ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

# SUBMISSIONS ON ISSUES RAISED IN INTERIM REPORT

**Smartline Home Loans Pty Ltd (trading as Smartline Personal Mortgage Advisers)**

## A. INTRODUCTION

### A.1. Structure of these submissions

1 These submissions address the questions outlined in Chapter 10 of the Royal Commission's Interim Report. They do so in three parts.

2 Part I describes the role of mortgage brokers in providing good outcomes for customers and promoting competition in the home lending industry. The submissions then examine the impact that prohibition of value-based commissions would have on brokers' ability to continue to fulfil that role. Recognising that "predictions of industry damage or collapse should be examined with special care",[1] the submissions undertake this analysis by reference to supporting evidence.

3 Part II addresses the particular findings made in the Interim Report regarding differences between broker- and non-broker loans. It is submitted that none of those differences can safely be attributed to the fact that the loans originate from different channels, as distinct from the reality that different customers use different channels. It is also submitted that the differences between broker and non-broker loans for which the strongest evidence exists do not constitute proof of poor customer outcomes. Finally, it is submitted that there is in any event no evidence before the Commission that any such differences are caused by brokers' remuneration structures.

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[1] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018), vol 1, 317 (**Interim Report**).

4 Part III addresses some of the questions posed by the Commission in the Interim Report in relation to mortgage brokers.

**A.2. Evidence base before the Commission**

5 The Commission has conducted three case studies concerning mortgage brokers. Those case studies exposed instances of serious misconduct, as well as the existence of systems and practices that fell below community expectations. Notwithstanding their gravity, however, it is submitted that care must be taken when relying on those case studies as anything more than illustrative examples.

*CBA broker relations and accreditation*

6 This case study concerned the role played by CBA's accreditation regime with respect to mortgage brokers. The case study involved a particular focus on the requirement by CBA for brokers to achieve a certain volume of loans written. The case study was directed to the experiences of a single broker Mr Mark Harris, who fell afoul of CBA's minimum loans written requirement. Mr Daniel Huggins, CBA's Executive General Manager for Home Buying also gave evidence. The CBA has subsequently addressed this practice.[2]

7 In addition, this case study focussed on the CBA's failure to disclose the amounts, or estimated amounts, of commissions paid to brokers.[3] But of course, those disclosures were required to be made by the broker in any event.[4] As a result the case study sheds light only on an example of a failure by a lender to comply with extant obligations, and does not say anything in that regard in relation to whether additional obligations ought be imposed.

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[2] *Commonwealth Bank of Australia and its associated Australian entities: Round 1 Hearing - Consumer Lending Closing Submissions* (3 April 2018), [54]; Exhibit 1.201, *Witness statement of Daniel James Huggins dated 26 July 2018*, [25] –[27], [31](a)(iii).

[3] Interim Report, vol 2, 30.

[4] See paragraphs [97] – [99] below.

8 Further, no evidence was adduced in this case study from or about any customer who exhibited or disclosed confusion about the roles and responsibilities of their broker or lender. Nor was there any evidence of a poor outcome suffered by a customer as a result of such confusion. As a result, it is submitted that the conclusion expressed at page 27 of the Interim Report that the relationships and tasks of the broker and lender are "apt to create confusion for the borrower" is not a conclusion which is open to be drawn from the case study.

*Aussie Home Loans broker misconduct*

9 This case study involved the conduct of four former Aussie Home Loans brokers, Mr Shiv Sahay, Ms Emma Khalil, Mr Madhvan Nair and Mr Bernard Meehan. Each of these brokers was accepted by Aussie as having engaged in fraudulent conduct involving falsification of home loan documents or signatures. Further, according to the Interim Report, each has been convicted of offences arising out of the conduct.[5]

10 Evidence was given by Ms Lynda Harris, Aussie's General Manager, People and Culture and Mr Giles Boddy, Aussie's Chief Financial Officer. A written statement was tendered from Mr David Smith, Aussie's General Manager of Strategy and Products.

11 As well as considering the nature of the four brokers' misconduct, the case study examined the systems and practices that Aussie Home Loans had in place to ensure its responsible lending obligations were fulfilled, particularly those aimed at detecting, reporting and remediating conduct of the kind engaged in by the four brokers. The Interim Report concluded that these systems were inadequate, and were a cause of the misconduct engaged in by the four brokers.[6]

12 This case study offered no evidence to the effect that it was the existence of value-based commission structures per se which motivated, caused or explained the

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[5] Interim Report, vol 2, 37.

[6] Interim Report, vol 2, 41.

misdeeds of the four brokers. Rather, the case study demonstrates only that the absence of sufficient supervision of these brokers contributed to their capacity to engage in fraudulent practices.

13 There is no evidence that brokers' remuneration structures caused the broker misconduct referred to in the Aussie Home Loans case study. It is of course accepted that an overwhelming inference is available, namely that the brokers were motivated by the pursuit of profit. It can also be accepted that the opportunity for profit came from the commissions available to them. But that is not to say that the commission structure *caused* the brokers' crimes in any relevant sense. As the Interim Report notes,[7] other conditions were also present at Aussie Home Loans which contributed to the conduct, most significantly inadequate governance and risk management practices.

*ANZ responsible lending*

14 This case study examined ANZ's lending practices with respect to home loans. Evidence was given by a customer of ANZ, Mr Robert Regan, and from the Lead of ANZ's Home Loans Team, Mr William Ranken. A substantial focus of this case study was the steps taken by ANZ to ensure its customers could meet their loan obligations without financial hardship, including the steps ANZ took to verify its customers' expenses (and its apparent misuse of the Household Expenditure Measure for that purpose).[8]

15 Mr Regan's evidence concerned a loan he had applied for, the proceeds of which Mr Regan paid towards a scam,[9] which was apparently inconsistent with the loan purpose Mr Regan had disclosed to ANZ.[10] The case study focussed on the fact that

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[7] Interim Report, vol 2, 41.

[8] Interim Report, vol 2, 44.

[9] Interim Report, vol 2, 46.

[10] Interim Report, vol 2, 48.

the ANZ had failed to identify Mr Regan's previous payments towards the scam when verifying his expenses.[11] The steps ANZ took in response to hardship applications by Mr Regan were also examined, and ANZ admitted that it had assessed an application for hardship relief incorrectly.[12] The case study provides no assistance in relation to the Commission's consideration of the role played by mortgage brokers in the market.

### A.3. Reports and research

16 The principal independent research referred to and relied upon in these submissions includes the following reviews and reports:

a. The Australian Securities and Investments Commission's *Report No. 516: Review of Mortgage Broker Remuneration,* published 16 March 2017 (**ASIC Mortgage Brokers Review 2017**).[13] This report is based on both qualitative and quantitative research, including analysis of data regarding the loans originated by 17 lenders in 2012 and 2015.[14]

b. The Australian Competition and Consumer Commission's *Interim Report of the Residential Mortgage Price Inquiry*, published in March 2018 (**ACCC Interim Report Mortgage Price 2018**).[15] This report examines how Australia's mortgage prices were set by Australia's largest lenders (CBA, NAB, ANZ, Westpac and Macquarie Bank) in the period 30 June 2015 to 30 June 2017.

c. The Productivity Commission's *Inquiry Report no. 89: Competition in the Australian Financial System,* published 29 June 2018 (**Productivity Commission Financial System Competition Report 2018**).[16] This inquiry was a broad ranging review of competition in Australia's financial system, based on submissions by

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[11] Interim Report, vol 2, 45 – 47.

[12] Interim Report, vol 2, 51.

[13] See https://download.asic.gov.au/media/4213629/rep516-published-16-3-2017-1.pdf.

[14] ASIC Mortgage Brokers Review 2017, [1053] – [1056].

[15] See https://www accc.gov.au/system/files/Residential%20Mortgage%20price%20inquiry%20interim%20report.PDF.

[16] See https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf.

interested parties and the Productivity Commission's independent analysis. The Inquiry also produced a Draft Report in February 2018 (**Productivity Commission Financial System Competition Draft Report 2018**).[17]

d. Deloitte's *Customer Experiences of Using Mortgage Brokers*, published in October 2016 (**Deloitte Customer Experience Report 2016**).[18] This study, commissioned by the Mortgage and Finance Association of Australia, surveyed over 1,000 customers who took out a home loan in the two years up to September 2016.

e. Deloitte Access Economics' *The Value of Mortgage Broking,* published July 2018 (**Deloitte Report Mortgage Broking 2018**).[19] This report was produced in consultation with the Mortgage Broking Industry Group, and addresses the role and impact of mortgage brokers in Australia.

17 It is recognised that the currency, origin, scope and nature of the various reports and reviews referred to above are important considerations when one is considering the utility and applicability of the observations and conclusions to be drawn therefrom. It is submitted that the case studies before the Commission specifically directed to the experiences of customers in relation to mortgage brokers (see discussion at paragraphs 5 to 15 above), must be carefully appraised as single examples against the background of the quantitative and qualitative analyses contained in other recently published reports and reviews.

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[17] See https://www.pc.gov.au/inquiries/completed/financial-system/draft/financial-system-draft.pdf.

[18] See https://www2.deloitte.com/content/dam/Deloitte/au/Documents/financial-services/deloitte-au-fs-home-loan-preferences-041116.pdf.

[19] See https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-value-mortgage-broking-230718.pdf.

# B. PART I: BROKERS, COMPETITION AND VALUE-BASED COMMISSIONS

## B.1. Role of brokers: customer outcomes

18 Each of ASIC, the ACCC and the Productivity Commission have recognised that mortgage brokers have an important role to play in providing assistance to consumers and promoting competition among lenders.

19 The Australian mortgage market is increasingly complex and difficult to navigate for consumers. These challenges are currently the subject of an inquiry by the ACCC into mortgage pricing by Australia's largest lenders (Commonwealth Bank, National Australia Bank, Westpac, ANZ and Macquarie Bank).

20 The ACCC Interim Report Mortgage Price 2018, has made preliminary findings that:

a. the pricing of home loan products by Australia's largest lenders is characterised by a lack of transparency. In particular, "opaque discretionary discounts" are common, and it is difficult for consumers to obtain information and make product comparisons;

b. home loan products that are often marketed as "basic" products may not necessarily be the cheapest; and

c. there are signs that there is a lack of vigorous competition between Australia's largest lenders, with pricing behaviour appearing focused on mutually beneficial pricing outcomes between the largest lenders.[20]

21 In light of the above, the assistance brokers provide to consumers is critical. As identified in the ASIC Mortgage Brokers Review 2017, brokers educate consumers and raise their financial literacy, helping them to make informed choices.[21] As noted by the ACCC, "[b]orrowers have increasingly turned to mortgage brokers to give

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[20] ACCC Interim Report Mortgage Price 2018, pages 6, 20-21.

[21] ASIC Mortgage Brokers Review 2017, [21].

them a broader view of the options available across a range of residential mortgage lenders."[22] Brokers assist consumers to navigate the complexity of the products on offer and obtain an appropriate home loan.

## B.2. Role of brokers: promoting competition in the home lending industry

22 The role of brokers in promoting competition among lenders was outlined in Smartline's previous submissions (**Smartline's April Submission**).[23] Since those submissions were made, the Productivity Commission has delivered the Productivity Commission Financial System Competition Report 2018, which includes the following conclusions in relation to brokers.

a. Brokers serve to lower barriers to entry for smaller, regional, or specialist lenders, by facilitating borrower access to those providers' home loan products. The Productivity Commission notes that brokers are "integral to smaller lenders' ability to compete", and smaller lenders originate a larger proportion of loans through brokers compared to the major banks.[24]

b. Brokers stimulate competition in the mortgage market by reducing costs for smaller or regional lenders, who would otherwise be forced to invest substantially in their own distribution channels (and in particular, the overheads and infrastructure of an expanded branch network) and additional marketing.[25]

c. By providing access to different lenders, brokers reduce search time and costs for consumers, and provide them with knowledge that they can use to exert competitive pressure on lenders and find products that better suit their needs.

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22 ACCC Interim Report Mortgage Price 2018, page 7.

23 Smartline Home Loans Pty Ltd, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Submissions on Issues Raised in Public Hearings – Consumer Lending*, 3 April 2018, [5] – [9].

24 Productivity Commission Financial System Competition Report 2018, 311 – 313.

25 Ibid.

Brokers' transactional services (such as pre-approval and loan application assistance) also allow consumers to apply for loans more efficiently.[26]

23 The Productivity Commission has noted that, in contrast, larger lenders are likely to find it more cost-effective to distribute loans through their own proprietary channels (i.e. bank branches) rather than using brokers.[27]

24 As noted in Smartline's April Submission, the service provided by brokers in the market has had a demonstrable impact on loan rates (reducing interest margins by 200 basis points within two years of entering the mortgage market).[28] Although differences in loan rates between broker-originated and lender-originated loans have narrowed over time,[29] brokers continue to stimulate competition by providing an enhanced service offering relative to many lenders. Brokers are more likely to be used by consumers with complex needs, and they are also more likely to tailor their advice to individual consumers.[30] Mortgage brokers have also contributed to significant innovations in lender services, by providing assistance to consumers outside business hours and at a location of their choosing, and facilitating online services that research and compare different lenders' loan products. That competitive service offering has resulted in brokers now originating the majority of home loans (55.3%) compared to lenders themselves (44.7%).[31]

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26 Ibid, 307.

27 Ibid, 313.

28 Smartline's April Submission, [7]. See also Productivity Commission Financial System Competition Report 2018, 302.

29 Ibid, 301 – 302. The Productivity Commission Financial System Competition Report 2018 has noted that while consumers believe brokers can achieve better rates on their behalf, in fact recent data suggests that home loan rates obtained by brokers are not significantly different to obtaining a loan directly from a lender. This may be due to a convergence of rates over time as lenders lower the rates offered in their branches to match brokers, as well as a higher proportion of experienced borrowers approaching lenders directly to negotiate lower rates: see at 301 and 310. Nevertheless, it is of note that the Reserve Bank estimates that loans issued by brokers receive approximately a 5 basis point larger discount relative to lender-originated loans, see Reserve Bank of Australia, *The Distribution of Mortgage Rates*, Reserve Bank Bulletin – March 2018, 15 March 2018, 12.

30 Deloitte Report Mortgage Broking 2018, 25.

31 Mortgage and Finance Association of Australia, "Consumers continue to select brokers as the preferred channel for a home loan – latest market share data", Media Release, 13 June 2018, see https://www.mfaa.com.au/news/consumers-continue-to-select-brokers-as-the-preferred-channel-for-a-home-loan. The Mortgage and Finance Association of Australia further notes that brokers' market share in originating home loans has also increased by 1.7% over the previous 12 months, demonstrating a continued consumer preference to approach brokers for loan advice, when compared to seeking a loan directly from a lender.

25 Lenders have responded by investing in improved services to accommodate brokers and their clients, including by introducing digital platforms that enable brokers to lodge loan applications and track their progress online, and by providing automated property valuation services to more efficiently assess certain loan applications.[32] Competition through enhanced service is a critical driver in improving market transparency and access to a broader range of products for consumers.

26 Analysis conducted by the Productivity Commission also confirms that smaller, foreign and non-bank lenders have originated a greater proportion of loans through brokers, than is the case in relation to the Big Four banks.[33] Further a submission made by a group of regional banks to the Productivity Commission Inquiry (see the combined submissions filed with the Productivity Commission on behalf of the Bendigo Bank, Bank of Queensland, Suncorp, AMP Bank and ME Bank, dated 22 September 2017) contended that, "smaller banks are typically dependent on unbiased distribution networks to overcome the disadvantage of smaller physical branch networks and marketing budgets."[34]

27 As can be seen from the above, brokers have played a significant role in informing and assisting consumers, and in acting as a disruptive influence on oligopolistic outcomes in mortgage markets.

**B.3. Consequences: prohibition of lender-paid commissions**

28 If lender-paid commissions for mortgage brokers are prohibited, it will give rise to the following highly undesirable consequences, each of which is discussed in more detail below :

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[32] For example, Bankwest's "Home Lending Portal" provides brokers with online property valuations for their clients and digital application services, see https://www.bankwest.com.au/about-us/media-centre/news/upfront-valuations-the-latest-offering-for-brokers-from-bankwest. Similar broker support services are provided by other lenders.

[33] Productivity Commission Financial System Competition Report 2018, 312, figure 11.3.

[34] Regional Banks, *Submission to the Productivity Commission*, 22 September 2017, 63.

a. the emergence of an "advice gap", as brokers' assistance to navigate the complexity of the home loan market is restricted to those who can pay;

b. reduced competition among lenders; and

c. reduced competition among brokers (which could have flow-on consequences for competition among lenders).

*Emergence of an advice gap*

29 Any move to a user-pays model of broker remuneration is likely to lead to reduced use of brokers by consumers. Evidence for this proposition comes from a recent study prepared by Deloitte, the Deloitte Customer Experience Report 2016, which found that 37% of broker customers would be unwilling to pay such a fee, and would instead commence to deal directly with the lender. A further 22% would only be willing to pay up to $500.[35] While commissions and remuneration arrangements vary, this could be about one third of what a broker typically receives for an average loan. Self-evidently, such a decline in compensation would lead to a corresponding decline in the numbers of brokers operating in the market. This will in turn create a significant risk that a substantial number of consumers will be unable to access independent advice regarding home loan products, leading to an "advice gap" between these consumers and those that can afford independent advice. This is of particular concern given the issues raised by the ACCC – including in respect of the opaque pricing behaviour of Australia's largest lenders, and the challenges faced by consumers in understanding mortgage products.

*Reduced competition in the home lending market*

30 The above analysis concerning the positive contribution by mortgage brokers to increased competition demonstrates that if the number of consumers using brokers were to decline as the result of a move to a user-pays model, the consequences for

[35] Deloitte Customer Experience Report 2016, 5.

competition could be severe. This has led the Productivity Commission to observe the following:

> fees-for-service paid by consumers are unlikely to be pro-competitive, because a lack of willingness to pay is likely to result in a smaller mortgage broking industry, and the greater damage would be to the lenders without branch networks. Given that many mid-size and smaller lenders rely on brokers to compete (section 11.3), competition in the home loan market would likely be weaker as a result.[36]

31 The Commonwealth Treasury has reached a similar finding:

> The risk with [a move to user-pays] is if customers switch to obtain[ing] home loans from lenders directly rather than paying brokers an upfront fee, threatening the viability of the mortgage broker distribution channel. Estimates of what most consumers may be willing to pay a broker, of no more than $1000, are well below the average value of commissions currently paid by lenders. If mortgage broking activity contracted, this could have a significant detrimental impact on competition in the mortgage market.[37]

*Reduced competition in the mortgage broking market*

32 A substantial number of brokers (approximately 30%) are estimated to operate under their own Australian Credit Licence, and rely on commission remuneration to fund their compliance and other operational costs.[38] Their ability to compete with larger lenders will be reduced under a capped remuneration structure.

33 Non-lender owned brokers compete not only with lenders themselves, but also with lender-owned brokers. The ACCC Interim Report Mortgage Price 2018 has highlighted the increased ability of Australia's largest lenders to place home loan products (whether bank-branded or "white-labelled") through vertically integrated operations. It identified that, compared to the overall broker channel, lender-owned brokers were more likely to originate loans with their related-party lenders. Examples provided from 2015 indicated that:

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[36] Productivity Commission Financial System Competition Report 2018, 333.

[37] Commonwealth Treasury, *Background Paper 24: Submission on Key Policy Issues*, (Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 26 July 2018) (**Background Paper 24**) [261].

[38] Deloitte Report Mortgage Broking 2018, 12.

a. CBA's share of loans (either bank-branded or "white-labelled") sourced through its related brokers Aussie Home Loans and Mortgage Choice were 16.4% and 4.1% higher than the broader broker channel, respectively;

b. NAB's share of loans sourced through its subsidiary aggregators was 8.8% higher than its share of the broader broker channel; and

c. Macquarie Bank's share of loans sourced through its related broker Yellow Brick Road was 18.2% higher than its share of the broader broker channel.[39]

34 In light of the above, any weakening of the mortgage broker channel caused by substituting a user-pays model for a commission-based remuneration structure is likely to serve only to further strengthen the market share of larger lenders. At a basic level, it will do so by reducing the number of non-lender owned brokers that are able to compete with lenders or lender-owned practices.

35 Similar trends have been identified as a consequence of the FOFA reforms in the financial advice sector.[40] In its submission to the Productivity Commission Inquiry, the Financial Planning Association of Australia noted that, over the past five years, there has been:

> an increase in fees charged to consumers, changing adviser numbers, and many sole traders, small licensees and medium licensees forced to move to a general advice only model, reduce client numbers or turn in their license altogether and join a larger licensee.[41]

36 The Productivity Commission Inquiry has acknowledged the role that changes in remuneration structures under the FOFA Reforms played in "reducing the contestability of financial advice", as smaller advisory firms' ability to compete has been reduced in the absence of economies of scale.[42]

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[39] ACCC Interim Report Mortgage Price 2018, page 13.

[40] Productivity Commission Financial System Competition Draft Report 2018, 191.

[41] Financial Planning Association of Australian, *Submission to the Productivity Commission Inquiry*, 15 September 2017, page 5.

[42] Productivity Commission Financial System Competition Draft Report 2018, 192.

### B.4. Consequences: introduction of up-front fees

37 It is submitted that careful consideration must be given to the impacts of a changed remuneration structure that substitutes an up-front fee model (whether paid by consumers or lenders) for the current hybrid model of up-front commissions combined with trail commissions.

38 As noted in Smartline's April Submissions, trail commissions and clawbacks support responsible lending by operating so as to encourage brokers to avoid inappropriately switching consumers from one product to another (known as "churning"), or placing consumers into a loan on which they are likely to default.[43]

39 The introduction of a flat fee model may also create an incentive for brokers to inappropriately split loans into multiple loans to generate additional fees, and discourage brokers from spending time advising clients with complex needs (such as first-home buyers, or borrowers seeking to consolidate multiple loans). [44]

40 Recent experience in the Australian life insurance industry and the UK mortgage market provides useful indicators of how the removal of ongoing incentives to brokers may give rise to negative outcomes for consumers. These are outlined below.

*Changes in remuneration models in the Australian life insurance industry*

41 It is useful to have regard, by analogy, to the experiences in the life insurance industry. In October 2014, ASIC published *Report No. 413: Review of retail life insurance advice*. ASIC's findings indicated that life insurance advisers remunerated under an "up-front commission model" were more likely to lead to: (i) advisers unnecessarily switching consumers from one life insurance product to another; and/or (ii) policies lapsing due to a lack of ongoing service.[45] Typically, the up-front

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[43] Smartline's April Submission, [36].

[44] See similar views expressed in relation to potential negative impact on after sales service by brokers, in Commonwealth Treasury, *Key Reforms in the Regulation of Financial Advice – Background Paper 8* (Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 13 April 2018) 62 (**Background Paper 8**).

[45] ASIC Life Insurance Review, 42 – 43.

commission model featured commissions that were between 100% to 130% of the value of the first year's premium, with only around 10% trail commission. Hybrid-commission models (where the up-front and trail commissions were more evenly weighted) and level-commission models (where the up-front and trail rates were equal) resulted in lower instances of inappropriate consumer switching and policy lapses.[46]

42 ASIC's findings in this regard led to the introduction of the *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017* (Cth), which capped up-front commissions. Notably however, the reforms preserved commission-based remuneration structures in order to support affordable access to life insurance advice and the viability of advisory practices.[47]

43 These reforms adopted a model which made provision for up-front and trail commissions. At the same time, the reforms introduced a requirement that commission payments include two-year claw-back arrangements, to reduce advisers' incentives to inappropriately switch clients to different products. This sort of approach is similar to the remuneration model for brokers which the Combined Industry Forum of participants in the mortgage industry (**CIF**) proposes by way of reform. Smartline supports those CIF proposals.

*Lessons learned from UK remuneration model*

44 In the United Kingdom, brokers are generally remunerated on the basis of up-front commissions paid by lenders, consumer-pays fixed fees, or a combination of both. Trail commissions have not traditionally formed a part of broker remuneration in the UK. Both the ASIC Review and the Commonwealth Treasury have identified that the lack of trail commissions in the UK may potentially drive increases in the

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[46] Ibid, 42 – 43.

[47] Background Paper 8, 11.

level of advisers inappropriately switching consumers into different mortgages.[48] This is evidenced by a higher proportion of consumers who were placed in short-term (often two year) fixed-rate home loans as brokers are not incentivised to retain consumers in appropriate home loan products.[49] However, the UK Financial Conduct Authority has also noted that lenders in the UK are increasingly paying brokers "retention procuration" commissions as part of their strategies to retain consumers.[50] Retention procuration commissions are paid to incentivise brokers to retain consumers on a lower-rate loan with their current lender. The extent to which this emerging lender practice alleviates the risk of advisers inappropriately switching consumers into different mortgages is presently unknown. Furthermore, the practice may not necessarily develop, or be capable of developing, in Australia should trail commissions be prohibited.

## C. PART II: INTERIM FINDINGS: POOR CUSTOMER OUTCOMES

### C.1. Findings in the Interim Report

45 In the Interim Report, the Commission found that:

> both CBA and ASIC rightly identified the consequences of value-based remuneration of brokers:
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> - higher leverage;
> - higher incidence of interest-only loans;
> - higher total debt-to-income ratios;
> - higher LVRs;
> - higher incurred interest costs; and

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[48] ASIC Mortgage Brokers Review 2017, 45; Background Paper 24, 62.

[49] ASIC Mortgage Brokers Review 2017, [218]. Preliminary analysis conducted by the Financial Conduct Authority, published on 4 May 2018 in its *Mortgage Market Study – Interim Report* indicates that high switching rates in the UK can also be influenced by the prevalence of short-term, introductory interest rates offered on many UK loans. In that context, consumers are likely to seek alternative home loans when their existing mortgage reverts to a higher rate following the end of the introductory offer. However, it is not yet clear the extent to which broker remuneration incentives contribute to this level of switching. The Financial Conduct Authority's analysis of the UK mortgage market and related remuneration issues is ongoing, and further data is required to properly understand broker incentives (including the use of lender commissions and retention strategies). The Financial Conduct Authority is expected to provide further data in a final report scheduled to be released in December 2018, see https://www.fca.org.uk/publications/market-studies/mortgages-market-study.

[50] Financial Conduct Authority, *Mortgage Market Study – Interim Report*, 4 May 2018, 60.

- over time, an increased likelihood of borrowers falling into arrears, borrowers paying their loans more slowly and paying more interest than other borrowers.[51]

46 The Commission has also suggested that these differences between broker- and non-broker channels were indicative of poor customer outcomes.[52]

47 It is submitted that the Commission ought not make those findings in its final report, because:

a. there is no reliable evidence that any of the differences that exist between broker and non-broker loans are caused by the conduct of brokers or by any feature of their remuneration; and

b. the two differences between broker originated and other loans for which the strongest evidence exists (namely the average of 2.48% higher leverage among broker loans, and a higher incidence of interest-only repayments) – are not in and of themselves proof of poor customer outcomes.

48 Care should be taken in assessing the findings made and opinions expressed by ASIC and the CBA on this topic. The Commission's Interim Report appears to suggest that the CBA's views are in some way confirmatory of the ASIC findings.[53] But this is not the case. ASIC based its analysis on loans written in 2012 and 2015 by 17 different lenders.[54] In contrast, it can only be assumed that the CBA had access solely to data regarding its own loans, and the time period interrogated in CBA's analysis is left undisclosed. As a result, the opinions of the CBA and the findings made by ASIC appear to relate to different data sets and cannot be assumed to be corroborative of each other.

49 In its Interim Report, the Commission referred to the six differences between broker and non-broker loans which are set out above at paragraph 45. The Interim Report

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[51] Interim Report, vol 1, 62.

[52] Interim Report, vol 1, 61 – 62.

[53] Interim Report, vol 1, 60.

[54] ASIC Mortgage Brokers Review 2017, [817].

suggests that CBA and ASIC identified these six differences as "consequences" of value-based remuneration of brokers. That is not so.

50 Neither ASIC nor CBA has expressed the conclusion that these differences are caused by the broker channel, let alone that they were the result of the existence of brokers' value-based commissions:

a. ASIC made no such finding. Indeed, its report expressly notes that, even after its attempts to control for differences in loans and borrowers, further research was required to identify the causes of the differences it observed.[55] Such restraint in attributing causal links, it is submitted, was appropriate.

b. The CBA chose its language with care, saying: "These findings are *consistent with the hypothesis* that differences in remuneration between the channels are driving different customer outcomes" (emphasis added).[56] See Exhibit 1.37, 16.

## C.2. ASIC's analysis

*Higher total debt-to-income ratios*

51 It is well documented that there are differences between borrowers who tend to use brokers and those who more commonly approach lenders directly.[57] On the whole and on average, borrowers using brokers are younger and have lower incomes.[58] It is for that reason that ASIC attempted to control for these differences in making many of its findings. But ASIC did not make any "controlled" finding regarding debt-to-income levels. ASIC only made a "raw" finding on that topic,[59] as, it appears, did the

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[55] ASIC Mortgage Brokers Review 2017, [822], [826].

[56] Exhibit 1.37, *Letter from Mr Narev to Mr Sedgwick dated 10/02/2017 and the annexed issues paper submission*, 16.

[57] ASIC Mortgage Brokers Review 2017, [47] – [50].

[58] ASIC Mortgage Brokers Review 2017, [47].

[59] ASIC Mortgage Brokers Review 2017, [817](e), table 14.

CBA.[60] As a result, such findings as were reported on the topic cannot be reliably used as evidence that brokers are a cause of higher debt-to-income levels.

*Increased likelihood of falling into arrears*

52 ASIC found that after controlling for *certain* differences between the two channels, there was a difference in arrears rates between broker and non-broker loans. That difference was small, and is not robust when limitations in the control methods are taken into account.

53 ASIC found the "controlled" difference in the likelihood of loans going into 30-days arrears to be between 0% (for two of seven lenders) and 25% (in relation to one of the lenders).[61] The percentage difference being the difference in the arrears rate between the respective lenders' broker-originated and non-broker originated loans. The mean difference across the seven lenders examined was 10.6%.

54 While a 25% difference in arrears rates may seem large, it does not translate to large differences in the arrears rate in absolute terms, because the arrears rates themselves are small. For example, in 2015 (the most recent of the two years examined by ASIC) the nationwide arrears rate was 1.34%.[62] This means that in 2015, a 25% difference in the *likelihood* of arrears likely equated to a difference in the arrears rate of about one-third of one per cent (0.3%).[63] The mean difference in likelihood of 10.6% across the seven lenders ASIC studied likely equates to a difference in the arrears rate closer to one-tenth of one percent (0.1%). And it should not be forgotten that two of the seven lenders had a difference in arrears rates of 0%.

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[60] Exhibit 1.37, *Letter from Mr Narev to Mr Sedgwick dated 10/02/2017 and the annexed issues paper submission*, 14.

[61] ASIC Mortgage Brokers Review 2017, [862], table 21.

[62] Moody's Investors Service, *Mortgage Delinquency map: Home loan arrears rise to five-year high* (18 September 2017), p 2 exhibit 1 < https://www.macrobusiness.com.au/wp-content/uploads/2017/09/Report-RMBS-Australia-Mortgage-delinquency-map-Home-loan-arrears-rise-to-five-year-Sep2017.pdf> (**Mortgage Delinquency Map**).

[63] The figures ranging from 0% – 25% were said by ASIC to represent "the percentage difference in the likelihood of broker-originated loans going into arrears compared to non-broker originated loans".

55 There is then the question of whether these “controlled” findings are robust, once all relevant differences between the loan channels (and the nature of customers who use each channel) are taken into account. That question may be answered by reference to just one of the variables ASIC attempted to control for. That variable is borrowers' geography. ASIC controlled for borrower location at the State or Territory level.[64] Yet the differences in arrears rates *within* States and Territories are high, and are far higher than the 0 – 0.3% arrears rate difference ASIC observed between loan channels. In May 2016 (the period for which we have been able to obtain data), the arrears rate in Sydney was 0.84%, nearly half that of the rest of NSW (1.61%). The differences existed in all States and Territories and were equally pronounced in Western Australia (Perth 2.66%; rest of state 5.10%) and Queensland (Brisbane 1.6%; rest of the state 2.46%).[65]

56 Given these disparities, even a slight skew towards a regional customer base for brokers' customers would be capable of producing the 0 – 0.3% difference in 30-day arrears rates. And there is every reason to believe that this skew exists. Three in ten loans originated by mortgage brokers are from borrowers in regional and rural areas,[66] which is slightly greater than that group's representation in the population.[67] By contrast, it is well documented that borrowers in regional areas have difficulty accessing lenders directly, due to branch closures and impaired access to the internet and other digital services.[68] In this respect Deloitte Access Economics has observed that mortgage brokers increase regional and rural residents' access to a greater range of mortgage products.[69]

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64 ASIC Mortgage Brokers Review 2017, [827](b).

65 Mortgage Delinquency Map, 3, exhibit 2.

66 Deloitte Report Mortgage Broking 2018, 8.

67 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Background paper 18: Some features of Financial Services in Regional and Remote Communities* (2018), 5 (**Background Paper 18**).

68 Background Paper 18, 3.

69 Deloitte Report Mortgage Broking 2018, 25.

57 In light of the above analysis, it is submitted that the Commission does not possess a sufficiently robust basis for concluding that there is a relevant difference in arrears rates between broker and non-broker loans.

*Higher leverage*

58 The story is similar when it comes to loan leverage, expressed as loan-to-valuation ratio (**LVR**). ASIC found a controlled difference in LVR of between 0% and 4.1% across the nine lenders examined. The mean difference across the lenders was 2.48%.[70]

59 ASIC controlled for attributes including age, income, expenses, employment status and marital status.[71] It appears ASIC did not, or was unable to, control for other factors that might be very relevant to loan leverage, notably assets, liabilities, credit history or dependants. In those circumstances, it is little wonder that ASIC did not record a conclusion that such difference in LVR as does exist between the two loan channels was caused by broker conduct or remuneration. In Smartline's submission, the Commission has no proper basis upon which to make that finding, either.

*Higher incidence of interest-only loans*

60 ASIC found a higher incidence of interest-only loans in the broker channel, compared to the non-broker channel. Nevertheless, ASIC did not go so far as to make any finding as to the <u>cause</u> of that difference.

61 Again, this is unsurprising given the variables for which ASIC did not control. Some of those are mentioned above. Another of particular relevance is the customer's strategies and objectives. It would be unsurprising if those seeking more complex loan products tend more often to draw on the services of a broker.

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[70] ASIC Mortgage Brokers Review 2017, [838], figure 26.

[71] ASIC Mortgage Brokers Review 2017, [827].

*Borrowers paying down their loans more slowly and paying more interest*

62 ASIC reasoned that "[a]ll other things being equal, loans with higher amounts, and/or interest-only terms will cost the consumer more in interest and may take longer to pay down."[72] That much can of course be accepted. But this finding would only be important for present purposes if there were also a finding that the broker channel *caused* entry by consumers into larger and interest-only loans. For the reasons stated above, that conclusion is not available.

*Conclusion in relation to ASIC*

63 Of the findings made by ASIC, the *most* robust are those with respect to which variables were attempted to be controlled, namely the findings that:

a. broker loans are associated with (an average of 2.48%) higher leverage across the nine lenders studied; and

b. broker loans are associated with a higher incidence of interest-only loans.

64 But even in respect of these findings, there has been no conclusion reached by ASIC that these differences were caused by brokers. And, even if it could be proven that such outcomes are the result of broker conduct, those results are not indicative of poor customer outcomes in and of themselves. The quality of a customer outcome cannot be determined in the aggregate; it can only be assessed by comparing that customer's needs, objectives and financial circumstances with the loan product(s) obtained. ASIC recognised this explicitly:

> All other things being equal, loans with higher amounts, and/or interest-only terms will cost the consumer more in interest and may take longer to pay down. Whether or not this is a poor consumer outcome depends on whether the loan met the consumer's requirements and objectives and did not result in the consumer experiencing financial hardship. For example, if a consumer is placed in a larger loan than they needed, this is clearly a poor consumer outcome (and may also breach responsible lending laws).[73]

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[72] ASIC Mortgage Brokers Review 2017, [54].

[73] ASIC Mortgage Brokers Review 2017, [54].

65 To treat all instances of higher leverage and interest-only loans as indicative of poor customer outcomes would be to oversimply.

66 The Commission appears in its Interim Report to have proceeded on the basis of a premise that it is in every customer's interest to "borrow no more than is necessary … on terms that minimise the cost to the borrower".[74] But borrowers' objectives vary. This can be illustrated in the varying approaches borrowers take to loan size and leverage, and interest-only repayments.

67 Many customers quite reasonably perceive it to be in their interests to take on a larger home loan, or indeed the largest home loan they can comfortably afford. For example, a young couple might take that view because they plan to grow their family and wish to avoid the significant transaction costs involved in buying a second, larger home down the track.[75] Equally, a borrower might view their home as their primary savings vehicle. Borrowing to invest in an asset that will almost inevitably appreciate over the long term and (exceptionally) be free from capital gains tax is hardly a misguided strategy.

68 It is accepted that entry into an interest-only loan may increase the amount of interest payable, but in many cases that is not inconsistent with achieving the customer's goals. For example, in some cases the customer's goals may mean that, notwithstanding the greater interest paid, the net economic result for the borrower is beneficial, for example, where the customer intends to make an investment, in respect of which the interest paid is tax deductible and the investor wishes to maintain leverage in the investment by not paying down principal.

69 In other cases, the customer may be willing to pay slightly higher interest costs over the longer term, in return for lower repayments in the short term. This can be an

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[74] Interim Report, vol 2, 28 – 29.

[75] Including at least stamp duty and real estate agent's fees.

appropriate strategy to deal with temporary dips in income, such as those arising from study or parental leave.

70 In any event, ASIC did not conclude that such differences as it had identified between broker- and non-broker-loans were "consequences"[76] of value-based and trail commissions, and such a finding is not otherwise available to the Commission on the evidence before it.

71 ASIC did find that there exist certain differences between broker and non-broker loans (including slightly higher LVR and higher incidence of interest-only loans), even after controlling for different borrower and loan characteristics. But ASIC concluded that it "[could] not always explain the causes of these differences" and "[f]urther work (e.g. a shadow shopping exercise or analysis of individual files) may be required to better understand the causes, and to determine whether any regulatory or policy response is required.[77] ASIC has informed the Commission that it is undertaking a shadow shopping study of both the mortgage broker and direct channel, the results of which it expects to receive by the end of 2018 or early 2019.[78]

72 With this in mind, the Commission ought not conclude (where ASIC has not) that any differences in leverage and interest-only repayments across the broker and direct channels are either caused by those channels, or bespeak poor customer outcomes in and of themselves.

## C.3. CBA's analysis

73 As noted in Smartline's April Submission, the views propounded by the CBA on this topic ought be treated with extreme caution, because:

a. *Basis for opinions not known*: the bases for the opinions expressed by the CBA, including the data that were examined and with respect to what time period,

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[76] Interim Report, vol 2, 30.

[77] ASIC Mortgage Brokers Review 2017, [826].

[78] ASIC, *Submissions of the Australian Securities and Investments Commission – Consumer Finance* (3 April 2018) [24].

are not disclosed in the materials. Even the nature of the findings themselves is in some cases not clear. For example, the CBA's confidential submission states that "[e]ven for customers with an identical estimate of ex-ante risk, loans through the broker channel have higher leverage". What this means is left opaque. What is the meaning of the reference to risk ? Is it a reference to "risk" of hardship, or "risk" of default?

b. *Self interest:* As is noted above, the CBA (which has since announced plans to separate itself from its mortgage broking arm, Aussie Home Loans[79]) stood to benefit from any recommendation by Mr Sedgwick that would have reduced the competitive pressure vis a vis the big four banks brought to bear by mortgage brokers. Likewise, it possessed an obvious self interest in any recommendation that would have reduced the cost to CBA of paying brokers' commissions.

74 It is not intended to suggest that the opinions expressed in the CBA's Confidential Submission are inadmissible.[80] Rather, it is sought to make the point that in the absence of any material concerning the basis upon which those opinions have been expressed, and in light of the risk that self-serving assertions may have influenced the formulation or expression of those opinions, the so-called "findings" made by the CBA might be seen as possessing little probative value.

## D. PART III: ANSWERS TO PARTICULAR QUESTIONS POSED BY THE COMMISSION

75 Below, Smartline addresses the questions posed by the Commission in the Interim Report, insofar as those questions pertain to mortgage broking.

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[79] Interim Report, vol 1, 80.

[80] Interim report, vol 2, xxvi.

## D.1. Role of mortgage brokers

- *For whom do intermediaries in the home loan market act?*
- *For whom should each kind of intermediary act?*
- *For whom does the borrower believe that the intermediary is acting?*
- *What does the borrower expect of the intermediary?*
- *Are those beliefs and expectations well-founded?*

76 A mortgage broker is an intermediary. The mortgage broker stands between the borrower and the lender, and provides services to both.

77 *For the borrower*, the mortgage broker provides credit assistance. The broker ascertains the customer's needs and objectives, verifies their financial situation, and suggests a loan that the broker has assessed as right for the borrower, and that, at a minimum, is not unsuitable. The broker's role in this respect is protective of the borrower, as brokers are forbidden from assisting their customers to apply for loans (or credit limit increases) that are unsuitable, regardless of the customer's instructions.[81] The mortgage broker also prepares and submits the loan application to the lender on the customer's behalf, and communicates with the lender through to settlement.

78 This Commission has not heard any evidence from customers dissatisfied with the service provided to them by a broker, or from any customer who could attribute a poor outcome to poor service by a broker. The Commission also has not received evidence from any customer who was confused by their broker's role, or entered into a loan which was unsuitable for their needs, in reliance upon a misconception caused by confusion surrounding their broker's role.

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[81] NCCP Act, s 123.

79 Indeed, overwhelmingly, brokers' customers are satisfied with the services that their brokers provide.[82] For the reasons stated in Part II, there is no evidence to suggest that they are misguided in that satisfaction. Nor is there any evidence that they are confused about the services the broker provides.[83] The continued growth of the broker channel over the past decade supports this.[84]

80 *For the lender*, the mortgage broker makes lenders' loan products available to customers and provides information on them as appropriate. Brokers also typically have obligations to lenders such as those summarised in paragraph 86 below. The mortgage broker's role is not to "push" the products of any particular lender over and above the products of any other lenders on its panel. That is not how a contractual requirement to "promote" a lender's reputation and products (and not to engage in any conduct which "may adversely affect" the lender's "good name or business reputation"),[85] should be understood.

## D.2. Duties of mortgage brokers

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[82] Nine out of ten customers are satisfied with the services provided by the broker: Deloitte Report Mortgage Broking 2018, vi.

[83] As noted above at fn 29, the Productivity Commission Financial System Competition Report 2018 found that "[w]hile many consumers believe that mortgage brokers can secure them a lower interest rate, interest rates on home loans obtained through brokers are not significantly different to those obtained directly from lenders." This does not mean that those consumers are confused. As stated in fn 26, in a competitive market one would expect the interest rates *obtainable* across the two channels to achieve parity (Productivity Commission Financial System Competition Report 2018, 309 – 310). The question is what level of negotiation it takes for a consumer to obtain a market leading rate. As both the Productivity Commission's report (at 110) and the ACCC Interim Report Mortgage Price 2018 (at 6) have noted, home loan pricing is notoriously opaque and discretionary discounts are common. While some consumers are willing and able to survey the market and negotiate with lenders themselves, others go to brokers for assistance – and, the rates achieved being almost the same across the two channels, they evidently receive that assistance. As the Productivity Commission's report noted, "one would not necessarily expect interest rates on home loans obtained through the broker channel to be lower than those obtained through direct channels", in part because "[t]hose who approach lenders directly tend to be more experienced and confident … and may therefore be equally as effective at applying competitive pressure on lenders as brokers" (309).

[84] Deloitte Report Mortgage Broking 2018, 4.

[85] Exhibit 1.27.4, *Formal written agreement between CBA and a particular Head Group*, cl 2.10.

- *What duties, if any, does the intermediary owe the borrower at the several stages between a borrower approaching a broker and the borrower drawing a loan?*

81 The principal obligations owed by a mortgage broker to a borrower are the responsible lending obligations contained within Part 3-1 of the *National Consumer Credit Protection Act 2009* (Cth) (**NCCP Act**). Those obligations include disclosure obligations (including the provision of a credit guide, quote,[86] and credit proposal disclosure document[87]).

82 They also include obligations to make reasonable inquiries about the consumer's requirements and objectives in relation to the credit contract and the consumer's financial situation, and to take reasonable steps to verify the consumer's financial situation.[88] Before providing credit assistance to the consumer, the broker must also make a preliminary assessment as to whether the credit contract in question will be unsuitable for the customer,[89] and decline to suggest or assist the consumer to apply for the credit contract if it will be unsuitable for the customer.[90]

83 These specific obligations are supplemented by the general obligations on licensees under the NCCP Act, including duties to:

a. do all things necessary to ensure that the credit activities authorised by the licence are engaged in efficiently, honestly and fairly;

b. have in place adequate arrangements to ensure that clients of the licensee are not disadvantaged by any conflict of interest that may arise wholly or partly in relation to credit activities engaged in by the licensee or its representatives; and

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[86] Except, in short, where the licensee does not intend to charge fees, and that fact is disclosed in the credit guide and credit proposal disclosure document: NCCP Regulations, reg 28C.

[87] NCCP Act ss 113, 114 and 121.

[88] NCCP Act, 2 117(1).

[89] NCCP Act, s 116.

[90] NCCP Act, 123.

c. ensure that its representatives are adequately trained, and are competent, to engage in the credit activities authorised by the licence.[91]

84 In addition to the broker's obligations under the NCCP Act, brokers are subject to, among other things, the *Privacy Act 1988* (Cth) and the *Australian Consumer Law*, including the prohibitions on unconscionable and misleading or deceptive conduct.

85 These existing obligations on mortgage brokers are well adapted to ensure good customer outcomes. While the hearings of the Commission have disclosed the existence of broker misconduct which can occur when those duties are not observed, such problems with compliance as have been revealed do not indicate problems with the content of the duties themselves.

- *How do these duties fit with whatever duties the broker might owe to the lender?*

86 The duties owed by brokers to a lender typically include:

a. maintenance of appropriate licenses and insurances;

b. compliance with the NCCP Act, Privacy Act and other legislation;

c. adherence to lenders' codes of conduct;

d. training and other accreditation requirements;

e. not holding itself out as an agent of the lender;

f. for some lenders – Anti-Money Laundering/Counter Terrorism financing procedures; and

g. for some lenders – promotion and non-disparagement (in the sense explained above).

[91] NCCP Act s 47(1)(a), (b) and (g).

87 None of the above obligations is inconsistent with the obligations brokers owe to their customers.

- *What should be disclosed to borrowers about an intermediary's obligations to the lender and to the borrower?*

88 Mortgage brokers are already required to disclose information about their responsible lending obligations in their credit guide.[92] But it is submitted that such obligations as brokers owe to lenders, summarised above, do not necessarily require disclosure to the borrower – even if many of them are protective of the borrower (such as the obligations requiring appropriate licensing and compliance with legislation).

- *What duties should an intermediary owe to a borrower?*

89 The existing duties owed to borrowers, in particular the duty not to suggest a loan that is unsuitable, are well adapted to the services mortgage brokers provide. Nevertheless, Smartline supports the CIF's proposal for a new customer first duty, which CIF proposes be expressed in the following terms:

> I place your interests first in my dealings with you. In doing so, I will ensure I recommend a loan which is appropriate (in terms of size and structure), is affordable, applied for in a compliant manner and meets your set of objectives at the time of seeking the loan.

90 Monitoring and enforcement of this customer first duty would be achieved through the use of key risk indicators, discussed below.

91 The customer first duty makes clear that the brokers must elevate their customers' interests above their own.[93] However, it avoids the legal uncertainty that a "best interests" duty could create, in circumstances where there is rarely a single loan capable of being assessed as objectively "best" for the consumer.

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[92] NCCP Act, s 113(2)(i).

[93] Which is what those promoting a best interests duty, including the Productivity Commission, seek to achieve. See Productivity Commission Financial System Competition Report 2018, 334.

92 As the following table illustrates (by reference to a limited number of loan features), loans vary from each other in a number of ways:

| Costs | Repayments | Features | Service | Lending criteria |
|---|---|---|---|---|
| Higher rates<br>Lower rates<br>Higher fees<br>Lower fees<br>Fixed rates<br>Variable rates<br>Split loans | Principal and interest<br>Interest-only | Offset accounts<br>Redraw facilities<br>Linked debit cards<br>Internet/phone banking | High service<br>Lower service<br>Fast approval times<br>Slower approval times | Accepts self-employed and/or non-wage income<br>Does not accept self-employed and/or non-wage income |

93 The particular features, or combinations of features, that are appropriate for a customer depend in part on the customer's needs, objectives and financial circumstances. But even once the field is narrowed down by reference to those matters, a degree of reasonable choice will generally remain. That remaining choice can be exercised only by reference to the customer's personal preferences. There is often no objectively best loan to be chosen from among those that are suitable.

94 For example, for a particular customer, the cheapest loan might not be the best loan, if the customer values other features; and even deciding what is the cheapest loan can involve judgments about how the customer's circumstances, and interest rates, are likely to change in the future.

95 Consistently with the above considerations, the CIF has developed the following definition of a good customer outcome:

> The customer has obtained a loan which is appropriate (in terms of size and structure), is affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan.[94]

96 In Smartline's submission, the proposed customer first duty would promote the achievement of that outcome.

- *What should be disclosed to borrowers about an intermediary's remuneration?*

97 The NCCP Act requires credit licensees providing credit assistance to give borrowers information about, among other things:

a. any commissions that the licensee, or an employee, director or credit representative of the licensee, is likely to receive, directly or indirectly, from credit providers in relation to credit contracts for which the licensee has provided credit assistance;

b. a reasonable estimate of the amounts of those commissions or the range of amounts; and

c. the method for working out those amounts.

98 This information must be disclosed, in writing, both:

a. in the *credit guide*, as soon as practicable after it becomes apparent to the licensee that it is likely to provide credit assistance to a consumer in relation to a credit contract;[95] and

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[94] Combined Industry Forum, *Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of Mortgage Broker Remuneration* (19 April 2017), 9.

[95] NCCP Act, s 113(1), (2)(g). Under the NCCP Regulations, the credit licensee can, in short, choose to instead include a statement that the consumer may obtain a reasonable estimate of the commission likely to be received upon request, provided the licensee has in place arrangements to make that information available when requested. See reg 27(2).

b. in the *credit proposal disclosure document*, when providing credit assistance to the consumer, at the same time as suggesting a loan, or assisting the consumer to apply for a loan, or suggesting that a customer remain in a loan.[96]

99 These documents make the remuneration of the broker clear to the customer, both at an early stage of the broker's interaction and at the time credit assistance is provided.

100 In addition, Smartline supports the CIF's proposal that the following matters ought be required to be disclosed by brokers to consumers:

a. ownership – disclosure would be required:

i. where ownership of the broker or aggregator by a lender is 20% or greater; or

ii. where ownership is less than 20% — a board seat is held or a white label product is offered by a substantial shareholder.

b. membership of a tiered servicing model;

c. list of lenders available to a broker via the broker's aggregator;

d. which lenders the broker used in the previous year;

e. top 6 lenders used and % of loans written concluded with each in the previous financial year.[97]

101 Smartline also supports the CIF's proposal to subject these disclosures to consumer testing once disclosure guidelines are finalised.

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[96] NCCP Act, s 121(1), (2)(b), as amplified by NCCP Regulations, reg 28G.

[97] See submission of the CIF on the Commission's Interim Report.

## D.3. Broker remuneration

- *What are the effects of value based remuneration for intermediaries?*

102 As explained in detail above, there is no direct evidence that brokers' existing remuneration structures lead to poor outcomes for consumers, and no evidence from which this can be inferred.

103 This is unsurprising. For the reasons explained in Smartline's April Submissions, the existence of latent or theoretical conflicts of interest is a ubiquitous feature of capitalist enterprise, and paints an incomplete picture of the incentives which actually confront and motivate brokers. In most areas of commerce it is of course possible, at least in the short term, for a service provider to provide their customers poor service which does not advance the customer's objectives – at least in the short term. But as the Commission has recognised, that is not how a successful business is run.[98]

- *How should brokers be remunerated?*

104 Consistently with the recommendations of the CIF, Smartline supports the phasing out of volume based-bonus commissions, volume-based bonus payments, campaign based-commissions and soft dollar benefits.[99]

105 For the reasons advanced above and Smartline's April Submission, value-based commissions paid at the lender side should be preserved. The existence of this remuneration structure supports the provision by brokers of credit assistance to a large segment of the population who otherwise would not, or could not pay for it. Further, the existence of a robust broker channel assists smaller, foreign and regional lenders to compete with the Big Four banks.

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98 Interim Report, vol 1, 54 – 55.

99 Combined Industry Forum, *Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of Mortgage Broker Remuneration* (19 April 2017).

- *Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice?*

106 No. For the reasons above, commissions paid by lenders should not be prohibited.

107 In any event, financial advice provides a poor analogy to mortgage broking, for two reasons.

108 First, at the time of the FoFA reforms, financial advice was already established as a fee-for-service industry. A ban on conflicted remuneration was far less radical for that industry than it would be for mortgage brokers, for whom commissions are generally the sole source of revenue.

109 Secondly, the scope for divergence between the client's and adviser's interests in the case of financial advice is far greater than in the case of mortgage broking. This is illustrated by some of the financial advice case studies, in which advisers recommended strategies, and suggested *types* of products (such as insurance), that were unnecessary or inappropriate for the customer. The upfront commissions derived from those inappropriate recommendations were in the tens of thousands of dollars.[100] The differences in commission received from recommending slightly different loans, or loan sizes, are considerably smaller, and so is the inducement for brokers to engage in misconduct.

## D.4. Misconduct and detection

- *How can entities' systems be improved to detect and prevent breaches of responsible lending obligations by intermediaries?*

110 This is the key question which arises from the case studies.

111 Smartline's approach to preventing and detecting breaches of responsible lending obligations focuses on (i) careful selection of Smartline franchisees; (ii) training and professional development (both initial and ongoing); (iii) oversight and reporting; and

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[100] See, for example, Interim Report, vol 2, 169 – 174.

(iv) an audit program. Further details of these are provided in Smartline's letter to the Royal Commissioner dated 29 January 2018.[101]

112 While not beyond improvement, the extremely low incidence of misconduct among Smartline's brokers suggests that fundamentally, this system works.

113 Smartline believes that its systems work in large part because of the culture that is maintained among its franchisees. This is made possible through the care with which Smartline selects and trains prospective franchisees. It is also reinforced by Smartline's business model, which favours organic growth through referrals and repeat business, and encourages franchisees to build their individual businesses through engagement in their local communities.

114 Smartline is currently working with the CIF to develop a comprehensive governance framework, to ensure that best governance practices are followed across the mortgage broking industry. That governance framework will include obligations in relation to:

a. greater reporting requirements;

b. portable unique identifiers, which would stay with individual brokers regardless of where they operate in the industry, allowing individuals with poor records to be sanctioned or removed from the industry. The CIF is working with ASIC to develop these;

c. key risk indicators against which brokers' behaviour could be assessed to identify possible breaches of responsible lending obligations. The key risk indicators will relate to:

i. arrears rates;

ii. percentage of portfolio in interest-only;

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[101] At [31] – [39]. See also Smartline's submissions dated 3 April 2018 at [64]-[65] (**Smartline's April Submissions**).

iii. loan switching in the first 12 months after settlement;

iv. elevated levels of customer complaints;

v. poor post-settlement customer survey results; and

vi. loan quality, identified through any deficiencies found in requirements and objectives documentation;

d. the development of an industry survey to measure customer feedback; and

e. revised protocols for enforcement where broker standards are, or are likely to, lead to poor customer outcomes.

115 Underpinning this governance framework would be the proposed customer first duty,[102] and a proposed Mortgage Broking Industry Code, which is under development.

116 Technology also holds great promise for improved oversight of brokers in the future. Smartline notes the work that Aussie Home Loans is doing to detect and prevent misconduct through analysing brokers' loan data. Smartline is already implementing similar methods.[103] The CIF is currently working on data driven monitoring platforms at an industry level.

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102 See [89] above.

103 See Smartline's April Submissions, [66]-[69].

## D.5. Section 912A of the Corporations Act 2001 (Cth)

- *Do broker contracts as they stood at the time of the hearings meet the statutory requirement imposed by s 912A of the Corporations Act 2001 (Cth) to have arrangements in place to manage conflicts of interest?*
- *Do broker contracts as now made meet these requirements?*

117 Section 912A of the *Corporations Act 2001* (Cth) is the analogue of s 47 of the NCCP Act.[104] Only the latter applies to mortgage brokers, unless the broker also holds an Australian Financial Services (**AFS**) licence. Section 912A(1)(aa) requires AFS licensees to:

> have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative …

118 Section 47(1)(b) of the NCCP Act requires credit licensees to:

> have in place adequate arrangements to ensure that clients of the licensee are not disadvantaged by any conflict of interest that may arise wholly or partly in relation to credit activities engaged in by the licensee or its representatives …

119 In the case of s 47(1)(b), the Explanatory Memorandum says that:

> This obligation only applies to conflicts of interests that arise <u>by operation of law.</u> It does not require a licensee to take action in respect of different interests of parties where they do not constitute a conflict of interest at law. [emphasis added]

120 Consistently, ASIC's guidance in regulatory guide RG 205 is that:

> The obligation arises where an interest of the licensee or unlicensed COI lender conflicts with a legal obligation that the licensee (or unlicensed COI lender) owes to the client, including one that arises under the credit legislation, National Credit Regulations, or at law (whether through statute, common law or contractual arrangements between the licensee and the client).[105]

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[104] It is submitted, however (see Interim Report, vol 2, 27 n 145), that the text and context (both statutory and commercial) of the two provisions differs, such that there may be differences in the particular obligations imposed by each with respect to mortgage broker commissions. ASIC's view is that "the conflicts obligation for credit licensees is more explicit about the required outcomes for the consumer": ASIC, *Regulatory Guide 2015: Credit Licensing: General Obligations* (June 2010), [205.80].

[105] ASIC, *Regulatory Guide 2015: Credit Licensing: General Obligations* (June 2010), [205.81] (**RG 205**).

121 As the examples given in RG 205 indicate, lender choice conflict and product strategy conflict (being latent conflicts between the broker's remuneration structure and their responsible lending obligations) are among the conflicts targeted.[106]

122 Importantly, neither section *prohibits* the existence of conflicts of interest arising in relation to the licensee's activities. So much has been held expressly in respect of s 912A.[107] The same construction must be given to s 47(1)(b).

123 The ordinary meaning of the word "management" presupposes the continued existence of the thing required to be managed.[108] In any event, s 47(1)(b) must be read with the provisions of the NCCP Act, which expressly acknowledge the existence of commissions requiring disclosure to consumers.[109] What management of the conflicts must achieve (expressly, in the case of s 47(1)(b) and implicitly in s 912A(1)(aa)) is the prevention of disadvantage to the licensee's client. It cannot be said that the mere existence of a commission structure giving rise to latent conflicts of interest constitutes a failure to manage them.

124 ASIC's regulatory guidance contemplates that management of conflicts of interest will include:

a. monitoring of conflicts of interest;[110]

b. compliance procedures designed to ensure that the licensee does not suggest a credit contract that is unsuitable for the consumer;[111] and

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106 RG 205, [205.82] – [205.83].

107 *Australian Securities and Investments Commission v Avestra Asset Management Limited (in liq)* [2017] FCA 497 at [192]-[194] (Beach J).

108 See *Melbourne Corporation v Barry* (1922) 31 CLR 174, 206 (Higgins J) (in relation to the word "regulate").

109 See [81] above.

110 RG 205, [205.80].

111 RG 205, [205.83].

c. the maintenance of a thoroughly researched and reasonably comprehensive product list.[112]

125 In Smartline's case, conflicts are identified and recorded on Smartline's conflicts of interest register, for assessment by Smartline's National Manager Corporate Services and/or National Manager Operations. Once identified, conflicts are subject to an appropriate form of management, which may be avoidance, disclosure or control.

126 Conflicts that can pose a significant inducement to misconduct are avoided entirely. Following the work of the CIF, volume-based commissions, campaign-based contributions and volume-based bonus payments are avoided. On the other hand, latent conflicts such as those posed by upfront and trailing commissions are managed through disclosure to consumers (in Smartline's credit guide and credit proposal document, and orally where appropriate) and controlled through training, professional development and audits. Smartline also maintains a large and representative panel of 31 lenders.[113]

127 Smartline's experience illustrates that with adequate training, governance and oversight, brokers can ensure that their customers receive good customer outcomes, notwithstanding latent or theoretical conflicts of interest in their remuneration.

128 It is submitted that it has not been demonstrated either in the Commission's case studies or in the analyses conducted by ASIC that broker arrangements give rise to unmanageable conflicts of interest.

### D.6. Changes to the law

- *Are changes in law necessary?*

129 Each of the examples of mortgage broker misconduct in the case studies involved the breach of existing laws, including criminal laws. In circumstances where it appears

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[112] RG 205, [205.85].

[113] The panel includes the four major banks, four sub-divisions of the major banks, ten foreign or smaller banks (including three that are customer owned), twelve non-bank lenders and the Smartline Select™ white label product.

that a lack of supervision of those brokers' conduct was a contributing cause of the misconduct, there may be scope for ASIC to work with industry to provide more detailed guidance around a credit licensee's obligation (in s 47(1)(e) of the NCCP Act) to take reasonable steps to ensure that their representatives comply with the credit legislation.

- *If changes to the law are made - should there be any carve outs or exceptions?*

130 Smartline submits that if changes to the law are made, the following carve outs and exceptions ought be considered:

a. *Changes to broker oversight and monitoring requirements* – Any such changes should recognise that the size of mortgage broking businesses differ greatly, and should ensure that the requirements imposed are proportionate to the kinds of businesses affected. Mortgage broking is not a high margin business, and substantial increases to overheads could disproportionately impact on smaller operators, particularly those not owned by lenders.

b. *Changes to mortgage broker remuneration* – Any changes to broker remuneration should provide a sufficient transitional period. Entitlements to trailing commissions on existing loans should not be prohibited, as a broker's "loan book" is an important aspect of the capital value of the broker's business, and can be part of the broker's strategy for operating through difficult market cycles. Further, if trail commissions are to be prohibited, it will take some time for the banks to be in a position to accommodate such changes within their commission systems.

26 October 2018

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**Dion Fahey**