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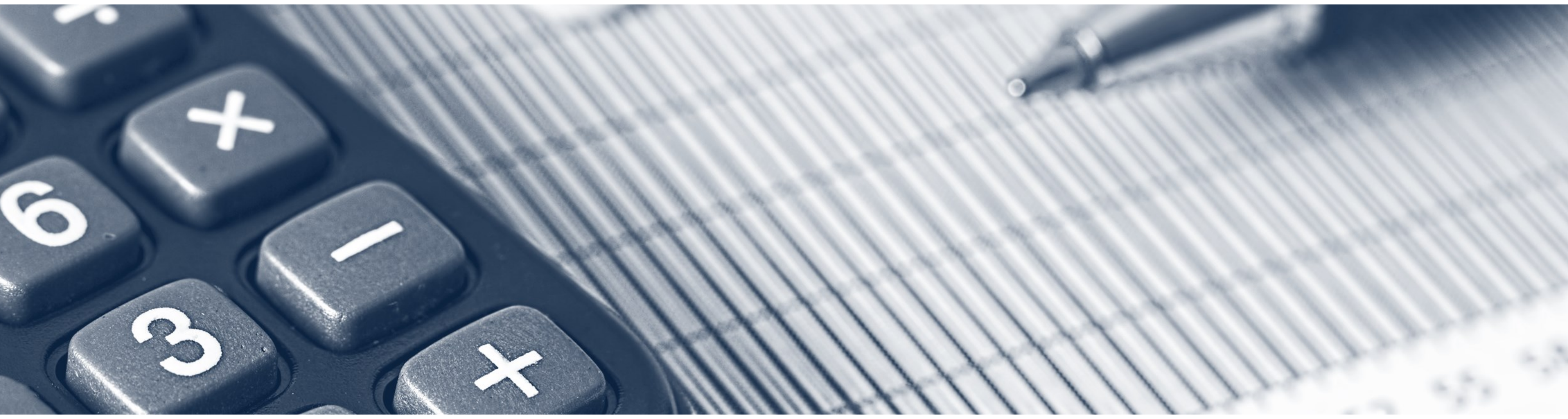

The Royal Commission's Effect on the Mortgage Broking Industry

The recent Royal Commission into the Banking, Superannuation and Financial Services sector has thrown the mortgage broking industry into a state of disarray.

The most immediate change which is proposed - the banning of trail commission - is enough to cause mortgage brokers, especially those less seasoned in the industry to consider leaving the industry altogether, which points to the magnitude of these proposed changes.

Another proposed change, being the shift towards a "*buyer pays*" model, further reinvents the traditional *"lender pays*" model requiring the mortgage broker to rely on market forces and the borrower's capacity to pay for its services upfront.[1]

The clear questions which arise are:

1. Will the Government proceed with these changes;
2. When will they proceed; and
3. How will this affect the industry?

THE BAN ON TRAIL COMMISSIONS

The Final Report of the Royal Commissions sets out at Recommendation 1.3 the following:

Recommendation 1.3 - Mortgage broker remuneration

- **The borrower**, not the lender, **should pay the mortgage broker a fee** for acting in connection with home lending.
- Changes in brokers' remuneration should be made over a period of two or three years, by:
  1. **prohibiting lenders from paying trail commission** to mortgage brokers in respect of new loans; and
  2. **prohibiting lenders from paying other commissions** to mortgage brokers.

IMPORTANT CONSIDERATIONS

While no one can say for certain whether recommendations from a Royal Commission will be implemented, certain surrounding considerations guide the discussion on whether the ban of trail commission is likely to occur. The considerations include the following:

1. Criticism for conflicted remuneration and ongoing fees was levelled not only against mortgage brokers but also the financial services industry which suggest a wider cross-industry attempt at removing perceived misconduct and conflicts of interest. The financial

services industry received heavy criticism for *'grandfathered commissions*' and *'ongoing annual fees'* analogous to the broker's *'trail commission'*.

2. Unlike other recommendations in the Report, Recommendation 1.3 specifically prescribes a time frame for the trail commission changes and "*buyer pays*" changes. Other recommendations in the Report contain less detail regarding when these suggested changes are to be implemented, which draws additional attention to this specific recommendation.

3. Parliament has reinforced the views of the Commissioner. The public announcement by Treasurer Josh Frydenberg on 4 February 2019, explicitly used affirmative wording, "*we are doing the following*", "*banning trailing commissions and volume -based commissions on new loans from 1 July 2020*."[2]

4. The Government's Report titled *Restoring trust in Australia's financial system, The Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* also announces that the government would be "*taking action*" on all 76 recommendations.[3]

5. Page 3 of the Government's Reports indicates that the Government will remove conflicts of interest between brokers and consumers by banning trail commissions and other inappropriate forms of lender -paid commissions on new loans from 1 July 2020 with a further review in three years on the implications of removing upfront commissions and moving to a borrower pays remuneration structure.[4]

BUYER PAY MODEL

While the immediate change to trail commissions may seem inevitable, the shift towards a buyer pays model is less certain. The buyer pays model is scheduled to occur within three years, in which there could be room for significant changes in views of Parliament.

Prime Minister Scott Morrison cast doubt that all recommendations would be implemented and has demonstrated support towards movement in the Mortgage Industry opposing the changes, using strong language as follows:

"I don't want to see this sector wither on the vine and be strangled by regulation that would throw them out of business, but more importantly would deny choice and competition in the banking system."[5]

An alternate proposal or suggestions, however, to counter the Commissioner's recommendations have not been announced.

The Government notes it will be monitoring the macroeconomic effects of the "borrower pays" model, its effects on competition in the market and the effect on interest rates to ensure that the changes will not compromise the market.

POTENTIAL ISSUES CREATED BY THE TRANSITION

Consistent with the recommendations, the response from Government indicates that the proposed bans on trail commission are to operate from 1 July 2020 with regard to "*new loans*".

While the prohibition is said to commence from 1 July 2020, what must be contemplated is how lenders will respond to this change.

The Report clarifies that existing trail commissions would "*stand unaffected*".[6]

This introduces ambiguity to the state of current trail commissions as it is not clear '*how long'* trail commissions would remain unaffected. It is not clear, for instance, whether loans finalised prior to 1 July 2020 would receive the benefit of trail commission for the entire life of the loan, or whether legislature further intends to limit payment of trail commission to a set number of years.

Noting the clear intention of Parliament to take action in accordance with this recommendations, the early adoption of these recommendations by lenders is possible. It may be worthwhile observing the response of lenders to see if they will review and update their existing arrangements with mortgage brokers and to keep a close eye on lenders who may seek to terminate payment of trail commissions prematurely relying on arguments that it could not honour those payments if it would contravene laws and the clear intent of parliament.

MORTGAGE INDUSTRY RESPONSE

The drastic changes recommended certainly appear to have sparked an outcry in the mortgage broking industry. Notable voices have advanced arguments against this change which includes for instance that:

1. Trail commissions are justified as they allow for mortgage brokers to provide a continuing service and relationship with clients after the loan is settled;

2. Mortgage brokers provide the "voice" to smaller tiered lenders to introduce and distribute their products;

3. The introduction to competition in the market which results in lower interest rates due to the increased pressure on lenders; and

4. That the commission being paid by the lenders allows for borrowers to access the services of mortgage brokers at a cost to the lender and that a "*buyer pays*" model will make the services of a mortgage broker inaccessible to many.

CONCLUSIONS DRAWN SUPPORTING REASONS FOR CHANGE

The Commissioner has, in its recommendations, considered the above arguments and identified evidence that:

- Mortgage brokers have increased the size and risk profile of the loan without consideration as to whether it is required or wise for the client to obtain such a loan;

- Mortgage brokers have acted in the best interest of the lender and fostered a continuing relationship with select preferred lender as it is the lender who pays the broker along with additional incentives;

- Mortgage brokers have encouraged that the borrower remain with the same lender after settlement of the loan due to clawback clauses with the lender, despite the availability of better loans which are commercially more advantageous to the client;

- There was little evidence that mortgage brokers actually maintained a relationship with the borrowers after the loan was settled. In contrast, there was significantly more evidence to suggest that the trail commission "*bound the mortgage broker to the lender*";

- While brokers may have the potential to increase competition between the lenders in the marketplace, this has not occurred as smaller lenders are unable to compete with the larger lenders to remunerate broker; and

The Commissioner stated his recommendations would address those issues and that the staggered introductions of reforms would not have as a large an effect on the economy as some would believe:

> *"Put another way, if 'appropriately managed, ensuring the industry consistently meets the requirements of existing laws will likely enhance rather than detract from macroeconomic performance'."*[7]

IS ANYONE TO BLAME?

Although it is arguable that this is a case of a few rotten apples ruining the basket, the Commissioner suggests that data from the banks and other case studies indicate otherwise.

If the industry is permitted to preserve its current status and method for remuneration, rather than to fight the changes head on, such evidence may need to be presented by mortgage brokers that they:

1. Maintained relationships with a client after a loan was drawn down,

2. Actively encouraged borrowers to switch to a lender with a better rate or more suitable for the borrower, especially if this was done so during the clawback period with the lender,

3. Ensured that their loan profiles were sufficiently diversified and included a significant portion of second or third tier lenders.

4. Did not receive significant volume based incentives from preferred lenders.

Unless the industry produces a strong response, it would seem unlikely that the Government would reconsider the recommendations of the Report, due to the heaving criticisms of the industry and diminishing public confidence.

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[1] Final Report, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Recommendation 1.3 – Mortgage Broker Remuneration [80].

[2] https://joshfrydenberg.com.au/latest-news/federal-treasurer-calls-for-financial-sector-to-put-consumers-first/

[3] Restoring trust in Australia's financial system, The Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

[4] Restoring trust in Australia's financial system, The Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry at [3].

[5] https://www.smh.com.au/politics/federal/morrison-backs-brokers-despite-warning-from-banking-royal-commission-20190211-p50wzv.html

[6] Final Report, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Recommendation 1.3 – Mortgage Broker Remuneration [77].

[7] Treasury, Interim Report Submission, 35 [177].

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