



**Finding focus in a complex market**

Mortgage Report 2017

12th Annual Deloitte Australian Mortgage Report

# Conduct Matters

Good conduct is when an organisation's behaviours and practices deliver fair and suitable outcomes for customers, employees, suppliers and markets.

**Financial Services Director Tim Noad examines** the opportunities identified by the roundtable and the market around conduct and how good conduct matters.

It is telling that the roundtable identified the risk of customer related conduct matters as the second highest risk to the industry, greater than significant macro-economic factors including unemployment rates and house prices that banks traditionally monitor in detail.

This is both a reflection of the roundtable's views that the macro-economic factors look fairly strong in 2017 and an acknowledgment of the importance of delivering the right outcomes for customers in light of greater community and regulatory focus. As noted, this is not just an Australia-centric concern, rather it has dominated retail banking internationally for a number of years.

Recent ASIC activity suggests a similar regulatory path to that prosecuted internationally will be followed locally.

Understandably, in the context of the industry focus, the roundtable's discussion of conduct was inextricably tied to discussions of risk and failure to provide customers with the right services or products. However, it is our view that equal attention should be paid to the opportunities arising from providing fair and suitable customer outcomes (the cornerstone of good conduct).

99

Equal attention should be paid to the opportunities arising from providing fair and suitable customer outcomes – that is the cornerstone of good conduct.

The roundtable identified using data to personalise customer offers, and holding the next best conversation as key drivers of change in 2017. Adapting the conduct view to this initiative, will both balance the fairness and suitability of the next best conversation and next best offer for the customer.

## Customer Outcomes

Many factors are needed to determine the exchange of value that comprises the 'best outcome' for a mortgage customer.

Throughout the discussion, the roundtable dispelled any sense that price was the only factor to consider when looking at customers, instead promoting ease of doing business, and personalising products and service. Below we look at the key elements of fair and suitable customer outcomes.

## Fair Customer Outcomes

Taking into account concerns regarding affordability raised by the roundtable, a mortgage has the ability to deliver benefits to both the bank and the customer. Fairness in the exchange of value is undermined where information asymmetry is either intentionally or unintentionally exploited by the bank or broker.

Fairness is typically considered at the distribution of the product, as evidenced by the ASIC review into broker remuneration structures. (see Page 46)

The roundtable also identified fairness as an issue throughout the term of the mortgage. In the discussion differential pricing of front and back books was identified as part of efforts to retain customers.

Such practices, although reasonably common in Australia, could be seen to take advantage of both the information asymmetry between bank and customer, as well as particular customer behavioural biases.

These practices are now rare in jurisdictions such as the UK, and we would expect differential pricing to become seen as unfairly impacting customer outcomes.

Ensuring the right product with effective controls, processes and systems is a key to achieving fair customer outcomes.

This issue is not limited to servicing mortgages as pointed out by Peter Kell (ASIC)<sup>1</sup> and Wayne Byers (APRA)<sup>2</sup> who stress banks' obligations to invest in systems, processes and controls that achieve fair customer outcomes in line with the product features sold to customers.

1. Bankwest remediation of interest offset

2. <http://www.apra.gov.au/Speeches/Pages/Remarks-for-regulators-panel.aspx>



**What to look for to achieve customer fairness:**

- Failed application of interest offsets
- Failed application of discounts for other packaged products
- Differential pricing by customer segments not linked to credit-worthiness
- Re-pricing of customer back-books
- Selective or concentrated broker introductions including 'too good to be true' application volumes
- Mortgage insurance products with poor terms and conditions
- Failed application of maturity terms of loan features

However as was noted, it is not access to the data, but the ability to synthesise it to provide meaningful information, which is the primary challenge.

Thinking about conduct in this way may extend the lender's obligations to monitor suitability of products beyond current set-ups, however, getting there aligns to the focus of the roundtable's discussion of innovation in 2017 on personalised products and service.



A suitability shift means a move from the lower threshold of 'not unsuitable', or 'OK' where 'near enough is good enough'. Achieving OK does not hold true in a world of good conduct.

A conduct lens can further enhance this process by getting to the heart of why, how and when your customers will use your products and services.

**Suitability in the spotlight**

- Assessing and understanding suitable mortgages, particularly interest only mortgages, has been a key focus of regulatory oversight in the last 12 months. This has been at the forefront of findings from industry reports (REP 443 (Review of Interest Only Home Loans), REP 493 (Review of Interest Only Home Loans: Mortgage Brokers inquiries into consumers' requirements and objectives).
- These reports and subsequent actions demonstrate intensified regulatory scrutiny over controls, processes and templates that lenders use during the underwriting process to protect customers from being approved for unsuitable loans. We expect that the suitability of Interest Only mortgages for instance will continue and that this will be the catalyst for further products and underwriting practices to come under scrutiny.

**Suitable Customer Outcomes**

The roundtable rightly identified that suitability, that is, whether the product meets customer needs and purpose, should be assessed and considered at the start when selling the mortgage to the customer, and constantly throughout the life of the product.

Whether customers are using products as intended can be particularly relevant to certain products. Similarly this can also be relevant to other products such as credit cards, where the customer's usage may more closely resemble a personal loan, rather than a credit card.

This is a fundamental shift for many lenders, as the focus has historically been at origination, rather than prospective, over the life of a loan. The ability to monitor, understand, anticipate and act on customer behaviour at both a product and customer level will require a significant uplift in a lender's data analytics capability.

**Suitable conduct**

For an outcome to be suitable, it must be appropriate for the needs of a particular stakeholder, purpose or situation. This implies several things.

Firstly, the situation in which customers will buy and use products and services must be appropriately considered. Secondly, organisations must ensure that products and services are 'sold' and delivered to the right customers in the right way. And finally organisations must continue to evaluate how customers are using their products and services.

Considering situations for products and services requires a change in mindset from 'can we sell this product/service?' to 'is there a genuine need for this product that will benefit our customers?' Many organisations are re-evaluating their business models and value propositions as a result of re-framing this very question.



**What to look out for with regards to customer suitability:**

- Affordability and serviceability of mortgages
- Suitability of mortgages
- Interest-only mortgages
- Lines of credit
- Reverse mortgages

### Bringing it together

Organisations need to constantly monitor and supervise fair and suitable customer outcomes. To do this they must design and put in place frameworks that will detect and where needed control activities to ensure any vulnerabilities and opportunities are being constantly checked on. Some suggested steps to assist coordinate this, as well as some detail around each of the three main approaches are articulated below.

- **Equip to look forward** – (Identify and manage conduct vulnerabilities and find opportunities to better help stakeholders)
- **Detect and control** – (Design and operate monitoring and supervision processes / frameworks)
- **Remediate and accelerate** – (Take action to fix wrongs and to accelerate strategy).

Some suggested steps to **equip and look forward** include:

- Know who your key stakeholders in your particular business are
- Define and communicate the expected outcomes you will deliver
- Identify the parts of the business where vulnerabilities and opportunities exist
- Assess by gap analysis any current arrangements where conduct does and does not line up to the outcome you want to deliver
- Build and implement the necessary tools and processes to address any deficiencies.

When it comes to **detecting and controlling** it is important to design and operate monitoring and supervision processes and frameworks that are focused on conduct outcomes and let organisations monitor, address and improve conduct.

Some suggested steps include:

- Use lead indicators to identify potential systemic issues before they crystallise
- Leverage the insights from data
- Integrate feedback and continuous improvement processes through all areas of the organisation.

**Remediate wrongs:** Where concerns around an organisation's operations begin to develop, it is essential to remediate any wrongs and listen to the concerns rather than let them grow. Developing a remediation framework is a first step.

**Accelerate strategy:** With many organisations focusing on fixing previous wrongs, it makes sense to assess whether there are lessons learnt and therefore opportunities to accelerate the achievement of a customer-centric strategy.

The customer conversations had; the way organisations motivate and reward employees; and the transparency and guidance provided through policies and frameworks; are some of the areas where opportunities to accelerate strategy are commonly identified.

The value of accelerating strategy is to enable organisations to confidently grow in the knowledge that they do so in a way that will be sustainable; that grows consumer and market confidence and trust in our financial services providers; and enables innovation and so growth.

### Conduct matters

Organisations that better understand the extent to which conduct will change their operations and outlook, will be better placed to evolve their business models and concepts to keep up with changing expectations and respond to competition and disruption, and most importantly to grow.

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