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Manager
Financial Services Reform Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

By email: consumercredit@treasury.gov.au

Dear Treasury,

AFA Submission – Mortgage Broker Best Interests Duty and Remuneration Reforms

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are currently practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting their wealth.

Introduction

It must be said that once again, we see exposure draft legislation without the release of a proposal paper or any form of discussion statement and no Regulation Impact Statement. Australians should be left in no doubt, that this is major reform that will have significant consequences and therefore it deserves to be taken seriously and to go through proper process.

Whilst it seems that it is easy to recommend that mortgage brokers be bound by a Best Interests Duty, in reality it is much more complicated to implement such a recommendation. As we have set out below, the experience with the application of the Best Interests Duty for financial advisers should stand-out as a strong warning that this is much more difficult and complicated than would be suggested by a simple statement in a Royal Commission final report.

We believe that in order to avoid this current complete avoidance of good policy process, the Government and the Parliament need to acknowledge that the Royal Commission did not comply with Paragraph (k) of the Banking Royal Commission Letters Patent (Terms of Reference) which stated:

> *We direct you to have regard to the implications of any changes to laws, that you propose to recommend, for the economy generally, for access to and the cost of financial services for consumers, for competition in the financial sector and for financial system stability.*

Until this is acknowledged and taken seriously, then it seems likely that we will continue to see this complete failure to follow due policy process. It is interesting to note on page 72 of the Royal Commission final report, with respect to the discussion on the introduction of a Best Interests Duty for mortgage brokers, the statement that "It is not an obligation that should affect the practices of lenders and, accordingly, it is not a change that should affect the price or the availability of credit…". This statement seems to fail to recognise that recommendations that impact the cost of distribution of credit will also impact the availability of credit. We would suggest that an honest assessment of the implications of this reform would require consideration of systems changes, process changes, documentation requirements, cost implications, mortgage broker and staff training, and audit processes. Once again, we find it totally remarkable that there is no discussion of the implications of any of these factors.

The AFA is a professional association for financial advisers and we predominantly focus upon reforms that impact financial advisers, however we felt that it was necessary to contribute our experience in the implementation of similar reforms for the financial advice profession, which we note, there appears to be virtually no recognition of.

The AFA's views on the Exposure Draft Bill, Exposure Draft Regulations and Draft Explanatory Material that Implements these Reforms

Best Interests Duty

In assessing this proposal, we believe that it is appropriate to start with three critical points:

- Mortgage brokers represent approximately 60% of the home loan market.
- Page 8 of the Exposure Draft Explanatory Materials document states:
  > "It is the responsibility of mortgage brokers to ensure that their conduct meets the standard of 'acting in the best interests of consumers' in the relevant circumstances."
- It is proposed that this legislation will commence on 1 July 2020, which is now less than 9 months away. In the context that this is unlikely to be legislated by the end of the year, this will leave a ridiculously short implementation timeframe.

Does the Government seriously want to put 60% of the home loan market in jeopardy by imposing a completely new obligation with no guidance, in an unachievable timeframe? In our view, this is totally impractical.

It is at this point in the analysis, that it might be beneficial to reflect upon the financial advice sector's experience with regards to the Best Interests Duty. In the case of financial advice, the Best Interests Duty idea was first put forward as part of the Ripoll Inquiry (final report - November 2009). It was part of the policy announcement when the Future of Financial Advice package was first announced in April 2010. The ALP Government, at that time, engaged in extensive consultation that led to the regime that we have today, which was passed in March 2012 and became effective from 1 July 2013. It must be pointed out that the financial advice Best Interests Duty replaced an existing Reasonable Basis (Section 945A of the Corporations Act) obligation, and as such it was not a completely new regime. This is not the case with mortgage brokers however. Yes, they do have responsible lending obligations, although this is not the same thing.

It is important to note that the consultation with respect to the Best Interests Duty for financial advice led to the development of a safe harbour for compliance with the Best Interests Duty, although noting that Commissioner Hayne has recommended that this safe harbour be subject to review by 2022 (Recommendation 2.3), with consideration being given to whether to retain the safe harbour. It seems surprising that the mortgage broker Best Interests Duty would be put forward without any clarity with respect to the obligations, no safe harbour and all before the review of the financial adviser safe harbour has been completed.

The safe harbour steps for financial advisers were subject to significant ongoing debate. ASIC provided guidance on the application of the Best Interests Duty, through updating Regulatory Guide 175. In addition, in September 2014, ASIC issued Class Order 14/923 that included obligations with respect to the record keeping requirements for compliance with the Best Interests Duty. In October 2016, ASIC amended Class Order 14/923.

Financial Adviser Best Interests Duty Experience

It must be acknowledged that the financial adviser experience with the Best Interests Duty has been troublesome at best, and it appears that six years after the commencement, there is still a great deal of uncertainty about what is required. We will address this further below.

Since the commencement of the Best Interests Duty for financial advisers, there have been three key reviews of advice quality undertaken by ASIC, as follows:

- October 2014 – ASIC Report 413 on Life Insurance advice, which demonstrated that 37% of files failed to comply with the law.
- January 2018 – ASIC Report 562 on superannuation advice within vertically integrated institutions that demonstrated that 10% of the advice left clients in a worse position, and 75% of the advice did not comply with the law.
- June 2018 – ASIC Report 575 on SMSF Advice which demonstrated that 91% of the advice did not comply with the law.

There is no way to deny that these results are incredibly concerning. It is also remarkable that such poor results would be generated, particularly by well resourced large organisations. There has been little critical analysis of this, however there are undoubtedly a significant range of reasons for such poor results, some of which will relate to a lack of clarity with respect to the requirements of the obligations and also a lack of awareness of the documentation requirements to evidence compliance with the Best Interests Duty and related obligations. Ultimately, at this point, over six years after the commencement of the FoFA legislation and the Best Interest Duty, it is hardly a good reflection on the implementation of this duty. It is also a very strong warning of the potential consequences for the introduction of a Best Interests Duty for mortgage brokers.

In March 2017, ASIC released Report 515, which addressed the manner in which the large institutionally owned licensees managed adviser misconduct. Within this report was some recommendations on the audit requirements for assessing compliance with the Best Interests Duty. Following the release of ASIC Report 562 in January 2018, ASIC commenced a program of activity that is known as the ASIC Report 515 project or the Best Interests Duty Uplift project. Under this project all the large institutionally owned licensees were required to appoint an external expert to assess 100 client files as at September 2019. As part of this project, these licensees were required to upgrade their standards and to deliver further training. The implementation of this project has had a huge impact on these licensees, with the introduction of extensive checklists and all advisers being put on advice document pre-vet requirements, where all files need to be reviewed by a third party before being issued to clients. This has also had a huge impact for financial advice clients, with the issue of Statements of Advice often taking three to four months. It has also significantly reduced the amount

of advice that is being provided and significantly increased the cost of the provision of financial advice. Little has been said publicly about this project, however it is very clear that it is having a huge impact on the efficiency of the financial advice sector and ultimately will mean that financial advice will no longer be accessible or affordable for everyday Australians.

In our view, the financial advice experience with the Best Interests Duty is a stark warning for the mortgage broker sector that this will have a huge impact and that it will result in a significant increase in costs. The implementation of a Best Interests Duty for mortgage brokers needs to be carefully worked through, and the implications diligently assessed.

At this point we imagine that there would be a lot of areas where mortgage brokers would want guidance. For example, what might be required in making a recommendation to take out a fixed rate loan versus a variable rate loan? In addition, at what level of interest rate differential should a mortgage broker be considering recommending a change of lender? We could imagine that there would be many more questions that mortgage brokers might have.

The other key learning from the financial advice experience, is the extent of the impact, which would be expected to include the following:

- System changes to address documentation and process requirements.
- Process changes to address the new requirements.
- Documentation changes to incorporate the new obligations, including the development of guidelines and rules for mortgage brokers.
- Mortgage broker and staff training to ensure that they understand the requirements.
- Changes to client file audit arrangements.

On the basis of everything that we have said above, we strongly recommend that the commencement date be pushed back from 1 July 2020. It is simply impractical to target this date.

Specific Feedback on the Legislation

We note that Subdivision B on credit representatives does not apply where the credit representative is not acting within the scope of the credit representative's actual or apparent authority (Section 158LD). Does this mean that the client will not be protected when the credit representative is not acting within their authority? Does this mean that the credit representative is not subject to the civil penalty provisions in this case? How will the client know if the credit representative is not acting within their authority? Clearly it is evident that greater clarity is required here.

Conflicted Remuneration

The AFA is concerned that the Government is choosing to implement the Conflicted Remuneration measures through regulations rather than legislation. We believe that this is important enough legislation to be primarily reflected in the legislation. The legislation provides no detail on what will be banned, and this is simply left to the regulations.

The AFA supports a ban on volume-based commissions and campaign based commissions. These incentives may influence a mortgage broker to select a product, that may not be in the best interests of the client. It does not appear, however, that the impact on existing volume bonus arrangements has been addressed. We caution with respect to provisions with soft dollar benefits, where they are used for training purposes. In financial advice, with the introduction of the ban on conflicted remuneration in July 2013, there was a high level of uncertainty with respect to the implications for product provider participation in licensee partner programs. We imagine that the same could apply with aggregators. Such arrangements can be structured in a way to ensure that they are used for appropriate purposes and are not allowed to inappropriately incentivise conduct that may not be in

the best interests of the client. It is important to provide clarity and ensure that these arrangements are allowed to continue in an appropriate manner.

Section 28VB of the regulations places a requirement that the commission should be based upon the drawdown amount and that this is defined in terms of the amount of credit that is used within the first 90 days. We question whether this is overly restrictive in the context of the prospect for delays in settlements and other arrangements such as home loans that will increase as a result of an initial commitment to renovate the property in the short term or loans taken out as part of a property development plan, where there is a commitment for future drawdowns. In our view, this is overly restrictive and may be counter-productive.

The AFA supports the proposal with respect to a cap on the clawback period, although we note that unlike the case with life insurance commissions, this is a cap and not a minimum stipulated clawback amount and set period.

Implementation of the Conflicted Remuneration reforms may involve changes to numerous contracts and employment agreements. The work-load in undertaking this activity should not be underestimated. Important changes to remuneration do require detailed consideration of the implications for business models and this takes time.

In our view, a 1 July 2020 start date is unrealistic, and we would recommend that this is deferred.

AFA Recommendations

The AFA Recommends the following:

- The Government provides detailed requirements on what is required for mortgage brokers to comply with the Best Interests Duty.
- The Government adequately consults with the mortgage broker sector and other stakeholders on the implementation of a Best Interests Duty and ban on Conflicted Remuneration.
- The Government extends the time limit for the drawdown amount or provides for a mechanism to address arrangements where the drawdown is expected to increase over time.
- The Government prepares a Regulation Impact Statement for this legislation.

Concluding Remarks

We have sought to highlight the learnings from the financial advice sector in the consideration of this proposal. It is a much more complicated reform than appears to have been recognised.

The AFA welcomes further consultation with Treasury, should clarification of anything in this submission be required. Please contact us on (02) 9267 4003.

Yours sincerely

Philip Kewin
Chief Executive Officer
Association of Financial Advisers Ltd