Submission to the

SENATE ECONOMICS LEGISLATION COMMITTEE

Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010

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Executive Summary

The Secretary of the Senate Economics Legislative Committee on Banking Amendment (Delivering Essential Financial Services for the Community) Bill advised that the Committee is interested in having a submission from me on the guarantee scheme. Accordingly, I am making this submission.

The Bill proposes four proposals, that is, introduction of fee free basic account, ATM fees changes, introduction of fixed interest gap mortgages and full disclosure of termination fees. I have addressed each of these proposals, provided relevant analysis and summarized my opinion.

As for the first proposal of introduction of fee free basic account while the proposal seems appealing, one can't altogether to ignore the provider's perspective. I compare the features of 'no-frills' account offered by the HSBC bank in India with the features of the basic bank account proposed in the Bill. While I support the proposal in the Bill, I believe some flexibility would need to be given to providers.

The second proposal seems to do away with ATM fees and bring the Australian ATM charging system in line with that prevailing in the UK and France in so far as basic accounts are concerned. However, it is possible that bank customer would open multiple bank accounts including a basic account so as to take advantage of the fee free, penalty free, ATM usage free account. Also ATM providers would have to recover the capital and operational cost of the ATM from some other sources. I provide support to this proposal with a caveat.

The third and the fourth proposal are straight forward and I support these. For proposal three, I suggest that we use official cash rate as the benchmark rate though.

1. Introduction

The Bill is aims at introducing a 'no-frills' or basic bank account, changes in ATM fees, fixed interest gap mortgages and disclosure of early termination fees. The Bill raises several issues. My comments on each of the proposals in the Bill are recorded below:

2. Analysis of the proposals in the Bill

Proposal 1: Part I (section 2 to 6): Introduction of Basic Account

The Bill proposes that banks introduce a basic account which should have certain features like provision of deposit, withdrawal and transfer services, internet access, ATM card or EFTPOS card linked to the account a debit card linked to the account suitable for use in credit card transactions; free of: ongoing service fees such as monthly account service fees; and penalty fees for actions and transgressions of third parties; and free of any penalty fee for a breach of a term of the contract by the account-holder.

Analysis of Proposal 1:

What the Bill has proposed is introduction of what are known as 'no-frills' bank accounts. For example, the HSBC bank offers such an account in the Indian banking market. It will be interesting therefore to compare the features of the HSBC 'no-frills' account with the basic account proposed in the Bill. Such a comparison has been attempted in attached Table 1. The features of the HSBC 'no-frills' accounts are available online (http://www.hsbc.co.in/1/2/personal/bank-accounts/accounts-service-charges-and-fees#frills).

Comments on Proposal 1:

As can be seen from the table, the proposal is seeking more concessions from banks for Australian consumers than the deal available to consumers in India. To be realistic even if Australian consumers could get a deal similar to what the Indians have, then in my opinion, it would be a great step forward.

I support the proposal of introduction of 'no-frills' bank account with features as outlined in the Bill. However, some flexibility would need to be accorded to the providers so that they are not short-changed in the process.

Proposal 2: Part I (7 to 10): ATM fees

Under these sections, the Bill seeks that (a) usage of own-branded ATMs should be fee free for account holders of the ATM card issuing bank (ACIB) and (b) the fee free usage of foreign ATMs by its own customers and by customers of other banks of its own ATM, that is, on a reciprocal basis. It also proposes certain stringent requirements before levying of fee for ATM usage by any bank for its own or 'foreign' customers such as applying to APRA and getting express permission to do so.

Analysis of Proposal 2:

The above proposal seeks to create a system of ATM usage which is similar to the UK and France where banks don't levy any usage fee. Since the introduction of interchange fee reforms, in Australia, customers pay a 'foreign fee' for using an ATM of another bank.

Pricing of ATM usage involves two sets of costs: wholesale level and retail level. At the wholesale level, banks could decide among themselves the interchange fee to be charged. This could, however, lead to collusion as the fees aren't transparent. Consequently, in Australia and South Africa regulators replaced 'interchange fee' with 'direct charging system' in which a fee is levied on customers for 'foreign ATM' usage.

Countries like the US and Canada charge card holders twice, that is a usage fee as well as a surcharge for 'foreign ATM' usage. Though the cost of such double dipping has been found to be high (approx USD 3) by Hayashi et al (2006), the ATM providers claim that it has allowed them to expand provision of ATMs leading to more convenience to the customers and consequent lesser transaction costs.

Latest statistics by the Bank for International Settlement seems to confirm the above claim as can be seen from Table 2 below:

Table 2: Number of terminals per million inhabitants

	2005	2006	2007	2008	2009
Canada	1627	1700	1748	1799	
US	1334	1318	1355	1336	
UK	968	998	1040	1041	
Australia	1151	1189	1219	1194	1235

(Source: For Canada, US and UK- BIS Statistical Tables. For Australia: Author’s calculations. ATM numbers are obtained from Australian bankers association website. Population figures in million from ABS catalogue 3101. 20.394 (2005), 20.697 (2006), 21.072 (2007), 21.498 (2008) and 21.955 (2009)).

Table 3: Growth of ATMs in Australia

Jun-05	23,472	8.9%
Jun-06	24,616	4.9%
Jun-07	25,681	4.3%
Jun-08	25,658	-0.1%
Jun-09	27,108	5.7%

(Source: Australian Bankers’ Association website)

As can be seen from Table 2, countries like Canada, US (except 2008) have which follow the direct charging system have shown a rise in ATM numbers while in UK where ATM transactions are free the ATM numbers appear to be stagnated. In Australia, after introduction of direct charging regime the number has significantly increased to 1235 per million inhabitants. Removal of direct charging may have adverse consequences for consumer welfare in terms of higher transaction costs.

A study by Donze and Dubec (2009) present a mathematical model (not empirical) that classifies three different regimes as under:

Regime I: Full prohibition: ATM usage fees are prohibited (that is fee usage for customers). Banks typically charge account keeping fee to customers (as in UK and France)

Regime II: Partial Prohibition: that is only surcharges are prohibited (as in Australia and South Africa)

Regime III: No prohibition: The case with foreign fees and surcharges (as in the US and Canada).

These authors find that 'regime one is the most profitable for banks and the worst for consumers because the collusive power of the interchange fee is only limited by the participation constraint of the marginal consumer' (Donze and Dubec, 2009, p. 603). The authors state that the mathematical model is consistent with empirical study by Knittel and Stango (2009) based on US data.

In effect what the Bill proposes is that in respect of basic account banks switch back to Regime I, but at the same time NOT charge any account keeping fee. The proposal is likely to erode bank profits and may meet with vehement opposition from the banks.

There could be two ways out of this situation for banks:

A. If we accept the Bill as it is consumer may have to agree to keep prescribed minimum account balances interest free. This hard core in the account would give opportunities for the banks to utilize the idle cash in profitable ventures and thus subsidize the cost incurred on provision of a fee free basic account.
B. To load the cost of running the 'fee free' basic accounts on 'non fee free' basic accounts.

One difficulty with the Bill is that it doesn't stop 'with fee' account holders from opening 'fee free' account and use the 'fee free account' for ATM purposes.

If the objective is to help socio-economically vulnerable customers then it may be necessary to restrict the basic account opening only for customers with income below a certain threshold. It may be easier to administer this for salaried consumers but harder for non-salaried consumers.

Comments on Proposal 2:

The proposal is frost with several practical difficulties as outlined above. It may be easier to get a concession from banks if the basic account is restricted to socio-economically vulnerable group of consumers only. I would support the proposed arrangement for such groups.

Proposal 3: Part 2 (2): Fixed Interest Gap Mortgages

To offer fixed interest gap mortgages to existing and prospective customers; and to develop its own formula for the benchmark base rate that it will offer to customers under a fixed interest gap mortgage.

Analysis of proposal 3:

The idea here seems to be to offer fixed interest gap mortgages for the life of the loan. Currently, banks offer fixed interest mortgage loans for say 3 to 5 years. While fixing the rate banks do take into account their benchmark base rate and the refinancing risk premium. They also take into account the likely changes in the official cash rate. Compared to variable rate loans, bank would make a loss in advancing fixed rate loan if the variable interest rates rise. Consequently, banks would take into account several factors before agreeing for a fixed interest mortgage.

Instead of asking the bank to develop its own formula for the benchmark rate (which the banks would already have), it would make more sense if the fixed interest gap rate mortgage is related to the official cash rate. For example, the standard variable mortgage rate used to be 180 basis points (or 1.80 percent) above the official cash rate for many long years. During the crisis however the gap has widened to 280 basis points. Currently the gap is 290 basis points[1]. Even when official cash rate was falling banks refused to pass on full reduction in the official cash rate to mortgage borrowers. However, when official cash rate started rising banks increased mortgage rates beyond the official cash rate rise. In both circumstances, banks cited rising funding cost as the reason.

Comment on proposal 3:

I support the proposal with an amendment that the base benchmark rate needs to be the official cash rate rather than the rate decided by the banks themselves.

I would particularly support the proposal for members of the society that belong to the socio-economically vulnerable groups.

[1] The standard variable home loan rate in June 2010 was 7.40 per cent. The cash rate was 4.50 per cent (source: RBA statistical tables Table F5. Available online at RBA website). Accordingly, the gap is 290 basis points.

Proposal 4: Part 3—Exit fees on mortgages

The Bill proposes that early termination fees be fully disclosed up front.

Analysis of proposal 4

Any party entering into a contract should be fully aware of the financial and other implications of signing up of the contract.

Another issue though not raised in the Bill is the product disclosure statements sent to consumers under the *Financial Services Reform Act 2001.* It is easily possible to hide important details in a maze of information.

Service providers be mandated to provide an executive summary highlights of the product disclosure statement. Just as in all legislations, the contents in brief are presented up front similar arrangements should be put in place so that the consumer is aware of what s/he is signing for.

Comment on proposal 4:

I fully support the full disclosure of early termination fees upfront as proposed in the Bill.

As a matter of fact in my submission to the Senate Inquiries on Bank Guarantee and Banking Act Amendment (Keeping Banks Accountable) Bill, I suggested that all fees, funding costs and lending rates should be fully disclosed by banks and that RBA and APRA should collect this information and make it publicly available periodically.   The Senate Inquiry was kind enough to accept that suggestion which is included in the final report. I reiterate this again.

3. Summary

I fully support the disclosure of termination fee. I also support the fixed interest gap mortgage with a suggestion to use official cash rate as the benchmark rate. As for ATM fees and basic bank account, the proposals are frost with several difficulties. These have been discussed and possible line of action has been suggested.

References

Donze, J. and I. Dubec (2009) Paying for ATM Usage: Good for consumers, Bad for banks? *The Journal of Industrial Economics,* vol. L VII (3), pp. 583-612.

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Knittel and Stango (2009) Knittel, C. and V. Stango (2009) 'How Does Incompatibility Affect Prices?: Evidence from ATMs,' *The Journal of Industrial Economics,* vol. L VII (3), September.