Good Shepherd Australia New Zealand's

Submission to The Senate Economics References Committee:

Inquiry into matters relating to credit card interest rates

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Introduction

Good Shepherd Australia New Zealand welcomes the Senate's enquiry into credit card interest rates. We have a long-standing concern with financial hardship, its causes and impacts. Our mission is to break the intergenerational cycle of disadvantage for women and girls, and we do this by working with individuals, families, communities and systems across our three specialist areas of financial security, safety and resilience, and education pathways.

We seek to address and build financial security in a range of ways, providing financial counselling and other practical support along with innovative programs in emerging areas, most recently women at risk of family violence and economic abuse.

We also conduct research into financial hardship and have undertaken innovative research into a range of areas including the intersection between mental illness and bankruptcy ('Smiling for the First Time: Bankruptcy for people with a mental illness' 2010), building the financial capability/literacy of women living on low income ('Money, Dignity and Inclusion' 2009), how microfinance builds financial inclusion, participation and wellbeing ('Microfinance and the Household Economy' 2011), and how financial support networks operate ('Collaborating for Outcomes' 2014).

Given this experience we have a strong interest in the impact of credit card interest rates on consumers. We respond to the committee's terms of reference as below.

Please note: Names and some minor details have been changed in the case studies to protect participants' privacy.

Terms of Reference

a) The Research Bank of Australia' s cash rate announcement and associated changes in credit card interest rates

There is a growing discrepancy between the Reserve Bank of Australia's (RBA) cash rate and the rate that is charged to credit card holders; as well as the ways in which increases and decreases in cash rates are applied to credit card interest rates.

When there is an increase in the cash rate, credit card interest rates are raised by 112 per cent of this increase. However, when cash rates are reduced, credit card holders only receive 54 per cent of the benefit.[1] It is also rare that interest rate reductions are applied as quickly to card holders as increases are.

We understand that the price of credit products is linked to many factors such as the cost of capital, the costs of administering credit, and the cost associated with managing risk. However, the level of discrepancy between cash rates and credit card interest rates indicates that consumers are being short changed and that the benefits of a decrease in cash rates are being absorbed by credit providers.

Australian banks have access to significant amounts of low cost capital; in Australia, the 'Big 4' banks have 80 per cent of the country's deposits, [2] have shareholders with paid up shares, and have income generating

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[1] Martin, Peter and Hutchins, Gareth (2015) *Banks face inquiry as credit card margins climb to record highs,* The Sydney Morning Herald http://www.smh.com.au/federal-politics/political-news/banks-face-inquiry-as-credit-card-margins-climb-to-record-highs-20150601-ghe6aw.html#ixzz3h3INxomq accessed 27.07.2015

[2] Jericho, Greg (2014) *Are Australia's banks too big to fail?* The Guardian http://www.theguardian.com/business/grogonomics/2014/jan/30/too-big-to-fail-banks-stranglehold-australian-loans Accessed 27.07.15

investments. These are resources that should enable them to reduce the costs of accessing capital to lend to consumers and further reduce then how much is charged for these products. While we understand that these banks are not the only providers of credit cards, they do by far have the biggest market share (65.2%). Other credit providers in Australia, however, are also backed by other deposit taking institutions albeit labelled with third party branding, notably Citibank and HSBC.[3] In a competitive economy this strong position should push rates down yet this does not appear to be occurring in practice. The benefits of lower capital costs do not appear to flow through to consumers.

This is played out when looking at the profit margins for credit cards. The average margin on credit cards is now as high as 16 per cent, up from 7 per cent in 2007-08. Money sourced at 3 per cent is being lent out at 19 per cent.[4]

This is a poor outcome for consumers and for policy makers.

The policy intent of changing rates is to stimulate or slow growth in the economy. The lack of flow down benefits for consumers when there is a rate reduction means that economic stimulus measures will be less effective.

For consumers it means they are faced with higher charges than are necessary, and hence, a higher likelihood of experiencing financial hardship. It also means that the 'choice' offered by non-bank credit providers is doing little to improve competition and consumer outcomes.

There is insufficient accountability for these discrepancies.

Recommendation 1: As a matter of urgency, this gap in cash rates and credit card interest rates needs to be rectified. Not passing on the full benefit of rate cuts should be seen as an exception, with credit providers being made accountable to the regulator and consumers to apply for an exception to this rule.

b) The costs to banks, credit providers, and payments systems, including those relating to:

- **i. Borrowings**
- **ii. Credit risk and default rates, and credit risk pricing**
- **iii. Various credit loyalty programs, and**
- **iv. Consumer protection measures, including reforms introduced following the global financial crisis**

We have discussed earlier the costs of borrowing for banks and what this means for retail credit card interest rates. We would like to focus with this Term of Reference on credit risk pricing and consumer protection measures.

Risk pricing and costing is a vexed issue for the consumers we work with. Based on certain assumptions about risk, many people are excluded from mainstream banking services.

> "If I had walked into (bank) they would have walked me out the door, they just would have said no" – Dina, NILS[5] Borrower

This exclusion is based on imperfect information about these consumers as being 'high risk' based on their low income. Good Shepherd Microfinance's No Interest Loans Scheme is evidence of the fact that low income does

[3] Asia-Pacific Banking and Finance (2014), *Coles, CBA corner credit card competition,* Asia-Pacific Banking and Finance https://www.australianbankingfinance.com/banking/coles--cba-corner-credit-card-competition/ accessed 30.07.2015
[4] Rolfe, John (2015) *Banks make $920 million from credit card interest rates with profit margin now 16 per cent*
[5] No Interest Loans Scheme: a loan given with no interest repayment.

not necessarily mean high risk if the product is appropriately designed and priced, with write-offs at 5.66 per cent last financial year.[6]

Those who are not excluded from credit altogether pay more for the credit they can access as they often need to access the fringe market or higher cost credit products. These costs are higher for low income earners both proportionate to their income and in real terms. Product design also excludes many as they often cannot afford to borrow larger amounts. This means people access small, fringe lenders at high cost.

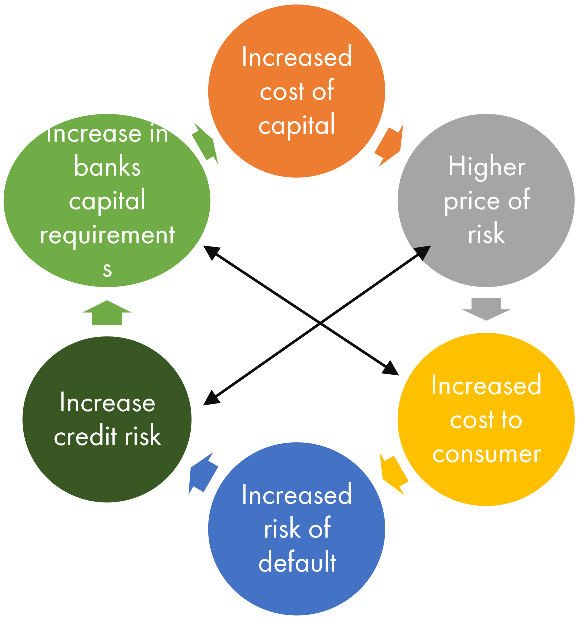
This quote, from a financial counsellor reflects this challenges of high cost lending:

> "People who are in vulnerable financial positions, the interest rate they have to pay is sky-high whereas it should be the other way. If people can demonstrate financial difficulty, they should be offered a **lower** interest rate with more reasonable payments. Our whole system, the banks and everyone else, does it in reverse."[7]

This creates a market failure. Imperfect information and incorrect assumptions about credit risk increase the cost of accessing credit. These consumers therefore pay more for credit. These higher costs increase the likelihood of not being able to afford payments, further contributing to the consumer's credit risk. This then increases the price they pay. This circularity, the nature of the imperfect market and imperfect information creates a market failure where this disadvantage continues to feed into itself.

Recommendation 2: The committee needs to consider the impact that pricing risk has on increasing risk and the market failure this creates.

Figure 2: Market failure inequity cycle



We understand that with the implementation of Basel III recommendations the cost of managing risk for credit providers will further increase as they will be required to keep more in reserve and we appreciate that this will

[6] Good Shepherd Microfinance, http://goodshepherdmicrofinance.org.au/ar2014/#highlights
[7] Banks, M; Martson, G; Karger, H; Russell, R (2012) *Caught Short: Exploring the role of small, short-term loans in the lives of Australians,* The Social Policy Unit, University of Queensland Pg. 90

support the banking sector to avoid future crises like that experienced with the GFC. [8] We would ask, however, that these costs do not disproportionately flow through to low income consumers based on incorrect assumptions on their credit risks.

Positive credit reporting may help or hinder this cause, depending on how the information provided is applied. While perhaps outside of the scope of this review, it is important to understand that positive credit reporting may support consumers that would have otherwise been considered 'high risk' based on income to provide evidence of a good credit rating. This then may mean an increase in financial inclusion for low income earners. The challenge is, however, that if some of the same assumptions apply about the credit risks of low income earners then this 'inclusion' may come at a higher cost. Credit providers will be able to price the risk posed as opposed to excluding consumers based on risk. Neither of these are an adequate outcome, and this needs to be considered when looking at overall risk pricing.

Recommendation 3: We would ask that the committee look into the impacts of positive credit reporting on credit card interest rates, and particularly what this could mean for low income earners. Factors beyond income need to be factored in when making assumptions about risk.

Case study: Credit risk assumptions

Jelena is an older women who relies on a Disability Support Pension. She needed some new furniture, in particular a new mattress for her and her husband as they both have bad backs and she had just had a hip operation. Her vacuum cleaner had also broken. In the past, she had continued to get it fixed, but because the vacuum cleaner was so old, they no longer made the parts required to fix it. She approached a couple of stores for 'interest free' finance as well as her bank. What was most frustrating to her was that neither seemed to explain why she was not able to be approved for finance. Being a regimented money manager, Jelena always makes sure her bills are paid on time. But in the absence of being approved by either, she did not feel she had many other options and went to a payday lender.

> *"Yeah, but I need it...I go to my bank but they not let me...There is nothing wrong with my paid record. If I have bad record, the other company (the payday lender) would not give it to me. There is something wrong (with the banks)...I pay off, you see that I have already gold card with that company. Even if I not have food, I pay bills, honestly, and I know I have my file, this fortnight, this much I make it...I give."*

Jelena found out about StepUP[9] through a local community organisation. She borrowed $3000 and purchased a new bed, mattress, vacuum cleaner and wardrobe and has paid this back.

> *"Oh yes, of course, an easy one, because before I had, I don't know for that loan (StepUP) and I borrow some money for, buy something, or register car, $600 I borrow from personal loan, I pay $150 fortnight for a couple of months..."*[10]

c) transaction costs, including interchange fees, on the payment industries

We won't provide specific commentary on this Term of Reference.

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[8] Reserve Bank of Australia (1994) *Capital Adequacy of Australian Banks,* Reserve Bank of Australia Bulletin December 1994, http://www.rba.gov.au/publications/bulletin/1994/dec/pdf/bu-1294-4.pdf

[9] StepUP is a low interest loan offered in partnership with NAB, Good Shepherd Microfinance and Community Partners

[10] Corrie, T (2011) *Microfinance and the Household Economy,* Good Shepherd Youth & Family Service, Collingwood

d) the costs to consumers, including those related to:

- **i. how and when interest is applied**
- **ii. minimum payment levels**
- **iii. various credit card loyalty programs of other users, and**
- **iv. card fees, including ATM and POS fees**

We have covered off some of the cost issues in previous sections, particularly related to risk pricing. We would like to also cover here issues to do with fees on cash advances, balance transfers, and minimum interest payments.

One of the main challenges is a lack of understanding and a lack of transparency about how fees are charged. Our financial counsellors have noted that many people do not understand the fee associated with cash advances, for example, and that interest starts to accrue right away. Many who need to access cash this way are already experiencing financial stress. The higher costs only add to this, and this is an area of concern for Good Shepherd Australia New Zealand. The case study below reflects these difficulties. In this case, economic abuse[11] was also present, adding to the stress. The credit card debt and cash advance were in the context of many other financial and emotional stresses that were already occurring.

> ***Case Study: High costs of financial stress***
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> Jayne had been in a violent relationship with Greg for some time. Once she had left him, however, the abuse did not stop. Greg would often demand money from Jayne, and she would give Greg the money to avoid the situation escalating, even though she could not afford it. She needed to use her credit card in order to transfer $3,000 to Greg in total, an amount she could not afford in her circumstances. It was making it extremely difficult for her to remove him from her life. The costs associated with the transfer increased her financial stress, and Jayne sought support from a community legal service.[12]

Consumers are often not also aware of low or no interest balance transfers, and that this low rate only applies to the transfer amounts. Another issue is that consumers are also not aware that by paying the minimum payment amount, they are paying very little off the principal amount, and will not manage to pay the debt off.

There are recent changes which makes this clearer. For example, placing information on credit card statements about when the debt will be paid based on the payment amount is helpful. We do believe, however, the product disclosure statements are too cumbersome and that these fees and charges need to be clearly understood by consumers.

Additionally, the documentation is onerous and far too legalistic for many to understand, especially non-English speaking customers, the visually disadvantaged and those who are not literate. Although there has been strengthening around the probity of disclosure and policy related to credit card contracts and fees, disclosing information does NOT ensure *understanding, nor its verification.*

We therefore strongly argue for there to be innovative ways in which customers' understanding of their credit card financial contract and undertaking can actually be verified. For example, following disclosure of the financial undertaking, customers might demonstrate their comprehension and understanding via videoed verbal feedback, or in a written explanation authored by themselves.

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[11] Economic abuse is a form of family violence that negatively impacts a person financially and undermines their efforts to become economically independent.

[12] Camilleri, O; Corrie, T and Moore, S (2015) *Rebuilding financial safety: Legal responses to economic abuse,* Good Shepherd Australia New Zealand and Wyndham Legal Service, Melbourne

Recommendation 4: That all financial institutions develop and incorporate into practice, a process by which they are able to *"verify and confirm a customer's understanding"* of their credit card financial undertaking, replacing the simple and shallow commitment to improve "disclosure" and the assumption that it leads to understanding and informed and effective decision making and behaviour.

We would also question the size of the fees, and that there be greater investigation of the true cost to credit providers compared the cost they are passing on to consumers.

Recommendation 5: Clearer information be provided to credit card holders on cash advance costs.

Recommendation 6: Investigations be made into the actual costs for credit providers on certain transactions as opposed to the charge levied to credit card holders.

e) what impact competition and price signals have on the credit card market

As discussed earlier, we do not believe the competition in the credit market is providing consumers with much better outcomes. We are also concerned at the inconsistency with which cash rate reductions and increases are applied to credit card holders. This is symptomatic of the larger issues as identified earlier.

Conclusion

The cost elements of financial inclusion can be neglected in policy development, and are not reflected in risk and further product pricing. Because of this, we see many people pushed to the fringe market. While many excluded consumers are able to access microfinance programs to meet their credit needs, there is still a large group for whom high cost credit or financial exclusion are a reality.

There are many reasons for this that we believe this inquiry has the capacity to investigate. Particularly, we are concerned about incorrect risk pricing, the discrepancy between the costs of capital and the costs of credit cards, and the circular nature of financial exclusion and financial hardship in the current system.

We thank the committee for the opportunity to provide commentary toward this enquiry, and are happy to elaborate further if needed.