RW NEWSLETTER

The age-old debate about the validity of commission payments

The purpose of commission

Many industries pay commission to distributors of products. Manufacturers benefit from the variable cost – no sale, no payment – which can be built into the product's price. Sales people also like commission as their income is not capped, and good ones can earn high levels of income.

One of the advantages of traditional commission structures is that the consumer is unaware of how much the distributor is receiving for their work, and the cost is built into the price of the product, so consumers don't have to pay a separate fee.

Prior to recent reforms in financial services, commission was the dominant form of remuneration for sales people. Stockbrokers, general insurance brokers, life insurance agents and financial planners have all been paid commission for selling, and many have received trail (renewal) commissions to stop churning the product. The mortgage broking industry grew from similar structures.

Commission was paid independently of any financial advice provided to the consumer and could vary substantially between products. If a consumer received poor advice, they had to seek redress from the licensee of the adviser, not the product manufacturer. A good example was Storm Financial where badly advised consumers were placed into geared investments. They could not sue the institutions that lent them the money, nor the investment platform, nor the product manufacturers. Their complaint was against the Storm Financial dealer group (licensee).

Conflicts and complications

The then Trade Practices Commission (ACCC) conducted an inquiry into life insurance sales including commissions in the early 1990's in response to concerns regarding unacceptable consumer outcomes. This led to greater disclosure of commissions and, consequently, to reductions in, and, in some cases elimination of, commissions for life insurance investment products. It also led to the development of asset-based trail commissions, which arguably have cost consumers more than the contributions-based commissions they replaced.

Later scandals and inquiries led to the development of the Future of Financial Advice (FoFA) framework built into the Corporations Act. The new legislation and regulations (2012) outlawed Conflicted Remuneration – that is, commissions and supporting reward structures - on all new investments.

The introduction of MySuper resulted in all Superannuation Guarantee (SG) contributions having to be made into MySuper products, on which no commissions are payable. This ruling forced many legacy products to be wound up. However, many superannuation Choice products and investment products retained *grandfathered commissions*, which were one of the subjects of the recent Royal Commission.

Importantly, FoFA exempted commissions paid on risk life insurance outside superannuation. The argument was accepted that removing commissions on these products would reduce the availability of insurance and lead to an underinsurance problem.

There remained ongoing concerns regarding consumer outcomes and the escalation of commissions as life companies paid more for new product sales. This led to the Trowbridge inquiry, which resulted in the current regime of capped initial and trail commissions that came into effect in January 2018. Commissions on life insurance risk products continue to be exempt from the FoFA provisions provided they are within the agreed caps and are clawed back should the customer discontinue or reduce their policy. This structure is set for review by ASIC in 2021.

When FoFA was established, the aim was to standardise the rules around providing advice across all financial products. However, the reforms did not consider mortgages, or the commissions paid on these products because mortgages are not Financial Products within the meaning of the Corporations Act. This has created the anomaly where someone can arrange to sell an investment property without any duty of care to the buyer, and then generate upfront and trailing commissions on the associated mortgage debt.

There is a similar issue of affordability for life insurance and mortgage broking. Both industries argue that consumers will not pay a large enough fee if it is visible and needs to be paid directly. This is presumably because they believe consumers will not agree that the size of the commissions represents fair value for the services delivered?

ASIC recognises that commission is paid by the manufacturer, and it forbids recipients of commission from calling themselves independent. The adviser's financial arrangement is with the product manufacturer which pays for product placement and sales.

The Royal Commission

Kenneth Hayne's final report for the ***Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*** made 76 recommendations which have been the subject of much analysis and debate. This commentary has almost exclusively focused on the individual recommendations in the context of the industry sector breakdown in which the report is presented. There are, however, some themes that cross over these industry sector boundaries. One of these is the issue of commissions or conflicted remuneration which Hayne dealt with in respect of financial advice, life insurance and mortgage broking.

In respect of financial advice, the main recommendation was in relation to historic commissions with the recommendation that grandfathered commission be repealed as soon as possible. In respect of life insurance and mortgage broking, the recommendations were in respect of the future structure of remuneration for advisers and intermediaries for which Hayne wishes to see the removal of all inherent conflicts. These sectors of the market have been swift to respond.

In respect of life insurance, Hayne recognised that a process is underway and chose not to disrupt it. His recommendation is that the current structure should remain and include a review by ASIC in 2021. He has, however, also recommended that unless this review finds a significant increase in underinsurance, that a process should be put in place to reduce the commission caps to zero over time – which would essentially mean that life risk insurance would be no longer exempted from the FoFA provisions.

Concerns expressed by the Financial System Inquiry regarding consumer outcomes and the level of commissions led to the 2017 review by ASIC of mortgage broker remuneration. Proposals were being developed to revise the remuneration, but were subsumed into the Royal Commission process with Kenneth Hayne's recommendations now being the focus of debate. The recommendations are that commissions on mortgages be phased out, in an orderly way, and replaced by a system by which brokers are paid directly by their customers (the borrowers).

Hayne is consistent in his approach to commissions across the market sectors. His view, as expressed in relation to mortgage commissions, is that, by their nature, value based upfront and trail commissions work against consumer interests. The purpose of his recommendations is to ensure that advisers (including mortgage brokers) are paid directly by their clients rather than by product suppliers. This is to ensure that there are no external interests that could conflict with the advisers' *best interests* duty to their clients. Hayne's focus is to reduce, or remove, the risk of poor consumer outcomes by removing one of the key sources of this risk.

Response to FoFA and Hayne

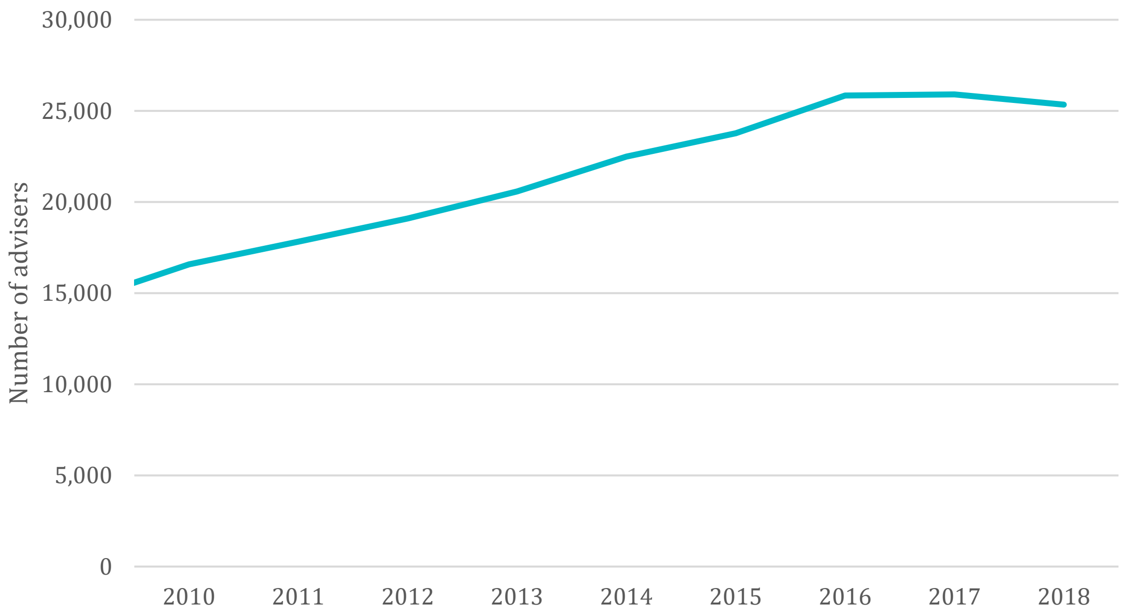
The industry response in both life insurance and mortgage broking is consistent. Both have argued that the removal of commissions will actually *increase* consumer risk. Life insurers and advisers have argued that the removal of commissions will reduce the number of advisers providing life insurance advice and will lead to underinsurance. Mortgage brokers and some lenders have argued that the removal of commissions will reduce competition in the market which will lead to interest rates being driven up by the big banks. Both industries are promoting the potential for separate consumer detriments against the detriments examined by the Royal Commission and other inquiries over the years.

The question, when considering the Royal Commission's recommendations, is whether the potential negative consumer outcomes from removing conflicted remuneration will outweigh the consumer benefits.

Before considering the life insurance and mortgage markets, it is worth reflecting that this approach of raising alternative consumer detriments was also followed when opposing the conflicted remuneration provisions in the lead up to the implementation of the FoFA legislation. In that case the potential, unintended consumer detriment was that reduced adviser incomes (because consumers would not pay adequate fees directly) would drive many from the market which would in turn result in insufficient advice being available to consumers who would then make sub-optimal financial decisions.

Our analysis of the market for financial advice shows that there has not been a significant reduction in adviser numbers. They have grown steadily under the FoFA regime, although they now appear to have reached a plateau (Graph 1)

Graph 1. **Total adviser numbers**[1]



The reduction in the number of full service, holistic advisers has been more than made up for by the growth in intra-fund and other advisers and there has also been noticeable growth in online (robo) advice. The market has adapted to the changes and the number of advice sessions has grown rather than declined. The movement to explicit fees-for-service has not led to the consumer detriment suggested.

Underinsurance

Underinsurance is an issue for the life insurance market, but this has existed for many years. Over recent years, the level of underinsurance has reduced primarily because of the increase in default insurance benefits provided by superannuation funds. Today, some 70% of life insurance benefits are provided via superannuation funds rather than via individual, retail risk insurance. The problems with retail and direct life insurance might see this percentage increase even further in the next few years.

Insurance via superannuation and its adequacy for members is increasingly being supported by intra-fund and scaled advice. The legislative changes will also improve the availability of insurance cover beyond the default within superannuation funds. This is because funds and their insurers will increasingly need to provide underwriting services to support the Opt-In provisions. This will undoubtedly result in more simplified and automated underwriting being available to support advised increases in cover. Writing insurance via superannuation funds will become simpler and more efficient. Consequently, we are likely to see an increasing use of life insurance within superannuation.

Mortgage competition

The debate about the mortgage industry is at an earlier stage to the debates regarding advice and life insurance. The debate is more about possibilities with fewer market examples to examine. Nonetheless the potential risks and likely developments can be examined using these other markets as examples. The Royal Commission's

[1] Rice Warner's *Financial Advice within Superannuation 2019 report*.

recommendations in relation to mortgage commissions were accompanied by recommendations that mortgage brokers be subject to much the same conduct and regulatory requirements as financial advisers. These also need to be kept in mind when contemplating the future.

The argument that brokers provide and facilitate the competition that keeps mortgage prices under control is partly correct. Brokers are a channel that provides consumer access to alternative lenders to the big banks, but they are not the only channel, and it is the alternative lenders that provide the price competition. In the early 1990's, Aussie Home Loans (AHL) and others including National Mutual's securitised lending operation that developed into Me Bank, brought a lot of price competition to bear on the banks, but they did not operate via brokers.

They had their own distributors. In National Mutual's case it was its own life insurance agents while AHL recruited life insurance agents from a number of life companies including National Mutual. These advisers did not have a suite of products from a range of lenders. Brokers like Mortgage Choice then came on the scene and the securitised lenders generally morphed into brokers when the GFC destroyed the securitisation market. Most of these companies were then acquired by the big lenders and today they deliver a proportion of their lending business to their owners that is greater than those lenders' market share. Thus the price competition does not appear to be uniform.

The continuation of competition will, therefore, depend much more on continued access for alternative lenders to consumers than it will on the continuation of the current mortgage broking structures and remuneration. We believe that there are a number of market forces at play that will deliver this increased consumer access to the alternative lenders with or without the brokers.

There is significant innovation taking place in this market especially using new, technologically sophisticated approaches. Online broker sites like Lendi and Uno will have lower cost bases than traditional brokers and would be able to sustain a movement to direct fees. New lenders are also coming to the market with new approaches to financing their lending and new approaches to distribution especially direct engagement with consumers for origination. They are being supported by increasingly sophisticated product comparison sites like Canstar.

These technology driven solutions generally appeal most to younger borrowers, but there are also opportunities for those less inclined to doing business online. The growth in intra-fund and scaled advice has seen an increase in the number of fee-for-service advisers dealing with their clients' long-term debts – especially mortgages. Many, if not most, will generally consider whether it is better for their clients to increase their superannuation contributions or pay down their mortgage. Whilst most do not currently engage in origination, this will undoubtedly change and direct, online fulfilment will facilitate this change. There are also examples in the market with direct lenders providing preferential rates to superannuation fund members which will increasingly be supported by direct, online fulfilment.

Increasing the involvement of financial advisers more broadly would also facilitate greater competition. We have previously recommended that mortgages be re-categorised as Financial Products within the meaning of the Corporations Act. We still believe that this would be the best way to achieve the changes proposed by the Royal Commission as it would result in a single regime rather than two separate regimes with essentially the same rules, but inevitable anomalies. It would also make the process of seeking advice and solutions simpler and more transparent for consumers.

The banking reforms that are slowly being implemented to allow consumers' banking information to be made available to competitors will facilitate greater distribution access for alternative lenders and improve their capacity for direct fulfilment. They will no longer need to rely on lengthy questioning of prospective clients to determine their financial viability and capacity to meet their loan commitments. Increasingly, consumers will also be able to directly gather quotes from a number of lenders all quoted on the basis of comprehensive financial information.

Taken together, these market developments can be expected to increase competition in the mortgage market no matter the form of remuneration for brokers.

Conclusion

The world has changed from one of flogging products. Today, consumers buy strategic advice and expect to receive the best products to meet their circumstances. Changes are needed to reflect this.

In conclusion, we believe that the recommendations by the Royal Commission in relation to conflicted remuneration, in respect to mortgage brokers, are timely and sensible. They will remove a source of consumer detriment and the recommended phased approach over time will minimise market disruptions and allow the market to respond with innovation. The starkly revealed consumer detriments can be removed and the potential ones avoided.

DISCLAIMER: Rice Warner and some of its shareholders hold shares in Athena Mortgage Pty Ltd, a start-up mortgage lender set to launch its services in 2019.

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