ASIC

Australian Securities & Investments Commission

Senate Standing Committee on Economics inquiry into matters relating to credit card interest rates

Submission by the Australian Securities and Investments Commission

August 2015

Regulation of credit cards: ASIC's role

1 The Australian Securities and Investments Commission (ASIC) is Australia's corporate, market, financial services and consumer credit regulator.

2 As part of our responsibility for regulating consumer credit, we administer:

(a) the responsible lending obligations, which apply to all forms of regulated credit, including credit cards; and

(b) a number of obligations that apply specifically to credit cards.

3 Because our mandate does not currently extend to competition, we are not in a position to directly comment on the key focus of the Senate Standing Committee on Economics inquiry into matters relating to credit card interest rates (Senate inquiry), which is the economic effect of the difference between cash rates and credit card interest rates.

4 However, a related issue of concern that does fall within our consumer protection objective is the likely detrimental impact on consumers, who are at or near their credit limits, of over-borrowing and under-repayment of high-interest credit card debts.

5 This submission to the Senate inquiry describes:

(a) the legislative framework for consumer credit, which ASIC administers;

(b) our policy, compliance and educational work on credit cards;

(c) an outline of the main costs to consumers associated with the use of credit cards and particular issues of concern with these costs; and

(d) behavioural economics insights relevant to these issues.

ASIC's jurisdiction: The legislative framework for consumer credit

National regulation of consumer credit

6 ASIC commenced the regulation of consumer credit, including credit cards, on 1 July 2010 under the *National Consumer Credit Protection Act 2009* (National Credit Act).

7 Before 1 July 2010, consumer credit was primarily regulated by the states and territories, with the transfer of jurisdiction to the Commonwealth following a series of recommendations from various sources. These included a 2008 report by the Productivity Commission[1] and an inquiry into home

[1] Productivity Commission, *Review of Australia's consumer policy framework*, April 2008.

lending by the Standing Committee on Economics in 2007[2] in response to concerns that credit was too easily available and that many Australians were over-committed and facing financial hardship.

8 Central elements of the National Credit Act include:

(a) the introduction of a licensing regime that imposes minimum standards of conduct for credit industry participants; and

(b) responsible lending obligations, which mandate that credit licensees must make inquiries into a consumer's:

(i) requirements and objectives for the credit contract; and

(ii) financial situation and verify that financial situation.

9 Lenders must also comply with the Sch 1 to the National Credit Act (National Credit Code)—which largely mirrors the now-superseded Uniform Consumer Credit Code (UCCC)—together with some key enhancements, including greater access to assistance for consumers in financial difficulty.

10 The licensing framework and responsible lending obligations in the National Credit Act work in partnership with the obligations in the National Credit Code to provide a more explicit regulatory framework—specifying what credit providers and intermediaries must do before providing credit.

Responsible lending

11 The responsible lending obligations in the National Credit Act apply to all forms of regulated credit, including credit cards. These obligations require credit licensees, who may be credit providers or credit assistance providers, to do certain things before providing a credit card to a consumer or increasing the credit limit of an existing credit card.

12 These processes include:

(a) making reasonable inquiries about the consumer's requirements and objectives, their financial situation, and the maximum credit limit that a consumer requires (this last obligation applies only to credit providers);

(b) taking reasonable steps to verify the consumer's financial situation; and

(c) making a preliminary assessment (for credit assistance providers) or a final assessment (for credit providers) about whether the credit contract is 'not unsuitable' for the consumer (based on the inquiries made and information obtained in the first two steps).

[2] House of Representatives Standing Committee on Economics, *Inquiry into home loan lending practices and the processes used to deal with people in financial difficulty*, September 2007.

Credit card reforms

13 The following obligations that specifically apply to credit cards were introduced by the *National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011* and associated regulations:

(a) *Key facts sheet*: A key facts sheet must be included in credit card application forms. It must set out how minimum repayments are calculated, the interest rates that will apply, and any interest-free periods and fees (annual and late fees). This information was intended to enable consumers to compare key features of credit card contracts between providers and assist them to minimise the fees and interest they have to pay.[3]

(b) *Prohibition on unsolicited offers to increase card credit limits:* Credit providers are prohibited from sending written invitations to consumers to apply to increase their credit card limit unless the consumer has previously provided their consent. Such unsolicited invitations can lead to consumers increasing their credit limits to levels that become difficult to repay and incur large amounts of interest. The prohibition is limited to written invitations, and to applications for limit increases on an existing credit card facility.

(c) *Use of credit cards in excess of credit limit:* Credit providers cannot charge a fee, charge or higher interest rates when a person exceeds their credit limit on a credit card contract unless they have obtained the consumer's consent. Credit licensees must also notify consumers within two business days where their credit limit has been exceeded, although only the first time this occurs during a statement period.

(d) *Allocation of repayments on credit cards:* For credit cards issued after 1 July 2012,[4] credit card repayments must be allocated towards those portions of the balance to which the highest interest rate applies. A consumer may ask for a different repayment allocation to apply, which the credit licensee may or may not agree to. This requirement prevents licensees from maximising interest payments by allocating repayments for the benefit of the licensee. Standardising this allocation also allows for easier comparison between credit cards.

(e) *Minimum repayment warning on monthly credit card statements:* This warning highlights to consumers the length of time it would take to repay their credit card balance and the total interest they would pay if they only make the minimum monthly repayment. The warning also

[3] Explanatory Memorandum to the National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Bill 2011.

[4] Although some credit card issuers have applied the new 'allocation of repayment' rules to credit cards issued before 1 July 2012, not all credit card issuers have done so.

includes an alternate repayment amount that would repay the balance in two years, the interest payable under this option and how much this would save compared to the minimum repayment. The alternate repayment amount is only included if the balance could not be paid off in two years by making the minimum monthly repayment. The consumer is encouraged to contact the credit provider if they are having difficulty making repayments and contact details are provided. The warning is included on each of the regular account statements.

Scope of focus of this inquiry

14 We have not responded to all terms of reference in the Senate inquiry as ASIC does not currently have a mandate to consider or regulate competition. Our role in relation to credit cards is grounded in the legal framework outlined above, with our activities on credit card interest rates focusing on disclosure of rates, fees and charges, rather than the interest rate itself.

15 We note recommendation 30 of the Financial Services Inquiry's final report, that consideration be given to include competition in ASIC's mandate.

ASIC's regulatory and educational activities

Policy and guidance

16 Our primary guidance on responsible lending is set out in Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209). RG 209 gives guidance to credit licensees on our interpretation of the responsible lending obligations and how licensees may comply with the law.

17 This guide also applies to credit cards, with several examples and issues specifically focusing on credit cards.

Compliance and enforcement action

18 Since the transfer of consumer credit regulation to ASIC in 2010, we have taken action against three credit licensees in relation to their activities around obtaining consumers' consent to send credit card limit increase invitations.

(a) *GE Capital Finance Australia* (GE Money): In 2014, the Federal Court ordered GE Money to pay a $1.5 million penalty for making false or misleading representations to more than 700,000 of its credit card customers.

(b) *Commonwealth Bank of Australia* (CBA): In 2012, we accepted an enforceable undertaking from the CBA due to concerns that a message sent to CBA internet banking customers was misleading. The message sought customers' consent to receive invitations about credit card limit increases. CBA agreed not to rely on the consents obtained and to contact each customer who provided consent over this period to correct the misleading impression and inform them of their rights.

(c) *Westpac Banking Corporation* (Westpac): In 2012, Westpac withdrew and modified messages sent to customers about credit card limit increases following ASIC concerns they were misleading

19 Other action we have taken on credit cards in recent years includes:

(a) obtaining agreement from ALDI in 2014 to improve signage and other point-of-sale communication for disclosing credit card surcharges; and

(b) undertaking a review in 2015 of travel insurance provided through credit cards, which led to improvements being made by card issuers and insurers in relation to these products.

Financial literacy

20 ASIC's MoneySmart website provides resources to assist consumers with the selection and management of credit cards, including:

(a) tips on how to choose an appropriate credit card and how to use it to avoid fees and charges; and

(b) a credit card calculator to help consumers calculate how much they could save by making more than minimum repayments.

Cost to consumers of using credit cards

21 The Senate inquiry's terms of reference seek information about the costs to consumers associated with credit cards.

22 Other than interest, the main costs to consumers include:

(a) fixed fees that relate to holding a credit card (e.g. annual fees and additional cardholder fees);

(b) transaction-specific fees (e.g. cash advance fees and international transaction fees);

(c) fixed fees for breach of contract (e.g. late fees and over-limit fees);[5] and

(d) costs incurred other than under the contract (e.g. merchant surcharges).

[5] Credit card reforms introduced in 2011 may have reduced the amount of over-limit fees being charged.

Application of interest

23 Interest payable on credit card debts is often the most significant cost associated with credit cards for consumers.

24 Most credit card products come with a feature that allows consumers to avoid paying interest on purchases if they pay the account in full by the due date every month. This is typically advertised as ‘up to XX days interest free on purchases’ (accompanied by a disclaimer that describes the conditions for interest-free purchases). A consumer will incur interest on their credit card purchases if they either do not pay the full balance in the month or pay after the due date. Interest free periods do not apply to cash advances or like transactions.

25 Where a consumer does not satisfy the conditions for interest-free purchases, they will be charged interest on purchases from the date that the transaction was first made (and not from the date that the payment was due). If the consumer continues to pay less than the full balance, interest will be accrued on the daily balance and charged monthly, as is done with almost all consumer credit facilities.

26 The ability to pay less than the full balance each month (with minimum repayments that can be as little as 2% of the balance) provides flexibility to consumers. For example, a consumer may make a large household purchase (e.g. a television) and wish to pay it off over a number of months. Likewise, a consumer may incur a large number of expenses in a particular month and decide to only pay the minimum monthly payment on the credit card in that month in order to free up their cash.

27 Such flexibility is one of the key product benefits of a credit card. It accommodates the behavioural bias ‘mental accounting’ (peoples’ habit of separating money into separate accounts or categories based on subjective criteria, rather than viewing available money as a total net amount).

28 However, given the relatively high interest rates that credit cards attract, we are concerned about the impact of high interest rates on that cohort of consumers who consistently pay less than the full balance because of over-indebtedness.

Issues of concern

29 We consider that perhaps the most significant problem associated with high interest rates on credit cards is that some consumer segments may have difficulty repaying their credit card debt and may possibly face substantial hardship. This is not caused by high interest rates in themselves, but by the fact that some consumers over-borrow and under-repay large amounts of credit card debt (to which that high interest is applied). For example, some consumers who are at or near their credit limit may take up credit card issuer

invitations to increase their limit.[6] These consumer may not be using their credit cards to manage cash flow month to month, but as borrowing facilities to take on significant amounts of ongoing debt, which they have little prospect of discharging in the short or medium term.

30 In other words, some consumers may be using credit cards when other products (such as affordable personal loans) may be more appropriate.

31 We note that, at this stage, these concerns are based on anecdotal evidence and that further investigation is warranted to determine the extent and impact, if any, of the issues raised.

32 If it is determined that there is an underlying problem for consumers, then the issues that warrant attention are not necessarily just high interest rates in and of themselves but also:

(a) the patterns of use by consumers of high-interest credit cards when other facilities (such as affordable personal loans) may be more appropriate; and

(b) the practices of industry in structuring credit cards and other relevant products and promoting these products to particular consumer segments.

Insights from behavioural economics

33 Item (f) of the Senate inquiry's terms of reference asks how consumer choice of credit card products can be improved, with reference to practices in other jurisdictions.

34 This section draws attention to behavioural economics research that may usefully inform this aspect of the Senate inquiry.

35 Behavioural economics seeks to understand the different, and often unconscious, biases that drive decision making and behaviour. It is based on empirical research from different fields—including finance, economics and psychology—and is increasingly being employed by regulators and policy makers in many different fields in Australia and internationally.

36 Behavioural economics is particularly relevant to the selection and use of credit cards, as this is an area in which consumer choice:

(a) can be driven by behavioural biases; and

(b) is made more difficult by the complexity of the products. Credit cards are at least two products in one—a non-cash payment facility and a credit facility, plus a means of withdrawing cash. They are also often

[6] Credit card issuers can still issue a credit limit invitation to a consumer if they have previously obtained their consent.

bundled and marketed with other financial products (such as insurance) and loyalty points, which make it more difficult for consumers to separate the price and value to them of each feature. This is particularly the case when some of the costs and benefits are immediate and others are realised in the future.

37 Behavioural economics research and analysis describes how underlying behavioural biases drive particular segments of consumers to make sub-optimal financial decisions about which credit cards are most appropriate to meet their needs. Examples include the following:

(a) *Optimism*: 'In certain contexts [optimism] is a rational, normal process of human thinking but [it] can affect adversely the ability to estimate future repayment capacity. Optimistic consumers underestimate or are blind to factors that can impede repayment of their credit card balances.'[7]

(b) *Present bias*: Present-bias is our tendency to make choices that are inconsistent over time. We make choices today that our future selves would prefer not to have made, despite relying on the same reasoning. In this way we place greater weight on costs and benefits that are more immediate when making decisions. Consumers who are present-biased are more likely to have a credit card debt, and also borrow more than their time-consistent peers for this reason. For example, a US study found that present-biased individuals are 15% more likely to have a credit card debt and to have a significantly higher credit card debt than others.[8]

(c) *Salience:* Information that stands out, is novel or seems relevant (e.g. price incentives, such as loyalty programs, and access to interest-free periods) is more likely to affect our thinking and actions. A research study commissioned by the Reserve Bank of Australia found these two price incentives increased the probability of credit card use at the expense of debit cards and cash by 23 and 16 percentage points respectively.[9]

(d) *Imperfect self-control*: 'Consumers may initially plan to repay credit card balances in full and on time, but imperfect self-control (exhibited in behaviours such as incremental indebtedness, temptation and hyperbolic discounting) over time leads to unmanageable debt.'[10]

[7] P Ali, CH McRae & I Ramsay, 'Consumer credit reform and behavioural economics: Regulating Australia's credit card industry', *Australian Business Law Review*, vol. 40, 2012, pp. 126–133.
[8] S Meier & C Sprenger, 'Present-bias preferences and credit card borrowing', *American Economic Journal: Applied Economics*, vol. 2, 2010, pp. 193–210.
[9] J Simon, K Smith & T West, *Price incentives and consumer payment behaviour* (RDP 2009-04), Reserve Bank of Australia research discussion paper, 2009.
[10] P Ali, CH McRae & I Ramsay, 'Consumer credit reform and behavioural economics: Regulating Australia's credit card industry', *Australian Business Law Review*, vol. 40, 2012, pp. 126–133.

38 Insights such as these suggest that, for example, people with strong optimism or present biases might begin with the intention of always paying off their balance in full and, based on this intention, may disregard the interest rate on a card in the belief they will not need to pay any interest. A 2013 survey by CHOICE found 48% of respondents who had used a credit card in the last three months did not know or were unsure of what their purchase interest rate was, despite the fact this is one of the most salient features of most credit cards.[11] Consumers might therefore choose between cards on the basis of more immediate benefits, such as balance transfer periods or rewards points.

39 Some consumers may also be overly sensitive to low introductory interest rate offers, because they underestimate the probability that they will later borrow at higher rates once the introductory rate has expired.[12]

40 If consumers incur credit card debt that they unable to repay in the short or medium term, the interest that will be charged is likely to cost the consumer significantly more than the value provided by the features and benefits on which they based their decision.

41 This raises the question of how lenders structure and promote their products in the context of these behavioural biases.

42 We note that:

(a) credit cards may be being marketed primarily as payment systems, eclipsing the borrowing component of the products;

(b) credit card issuers may compete and market on product features rather than price; and

(c) the availability and promotion of affordable small personal loans may be limited.

43 We have not yet investigated how industry structures these products or what drives their decisions.

44 If the practices set out in paragraph 42 are substantiated, it is likely that current industry practices and the predictability of behavioural biases impede the potential for demand-side competition to drive some consumer segments to switch from high-rate to low-rate cards or other more appropriate products.

45 We note that some insights consistent with behavioural economics have already been applied in the context of recent reforms, although the

[11] CHOICE, *Almost half of Australians do not know their credit card rate*, media release, 28 June 2013.
[12] S Agarwal, S Chomsisengphet, C Liu & NS Souleles, *Do consumers choose the right credit contracts?*, Center for Financial Studies working paper No. 2005/32, November 2005.

effectiveness of these measures has not yet been reviewed in Australia. For example:

(a) the ban on credit limit increases invitations (except with the consent of the consumer) takes into account optimism bias; and

(b) the minimum repayments warnings repayments take into account present bias and imperfect self-control.

46 We note that analysis of the impact of the introduction of minimum payments warnings in the United States found that the warnings failed to induce intended behaviours to any significant degree and had unintended perverse outcomes on some consumer segments (reducing the amount of repayments made).[13]

47 Policy makers will be better able to target and tailor interventions appropriately the more they understand about:

(a) which segments of Australian consumers are driven by particular biases and the impact of their selection and usage of credit cards;

(b) how industry structures and promotes credit cards in this context; and

(c) the impact of existing and new interventions on industry and consumer behaviour.

48 For example, refining the responsible lending obligations under the National Credit Act may improve outcomes for some consumers if it leads to more appropriate product selection, whether this is a low rate credit card (instead of a higher interest rate rewards-based card) or a different product.

Research on consumer segments

49 Available research indicates significant numbers of consumers do not pay off their credit card balances in full each month and that some only make minimal repayments:

(a) A Citibank survey conducted in October 2010 found that 62% of low-income households have a credit card, compared with 84% and 90% of middle- and high-income households, respectively. Of those households that have a credit card, 49% of low-income households report not paying off their monthly balance in full, versus 42% and 30% of middle- and high-income households.[14]

(b) The 2014 ANZ adult financial literacy survey found that:

> During the last 12 months, 65% of card holders said they had always paid the balance on their main credit card in full (down 4 points since 2011); 23% said they had been charged interest in at least some months;

[13] BJ Keys & J Wang, *Perverse nudges: Minimum payments and debt paydowns in consumer credit cards*, 2014 Meeting Papers 323, Society for Economic Dynamics.
[14] Citi Australia, *Evidence versus emotion: How do we really make financial decisions?*, December 2010.

> 14% made only the minimum repayment on at least one occasion; 20% had been charged a late payment fee; 7% had been charged a fee for exceeding their card limit; and 11% had used their main credit card for a cash advance.[15]

50 However, it is important to qualify the results of these surveys, because:

(a) consumer self-reported data such as this may be unreliable—consumers generally under-report, particularly about perceived behavioural flaws such as failing to repay debt; and

(b) the research does not provide detailed information about patterns of use of credit cards by particular consumer segments, so we do not yet know the extent of the problem or who it affects.

51 Internationally, a study of American consumers[16] found that:

(a) on average, consumers chose the credit card contract that minimised their total interest costs net of the annual fee;

(b) a substantial fraction of consumers (about 40%) chose less suitable contracts, but the probability of choosing less suitable contracts declined with the dollar magnitude of the potential error;

(c) relatively few consumers switched contracts, but those who made larger errors in their initial contract choice were more likely to subsequently switch; and

(d) a minority of consumers persisted in holding significantly less suitable contracts.

52 It is important to note that research findings can vary across studies, regions and different contexts.

53 In the Australian context, the Citibank research[17] found that household income is not one of the main determinants of the behavioural categories that people fit into.

54 Yet, the ANZ research shows that:

> families with household incomes of $65,000 or less and people with significant mortgage debt of $300,000 or more (particularly those with household incomes of less than $100,000) were more likely to be experiencing difficulty with their credit cards in terms of paying interest, being charged fees for late payment and/or exceeding their credit limit.[18]

55 We are considering undertaking further work to better understand the main consumer protection issues in the credit card market in Australia and the consumers groups most affected by those issues.

---

[15] ANZ, *ANZ survey of adult financial literacy in Australia*, May 2015, p. 51 and Section 7.
[16] S Agarwal, S Chomsisengphet, C Liu & NS Souleles, *Do consumers choose the right credit contracts?*, Center for Financial Studies working paper No. 2005/32, November 2005.
[17] Citi Australia, *Evidence versus emotion: How do we really make financial decisions?*, December 2010.
[18] ANZ, *ANZ survey of adult financial literacy in Australia*, May 2015, p. 51 and Section 7.

Key terms

Term	Meaning in this document
ASIC	Australian Securities and Investments Commission
National Credit Act	*National Consumer Credit Protection Act 2009*
National Credit Code	Sch 1 to the National Credit Act
REP 436 (for example)	An ASIC report (in this example numbered 436)
RG 209 (for example)	An ASIC regulatory guide (in this example numbered 209)
Senate inquiry	Senate Standing Committee on Economics inquiry into matters relating to credit card interest rates