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By email: economics.reps@aph.gov.au

Committee Secretary
Standing Committee on Economics
PO Box 6021
House of Representatives
Parliament House
CANBERRA ACT 2600
AUSTRALIA

Dear Sir/Madam

Inquiry into competition in the banking and non-banking sectors

Consumer Action Law Centre (**Consumer Action)** is pleased to make a submission to the House of Representatives Standing Committee on Economics (the **Committee**) inquiry into competition in the banking and non-banking sectors.

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign focused, casework and policy organisation. Consumer Action provides free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and is the largest specialist consumer legal practice in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

Summary

Our submission considers that:

- There remain significant competition problems in the retail banking and non-banking sector, despite vigorous competition on some matters that has brought about benefits to the majority of consumers, including improved price and service outcomes over a range of products.
- The failures of competition in a number of areas in the retail banking and non-banking sectors particularly relate to the inability of the demand side to drive

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competition and for all consumers to receive the benefits of competition equitably. Search and switching costs are a particular problem in these sectors.

- There is increasing complexity for consumers, not only in terms of product offerings, but in how products are delivered through the increasing use of brokers and other intermediaries.
- In the area of consumer credit particularly, vigorous competition has contributed to a range of irresponsible lending practices that have not been in the interests of consumers.
- Some classes of consumers continue to be excluded or penalised in the retail banking and non-banking sector, especially through the use of disproportionate penalty fees.

Our submission recommends that the Committee consider making the following recommendations:

1. That the Australian Government take back from the Australian Payments Clearing Association (**APCA**) the principal responsibility for ensuring the delivery of an appropriate listing and switching service for bank customers.
2. That the Australian Government consider introducing a bank account portability scheme, so that consumers own their bank account numbers and can switch them to new institutions.
3. That the new national credit regulatory regime include provisions allowing the regulator to limit the types of costs that may be recovered by an early termination fee and to provide guidance as to an appropriate level for such a fee.
4. That the draft national finance broking bill be enacted as soon as possible or be included in the new national credit regulatory regime.
5. That the new national credit regulatory regime include obligations on all lenders to ensure products meet the needs of customers, and that customers have the capacity to repay credit without hardship
6. That, subject to minor amendments, the provisions of the Australian Securities and Investments Commission (Fair Bank & Credit Card Fees) Amendment Bill 2008 be adopted.
7. That the new national credit regulatory regime include an effective comprehensive interest rate cap that includes fees and charges.
8. That the Australian Government introduce market studies and investigations powers, based on the model in the UK *Enterprise Act 2002*, into Australian law.

Introduction – competition and consumers

Consumer Action believes that fair, effective and competitive markets generally deliver the best price, quality and access to goods and services to the majority of consumers.

Since the retail banking and non-banking sectors were deregulated over 20 years ago, Australian consumers have benefited from competition through an improved range of product offerings and cheaper prices for many financial services, which has, in turn, improved access for many consumers. While in recent months there appears to be some lessening of competition in these markets due to the "credit crunch", which has purportedly increased the cost of wholesale credit and reduced provider's margins,[1] there are still many more providers and products than there were even ten years ago.

However, competition is not effective for many aspects of retail banking and non-banking financial services in Australia. In our view, this is largely because effective competition will not necessarily occur just because the supply side of a market is competing vigorously; consumers must also be able to choose effectively from among the options. At present, there are some significant obstacles to this occurring.

Until recently, insufficient attention has been paid to the actual role of consumers in driving competition as well as the behaviour of consumers in markets. However, it is now more widely recognised that consumers are not just passive beneficiaries of competition, rather, they activate it.[2] The Productivity Commission again recently acknowledged that consumers play an important role in facilitating competition and promoting well-functioning markets.[3] The Committee will therefore need to include a strong focus on the demand side of the retail banking and non-banking sectors if it wishes to gain an accurate picture of why the retail banking and non-banking sectors in Australia are not operating as well as they could be.

Further, as in other major consumer markets, the benefits of competition in retail banking and non-banking financial services have not been distributed evenly and some disadvantaged and vulnerable consumers are actually worse off, as has been noted previously by the Reserve Bank of Australia.[4] It should be remembered that the overall goal of competition policy in Australia is essentially a social policy goal – to improve or enhance the welfare of all Australians.[5] The Committee should therefore consider ways to rectify market failures so as to enable the benefits of competition to be distributed to consumers more equitably.

Search and switching cost problems in the retail banking and non-banking sectors

In the Australian retail banking and non-banking sectors, the ability of consumers to facilitate competition is currently limited by a number of factors. Some of the principal problems are with search and switching costs for consumers.

In the UK, writers such as Waterson, Waddams and Klemperer have discussed the effect of barriers to consumers effectively exercising their power in the market place, particularly

[1] See, eg, Choice, 'Reverse mortgage update', July 2008, where it is reported that a number of reverse mortgage providers have suspended their products due to the increase in the cost of funds.
[2] See, eg, Productivity Commission, Review of National Competition Policy Reforms, Report no. 33, Canberra 2005, box 10.3, p.280; Louise Sylvan, 'Activating competition: The consumer-competition interface', (2004) 12 Competition & Consumer Law Journal 1; see also, in the US, Neil W. Averitt and Robert H. Lande, 'Consumer Sovereignty: A Unified Theory of Antitrust and Consumer Protection Law', (1997) 65 Antitrust Law Journal 713; and in the UK, John Vickers, Economics for consumer policy, British Academy Keynes Lecture, 29 October 2003.
[3] Productivity Commission, *Review of Australia's Consumer Policy Framework - Productivity Commission Inquiry Report: Volume 2 – Chapters and Appendixes*, No. 45, 30 April 2008, p.28.
[4] See, Reserve Bank of Australia, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, April 2003, pp.4-6; Reserve Bank of Australia, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, May 2005, p.69.
[5] See, eg, National Competition Council, 'National Competition Council's mission statement', www.ncc.gov.au/; *Trade Practices Act 1974* (Cth) s.2.

search and switching costs.[6] As well as the effect on individuals (for example, that they pay more than they should for a product or service or that they are unhappy with their purchase), they point to significant effects on competition and efficiency more generally.

Waterson, for example, examines levels of consumer switching across a number of markets, showing how even across similar industries, different consumer behaviour leads to markedly different results in performance.[7] He found that in markets with significant search or switching costs, firms' prices were higher, or even at the monopoly pricing level. Further, in markets where firms can discriminate between old and new customers, and switching costs are significant, prices are lower in the first (new) period and higher in the second (old) period than if there were no switching costs.[8]

Klemperer identifies six key switching costs, which he defines as 'a cost [that] results from a consumer's desire for compatibility between his current purchase and a previous investment.'[9] These are:

1. Need for compatibility with existing equipment;
2. Transaction costs of switching suppliers;
3. Costs of learning to use new brands;
4. Uncertainty about the quality of untested brands;
5. Discount coupons and similar devices; and
6. Psychological costs of switching or non-economic "brand loyalty."[10]

He concludes that 'consumer switching costs (whether real or perceived) are widespread, and our analysis suggests that the resulting welfare losses may be substantial: switching costs generally raise prices and create deadweight losses…in a closed oligopoly.'[11]

The significance of the potential impact of these factors has lead both Waterson and Klemperer to conclude that there is a positive role for policies or interventions that reduce these costs. Klemperer sees a role for better public policy to help consumers drive competition:

> …public policy should discourage activities that increase consumer switching costs (such as airlines' frequent-flyer programmes), and encourage activities that reduce them (such as standardisation that enhances compatibility and reduces learning costs of switching,

[6] See for example Waterson, M. 2001. *The Role of Consumers in Competition and Competition Policy*. University of Warwick Economic Research paper no.607; Klemperer, P. 1995. Competition when Consumers have switching Costs: An Overview with Applications to Industrial Organization, Macroeconomics, and International Trade". R*eview of Economic Studies.* 62: 515–539; and Waddams, C., Giulietti, M. & Waterson, M. 2005. Consumer Choice and Industrial Policy: a study of UK Energy Markets. *The Economic Journal*. 115: 949-968. See also from the United States: Camerer, C., Issacharoff, S., Lowenstein, G., O'Donoghue, T. & Rabin M. *Regulation for Conservatives and the Case for "Asymmetric Paternalism"*. 2003. University of Pennsylvania Law Review. 151: 1211-1254.
[7] Waterson, M., as above, p.7.
[8] As above, pp.4-5.
[9] Klemperer, above n6, p.517.
[10] As above, pp.517-518.
[11] As above, p.536.

> and quality regulation and information sources that reduce consumer uncertainty about untested brands).[12]

Importantly, Waterson points out that the difficulties consumers can face in searching for different choices and switching between providers is not just the fault of individuals, so governments have a role to counteract bad practices by suppliers:

> Search behaviour may be thought to be a characteristic of individual consumers and therefore not something that may be influenced by public policy, unlike the actions of firms. However, this is untrue since consumers' search costs are manipulable by those who supply the good in question…Therefore, by enforcing or prohibiting particular practices, public agencies may influence search costs…Similarly, and perhaps more obviously, switching costs are altered by various means by the suppliers in their own interest.[13]

In fact, Waterson explicitly examined UK current account banking. He found it was a market where low switching by consumers, due to cumbersome procedures to change bank, had led to abnormally high profitability, especially in comparison with other financial services markets, for example the car insurance market.[14]

The Australian Government recently acknowledged the high cost of switching in the retail banking sector in Australia.[15] In the market for transaction accounts, switching is complicated by the widespread use of direct debit and credit arrangements. While direct debit and credit arrangements are generally efficient payment methods, the way in which they interfere with a consumers' ability to change bank accounts creates a switching cost. Currently, the responsibility for transferring such arrangements (which may exist for a range of automatic transfers, including salary, mortgage repayments, utility bills, insurance bills and others) lies with consumers. Often, consumers rationally decide that it is too difficult or costly to switch providers, if they have to terminate and re-establish a number of direct debit and credit arrangements.

Direct debit and credit arrangements are an important, but certainly not the only, barrier to consumers being able to switch bank accounts. In the market for mortgages, switching is impacted by a range of exit and early termination fees, including what the industry terms "deferred establishment fees" – a fee the borrower pays upon early repayment and termination of their mortgage. A recent report by the Australian Securities and Investments Commission (**ASIC**) on mortgage exit and early termination fees demonstrates that such fees vary wildly across the sector, and that many large fees act as a disincentive to switch.[16]

The experience of a recent Consumer Action client illustrates this:

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[12] Klemperer, above n6, p.536.
[13] Waterson, above n6, p.5.
[14] As above, pp.8-10.
[15] Treasurer Wayne Swan, *Media Release – Rudd Government makes it easier for Australian families to switch banks*, 9 February 2009.
[16] Australian Securities and Investments Commission, *Report 125 – Review of Mortgage Entry and Exit Fees*, April 2008.

Case study – disincentive to switch

In July 2007, Ms M took out a low-doc mortgage with a variable interest rate from RAMS Home Loans. Ms M chose the low-doc mortgage because she was self-employed. The mortgage had a low interest rate of 7.93% and included an early termination fee of $14,000.

The interest rate on the mortgage was increased in August and November 2007 in line with increases of the Reserve Bank of Australia. In early January 2008, RAMS Home Loans collapsed and its loan book was sold to RHG Home Loans. The RAMS Home Loans brand name was sold to Westpac who continue to sell mortgages under that name. Since the transfer of the mortgage to RHG Home Loans, the rate of interest has been increased four times, in addition to the two increases from the Reserve Bank of Australia. The current rate of interest being charged on the mortgage is 10.13%. RAMS Home Loans are currently selling a similar low-doc loan at an interest rate of 9.4%.

Ms M would like to take advantage of the other mortgage products on the market that have interest rates that are lower than her current loan with RHG Home Loans. Although switching might save her up to $500 per month on her repayments, she will be charged the $14,000 early termination fee should she do so. Considering this, Ms M has decided not to switch and feels "locked in" to a mortgage that is not competitive.

The current "credit crunch" is purportedly increasing the cost of wholesale credit for financial service providers. Consequently, and as the above case study demonstrates, lenders have increased interest rates directly to consumers on a number of occasions (in addition to rate increases passed on from rate rises by the Reserve Bank of Australia). Given high termination fees, consumers have no ability to switch to cheaper products or challenge such interest rate rises and are subject to the vagaries of the market. This demonstrates Waterson's contention that where switching costs are significant, firms can discriminate between new and old customers. This is not a good, competitive outcome in the market.

In February this year the Government, in collaboration with industry, announced a package of reforms aimed at improving the capacity of consumers to switch bank account providers, thereby ensuring the market satisfies consumer preferences while forcing down the cost to the lowest possible level.[17] We strongly welcomed these reforms and believe that steps must be taken to improve the ability of consumers to promote competition.

The substance of the package amounted to a new listing and switching service to make changing bank easier, as well as the ASIC review of mortgage exit and early termination fees referred to above. Unfortunately, we have become concerned with the progress of these reforms. The Australian Payments Clearing Association (**APCA**) has been tasked with the primary responsibility of implementing the listing and switching service and has released regular progress reports on its implementation of the initiative.[18] Our concern relates to APCA's heavy emphasis on the costs to business of implementing the service with little emphasis on a system that is actually effective in assisting consumers to switch, the whole point of the initiative. In particular, our concerns include:

[17] Swan, above n15.
[18] See www.apca.com.au.

- The new service will not apply to credit card accounts (including scheme debit cards). This is an illogical exclusion as consumers are increasingly using direct debit and direct credit arrangements on their credit card accounts. However, as APCA has no jurisdiction over credit card schemes, such card transactions are outside the scope of the reform package.

- The proposed obligation on financial services providers is to provide a list of direct debit and credit arrangements and pass this onto consumers, who can then take it to their new financial services provider. However, there is no clear obligation for the new financial services provider to set up the new direct debit and credit arrangements. Rather, the obligation is merely to *offer* assistance if requested by consumers. This is inadequate – if the obligation only arises when a consumer requests assistance, then lack of knowledge of this obligation on the part of consumers may result in limited uptake of the available assistance.

- The proposal does not allow for consumer redress should the service not be provided appropriately or should the consumer suffer loss. For example, we believe a consumer should have a right of redress should the list not be provided within a sufficient time or should the list be incorrect resulting in the consumer incurring a charge or otherwise suffering a loss. This would provide an appropriate incentive for the 'losing' financial institution to provide an accurate list in a timely manner.

- There has been no assurance that consumers will not be charged for the service. In our view, the service would be self-defeating if consumers were charged, as any charge would increase the cost of switching (the very thing the initiative was designed to reduce).

We have raised these issues with APCA, yet it appears that they are unable to substantively deal with these concerns. To be fair, this is in part due to its limited role as an entity that deals only with certain payments clearing systems and does not deal with the credit card and scheme debit card systems. APCA is also an industry collaboration body owned by the banks, building societies and credit unions - it is not a government regulator, nor does it have consumer policy functions. As such, it is inappropriate to expect APCA to deliver this policy on behalf of the Government. We therefore strongly recommend that Government take back principal responsibility for ensuring the delivery of an appropriate listing and switching service for bank customers.

There are other reforms that could be considered to ensure switching accounts is easier for consumers. In the telecommunications industry, switching costs were recognised as a barrier to effective competition and the portability of phone numbers was introduced to address this. One suggestion has been to introduce a similar scheme in banking, so consumers own their bank account numbers and could switch them to new institutions.[19] We would encourage further consideration of such a scheme. Clearly, the ability for consumers to switch just their bank account number to a new provider, rather than have to switch all direct debit and credit arrangements over, would be more effective in reducing switching costs in the banking sector.

[19] Joshua Gans, *How easy is it to switch banks?*, CoreEcon blog, 9 January 2008, available at: http://economics.com.au/?p=1251 and Gans J., King S. & Woodbridge G. 'Numbers to the People: Regulation, Ownership and Local Number Portability' 2001. *Information Economics and Policy*, 13: 167-180.

Regarding mortgage exit and early termination fees, we have welcomed the publication of the ASIC report. Publication of fee type and levels has created some debate about these fees but, in our view, publication alone will not ensure the fees are set at fair levels and do not unreasonably restrict consumers from switching. We understand ASIC is undertaking further work investigating how fees are disclosed and applied.[20] However, it should be noted that, because they are contingent fees, consumers do not actively take exit and early termination fees into consideration when choosing a mortgage (as consumers do not think they will pay them).[21] Thus, these fees are not subject to competitive pressure, even if they are disclosed clearly.

This fact means that the need for regulatory intervention in relation to these types of fees is inevitable if Government wishes to stop their negative effect on competition in financial services markets. We note that such regulation would not be regulation that interferes with the operation of a competitive market, but regulation that facilitates the operation of a competitive market.

In Victoria, there is already a regulatory model for the appropriate regulation of termination fees. The Energy Retail Code, enacted by the Victorian Essential Services Commission, regulates early termination fees under its clause on agreed damages terms. The relevant clause is as follows:

> 32. AGREED DAMAGES TERMS
>
> (a) Any agreed damages term, whether providing for a late payment fee, an early termination fee or otherwise, must either include the amount that will be payable by the customer to the retailer for the customer's breach of their energy contract or include a simple basis for determining that amount.
>
> (b) Subject to clause 32(c), the amount payable by a customer under an agreed damages term must be a fair and reasonable pre-estimate of the damage the retailer will incur if the customer breaches their energy contract, having regard to related costs likely to be incurred by the retailer.
>
> (c) Any amount of an early termination fee payable by a customer upon the customer breaching their energy contract must be determined by reference to, and must not exceed, the total of the following direct costs incurred by the retailer in relation to that particular customer which remain unamortised at the time of termination:
>
> i) pro-rata costs of procuring the customer to enter into the contract
>
> ii) additional costs of giving effect to the early termination of the contract, final billing and ceasing to be responsible for the supply address; and
>
> iii) the value of any imbalance in the retailer's electricity or gas hedging program to the extent that it is directly attributable to that breach of contract.

This clause makes it clear that an early termination fee should not exceed the direct costs incurred by the service provider due to a customer's early termination. While it is similar to section 73 of the Uniform Consumer Credit Code which provides that an early termination fee may be unlawful if it 'exceeds a reasonable estimate of the credit provider's loss arising from the early termination', it goes further by limiting costs recoverable to direct costs, identifying the particular direct costs that may be recoverable, and giving power to the

[20] Tony Boyd, 'Concealed Exit', *Business Spectator*, 11 July 2008.

[21] This is due to well known cognitive biases such as overconfidence and difficulty with estimating low probabilities. See the next section of our submission for more information about the effect of biases on consumer behaviour in markets.

regulator to overturn fees that exceed those costs. In its final decision amending the Energy Retail Code to include this clause, the Essential Services Commission also provided guidance as to an amount it believed would be an appropriate level of an early termination fees. We view this sort of regulation and guidance to be appropriate for a regulator and believe that it can ensure early termination fees do not act as an unreasonable barrier to switching. We therefore recommend that the new national credit regulatory regime include provisions allowing the regulator to regulate the types of costs that may be included in an early termination fee and to provide guidance as to an appropriate level for such a fee.

Behavioural biases of consumers and the effect on competition

Classical economics assumes that markets are filled with perfectly rational consumers who will try to make choices that maximise their self-interest and fulfil their pre-determined preferences using all the relevant information available. However, it is now understood that *actual* consumer behaviour in markets can often differ markedly from this assumption.[22]

Therefore, in considering policy responses aimed at assisting consumers to drive competition, including in the retail banking and non-banking sector, policy makers need to consider consumers' actual behaviour in markets. Behavioural economics examines actual consumer behaviour in markets and identifies systematic biases and departures from the perfectly rational consumer that is assumed by classical economics.[23] Behavioural economics has significant implications for policy, allowing these systematic biases or departures to be considered in determining whether intervention is necessary and in judging the efficacy of proposed responses to market problems.

There are a number of insights from behavioural economics that help explain consumer behaviour in financial services markets. These include:

- Heuristics: individuals tend to use simple rules of thumb rather than weigh up all options, which in the most part serve us well. Sometimes, however, our departures from rational decision making lead us away from sound decisions and sometimes they can have costly implications.
- Confirmation bias: once individuals make a commitment (for example, opening a bank account or borrowing from a particular lender) they seek evidence to confirm they have made the right choice and disregard evidence that they have made the wrong choice.[24]
- Default bias: individuals tend to procrastinate and remain with the status quo (for example, consumers adopt the default superannuation fund of their employers).[25]
- The endowment bias: people are reluctant to give up what they have and will retain a financial product that they would not now newly take-up (for example, they may stay

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[22] See, eg, Productivity Commission, above n3, pp.373-388.
[23] For a list of biases in consumer behaviour, see: OECD Committee on Consumer Policy, *Roundtable on Demand-side Economics for Consumer Policy: Summary Report*, 20 April 2006, Appendix II. Behavioural Biases, p.3; also Productivity Commission, above n3, pp.380-381.
[24] McAuley, Ian*, YOU CAN SEE A LOT BY JUST LOOKING: Understanding human judgment in financial decision-making*, Centre for Policy Development, Paper to accompany presentation to Australian Bankers' Association: Broadening financial understanding – financial literacy summit, 2 July 2008, p.13.
[25] As above.

with a managed fund that posted negative returns in the last year although they would not join a managed fund that posted negative returns in the last year).[26]

- Overconfidence: people overestimate their own abilities. In one study it was found that 80 per cent of respondents rated themselves in the top 30 per cent of drivers. A 1999 study found that individuals over-respond to low pre-teaser interest rate offers on credit cards, naively thinking that they will not borrow much on the credit card after the teaser rate is removed.[27]

There are numerous other biases consumers are subject to that can, in some circumstances, mean that consumers fail to foster competition as neoclassical economics predicts them to. In the banking and non-banking sectors, structural factors can often bring the negative consequences of these biases to the fore. The increased use of direct debit and credit arrangements outlined above is an example of such a structural factor.

It should be noted that financial services providers already regularly apply consumer behavioural principles in their own product design, advertising and marketing. For example, credit cards can be designed so that the lender profits from consumers' tendency to discount future costs, preferring short-term benefit. Thus, any government failure to use these principles in its own policy responses immediately places government at a disadvantage.

The effects of failing to consider behavioural principles have already been seen in the use of disclosure regimes in the Australian financial services market. Not only are consumers highly unlikely to actually read complex and detailed disclosure documentation, other forms of disclosure, such as the disclosure of a conflict of interest by an adviser, can have the opposite effect to that intended. For example, one study found that rather than making consumers more cautious, disclosure of a conflict of interest raised their trust regarding the adviser.[28] Another study showed that mortgage broker compensation disclosure can actually confuse consumers and lead them to make worse decisions than they would have had no disclosure been provided.[29]

The emerging body of work in behavioural economics is providing insights about why products or policies succeed or fail. Policy makers and regulators should actively explore opportunities to consider these in current policy design. One such practical example was described above – consumers do not generally take exit and early termination fees into consideration when choosing a mortgage. This means that a policy of simply ensuring such fees be disclosed more clearly to consumers would be unlikely to be effective in meeting the ultimate goal of such a policy, as it would not actually drive consumers to make decisions properly taking those fees into account. Those fees would therefore continue to act as a barrier to switching when consumers were later considering whether to change mortgage provider.

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[26] As above, p 21.
[27] Productivity Commission, above n
[28] See Cain, D.M., Loewenstein, G. & Moore, D.A. 2005. *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*. Journal of Legal Studies. 34: 1 - 25.
[29] See Lacko J.M. and Pappalardo J.K., 'The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment', *Bureau of Economics Staff Report*, Washington DC: Federal Trade Commission, February 2004.

Increased complexity in the retail banking and non-banking sectors

One consequence of increased competition in the retail banking and non-banking sectors has been an increased number and complexity of products. A further consequence of this complexity, coupled with limits on consumers' time, has been the expansion of intermediaries markets. Intermediaries such as brokers or advisers are a logical development, as it is generally more efficient for consumers to use intermediaries to help them make choices, rather than pay the costs (both direct and opportunity) of informing themselves of all relevant matters, particularly for complex and one-off or irregular purchases.

Broker originated home loans now make up approximately 35 per cent of the new home-loan market.[30] Financial advisers and brokers now offer intermediation services for a wide range of products other than just home loans, such as insurance and investment products. These products are often bundled in offerings from many of the large financial service providers and such bundling creates further complexity.

In our view, the role of intermediaries is often conflicted, which means that they do not necessarily act independently or in the best interests of the consumer. This conflict generally arises because the intermediaries' source of income is commission or another form of payment from the supplier rather than from the consumer. This is particularly common in the financial services sectors.

This form of remuneration can affect the services provided by intermediaries in several ways, including:

- Most obviously, being financially motivated by payments from the supplier, intermediaries have a strong incentive to promote the product or service that provides the greatest payment to the intermediary, rather than the best deal for the consumer;
- As intermediaries are often paid in commission-form as a percentage of the amount sold, there is a strong incentive to encourage consumers to take out a more expensive product than the consumer needs, in order to increase the commission;[31]
- Intermediaries often represent products as more complicated than they actually are, in an attempt to convince the consumer to use their services;[32]
- While brokers may be expected to offer the best mortgage based on price, there is

[30] Research by JP Morgan showed that the percentage of broker-originated new home loans increased to 35 per cent in 2005 from 30 per cent in 2004: see Moncrief, M. 2005. Bank home loan sector under siege. *The Age*. 19 October 2005. This represents a consistent annual increase in the volume of broker-originated loans in recent years; the Reserve Bank reported that broker-originated loans made up one quarter of new home loans in 2003: see Reserve Bank of Australia 2004. *Financial Stability Review - September 2004*, pp.39-40). A 2003 report by the Australian Prudential Regulation Authority also noted the increasing prevalence of broker originated loans, and found that broker originated lending is most prominent in the housing loan market: see Australian Prudential Regulation Authority. 2003. *Report on broker originated lending*. Sydney: APRA.

[31] See, for example, the findings of a Choice Reverse Mortgage Shadow Shop investigation, which found that a majority of brokers and salespeople encouraged borrowers to take the maximum possible loan instead of the requested amount. The findings can be reviewed at: www.choice.com.au/viewArticle.aspx?id=105198&catId=100296&tid=100008&p=1&title=Reverse+mortgage+shadow+shop.

[32] For example, a Google search of "mortgage maze" delivers over 400 Australian web sites.

industry criticism of brokers who “sell on price”;[33]

- In some cases intermediaries offer only one product or a limited range of products, which may lead to the consumer buying an expensive product chosen by the intermediary based on the high commissions paid; and
- Some intermediaries will try to act professionally, and will genuinely regard their role as arranging the best deal for the consumer. However, even in these circumstances commissions (or other incentives) can sway a recommendation.

For individual consumers, this is worsened by the fact that it is very difficult to obtain effective redress when something goes wrong. The lender may not even be considered directly responsible for the intermediary’s conduct, despite relying on it for supply of business.

Apart from the individual detriment suffered by consumers, this also affects the efficient operation of the market and impinges on competitive outcomes. Rather than working to address consumer information problems caused by the increasing complexity of products in the marketplace, intermediaries are exacerbating them by distorting consumer choices towards products and services that benefit the intermediaries. This greatly undermines consumers’ abilities to be effective in the market and the likelihood of better products and services that may result through more rational choices.

These problems are not just unfortunate accidents. Rather, they are the result of market forces operating without the anchor of long-term consumer interest. In this unregulated environment, it is more lucrative for individual intermediaries to source income from suppliers. It also allows them to compete more strongly for consumer business by seeming to offer their services at a cheaper price than intermediaries who offer services on a fee-for service basis. As consumers make more and more use of intermediaries, suppliers will compete to offer greater payments to intermediaries to secure their referrals.

Current policy responses to these problems in the financial sector have relied heavily on the use of disclosure – requiring brokers and advisers to give consumers a mass of information about their advice and recommendations, the grounds for these recommendations and the manner in which they are paid – rather than more prescriptive regulation or “interference” with the market. This approach is now widely agreed to have been inefficient and ineffective.

[33] For example, Phil Colton, head of broker sales at BankWest, made the following comments about how brokers can increase their market share in *Broker Review* (published for Choice Aggregation Services, Autumn 2007): “The biggest challenge will be in educating the mortgage broking industry that price concerns shouldn’t be leading the agenda. Brokers offer customers a relationship and if the industry encourages price to be the main concern, then the customer will ultimately start to value price over relationship, and look for a more direct way to obtain their finance”. Further, the results of Mortgage Professional Australia’s annual survey noted that: “Interestingly, while only 11% of brokers said price was a key consideration when choosing non-banks, when asked what would make them sell more non-bank products, 42% said improved pricing. This statistic could be a little disconcerting to those in the industry who argue that brokers should focus on adding value to the customer experience, rather than promoting discounts and the cheapest rates. A focus on price sees mortgages become increasingly commoditised, the argument goes, effectively diluting the need for consumers to use a broker in the first place. People can search for the cheapest loans via the internet.” See *Mortgage Professional Australia*, Issue 7.3, March 2007, p.86.

In recognition of this, the Ministerial Council of Consumer Affairs has proposed a new national finance broking law. We strongly supported the draft legislation, and we refer you to our joint submission with Consumer Credit Legal Service.[34] We recommend this legislation being enacted as soon as possible or be included in the new national consumer credit regulatory regime.

Where competition exacerbates market problems – irresponsible lending

Increased competition in the consumer credit market, in particular, has had some perverse market outcomes. Particularly in response to the entry of non-bank providers, more and more credit providers are making access to credit easier for consumers. This has resulted in increased levels of irresponsible marketing and lending strategies. Competition has exacerbated this problem as institutions vigorously compete to offer credit to consumers to maintain their market share.

Irresponsible lending strategies include marketing that attempts to "up sell" credit, by focusing on how much the lender is willing to advance the consumer rather than how much the consumer wants to borrow. Further, credit providers are less focused on the purpose for which credit is used compared to the past. Practices such as offering retail items on interest-free terms as a draw down on a high limit credit card (with limits up to $10,000 or more) clearly involve providing consumers with more credit than they actually want. Unsolicited credit card limit increase offers are also an issue. We have recently seen an example of a consumer who made an application for an increase of their credit card limit, which was refused. The consumer shortly thereafter received an unsolicited credit card limit increase offer, which was approved, despite there being no change in the consumer's situation. This suggests that credit assessment processes in some institutions diverge depending upon the nature of the credit application.

Making credit easy to access is a related problem. Lenders commonly make "pre-approved" credit offers, use internet banking to show funds available for redraw on a mortgage in the same way as a consumer's transaction account balance, or put messages on a credit card statement such as "withdraw cash at an ATM". These strategies encourage borrowers to access more credit than they may actually require.

Some lending strategies target borrowers in difficulty or default. Examples of such lending include re-financing or debt consolidation, particularly where borrowers are encouraged to increase borrowings as part of the refinance or after the refinance. Related to this is asset lending or "equity stripping". This usually takes the form of consumers entering into expensive home loan refinancing arrangements in an (often emotional) attempt to save the family home from foreclosure. These refinancing efforts often do not prevent the loss of the home, however, as due to the additional costs of refinancing, the consumers lose more of the equity than they would otherwise have retained. It is stripped by the refinancing costs and extra interest.

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[34] Consumer Action and Consumer Credit Legal Service, *Joint submission on draft national finance broking legislation*, April 2008, available at: http://www.consumeraction.org.au/downloads/Finalsubmissiononfinancebrokinglegislation.pdf.

Policy makers should acknowledge that vigorous competition in the consumer credit market can operate in a way that defeats not only individual consumers' long-term interests, but those of the economy and society more broadly. Consumers who are constantly in debt, especially debt related to personal consumption, have a limited ability to save for their retirement, access the housing market, or promote economic growth through investment.

So as to limit consumer detriment from irresponsible lending practices, we believe that there needs to be clear obligations in law that require credit providers to take reasonable steps to ensure that (i) the product meets the needs of the customer, and (ii) the customer has the capacity to repay the loan without hardship. Such obligations should be included in the new national consumer credit laws when they are drafted.

Such principle-based regulation should ensure that consumers have access to remedies if the principles are not complied with. If such regulation is effective, it should avert the need for heavier regulation, such as restrictions or banning of certain products.

Distributing the benefits of competition more equitably

Although generally competition has improved access to banking products and services, some consumers continue to be excluded or penalised in the market. Low-income consumers, in particular, are in many cases excluded from banking markets or made to pay more than others to access banking services and consumer credit.

We acknowledge that banks have improved accessibility to transaction accounts, through the offering of basic or concession bank accounts. Most of the major banks now offer such accounts which have very limited or no fees. We applaud these initiatives. However, many low-income consumers are still subject to high-fees on transaction accounts in the form of penalty fees.

Penalty fees include over-limit, late payment and payment failure fees on credit card accounts, inward cheque dishonour fees, honour or dishonour fees and account overdrawn fees on transaction accounts. While all consumers are vulnerable to such fees, low-income consumers in particular are charged such fees. This is because low-income consumers on fixed incomes are more likely to have account balances that attract such fees.

Importantly, similarly to mortgage exit fees described above, there is little competitive pressure on financial institutions to keep these fees in check. This is because consumers do not expect to pay penalty fees at the time they open an account or take out a loan or credit card, thus they do not negotiate over these terms (even if they are aware of them). Nor, for similar reasons, do they choose one financial product over another based on the amount of penalty fees.

This is reflected in the growth in these fees yet again in the 2006-07 financial year. For example in the Reserve Bank of Australia's recent May 2008 Bulletin, it reported that Australian banks' total domestic fee income growth last financial year was 8%, with fee income from households growing slightly faster at 9%. However, fee income from household credit cards grew by a larger 12%. Of those fees, the fees *other* than standard fees such as annual fees – 'mainly late payment fees, over-limit fees and foreign currency conversion fees' according to the Reserve Bank – grew by a whopping 16 per cent.[35] This clearly indicates a lack of competitive pressure on penalty fees in comparison with greater pressure to keep standard account-keeping and transaction fees lower. The main difference is that consumers expect to pay and thus take into account standard bank fees in making decisions about their banking needs.

Given these factors, we think there is a strong case for governments to further regulate penalty fees to ensure that they are not exploitative. Together with CHOICE, we have launched a consumer campaign that seeks to ensure such fees are fair.[36] We have also recently participated in the Senate Economics Committee inquiry into a private member's bill that proposes to provide ASIC with the power to investigate the fees and declare some fees invalid and/or set a maximum amount for fees, if considered appropriate. This would ensure some discipline on the fees, *which the market is unable to provide*, while continuing to allow for flexibility in the structure and amounts of such fees. We refer you to our submission to that inquiry,[37] but in summary, we consider that the bill, which allows for ASIC to regulate penalty fees where they become exploitatively high, should be adopted subject to some minor amendments.

In the consumer credit market, some consumers are pushed to use exploitative fringe lenders as the mainstream banks and non-banks view them as undesirable customers. This is generally due to their low-income status and/or a poor credit history. Exploitative fringe lending includes small amount pay day loans that have annualised interest rates of many hundreds of per cent. Mainstream banks and other credit providers do not provide appropriate, fair, small-amount credit products or if they do (such as some credit unions), they are not widely available.[38] This leaves vulnerable consumers with a lack of choice, despite the increased competition in the consumer credit market more broadly. Difficulties with expensive pay day loans are exacerbated by loans commonly being rolled over. This indicates that the loans do not alleviate consumers' financial problems.

We have recently provided a submission to the Victorian Government on the issue of pay day lending, which we refer you to.[39] In our view, the implementation of an effective comprehensive interest rate cap, similar to that which operates in NSW, the ACT and soon Queensland, would ensure that vulnerable consumers are not subject to exploitative charges for credit and would be the least-cost effective regulatory response. We recommend that a comprehensive interest rate cap be introduced as part of the enactment of the new national consumer credit laws. This would have the added benefit of ensuring national consistency so that Australian consumers are protected no matter where they live.

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[35] Reserve Bank of Australia, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, May 2008, pp.79-82.

[36] See www.fairfees.com.au.

[37] Choice and Consumer Action, Submission to the Senate Economics Committee Inquiry into the Australian Securities and Investment Commission (Fair Bank & Credit Card Fees) Amendment Bill 2008, April 2008, available at: http://www.aph.gov.au/Senate/committee/economics_ctte/asic_bankfees_08/submissions/sublist.htm.

[38] We note that the NAB is currently undertaking a pilot study about the provision of 'fair' loans in the fringe lending sector. We welcome this development and look forward to the results of the pilot. It should be noted, however, that this is largely being undertaking as part of NAB's corporate social responsibility agenda. See http://www.nab.com.au/About_Us/0,,94236,00.html.

[39] Consumer Action, Submission to Victorian Government Small Amount Cash Lending Inquiry, June 2008, available at: http://www.consumeraction.org.au/publications/other-publications.php.

Market studies and investigations powers

As a final matter, we note that in the UK the competition regulators have general 'market studies' and 'market investigations' functions and powers that are simply not available in Australia. These powers have given the UK regulators the ability to address problems within various markets, including the UK retail banking and non banking sectors. We consider they would be a valuable addition to the Australian competition regulatory scheme and would greatly assist in dealing with retail banking and non-banking problems.

To explain how the UK system works, the UK's independent competition and consumer protection regulator, the Office of Fair Trading (**OFT**), is able to undertake what are termed 'market studies' pursuant to section 5 of the UK *Enterprise Act 2002*. Further, the UK Competition Commission (**UKCC**) can undertake what are termed 'market investigations' under the same Act.

Market studies enable the OFT to examine market problems in any sector of the UK economy, and determine whether perceived problems should be addressed through the OFT's other functions.[40] They can take the form of a short preliminary review, a short study or a more detailed full study and after conducting a market study, the OFT can take a range of actions, including:

- publishing information to help consumers;
- encouraging firms to take voluntary action or adopt a code of practice;
- making recommendations to the Government or other regulators;
- taking enforcement action for breaches of consumer or competition law;
- making a market investigation reference to the UKCC (see below); or
- deciding that no further action is warranted.[41]

The *Enterprise Act* explicitly gives the OFT (and some other industry regulators) power to make a market investigation reference to the UKCC if they have 'reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK'.[42] For example, the OFT may consider that it should make a market investigation reference regarding features of a market after undertaking a market study.

After an investigation, if the UKCC finds any 'adverse effects on competition', it *must* take reasonable and practicable action to both remedy, mitigate or prevent the adverse effect on competition concerned and remedy, mitigate or prevent any detrimental effects on customers so far as they have resulted from, or may be expected to result from, the adverse effect on competition, by accepting undertakings or making various orders.[43] Some of the orders available to the UKCC include:

[40] Office of Fair Trading, *Guidance on the OFT approach: Market studies*, November 2004, p.4.
[41] As above, pp. 5-10, 13.
[42] *Enterprise Act 2002* (UK) s.131.
[43] As above, ss.138, 159-161.

- prohibiting charging prices differing from those in any published list or notification;
- regulating the prices to be charged for any goods or services;
- requiring a person to supply goods or services to a particular standard or in a particular manner; and
- requiring a person to publish a list of prices or otherwise notify prices for goods or services being supplied, and providing for the manner in which this information is to be published or otherwise notified.[44]

The OFT explains that these tools are used by the OFT when market forces cannot overcome threats to consumer welfare, for example where there are structural or behavioural barriers to free competition.[45] It has undertaken market studies on issues including debt consolidation, payment protection insurance and personal current bank accounts in the UK, and the studies have resulted in actions such as education campaigns for consumers, enforcement action, advice to the government to amend legislation and market investigation references to the UKCC.[46]

The UKCC has also undertaken a number of market investigations, including into store card credit services, Northern Irish personal banking services and payment protection insurance, with some of these following market studies by the OFT.[47] As an example of the results that can be achieved, the store credit investigation resulted in store card credit providers being required to warn cardholders on monthly statements that cheaper credit may be available elsewhere (where annual percentage rates are 25 per cent or above), and to offer an option to pay by direct debit and offer payment protection insurance separately from other elements of store card insurance.[48]

An excellent recent example of a market study is the OFT's study of the UK personal current bank account market, released on 16 July 2008. It has found that the market as a whole is not working well for consumers, with very low rates of switching between accounts due to the complexity of determining the best deal on fees and the problems that can occur when switching, for example the incurring of penalty fees.[49] The findings support our earlier arguments about switching problems in the Australian banking sector, and we note the OFT has come to a provisional view that while market forces are generally the preferred option, in this case some form of regulatory intervention is necessary.[50]

The UK market studies and investigations powers have resulted in a variety of important investigations and a large range of different and considered actions to fix problems. Thus in a 2003 report comparing the different consumer policy regimes of various countries, including the UK, the US, Canada and Australia, the UK Department of Trade and Industry

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[44] As above, schedule 8.
[45] Office of Fair Trading, *Annual Plan 2007–08*, March 2007 p.8.
[46] See Office of Fair Trading, *Market studies*, webpage, available at: www.oft.gov.uk/advice_and_resources/resource_base/market-studies/.
[47] Competition Commission, *Market references to the Competition Commission (previously monopoly references): 2000-2007*, webpage, available at: www.competitioncommission.org.uk/inquiries/reference_type/market.htm.
[48] Competition Commission, *Store Cards Market Investigation Order*, 27 July 2006.
[49] Office of Fair Trading, *Personal current accounts in the UK: An OFT market study*, July 2008.
[50] As above, p.111.

concluded that, while it could make improvements in many areas, the UK was amongst the best in terms of investigating markets that are not working well for consumers.[51] Australian law contains no similar provisions, meaning the Australian Competition and Consumer Commission and ASIC are unable to undertake these important studies and investigations where market problems and their solutions are not immediately obvious.

Our recommendation is therefore that the Australian Government introduce market studies and investigations powers, based on the model in the UK *Enterprise Act*, into Australian law.

If you would like to discuss any matters raised in this submission please contact us on 03 9670 5088.

Yours sincerely
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[51] Department of Trade and Industry UK, *Comparative Report on Consumer Policy Regimes*, October 2003, p.33.