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

SUBMISSIONS ON ISSUES RAISED IN PUBLIC HEARINGS

CONSUMER LENDING

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

Introduction

1 These submissions address certain of the questions posed by Counsel Assisting and the Commissioner, in the course of Counsel Assisting's closing address.

2 The remuneration of brokers and related questions concerning the potential for conflicts of interest in the industry have recently been the subject of consideration in each of:

a. the Australian Securities and Investments Commission's *Report No. 516: Review of Mortgage Broker Remuneration* (**ASIC Review**),[1] published 16 March 2017; and

b. the final report of the *Retail Banking Remuneration Review*, chaired by Mr Stephen Sedgwick AO, published on 19 April 2017 (**Sedgwick Review**); and

c. the report issued by the Combined Industry Forum (**CIF**) entitled "*Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of Mortgage Broker Remuneration*" (**CIF Review**), dated 19 April 2017.

[1] RCD.0003.0023.0001.

3 The Productivity Commission's inquiry into Competition in the Australian Financial System has also considered aspects of broker remuneration in the context of competition more generally. Its draft report was published 7 March 2018[2] (**Productivity Commission Draft Report**).

4 These reviews and reports have considered broker remuneration through different prisms, including competition, impact on customer outcomes, and the regulator's interest in governance and oversight. Some of the findings made in those reviews and reports are addressed in more detail below in the answers to the questions posed by Counsel Assisting and the Commissioner.

Brokers and competition in the banking sector

5 The role played by brokers in relation to competition in the banking sector is currently the subject of consideration in the Productivity Commission's Inquiry. The following findings in the Draft Report[3] are instructive:

a. home lending in Australia is dominated by the Big Four banks,[4] and the barriers to entry for new and smaller entrants are high.[5]

b. smaller lenders look favourably on mortgage brokers as an effective means of distributing home loans, particularly because those banks have smaller (or non-existent) branch networks and smaller marketing budgets.[6]

c. brokers increase smaller lenders' market shares by 1.55%.[7] If mortgage broker services were not available, those lenders would, on average, need to have an additional 118 branches each in order to maintain their current shares in the home loan market.[8]

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2 The final report is due to be published by the Productivity Commission in July 2018

3 Productivity Commission, *Competition in the Australian Financial System: Draft Report* (January 2018), <http://www.pc.gov.au/inquiries/current/financial-system/draft/financial-system-draft.pdf>.

4 Draft Report, page 111.

5 Draft Report, page 122.

6 Draft Report, page 219.

7 Draft Report, page 219.

8 Draft Report, page 219.

d. Australians have a strong tendency to stick with their existing financial institutions (noting, for example, evidence that over 50% of Australian adults have always been with the bank they first opened an account with).[9] This is in part driven by the "hassle" of shopping around,[10] and the difficulty of researching the different products available in the market.[11]

6 The Reserve Bank of Australia submitted to the Productivity Commission Inquiry that:

> Increased use of brokers by borrowers has resulted in greater competition among lenders via this loan origination channel. Smaller lenders have made greater use of this distribution channel than the major banks because it is lower cost than a branch network … . For borrowers, brokers reduce search costs by efficiently comparing deals across lenders. The introduction of a wider range of mortgage products, partly in response to prudential regulations, has increased the benefits for consumers of using brokers.[12]

7 Against this background, the Productivity Commission concluded in the Draft Report that the introduction of mortgage brokers to the Australian market in 1996 led to interest margins falling 200 basis points within two years.[13]

8 In similar vein, ASIC concluded in its Review that: "[b]rokers can play an important role in promoting good consumer outcomes and strong competition in the home loan market".[14] The ASIC Review identified not only the positive consumer outcomes derived from mortgage broking,[15] but also identified the fact that mortgage broking promotes competition by playing a valuable role in providing a distribution channel

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9 Draft Report, page 381.

10 Draft Report, page 383.

11 Draft Report, page 383.

12 Reserve Bank of Australia, Submission to the Productivity Commission Inquiry (September 2017), pages 23–4, < http://www.pc.gov.au/__data/assets/pdf_file/0008/221876/sub029-financial-system.pdf>.

13 Productivity Commission Draft Report, page 212.

14 ASIC Review at [20].

15 ASIC Review section 21, p 8.

for lenders, particularly smaller lenders[16] and exerting downward pressure on home loan pricing.[17]

9 The role played by brokers in increasing competition among lenders is an important contextual matter required to be understood before closer consideration is given to aspects of broker remuneration in answer to the questions set out below.

Does the use of up-front and trailing commissions lead to poor customer outcomes?

10 It is not open to the Commission to conclude that the use of up-front and trailing commissions (referred to in these submissions collectively as **volume commissions**) leads to poor customer outcomes:

a. there is no direct evidence that volume commissions lead to poor customer outcomes and no evidence on the basis of which the Commission can safely infer that the existence of volume commissions generally has this effect;

b. Smartline's experience is that volume commissions do not have that effect; and

c. the incentives affecting brokers' behaviour do not in and of themselves promote poor customer outcomes, as appears to be assumed by the assignment of the epithet "conflict of interest".

No evidence that volume commissions lead to poor consumer outcomes

11 The Commission has not received any direct evidence that up-front and trailing commissions for the remuneration of head groups and brokers lead to poor customer outcomes. The highest the evidence rises is the assertion by Mr Ian Narev, then CEO of the Commonwealth Bank of Australia in a submission that "the use of upfront and trailing commissions linked to volume *can potentially* lead to poor customer outcomes" (emphasis added).[18]

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16 ASIC Review, [22].

17 ASIC Review, [22].

18 Exhibit 1.37 (CBA.0001.0038.0929) (emphasis added).

12 Mr Narev's assertion appeared in a confidential submission dated 10 February 2017 (**CBA Confidential Submission**).[19] The CBA Confidential Submission was made to Mr Stephen Sedgwick AO for the purposes of the Retail Banking Remuneration Review. When the content of the submission was put to Mr Narev's subordinate, Mr Huggins in evidence, he agreed that "these were the findings that were made out".[20] Mr Giles Boddy of Aussie Home Loans was also taken to Mr Narev's statement. When asked if he agreed with the statement, he said he did (repeating the words "may potentially"),[21] but Mr Boddy did not explain on what basis he had formed this opinion.

13 The CBA Confidential Submission ought be treated with caution:

a. Neither Mr Huggins, nor Mr Boddy proffered examples of poor customer outcomes which they attributed to the "use of upfront and trailing commissions".

b. Neither witness identified the evidence upon which they based their opinion when asked to adopt the language of Mr Narev.

c. The conclusions expressed in the CBA Confidential Submission have not been tested in evidence.

d. The underlying analysis is specific to the CBA and cannot be assumed to represent the universal practice of brokers in the industry. As the analysis was contained in a confidential submission, neither Smartline nor any other parties with leave to appear in this Royal Commission were aware of the existence of the analysis before 15 March 2018 (when it was referred to during the Commission hearings).

14 Mr Narev based his assertion in the CBA Confidential Submission on what he described as CBA's "analysis of loans applied for through the proprietary versus broker

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[19] Exhibit 1.37 (CBA.0001.0038.0929).

[20] T241.25–6.

[21] T426.5–7.

channel".[22] But the CBA Confidential Submission does not disclose when the analysis was conducted, or on what data it was based. Neither the number nor volume of loans considered is known.

15 Further, Mr Narev's assertions are affected by self interest – another matter which has not been tested in evidence. The Big Four banks have an interest in limiting mortgage brokers' market share, given their documented role in increasing competition with respect to home lending, to the advantage of smaller players. Secondly, lenders obviously have an interest in reducing commission size or passing on those costs to the consumer, improving their own bottom line. This is another reason for treating the CBA Confidential Submission with caution.

16 In contrast, the comprehensive ASIC Review of Australian mortgage brokers' remuneration, undertaken as recently as 2017, did not conclude that up-front and trail commissions led to poor consumer outcomes. ASIC engaged with 82 participants through approximately 100 meetings, 73 formal information requests and 52 other requests for information, and analysed 1.4 million lines of home loan data.[23] While ASIC concluded that certain aspects of broker remuneration (such as bonuses and soft dollar benefits) presented risks and required modification, ASIC did not conclude that up-front or trail commissions were leading to poor customer outcomes.

17 The ASIC Review did find (as did the CBA in its analysis) that, when compared with non-broker loans, broker-originated loans were slightly larger,[24] had slightly higher leverage,[25] and were more likely to be interest-only.[26] As ASIC noted, however, these differences are not necessarily indicative of poor customer outcomes.[27] The quality of a customer's outcome can only be identified by comparing that customer's needs, objectives and financial situation with their loan product. It cannot be assumed that,

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22 Exhibit 1.37, page 14.
23 ASIC Review at [149].
24 ASIC Review at [835].
25 Ibid at [838].
26 Ibid at [838].
27 Ibid at [853].

because a certain type of loan (such as an interest-only loan) is more prevalent among customers of mortgage brokers, that some or all of those loans were unsuitable.

18 ASIC also noted that typically, brokers serve different customers to those who use the proprietary channel. Brokers' customers tend to be younger, to have lower incomes, to be more often in full-time employment, and to be purchasing less expensive properties.[28] While ASIC controlled for these particular factors[29] (leading to a reduction in the differences in loan size and leverage),[30] it was still not able to say in every case what was the *cause* of the differences between the broker and non-broker samples, or whether any regulatory or policy response was required.[31]

Evidence that commission rates do not affect lender choice

19 It is accepted that it may constitute a poor customer outcome if a broker recommended a particular lender based on the rate of commission that the lender paid to the broker or their head group, rather than by reason of any benefits that lender was able to offer the broker's customer. However Smartline's own data suggests that this is not the practice of its brokers. The table at **Appendix A** shows the up-front commission rates and loan volumes of Smartline's top 20 lenders in calendar years 2015, 2016 and 2017. As can be seen from the table, there exists no correlation in the data between the level of commission paid by the lender, and the volume of loans directed by brokers to that lender.

No conflict of interest created by volume commissions

20 In his evidence, Mr Huggins suggested that there was a "conflict in the commission structure" of mortgage brokers, whereby brokers are incentivised to place their customers into larger loans that take longer to pay off, in order to maximise the value of their up-front and trailing commissions.[32] Separately, ASIC has also suggested that

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28 Ibid at [831], Table 12.
29 Ibid at [827](b).
30 Ibid at p 159, figure 26, table 15.
31 Ibid at [826].
32 T239.18–26.

such an incentive exists (which gives rise to what it calls "product strategy conflict") and that an incentive also exists for brokers to write loans with the lender who pays the highest commission (which it says gives rise to "lender choice conflict").[33]

21 Any analysis of these perceived conflicts must commence with an assessment of the nature of broker remuneration. Brokers are not contracted labour working for either lenders or consumers. Further, broker commissions are not structured as a fee for service based on the traditional reward / effort or hourly rate of pay model. Rather, broker commissions (which have evolved over some twenty five years) reflect the value derived by each of the lender and the consumer from the commercial arrangement embodied in the loan into which those two parties ultimately enter. All three parties derive value from this tripartite arrangement. The broker's commission is, in this sense, reflective of the value the market places on the benefit derived by lender and customer from the broker's effort being applied to 'matching' lender with borrower.

22 While it is the case that a broker will earn more from a larger loan, and earn more from a lender which pays a higher rate of commission, the mere existence of this remuneration structure does not demonstrate the existence of an intractable conflict. This is no more the case than, for example, would arise in respect of professions in which fee earners are paid by the hour. While this fee structure has the result that the longer spent on a particular task the higher the fees, it is not assumed that anyone paid by the hour will draw out every task unnecessarily for the self-interested purpose of generating more fees.

23 Businesses are subject to complex sets of incentives, that do not generally favour the extraction of every last dollar from every customer. Mortgage broking is a relationship-based business, which relies heavily on customer satisfaction. A 2016 study by Deloitte found that two thirds of customers using brokers did so because they had an existing relationship with the broker, or because the broker had been

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33 ASIC Review at [29].

recommended by family or friends.[34] Smartline's own data for the year ending 30 June 2017 records a rate of repeat or referral business of 80-86%. If a broker placed his or her customers into inappropriate loans, the broker might make more in the instant transaction, but may jeopardise their ability to win business in future.

24 Secondly, brokers, like other professionals, are valued for their expertise. As both ASIC[35] and Deloitte[36] have found, this is a key reason why customers use brokers rather than navigating the borrowing process on their own.

25 Thirdly, brokers are subject to countervailing financial "incentives", which encourage responsible lending. These include trail commissions (which are paid for the life of the loan, but suspended if a loan enters arrears or defaults) and clawbacks (which require the broker to repay up-front commissions in certain circumstances, including where loans enter arrears or default within a certain period). ASIC found in its Review that these "provide an incentive to aggregators and brokers to put forward higher quality loans where consumers are less likely to default on their obligations".[37] Trail forfeiture and clawbacks also apply, appropriately, in cases of broker misconduct.

26 Fourthly, the differences in the commissions paid by different lenders are generally small. For example, ASIC noted that the up-front commissions paid by lenders to head groups were usually between 0.5% and 0.8%, and trail commissions generally ranged from 0.1-0.35%. The most recent year studied by ASIC was 2015.

27 Smartline's experience suggests that the distribution of commissions is tight. In calendar year 2017, the up-front commissions Smartline received from its top 10

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[34] Deloitte, *Customer Experiences of Using Mortgage Brokers*, October 2016 < https://www2.deloitte.com/content/dam/Deloitte/au/Documents/financial-services/deloitte-au-fs-home-loan-preferences-041116.pdf>.

[35] ASIC Review, page 176 figure 33.

[36] Deloitte, above n 34, page 11.

[37] ASIC Review at [432].

lenders ranged from 0.49% to 0.72% (see Appendix A), and trail commissions varied by no more than 0.1% in any given year after settlement.[38]

28 Fifthly, the conflict of interest model wrongly assumes that brokers are cognisant of the (small) differences between commission rates offered by lenders. There is no evidence that this is so, and in Smartline's case it is not. Smartline's brokers typically make recommendations based on the options generated by Smartline's proprietary software, which are determined by a customer's needs, objectives and financial situation. The software does not take into account the rates of commission paid by the lender with respect to any particular loan, nor does it display these to the broker. Nor does the software promote any particular product, including Smartline's white-label product.

Do remuneration structures that reward mortgage brokers for volume of sales of loans create an unacceptable risk that mortgage brokers will prioritise the sales of loan products over:

a. **their responsible lending obligations;**
b. **their obligation to recommend loans to customers in a manner that is efficient, fair and honest;**
c. **their obligation to have adequate arrangements in place to ensure that customers are not disadvantaged by conflicts of interest; and**
d. **their obligation to ensure that the conduct of the brokers is not misleading, deceptive, or unconscionable?**

29 While the Commission has heard evidence regarding a small number of instances of misconduct by brokers, it has not heard any evidence about what *caused* those brokers to engage in misconduct. While some broker misconduct may well be motivated by a desire to obtain financial advantage, in the cases of misconduct identified by Smartline (listed in its response to the Commission (**Smartline's Response**)[39]) the more prevalent motivation appeared likely to be the broker's overzealous pursuit of the customer's stated objectives. That is not, of course, to say that these cases present any

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[38] Save for a single outlier of 0%, which was offset by an increased up-front commission.
[39] Smartline Letter of Response to the Royal Commissioner, 29 January 2018.

less serious a problem. It is only to say that these cases did not appear to be caused by the existence of a particular remuneration model.

30 Further, while the Commission has been informed of instances of serious misconduct by individual brokers,[40] evidence has not been adduced of the prevalence of such misconduct in the industry. In Smartline's Response, the incidence of detected misconduct was noted to be one instance in every 26,166 loan applications.[41]

31 While it may be safe to assume that in some cases, misconduct will be motivated by the desire to profit from commissions, it is difficult say whether an unacceptable risk is created by reason of the mere existence of particular remuneration structures, or whether that risk only arises where culture, supervision, training, or other protective factors are also absent or inadequate.

Should up-front and trailing commissions be replaced with an up-front flat fee payment?

32 As Mr Huggins noted in his evidence,[42] if a move to flat-fee for payment to brokers is to be adopted, it would need to be structured carefully so that brokers remain adequately remunerated and to ensure that the new remuneration structure did not give rise to new potential for other conflicts. It is noted that broker remuneration was extensively considered by ASIC in its Review, which did not recommend introduction of flat fee payments.

33 It is not possible to say how any new approach to broker remuneration ought be structured or achieved. Nor is there any evidence before the Commission to suggest that there is a basis for intervening in the market in the manner suggested. The evidence presently before the Commission is not apt to answer this question, nor does it provide any proper foundation upon which the Commission could move to interfere with current commercial arrangements. Any move to mandate a flat-fee should only

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40 See for example at T39.29 – 40 and T969.36-44

41 When the example referred to therein of a privacy breach (which entailed no possible financial advantage to the broker) is omitted, the rate drops to one case in 31,400 loan applications.

42 T243.5–17.

follow extensive consultation with all stakeholders (including lenders, head groups, brokers and consumer groups).

34 Questions required to be considered would include by whom a flat fee would be paid (the customer, the lender or both) and how it would be fashioned in order to both adequately remunerate brokers and avoid unforeseen consequences or other potential conflicts to which Mr Huggins referred.

35 For example, there is no apparent reason why all customers would be (or should be) willing to pay the same flat fee, regardless of loan size or complexity and regardless of the number of hours devoted by a broker to working with them to ascertain their needs. Equally, if a flat fee were to be paid to brokers by lenders, consideration would need to be given to whether it would be possible to structure a fee which reflected the average size and complexity of certain types of loans. The risk would then arise that such a fee would be passed on by lenders to the consumer. It can be seen immediately that a body of work is required to be done in order to anticipate and address the flow on consequences of any such change.

36 The *theoretical* or *latent* conflict which exists between a business' desire to make money and its customer's desire to be well served is a ubiquitous feature of capitalist enterprise. As such, it is to be expected that where remuneration structures are altered, any potential for such conflict will only be altered, not eliminated. In the case of flat, up-front payment for mortgage brokers:

   a. a single fee per loan product might only serve to incentivise brokers to structure their customers' lending across multiple products;

   b. a single fee per customer, or per security,[43] would likely discourage brokers from spending the additional time required to assist customers with more complex structures such as split loans; and

[43] As suggested by Mr Narev at Exhibit 1.37, page 14.

c. any model where all fees are paid up-front would risk creating an incentive for brokers to shift their customers from product to product, introducing a species of churn.

37 These complexities were recognised by Mr Huggins.[44] Further, as is noted above, the role played by brokers in increasing competition in the banking sector is presently the subject of the Productivity Commission's Draft Report.[45] If brokers' remuneration is reduced, the number of brokers will likely be reduced. This will have a negative impact on the level of competition that brokers bring to the home lending market.

Is the first mover issue identified in CBA's evidence a genuine commercial impediment to change in respect of the structure of broker remuneration? If so, what can and should be done to remove that impediment?

38 In the CBA Confidential Submission, Mr Narev appeared to apprehend that if one lender were to move to a flat-fee structure, that lender would attract fewer recommendations from brokers. [46] Mr Huggins apprehended the same risk.[47]

39 But there is no reason why this risk would arise, unless the total remuneration under the lender's proposed flat-fee were significantly less than the total remuneration offered by the lender's competitors. If that is what is contemplated, it is difficult to see why the lender who acts as "first mover" should be assisted to coordinate such a change. Indeed, co-ordination by the lenders in such a manner may constitute anti-competitive conduct.

Will the program of reforms announced by the Combined Industry Forum in 2017 ameliorate the conflicts of interest that were referred to in the CBA broker case study?

40 The CIF Review sets out a package of reforms to address six proposals of the ASIC Review and recommendations of the Sedgwick Review pertaining to remuneration of

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44 T307.8–20.

45 Productivity Commission, *Competition in the Australian Financial System: Draft Report* (January 2018), <http://www.pc.gov.au/inquiries/current/financial-system/draft/financial-system-draft.pdf>.

46 Exhibit 1.37, page 9.

47 T242.5-12.

aggregators and mortgage brokers. There are three important features of the context in which the CIF Review was conducted.

41 First, the CIF Review is not a submission made by only one interest group or segment of the industry. The CIF is constituted by a number of entities across the mortgage broking industry with varying and even opposing interests. The CIF comprises mortgage broker practitioners and representatives (including the Mortgage & Finance Association of Australia (**MFAA**)), aggregators, referrer aggregators, lenders, various industry bodies (including the Australian Bankers' Association, Finance Brokers Association of Australia Limited, Customer Owned Banking Association, and the Australian Finance Industry Association), and consumer representative group, CHOICE.[48]

42 Secondly, the CIF Review's package of reforms have been designed to achieve the objectives of removing the potential for conflict, while preserving the contribution to competition that the ASIC Review has recognised as important.[49]

43 Thirdly, the CIF has committed to having its reform package implemented by the end of 2020, and will report on implementation to Government, Treasury and ASIC on a semi-annual basis.[50] These reforms will be captured in an industry code that enables enforcement and application across the industry.[51]

Reform 1: commission to be based on funds drawn down and used rather than loan size.

44 This reform adopts ASIC's proposal and recommendation 18 of the Sedgwick Report by providing that mortgage brokers will no longer be paid on facility limits.[52] This reform directly addresses "product strategy conflict" by removing the financial

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48 CIF Review, p 5 and Appendix 1.

49 CIF Review, pp 6 and 9.

50 CIF Review, p 8, [4.2].

51 CIF Review, p 8, [4.3].

52 CIF Review, p 11.

incentive for mortgage brokers to recommend larger loans which commence with large offset balances.

45 The CIF rigorously assessed five alternatives to this outcome. These included some possibilities which have been referred to during the Royal Commission (consumer paid fee for service in lieu of commissions, and flat lender fees), and other reforms which this Commission has not yet considered (standardisation of upfront commissions, base commissions paid on loan value ratio, and removing lenders' and brokers' ability to discount). Each of the alternatives was found to involve risk of serious unintended consequences, including unacceptable negative impact on competition, a failure to adequately reduce conflicts, or the possibility of being 'gamed'.[53] The CIF has committed to implementing this reform by the end of this year.

Reforms 2 and 3: Departure from: (i) volume based- bonus commissions, volume-based bonus payments, and campaign based-commissions; and (ii) soft dollar benefits

46 The CIF has committed to removing volume-based bonus commissions and payments and removing campaign-based commissions (paid by lenders and aggregators to brokers, and lenders to aggregators). It has also determined to end the practice of 'soft dollar" benefits.

47 As a result of this reform, the risks of "lender choice conflict" as identified in the ASIC Review[54] and product strategy choice arising from these payments will be reduced.[55] Reform 2 has already been implemented, and the CIF has committed to implementing Reform 3 by the end of this year.

Reforms 4 and 5: clearer disclosure of ownership structure and new public reporting regime

48 These reforms adopt Sedgwick Review recommendation 19. Aggregators and lenders will provide valuable statistics and information to ASIC. In addition, brokers will

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[53] CIF Review, pp 12, 13.

[54] ASIC Review, section 22, p 8.

[55] CIF Review, pp 13 to 17.

provide statistics to consumers concerning lender use and disclosing ownership. Not only will this reform facilitate transparency in lending and broking practices, but it will also enable ASIC to evaluate lender choice conflict.[56] The CIF has committed to implementing these reforms by the end of this year.

Reform 6: improved Corporate Governance Framework

49 This reform adopts recommendation 17 in the Sedgwick Review. A Governance Framework will be created which comprises: key indicators (to act as triggers / flags), unique identifiers (to allow for more complete reference checking), annual reviews of individual aggregators and broker governance frameworks, data based broker monitoring, customer feedback, reporting and ongoing review of remuneration structures, and remediation processes.[57] The new framework will be instrumental in effecting positive change across the mortgage broking industry in reducing misconduct. CIF has committed to implementing this reform by 2020.

Conclusion

50 The CIF's reforms constitute effective measures to address conflict and misconduct, while preserving competition in home lending. As a result of these reforms, the mortgage broking industry which the Commission is reviewing today will be different from the industry which will exist by the end of 2020.

Who does the mortgage broker act for?

51 Smartline brokers' primary role is to provide credit assistance to their customers. They ascertain the customer's needs, objectives and financial situation, and suggest a loan that they have assessed as right for the customer. In this sense, Smartline brokers act "for" their customers. But Smartline brokers also have another, complementary, role, that is no less important. They must take reasonable steps to verify the financial situation of their customer, before suggesting a loan or assisting their customer to

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[56] CIF Review, pp 18.

[57] CIF Review, pp 19 to 22.

apply for it.[58] They must also refrain from suggesting a loan or assisting the customer to apply for a loan they have assessed as unsuitable.[59] Thus, a broker might be thought of as acting "for" the customer's interests, in the sense that this part of their role is protective of their customer. But the broker's role involves statutory requirements, which must be discharged independently of what the customer desires them to do.

52 Brokers also undertake certain steps *on behalf of* the customer, including filling out the customer's loan application based on the information provided by the customer, and submitting it to the lender. However the broker's role as representative of the customer is limited. For example, the details included in the loan application form are the details provided by the customer. While the broker takes reasonable steps to verify the customer's financial situation, the broker does not warrant the *truth* of the details per se: they do not have any sensible basis on which to do so. Similarly, the broker does not have the power to commit the customer to a loan: the loan contract is ultimately signed by the customer on the customer's own behalf.

53 Brokers owe duties to their panel lenders under contract, but they do not act *for* their lenders any more than a shopkeeper acts for the manufacturers of products she stocks.[60] Provisions in head group agreements requiring the head group to "promote [the] reputation and products"[61] of a lender must be understood in their commercial and statutory context. Head groups have an array of lenders on their panel and owe similar obligations to most or all of them. In addition, head groups and their brokers are subject to duties under the NCCP Act.

Do credit providers have adequate policies to ensure that they comply with their obligations under the National Credit Act when offering broker-originated home loans to customers, insofar as those policies require them to:

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58 NCCP Act, s 115(1).

59 Ibid.

60 One, limited exception to the above analysis is that some lender agreements purport to appoint Smartline as the lender's agent for the purpose of customer identification.

61 T238.26-30.

a. make reasonable inquiries about the consumer's requirements and objectives in relation to the credit contract;

b. make reasonable inquiries about the consumer's financial situation, and

c. take reasonable steps to verify the consumer's financial situation?

54 Smartline takes the following steps to ensure that it complies with the above obligations under the National Consumer Credit Protection Act 2009 (Cth) (**NCCP Act**). These steps are set out in Smartline's NCCP Workbook, 2017 edition.[62]

Consumer's requirements and objectives

55 One of the first steps a broker takes with a new customer[63] is to discuss the customer's needs and objectives. At Smartline this is called a Fact Find, and it is facilitated by Smartline's Fact Find form.[64] The Fact Find involves a discussion of:

a. the purpose of the loan (that is, why the customer is borrowing the money);

b. the customer's goals and objectives (that is, their short and long term aspirations in relation to the loan or the asset purchased);

c. the customer's product requirements (this involves a discussion of the different features of various loans – such as fixed and variable rates, offset accounts, break costs, and application fees – and the identification of which of these are important to the customer); and

d. any ways in which the customer sees their circumstances changing that could impact on their capacity to repay the loan.

56 Where the customer identifies a desire for an interest-only loan, the broker is specifically required to record the customer's reasons for wanting that feature. These

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62 A copy of this can be provided to the Commission upon request.

63 After providing the customer with Smartline's Credit Guide, which provides details about Smartline, the nature and range of the services Smartline offers, Smartline's lending panel, the fees, commissions and benefits the broker may receive, and Smartline's internal & external dispute resolution contact process.

64 A copy of this is available upon request.

reasons might include a desire to accommodate temporarily inflated expenses (such as education, renovation or construction) or temporarily reduced income (eg due to parental leave). A borrower may also, for example, seek an interest-only loan based on strategies formulated on advice from a financial or taxation adviser.

57 In all cases, Smartline assesses loan serviceability based on the borrower's capacity, at the time of the application, to make repayments at the level required during both the interest only period, and during any principal and interest phase of the loan.

Consumer's income and assets – inquiries and verification

58 The broker is then required to ask for details of the borrower's income, and the nature and value of the borrower's assets. The broker takes steps to verify this information. Smartline's panel lenders prescribe checklists for the documents that must be acquired, and at a minimum, Smartline's brokers will comply with these checklists. Typically the checklists require the collection and examination of business records such as payslips, bank statements and tax returns, depending on the type of income to be verified. Smartline brokers are instructed to see the original documents where possible, and to take extra care when copies are provided.

59 Smartline brokers also exercise their professional judgment to determine whether further inquiries are necessary. For example, the brokers might telephone an employer's HR department or seek additional bank statements. Smartline brokers are trained to do this when, for example, the broker detects inconsistencies in the information the customer provides, or where the customer's financial situation appears unlikely or unusual (such as where the customer has income that seems high for their stated profession or industry).

Consumer's expenses and liabilities – inquiries and verification

60 Smartline's Fact Find form requires the broker to ask questions about the customer's expenses, which are broken down into more than 40 different categories, ranging from utilities such as electricity and gas, through to school fees, pet expenses and car maintenance. The Fact Find form also asks the customer to provide the details of

any mortgages, personal loans, overdrafts or lines of credit, and credit cards including financier, current interest rate, monthly repayment, amount owing, and credit limit.

61 Smartline brokers typically ask for statements from all of their customer's bank and credit accounts, which they use to verify the customer's expenses. Smartline brokers do not use the HEM benchmark, or any other benchmark, either as a substitute for, or as a cross-check against, their record of their customer's actual expenses.

Do credit licensees, whose representatives engage in mortgage broking activities, have adequate systems and processes to prevent fraud, detect fraud, respond to fraud; and identify and address any detriment to current and former customers occasioned by the fraudulent conduct of their representatives ?

62 Smartline's main means of fraud prevention are its audit program; its culture and business model; its processes for selection of franchisees; and its training model.

63 Smartline's audit program involves at least 5% of each franchisee's files being audited, at least every two years. Smartline also maintains a complaints register, which is monitored continually, and responds actively to complaints from lenders, investigating the circumstances in each case and making referrals to the MFAA where appropriate, for the MFAA to investigate independently.

64 Smartline is also able to gather data via its IT systems.[65] For a given broker, Smartline can determine:

a. number of loan applications submitted to each lender;

b. conversion rate (percentage of home loan applications that go through to settlement);

c. percentage of declined home loan applications;

d. percentage of withdrawn home loan applications;

e. percentage of discharged home loan applications;

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[65] See similar system described in relation to the Aussie Home Loans in the Witness Statement of Giles Boddy (AHL.0008.0020.0053) at [16].

f. home loan applications for interest-only loans;

g. percentage of home loan applications for investment properties;

h. percentage of home loan applications in which LVR is greater than 80%;

i. percentage of home loan applications which settle and are thereafter discharged within 24 hours; and

j. the location of the broker's customer.

65 In light of the evidence before the Royal Commission, particularly that contained in the Aussie Home Loans case study, Smartline is currently revising its compliance policies to determine how this information can be utilised to provide a further layer of insight into broker behaviour, and to identify any brokers whose conduct requires investigation.

66 Smartline's culture and business model are explained in Smartline's Response to the Royal Commissioner. To reiterate, they involve: (a) the steady growth of Smartline's franchise network; (b) the pursuit by Smartline franchisees of repeat and referral business; and (c) a transparent approach to customer feedback. These combine to create a sales culture that pursues revenue growth by growth of the customer base, rather than maximisation of per-transaction commissions.

67 Smartline also actively encourages a culture of reporting misconduct. At Smartline's professional development days discussions are regularly conducted around the topic "if someone does the wrong thing, we could all be damaged, so speak up".

68 Smartline's process for recruitment of franchisees is long and detailed. Prospective franchisees are required to undertake three interviews with the National Recruitment Manager, the relevant State Manager and, if appropriate, a Smartline Executive Director. They must produce business plans, and provide personal and financial information. They must undergo a police check. Smartline also conducts a detailed analysis to ensure that the applicant is suitable in terms of their mindset, resources

and skills. Details of Smartline's training and professional development program are set out at paragraphs 34 to 37 of Smartline's Response.

69 When Smartline identifies misconduct by a broker, its policy is to inform the MFAA. This policy is only deviated from where circumstances otherwise dictate that the broker is unable to work as a broker or the broker's return to the industry appears extremely unlikely.[66] In most cases of misconduct Smartline will cancel the broker's authorisation to act as a credit representative of Smartline, and inform Smartline's panel of lenders of that revocation.[67] Smartline is of course concerned with customer remediation, however in the limited instances of misconduct that in Smartline's history this has rarely been an issue.[68]

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66 For example, in the incident described in item 3 of the table in the Smartline's Response, the MFAA was not informed by reason of the fact that the broker had been admitted to a psychiatric facility and his return to broking appeared extremely unlikely.

67 An exception was made in the case identified in item 6 of the table in the Smartline's Response, where the MFAA found that the misconduct was of a *de minimis* nature. Nevertheless, Smartline conducted a special audit of the franchise, and further follow up audits.

68 As the table in Smartline's Response indicates, the only incident of misconduct resulting in loss to the customer was a theft (item 3). The money was returned to the customers. In the case of item 6, Smartline offered an ex gratia payment to the customer, despite Smartline determining that the broker's misconduct was not a cause of the customer's grievance (that their loan application had been denied), a finding with which the MFAA concurred.

APPENDIX A

This table shows the average commission rates and loan volumes of Smartline's top 20 lenders in calendar years 2015, 2016 and 2017.[69]

2017

	Lender	Loan volume ($)	Avg. up-front rate
1.	ANZ	$963,010,851	0.643%
2.	CBA	$930,870,119	0.593%
3.	NAB	$506,337,098	0.602%
4.	Bankwest	$383,872,120	0.627%
5.	SMARTLINE Select™	$371,915,190	0.680%
6.	ING Direct	$328,778,974	0.590%
7.	Westpac	$278,881,738	0.647%
8.	Credit Union Australia	$256,391,736	0.589%
9.	St George	$194,345,092	0.593%
10.	Suncorp Metway	$181,059,951	0.638%
11.	ME Bank	$162,487,783	0.651%
12.	BankSA	$98,862,448	0.567%
13.	AMP	$94,961,118	0.633%
14.	Macquarie Mortgages	$87,476,763	0.516%
15.	Bank of Melbourne	$85,944,316	0.604%
16.	Liberty Financial	$73,001,678	0.720%
17.	Heritage	$41,965,495	0.627%
18.	Keystart Home Loans	$41,391,456	0.494%
19.	FirstMac	$33,621,658	0.595%
20.	Police and Nurses Mutual Banking WA	$22,380,079	0.586%

[69] Average up-front commissions determined by dividing total up-front commissions received by total loan volume. Based on data for the whole calendar years (25 lenders) or three-month samples where whole-year data could not be obtained in time (two lenders).

2016

	Lender	Loan volume ($)	Avg. up-front rate
1.	CBA	$1,241,760,399	0.612%
2.	ANZ	$986,131,584	0.627%
3.	Bankwest	$459,764,811	0.628%
4.	Westpac	$372,197,715	0.637%
5.	NAB	$361,214,787	0.592%
6.	ING Direct	$335,939,156	0.606%
7.	SMARTLINE Select™	$307,864,341	0.699%
8.	St George	$245,637,727	0.603%
9.	Credit Union Australia	$220,122,830	0.581%
10.	BankSA	$156,204,317	0.596%
11.	ME Bank	$145,624,544	0.634%
12.	Suncorp Metway	$124,943,620	0.637%
13.	Bank of Melbourne	$89,799,570	0.644%
14.	AMP	$88,253,273	0.639%
15.	Macquarie Mortgages	$77,808,604	0.505%
16.	Heritage	$55,178,671	0.623%
17.	Liberty Financial	$43,328,157	0.718%
18.	Police and Nurses Mutual Banking WA	$38,238,028	0.570%
19.	Adelaide Bank	$26,377,854	0.701%
20.	Keystart Home Loans	$24,775,900	0.496%

2015

	Lender	Loan volume ($)	Avg. up-front rate
1.	CBA	$1,288,610,613	0.614%
2.	ANZ	$1,115,958,095	0.598%
3.	BankWest	$507,838,375	0.659%
4.	Westpac	$345,872,342	0.637%
5.	ING Direct	$341,719,182	0.552%
6.	Credit Union Australia	$242,679,936	0.590%
7.	St George	$225,381,564	0.610%

8.	Macquarie Mortgages	$159,715,894	0.558%
9.	Suncorp Metway	$142,421,647	0.660%
10.	BankSA	$133,417,104	0.613%
11.	ME Bank	$123,967,608	0.606%
12.	Smartline combined	$87,343,631	0.733%
13.	AMP	$83,371,107	0.647%
14.	Heritage	$64,928,977	0.556%
15.	Bank of Melbourne	$58,306,411	0.620%
16.	SMARTLINE Select™	$44,118,266	0.744%
17.	Keystart Home Loans	$39,612,175	0.474%
18.	Liberty Financial	$37,285,211	0.784%
19.	Citibank	$37,208,466	0.632%
20.	Adelaide Bank	$28,896,946	0.692%