SUBMISSION 23

Submission to the House Standing Committee on Economics Inquiry into competition in the banking and non-banking sectors

11 July 2008

Terms of Reference

The Committee should examine competition in the retail banking and non-banking sectors in Australia. The inquiry will pay particular attention to home mortgage products and linked facilities frequently offered to consumers such as credit cards and savings accounts.

1. The Committee will undertake a stock take of the Australian retail banking and non-banking industries, focussing on:
    a. Recent developments in relation to products, providers and distribution channels;
    b. the current state of the retail banking and non-banking industries;
    c. the likely drivers of future change and innovation in the retail banking and non-banking sectors including the continuing impact of technological developments; and
    d. comparisons with relevant international jurisdictions.
2. The Committee will also identify any barriers that may impact on competition in the retail banking and non-banking sectors, and policies to enhance further competition and product choice for consumers.

CHOICE is a not-for-profit, non-government, non-party-political organisation established in 1959. CHOICE works to improve the lives of consumers by taking on the issues that matter to them. We arm consumers with the information to make confident choices and campaign for change when markets or regulation fails consumers.

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Key Points

This inquiry will review the operation of home mortgage markets and linked facilities including credit cards and savings accounts. Parts of these markets are working well to deliver consumers with the products and services demanded. Equally, though, there are segments of the market that are not effectively competitive and are causing consumers to suffer harm.

The home loan market is increasingly characterised by complex and sometimes risky products that are difficult to compare, costly to pay out and leave consumers exposed to volatile prices.

While robust competition from non-bank lenders over the past decade has played a critical role in bringing down interest rate margins, the current global liquidity crisis has reduced the competitiveness of non-bank lenders and with it weakened a formidable force from the market. Coupled with increasing consolidation through large scale mergers and creeping acquisitions, it is reasonable to be concerned about the cost and quality of mortgage products and services in the future.

The Australian community has enjoyed many positive product and service innovations in the home loan and other credit markets. But alongside these improvements there are also worrying signs that competitive rivalry in home loan markets has also been detrimental for consumers. Lenders have taken advantage of market weaknesses to apply high early-exit fees on mortgages and rapidly increasing penalty fees on credit cards and transaction accounts. While large numbers of customers express dissatisfaction with their current financial institution, most consumers find it difficult to switch providers. It's also evident that predatory lenders and unscrupulous mortgage brokers are preying on desperate borrowers in default.

Competition works best when consumers are protected from harm and are able to stimulate competitive rivalry on price and service that doesn't erode consumer protections. Policy and regulatory changes are needed to facilitate effective competition in the new landscape of the home mortgage market. In this submission CHOICE proposes 6 initiatives to enhance further competition and product choice for consumers.

Key reforms needed to improve competition in the banking and non-banking sectors include:

1. **National Unfair Contract Terms Laws**
2. **Better tools to compare products**
3. **Removal of barriers to switching providers**
4. **Mandatory membership of External Dispute Resolution schemes**
5. **Limits on interest rate increases whilst early exit fees apply**
6. **Regulation of consumer credit advisors**

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1. National Unfair Contract Terms Laws

1.1. Mortgage contracts

Home loan mortgage contracts typically include terms and conditions that can disadvantage consumers. Some contracts give the lender very broad rights to declare a borrower in default under their contract. One contract CHOICE reviewed found that the lender reserved the right to declare the borrower in default if they lose their job or the value of their property decreases. With some contracts, even failing to pay a credit card bill can put a consumer in default on their mortgage.

Lenders typically defend these contract terms on the basis that they are standard across all mortgage contracts, that they are necessary to protect the lenders' legitimate interests and that they are used very rarely, if at all.

Mortgage contracts also typically include broad terms that allow the lender to introduce new fees, or change existing fees at any time. Borrowers can be very vulnerable under these terms. At least one company has used this contract terms to increase barriers to customer switching. RAMS mortgage business sold its brand and distribution network to Westpac in October 2007 and the company changed its name to RHG. Loans offered by RAMS were originally very competitive on interest rates and early exit fees were higher than banks, but lower than many non-bank rivals. Since the sale of the RAMS brand, RHG has regularly increased its standard variable interest rate and is now at the top end of the market. As a result some RHG customers are looking to change providers. But recently, RHG customers on the RHG interest saver loan were advised that the early termination fee had increased from $1400 in the first year, $1000 in the second year and $700 in the third year to a flat fee of $2000. RHG relied on a term in its loan contracts that purports to allow it to unilaterally vary "the amount and type of fees and charges (including by imposing new fees and charges or changing the method of calculation of a fee or charge)."

Mortgages contracts, like those of RAMS/RHG, consistently have terms that grant the lender very broad rights which may be used unfairly to the ultimate detriment of the consumer. Household borrowers are not able to negotiate standard contract terms and conditions and are left without any protection when these terms are used unfairly against them.

1.2. Unfair Penalty Fees

Penalty fees which significantly exceed underlying cost indicate that part of the market for banking and credit products is not competitive.

A penalty fee is charged to a bank customer when the customer breaches a requirement of the terms and conditions of their bank account. CHOICE has included the following types of fees in its campaign to stamp out unfair bank penalty fees: inward cheque dishonour fees, credit card over-limit fees, late payment and payment failure fees on credit card accounts and honour or dishonour fees on transaction accounts.

These fees can be as high as $50 and have been steadily increasing since 2002. In the case of credit card over-limit fees, the rate of growth has been exponential. These fees did not exist in 2000 and now average $30 (and can be as high as $35).

Contract terms giving the financial institution broad powers to change fees at any time are routinely used in transaction account and credit card contracts. Consumers do not have the market power to negotiate the terms and conditions of clauses in contracts. We believe this creates an inbuilt temptation to add in unjustifiable margins when financial institutions set penalty fees. The contract terms have facilitated a rapid increase in the level of penalty fees and the circumstances in which they are charged. For example, in response to a complaint about the level of a penalty fee, one bank told its customer

> Whilst I appreciate you were unable to negotiate the terms of your contract, you agreed to the terms and conditions of the contract when you elected to sign them.[1]

Consumers are taken to have accepted the application of default fees to their account upon opening the account and must accept any change that is unilaterally applied to the level and application of penalties.

A particular difficulty with penalty fees is that, for most consumers, the existence or level of penalty fees does not influence their choice of banking or credit product. There is no competitive advantage in a financial service provider offering lower or fewer penalty fees and thus no opportunity for competition to regulate prices.

Consumers generally understand and accept that in reasonable circumstances additional fees will apply to particular actions. Our campaign argues that penalty fees should only be applied in fair circumstances and should be set at a level which reasonably reflects the cost to the bank of the customer's default. A private member's bill is currently before the federal parliament which seeks to give ASIC specific powers to oversight these fees. CHOICE supports the *Australian Securities and Investment Commission (Fair Bank & Credit Card Fees) Amendment Bill 2008*. We recommend that the proposed industry-specific laws are adopted to deal with the problem of unfair bank penalty fees. As an alternative, national unfair contract laws may provide a similar level of protection, which is detailed in our submission to the Senate Economics Committee Inquiry into the Bill.

1.3. Recommendation for new unfair contract laws

Laws excluding unfair contract terms from consumer contracts facilitate a more competitive market. They increase consumer confidence and ensure that unscrupulous lenders cannot manipulate contracts to their own advantage. These laws are desperately needed in banking and non-banking markets.

In 2003 the Victorian Government introduced laws to exclude unfair terms in consumer contracts however the laws specifically exclude consumer credit contracts. The Victorian Government is currently considering removing this exemption.

Earlier this year the Productivity Commission recommended a form of national unfair contract term laws be included in a new national consumer protection law. The need for national unfair contract laws in Australia is not disputed. However, there remains some disagreement about the form the laws should take. CHOICE has argued that the regulators should be able to take actions against unfair contract terms at any time and should address all fees and charges not relating to the main price of the contract. This is the approach taken by the Victorian unfair

[1] Correspondence from Westpac to customer, 16 January 2008

contract term laws – Consumer Affairs Victoria is able to negotiate directly with businesses to make changes to their contracts and only litigate if they refuse to change their contracts. The Victorian experience has shown that many, if not most, businesses are willing to work with the regulator to ensure their contract terms and conditions are fair.

The Victorian model is based largely on the United Kingdom's Unfair Terms in Consumer Contract Regulations, which provide that "a contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer" (Regulation 5(1)). Terms can't be considered unfair where they relate to the main subject of the contract or the adequacy of the price (Regulation 6(2))[2].

Unfair contract laws in the UK allow consumers to seek redress for unreasonable bank default charges. The UK laws have successfully been applied to rein in fees on credit cards and a major review of overdraft fees is currently underway. With the right national unfair contract laws it would be reasonable to expect that Australian consumer could enjoy similar protections.

The UK and Victorian experience demonstrates the unfair contract laws in place do not impose any significant cost on business – a conclusion also reached by the Productivity Commission.

2. Better tools to compare products

Consumers have a huge range of choices available to them, particularly in non-banking markets. Rather than basing decisions on relatively straightforward calculations, consumers have to contend with a variety of different fees, charges, options and features on top of the loan repayments.

The Mandatory Comparison Rate was introduced in 2003 to enable consumers to understand the total impact of the fees and charges on the overall cost of credit and to provide consumers with an added tool in comparing the cost of different products offered by different providers.

Unfortunately there is now evidence that lenders are using loopholes in the MCR rate to inflate contingent fees, particularly early exit charges.

The Ministerial Council on Consumer Affairs recently resolved to reform the scheme of MCR. At its May 2008 meeting it resolved to revise the calculation of MCR used in credit advertising. The recent independent review of the MCR found that the following changes would improve the operation of the MCR:

- Expand the MCR to pre-contractual disclosure of specific contract amounts;
- Increase the range of fees and charges to be included in the calculation of the MCR;
- Change the way MCR applies to Credit Advertisements in the following ways:
    - The prescribed term and loan amount to accompany mortgage interest rate advertisements should be amended to reflect current loan amounts and duration;

[2] "Assessment of the unfair nature of the terms shall relate neither to the definition of the main subject of the contract nor to the adequacy of the price and remuneration, on the one hand, as against the service or goods supplies (sic) in exchange, on the other, in so far as these terms are in plain intelligible English" Regulation 6(2)

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  - The Regulations should prescribe the inclusion of all fees that would be unavoidable within that revised term, e.g. deferred establishment fees;
  - The prescribed term and loan amount to accompany other interest rate advertisements should also be reviewed and amended where considered necessary to reflect realistic amounts and terms;
  - The obligation to provide the comparison rate should expand beyond the credit provider to linked suppliers and finance brokers; and
  - The term "comparison rate" should be revised.
- Change in the current arrangement to have the MCR calculation based only on any initial interest regime;
- Advertise the comparison rate only.
- Each of these amendments, if adopted, should be coupled with a comprehensive consumer education and awareness campaign.

Easily comparable information is essential for a complex market like home mortgages. Comparative tools that accurately reflect the cost structures of products are necessary to facilitate good consumer decision-making. CHOICE therefore supports the retention of the MCR with the changes recommended above. We also believe consumers would benefit from greater standardisation in the type of fees that can be charged on specific types products.

3. Removal of barriers to switching providers

A high level of consumer inertia in the transaction account market means that market forces cannot be relied upon to constrain anti-competitive outcomes. Customers in the sector have historically displayed a high level of inertia. In the early 1990s the then Governor of the Reserve Bank observed that:

> *Competition in the real world, however, seldom works in the manner described in the textbooks. There it is assumed that customers will actively play their part, and be prepared to shop around and switch their business if necessary… But in practice many borrowers are reluctant to shop around for a number of reasons, including inertia and the convenience of current 'packaged' services (comprising housing loan, cheque account, credit cards and so on), reluctance to try non-traditional sources of funds, and the actual or perceived costs of switching some or all transactions from one bank to another.* ***To the extent that customers do not shop around for individual products, however, the competitive pressure on banks is reduced.***[3]

The rate of transaction account switching in Australia is low. It is estimated that in Australia, 3.1% of financial institution customers switch their accounts to alternative providers on an annual basis, compared with United Kingdom customers who switch up to nearly double that rate.[4]

Earlier this year federal Treasurer Wayne Swan announced a high-level agreement with the banks to simplify account switching. A key part of the reform package was designed to overcome the fact that increasing use of direct debit and direct credit arrangements has made switching financial institutions both more complex and riskier for the consumer.

[3] Fraser, B. 1994, "Some current issues in Banking" in *RBA Bulletin* AGPS Sydney June pp9-17 (emphasis added)
[4] Australian Payments Clearing House, *Payments Industry Consultation Paper: Aspects of account switching*, September 2007

After years of arguing that simpler processes were needed, CHOICE was pleased to see action finally taken on this issue. However, the industry implementation of the package through the Australian Payments Clearing Association (APCA) is hopeless. It provides consumers with no more than a list - on paper - of their current direct debit arrangements. It requires multiple physical trips to financial institutions and provides no guarantee that the notifications will be undertaken free of charge. It envisages that banks will offer a premium switching service for those who are willing to pay. The model uses an outdated approach in an industry which relies increasingly on the internet for everyday banking.

The Bulk Electronic Clearing System, which manages direct debit and credit arrangements, has structural limitations that will ultimately shape the implementation of the Government's proposals. However, CHOICE believes it is possible to work within these limitations to facilitate simple redirection of authorised Direct Debit and Direct Credit payments.

Consumers expect to be able to go to their chosen new bank and authorise them to transfer all their direct payment arrangements to their new transaction account. Anything less will deter many consumers from acting, substantially reducing the ability of competition to deliver good consumer outcomes. The implementation strategy adopted by industry organisations does not go far enough to remove barriers to account switching.

To achieve a simple account switching process, the system must:

- Require a single customer authorisation to the new Financial Institution, either physically or on-line.
- Upon customer authorisation, require the new Financial Institution to undertake the merchant notifications of new payment details at no cost to the customer.
- Protect the consumer from risk of penalties imposed by financial institutions or merchants caused by timing issues in the transfer process.

We recommend these measures be immediately built into the APCA process currently under development.

4. Mandatory membership of External Dispute Resolution schemes

Since their creation 15 or so years ago external dispute resolution (EDR) bodies have provided access to low cost and effective dispute resolution for customers of Authorised Deposit-taking Institutions (ADIs) and other scheme members. Developments in the Banking Code of Practice and practices of ASIC approved external dispute resolution schemes have also cemented better standards for dispute resolution between members and their customers.

In its recent Report on Australia's Consumer Policy Framework, the Productivity Commission describes the absence of comprehensive EDR for all consumer credit providers as "the most glaring gap in consumer dispute resolution processes." With the exception of ADIs, there is currently no legal obligation for businesses supplying credit or financial advice associated with credit to belong to an EDR scheme, though some voluntarily agree to do so.

EDR schemes were developed because of the almost insurmountable barriers in taking small and medium value consumer finance disputes to ordinary courts. There are four ASIC approved EDR schemes which deal with complaints about financial institutions and consumer credit: The

Financial Ombudsman Service (FOS)[5]; the Credit Union Dispute Resolution Centre (CUDRC); the Credit Ombudsman Service (COSL); and, the Financial Co-operative Dispute Resolution Scheme (FCDRS). Where a credit provider is a member of one of these schemes consumers have access to an effective dispute resolution in relation to most disputes.[6]

CHOICE submits that all providers of consumer credit and advice related to consumer credit should be members of an ASIC approved EDR scheme. Voluntary arrangements are an unsatisfactory solution. Lender RAMS, for example, was a voluntary member of the Credit Ombudsman Service Limited (COSL) but upon selling the distribution business to Westpac, the newly renamed RHG discontinued its membership and is no longer a member of any external dispute resolution scheme. Many lenders who commence foreclosure action are also not members of any ASIC approved EDR scheme.

It is widely expected that mortgage arrears and foreclosures will increase as borrowers struggle with four official rate rises since August 2007, the additional increases by issuers above the official rises and the rise in the cost of living. Comprehensive access to an effective EDR scheme is urgently needed for all lenders in consumer credit markets.

5. Limits on interest rate increases whilst early exit fees apply

Early exit fees are now routinely applied to mortgage contracts. In its review of entry and exit fees on home loans, ASIC found that 93% of large banks loans included early exit fees, 83% of small bank loans, 45% of credit union loans and 85% of non-bank loans. ASIC also found that these fees were much higher than international comparisons and varied from $400 to $5,500 for an average size loan.

These fees have the effect of trapping consumers in a loan product for a period of 3-5 years. Because of this limitation we suggest that during the period under which the consumer is unable to leave the contract without significant penalty there should be limitations on the unilateral price increases applied to loans. CHOICE submits that it is entirely appropriate to pass official RBA cash rate changes through to the consumer, but not other cost of funding increases.

CHOICE is calling on the government to limit interest rate increases during the period early exit fees apply to a loan. We believe this will provide a countervailing force to the growth in the size and timeframe during which early exit fees apply. It will also ensure that consumers are not unreasonably disadvantaged through the routine application of early exit fees on mortgage contracts.

6. Regulation of consumer credit advisors

One obvious symptom of the increased complexity in mortgage and debt markets is the increasing importance of mortgage brokers as an intermediary between consumers and providers.

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[5] The Financial Ombudsman Service was recently formed after merger of the Banking and Financial Services Ombudsman, the Insurance Ombudsman Scheme and the Financial Industry Complaints Service.
[6] An important area which is not covered is that of default or penalty fees.

CHOICE supports the introduction of the National Finance Broking Legislation which was released for consultation in November 2007. The draft legislation would, if implemented, greatly assist Australian consumers. The aspects of the legislation that are particularly valuable for consumers include:

- the requirement for brokers to independently satisfy themselves that the borrower can repay the loan without hardship;
- the requirement that brokers be licensed;
- the requirement that brokers act efficiently, honestly and fairly and in the best interests of consumers;
- the requirement for finance brokers to be members of an EDR scheme;
- the provision of a public register of brokers and brokers' representatives;
- the requirement that brokers hold mandatory professional indemnity insurance; and
- the requirement that brokers disclose the commissions they receive.

In the interests of maintaining competitive neutrality between intermediaries and lender-originated loans, it may be appropriate to extend these obligations to credit providers. In its submission to the Federal Government's Green Paper on Financial Services and Credit Reform, the Consumer Credit Legal Centre (CCLC) has argued that credit providers should have an obligation to ensure that any credit product is appropriate in so far as it matches the borrower's needs, circumstances and capacity to pay. CCCLC believes this would be the first step in establishing a strong responsible lending culture, giving the regulator the power to engage with lenders over assessment processes and to intervene in serious, systemic failures. CHOICE supports this approach and encourages the Federal Government to adopt these measures in its new role as the sole regulator of consumer credit.

CHOICE is pleased to be able to make this contribution to the House of Representative Economics Committee. Should any further information be required, please contact Elissa Freeman, CHOICE senior policy officer on (02) 95773349 or efreeman@choice.com.au.