6 December 2010

By email: economics.sen@aph.gov.au

Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Senators

Submission to Inquiry into Competition within the Australian banking sector

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to provide a submission to the Senate Economics Committee (the **Committee**) regarding its inquiry into competition within the Australian banking sector. We apologise for the delay in making our submission.

We recognise that there are a large number of issues and potential policy and regulatory measures that it will be relevant to consider in conducting this inquiry. However, we do not propose to canvass each relevant issue, as we do not pretend to have expertise in all aspects of the banking market and banking regulation.

Instead, this submission focuses on measures which we believe would enhance the ability of Australian consumers to help drive competition in banking. We do not suggest that these alone would provide a panacea for problems in the Australian banking sector, but we do consider that they could have a significant positive impact in terms of enhancing banking competition.

Our submission is structured as follows:

1. An introduction to the role of consumers in effective competition, focusing on search and switching costs and behavioural biases.
2. Account switching
3. Mortgage early exit fees
4. Simplified comparable disclosure
5. Conflicts of interest
6. Unfair terms in contracts
7. Distributing the benefits of competition more equitably, focusing on concession accounts, penalty fees and ATM fees
8. Monitoring of the banking sector, focusing on market studies and investigations powers and public information.

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We note that Consumer Action has raised many of the matters in this submission when participating in previous inquiries and consultations, including the Productivity Commission's inquiry into Australia's consumer policy framework from 2007-2008, the consultation on aspects of account switching undertaken by the Australian Payments Clearing Association in 2007, the House of Representatives Standing Committee on Economics inquiry into competition in the banking and non-banking sectors in 2008, and the Australian Securities and Investments Commission's (**ASIC**) consultation on the application of the new national consumer credit and unfair contract terms laws to mortgage early exit fees in August 2010.

Our comments are detailed more fully below.

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action provides free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and is the largest specialist consumer legal practice in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

Since September 2009 we have also operated a new service, MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians with changed financial circumstances due to job loss or reduction in working hours, or experiencing mortgage or rental stress as a result of the current economic climate.

The role of consumers in effective competition

Consumer Action believes that fair, effective and competitive markets generally deliver the best price, quality and access to goods and services to the majority of consumers.

Since the retail banking sector was deregulated over 20 years ago, Australian consumers have benefited from competition through an improved range of product offerings and cheaper prices for many financial services, which has, in turn, improved access for many (but not all) consumers. Some of these benefits have diminished somewhat in the immediate aftermath of the global economic downturn, but in general it does appear that the introduction of competition into the banking market has been beneficial for many Australian consumers.

However, we can sometimes forget that consumers are not just the passive beneficiaries of competition. Rather, informed and active consumers are also a precondition to effective competition.[1]

[1] See, eg, Productivity Commission, *Review of National Competition Policy Reforms*, Report no. 33, Canberra 2005, box 10.3, p.280; Louise Sylvan, 'Activating competition: The consumer-competition interface', (2004) 12 *Competition & Consumer Law Journal* 1; see also, in the US, Neil W. Averitt and Robert H. Lande, 'Consumer Sovereignty: A Unified Theory of Antitrust and Consumer Protection Law', (1997) 65 *Antitrust Law Journal* 713; and in the UK, John Vickers, *Economics for consumer policy*, British Academy Keynes Lecture, 29 October 2003.

This means that effective competition will not necessarily occur just because the supply side of a market is competing vigorously. Instead, consumers must also be able to locate, understand and choose between the options available in a market, in a manner that genuinely reflects their interests and preferences. For ongoing products and services, consumers must be able to switch to new suppliers if they find a better option. Barriers to consumers searching and switching are called search costs and switching costs – these must be tackled in order to release consumers to drive competition.

The Productivity Commission provides a good summary of this important role that consumers play in facilitating competition and promoting well-functioning markets, as well as the role of competition and consumer policy more generally, in its review of Australia's consumer policy framework.[2] It states:

> In seeking the 'best' value (the good or service and price/quality combination most appropriate for them) consumers not only advance their own self-interest, but also provide signals to suppliers on the product characteristics they require. Competition between suppliers, who respond to these signals, can variously lead to lower costs, improved product quality, greater innovation and higher productivity (see, for example, OECD 2007b, p. 8).
>
> However, poorly informed consumers send weak and confused signals to the market, limiting the benefits they receive from transactions and reducing gains from competition more generally. As pointed out by Vickers (2003), informed choice has two dimensions — knowing the alternatives on offer and having the ability to judge their price and quality differences.
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> ...
>
> To this end, a key goal of consumer policy is to overcome significant information failures that can hinder effective competition. However, it is important to emphasise that competition is a means to achieving an improvement in consumer wellbeing rather than an end in itself. In addition, it is only one means. Where competition is limited (or absent), consumer policy can still achieve improvements in consumer wellbeing through other policy responses such as business or product regulation, improved access to redress mechanisms, and support measures (such as legal aid and financial counselling).
>
> It is also important to note that good consumer policy benefits good businesses (and their shareholders) as well as consumers. To the extent that consumer policy makes it more difficult for rogue operators to survive, those who do the right thing benefit.

Therefore, our view is that the Committee will need to include a strong focus on the demand side of the banking sector in addition to the supply side, if it wishes to gain an accurate picture of why the banking sector in Australia is not operating as well as it could be.

A further issue to note is that, as in other major consumer markets, the benefits of competition in banking have not always been distributed evenly, and some disadvantaged and vulnerable consumers have actually been made worse off, as has been noted previously by the Reserve Bank of Australia (**RBA**).[3]

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[2] Productivity Commission, *Review of Australia's Consumer Policy Framework - Productivity Commission Inquiry Report: Volume 2 – Chapters and Appendixes*, No. 45, 30 April 2008, p.28.
[3] See, Reserve Bank of Australia, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, April 2003, pp.4-6; Reserve Bank of Australia, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*,

As stated by the Productivity Commission above, it should be remembered that the overall goal of competition policy in Australia is to improve or enhance the welfare of Australians.[4] We therefore recommend that the Committee, as an important related matter, include a consideration of ways to rectify market failures in order to enable the benefits of competition to be distributed to all Australian consumers more equitably.

Search and switching costs in the banking sector

In the Australian retail banking sector, the ability of consumers to facilitate competition is currently limited by a number of factors. Some of the principal problems are with search and switching costs for consumers.

In the UK, writers such as Waterson, Waddams and Klemperer have discussed the effect of barriers to consumers effectively exercising their power in the market place, particularly search and switching costs.[5] As well as the effect on individuals (for example, that they pay more than they should for a product or service or that they are unhappy with their purchase), they point to significant effects on competition and efficiency more generally.

Waterson, for example, examines levels of consumer switching across a number of markets, showing how even across similar industries, different consumer behaviour leads to markedly different results in performance.[6] He found that in markets with significant search or switching costs, firms' prices were higher, or even at the monopoly pricing level. Further, in markets where firms can discriminate between old and new customers, and switching costs are significant, prices are lower in the first (new) period and higher in the second (old) period than if there were no switching costs.[7]

Klemperer identifies six key switching costs, which he defines as 'a cost [that] results from a consumer's desire for compatibility between his current purchase and a previous investment'.[8] These are:

1. Need for compatibility with existing equipment;
2. Transaction costs of switching suppliers;
3. Costs of learning to use new brands;
4. Uncertainty about the quality of untested brands;
5. Discount coupons and similar devices; and

May 2005, p.69.

[4] See also, *Trade Practices Act 1974* (Cth) s.2; *National Competition Policy*, Report of the Review, 1993 (the Hilmer Report), pp.1-7.

[5] See for example M. Waterson, *The Role of Consumers in Competition and Competition Policy*, University of Warwick Economic Research paper no.607, 2001; P. Klemperer, 'Competition when Consumers have switching Costs: An Overview with Applications to Industrial Organization, Macroeconomics, and International Trade', (1995) 62 R*eview of Economic Studies* 515–539; C. Waddams, M. Giulietti & M Waterson, 'Consumer Choice and Industrial Policy: a study of UK Energy Markets' (2005) 115 *The Economic Journal* 949-968; See also from the United States: C. Camerer, S. Issacharoff, G. Lowenstein, T. O'Donoghue & M. Rabin, 'Regulation for Conservatives and the Case for "Asymmetric Paternalism"' (2003) 151 *University of Pennsylvania Law Review* 1211-1254.

[6] Waterson, as above, p.7.

[7] As above, pp.4-5.

[8] Klemperer, above n5, p.517.

6. Psychological costs of switching or non-economic "brand loyalty."[9]

He concludes that 'consumer switching costs (whether real or perceived) are widespread, and our analysis suggests that the resulting welfare losses may be substantial: switching costs generally raise prices and create deadweight losses…in a closed oligopoly'.[10]

The significance of the potential impact of these factors has lead both Waterson and Klemperer to conclude that there is a positive role for policies or interventions that reduce these costs.

Klemperer sees a role for better public policy to help consumers drive competition:

> …public policy should discourage activities that increase consumer switching costs (such as airlines' frequent-flyer programmes), and encourage activities that reduce them (such as standardisation that enhances compatibility and reduces learning costs of switching, and quality regulation and information sources that reduce consumer uncertainty about untested brands).[11]

Importantly, Waterson points out that the difficulties consumers can face in searching for different choices and switching between providers is not just the fault of individuals. He therefore considers that governments do have a role to counteract bad practices by suppliers:

> Search behaviour may be thought to be a characteristic of individual consumers and therefore not something that may be influenced by public policy, unlike the actions of firms. However, this is untrue since consumers' search costs are manipulable by those who supply the good in question…Therefore, by enforcing or prohibiting particular practices, public agencies may influence search costs…Similarly, and perhaps more obviously, switching costs are altered by various means by the suppliers in their own interest.[12]

In fact, Waterson explicitly examined the UK current account banking market at that time. He found it was a market where low switching by consumers, due to cumbersome procedures to change bank, had led to abnormally high profitability, especially in comparison with other financial services markets, for example the car insurance market.[13]

Another example that Waterson examined was the UK electricity market. In this context he noted that with so many firms competing to sell an essentially homogeneous product, all incurring fixed costs, it should not be expected that they would engage in proper price competition. Rather, he pointed out that they would aim to differentiate the product in some way, either by adding on services to create product differentiation in order to relax price competition, or by seeking out particular market niches. Price movements were not converging towards lower prices and consumers were not switching due to perceived high search costs and switching costs. Parallels with retail banking, particularly transaction accounts, are clear.

Consumer Action believes that one important way in which high search costs in the Australian retail banking sector could be tackled is by introducing better information through simplified,

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[9] As above, pp.517-518.
[10] As above, p.536.
[11] As above, p.536.
[12] Waterson, above n5, p.5.
[13] As above, pp.8-10.

comparable disclosure. We also believe that high switching costs in banking, like was observed in the UK, could be tackled by introducing an effective account switching procedure and further action to address unfair mortgage early exit fees. We discuss these specific policy measures in more detail below.

Behavioural biases of consumers and the effect on competition

The points made above all fit with the view of markets, competition and consumer behaviour assumed by classical economics – that markets are filled with *perfectly rational* consumers who will try to make *choices that maximise their self-interest* and fulfil their *pre-determined* preferences using *all the relevant information available*.

However, while this assumption may hold in general terms for some consumers some of the time, it is now understood that actual consumer behaviour in markets can also often differ markedly and systematically from this assumption.[14]

Therefore, in considering policy responses aimed at assisting consumers to drive competition in the banking sector, the Committee needs to consider consumers' actual behaviour in markets.

Behavioural economics examines actual consumer behaviour in markets and identifies systematic biases and departures from the perfectly rational consumer that is assumed by classical economics.[15] It is the systematic nature of the departures that is significant, as classical economics has sometimes tended to respond to observed consumer irrationality by asserting that such behaviour by individuals in effect "averages out" to overall rational behaviour. Behavioural economics directly challenges that thesis. Behavioural economics has significant implications for policy, allowing these systematic biases or departures to be considered in determining whether intervention is necessary and in judging the efficacy of proposed responses to market problems.

There are a number of insights from behavioural economics that help explain consumer behaviour in financial services markets. These include:

- Heuristics: individuals tend to use simple rules of thumb, particularly in the face of complexity, rather than weigh up all options. Where those rules of thumb are inaccurate or wrong they lead us away from sound decisions and sometimes they can have costly implications.
- Confirmation bias: once individuals make a commitment (for example, opening a bank account or borrowing from a particular lender) they seek evidence to confirm they have made the right choice and disregard evidence that they have made the wrong choice.[16]
- Default bias: individuals tend to procrastinate and remain with the status quo (for example, consumers tend to adopt the default superannuation fund of their employers).[17]

[14] See, eg, Productivity Commission, above n2, pp.373-388.
[15] For a list of biases in consumer behaviour, see: OECD Committee on Consumer Policy, *Roundtable on Demand-side Economics for Consumer Policy: Summary Report*, 20 April 2006, Appendix II. Behavioural Biases, p.3; also Productivity Commission, above n2, pp.380-381.
[16] McAuley, Ian, *YOU CAN SEE A LOT BY JUST LOOKING: Understanding human judgment in financial decision-making*, Centre for Policy Development, Paper to accompany presentation to Australian Bankers' Association: Broadening financial understanding – financial literacy summit, 2 July 2008, p.13.

- The endowment bias: people are reluctant to give up what they have and will retain a financial product that they would not now newly take-up (for example, they may stay with a managed fund that posted negative returns in the last year although they would not join a managed fund that posted negative returns in the last year).[18]
- Overconfidence: people overestimate their own abilities. In one study it was found that 80 per cent of respondents rated themselves in the top 30 per cent of drivers. A 1999 study found that individuals over-respond to low pre-teaser interest rate offers on credit cards, naively thinking that they will not borrow much on the credit card after the teaser rate is removed.[19]

There are numerous other biases which consumers are subject to and that can, in some circumstances, mean that consumers fail to foster competition as neoclassical economics predicts them to.

In the banking sector, structural factors can often bring the negative consequences of these biases to the fore. For example, the increased use of direct debit and credit arrangements on bank accounts has exacerbated the bias to stay with a bank account once opened (discussed further below).

It should be noted that financial services providers already regularly apply consumer behavioural principles in their own product design, advertising and marketing. For example, credit cards can be designed so that the lender profits from consumers' tendency to discount future costs, preferring short-term benefit. Marketing of offers to increase credit card limits can be framed not as an invitation to apply but as 'pre-approved', activating consumers' disinclination to give up something they already have.

Thus, any government failure to use these principles in its own policy responses immediately places government at a disadvantage.

The effects of failing to consider behavioural principles have already been seen in the use of disclosure regimes in the Australian financial services market. Not only are consumers highly unlikely to actually read complex and detailed disclosure documentation, other forms of disclosure can have the opposite effect to that intended. For example, one study found that rather than making consumers more cautious, disclosure of a conflict of interest raised their trust regarding the adviser.[20] Another study showed that mortgage broker compensation disclosure can actually confuse consumers and lead them to make worse decisions than they would have had no disclosure been provided.[21]

The emerging body of work in behavioural economics is providing insights about why products or policies succeed or fail. We believe that policy makers and regulators should actively explore

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[17] As above.
[18] As above, p 21.
[19] Productivity Commission, above n2.
[20] See D.M. Cain, G. Loewenstein & D.A. Moore, 'The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest' (2005) 34 *Journal of Legal Studies* 1 - 25.
[21] See J.M. Lacko and J.K. Pappalardo, 'The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment', *Bureau of Economics Staff Report*, Washington DC: Federal Trade Commission, February 2004.

opportunities to consider these in current policy design. The Committee should also take these insights into account in formulating its recommendations.

For example, behavioural insights will be relevant in relation to mortgage exit fees, where better disclosure may be of some but limited use. Consumers do not generally take early exit fees into consideration when choosing a mortgage - due to biases such as overconfidence (thinking they will not need to end their mortgage early) and hyperbolic discounting (difficulty weighing present and future costs). Thus, a policy of simply ensuring that such fees be disclosed more clearly to consumers would be unlikely to be effective in meeting the ultimate goal of such a policy, as it would not actually drive consumers to make decisions properly taking those fees into account. Further, those fees would then continue to act as a barrier to switching when consumers were later considering whether to change mortgage provider. Mortgage exit fees are discussed further below.

Account switching

Consumer Action believes that a very low rate of account switching in the retail banking sector is inhibiting effective competition in Australian banking.

There are several factors that are probably contributing to high switching costs and leading to low customer mobility between bank accounts. These include difficulties in being able to compare information about different options, bundling and tying practices (where customers have their bank account tied to other products with the same provider, for example a home loan and credit cards), and cumbersome administrative processes for switching accounts.[22] There are also psychological barriers to switching including as a result of behavioural biases such as the default or status quo bias, described above.

One of the particular problems in terms of the administrative burden is that switching a transaction account is now further complicated by the widespread use of direct debit and credit arrangements. Direct debit and credit arrangements are generally efficient payment methods, but they do interfere with a consumer's ability to change bank accounts easily, and thus create an additional switching cost.

Europe has moved to address some of these problems, with the European Commission releasing proposals in late 2007 to facilitate bank account switching and review measures to address product tying or bundling.[23] In relation to account switching, the European Commission asked the European banking industry to develop a set of common rules for account switching based on benchmarks it provided and indicated it would consider legislation if this was not done.

[22] See European Commission, *Summary of the Responses to the Public Consultation on the Report of the Expert Group on Customer Mobility in Relation to Bank Accounts*, 20 November 2007.
[23] European Commission, *Initiatives in the Area of Retail Financial Services*, Commission Staff Working Document, Accompanying Document to the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A single market for 21st century Europe, 20 November 2007.

The banking industry responded by developing *Common Principles for Bank Account Switching*, which have been implemented in almost all member states since 1 November 2009.[24] The European proposals fall short of full bank account portability, but do provide that:

- banks must provide consumers with a switching guide explaining what steps need to be taken in the switching process, by whom and within which timeframe;
- if the consumer chooses, their new bank must act as a "complete" intermediary between the consumer and their old bank as well as third parties, by which we mean that the new bank (not the consumer) performs all the relevant steps, including obtaining the necessary information about the consumer's recurrent payments from their old bank, reinstalling these payments on the new account, asking the old bank to cancel these payments on the old account, and informing third parties about the consumer's new account details;
- the new bank must assist the consumer to request that their old bank close their old account and transfer the remaining balance;
- there are clear timeframes that must be followed, including that the old bank must provide the information about recurrent payments within seven banking days of receiving the request to do so and the new bank must set up the recurrent payments on the new account within seven days of receiving this information; and
- the information provided by the consumer's old bank and the closure of their old bank account should generally be free of charge.

Member states have also been free to build on these minimum requirements. For example, the Netherlands banking industry had developed an interbank switching service before these common principles were implemented. The Dutch service is not a full bank account portability service but from the consumer's viewpoint it presents as a seamless service. Once a consumer (or a small business) applies to use the switching service, for 13 months their new bank ensures that their old bank reroutes direct credits to the new account and as direct debits hit the old account, they are also rerouted and the creditor is informed of the new account and to change their details for future debits. (The consumer must inform their employer and other parties that direct credit their account about their change in account sometime within the 13 months – they receive a notification of the impending end of their switching service one month before it ends.) Rerouted transactions are separately noted on the consumer's bank account statements.[25]

In Australia, the responsibility for transferring such arrangements, which may exist for a range of automatic transfers, including salary, mortgage repayments, utility bills, insurance bills and others, still lies with consumers.

Often, consumers decide that it is too difficult or costly to switch transaction account providers, if they have to terminate and re-establish a number of direct debit and credit arrangements.

[24] See the documents at the European Commission's webpage on *Customer mobility-Bank accounts* for more information: http://ec.europa.eu/internal_market/finservices-retail/mobility/bank_switching_en.htm.

[25] See OECD, *Competition and Regulation in Retail Banking*, Background paper by the Secretariat, Working Party No. 2 on Competition and Regulation, 16 October 2006, p.23.

In February 2008, the Government, in collaboration with industry, announced a package of reforms aimed at improving the capacity of consumers to switch bank account providers.[26] The package included a new listing and switching service to be developed by the industry to make changing bank easier and an ASIC review of mortgage exit and early termination fees (discussed below).

Consumer Action strongly welcomed these reforms and participated in initial consultations with the Australian Payments Clearing Association (**APCA**), the industry body tasked with primary responsibility for developing and implementing the listing and switching service. However, we became concerned with the progress of the service as it was developed, particularly due to APCA's heavy emphasis on the costs to business of implementing the service balanced with very little emphasis on producing a system that was actually effective in assisting consumers to switch, the whole point of the initiative.

An interim listing and switching service was implemented soon after the announcement was made, and the final listing and switching service was in place from November 2008. Consumer Action believes that the service is inadequate for several reasons, including:

- The service only requires the consumer's old bank to provide the consumer with a paper print-out list of direct debit and credit arrangements that have been made on their account over the past 13 months. It is then up to the consumer to use this list to identify all direct credit and debit users and notify each party individually of their new bank account details.

  The consumer's new bank must offer assistance in producing letters to send to each third party if requested by the consumer, but not actually take charge of setting up the recurring payments. Also, the list will include periodic payments (direct debits set up by the consumer rather than a third party creditor), but the switching service does not extend to these payments (or to "Pay Anyone" regular payments), meaning the consumer is then responsible for re-establishing these on their new account.

  Further, the list produced by the old bank is not a clean list of each unique direct debit and credit, but, literally, every single recurring payment made in the 13 month period, meaning the consumer receives a long list of direct debits and credit, with the same third parties often appearing many times.

- The new service does not apply to credit card accounts, including scheme debit cards. This means that any direct debits established on the consumer's account using the number of a scheme debit card attached to their account will not appear on the list and must be separately identified by the consumer and advice then provided separately to third parties making these direct debits.

  Given that the use of scheme debit cards for access to transaction accounts is now the norm in Australia, this is a particularly unhelpful exclusion. We note that it was difficult for APCA to address this issue, as it has no jurisdiction over credit card schemes, but this does raise the question of whether APCA was the appropriate body to have carriage of the reforms.

[26] Treasurer Wayne Swan, *Media Release – Rudd Government makes it easier for Australian families to switch banks*, 9 February 2009.

- There is no provision preventing consumers from being charged for the service. The service is self-defeating if consumers are charged as any fee would increase the cost of switching (the very thing the initiative was designed to reduce).

Further, in mid November 2010, Consumer Action conducted a review of the listing and switching service currently offered by various Australian banks and credit unions.[27] Information about the switching aspect of the service is generally easy to find and institutions do not appear to charge for its use. However, information about the listing service – the requirement to give a 13 month list of recurring payments – was more difficult to find and it was particularly difficult to determine whether institutions charge for this aspect of the service. In our view, this only exacerbates the ineffectiveness of the service for consumers.[28]

In its final report to the RBA on the implementation of the account switching package, APCA stated that it had requested that its members provide regular statistics to monitor usage of the package following implementation.[29] However, we are unaware of such statistics being published.[30]

We believe that the Australian listing and switching service compares poorly with overseas practice and strongly recommend that it be improved. We also strongly recommend that the Federal Government take charge of developing this initiative.

To be fair, as noted above, APCA has a limited role as an entity that deals only with certain payments clearing systems and does not deal with the credit card and scheme debit card systems. APCA is also an industry collaboration body owned by the banks, building societies and credit unions, thus it is not a government regulator, nor does it have consumer policy functions. As such, we believe that APCA was not necessarily best placed to deliver the initial switching package.

In terms of the content of an improved switching initiative, Consumer Action recommends that bank account portability should be properly considered as part of the process for developing a better initiative. Clearly, the ability for consumers simply to move their bank account number to a new provider, rather than have to switch all direct debit and credit arrangements over, would be more effective in reducing switching costs in the banking sector than other arrangements.

We acknowledge that there may be technical difficulties in adopting this approach, but we also note that similar opposition was raised to proposals for mobile telephone number portability. Such a scheme was ultimately introduced to address barriers to consumers switching mobile telephone provider and this has proved successful.

There are also alternatives to full account number portability that would still provide a much easier service for consumers than currently exists in Australia. The Dutch service is an

[27] We reviewed the websites of the following institutions: ANZ, Bank of Queensland, Bendigo Bank, CUA, CBA, ME Bank, MECU, NAB, Teachers Credit Union, and Westpac.

[28] It does appear that several institutions may charge for producing the list but this was not clear. The Committee may wish to ask institutions appearing before it to confirm whether this is the case and, if so, how much they charge.

[29] APCA, *Final Progress Report on Implementation of an Account Switching Facilitation Package*, 31 October 2008, p.4.

[30] See, however: Jessica Irvine, 'Broken promises derail bank plan', *Sydney Morning Herald*, 15 August 2008, which reported that at that stage very few Australian customers had used the new listing and switching services.

excellent example of such an alternative, using automatic rerouting of direct debits and credits to facilitate switching.[31] APCA has noted that in the Netherlands and various other overseas payments systems, direct entry transactions occur through a central processing switch, whereas in Australia they are cleared and settled on a bilateral basis, and it has stated that, therefore, automated processes such as occur in the Dutch service 'are not currently considered technically feasible for Australia'.[32] However, the head of ING in Australia (a Dutch bank) has recently been reported as calling for just such a service in Australia, reportedly saying the process could be enabled fairly quickly by requiring banks to forward direct debit charges or credit payments to a customer's new bank and that it 'can be implemented overnight. It is not technically difficult'.[33] We therefore do not accept that such an initiative should simply be dismissed without proper consideration.

Finally, even if such initiatives did prove technically difficult and too expensive, we note that the current Australian package would still compare poorly with the basic European standards, which require banks to perform all the relevant steps in the switching process rather than relying on consumers to discover that they are entitled to an incomplete, paper-based, confusing list of recurring payments.

We therefore recommend that the Government immediately begin a process of developing an improved bank account switching initiative and impose a deadline on the banks to deliver the final package within the next two years. At a minimum, this initiative should require a consumer's new financial institution to undertake all relevant steps to facilitate the switch, as is the case under the European principles.

Recommendation

The Committee should recommend that the Government immediately begin a process of developing an improved bank account switching initiative and impose a deadline on the banks to deliver the final package within the next two years.

This process should examine all options, including account number portability and automatic rerouting of direct debits and credits. At a minimum, the final initiative should require a consumer's new financial institution to undertake all relevant steps to facilitate the switch, as is the case under the European principles.

Mortgage early exit fees

As noted above, the Government's February 2008 announcement on a package of switching reforms included tasking ASIC with a review of mortgage exit and early termination fees.

[31] See also J. Gans, S. King & G. Woodbridge, 'Numbers to the People: Regulation, Ownership and Local Number Portability' (2001) 13 *Information Economics and Policy* 167-180, which discusses how mobile telephone number portability could potentially have been effected in more efficient ways.

[32] APCA, *Payments Industry Consultation Paper: Aspects Of Account Switching*, September 2007, pp.14-16.

[33] 'ING Direct chief calls for account number portability' *Business Spectator*, 22 November 2010, www.businessspectator.com.au/bs.nsf/Article/Banker-calls-for-account-number-portability-pd20101122-BERH6?opendocument&src=rss.

Consumer Action believes that excessive and unjustified early exit fees represent a serious barrier to switching in the mortgage market, inhibiting competition. Consumers not only suffer the cost of onerous exit fees, but also the opportunity cost of being prevented from opting for a more attractive alternative product. Across the market more broadly, the reduces the pressure on lenders to provide better and more competitive products.

Mortgage early exit fees are justified to the extent that they represent a genuine pre-estimate of the loss, or costs, borne by lenders in the event that the consumer chooses to terminate their contract early. However, where fees do not reflect, or indeed exceed, a genuine pre-estimate, they unreasonably profit the lender and stifle competition by 'locking' consumers into contracts they would otherwise exit.

In our own legal casework, we have seen mortgage early exit fees act as a strong barrier against a consumer exiting their mortgage in order to take up a mortgage with a different provider. For example, this was the situation in the legal action we brought on behalf of a consumer against RHG Mortgage Corporation in December 2008 (which has since settled on confidential terms). In that case, our client chose a variable rate home loan based on representations that the product's interest rate would remain competitive, but after several rate rises over approximately an 18 month period, her home loan rate was considerably higher than other rates in the market, but she felt unable to switch because she faced an early exit fee of over $12,000.[34] Over 100 other customers of that lender also contacted us in response to publicity about the case.

ASIC released its report on mortgage entry and exit fees in April 2008.[35] This was welcome, because information about fee types and levels provided a platform for further debate.

Amongst other matters, the ASIC report found that most Australian mortgages now charge an early termination fee and that Australian mortgage fees are generally higher over the transaction lifecycle when compared internationally, while average home loan interest rate net margins are also higher in Australia. It also showed that average mortgage entry fees were higher in the US and UK but average mortgage early exit fees were much higher in Australia. Further, it showed that, in Australia, there is not necessarily a correlation between higher fees and a lower interest rate.

However, publication of the report alone does not ensure that these fees are set at fair levels and do not unreasonably restrict consumers from switching. No public action has been taken directly based on the ASIC report.

On the other hand, both the Government and ASIC have done further work on the issue. Two new pieces of Federal legislation were passed in the 2009-2010 period that will have an impact on mortgage early exit fees. These are the *National Consumer Credit Protection Act 2009* (specifically, the provisions in the National Credit Code under that Act that allow a court to review an unconscionable early termination fee in a credit contract) and the new national unfair contract terms provisions inserted into the *Australian Securities and Investments Commission*

[34] Consumer Action Law Centre, *Consumer Action Launches Test Case Against Mortgage Exit Fees*, Media Release, 8 December 2008.
[35] ASIC, *Review of mortgage entry and exit fees*, Report 125, April 2008.

Act 2001, to apply to all consumer contracts for financial services, by the Australian Consumer Law reforms.

These laws are what might be called “principles-based”, in that they are not targeted solely at mortgage early exit fees nor do they set out prescriptive requirements, but do provide for general rules that apply in numerous situations including to home loan contracts.

The consumer credit law provisions provide that an early exit fee in a credit contract (such as a mortgage but also other loan products) can be challenged by a consumer or ASIC as ‘unconscionable’, which if successful allows a court to cancel or reduce the fee. A court can determine that the fee is unconscionable if it appears to the court that the fee ‘exceeds a reasonable estimate of the credit provider’s loss arising from the early termination or prepayment, including the credit provider’s average reasonable administrative costs in respect of such a termination or prepayment’.

The unfair contract terms provisions provide that a consumer or ASIC can challenge a term in a consumer contract (which includes a home loan contract) as ‘unfair’, which if successful renders that contractual term void, meaning it is struck from the contract and cannot be enforced (a range of related orders are also then potentially available). A term is unfair if it would cause a significant imbalance in the parties’ rights and obligations arising under the contract, it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term and it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on. Courts are also directed to take certain factors into account in making an assessment of whether a term is unfair under this general test.

On 10 November 2010, ASIC released a formal Guidance on how it will approach its role in administering and enforcing these two new laws as they apply specifically to mortgage early exit fees.[36] This Guidance makes it clear that ASIC does consider that these fees could fall foul of the new laws in certain circumstances and that ASIC could potentially take action to enforce the new laws in the future if it considered doing so was in the public interest.

In relation to the consumer credit laws, ASIC states that it considers only losses caused by an early termination (and not just termination per se) can be recovered through an early exit fee, and sets out some types of costs that may or may not be considered in this category. Regarding the unfair contract terms law, ASIC sets out what it thinks might make an early exit fee unfair, including what types of business interests it may not be ‘legitimate’ to cover through these fees. Importantly ASIC considers 'deferred establishment fees' to be a type of fee for early termination, a view Consumer Action agrees is correct.

Consumer Action believes that the need for regulatory intervention in relation to these types of fees was inevitable, given a policy goal of preventing their negative effect on competition in financial services markets.

[36] ASIC, *Early termination fees for residential loans: Unconscionable fees and unfair contract terms*, Regulatory Guide 220, November 2010.

Such regulation does not interfere with the operation of a competitive market, rather it is the type of regulation that supports and facilitates the market to operate in an effective and competitive manner.

There have been arguments that mortgage early exit fees (or deferred establishment fees) actually allow some lenders to “compete”, and that regulating or removing them would have a negative outcome for consumers because this would stifle competition and/or lead to an increase in mortgage entry fees as an alternative.

We certainly agree that early exit fees (including deferred establishment fees) may allow some lenders to *attract* mortgage business away from other lenders, but we do not agree that this attraction of business is the same thing as *effective and beneficial competition for* that mortgage business.

Early exit fees allow loans *artificially* to appear cheaper than they are. To the extent that they do represent establishment costs, by back-ending them and expressing them to be contingent on an event occurring or not occurring, consumers are much less likely to be aware of them than if they were disclosed clearly upfront, and behavioural insights teach us that consumers are also less able to take them into account in calculating the total of the loan than an upfront fee, due to biases such as overconfidence and hyperbolic discounting. This may lead consumers wrongly to choose a loan that is actually more expensive in total.

It has also been argued that the interest rate on a home loan with an early exit fee has been set to take account of establishment costs, with the early exit fee applying for, say, 3-5 years, namely, after 3-5 years the establishment costs have been recovered through the interest paid over the period and an early exit fee no longer need apply. This suggests that the interest payments are thus higher than they might be if an upfront establishment fee was charged instead. It also then follows that in the absence of an interest rate decrease at that point, ongoing interest payments are recouping additional, inefficient, profits because the interest rate remains at that higher level on an ongoing basis. Again, this highlights the distorting and anti-competitive effect that early exit fees can create.

It may well be that the removal of mortgage early exit fees would lead to increased entry fees (and the ASIC report shows this may be the case in the UK and the US). We strongly believe that this would, in fact, be a preferable outcome. Instead of assuming that early exit fees save borrowers money, it should be understood that they shift the costs to other places that borrowers are less likely to be able to notice, understand and take into account in making informed decisions about which mortgage to choose. This means that consumers are still ultimately paying those costs, but are not taking them into account in making their decision about which mortgage product best suits their needs. This is a negative result both for the individual consumer concerned and for competition more generally. Upfront fees would be much less distorting, and would be much more likely to be subject to competitive discipline restraining the level of these fees, than early exit fees.

Note that the ASIC report stated that the average Australian mortgage is terminated or refinanced within approximately three years. This means that, although consumers are not aware of it, they are reasonably likely to pay an early exit fee set to apply for between 3-5 years after entering into the loan, even though the fee is expressed as a contingent fee.

However, there is now a question about whether the measures introduced by the new laws are sufficient to address the mortgage early exit fee problem.

This question will, in part, be answered by how vigorously the market is monitored and the new laws enforced by ASIC, and we accept that this can only be determined in time. Further, some lenders have already moved to drop their mortgage early exit fees altogether.

Nevertheless, we believe that there are still some additional, clear ways in which more could be done to clamp down on unfair mortgage early exit fees that the Committee should consider.

First, we could follow the UK lead, described in the ASIC report, of imposing some important disclosure obligations on lenders in relation to these fees. These would include requiring lenders always to disclose early exit fees upfront, and using easy to understand cash amounts (not just complex formulae). These would also include requiring all lenders to call this type of fee by the same name, so that different phrases such as "early termination fee", "early repayment charge" and "deferred establishment fee" do not make it harder for consumers to compare costs across different home loan products. (We discuss simplified, comparable disclosure further below.)

However, disclosure is only a limited tool. Consumers will still be less likely to take exit fees into consideration actively when choosing a mortgage, for the reasons described above - consumers have a tendency to think they will not have to pay them and find it hard to calculate their true cost. Of course, available evidence suggests that on average, consumers will pay them.

The new consumer credit and unfair contract terms provisions are useful in this regard, because they target unfair or excessively high fee levels, not just whether the fee amounts have been disclosed. This leads to our second recommendation, which is that these laws – most obviously the relevant consumer credit law provision – be amended to clarify that that only costs *directly* related to *early* termination can be recovered in an early exit fee.

In Victoria, there is already a model for regulating early termination fees in this way. The *Energy Retail Code*, enacted by the Victorian Essential Services Commission, regulates early termination fees in energy contracts and sets out what are considered direct costs of early termination. The relevant clause states:

> 31. AGREED DAMAGES TERMS
>
> (a) Any agreed damages term, whether providing for an early termination fee or otherwise, must either include the amount that will be payable by the customer to the retailer for the customer's breach of their energy contract or include a simple basis for determining that amount.
>
> (b) Subject to clause 31(c), the amount payable by a customer under an agreed damages term must be a fair and reasonable pre-estimate of the damage the retailer will incur if the customer breaches their energy contract, having regard to related costs likely to be incurred by the retailer.
>
> (c) Any amount of an early termination fee payable by a customer upon the customer breaching their energy contract must be determined by reference to, and must not

exceed, the total of the following direct costs incurred by the retailer in relation to that particular customer which remain unamortised at the time of termination:

(i) pro-rata costs of procuring the customer to enter into the contract; and
(ii) $20:

which comprises:

- the additional costs of giving effect to the early termination of the contract, final billing and ceasing to be responsible for the supply address; and

- the value of any imbalance in the retailer's electricity or gas hedging program to the extent that it is directly attributable to that breach of contract.

This clause is similar to the National Credit Code provision, but also clearly limits the costs recoverable to *direct* costs and identifies the *particular* direct costs that are recoverable.

It is also much easier for a regulator to enforce. A previous version of this clause only set out the types of direct costs that were recoverable and provided guidance as to the likely maximum amount of these direct costs, but more recently the clause was amended to insert the "hard" maximum cap of $20 on some of those direct costs, in light of the regulator's experience that it was difficult, in practice, for consumers to assess whether a retailer's claims regarding the amount payable for these sorts of costs was reasonable.

Recommendation

The Committee should recommend that the Government introduce limited additional regulation of mortgage early exit fees (including deferred establishment fees), requiring disclosure of these fees upfront in a simplified and comparable format (following the UK lead) and clarifying that these fees may only include specified costs that are directly attributable to an early termination.

Simplified comparable disclosure

The Australian banking market is now marked by an increasing number and complexity of products. This creates higher search (and switching) costs for consumers because it becomes more difficult for consumers to find and understand information about the different options available and, importantly, to be able to compare different products and choose between them.

As noted earlier, there is a role for public policy to play in tackling these costs, including through good sources of information and through standardisation measures that enhance the ability to compare information about different providers' products and services.

It is also in the interests of industry participants to do the opposite, making it harder to compare deals by producing more complex products and information about those products, and attempting to differentiate products on a basis other than price, even where products are essentially commoditised or homogenous goods. In Australia, the telecommunications market provides an excellent example of this phenomenon in action – we believe it is currently impossible for consumers to undertake an effective comparison of mobile phone plans and choose the best deal for their usage pattern.

Recent policy responses to problems in the Australian financial sector have relied heavily on the use of disclosure, requiring financial product and service providers as well as brokers and advisers to give consumers a mass of information about their products, advice and/or recommendations, the grounds for these recommendations, and the manner in which they are paid. However, this approach is now widely agreed to have been inefficient and ineffective, in that the disclosure to consumers is simply too much and too complex to be able to process.

Consumer Action agrees and considers that newer, more sophisticated regulatory approaches such as the new national unfair contract terms law will potentially have a much more effective impact in ensuring competitive and fair outcomes in the market than current disclosure obligations. Further, research also suggests that there are other reasons why consumers may not understand core features of a product or service they are buying even with disclosure, such as their financial literacy level, or the time they have to consider the information.[37]

However, this does not mean that disclosure should be rejected completely. We also believe that genuinely simple, short and comparable disclosure would enhance the ability of many consumers to navigate the market and locate the best deals, in turn driving genuine competition. The Federal Government's Green Paper on "Phase 2" of the national consumer credit law reforms (Phase 1 culminated in the *National Consumer Credit Protection Act 2009* and related legislation) points out that research suggests that 'consumers can have a better understanding of the credit contract if the disclosure document focuses on core information, has better formatting and if the consumer has enough time to consider the information'.[38]

We do not consider that 3-4 page documents describing product costs and features represent this sort of simple, short, comparable disclosure, even though such documents would represent a significant change from current disclosure documents produced by the financial services industry.

Instead, we recommend that Australia introduce regulation for genuinely simple and comparable disclosure of information about financial products and services, based on the model of one page, standardised Financial Summary Tables (sometimes called a Schumer box).

Such regulation would require that these Tables be easily available to consumers at any time, including when they are in the process of shopping around, not just when they have already applied for a product and are being given the contract to sign.

On this issue, we refer the Committee to the report produced by Uniquest earlier this year for the Standing Committee of Officials of Consumer Affairs on simplifying the disclosure obligations under Australia's consumer credit laws.[39] The Uniquest report engaged in consumer testing of different forms of Financial Summary Tables and showed that consumers do increase their understanding of the different choices available for a particular financial product, for example a credit card or home loan, if given simple, comparable information about each of the choices. The report concludes that there is an evidence-based rationale for mandating both pre-contractual

[37] For a summary, see The Treasury, *National Credit Reform: Enhancing confidence and fairness in Australia's credit law*, Green Paper, July 2010, p.112.
[38] As above, p.113.
[39] Paul O'Shea, *Simplification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign – Final Report* , Uniquest Pty Ltd, 12 March 2010.

disclosure and also earlier disclosure in a more simple format to enhance the effectiveness of consumer choice. The Report also contains examples of what these Financial Summary Tables would look like.

We also note that the Federal Government has already committed to further reforms specifically in the consumer credit area, as part of “Phase 2” of the national consumer credit law reforms. One of these commitments is to require credit card application forms to include a clear summary of key account features. As part of this process, it is also considering how to apply the findings of the Uniquest report to improve consumer credit disclosure regulation more generally.

This process could be used as the vehicle to develop regulation requiring one page, standardised Financial Summary Tables to be produced and available for all consumer credit products, including home loans, credit cards and personal loans. However, we also believe that such regulation should extend to other banking products, such as transaction accounts.

Recommendation

The Committee should recommend that the Government develop and introduce regulation requiring one page, standardised Financial Summary Tables to be produced and available for all common banking products, including transaction accounts, home loans, credit cards and personal loans.

Conflicts of interest

Another effect of the increasing number and complexity of products and services in Australian banking, coupled with limits on consumers’ time and ability to search and compare, has been the large expansion of intermediaries markets in the Australian banking sector.

It can be more efficient for consumers to use intermediaries to help them make choices than to pay the costs (direct and opportunity) of wading through all relevant information, particularly for one-off or irregular purchases and where the documents are complex and difficult to compare. Further, a tendency to use heuristics means consumers will not necessarily make good choices in any case, whereas an expert intermediary can assist in this process.

However, in the Australian financial services market, intermediaries have tended to source their income from commissions or other forms of payments from the product providers rather than from the consumer. This has meant they do not necessarily act independently or in the best interests of the consumer. These problems with conflicted remuneration structures have now been highlighted in various fora, including other parliamentary inquiries.

Consumer Action therefore recommends that the Committee support reforms to the regulation regarding remuneration of financial advisers and brokers. We support the broad thrust of the Government’s current proposed “Future of Financial Advice” reforms. We note also that it is essential that the final package of reforms capture all forms of conflicted remuneration, for example volume-based targets set for brokers by lenders and platform fees, thus we recommend that the reforms be expanded to cover any form of conflicted remuneration.

Finally we recommend that the Committee support the placement of a fiduciary or 'best interests' duty upon licensees *and* individual advisers. It is necessary that the duty attach to both groups in order to ensure that reforms are effective. Licensees must be subject to the duty to provide incentive to implement systems to ensure compliance and to address poor employee conduct. In turn, the advisers themselves must be subject to the duty to prevent an adviser who has breached the duty with one licensee from simply moving on to another.

Recommendation

The Committee should recommend that the Government expand its proposed Future of Financial Advice reform proposals to cover all forms of conflicted remuneration, including asset-based fees, platform fees and volume-based targets set for brokers by lenders.

Unfair terms in contracts

One of the Committee's specific terms of reference is to inquire into how competition impacts on unfair terms that may be included in contracts.

We have already discussed terms imposing mortgage early exit fees above. On the more general question, we have written extensively in the past about the problem that firms may compete on price and product offering but do not tend to compete on other, non-core contractual terms. One of our reports also includes a cost benefit analysis of introducing unfair terms regulation and concludes that the benefits outweigh the costs.[40]

Recognition of these matters was one of the major drivers for the new national unfair contract terms laws. Given that these new laws have only recently been introduced and are specifically designed to target unfair contractual terms, Consumer Action considers that they should now be given a chance to work, and that the regulators should be given an opportunity to monitor the market and enforce the law. We note that the new laws do not apply to small business banking contracts, however.

Distributing the benefits of competition more equitably

Concession accounts

We pointed out earlier that the benefits of competition in banking have not always been distributed evenly, and some Australians consumers have missed out on the benefits of increasing competition.

Low-income consumers, in particular, are in many cases excluded from banking markets or made to pay more than others to access banking services and consumer credit.

We acknowledge that banks have improved accessibility to transaction accounts, through the offering of basic or concession bank accounts. Most of the major banks now offer such accounts, which have very limited or no fees, and we welcome these initiatives. We do, though,

[40] Consumer Action Law Centre, *The consumer protection provisions of the Trade Practices Act 1974: Keeping Australia up to date*, May 2008, available at www.consumeraction.org.au/publications/policy-reports.php.

note with concern the recent withdrawal of a concession account by one of the major banks, CBA.

However, it is our understanding that very few consumers who are eligible for these accounts are, in fact, using these accounts – although public information about this issue is not available. Many such consumers remain on more expensive accounts that, in some cases, also impose high penalty fees for matters such as overdrawing their account or having a payment on the account dishonoured. While all consumers are vulnerable to such fees, low-income consumers in particular incur these fees because they are more likely to run low account balances.

We strongly recommend that financial institutions be required to take more proactive steps to inform consumers about the most appropriate accounts for their needs.

One way to impose such obligations is through the Code of Banking Practice, a voluntary code of conduct subscribed to by Australian banks, which then forms a contractually enforceable part of consumers' contracts with their bank.

Clause 14 of the Code currently provides for some limited obligations around account suitability, requiring a bank to provide their customer with details of accounts which may be suitable to their needs but only if the customer tells them proactively that they are 'a low income earner or a disadvantaged person' or if, in the course of dealing personally with the customer, the bank becomes aware that the customer is in receipt of Centrelink or like benefits.

The most recent review of the Code finished in December 2008 and recommended strengthening these requirements, including to require banks to provide information about more suitable accounts in more general circumstances, including if asked or if they become aware that the customer's needs are suited to an account which attracts no or low fees and charges. The review also recommended clarifying that the information to be provided in these circumstances includes information about accounts which attract no or low fees and charges.[41] However, these recommendations have not yet been implemented.

We would also recommend that similar changes be made to the Mutual Banking Code of Practice, the code of practice for Australia's credit unions and mutual building societies, to ensure they are subject to the same requirements. This Code does not currently contain account suitability requirements.

Recommendation

The Committee should recommend that the Code of Banking Practice and the Mutual Banking Code of Practice be amended to impose stronger obligations on financial institutions to advise consumers, particularly lower income consumers, about low or no fee accounts for which they are eligible.

[41] Jan McClelland and Associates Pty Limited, *Review of The Code of Banking Practice: Final Report*, December 2008, pp.19-20.

Penalty fees

In terms of penalty fees more generally, we note and welcome moves by the banking industry to lower or remove penalty fees from many of their transaction account and loan products, including credit card over-limit and late payment fees and dishonour and account overdrawn fees on transaction accounts. Importantly, similar to mortgage early exit fees described above, there has been little competitive pressure on financial institutions to keep these fees in check. This is because consumers do not expect to pay penalty fees at the time they open an account or take out a loan or credit card, thus they do not negotiate over these terms (even if they are aware of them). Nor, for similar reasons, do they choose one financial product over another based on the amount of penalty fees.

This is reflected in the growth in these fees over the past decade as reported by the RBA (until moves to eliminate them began last year). Note that transparent information about penalty fee income was not produced by the RBA until its 2009 banking fees bulletin, when it was revealed that in 2008, these fees totalled $1.2 billion, around 10 per cent of banks' total fee income.[42]

However, penalty fee income continues to be very large. In 2009 the RBA reported that while penalty fee income on deposit accounts had started to fall following moves to eliminate the fees, penalty fee income from loans had continued to rise.[43]

We think there is a strong case to further regulate penalty fees to ensure that they are not exploitative, particularly given that the industry has been given more than ample time to address the problem.

Together with CHOICE, we provided a submission to the most recent review of the Code of Banking Practice setting out seven measures that could be taken to enshrine good banking practice regarding penalty fees. Some of these are being implemented but others continue to languish, and we recommended that they be adopted:

1. Disallow unavoidable fees – including deposited or 'inward' cheque dishonour fees (third party dishonour fees) and penalty fees triggered by the bank's own fees and charges.
2. Seek customer approval for transactions exceeding the customer's credit card limit.
3. Do not process account over-draws without the customer's consent.
4. Exclude penalty fees from concessional bank accounts.
5. Ensure the level of fees is referable to the direct costs involved in processing the default and set out what can be considered direct costs.
6. Ensure customers are given a real-time warning that a penalty fee will be imposed if a particular transaction goes ahead.
7. Establish standard penalty fee names.

[42] RBA, 'Banking Fees in Australia', *RBA Bulletin*, May 2009, p.15. In the May 2008 Bulletin, it was reported that Australian banks' total domestic fee income growth for the 2006-07 financial year was 8%, with fee income from households growing slightly faster at 9%. However, fee income from household credit cards grew by a larger 12% and of those fees, the fees other than standard fees such as annual fees – 'mainly late payment fees, over-limit fees and foreign currency conversion fees' according to the Reserve Bank – grew by a whopping 16%.
[43] RBA, 'Banking Fees in Australia', *RBA Bulletin*, June 2010, p.35.

The first and fourth measures above have now been largely adopted by the Australian industry, and the Federal Government has committed to implementing the second and third measures as part of its credit card reforms under "Phase 2" of the national consumer credit law reforms.

However, the remaining three measures have not yet been tackled. Two are similar to the recommendations we have made above in relation to mortgage early exit fees, thus we repeat those recommendation below for penalty fees. The final measure, on consumer warnings, could be implemented by requiring the industry to amend its payment system clearing rules, to require a real-time warning to be given to consumers on ATM screens where a penalty fee will be imposed if a particular transaction goes ahead. Such a measure has been recommended in the past but has still not been voluntarily adopted by the industry.

Recommendation

The Committee should recommend that the Government introduce limited additional regulation of penalty fees, requiring disclosure of these fees upfront in a simplified and comparable format and clarifying that these fees may only include specified costs that are directly attributable to the costs involved in processing the underlying transaction.

The Committee should also recommend that the RBA require the industry to amend its payment system clearing rules, to require a real-time warning to be given to consumers on ATM screens where a penalty fee will be imposed if a particular transaction goes ahead.

ATM fees

There are strong community concerns about the level of ATM fees in Australia, following the implementation of the RBA's reforms in 2009 that saw Australia move to a system of direct charging by ATM operators for consumer use of their ATMs.

Despite the move to direct charging, it initially appeared that banks and other institutions might attempt to continue to charge their own customers "foreign ATM fees" for using other operators' ATMs. These fees were quickly dropped after public pressure following the commencement of the new system.

However, concerns continue around the level of the direct charges that have now replaced "foreign ATM fees". These direct charges are charged by the ATM operator at the time a consumer uses an ATM not operated by their financial institution (or another institution with whom theirs has an agreement for free ATM access).

When the RBA was consulting on its ATM reforms, we made a submission generally supporting the thrust of the reforms but pointing out what we believe were, and continue to be, some shortcomings in the proposals.

In terms of the direct charging regime, we remain concerned that the RBA is relying principally on competitive discipline to keep ATM direct charges to an efficient level. We agree that competitive forces are likely to operate effectively in many circumstances, particularly where there are a number of ATMs available within close proximity to one another, for example in urban (especially urban metropolitan) shopping centres, strips and business areas.

However, we can envisage a number of circumstances in which, in practice, a consumer will have limited other options than simply to use a particular ATM regardless of the direct charge being imposed. These include in regional and particularly rural areas with fewer ATMs available, where it is likely that consumers will have less, and sometimes very little if any, ability to avoid any high direct charges by using a different ATM to make cash withdrawals or balance inquiries; at night (particularly for women) where consumers may not feel comfortable walking to access a more distant ATM regardless of the direct charge; and for people with a visual impairment, who generally require access to particular ATMs that are equipped with the technology to assist them to make cash withdrawals or balance inquiries, including audio enabled ATMs, which is likely to be a more significant factor in their decision about which ATM to use than the direct charge imposed.

In these circumstances, because consumers cannot or will not switch away from that ATM, there is less (if any) competitive pressure on the ATM operator to lower a direct charge.

In all such circumstances, this would mean the direct charges would be free to increase to inefficient and uncompetitive amounts, at odds with the intention of the reforms. Further, we consider that such outcomes are neither appropriate nor in the public interest overall, in that they essentially discriminate between different types of consumers.

We continue to recommend that the RBA provide some limited regulation of direct charges under its Access Regime for the ATM System to address these sorts of circumstances, by:

a. placing a maximum cap on the amount of ATM direct charges, which would act as a proxy or safety-net for an efficient amount where competition is not effective; and/or
b. preventing ATM operators from varying the direct charge levied by any given ATM at different times of the day and night; and/or
c. preventing direct charges from being levied on consumers with specific ATM usage needs such as the visually-impaired or requiring such customers to be provided with rebates for direct charges incurred.

We also note that the new ATM direct charging system also applies both to cash withdrawal transactions and to balance inquiry transactions.

For many lower income consumers, the ability to make a balance inquiry before withdrawing cash from an ATM is an essential step in trying to manage their finances appropriately and avoid other charges such as penalty fees. This is a particular issue in more remote and Indigenous communities, where checking balances regularly can be a common practice.

The ATM Access Regime does not make any distinction between balance inquiries and cash withdrawals and, indeed, consumers will incur two direct charges if they are using a foreign

ATM and first seek a balance inquiry before then making a cash withdrawal.[44] This either acts as a disincentive to consumers undertaking both transactions, increasing the risk that lower income consumers will incur overdrawn account fees charged by their own financial institution, or it simply means that lower income consumers get charged several fees for accessing their funds (or checking whether they have arrived).

Further, the payment system arrangements state that financial institutions *may* decline a foreign ATM transaction where the direct charge may result in the consumer's account being overdrawn,[45] but certainly do not require financial institutions to do so, meaning they are free to allow accounts to be overdrawn by a foreign ATM direct charge and simply levy an additional overdrawn account fee.

This issue highlights the urgency of the reform we recommended above under our discussion of *Penalty fees*, to require the real-time disclosure on ATM screens of a warning to a consumer about to proceed with a transaction for which they do not have sufficient funds in their account, that the transaction may overdraw their account and a fee may be charged by their financial institution for this – giving the consumer the option of cancelling the transaction at that point.[46]

The issue may also require more intensive regulatory intervention to prevent the charging of multiple ATM direct charges in such circumstances, on social policy grounds. We are also aware of strong concerns about the level, not just number, of ATM fees charged in more remote communities and Indigenous communities, thus we recommend that the Committee consider this problem more closely.[47]

Recommendation

The Committee should recommend that the RBA provide some additional limited regulation of direct charges under its Access Regime for the ATM System by:

a) placing a maximum cap on the amount of ATM direct charges, which would act as a proxy or safety-net for an efficient amount where competition is not effective; and/or
b) preventing ATM operators from varying the direct charge levied by any given ATM at different times of the day and night; and/or
c) preventing direct charges from being levied on consumers with specific ATM usage needs such as the visually-impaired or requiring such customers to be offered rebates for direct charges incurred.

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[44] Australian Payments Clearing Association, CECS Manual for Consumer Electronic Clearing System (CS3), Effective 31 May 2010, Version E222, clauses 11.3.1, 11.4.1(d).
[45] As above, clause 11.5.4.
[46] We believe that the speed with which the industry implemented the ATM reform requirements regarding disclosure of information about ATM direct charges on ATM screens demonstrates the ability of the industry to implement the required technology to allow for real-time disclosure of other information, such as regarding overdrawn accounts.
[47] See AFCCRA, *ATM Fees in indigenous communities*, November 2010, available at: www.afccra.org/media%20releases%20documents/ATM%20Fees%20in%20Remote%20Indigenous%20Communities.pdf.

Monitoring of the banking sector

As a final matter, we consider that Australia could greatly improve the manner in which it provides for the public scrutiny and review of important sectors of the economy such as banking.

Future reviews - market studies and investigations powers

Earlier we noted that there are other factors that can act as a barrier to consumers switching accounts, including product tying or bundling. Product tying and bundling is a complex issue and the Europeans have tackled it by conducting a more detailed study of the problem and then a consultation on the evidence and possible measures to address any problems.[48] This is a good example of a sophisticated market review which examines more complex problems in a market in detail in order to come up with more targeted and effective solutions.

More generally, Australia continues to conduct regular public debates and inquiries into banking competition, as well as competition in other industries. However, we have no standing mechanisms for our competition authorities to conduct more targeted or sophisticated reviews and analysis of particular problems in Australian markets.

In the UK, the competition regulators have general 'market studies' and 'market investigations' functions and powers that are not available in Australia. These powers have given the UK regulators the ability to address problems within various markets, including the UK banking sector. We consider they would be a valuable addition to the Australian competition regulatory scheme and would greatly assist in dealing with banking and non-banking problems.

To explain how the UK system works, the UK's independent competition and consumer protection regulator, the Office of Fair Trading (**OFT**), is able to undertake what are termed 'market studies' pursuant to section 5 of the UK *Enterprise Act 2002*. Further, the UK Competition Commission (**UKCC**) can undertake what are termed 'market investigations' under the same Act.

Market studies enable the OFT to examine market problems in any sector of the UK economy, and determine whether perceived problems should be addressed through the OFT's other functions.[49] They can take the form of a short preliminary review, a short study or a more detailed full study and after conducting a market study, the OFT can take a range of actions, including:

- publishing information to help consumers;
- encouraging firms to take voluntary action or adopt a code of practice;
- making recommendations to the Government or other regulators;
- taking enforcement action for breaches of consumer or competition law;
- making a market investigation reference to the UKCC (see below); or

[48] See the documents at the European Commission's webpage on *Customer mobility-Tying* for more information:: http://ec.europa.eu/internal_market/finservices-retail/mobility/tying_en.htm.
[49] Office of Fair Trading, *Guidance on the OFT approach: Market studies*, November 2004, p.4.

- deciding that no further action is warranted.[50]

The *Enterprise Act* explicitly gives the OFT (and some other industry regulators) power to make a market investigation reference to the UKCC if they have 'reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK'.[51] For example, the OFT may consider that it should make a market investigation reference regarding features of a market after undertaking a market study.

After an investigation, if the UKCC finds any 'adverse effects on competition', it *must* take reasonable and practicable action to both remedy, mitigate or prevent the adverse effect on competition concerned and remedy, mitigate or prevent any detrimental effects on customers so far as they have resulted from, or may be expected to result from, the adverse effect on competition, by accepting undertakings or making various orders.[52] Some of the orders available to the UKCC include:

- prohibiting charging prices differing from those in any published list or notification;
- regulating the prices to be charged for any goods or services;
- requiring a person to supply goods or services to a particular standard or in a particular manner; and
- requiring a person to publish a list of prices or otherwise notify prices for goods or services being supplied, and providing for the manner in which this information is to be published or otherwise notified.[53]

The OFT explains that these tools are used by the OFT when market forces cannot overcome threats to consumer welfare, for example where there are structural or behavioural barriers to free competition.[54] It has undertaken market studies on issues including debt consolidation, payment protection insurance and personal current bank accounts in the UK, and the studies have resulted in actions such as education campaigns for consumers, enforcement action, advice to the government to amend legislation and market investigation references to the UKCC.[55]

The UKCC has also undertaken a number of market investigations, including into store card credit services, Northern Irish personal banking services and payment protection insurance, some of these following market studies by the OFT.[56] As an example of the results that can be achieved, the store credit investigation resulted in store card credit providers being required to warn cardholders on monthly statements that cheaper credit may be available elsewhere (where annual percentage rates are 25 per cent or above), and to offer an option to pay by direct debit

[50] As above, pp. 5-10, 13.
[51] *Enterprise Act 2002* (UK) s.131.
[52] As above, ss.138, 159-161.
[53] As above, schedule 8.
[54] Office of Fair Trading, *Annual Plan 2007–08*, March 2007 p.8.
[55] See Office of Fair Trading, *Market studies*, webpage, available at: www.oft.gov.uk/advice_and_resources/resource_base/market-studies/.
[56] Competition Commission, *Market references to the Competition Commission (previously monopoly references): 2000-2007*, webpage, available at: www.competitioncommission.org.uk/inquiries/reference_type/market.htm.

and offer payment protection insurance separately from other elements of store card insurance.[57]

An excellent example of a market study is the OFT's study of the UK personal current bank account market, released on 16 July 2008. It found that the market as a whole was not working well for consumers, with very low rates of switching between accounts due to the complexity of determining the best deal on fees and the problems that can occur when switching, for example the incurring of penalty fees.[58] The findings support our earlier arguments about switching problems in the Australian banking sector, and we note the OFT came to a view that while market forces are generally the preferred option, in this case some form of regulatory intervention was necessary.[59] The OFT has since been undertaking a range of measures in consultation with the banking industry to address various strands of its review, including switching and unarranged overdraft charges.

The UK market studies and investigations powers have resulted in a variety of important investigations and a large range of different and considered actions to fix problems. Thus in a 2003 report comparing the different consumer policy regimes of various countries, including the UK, the US, Canada and Australia, the UK Department of Trade and Industry concluded that, while it could make improvements in many areas, the UK was amongst the best in terms of investigating markets that are not working well for consumers.[60] Australian law contains no similar provisions, meaning the Australian Competition and Consumer Commission and ASIC are unable to undertake these important studies and investigations where market problems and their solutions are not immediately obvious. Instead, they are confined to narrower investigations based on the issues raised in particular complaints received.

We therefore strongly recommend that Australia introduce market studies and investigations powers, based on the model in the UK *Enterprise Act*, into its regulatory framework.

Recommendation

The Committee should recommend that the Government introduce market studies and investigations powers, based on the model in the UK *Enterprise Act*, into Australia's competition law framework.

Public information

We also noted earlier that in the past there have been problems with accessing public information about important aspects of the Australian banking sector, such as statistics on consumer use of the account listing and switching service, information about penalty fees and their underlying costs, and information about the number of consumers accessing concession bank accounts.

We believe that important information about the banking sector should be more transparent and published regularly by our financial regulators. We recommend that the Government review the

[57] Competition Commission, *Store Cards Market Investigation Order*, 27 July 2006.
[58] Office of Fair Trading, *Personal current accounts in the UK: An OFT market study*, July 2008.
[59] As above, p.111.
[60] Department of Trade and Industry UK, *Comparative Report on Consumer Policy Regimes*, October 2003, p.33.

powers of the financial regulators to require information from banking sector participants and that our regulators consult with stakeholders on ways to enhance the regular publication of information about the banking sector (and the financial services sector more broadly) of interest to the Australian community.

Recommendation

The Committee should recommend that:

a) the Government review the powers available to the financial regulators to require information from banking sector participants; and
b) our regulators consult with stakeholders on ways to enhance the regular publication of information about the banking sector of interest to the Australian community.

Thank you again for inviting submissions on the Committee's inquiry into banking competition. Please contact Nicole Rich on 03 9670 5088 or at nicole@consumeraction.org.au if you have any questions about this submission.

Yours sincerely
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