consumer action law centre

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

Senate Economics References Committee
Suite SG.64
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee members

Inquiry into the post-GFC banking sector

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to contribute to the committee's inquiry into the post-GFC banking sector.

Rather than responding to each point of the Committee's terms of reference, this submission makes the following brief points:

- that the development of an independent measure of the cost of bank funding (including offshore wholesale funding, and deposits), regularly reported by a reputable source, may help resolve consumer frustration about home loan pricing; and
- that consumer search and switch costs have a considerable impact on competition, and that there are a number of limitations in the Government's proposed account switching package which should be reconsidered during the package's post-implementation review.

Our comments are detailed more fully below.

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.

We also operate MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians experiencing financial difficulty.

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Transparency of bank funding costs

We refer to item (c) in the Inquiry's terms of reference, the current cost of funds for lending purposes. In our view, more needs to be done to help consumers understand costs of funding for lenders. If these costs were made more transparent, we believe consumers would be better equipped to choose between lenders and would have more faith in bank pricing decisions.

It is now a regular occurrence for consumers and media outlets to loudly condemn any lender who fails to reduce their mortgage rates in line with a fall in the RBA cash rate, or who increases their prices without an increase by the RBA. The banking industry responds that these complaints are overly simplistic because their pricing decisions are based on many factors other than the RBA cash rate, such as the cost of international funds. Those comments then prompt a debate where some commentators defend the banks[1] while others disagree and accuse the banks of profiteering.[2] Consumers are further confused and frustrated when banks take a different approach to savings or credit card interest rates. For example, it is entirely unclear on what basis credit card interest rates are changed. For savings interest rate accounts, it seems banks are quick to pass on the full value of RBA cash rate cuts, while they are slow to increase rates should the cash rate increase.

Throughout this process most consumers will have no way of telling whether a bank's funding is becoming more or less expensive. Many will not be convinced by the arguments made by the bankers, partly because they distrust the banks but mostly because they—understandably—have little knowledge of how banks fund loans. This being so, many consumers will continue to focus on the RBA cash rate (the factor they are aware of) and reasonably query why rates offered by banks do not move parallel to the RBA rate.

This is a problem for consumers because without understanding how banks price loans, they are less able to assess which lenders they should buy their loans from. It is also a problem for lenders, because it entrenches the distrust many consumers have for banks.

We recommend that an independent measure of the cost of funding (including international wholesale funding and local deposits), regularly reported by a reputable source (perhaps the RBA) could help resolve these problems. By removing some of the mystery behind loan pricing, consumers would be better placed to judge if rates offered reflect funding costs and apply competitive pressure on lenders. In turn, this may improve public opinion of the banking sector if the new information allows consumers to see more clearly how banks come to pricing decisions.

Competition reforms

Any inquiry into the shape of the post-GFC banking sector should include consideration of the competitiveness of banking in Australia on the demand side. In particular, we think it is worth looking at the search and switch costs currently faced by consumers and how they affect the ability of consumers to drive competition.

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[1] For example, see Terry McCrann, 'Bashing the banks could bash you', *Herald Sun*, 31 January 2012.
[2] For example, see Ian Verrender, 'They're having a lend of us', *Sydney Morning Herald*, 17 April 2012.

Active consumers are a necessary pre-condition of a competitive market. True competition does not flow only from supply side participants undercutting each other on price—it can only occur where consumers are informed and confident, where they are able to locate, understand and choose between the options available in a market, in a manner that genuinely reflects their interests and preferences.

It follows that the presence (or absence) of searching and switching costs can have a considerable impact on the competitiveness of a market. In the UK, writers such as Waterson, Waddams and Klemperer have discussed the effect of barriers to consumers effectively exercising their power in the marketplace, particularly search and switching costs.[3] 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.[4] 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.[5]

It is for this reason we have supported proposals to minimise search and switch costs in the banking market. In particular, we welcomed initiatives introduced by this Government to prohibit exit fees on home loans and require the provision of key facts sheets for new home loan customers.

However, we have been disappointed by the Government's bank switching package[6] which is limited in that:

- **the switching process currently being developed will not allow consumers to switch accounts by signing one form, as proposed by Bernie Fraser's report[7] and described by the Treasurer when he announced the scheme[8].** As far as we understand, the scheme being developed will require a consumer to sign two authorities

[3] See for example M. Waterson, *The Role of Consumers in Competition and Competition Policy*, University of Warwick Economic Research paper no.607, 2001; P. Klemperer, ‗Competition when Consumers have switching Costs: An Overview with Applications to Industrial Organization, Macroeconomics, and International Trade', (1995) 62 R*eview of Economic Studies* 515–539; C. Waddams, M. Giulietti & M Waterson, ‗Consumer Choice and Industrial Policy: a study of UK Energy Markets' (2005) 115 *The Economic Journal* 949-968.
[4] Waterson, as above, p.7.
[5] Waterson, as above, pp.4-5.
[6] For an overview of the switching proposal, see Wayne Swan, 21 August 2011, 'Taking the headache Out of Switching Bank Accounts', media release. Accessed from: http://www.treasurer.gov.au/wmsDisplayDocs.aspx?doc=pressreleases/2011/095.htm&pageID=003&min=wms&Year=2011&DocType=0
[7] Australia (2011), *Banking Services: Cost-Effective Switching Arrangements,* p 14. Accessed from: http://archive.treasury.gov.au/banking/content/reports/switching/downloads/switchingarrangements_aug2011.pdf
[8] Swan 2011.

on different occasions. This adds more barriers and complexity to the process than we believe is necessary, and will result in consumers dropping out of the switching process;

- **the streamlined switching process only applies to deposit accounts**. To be effective, the reforms will need to apply to other types of accounts and to credit cards in particular. Consumers experience the same barriers to switching credit card accounts as they do with transaction accounts, and are increasingly using direct debit and direct credit arrangements in relation to credit card accounts. Even with transaction accounts, consumers commonly provide merchants with a scheme debit card number to facilitate regular direct debits—it is our understanding that such regular payments will be outside the scope of the current reforms. In our view, this is unacceptable and will mean that the switching reforms will be ineffective in practice. A large number of consumers with different types of accounts with the same lender (often bundled into a package), will not benefit from a simplified process;

- **the Government provided no meaningful reform regarding Lenders Mortgage Insurance (LMI) portability.** Rather than introducing a scheme for transferring LMI when borrowers switch lenders, the Government has committed to a key facts sheet which the Treasurer says will:

> ...allow consumers to compare quotes side-by-side, including the difference in premiums and rebate schedules, helping them get the deal that's right for them. This will help home buyers compare apples with apples when it comes to shopping for lenders' mortgage insurance.[9]

We fail to see the point of this response. We support the introduction of key facts sheets where consumers need to make a choice between many providers and complex products and would struggle without simplified disclosure. But, unlike other banking products, LMI is chosen by lenders, not consumers. There is no value in a consumer being able to compare products when they have no choice about which one they buy. The initial proposal was to develop a framework to transfer LMI when a consumer switches home loans, as a requirement to obtain LMI with a new loan might act as a disincentive to switching[10]. This approach was abandoned as it was deemed to benefit only a minority of borrowers, but it is unclear on what analysis this decision was made.[11]

One of the most significant consumer misunderstandings about LMI relates to the fact that it insures the lender and not the borrower. We are not aware of other circumstances where a consumer pays for insurance, but receives no direct benefit, so the confusion is understandable. Indeed, from a consumer perspective, it is not an insurance at all, but rather a fee paid to their lender that it passes on as an insurance premium to the LMI provider. Given this, and given that the intention of the LMI fact sheet is to improve consumer understanding, we believe a better proposal would be to change the name of LMI when it is represented to consumer.

[9] Swan 2011.
[10] Australian Government (2010), *Competitive and Sustainable Banking System,* http://archive.treasury.gov.au/banking/content/reports/announcement/downloads/competitive_and_sustainable_banking.pdf, page 9.
[11] Swan 2011.

As the LMI is generally charged where a consumer has paid a deposit of less than 20 per cent, we suggest that the fee be named "high loan-to-value ratio fee", "high risk loan fee", or "low equity lender protection fee". If it was felt that the term "insurance" should be used, then another alternative might be "low equity lender insurance". We feel that these names more accurately reflect the purpose of the fee from a consumers' perspective and would serve to inform consumers about the nature of the fee.

While the new switching mechanism will benefit some consumers, it has failed to address a number of barriers to switching which will lead consumers to abandon (or never begin) a switching process, continuing frustration with banks and stifling competition. We understand that there are plans to review the success of the switching package after it has been implemented. We recommend that that review:

- consider how successful the two stage process has been and whether there are any genuine barriers to having a one stage process;
- start a process of extending the streamlined switching arrangements to other types of account, in particular credit cards; and
- consider more openly and in more detail the issue of consumer understanding of LMI and LMI portability.

Please contact David Leermakers on 03 9670 5088 or at david@consumeraction.org.au if you have any questions about this submission.

Yours sincerely
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