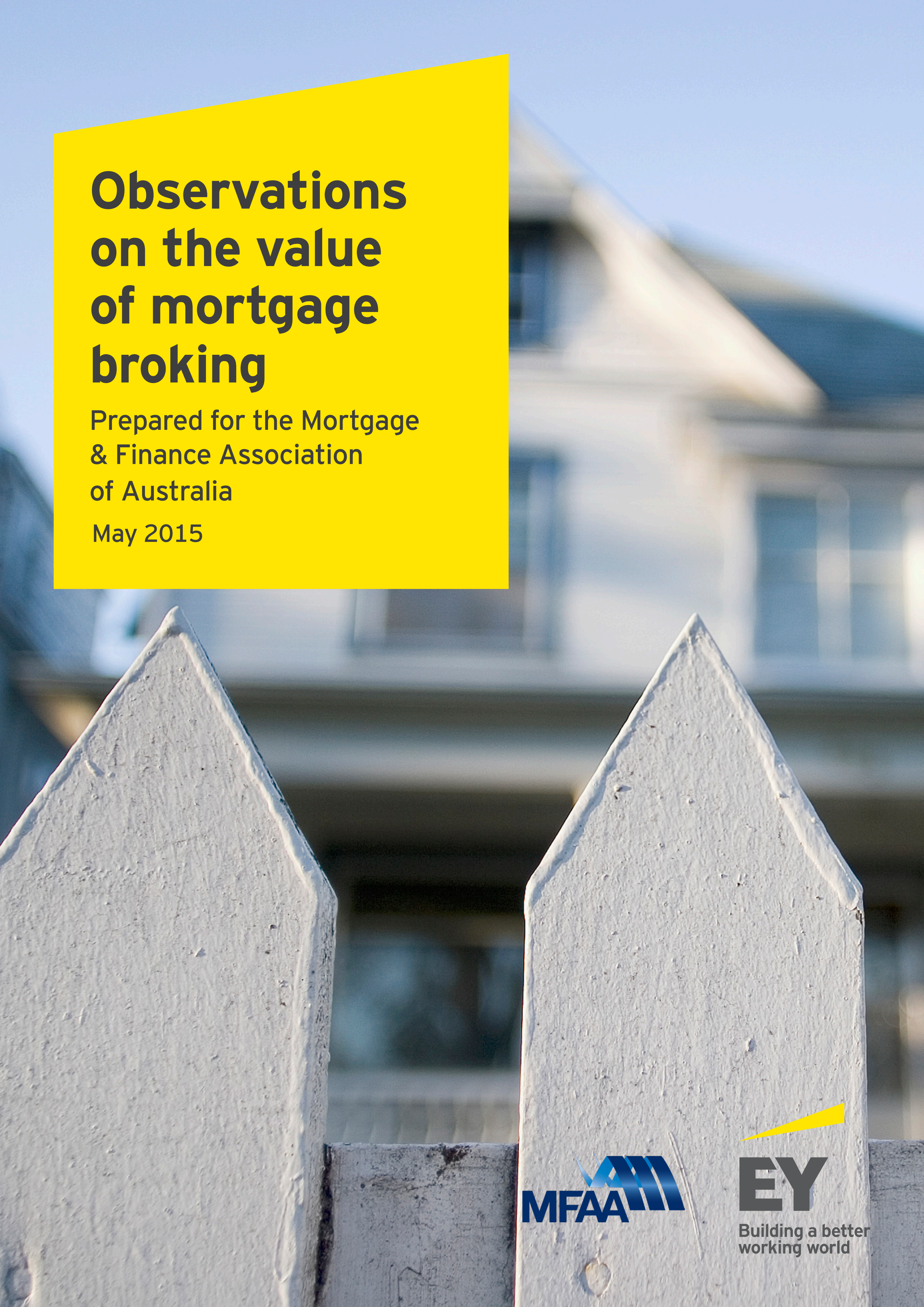
Observations on the value of mortgage broking

Prepared for the Mortgage & Finance Association of Australia

May 2015



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Executive Summary

This is a study commissioned by the Mortgage and Financial Association of Australia to examine the value of mortgage brokers to both lenders and customers. EY has assisted the MFAA to compile this report by conducting qualitative customer testing and interviews with lenders. The findings contained within this report represent the feedback from these two groups.

The mortgage industry is a key pillar of the financial services sector in Australia only second to superannuation in terms of size with approximately $1.4tn in stock of home loans. Having successfully disrupted the market by combining a leading customer experience and product transparency, brokers have become a notable part of the landscape accounting for c.50% of system growth. The business model of the broker has evolved since the 2000s from being transactionally focused on customer switching and upfront commissions, to a relationship model whereby they work with lenders to help assist in customer retention, cultivating their large back books for new business and targeting first home buyers.

This shift has helped reinforce the strategic importance of brokers for most lenders whether through providing additional channel choice for customers or distribution leverage where it currently does not exist. Despite the shift in approach, the value proposition of the broker remains the same: to provide choice, expertise and convenience to customers in their home buying journey. Feedback from consumers suggests this value proposition is likely to be valued well into the future.

In pursuing a partnership model with brokers, most lenders noted that the broker channel facilitates a need that is demanded by the customer and therefore is managed actively as part of a broader channel strategy. In practice this means there has not been any material differences witnessed in the characteristics (i.e. credit quality, cost of acquisition (post commissions), net interest margin and loyalty) of the broker portfolio to that of proprietary channels. With regards to loyalty, many lenders noted that due to the high proportion of investor loans the tenure of customers in the broker channel is marginally shorter.

Further development of the partnership model with lenders is likely to deliver better outcomes for consumers. Mortgagees who have used the broker channel generally have high levels of satisfaction and advocacy as they feel a broker provides access to a wide range of products, matches customers with the most suitable product and takes the stress out of the arrangement process. Consequently many lenders believe that the broker channel could account for as high as 60% of system growth in the future.

Although customers feel they receive a superior experience from brokers, a few areas were highlighted for further development. First, a small proportion of customers felt that the commissions received by brokers influenced the recommendation made, particularly where the broker had a relationship with the lender. Second, customers felt that the broker could play a broader role in arranging other financial products.

Whilst brokers have been very successful in disrupting the mortgage market, they too are now at risk of being disrupted by several trends in the market. The most notable is digital, which is increasingly becoming the preferred channel for consumers and that banks are heavily investing in. Digital can complement the existing face-to-face model and potentially assist brokers to expand their relationship with customers to that of a trusted advisor. This is likely to require brokers to broaden their product offering to customers through other banking and insurance products.

In addition, brokers should carefully watch for competitors from elsewhere in the mortgage value chain integrating a broker offering into their proposition. In response brokers should potentially look to a range of options including innovation of their business models, which may be delivered through strategic partnerships. Whilst mortgage broking could be seen as a successful industry to date, there are threats emerging. The key to continued success may lie in injecting new talent into the mortgage broking industry whether through succession planning of existing brokers or a new generation of professionally qualified brokers.

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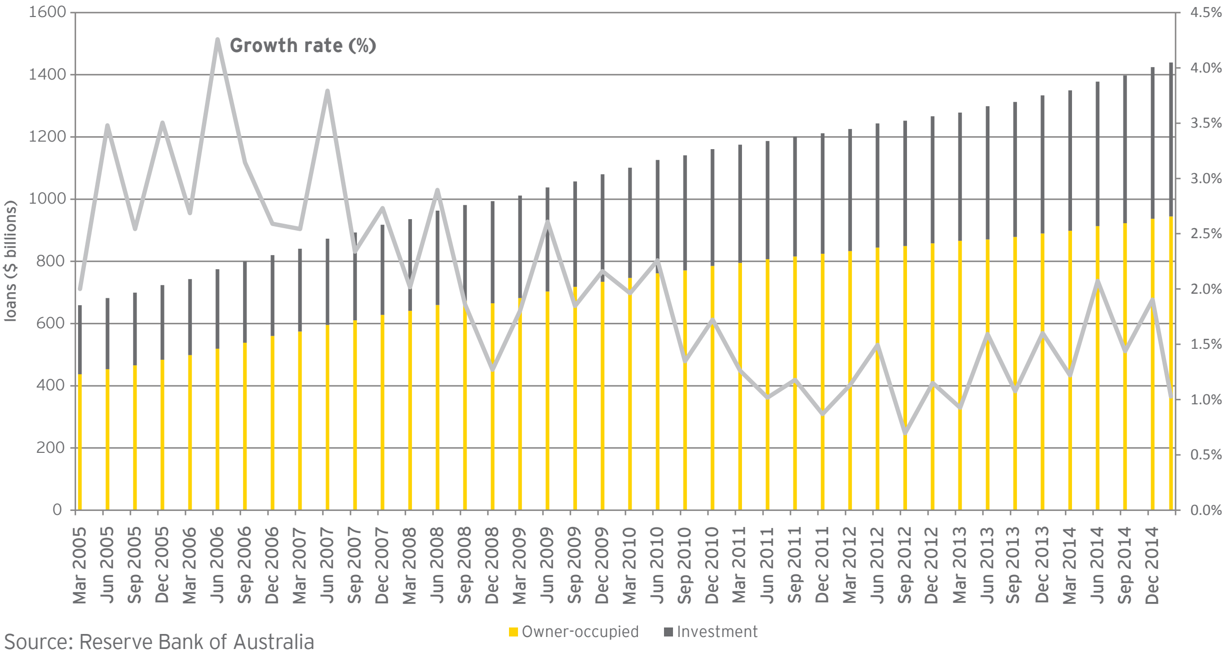
1. Introduction and objectives

1.1 Market context

The home loan industry in Australia has grown uninterrupted for nearly 100 straight quarters which is remarkable given this period includes major economic corrections including the Asian crisis, dotcom bust, global financial crisis and more recently the post-resources slowdown in the Australian economy. As noted in Figure 1 below, the mortgage industry has grown at 10% annually since 2005 with total outstanding loans standing at approximately $1.4tn. Record low interest rates have been the main impetus for this, however competitive pricing from lenders and a ban on mortgage exit fees since 2011 have also been notable catalysts.

During this same period, we have witnessed the rise of the mortgage broking industry with annual growth of nearly 4% in terms of revenue. Mortgage brokers accounted for approximately 25% of flow in 2003[1] and now consistently make up approximately half of all mortgages originated in the system (both new and refinanced). Lenders have acknowledged that the mortgage broker industry has disrupted the mortgage lending market by providing a proposition centred on a leading customer experience combined with transparency on lender product and service. This is a proposition that lenders, by their own admission, have struggled to emulate.

Figure 1: Quarterly home loans outstanding and growth 2005-14



Source: Reserve Bank of Australia

[1] Reserve Bank of Australia (2004), 'Financial Stability Review', September 2004'.

Following a contraction from 2009 to 2012 growth in the industry has accelerated to 10% annually (refer Figure 2) however this is expected to plateau, reflecting the position of the broker moving from that of a rapid customer acquisition phase through the churn of customers to working with lenders to service existing customers for greater retention. This shift suggests brokers whose primary aim is to churn price sensitive customers are at risk of becoming irrelevant to customers and lenders. Some lenders commented that there could be a meaningful consolidation in the number of brokers.

They also noted that several other factors have the potential to accelerate this consolidation. These include the rise of digital and continued interventions from regulators looking to improve consumer outcomes whilst reducing systemic risk.

Figure 2: Annual revenue of mortgage broking industry 2005-15

Source: IBIS World

1.2 Objectives of this study

The overall purpose of this study is to examine whether brokers have a strategically important role in the financial services sector and in particular the delivery of positive outcomes for consumers in Australia. Specifically this has been tested with a series of questions across three themes:

1. Strategic importance of brokers to lenders:
    a. What is the strategic importance of the broker channel for the different types of lenders, i.e. big 4, regional and non-bank lenders?
    b. How do lenders work with brokers and how has this evolved over the last 10-15 years?
2. Characteristics of the broker originated book:
    a. Are the characteristics (i.e. credit quality, cost of acquisition, net interest margin and loyalty) of broker originated mortgages materially different to that of lender proprietary channels?
3. Value of mortgage brokers to customers:
    a. Do customers receive a better home buying experience via brokers or through lenders' proprietary channels?
    b. Do customers receive greater transparency (quality and relevance of information) via brokers on the suitability of lenders' propositions?

In addition, the report highlights the key emerging trends likely to impact consumer choice between brokers and lenders in the future.

1.3 Methodology

The study commissioned three approaches to testing the aforementioned hypotheses: an online qualitative customer survey, face to face interviews with selected lenders and desktop research.

Online qualitative customer survey

Qualitative customer testing of 700 respondents:

- Who have taken a mortgage in the last 2 years (includes refinancers) or expect to in the next 2 years
- Via an online survey with key areas of questioning regarding customer experience and value they perceived of their experience with both brokers and direct to lenders
- The survey tested for the following elements:
    - Behavioural
        - Mortgagee characteristics: longevity, channel, type, etc.
    - Decision-making
        - Sources of information, influencers, key criteria
    - Service experience
        - Ratings of service provider overall and on a series of attributes (e.g. knowledge, access to a wide range of products, trust, quality of advice, convenience)
        - Perceptions of mortgage brokers as a whole (a series of agree/ disagree statements)
        - Satisfaction with outcome
        - Demographic and psychographic differences
        - Gender, age, type of home, switching propensity

Table 1: Breakdown of sample structure

	Used broker		Total #
	Yes #	No #	
NSW/ ACT	160	95	255
VIC	130	75	205
QLD	77	45	122
WA	48	12	60
SA	32	9	41
TAS	8	9	17
TOTAL	455	245	700

Face-to-face qualitative lender interviews

A series of qualitative face to face interviews with selected lenders comprising big 4 banks, regional banks and non-bank lenders. The coverage of the selected lenders accounts for 88%[2] of mortgage market share in Australia (refer Appendix B for a list of participating lenders). The line of questioning with the lenders aligned with the three themes noted in the objectives above.

Desk based research

In addition to the qualitative testing, a range of desk research has been conducted to identify and validate themes with regards to the mortgage broking industry. A full list of external sources used in this report has been provided in Appendix C.

[2] APRA: Monthly Banking Statistics, February 2015

2. Key findings

2.1 Strategic importance of mortgage brokers to lenders

The approach of the broker has evolved significantly since becoming part of the mainstream banking landscape in the early 2000s. A decade ago brokers tended to focus on growing their portfolio of customers and hence incentivised customers to switch via market leading pricing. Lenders now view the broker as a channel that is effective in the retention of existing customers. Whilst the positioning of the broker has evolved in line with market demands, the strategic importance of the broker remains the same:

- Major lenders treat the broker as another channel alongside their proprietary channels and is therefore managed as such. Brokers account for approximately half of new mortgage flow and, where customers have allowed this, lenders now share customer information with brokers in order to service customers more effectively.
- For regionals and non-bank lenders the broker channel provides scale to penetrate into new customer segments and geographic markets that otherwise would not have been accessible given the prohibitive cost of a physical branch network. Consequently brokers account for significantly more of new mortgage flow with many noting the broker accounting for c.90-95% of new flows. The use of brokers by these lenders has enabled them to compete more effectively in the market with the majors.

Lenders noted that they are moving to a partnership model with brokers whereby they work together to provide customers with the most appropriate proposition and thereby focus on retention. Lenders believe this model will become more prevalent and hence the total contribution of broker originated mortgages will increase to approximately 60%. Lenders also believe that well managed brokers have amassed large back books and therefore are less focused on churning customers to get the upfront commission. Brokers are however looking to acquire customers for new mortgages and therefore are an effective channel at targeting first home buyers and investor borrowers.

The majority of lenders interviewed recognised that the core competency of the broker is typically managing customer relationships. They acknowledged that in the past banks had focused more on processing, servicing and risk management. However this has changed and lenders are very focused on providing an equally good customer experience to customers, regardless of the channel.

With regards to the types of loans being originated, research suggests (Table 2) that c.40% of broker flow is from investors and this has been validated by lenders. APRA has recently announced a focus on keeping a check on the growth in investment lending, raising questions of how lenders (namely majors) manage this going forward.

Table 2: split of types of borrowers

Customer segment	Percentage of market (%)
Investors	40.5
Owner-occupiers	37.0
First home buyers	14.0
Commercial borrowers	6.0
Other	2.5

Source: IBISWorld

2.2 Characteristics of the broker originated book

The quality of the book has been measured across four areas: credit quality, cost of acquisition, net interest margin and loyalty. Each of these four areas is discussed below. In general, lenders observed that the quality of the broker originated book is comparable to that of proprietary channels. Further, brokers have increasingly become important to lenders to assist in the retention of existing customers.

With regards to credit quality, lenders noted that the arrears rate in both portfolios is largely similar. It should be noted however, that given the historically low levels of arrears lenders are experiencing this has only been analysed by lenders at a headline level. Lenders also noted that broker originated books have a higher proportion of investor borrowers, therefore leading to higher average LVR in the broker originated portfolio. However there is no evidence seen by interviewed lenders that suggests these are higher risk than owner-occupied mortgages. Further, LMI is levied on higher LVR mortgages to cover any additional risks from the greater exposure.

Cost of acquisition is also considered to be comparable to that of proprietary channels. On the one hand there is a measurable upfront commission that is paid to brokers that increases the cost. On the other hand, as brokers invest more time to screen customers and match them to the right lender, the conversion rate of customers in the buying process is measurably better and therefore less costly from a credit checking and valuations perspective. Quality of applications submitted by brokers is viewed as high and continually improving, however some lenders noted that this is still an issue with a select few brokers.

On net interest margin, lenders noted that the broker channel NIM is only slightly lower (pre-commission). This is a factor of pricing being comparable to that of the direct book. As noted previously, lenders manage the broker channel as they would proprietary channels and therefore price differentiation is not perceived as necessary. Equally important however, the average loan size of a broker originated mortgage is higher than direct and therefore so is NIM.

Lastly, with regards to loyalty, there is a perception that customers who are price sensitive will be attracted to brokers and therefore not loyal. However lenders noted that there is no material difference at a portfolio level in the tenure of customers across broker and proprietary channels. Whilst this has historically been the situation and is the minority of cases at the moment, as noted earlier it is a changing trend. Of which there are two key aspects to this. First, lenders commented that they now actively work with brokers to retain customers on existing arrangements under the right circumstances. Second, there has been a trend of lenders to restructure their remuneration models such that the trail commission increases over the tenure of the loan to reward the broker for the longer tenure of the customer.

2.3 Value of mortgage brokers to customers

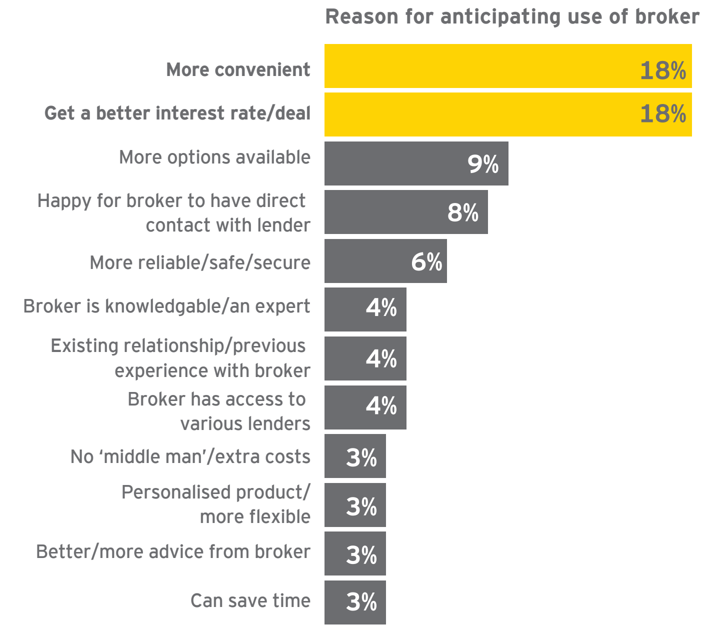
Brokers offer a customer value proposition that entails choice, expertise and convenience. This manifests itself in product and service transparency and often a good customer experience during the home buying journey. This CVP is particularly valued by customer segments that place emphasis on face to face interactions that take the hassle out of the process and those who are less confident with the process. The consumer survey conducted as part of this study has validated this finding. Lenders commented that they are creating a similarly good experience for direct customers.

Selected survey responses that validate the perceived value of brokers to customers.

Customers value the convenience and the perception of a better deal

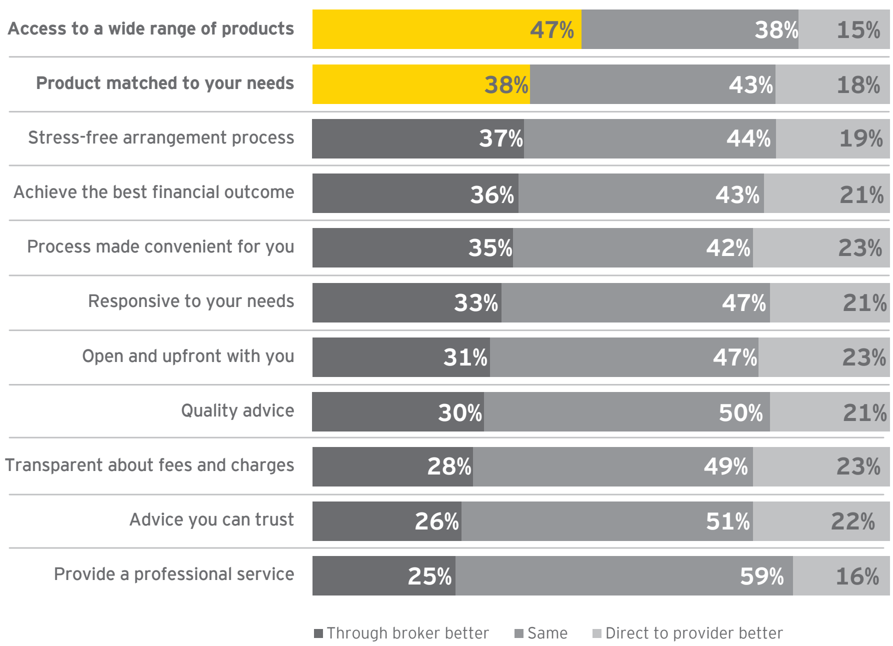
Almost one in five intend to use broker services out of convenience and/or in order to obtain the best possible interest rate.

Consumers between 25-34 and 65+ years of age, and those with a combined household income of $100K or more value these reasons particularly.



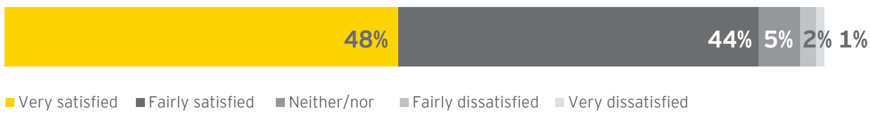
Brokers are proficient at matching the right product customers' needs

Overall, there is a sense that brokers have access to a wider range of mortgage products than banks or other financial organisations (47%), though most do not assume complete independence/ impartiality. Brokers are also seen to offer a more personalised service, with around two in five (38%) indicating that brokers are better able to match a product to your needs.



There is a high level of trust in brokers

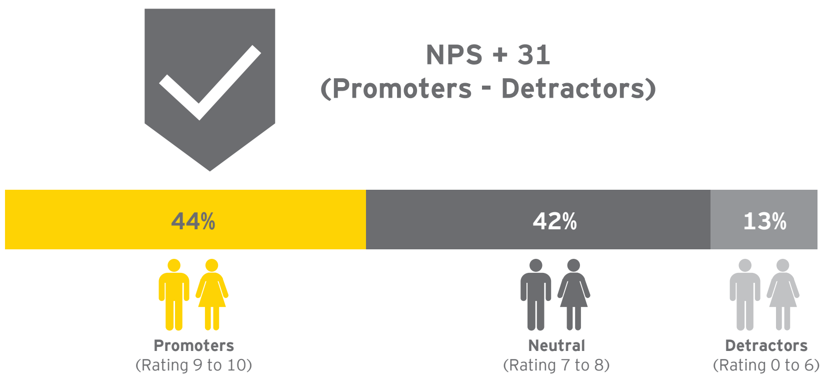
Satisfaction is relatively high across the board. Few are dissatisfied with their past experience arranging a mortgage either with or without broker involvement (0% vs. 2%).



Were ‘very’ or ‘fairly’ satisfied with the process of arranging their recent mortgage.

Customers are likely to recommend their broker

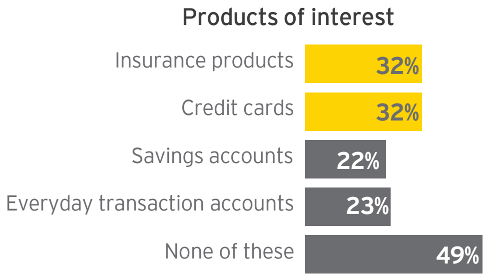
Likelihood of recommendation is generally high. But those who went through a broker are more likely to recommend their approach than those who made arrangements through a provider.

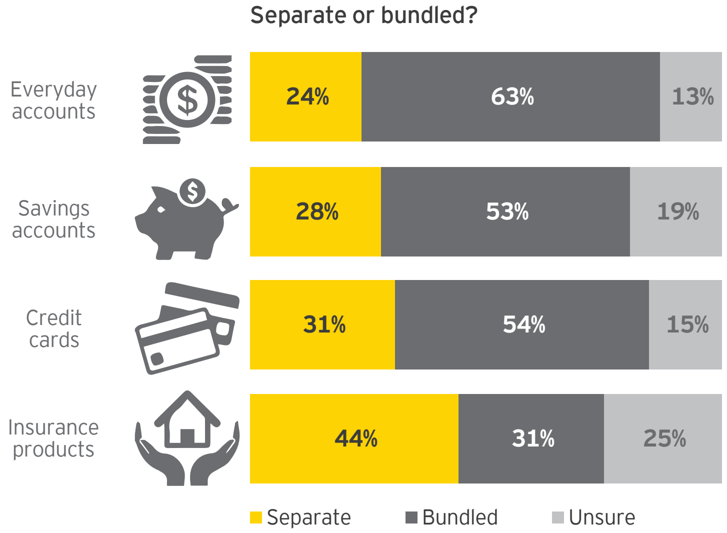


Brokers could assist in arranging other products

Those that have utilised broker services are most interested in discussing credit cards and insurance products alongside their mortgage product.

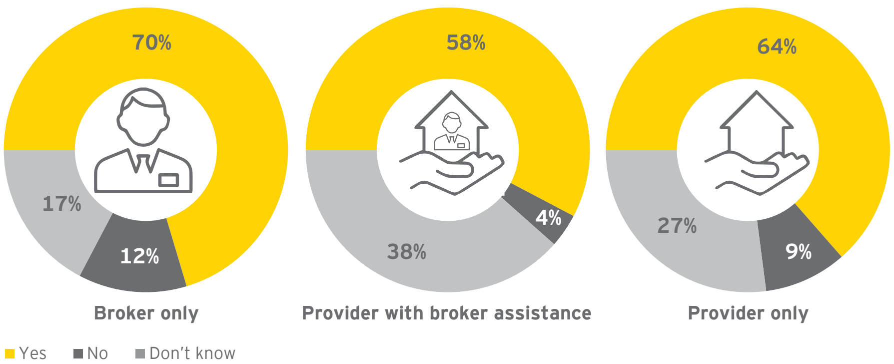
Although transaction and savings products are more valued as part of a package arrangement.





Two in three would happily use the same strategy when arranging future mortgages

Whether through a broker, direct or a combination of both; most customers felt they would take the same approach again to arranging their next mortgage.



3. Looking forward

The industry has been consolidating and many respondents believe this may accelerate further. Indeed lenders noted that brokers who focused on price, rather than service, were increasingly less common. Several lenders noted however that the broking industry itself is now being threatened by disruption given the rise of digital and the evolution of customer preferences. Lenders did note that the industry has a chance to respond to these disruptors. Table 2 summarises the threats and potential responses the broker industry may consider.

Table 2: Broker responses to key threats

Threat	Response
Digital: Australia has one of the highest take up rates of digital banking in the world[3] and this will continue to increase as a) lenders invest heavily in digital capability to enhance the customer experience and b) younger digital natives become the core mortgage consumers.	**Relationship based model:** The core CVP of choice, expertise and convenience that brokers provide is likely to remain relevant to consumers in the future. However, lenders suggest that brokers could advance the relationship to the position of an educator. In parallel, brokers need to adapt their business model to the digital age, for example through the use of data driven digital marketing that could assist customer communications and engagement.
Regulation: Commissions on intermediated financial products are under scrutiny locally and globally. There are a few notable examples globally where commissions have been banned on all products. Although no signs of such moves by local regulators at this stage, the threat remains a possibility. Such a move may well threaten the broker business model as customers may not be willing to pay an upfront fee for mortgage advice.	**Focus on customer outcomes:** The findings from the research suggest that brokers are able to add value to customer outcomes and that they are not any more risky than proprietary channels. Brokers need to demonstrate these facts more proactively to the financial services sector. Further, banks are looking to work with brokers more closely to jointly strengthen the outcomes they deliver to customers.
Revenue concentration: The current focus of brokers in providing a single product creates potential risks. Firstly, the concentration of revenues heightens risks associated with a dislocation in the market, whether this is due to a correction in property prices or regulatory intervention. Secondly, a large subset of customers does value the convenience of packaging all their financial needs, which many brokers are unable or unwilling to address.	**Broaden product suite:** Brokers should be looking to broaden the solutions they advise customers (with or without remuneration). The logical extension would be products associated with a mortgage, such as home & contents or landlord insurance. Additionally, brokers can play a role in assisting lenders gain MFI market share via transaction and savings accounts.

[3] Forester: The State Of Mobile Banking, November 2014

Threat	Response
Competition: The mortgage broking industry has relatively low barriers to entry and could potentially be disrupted by digital businesses such as online real estate classifieds or supermarkets (trusted brands with large customer bases) that are already providing leading digital experiences and in some cases partnering with lenders.	**Innovation and Partnerships:** Lenders offered several ideas on how brokers could maintain their competitive advantage in the future. One such option is to innovate the current customer experience through the use of digital and analytics. Brokers could potentially look at creating partnerships in order to deliver this innovation.
Intergenerational change: Many brokers are privately operated small enterprises with less than ten employees. The legacy of these businesses is at threat as many may not have formalised their succession planning. Further, the industry is not perceived to attract younger generations and therefore succession is not an option for some brokers.	**Professionalism and succession planning:** Lenders observed that the industry should be looking to institute structures whereby successful brokers are able to operate well into the future. The first is through the continuation of professional development raising the qualification from a diploma to a degree for mortgage brokers as is common in other advice industries. Secondly there is the need to help tenured brokers in the sale of their business in order to help them achieve a return as they exit the industry.

4. Conclusion

In closing, the findings from this study suggest that brokers do add value to both lenders and customers and will continue to do so as long as brokers continue to focus on customer outcomes and innovate their organisations.

Customers value their broker experience and lenders see more engagement going forward. Therefore the proportion of broker originated mortgages could peak to as high as 60%.

However, there is likely to be consolidation of brokers as some are likely not to respond to the threats outlined in this study and those that continue to be transactionally focused looking to churn customers are unlikely to succeed as it is out of sync with the needs of customers and destroys value for lenders. Those that remain will have created a sustainable model that will see them well into the digital age.

In addition to evolving the business model, brokers should be looking to address the potential succession planning issue. Key to this will be to understand how to attract the younger generation, possibly through a professional qualification, and long-standing brokers taking practical approaches to the sale of their large back books.

Appendix A Glossary

Term	Meaning
APRA	Australia Prudential Regulatory Authority
BPS	Basis points
CVP	Customer Value Proposition
EY	Ernst & Young Australia
LMI	Lenders Mortgage Insurance
LVR	Loan to Value Ratio
MFAA	Mortgage and Finance Association of Australia
MFI	Main Financial Institution
NIM	Net Interest Margin
NPS	Net Promoter Score
RBA	Reserve Bank of Australia

Appendix B Participating lenders

Australia and New Zealand Banking Group
Bankwest
Commonwealth Bank of Australia
ING Direct
Macquarie Bank
National Australia Bank
Pepper Home Loans
St. George Bank (including Bank of Melbourne and BankSA)
Westpac Banking Corporation

Appendix C Information sources

In addition to the primary research conducted by EY for this study, we have utilised the following information sources.

1. Australian Prudential Regulation Authority (2015) Monthly Banking Statistics.
2. Australian Government (2007), 'Inquiry into home loan lending practices and processes'.
3. Australian Government (2014), 'Financial System Inquiry- Final Report'.
4. Australian Housing and Urban Research Institute, RMIT (2010), 'Mortgage default in Australia: nature, causes and social economic impacts'.
5. Australian Prudential Regulation Authority (2014), 'Prudential Practice Guide, APG 223 – Residential Mortgage Lending'.
6. IBIS World (2015), 'A human touch: Demand for personalised mortgage advice underpins industry growth'.
7. IBIS World (2014), 'Variable conditions: Interest rates hikes are set to increase industry revenue'.
8. Forester (2014), 'The State Of Mobile Banking'

Appendix D Customer research demographic profile

Gender

Female	Male
57%	43%

Age

18-24 years	5%
25-34 years	28%
35-44 years	29%
45-54 years	20%
55-64 years	13%
65+ years	5%

Location

New South Wales (inc. ACT)	36%
Victoria	29%
Queensland	17%
Western Australia	9%
South Australia	6%
Tasmania	2%

Working status

Full or part time work	77%
Home duties	9%
Non-worker or retired	7%
Looking for work	5%
Student (secondary or tertiary)	3%

Household status

Couple with children	41%
Couple with no children	29%
Single living alone or sharing	16%
Single living with parents	6%
Single parent with children	6%
Other	2%

Children's ages

Under 6 years	42%
6-12 years	39%
13-16 years	24%
17 years or older	31%

Household income

Less than $30,000	5%
$30,000 to $59,999	20%
$60,000 to $99,999	32%
$100,000 to $149,999	22%
$150,000 plus	10%
	11%

Mortgage value

Less than $100,000	6%
$100,000-$299,999	36%
$300,000-$500,000	39%
More than $500,000	11%
Prefer not to say / not sure	7%

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