HERBERT SMITH FREEHILLS

CREDIT DISTRIBUTION

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Legal Briefings – By **Tony Coburn, Amy Ciolek, Julia Massarin and Lisa Whiting**

The Final Report has made a number of recommendations that aim to address issues that exist within intermediated lending, with a particular focus on mortgage brokers. This article focusses on home lending. Please see Banking and Credit (General) for our discussion about the recommendations relating to intermediated lending for motor vehicles, whitegoods and furniture, banking and other credit topics. For further information on the responsible lending recommendations, please see Responsible Lending: "Apply the law as it stands!".

The recommendations relating to intermediated home lending distribution focus on issues specifically applicable to mortgage brokers, but the Final Report also addresses aggregators and introducers.

To remedy two of Commissioner Hayne's four observations of most concern - the connection between conduct and reward, and the conflict of duty to borrowers - the Final Report recommends a series of changes to the law to extend a number of financial adviser safeguards to brokers in the mortgage industry. These include conflicted remuneration bans, requiring mortgage brokers to a apply a "best interest" duty in addition to conducting responsible lending, and eventually, requiring mortgage brokers to become regulated under the same law that applies to financial advisers.

The Royal Commission has identified that controls, checks and balances that currently apply to mortgage brokers (eg under the *National Credit Consumer Protection Act 2009* (Cth) (**NCCP Act**)) are not practically operating as intended. This is due to a range of factors, such as remuneration, duties and commercial pressures. These recommendations are intended to reduce the potential of a commission-based conflict of interest, reinforce that mortgage brokers act on behalf of their customer, and not as agents for the lender, and align the law with community expectations.

POLICY RECOMMENDATIONS

ADDITIONAL OBLIGATIONS IMPOSED ON MORTGAGE BROKERS

The Royal Commission recommends that the law be amended to impose additional requirements on mortgage brokers. These additional requirements are:

- Requiring mortgage brokers to act in the best interests of the borrower when acting in connection with home lending. A breach of this duty would result in a civil penalty (Recommendation 1.2).
- Mortgage brokers should be subject to the law that applies to financial product advisers that provide advice to retail clients (Recommendation 1.5).

MORTGAGE BROKER REMUNERATION

The Royal Commission has made a number of recommendations in relation to remuneration of mortgage brokers which aim to reduce the conflicted remuneration issues that currently exists in the broker industry. The Royal Commission's recommendations for broker remuneration are:

- Borrowers (rather than lender) should pay the mortgage broker's fees in connection with home lending (Recommendation 1.3).
- Banning lenders from paying commission to brokers, initially by banning trail commissions (Recommendation 1.3).
- Establishing a working group to monitor and adjust broker remuneration as necessary, including the setting of fees that lenders can charge for dealing directly with borrowers, rather than through a broker (Recommendation 1.4).

MORTGAGE BROKER MISCONDUCT

The Royal Commission has also recommended that ACL holders be required to inquire into and, where necessary report on, broker misconduct (Recommendation 1.6).

Expected	Unexpected
Banning trail commissions	Moving to a borrower pays system
Banning all commission payments	Establishing a working group to review the result of commission changes
The imposition of a duty to act in the best interests of the borrower	Recommending that mortgage brokers should be subject to the law that applies to financial product advisers advising retail clients

THE BIG PICTURE

ADDITIONAL OBLIGATIONS IMPOSED ON MORTGAGE BROKERS

In recommending that additional obligations be imposed on mortgage brokers, Commissioner Hayne wants to ensure that the law reflects community expectations.

The Final Report considers that because borrowers expect brokers will act in the borrower's best interests, the law should be changed to impose a statutory duty on mortgage brokers to act in the best interests of borrowers. This is similar to the duty that is imposed on ACL holders and financial advisers under section 47(1)(a) of the NCCP Act and section 912A(1)(a) of the Corporations Act respectively.

The Royal Commission further recommends that mortgage brokers be subject to the law that applies to financial advisers providing product advice to retail clients. This is because consumers expect brokers to provide them with advice on the most suitable mortgage product.

The traditional role of a broker was to have relationships with multiple lenders, be aware of products in the market, and help borrowers to find a suitable loan for their needs. In reality, the mortgage industry is now cluttered with a range of participants, including lenders, brokers, introducers and aggregators.

However, the Royal Commission reports that the reality is that lenders are offering competing commission rates to brokers and aggregators to encourage brokers to offer that lender's mortgage product to borrowers. The removal of commission payments (see below) and the imposition of additional obligations on brokers aim to reduce conflict between lenders, brokers and borrowers.

MORTGAGE BROKER REMUNERATION

The current remuneration model for mortgage brokers creates a potential conflict that brokers will recommend loan products for their borrowers based on the amount of the broker's commission. In making these recommendations to remuneration, Commissioner Hayne is creating a system where brokers are incentivised to serve the customer, not the lender – a further attempt to reduce conflicts between lenders, brokers and borrowers.

Commissioner Hayne acknowledges that the removal of commission payments will need to be carried out over a few years and delivered in stages. Current loans with trail commissions will be grandfathered, within 12 to 18 months trail commissions will be banned, and within a further 12 to 18 months lenders should be prohibited from paying any commission to mortgage brokers.

In December 2017, the Combined Industry Forum (**CIF**) proposed broker remuneration reforms that included linking commission payments to the amount of the loan actually drawn down, not the total size of the credit facility, and ceasing volume and campaign-based commission. Similar recommendations were made by the Productivity Commission in 2018, as well as a ban on trail commissions. However, Commissioner Hayne has gone further in proposing a total prohibition on commission payments because he considers that that these do not solve the conflicted remuneration issues.

If commission payments are not prohibited, Commissioner Hayne has stated that he supports the Productivity Commission’s recommendation to prohibit commission clawbacks from being passed on to borrowers.

The Final Report acknowledges that lenders should be able to charge borrowers for originating a loan without a broker – ensuring competition between brokers and lenders (and this will be monitored by the Treasury-led working group established to monitor the market). This working group will also monitor and react to future changes in the market if required.

In its response, the Government has agreed to prohibit trail commissions for new loans from 1 July 2020, and it will also require the value of upfront commissions be linked to the amount actually drawn-down by borrowers, and ban campaign and volume-based commissions and payments (adopting the Productivity Commission’s recommendations). However, the Government has not addressed whether it will implement the recommendation that borrowers pay broker fees.

MORTGAGE BROKER MISCONDUCT: COMBATTING THE ‘ROLLING BAD APPLES’ PHENOMENON

In bringing the framework for mortgage brokers in line with that of financial advisers, Recommendation 1.6 will ensure that broker misconduct is identified and remediated promptly and more importantly should stop brokers from simply avoiding consequences by moving from one lender to another.

This will involve ACL holders being required, as a condition of their licence, to:

- undertake reference checking and information-sharing in respect of mortgage brokers, making it more difficult for brokers who engage in misconduct to find alternative employment in the industry;

- report ‘serious compliance concerns’ about individual mortgage brokers to ASIC on a quarterly basis; and
- take prompt inquiry and remediation steps when they detect that a mortgage broker has engaged in misconduct.

In practice, this requires ACL holders to create policies to enable reference checking, information-sharing and reporting obligations in respect of misconduct by brokers. In particular, in respect of the latter requirement, the policy will need to cover the process a licensee will undertake to make whatever inquiries are reasonably necessary to determine the nature and full extent of misconduct and to inform affected borrowers with a view to implementing a remediation program for those borrowers promptly.

FURTHER OBSERVATIONS AND TRENDS

The Royal Commission’s recommendations raise a number of questions for those in the industry.

The additional obligations imposed on mortgage brokers will result in increased education and training requirement for brokers, therefore increasing the cost of maintaining a brokerage business. Meanwhile, the removal of commissions, and requirement that borrowers pay the broker directly will likely reduce a broker’s income for each home loan. This may reduce the viability of mortgage brokering as a business.

In addition to the added layer of policies and reporting processes which ACL holders will be required to implement to ensure sound compliance with Recommendation 1.6, it will be crucial to ensure that reporting of ‘serious compliance concerns’ about individual brokers is central to the ACL holder’s best practices. In other parts of the Final Report, the Commissioner has highlighted concerns around the existing breach reporting practices of AFSL holders to ASIC with emphasis on a failure to report significant breaches to ASIC in a timely manner.

On top of this, lenders will now have carriage of the customer remediation program following an identified broker misconduct. This is likely to impact on BAU resourcing and increase compliance costs.

We look forward to sharing further observations and trends with you as we work through these ourselves, and with clients, and consider how these recommendations may affect your product design strategy and approach.

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