. new entrants and models, disruptors, online/technology influences, market consolidation, succession planning etc

Rate comparators
There are many websites by which borrowers can find the best advertised rates available but these do not always provide sufficient information about potential discounts, special offers (such as cash rebates), processing times and product features. These tools help consumers find information about potentially suitable products but they do not provide sufficient information to make a well informed decision.

Lender automation of credit decisioning
It is expected that there will be increasing pressure for lenders to automate as much of the credit decisioning process as possible in order to save costs.

Alternative funding of loans
Several aggregators, including AFG, Aussie and Advantedge, have secured independent funding sources and now offer their own loan products. These products increase consumer choice but are

vulnerable to changes in the cost of funding driven by the limited number of warehouse funding providers.

Irrelevance of comparison rates
The emergence of new incentives, such as cash rebates, and the increasing average value of a loan are making comparison rates increasingly irrelevant. The average loan originated by AFG brokers is now over $450,000 while NCCP mandates that comparison rates evaluate the cost of a $150,000 loan over 25 years. This lower loan value magnifies the impact of fees on the comparison rate and distorts the true cost of a loan to the average borrower. The comparison rate also excludes the impact of any cash rebates that may be offered as these are typically only offered for larger loans. The Commonwealth Bank is currently offering a $1,500 cash back offer for new customers borrowing at least $250,000.

Furthermore, a comparison rate assumes that, if the interest rate on a loan increases at the end of an introductory period, the borrower will not refinance to a cheaper product. The average loan is now closer to $450,000 and many borrowers now take advantage of 'honeymoon rates' before refinancing when the loan reverts to the standard variable rate or are offered 'life of loan' discounts to the standard variable rate. For example, the Commonwealth Bank's 3 Year Special Economiser is advertised with an interest rate of 4.29% but a comparison rate of 4.92%. This is because the loan reverts to the Base Rate Economiser loan (at 5.14%) after three years and it is assumed that the borrower would not refinance.

The absence of Deferred Establishment Fees removes one of the barriers for this loan to be refinanced once the 'honeymoon period' is over.

5. Are there any other matters you feel may be beneficial for consideration

Comparison of brokers and salaried distributors
A mortgage broker is invested in the outcome of a lending proposition for a consumer. With a commission-based model of remuneration, a broker is remunerated based on the placement and ongoing suitability of the product. The removal of a commission-based model would result in a 'salaried' workforce for lenders with no incentive to ensure a thorough comparison across lenders or products. We would encourage ASIC to examine the remuneration and incentives that lenders pay their own mobile workforce.

Higher standards for reverse mortgages and SMSF lending
Products such as SMSF lending and reverse mortgages should require a higher level of training and scrutiny than other residential mortgage products.

Consideration of impact on competition
AFG is concerned about the risk of market distortion by bank-owned aggregators if a fee-for-service model was mandated. Lender advisors and aggregators owned by lenders would be able to absorb the cost of providing advice as the cost of distributing a product is modest compared to the income that can be gained from the interest margin.

Remuneration Structures

Scoping Considerations

Remuneration Type and Categorisation

Commissions

Remuneration types do vary widely across the value chain although the principal form that is relevant to brokers is commission. The level of commission offered by most lenders is remarkably similar with upfront commission for residential loans generally ranging between 0.6% and 0.7% of the loan amount. Some lenders periodically offer bonus commission in conjunction with a special offer and this may be tiered in accordance with the loan to valuation ratio (LVR) (more commission for lower LVR) and loan amount (higher commission for larger loans). There is slightly more variance in trail commission with some lenders adopting a flat rate while others 'ramp' their trail to encourage brokers to maintain contact and provide ongoing advice to the borrower. This ongoing relationship assists the broker because the customer is more likely to seek advice if their broker has been proactive in providing ongoing assistance.

Payout rate

Like most aggregators, AGF negotiates a 'payout rate' with each broker that reflects the level of settlements the broker originates. Competition for experienced brokers between aggregators is keen and some aggregators adopt aggressive market share-based recruitment strategies by offering to pass through 100% of commissions received in return for a modest fixed fee. It flows therefore that the margins for this type of model are very thin leaving little available for reinvestment in the business of the aggregator ultimately impacting the ability of these aggregators to support their own broker network. In our view, the level of support that can be offered to brokers through this business model is scant and not sustainable.

Mortgage Choice has adopted a different approach whereby it passes through a fixed percentage of the commission received, irrespective of who the loan was funded by and what commission they pay. The level of commission is substantially less than non-franchised aggregators as a significant proportion of revenue is retained to fund group activities.

AFG presumes lender employed loan consultants are remunerated by a combination of base salary together with volume-based bonuses and non-monetary benefits, such as a company car.

Aggregator sponsorship and volume payments

At the aggregator level, some lenders make payments of sponsorship or contributions to development programs based on metrics such as the volume, quality and conversion of loans written. These payments are not passed directly through to brokers so do not constitute an incentive for brokers to direct more business through to the lender. Instead, they are made in recognition of the investment that larger aggregators have made in developing platforms which have enhanced distribution of the lenders' products and ensuring brokers have an opportunity to receive subsidised ongoing professional development and information about emerging business trends.

Payment Timing

Upfront commissions
Upfront commission payments by lenders are generally made within 30 days of loan drawdown but can be subject to clawback for up to 24 months after settlement. As mentioned previously, the payment of commission is sometimes different with regard to construction loans with the first drawdown not typically occurring until several months after approval and the last drawdown often more than a year later.

Trail commissions
Trail commission is based on the outstanding loan balance (net of funds held in offset accounts) at the beginning of the relevant month. Although the loan balance will usually decrease at a predictable level in accordance with the loan amortisation schedule, variations can occur as a result of payments from the offset account or additional prepayments.

Timing of aggregator payments
AFG pays its brokers' upfront commission weekly and trail commission monthly (after the commission is received from the lender).

Payment Controls

Lender contracts
AFG has a contract with each lender on its lending panel setting out the terms on which AFG's affiliated brokers may introduce loans to that lender. Because the lenders have a contractual relationship with AFG, they pay commissions to AFG. AFG then pays a proportion of the commissions received from the lender to the relevant broker (in accordance with contractual arrangement). A broker may also direct AFG to pay a proportion of commissions from some or all loans to other parties which may include referrers.

Contractual rights in the event of broker wrongdoing
If a broker is suspected of wrongdoing (including failure to comply with NCCP requirements) their entitlement to arrange loans through AFG may be suspended. In the event that a broker's agreement is terminated for breach (including failure to comply with NCCP requirements) they may lose any entitlement to receive upfront or trail commission on loans introduced prior to termination. This is a significant deterrent to a broker breaching their legal obligations as it effectively excludes them from the industry and deprives them of any ongoing trail income that they would have otherwise received.

Services

Educating borrowers and developing leads
One issue that is rarely considered is how much time brokers spend developing and converting leads – a process which involves significant education of potential borrowers. A considerable amount of time, money and effort goes into sourcing potential customers. Once a prospective customer is secured more time and work goes into meeting with them, satisfying responsible lending requirements and gathering

the relevant information to submit a loan application. AFG data shows that only 70% of applications lodged result in settlement.

Scoping Questions

6. What are the primary remuneration structure models utilised by industry participants? eg. rebate, no commission, upfront/trail models, non-monetary benefits etc.

Commission (upfront and trail) are almost the only remuneration model used by AFG brokers. The proportion of the commission paid by the lender that is passed through from aggregator to broker is negotiated on a case by case basis in conjunction with the fees payable for services provided by the aggregators, such as access to the loan platform, compliance and marketing support. The level of service provided by different aggregators varies as does the level of support required by each broker. These differences may affect the proportion of the commissions paid to the broker and the proportion retained by the aggregator. Brokers originating high volumes are usually able to negotiate higher pass-through rates.

A proportion of the commissions received may also be paid to referrers such as accountants, real estate agents or comparison websites.

How predominant is each model type across industry, and does utilisation depend on participant characteristics? e.g. do larger scale participants only use certain models?

The majority of AFG brokers receive only commissions and this is common throughout the industry. Each aggregator has a different policy with regard to the proportion of the commissions received from the lenders that are passed through to brokers.

7. What is the level and nature of stability in remuneration structures? e.g. how frequently are the principles underpinning structures updated, varied or amended? What are the typical drivers for change (if any)?

Upfront commission rates are largely comparable between lenders although some may increase the commission offered for a limited period, usually coupled with a special offer for consumers.

In considering whether commissions influence broker recommendations, these ‘specials’ should not be considered in isolation, especially when there are strong grounds for recommending the corresponding product to borrowers. For example, a number of lenders have recently offered cash rebates of up to $3,500 as well as waiving application or Lenders Mortgage Insurance fees. These cash rebates are not reflected in comparison rates as they are not available to all borrowers but have the effect of reducing the effective interest rate, especially if considered over the period in which loans are typically refinanced.

Furthermore, these ‘specials’ can backfire on lenders when they are incapable of coping with an increase in volume. As a result, brokers may be cautious about recommending product ‘specials’ that result in a substantial increase in applications as there may be significant delays in obtaining approval and settlement. AFG recommends that ASIC seek information from lenders about processing/settlement times when specials are offered.

Some lenders have a ‘ramped’ commission policy which sees trail commission increase in years after settlement.

Brokers are expected to achieve minimum performance levels by aggregators to offset costs associated with administration and compliance services. If they do not achieve the performance benchmark, the proportion of commission that they receive may be reduced but may be reinstated if they once again achieve the performance benchmark.

If a broker’s authorisation is terminated due to breach of the agreement, they may lose their entitlement to ongoing payment of trail commissions. Breaches include but are not limited to legislative requirements such as NCCP, Privacy and AML / CTF.

Upfront commission on residential loans is also subject to clawback from the broker over the first 24 months of the loan. Policies vary from lender to lender but mortgage brokers generally face a 100 per cent ‘claw back’ of their commission over the first 12 months, and 50 per cent over 18 months, of a settled loan’s life if they refinance.

8. Given the size of the broker business sector (i.e. over 5,000 businesses), what cross section of the broker business sector do you consider should form the focus of the review so that a fair representation of remuneration structures are examined?

We suggest ASIC examine a broad cross section including small and large credit licensees and credit representatives. We suggest ASIC undertake a comparative examination of the salaried staff of lenders, also known as ‘mobile lenders’ whose remuneration structure includes a significant commission/bonus component.

9. What do you view as the emerging and potential future trends within remuneration structures?

We expect commission levels to stay at or around the same level and envisage the outcome of this review may drive future trends.

10. Are there any other matters you feel may be beneficial for our consideration?

AFG notes ASIC has stated that “commissions are a form of conflicted remuneration” and that broker recommendations may be influenced by the commissions offered by individual lenders resulting in disadvantage to the consumer. While AFG agrees that commissions *can* lead to conflicts of interest in many situations, it does not believe that this is the case within the current structure of the mortgage broking industry and has not seen any reports that use hard data to support these negative assertions. AFG has undertaken extensive analysis of its database to provide empirical evidence that, in its view, refutes these claims.

<u>Correlation between Market Share and Commission</u>

AFG has analysed the monthly market shares for each of the lenders on its panel and compared it to the average and lender-specific commission rate at the time. It has also determined the present value of upfront and trail commission for a typical loan to evaluate the difference in dollar value between commissions offered by various lenders and whether the difference is material enough to influence broker recommendations.

As with all data sets, there are incidences which, if taken in isolation, suggest that commission levels may have driven recommendations. In situations such as these, we have examined all contributing factors to determine possible influencers of broker recommendations. Factors such as market-leading rate, cash rebate or fee waivers were involved in each. This level of analysis is needed to ensure that correlation is not confused with causation.

<u>Annual Broker Income</u>

AFG estimates that an established broker may generate average upfront commission of approximately $80,000 per annum. It must be remembered that this is before the costs of running a business are deducted including motor vehicle, office expenses, compliance, telecommunications, administrative support and referral expenses. Established brokers also earn trail commission although this can take many years to build up.

<u>Clawback</u>

Brokers have no capacity to receive alternative remuneration for arranging a loan if it is subject to clawback. It can take 12-18 months for a new broker to develop sufficient leads and settlements for a sustainable business. If upfront commission were to be restricted, it would take significantly longer to develop a sustainable business and this would severely restrict the viability of mortgage broking as a career for new entrants.

<u>Overseas Experience - Netherlands</u>

The banning of commissions in the Netherlands has led to anti-competitive behaviour from some lenders that required intervention from the regulator. Oxera Consulting, a financial consulting firm based in the UK, undertook a review of markets where commissions had been regulated and has published a report which is available at:

http://www.oxera.com/Latest-Thinking/Publications/Reports/2015/Regulating-remuneration-systems-effective-distribu.aspx

<u>Overseas Experience - UK</u>

The UK mortgage broking industry has also gone through a recent regulatory transformation but was coming from a very different environment to the current situation in Australia. Prior to the Mortgage Market Review (MMR), over 50% of mortgage sales were categorised as 'non-advised' which meant that they could be sold by non-specialists, such as call centre staff, with very little recourse to the lender. Up to 70% of mortgages were originated by third party channels with many products only available through the indirect channel. MMR eliminated the 'non-advised' loan category and reasserted that it is the lender's responsibility to ensure that the mortgage is suitable and affordable. This has greatly increased the onus on lenders but has resulted in a significant reduction in broker numbers as well as settlement delays as prospective borrowers wait for appointments with lenders.

We have been advised that some sectors of the market are now under-served as borrowers no longer meet the lending criteria that banks have been forced to adopt. This means that some existing borrowers are no longer able to refinance their loans. They may have had a mortgage for ten years, never missed a payment but, because of the new regulatory regime, they no longer meet the lending criteria and so are stuck with a non-competitive product. They are known as 'mortgage prisoners'.

Alternative Remuneration Structures

AFG has considered the impact of a number of alternative remuneration structures and believes that each would have adverse consequences for consumers as well as for industry participants. Given the reticence of consumers to pay an equivalent fee for advice upfront, a ban on upfront commissions would leave existing brokers reliant on trail commission and present a substantial barrier for new industry entrants.

Correspondingly, if trail commission was to be prohibited, there would be no incentive for a broker to maintain a long-term relationship with borrowers. Brokers are currently prompted to schedule regular reviews with their clients to assess whether their loan is still suitable. This would weaken the level of advice available to consumers and diminish the position of trust that brokers establish.

We do not believe that fee for service model is a viable remuneration structure for the following reasons:

- Few borrowers are willing to pay an equivalent upfront fee for advice
- Not all potential borrowers recognise the discounts that brokers can secure for them
- It would lead to anti-competitive behaviour from lenders with branch networks that are able to absorb the cost of providing advice
- A fee for service would also have a detrimental effect on First Home buyers or those borrowers entering the market with minimal spare funds to afford an upfront fee. These customers will be forced to use a lender that does not charge a fee, limiting their choice of funders and in all likelihood they will end paying a higher interest rate.

We believe that undermining the broking model the result will be a significant reduction in competition in the mortgage sector, to the detriment of the consumer. Every mortgage customer will pay for reduced competition throughout the life of their loan.

Furthermore, the mortgage broking sector itself would be severely impacted by the changes. With more than 14,000 brokers across the country, and a further 30,000+ jobs tied to the industry, the consequences should not be underestimated.

Consumer Outcomes

Scoping Considerations

Consumer Categorisation

Owner occupiers and investors
The two principal lender categories are owner occupiers and investors as every borrower fits into one or other of those categories. There are a host of other sub-categories that may have an influence on the product or rate that is available to them including:

- First Home Buyers
- Refinancers
- Employment –type (PAYG, Self Employed, Contractor)
- Credit Status (ie credit impaired which has an impact on the products that a borrower will qualify for).

Product Features

Key requirements of the borrower
At their initial meeting, a broker will try to ascertain the key features that a borrower wants from their loan. Some will be a matter of choice while others, such as the requirement for Lenders Mortgage Insurance, will be a consequence of their situation. Key features are likely to include:

- Loan type (Principal and Interest, Interest only, Line of Credit)
- Fixed vs Variable or Split
- Appetite for consolidating all banking products with lender (this may impact eligibility for a professional pack)
- Offset accounts
- Potential requirements for additional borrowings.

Additional borrowings
It is not unreasonable for a broker to enquire as to whether a borrower will have a requirement for additional borrowings in the near future. If a borrower has sufficient equity, they may choose to seek approval for a higher borrowing limit than they currently require in order to finance a range of potential expenses which may or may not be related to the property. The borrower does not pay any additional fees by having a higher loan limit providing the additional drawings are held in an offset account. Mortgage borrowings will typically be the lowest cost funds available to a borrower and an offset account avoids additional expenses associated with applying for a loan variation or a separate loan.

Product Price and Set Up

The home loan market is extremely complex and there are a wide range of factors that influence a product's interest rate and cost.

Accessibility

Application processing times

Most brokers are aware of the prevailing processing times of most lenders and will bear this in mind if a borrower's settlement timeframe is tight. There have been many occasions where a lender has promoted a special offer that has attracted so many additional applicants that they have been unable to cope with the additional volume and processing times have blown out. While the major lenders are reasonably transparent with their current processing times, this is not always the case with smaller lenders. Some brokers may be cautious about recommending special offers even if they are the 'cheapest' available product as they may not have confidence that finance can be arranged within the client's timeframe potentially resulting in costly bridging finance.

Branch access

Access to a branch is not important for all borrowers and increasingly many are comfortable managing their loans through phone and internet-based media. Importantly the broking channel delivers consumer choice by facilitating access to those lenders without a branch network, and by providing access to lending options for rural and regional consumers.

Our experience also shows brokers of different cultural backgrounds provide an important conduit for explanation of, and engagement with, the Australian lending market for those within their communities.

APRA publishes data on the number of points of presence of Banks, Building Societies and Credit Unions have. The four majors accounted for 71% of the bank points of presence that offer a branch level service.

Bendigo & Adelaide (inc. Rural Bank), BOQ and Suncorp comprised another 22%.

This leaves 7% for the remaining **67** lenders, many of which are currently on AFG's panel including:

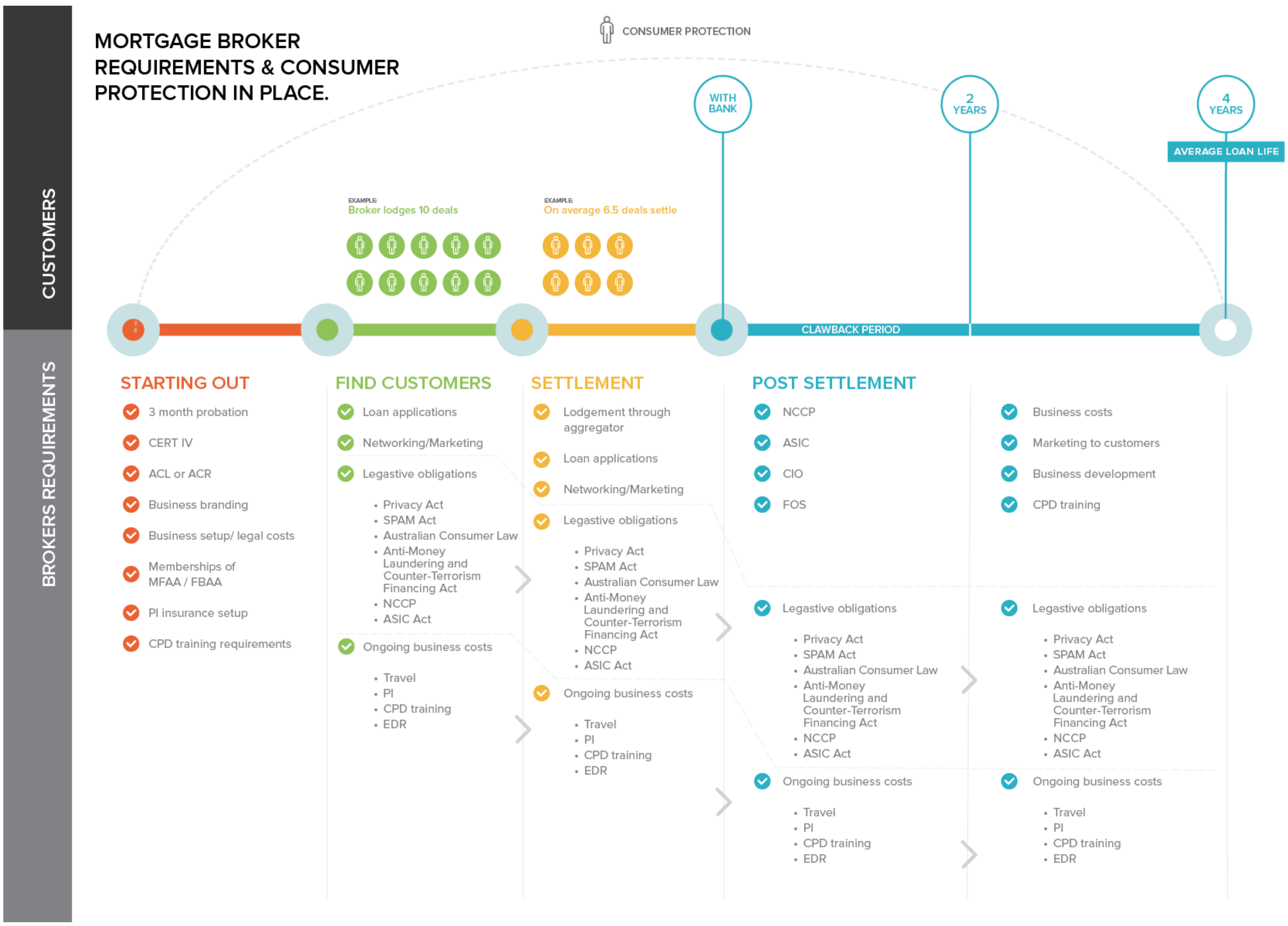
LENDER	**BRANCHES**
AMP	0
Auswide	31
Bank of China	9
Bank of Sydney	16
Heritage Bank	61
Macquarie	3
Members Equity	0
Police & Nurses	17
ING	0

There are other non-bank lenders such as Bluestone, Homestart, Keystart, LaTrobe, Liberty, and Pepper on the AFG panel who do not have branches.

Legal Requirements

The mortgage broking sector is highly regulated, and justifiably so. All broker-introduced mortgages are placed under tough scrutiny, and brokers are heavily regulated by ASIC under NCCP. Loans introduced by brokers are subject to a range of requirements including NCCP, industry body MFAA's procedural requirements, the requirements of their aggregator and each lender's own requirements.

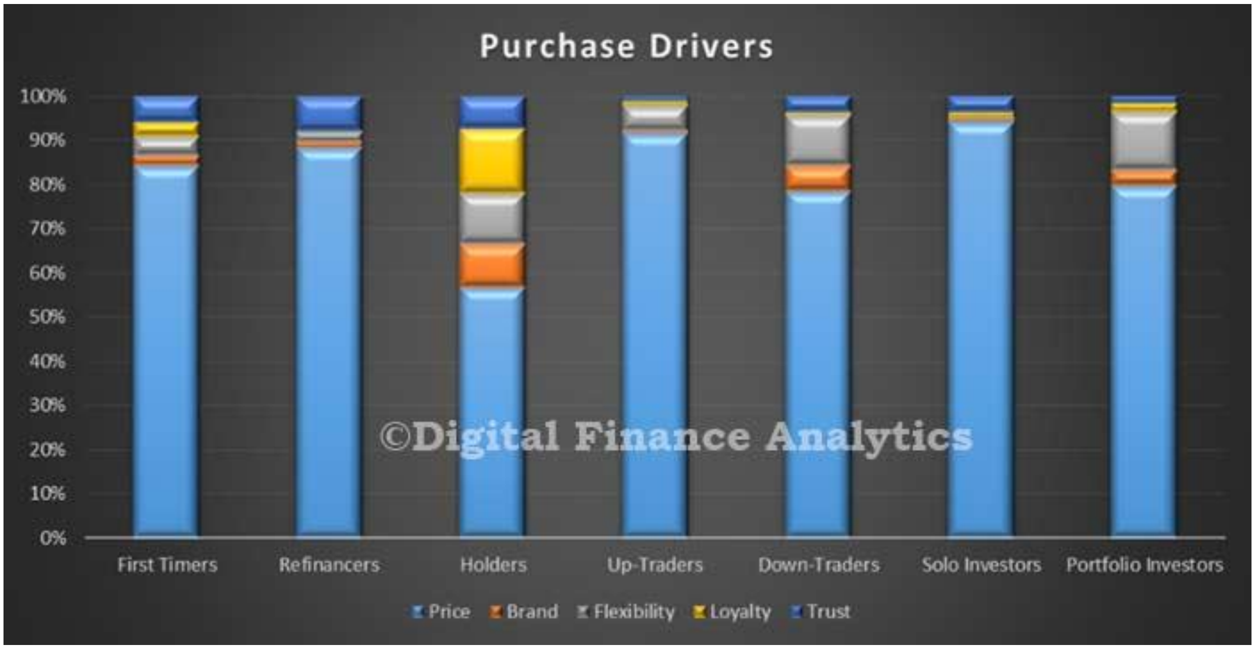
The following infographic shows the layers of regulation within the mortgage broking industry and consumer protection mechanisms in place.



Intangibles

Intangibles are secondary to price

Despite what some of the larger lenders may wish, the overwhelming factor that influences loan choice is price.



Source: Digital Finance Analytics "Households still want property, but it's becoming more challenging" 21 September 2015
Available from http://www.digitalfinanceanalytics.com/blog/author/mnorthDFABlog/

It would appear that 'brand' is relatively unimportant for many types of buyers, as long as the product has the features that meet their requirements.

AFG conducts customer surveys to ascertain customer satisfaction with the home loan process.

We would encourage lenders to provide any surveys that relate to customer satisfaction with lender direct mortgages.

Brokers are highly valued by their clients and by many prospective purchasers as they have extensive knowledge of the products offered by their panel of lenders and not just from a single lender.

<u>Short-term outcomes</u>

The purchase of a property, whether it is as an owner occupier or investor, can be very stressful and prospective borrowers want confidence that the loan application and settlement process will proceed smoothly. Brokers rapidly become aware if a lender's approval times are becoming longer and will revise their recommendations accordingly if the buyer is sensitive to delays. In states where auctions are more common, ie NSW and Vic, applications for pre-approval are common. Most lenders will provide pre-approval for a limited period (3-6 months) confident in the knowledge that, once a customer has pre-approval, they are likely to exercise it if they are successful with their offer. Brokers are also keen to develop relationships with potential clients even if the consumer has yet to identify a prospective property purchase or is considering bidding at auction. Final finance approval is always conditional on a number of factors including valuation and income verification.

Long-term Outcomes

Brokers and lenders are required to assess that borrowers have a plan for full repayment of the loan. This is not usually a problem for younger borrowers who have a consistent employment record and who are likely to be working for the term of the loan. However, it can be more problematic for older borrowers who are likely to have retired before the loan has been repaid. All parties need to consider the borrower's ability to continue servicing the loan after retirement or repaying it, whether that is from the sale of an investment property, servicing from superannuation or downsizing.

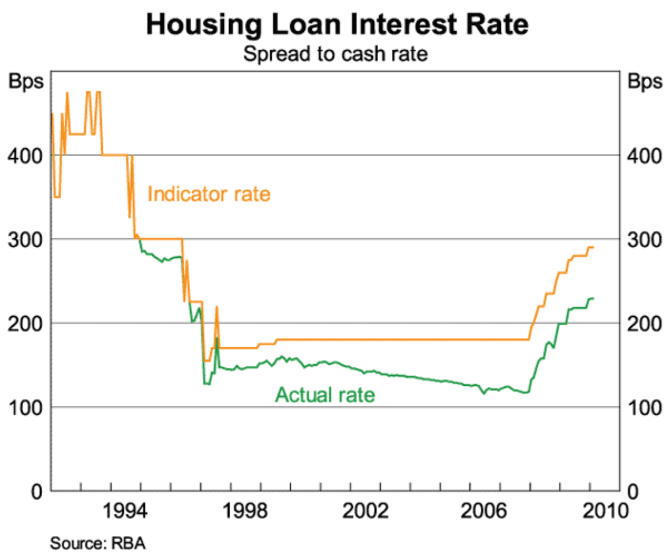
The bargaining power of a broker in the mortgage equation should not be underestimated. It is our assertion a mortgage broker dealing with a panel of lenders drives competition between lenders.

The discounts that brokers can secure for their clients can save them a considerable sum over the life of a loan. A discount of 0.4% on a $450,000 25 year mortgage advertised at 4.8% would see the consumer pay off their loan 21 months early and save approximately $54,000 in interest. Many borrowers 'set and forget' their mortgage and do not have the expertise to evaluate the impact of refinancing at a lower rate. Without the broker channel periodically evaluating the suitability of the loan, many consumers would be paying significantly more interest over the life of their loan.

Scoping Questions

11. What factors do you consider we should prioritise in assessing consumer outcomes?

The principal feature that consumers look for is cost – the broking sector has already delivered substantial benefits to consumers by assisting new mortgage lenders to distribute their products, leading to increased completion in the mortgage sector which had the effect of driving down the indicative variable home loan interest rate from around 400bps above the cash rate in 1994 to around 175bps above the cash rate by 2010.



Source: Reserve Bank of Australia Available from: http://www.rba.gov.au/speeches/2010/sp-ag-300310.html

Loan performance, or the incidence of arrears and defaults, can be a reasonable indicator of consumer outcomes. However, it can also be driven by factors that are outside the control of the broker or lender including:

- Extended loss of income, through redundancy, illness
- Consumer fraud (eg undisclosed expenditure, such as gambling).

Any comparison across distribution channels should be made on a like-for-like basis. If you are examining the performance of the loan book of, for example, a lender who only previously held proprietary home loans for staff (where they had extensive knowledge of the borrowers) and then aggressively expanded through the broker channel the structure of the data set within the channels by comparison will be fundamentally different.

Lenders will collect data on the reasons for default that should be considered and we suggest that ASIC endeavour to obtain this data.

As a result of their in depth knowledge of the market, brokers are often able to secure discounts to the published interest rates that borrowers would not be able to achieve or even ask for. AFG brokers are encouraged to record the discount on the standard variable rate that they are able to achieve.

The bargaining power of a broker in the mortgage equation is not to be underestimated. It is our assertion that a mortgage broker dealing with a panel of lenders drives competition between lenders. The lenders themselves should be asked for a record of the discounts agreed to through the broker and their proprietary channels.

The level of complaints made to External Dispute Resolution organisations may be regarded as an independent indicator of the level of customer satisfaction.

Brokers are required to follow strict processes to ensure that the loan they recommend is not unsuitable for the customer's needs. Whilst policy differs from one financial institution to the next, to protect both the lender and the customer from the provision of an inappropriate product, brokers generally also face a 100 per cent 'clawback' of their commission over the first 12 months, and 50 per cent over 18 months, of a settled loan's life. It is therefore in the broker's interest to ensure the product selected meets the customer's needs.

Despite the role of the intermediary, the decision to fund a loan is ultimately that of the lender who must meet responsible lending requirements as well as its own credit policy. As a result, if a loan defaults as a result of the borrower failing to meet their payments the lender's own credit policy should primarily be examined together with its approach to its own responsible lending obligations.

While brokers maintain contact with their clients, they cannot control whether a borrower chooses to refinance and therefore do not recommend loans based on clawback policy. AFG has analysed its data to see if there is a correlation between the incidence of clawback and the severity of the lenders' clawback policies and there is not.

12. What are the typical ways in which industry measures the quality of consumer outcomes? e.g. loan performance, complaint levels, etc

Brokers will typically be contacted by their clients if they are dissatisfied with any aspect of their loan. AFG, through its SMART customer marketing tool, gives brokers the opportunity to seek feedback from borrowers after settlement and automatically prompts brokers to contact customers at periodic intervals thereafter. This information will be made available to ASIC and we suggest that ASIC seek equivalent data from other industry participants.

Run-off is a measure of loan management but is not necessarily indicative of an adverse outcome. The runoff rate is a function of the following:

- Borrower's capacity to make additional payments
- Borrower's ability to refinance with better terms (such as when their credit profile improves and they are no longer limited to specialist lending)
- Specials offered by lenders from time to time which may lower the cost of borrowing after costs

13. What information gathering methods do you consider would best assist us to identify:

- **the factors and priorities which drive consumers to apply for home lending products through particular distribution channels?**
- **consumer expectations of, and experiences with, particular home lending distribution channels and their respective sales processes?**
- **the influence or impact (if any) of remuneration structures on consumer decision making and outcomes?**

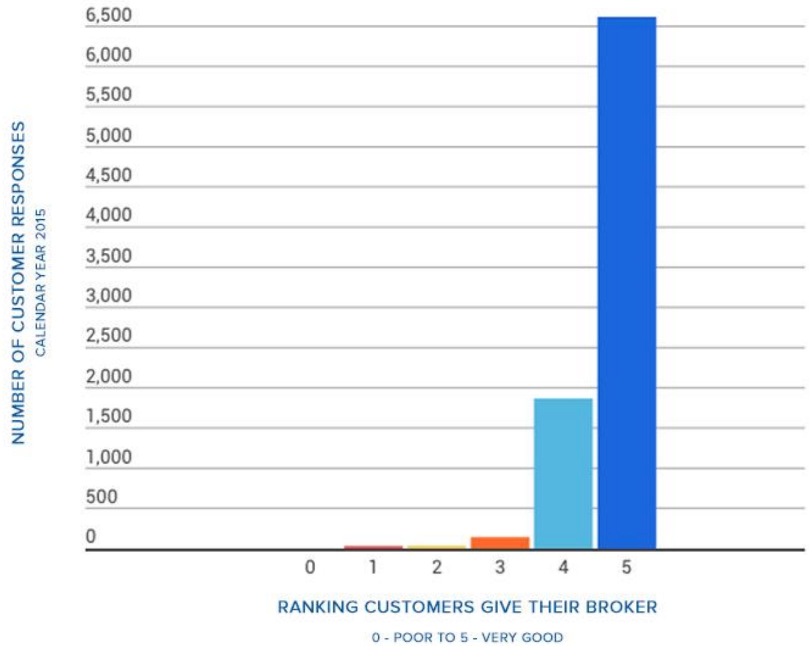
e.g. consumer focus groups, behavioural economic research, testing consumer outcomes against particular remuneration structures etc.

AFG believes Australian consumers are voting with their feet. The mortgage broking industry provides customers with access to a range of providers at a time and location that suits the often time-poor consumer. The mortgage broking channel represents more than 52 per cent of the mortgage market[1], with AFG comprising 22 per cent of broker market and 11 per cent of the overall market. Through their choices, consumers are clearly indicating a high level of comfort with the current mortgage broking model.

Mortgage broking is a professional industry that understands the value of medium-long term client retention. AFG has spent tens of millions of dollars on a highly successful client retention strategy that is strongly supported by AFG's brokers. The program, SMART, aims to protect and increase the loan portfolios of AFG brokers by retaining customers and attracting new business by maintaining regular and ongoing communication with clients. An analysis of 8,699 customer surveys for AFG brokers on the SMART program in calendar year 2015 showed an average customer satisfaction score of 4.72 out of 5.

[1] MFAA: Comparator report 2015

AVERAGE OF 4.72 (OUT OF 5) ACROSS 8699 SURVEYS



Australian credit licensees and their credit representatives are required to be members of an approved External Dispute Resolution scheme. AFG is a member of the Credit and Investments Ombudsman. The number of complaints about brokers or aggregators (including those, such as AFG, that are classified as Lenders and Mortgage Managers) is small. The Credit and Investments Ombudsman's Annual Report for 2014/15 showed AFG Ltd had 4 complaints with $31 billion in settlements for the same period.

The outcomes of those complaints were:

Resolved by agreement	1
Complaint not substantiated	1
Outside jurisdiction	2

There are a number of tools ASIC may wish to use to gauge consumer sentiment. These may include:

- Surveying of end clients – lender/aggregator/broker to run brief survey asking 2-3 key questions on web/app login, Facebook survey or LinkedIn
- Implement an industry standard Net Promoter Style 1-2 questions with a 0-10 range on both questions
- Lender customer satisfaction surveys – some are public with headline stats in annual reports etc
- Online market research ie iPoll or Australian Survey Sites

- Phone surveying or small focus groups via an external market research company – low cost when run in their larger calendar of surveying
- Cross industry research/analysis – eg working with real estate industry to survey potential home buyers in person and on real estate portals
- Broker surveying of end clients at settlement

14. When reviewing loan performance, what is your view regarding the appropriate time period which will provide a fair representation of performance? e.g. loans written in the past year, two years, five years etc.

Although both lenders and brokers have responsible lending obligations under NCCP, the decision to lend funds is ultimately made by the lender and will be dependent on the lender's risk appetite. Lenders usually have a considerable amount of data on potential borrowers, especially if they are existing customers, and are therefore best placed to consider whether a product is suitable for that borrower's circumstances. Brokers recommend products based on the applicant's situation at the time and, the greater the period between drawdown and the adverse event, the more likely it is that the cause was unforeseeable. With the abolition of exit fees, borrowers can now switch lenders at minimal cost providing they are not part way through a fixed interest term.

Unlike many participants, AFG is both a lender and aggregator and therefore has a more holistic perspective on consumer outcomes. AFG has offered its own white-label loans since 2011 and, through prudent credit assessment, has yet to experience a material loss.

The average life of a loan is approximately four years; however, many loans are refinanced sooner than that – often as soon as two years after they were originally established. This can be because some products offer a discounted rate for a specified period after which they revert to a higher rate. The cost of not re-financing, whether to the same or a different lender, is often much greater than the costs of refinancing.

15. Are there any other matters you feel may be beneficial for our consideration?

Most brokers are willing to invest their time and effort helping potential borrowers even if there is no certainty that it will result in a commission. This includes facilitating pre-approval for a buyer who is embarking on the house hunting process or simply helping consumers evaluate their borrowing capacity. If brokers were prohibited from earning commission, this would limit the extent of advice that they were able to give as borrowers are likely to be reluctant to pay upfront fees for advice.

It is important to consider what the consumer outcomes would be if the broking channel was restricted. A viable mortgage broking sector is crucial for retaining an element of competitive pressure in the mortgage market. Many of Australia's smaller lenders rely on mortgage brokers to act as a distribution network for their products. Without access to the network of mortgage brokers provided by the likes of AFG, these organisations would simply not have the resources to broadly distribute their products.

Just as importantly, without the diversity of the underlying mortgage assets particularly in terms of customer type and their location, the ability of these smaller financial institutions to attract ongoing funding for their residential mortgages, on commercially competitive terms, would be hindered which would further limit competition in the residential mortgage sector.

Loans from brokers face a range of checks, including the requirements under NCCP, industry body MFAA's procedural requirements, the requirements of their aggregator and the lender's own requirements.

The performance of any mortgage starts and ends with credit assessment standards, driven by the risk appetite of the lender, not the mortgage broker.

Our own AFG Securities book has written $2 billion worth of home loans, 100 per cent broker-introduced, and the overall performance of these loans has been exemplary. This performance is a direct reflection of our credit assessment procedures and our conservative risk appetite.