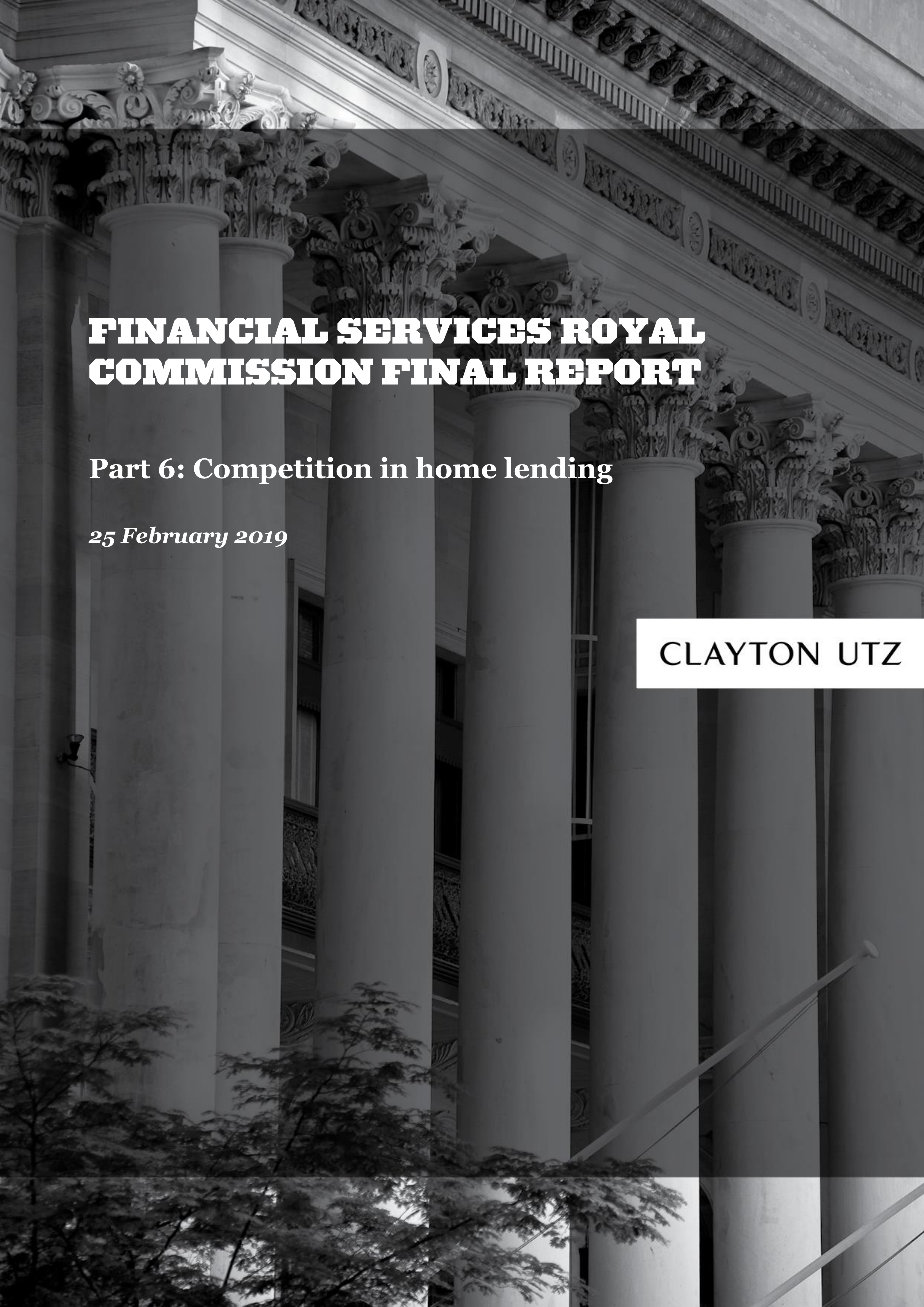

FINANCIAL SERVICES ROYAL COMMISSION FINAL REPORT

Part 6: Competition in home lending

25 February 2019

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In the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Commissioner Hayne made five recommendations concerning intermediated lending or mortgage broking. These recommendations are set out in **Annexure A**.

This update focuses on Commissioner Hayne's recommendation that the market structure for mortgage broking for home lending in Australia should be fundamentally rewritten to require brokers, amongst other things, to act in the best interests of borrowers and to prohibit lenders paying commissions to brokers.

So far that proposal has not been accepted by the Federal Government and the Labor Opposition has recently backed away from its initial support if it comes into Government.

It may be that Commissioner Hayne's proposals are ultimately not adopted (or not adopted in full if the Labor Opposition wins the upcoming election). Nevertheless, the question being debated is whether, if these recommendations are adopted, the mortgage broking industry in Australia can adapt to have a viable future, and what that might mean for competition in residential lending.

1 CURRENT LEVELS OF COMPETITION

In Australia, both the ACCC and the Productivity Commission recently raised concerns that competition in home lending in Australia is not as robust or effective as it should be, with persistent marketing and brand activity promoting a "blizzard" of barely differentiated products and white labels supplied at allegedly high margins.

While at one time mortgage brokers were considered to revitalise price competition, the Productivity Commission concluded that brokers have become part of the banking establishment and captured by trailing commissions and perceived conflicts of interests with borrowers.

The Australian mortgage brokers industry is a key distribution channel for home loans and accounts for greater than half of all residential loans settled. Smaller lenders are even more dependent on brokers to compete in the home lending market due to their smaller branch networks.

Critics of Commissioner Hayne's recommendations have pointed out the reduction in broker remuneration is likely to cause many brokers to leave the industry. They have suggested that the service which brokers provide is of value to the banks, and should be paid for by the lender, since it saves the lender the costs of introducing and setting up the loan application.

2 CONFLICTED REMUNERATION

Commissioner Hayne found that value-based commissions earned by mortgage brokers are a form of conflicted remuneration that can reasonably be expected to influence the choice of mortgage, the amount to be borrowed and the loan terms.

His recommendations to abolish those commissions by regulation rest on the propositions that:

- borrowers value the cost of the service provided by a broker and are willing to pay a fee to cover that cost;
- the cost of using the broker can be capitalised in a loan and repaid over the life of the loan; and
- the potential for brokers to increase competition in home lending does not require commission-based remuneration as that leads to lenders competing on the basis of who can offer higher commissions to brokers, rather than the best loan terms to consumers.

More controversially, Commissioner Hayne recognised this change to broking would deliver a significant advantage to lenders with a branch network, if they can lend to borrowers without any fee being payable by customers. The Commissioner therefore proposed a solution to ensure competitive neutrality: require banks to charge borrowers a mandatory fee to recover the costs, that would be avoided by the lender, if the loan were to be originated through a broker.

Mandating the charging of a minimum cost-based fee as a condition of direct lending in the market is an unprecedented solution to address competitive neutrality between broker arranged loans and those made by banks.

The Commissioner cited the Netherlands reforms in 2013 where brokers charged borrowers a fee and proposed that the fee which lenders are required to charge borrowers be determined by a Treasury-led working group and subject to monitoring from the ACCC.

3 POTENTIAL EFFECTS ON COMPETITION REGULATION IN AUSTRALIA

There is a practical concern with these recommendations: will borrowers be willing to roll a cost of the advice they receive from a broker into their home loan, or instead forego that option and go to lenders directly and be charged the same fee – but receive no advice? If lenders are not required to charge that fee they will have an advantage, although the borrower will not receive from a direct lender the benefit of the broker's comparison services.

More fundamentally, however, is the change they could make, if implemented, to the shape of Australian competition regulation.

Legislating to require fees to be charged by lenders to consumers referable to costs (when the loan is not initiated through a broker) is likely to tax the ACCC and would be a fundamental change to its role.

Allegations of an anti-competitive margin/price squeeze between lenders and brokers over the charging of such fees might arise if these reforms take shape. We saw similar complaints in telecommunications when resellers of telco services had to compete against the vertically integrated pricing of Telstra when it controlled the network.

3.1 Risks of abuse of market power?

In this context Australia's competition laws will need to be considered.

The ACCC enforces section 46 of the Competition and Consumer Act, which prohibits a corporation which has a "substantial degree of power in a market" from engaging in any conduct – including charging fees or prices – if the effect, or likely effect, of that conduct is to substantially lessen or hinder competition in a relevant market.

The ACCC's Guidelines to section 46 note the risks for companies contemplating a margin/price squeeze directed at rivals who sell the same services in a downstream market:

> "a firm with a substantial degree of market power in the supply of a key input can disadvantage competitors in downstream markets by reducing the margin available to these competitors. It could do this, for example, by charging its competitors an input price that makes it uneconomical for them to offer a competitive price in the downstream market"

If the Commissioner's proposals were adopted, lenders would not be permitted to pay brokers any "input price" or fee for arranging a loan on behalf of the lender, and therefore one assumes lenders would not be likely or permitted to charge a fee to brokers that could make it uneconomical for brokers to compete against the lender.

But is it possible, under Commissioner Hayne's proposals, that a lender could achieve a margin/price squeeze on brokers by other means, and make them less competitive in the home lending market?

Would a margin/price squeeze be possible if, when competing against brokers, a lender could reduce any of its other loan fees such as establishment fees for direct loans, below the level of the same fees charged if the borrower elected to apply for the loan through the broker?

This seems unlikely. The large penalties available for breach of section 46 should serve to prevent a lender considering such a strategy – and assuming the lender was bound by section 46 (because it was likely to enjoy substantial market power). Smaller lenders are unlikely to have anything to fear from section 46 if they lack substantial market power (as the section will not apply to them).

But in the scenario suggested, of discrimination between various fees charged for a loan depending whether the borrower deals direct with a lender or via a broker, the application of section 46 is unclear – it is a new provision introduced its current form in 2017, and yet to be tested.

While such discrimination in fees across different lending channels might lead to claims of market abuse and anticompetitive behavior it is possible that lenders could try to justify higher fees for broker introduced loans, on the basis that they incur higher compliance costs to assess loan applications through brokers than for direct applications.

If lenders can charge borrowers higher fees for broker introduced loans than for direct loans, the competition effects of the Commission's recommendations will be challenging

3.2 The ACCC's role

Under the Commission proposal for direct lending, the ACCC would have an unprecedented role in the design and policing of a floor under the "service fee" which lenders must charge for direct lending. The closest but imperfect analogy we can see is the ACCC already polices a cost based cap on surcharges which merchants may levy, when consumer use credit and debit cards. Regulations limit merchants' right to impose a payment surcharge on specified payment types, so that the amount of the surcharge must not exceed the merchant's costs of accepting the payment type.

However it is one thing to police a "cap" on surcharges (to limit them to the costs incurred) and another to invoke a minimum fee. The Commission proposal is to put a cost-based "floor", not a cap, on the fee which lenders much charge which is equal to the costs avoided by the lender. This might prompt some lenders to set a fee using the lowest possible cost broker. Or will one fee be imposed across the industry and, if so, how would it be set so as not to harm some lenders and advantage others?

With up to 90% of some banks' loans being originated from brokers under the commission-based system, whether these changes will be implemented and in what form are likely to be the most controversial recommendations from the Commission.

We believe a more thorough competition analysis will be needed to consider Commissioner Hayne's recommendations for mortgage broking. Drawing on long experience with competition analysis, and also the experience we have with the use of cost-based caps on fees, there are some lessons to be drawn that may favour a more market-focused solution to the problems identified by the Commissioner.

ANNEXURE A – THE RECOMMENDATIONS

Consumer lending: Direct lending

Recommendation 1.1 — The NCCP Act

The NCCP Act should not be amended to alter the obligation to assess unsuitability.

Consumer lending: Intermediated home lending

Recommendation 1.2 — Best interests duty

The law should be amended to provide that, when acting in connection with home lending, mortgage brokers must act in the best interests of the intending borrower. The obligation should be a civil penalty provision.

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 first prohibiting lenders from paying trail commission to mortgage brokers in respect of new loans, than prohibiting lenders from paying other commissions to mortgage brokers.

Recommendation 1.4 — Establishment of working group

A Treasury-led working group should be established to monitor and, if necessary, adjust the remuneration model referred to in Recommendation 1.3, and any fee that lenders should be required to charge to achieve a level playing field, in response to market changes.

Recommendation 1.5 — Mortgage brokers as financial advisers

After a sufficient period of transition, mortgage brokers should be subject to and regulated by the law that applies to entities providing financial product advice to retail clients.

Recommendation 1.6 — Misconduct by mortgage brokers

ACL holders should:

- be bound by information-sharing and reporting obligations in respect of mortgage brokers similar to those referred to in Recommendations 2.7 and 2.8 for financial advisers; and
- take the same steps in response to detecting misconduct of a mortgage broker as those referred to in Recommendation 2.9 for financial advisers.

GET IN TOUCH

We welcome conversations on Commissioner Hayne's report. If you wish to have your own conversation with us on the report and how it may affect you and your business, please contact us: **FinancialServicesRC@ClaytonUtz.com**

You can also keep up with our rolling coverage at our dedicated Financial Services Royal Commission hub **https://www.claytonutz.com/financial-services-royal-commission/hub**.

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