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Inquiry into promoting economic dynamism, competition and business formation

The FBAA appreciates the opportunity to make a submission to the Inquiry into promoting economic dynamism, competition and business formation.

The FBAA is a peak industry body representing almost 11,000 members, comprising lenders, aggregators, finance and mortgage brokers, many of whom are small business operators. We have worked closely with Government over the years and actively contribute to consultation around the establishment of new laws and regulations and the development of industry guidance.

In this paper we use the terms "finance broking" and "finance broker". These terms encapsulate brokers that provide services relating to all consumer and commercial credit including mortgage brokers who are a subset of finance brokers that specialise in home finance and who are subject to additional regulation.

There is no question that the finance and mortgage broking industry has undergone a transformational journey since the introduction of the National Consumer Credit Protection Act ("NCCP Act") in 2009 – including the licensing regime administered by ASIC.

The legislative framework is complex, with many interdependent, and at times conflicting obligations arising under different pieces of legislation. To operate as a licensed finance broker in Australia, at a minimum, a person must understand the obligations arising under the following legislation:

- National Consumer Credit Protection Act
- National Consumer Credit Regulations
- National Credit Code
- Australian Securities and Investments Commission Act
- Privacy Act
- Anti-Money Laundering and Counter Terrorism Financing Act
- Competition and Consumer Act

Brokers are answerable to multiple regulators and enforcement bodies. The Australian Securities and Investments Commission is the most prominent for finance brokers but there is also the Competition and Consumer Commission, Office of the Australian Privacy Commissioner and the Australian Financial Complaints Authority plus the Industry Bodies such as the FBAA that have their own membership criteria and disciplinary processes.

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Each piece of legislation identified above is modified through further legislative instruments and guidance issued by the relevant regulators.

Since the commencement of the NCCP Act there has been incessant modification to the primary legislation and other legislation that applies to finance broking. Regulators frequently update their guidance to industry and with each revision, the guidance appears to become more prescriptive, more demanding and more onerous. Since the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, some ASIC "regulatory guidance" has become enforceable. Failure to follow ASIC guidance is punishable in its own right. This causes us considerable concern as we have seen from numerous unsuccessful legal actions that ASIC often does not get its interpretation of the law correct, or only gets it partially correct. There have been inquiries in to the effectiveness of ASIC as a regulator and scrutiny continues to be applied.

Perhaps our greatest concern is that of law enforcement agencies supplanting the function of Parliament in making laws. More and more often, laws are drafted in broad and general terms with Government deferring to a regulator to make a legislative instrument that provides detail on how the law is to operate.

An example of this is the mortgage broker's best interests duty which was introduced as law following the Royal Commission.

The best interests duty in the National Consumer Credit Protection legislation is established by 17 words. They are:

158LA Licensee must act in the best interests of the consumer
The licensee must act in the best interests of the consumer in relation to the credit assistance.

The Replacement Explanatory Memorandum to the Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2019 Measures) Bill at paragraph 3.24 said "*The duty to act in the best interests of the consumer in relation to credit assistance is a principle-based standard of conduct that applies across a range of activities that licensees and representatives engage in*".

ASIC subsequently produced a prescriptive 50 page Regulatory Guide imposing a long list of specific requirements it expects brokers to meet to demonstrate compliance with the best interests duty. ASIC conducts its compliance and enforcement activities against its regulatory guidance. Government did not make the laws with respect to the mortgage broker's best interests duty. ASIC did.

What challenges us with this process is that guidance is often made in response to specific misconduct rather than giving guidance in the spirit of the principles-based legislation. It becomes prescriptive and focuses on dis-proving non-compliance. Where a regulator spends most of its time catching non-compliance and enforcing laws against those intent on breaking them, they lose perspective and begin to treat everyone like criminals.

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The approach taken with responsible lending was very similar to that of the more recent best interests duty. ASIC took a concise obligation from the legislation and turned it into almost 100 pages of regulatory guidance that was amended at least 6 times over 10 years. Many of the revisions were to address wilful misconduct and specific avoidance practices. ASIC enforced its guidance against small licensees and brokers who were powerless to argue. When ASIC took the same approach with Westpac, the bank had sufficient capital to defend itself when ASIC challenged the bank over its responsible lending practices and the Federal Court handed down a definitive rebuke of ASIC's regulatory guidance.

The same guidance that was disassembled by the Federal Court in the Westpac case was used as the basis of enforcement action and licensing action against many small licensees and operators over years – many of who believed they had done nothing wrong but who did not have the financial capacity to take ASIC to Federal Court.

The example provided here is representative of many of the challenges that face small operators in heavily regulated spaces. Costs of complying with regulation represent a much higher percentage of revenue than for a large institution, it is more difficult for small businesses to resource the infrastructure that is required and when subjected to scrutiny they are unable to adequately defend themselves and any penalties meted out are material. A $100,000 fine to mortgage broker is likely to put them out of business (this amount is more than the average annual income of a mortgage broker) whereas a $100,000 fine to a bank is immaterial. Ironically, a small operator is more likely to receive and not be able to defend against such a fine when compared to a Bank.

Elements that are critical to provide a strong foundation to promote growth and economic competition include stability, certainty and consistency.

The operation of consumer credit laws is not consistent between large and small operators. The differences are both attitudinal and legislated.

Attitudinal differences

Major financial institutions are promoted as safe, responsible entities. They are exempt from a number of the consumer credit laws around acting in the best interests of the consumer and obligations to disclose remuneration.

Third party service providers such as brokers are viewed more as a high-risk group of opportunists requiring heavy regulation to force them to act appropriately. Despite third party service providers being the only avenue for consumers to obtain unbiased, non-conflicted support, third party providers are subject to more obligations regarding the inquiries they need to make before providing a service, disclosure of the payments they receive (regardless of who pays them and whether the fees alter the cost to the end consumer) and are vulnerable to have their income confiscated for reasons that are both out of their control and sometimes caused by the entity that is endorsed to confiscate the income.

We have a really interesting situation in Australia where financial institutions cannibalise each others' clients through offering incentives and embarking on clever marketing campaigns but have a right enshrined in legislation to take back commission they have paid to a broker who introduced a customer to them up to 2 years prior – even where it occurs because of that institution's conduct.

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That customer may have been paying fees and interest for the time they were with the institution and may be leaving because they are dissatisfied with the products or services offered by the institution. In most cases, the consumer will be leaving because they have been incentivised by another institution or they are receiving poor service from their current institution. The person impacted by the outcome is the broker who introduced the customer. They have no control over the service level offered by the financial institution or the incentives offered by another institution. Often a broker will have no choice but to trigger a clawback against themselves in order to retain their customer's business.

Other situations also come into play. Brokers actually have a legal obligation under the best interests duty to trigger the clawback if a consumer asks for assistance and the broker can identify a better product than the one the consumer is currently in. Clawbacks can also be triggered where consumers pay out their loans early. There are many examples of where a broker has had their income clawed back by a bank because a consumer has paid out their loan as a result of life events such as receiving an insurance payout (life insurance on the partner for example), receiving an inheritance, selling the home and even winning the lottery.

Financial institutions have been known to use "retention teams" which are dedicated teams of marketing staff authorised to offer rate discounts and other incentives to existing customers when the institution receives an application for an existing client to close their accounts and switch to another financial institution. Retention teams intervene after a broker has submitted a customer application to switch institutions. The broker undertakes all of the work to identify a better consumer outcome and prepares the application for the new product then the current institution has a last chance opportunity to buy the customer back through offering financial incentives that are not available to other customers and would not have been made were it not for the broker's work. In these situations, the broker receives no payment, the customer receives a windfall and the financial institution continues to make money from the customer. Such behaviour is supported by legislation.

Legislated differences

Credit providers do not have a legislated obligation to act in a consumer's best interests
Credit providers that provide home loans to consumers are not subject to the same laws as third parties that assist consumers to find home loans.

Credit providers can recommend a consumer switch into their product without giving consideration to whether the consumer's current product is better for them.

This has promoted the behaviours referenced earlier of banks paying large financial incentives to consumers to switch away from their current credit provider. They can do this without needing to know if the consumer is currently in a better product.

Marketing tactics to win new business are not new. Prior to the more recent cashback offers, banks used to offer honeymoon rates – heavily discounted rates to new customers for a short period of time in the hope that customer apathy would see them remain on as a customer after the honeymoon rate expired. We recognise that it is part of business to compete for new clients. Australia is a relatively shallow pool meaning most clients moving to a new institution are leaving

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another institution. The frustration we have is that brokers are critical to agitate for fairer pricing and to challenge the power that large financial institutions have over their customers yet they are subject to a range of outcomes caused by poor legislative drafting or regulatory attitudes where they often derive no financial compensation for their efforts.

There are also differences in the disclosure obligations between credit providers and brokers.

Brokers must disclose the commission they earn from a recommendation to a particular financial institution, yet the financial institution does not have to disclose to the consumer any information about how it remunerates employees and sales staff or its interest rate margins or profitability. We are not suggesting that they should as that level of disclosure would only raise consumer dissent while tat the same time change nothing about the cost of credit. Our concern is the imbalance between disclosure obligations between brokers and lenders.

The imbalance of disclosure obligations puts a focus on broker remuneration which at times is played upon by other entities and portrayed as a negative attribute of broking. The burning issue which has never been conceded is that the commission banks pay to brokers for introducing an application have no bearing on the cost of the product to the consumer. Whether a consumer applies to a financial institution directly or through a broker, the cost is the same – or in some cases lower for those introduced through a broker. No regulator or commission of inquiry has ever acknowledged this.

Third parties have their remuneration taken away

Also referenced earlier, clawbacks are enshrined in legislation. The more powerful party can take commission back from the smaller party leaving them vulnerable to sharp marketing practices.

Clawbacks of all things create more uncertainty and unmitigable risk to brokers than just about anything else.

We believe the examples above support a conclusion that the power imbalance and inconsistency of legislative drafting and enforcement promote anti-competitive behaviour. It allows larger institutions to dictate to small business operators and to engage in behaviours which confer significant advantages on them to the expense of small business operators.

Growth of the broker channel

There is empirical evidence that the growth of the broker channel has resulted in margin decreases to financial institutions. Brokers raise consumer awareness of smaller credit providers and a wider choice of products and this forces larger institutions to price their products to remain competitive. Over the past decade, as the broker market share has grown to more than 60% of all applications being submitted to lending institutions, margins have declined.

A strong third party (broker) channel promotes competition and limits the ability of any particular institution to exploit consumer ignorance.

Conclusions

The legislative framework is complex. This much will never change.

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The cost of seeking advice to comply with complex legislative requirements is significant for small and large entities. It is most significant (as a proportion income) for a small business. This, coupled with legislated rights for large financial institutions to clawback commission that is legitimately and fairly earned, increases the economic barriers to entry for new, smaller operators.

We strongly support better recognition of the pressures placed on small business where they are expected to comply with standards that are the same, or in many cases higher than for the largest of national and multi-national financial institutions. It is time to identify and eliminate rules that create an imbalance in the rights between parties.

Yours faithfully

Peter J White AM MAICD
Managing Director

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Life Member – Order of Australia Association

Advisory Board Member – Small Business Association of Australia (SBAA)
Chairman of the Global Board of Governors – International Mortgage Brokers Federation (IMBF)