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Submission to the House of Representative Economics Committee Inquiry into Competition in the Retail Banking and Non-banking Sectors in Australia

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Further information: Chris Gration, Head of External Relations (02) 99517540 or Matthew Strassberg, Senior Adviser, Government Relations, (02) 9951 7838

"…greater availability of credit data will tend to reduce information asymmetry between lenders and clients and reduce the information advantage of large banks over new entrants."

European Commission Directorate General for Competition
Report on the retail banking sector inquiry 31 January 2007

Introduction

A foundation stone of the credit economy is credit reporting.

Credit reports give lenders the capacity to accurately assess and price the risk of lending and give consumers the ability to demonstrate their credit history.

In examining the provision of credit products, it is critical the Economics Committee consider Australia's twenty-year-old credit reporting regime.

Australia is one of only three OECD countries restricting credit reports to negative information.

Worldwide, economies have moved to embrace comprehensive reporting, allowing much more accurate and insightful data to be recorded on a credit file.

The current laws inhibit equity and competition:

- The limited information on credit files reduces the likelihood of banks lending to an unknown customer, making it harder for consumers to switch banks.

- Lenders entering a new market are disadvantaged in assessing risk – there is a very uneven information playing field.

- Borrowers cannot demonstrate their sound management of credit - people can be unfairly excluded from receiving credit or end up paying higher interest than they should.

- Competition to attract consumers with good credit profiles is inhibited.

- Lenders may not be able to see a person is in financial stress – and so inadvertently extend credit to an already overcommitted borrower.

International research supports these conclusions.

In 2007 the Directorate-General for Competition in the European Commission examined in-depth competition issues in the banking sector and found that:

"...the extent of credit data market coverage is likely to influence the strength of competition in retail banking.

Where the coverage of credit registers is low, large banks are more likely to have an advantage since their extensive client book will enable them to build more accurate risk models than smaller players and new entrants."

European commission Directorate General for Competition
Report on the retail banking sector inquiry[1]

In the Australian context, Access Economics estimates comprehensive reporting will deliver $1.7 billion boost to household spending power through:

- Lower interest rates as banks compete for good risk customers;
- More accurate assessment of risk leading to increased access to mainstream and better priced credit;
- Lower default rates, particularly on mortgages.

Credit reports in Australia are governed by specific legislation within Part IIIA of the Privacy Act; a complete review of the Act was recently completed by the Australian Law Reform Commission (ALRC).

Industry is calling for credit reports to include account payment status - how often have accounts been overdue, or payments missed, over the previous 24 months.

Veda Advantage calls on the Economics Committee to support modernising Australia's credit reporting laws. Comprehensive reporting will:

- Increase competition within the finance industry and downward pressure on interest rates;
- Increase capacity for consumers to switch banks or seek better terms based on their demonstrable repayment capacity;
- Reduce numbers of people who become overcommitted and default, particularly on mortgages.

[1] European Commission Directorate General for Competition *"Report on the retail banking sector inquiry"* 31 January 2007

Credit reports in Australia

Australia's credit reporting legislation limits the information permitted on a credit file to:

- identifying information such as name, address, date of birth and drivers licence;
- applications for credit – when, with whom, amount and type - (but not whether credit was granted or still active);
- negative payment information including payment defaults, court judgements over the previous five years (and bankruptcies seven years)

A credit file does not show credit's current limit or outstanding balance or if the line of credit has been cancelled.

No detail is available for a person to demonstrate they have a good payment history - *only the bad news counts.*

Over the last 25 years greater competition and widespread innovation in credit products have contributed to a widening of the number of people able to access credit from mainstream lenders[2].

Overwhelmingly, this has been used to build up wealth, with the Reserve Bank estimating 90 per cent went to acquiring assets,[3] with the biggest increase in credit use by the highest income group and people in the 45-64 age demographic.

As an Access Economics study recently commissioned by Veda points out:

One of the main motivations behind the deregulation of the Australian financial system in the 1980s was the lack of access to credit for many Australians. Credit was only readily available to those with either high incomes or long banking histories...many mortgages in the late 1970s and early 1980s involved a combination of finance...so called 'cocktail' loans.

Access Economics[4]

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[2]"*In short, deregulation, innovation and lower inflation have simultaneously increased the supply, and reduced the cost, of finance to households, and not surprisingly, households have responded by increasing their use of it.*" Address by Ric Battelino, Deputy Governor to Finsia- Melbourne Centre for Financial Studies 25 September 2007.

[3] Ibid

But twelve increases in the cash rate since 2001 have brought the health of Australian households' balance sheets into sharp focus.

While the total amount of borrowings is of less relevance than the capacity to repay borrowing, in the current environment the decision to extend another line of credit – and the basis on which that decision is made – becomes more critical.

A Galaxy Research survey on debt commissioned by Veda Advantage[5] revealed that 18 per cent of respondents – as many as 2.7 million Australians - admitted they had deliberately exaggerated their financial situation to gain credit.

Credit files should identify people who are potentially over-committed and to whom additional credit should not be extended. Yet Australian laws currently prevent lenders seeing whether a borrower is over-committed.

Similarly, 13 per cent of respondents – equal to 1.9 million Australians, stated they had been denied credit despite having a sound payment history.

Credit files should allow consumers to demonstrate their financial competence, rather than just rely on income.

This is particularly important for people who may have gone through a period of financial difficulty but recovered, typically after a divorce.

European studies highlight divorce as the second most common cause of over-indebtedness after unemployment[6]. Currently in Australia, a person's credit report would only show a series of defaults up to five years old; but having financially recovered, there is no means of demonstrating their subsequent stable finances and recent good payment history.

Borrowers and lenders need the best information possible to get fair access to credit – outdated Australian laws make that impossible.

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[4] Pg 6 "*The benefits of broadening access to credit via comprehensive credit reporting.*" Access Economics Pty Ltd Report commissioned by Veda Advantage, May 2008

[5] Galaxy Research Australian Debt Survey commissioned by Veda Advantage September 2007

[6] Pg 18 Various studies cited in "An Economic analysis of the EU Commission's proposal for a new Consumer Credit Directive" Wim Kosters, Stephan Paul and Stefan Stein

Credit reporting law reform – increased competition

Australia's opaque credit reporting regime hinders competition in the finance sector.

Established lenders have a clear information advantage over new entrants when assessing lending risk. Their large existing customer base gives them broad insight into a consumer's ability to make repayments.

In contrast, a new bank, having to rely on the limited information available on credit reports, will have significantly less capacity to accurately differentiate high and low risk borrowers.

"...greater availability of credit data will tend to reduce information asymmetry between lenders and clients and reduce the information advantage of large banks over new entrants."

European Commission Directorate General for Competition
Report on the retail banking sector inquiry 31 January 2007[7]

Conversely, consumers are hindered from switching banks as their ability to access credit as a new-to-bank customer is significantly weakened.

Access Economics found:

"The acceptance rate for new customers is often nearly half the rate for existing customers and around 50% of this difference can be attributed to the relative quality and quantity of information available."

Access Economics[8]

Comprehensive reporting helps level the playing field, increasing competition as people find it easier to leave their existing bank and successfully apply for credit with a new lender.

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[7] Pg 34 European Commission Directorate General for Competition *"Report on the retail banking sector inquiry"* 31 January 2007

[8] Pg 3 *The benefits of broadening access to credit via comprehensive credit reporting.* "Access Economics

Similarly, banks will be more likely to compete for new customers whose credit report shows them to be a good risk. Lower interest rates are likely to result as financial institutions compete to attract people who can demonstrate sound management of credit. The focus on income will broaden to include demonstrated ability to meet repayments.

Hong Kong moved to comprehensive reporting in June 2005 after a two year transition period. In its first review of the impacts, the Hong Kong Money Authority noted:

"A few major players said they were proactively offering lower interest rates products to selected credit card holders – presumably as a response to the challenge coming from non-bank players. New players continue to emerge and the consumer credit market has become more competitive."

Hong Kong Money Authority[9]

The European Commission is forming an Expert Group on Credit Histories with a view to identifying obstacles (and solutions) to the access and exchange of credit data across the EU.

In its terms of reference, the European Commission[10] states:

"The existence of these information asymmetries may deter new market entrants."

The extensive work being undertaken in Europe highlights the need for Australia to give priority to credit reporting law reform.

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[9] Pg 10 Hong Kong money Authority Quarterly Bulletin March 2006

[10] Terms of Reference for the Expert Group on Credit Histories, European commission decision of 13 June 2008

Credit reporting law reform – boosting the economy

Access Economics was commissioned by Veda Advantage to assess the impact of comprehensive reporting in the Australian context.

The Access Economics Report, *The Benefits of Broadening Access to Credit via Comprehensive Credit Reporting*[11], provides important Australian evidence of the economic and social benefits from comprehensive credit reporting, including lower interest rates, increased access to credit, lower default rates and a $1.7 billion boost to the economy.

The Report found that under a comprehensive credit reporting system, banks and credit institutions will have access to better quality information, enabling them to better manage risk and therefore make more accurate lending decisions.

Moving to a comprehensive credit reporting system will give Australians greater access to mainstream, better priced credit, particularly younger Australians and families who currently have inadequate information on their credit file.

Access Economics finds the people most likely to benefit from increased access are those low-risk individuals who are currently viewed as high-risk.

"...Overwhelmingly these tend to be low to middle income earners with limited track records with financial institutions...[and] new-to-bank customers, where declined applications are often as much the result of poor information as the financial status of the applicant"

Access Economics[12]

The Report finds the current credit reporting system denies people the ability to prove they can make their financial repayments on time.

Referring to defaults, Access Economics cited a US study conducted by Barron and Staten that demonstrated maintaining a target acceptance rate would lead to a decrease in defaults, as lenders can more easily identify high risk borrowers.

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[11] *"The benefits of broadening access to credit via comprehensive credit reporting."*Access Economics Pty Ltd Report commissioned by Veda Advantage, May 2008

[12] Pp 21,22 Ibid

In the Australian context, Access Economics believes that in the critical area of mortgage defaults, a move to comprehensive credit reporting would lead to a small but significant decline in default rates from 0.4 per cent to 0.35 per cent and concludes:

"While small, the total size of the mortgage lending pool – close to AU$ 1trillion – means that any decline in mortgage default rates will still have a noticeable impact on the economy."

Access Economics[13]

ACCESS ECONOMICS - MACROECONOMIC OUTCOMES OF COMPREHENSIVE CREDIT REPORTING

While the lack of detailed credit data limited the nature of formal modelling possible, the task was approached using outcomes from earlier US research. Using current Australian reporting framework as a base, the research was applied to aggregate Australian credit data.

The main results from the economic modelling are as follows:

- In the first year, consumers receive a boost in real incomes of around A$265 million, in 2005-06 prices, which in turn flows through into a combination of higher real consumption expenditure, of around A$160 million, and higher prices.
- In subsequent years, consumption increases by an average of around A$84 million per annum, in 2005-06 prices:
  - The higher prices feed through into (slightly) higher inflation which tends to unwind part of the initial boost to real household consumption.
- Assuming a real discount rate of 5%, these results translate into a boost to real household consumption of A$1.7 billion in net present values.

From the perspective of past microeconomic reform agendas, these estimates would indicate that reform to credit reporting would yield useful rather than large economic benefits at a national level, in the form of a meaningful boost to national living standards.

[13] Ibid pg 24

Credit reporting in the OECD and internationally

Australia, New Zealand and France are the only OECD nations without comprehensive credit reporting.

In the past five years Belgium and Greece have moved to comprehensive credit reporting models. Under an EU directive passed in early 2008, Spain is moving to comprehensive reporting and similar pressure is being applied to France.

"The evidence suggests that overall, consistent with data protection and competition rules, greater credit data availability strengthens banking market competition."

European Commission Directorate General for Competition[14]

Having gained agreement on other aspects of uniform consumer credit protections, the European Commission is now forming an Expert Group on Credit Histories to harmonise the operation of credit throughout the EU.

More broadly, comprehensive reporting has been introduced in India, Brazil and Hong Kong.

Hong Kong's recent move to comprehensive credit reporting is instructive. Its previous negative credit reporting regime failed to prevent a huge surge in consumer bankruptcies in 2002, with bankruptcies peaking at 25,328[15].

Positive data sharing was introduced in stages from 2003 and by 2004 the number of bankruptcies dropped by 45 per cent[16].

"...financial institutions are in a better position to avoid lending to borrowers on the verge of bankruptcy."

Hong Kong Money Authority following the introduction of positive credit reporting

[14] European Commission Directorate General for Competition Report on the retail banking sector inquiry pg 34
[15] Official Receivers Office, Hong Kong Compulsory Winding Up and Bankruptcy Statistics
[16] Ibid

Average indebtedness of bankrupts also declined from over 35 times a bankrupt's monthly income to 25 times – described by the Hong Kong Money Authority (HKMA) in a 2006 review of comprehensive reporting as a "conspicuous improvement in the problem of over-indebtedness"[17].

> *"The HKMA's assessment shows there are obvious benefits of positive data sharing to financial institutions in their ability to control bankruptcy losses.*
>
> *More importantly, consumers are also benefiting, particularly those who have taken out non-card credit to repay their credit cards debts. Now that the moratorium is over, it is expected that more benefits of positive data sharing will flow to consumers.*
>
> *There are several developments in support of this assessment.*
>
> *From the interviews with financial institutions, most banks indicate they will make fuller use of positive data to provide better services to their customers.*
>
> *All these developments suggest that consumers will stand to benefit more from positive data sharing in the future."*
>
> ***Overall Summary, Hong Kong Monetary Authority Quarterly Bulletin March 2006***

The success of other jurisdictions who have recently introduced comprehensive reporting is reassuring - and emphasises the need for Australia to embrace better information on credit reports.

[17] Hong Kong Money Authority Quarterly Bulletin March 2006.