A submission to the Senate Economics Committee for the Inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010

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Dear Secretary,

Thank you for the opportunity to make a submission to the Committee's inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010. With my coauthor Isabelle Dubec, we've been working for nearly ten years on the pricing of bank services, more especially on the pricing of ATMs, both at the wholesale and retail levels. I hope that this submission can help to clarify the issues at stake.

Jocelyn Donze. Toulouse, France. July 2010.

NB : the opinions expressed herein are my own and do not necessarily represent the views of Toulouse School of Economics or University of Toulouse 1 Capitole.

The amendment “Delivering Essential Financial Services For the Community” imposes banks to propose their account-holders

- a bank account endowed with the “basic” features described below.

- “fixed interest gap mortgages” : the mortgagee’s interest rate is set at a fixed percentage (chosen at the outset of the mortgage) above the lender’s cost of funds.

The basic features of the bank account are the following:

- (a) Basic transactions: deposits, withdrawals, transfers.
- (b) Accessibility through the Internet.
- (c) An ATM or EFTPOS card linked to the account permitting ATM and EFTPOS transactions (EFTPOS= Electronic Funds Transfer at the Point of Sale).

“Home” ATM transactions (the account-owner uses an ATM of his bank) are free. “Foreign” ATM transactions (the account-owner uses an ATM of another bank) may be charged, but there is a cost-based cap on the fee (around 50 cents)

- (d) A debit card linked to the account permitting credit card transactions.
- (e) No monthly account fees ; no penalty fees for transgressions of third parties (such as inward cheque dishonor)

The amendment also requires financial institutions to offer mortgage loans in which the interest rate is fixed at a negotiated margin above the institution's cost of funds. Mortgage exit fees are also capped at a level that recovers the cost of the lender of the early termination (speech of senator Bob Brown, 15 June 2010).

The amendment amounts to imposing a universal service obligation to banks for a set of “basic” services and it is therefore illuminating to study the subject with respect to this economic concept. Crémer, Gasmi, Grimaud, Laffont (2001) define a universal service obligation (USO) as the *obligation of a single or several operators to provide all users with a range of basic services of good quality at affordable rates.* In a sense, the USO can be seen as a price-quality regulation. Usually, a condition of uniform pricing is also imposed: the operator(s) cannot price-discriminate neither geographically nor between consumer types.

Several questions naturally arise when one wants to apply the notion of universal services to the banking sector:

- What are the main motives to impose a USO for banking services ?
- What banking services should be available at affordable prices ?
- Should all banks provide the universal services ?
- Who should pay to finance the provision of the affordable universal services ?
- Where should the services be available ?

Answering these questions provide interesting clues to evaluate the banking amendment bill 2010. It is the objective of this submission. USOs have been justified by several normative reasons in the economic literature:

SPECIFIC EGALITARISM

Tobin (1970) defined this notion to describe a situation in which a society attaches a special importance to limiting the domain of inequality in certain areas. According to this view, some goods are considered as essential because they either satisfy basic needs or are necessary to fully participate in the economic life of society (horizontal equity). The specific egalitarism argument is often used to justify universal provision of education or health care.[1]

This argument is probably an important motive behind the proposal of the amendment: facilitating easy access to basic banking services is a necessary condition to prevent the exclusion of poor households from the economic life. More broadly, senator Brown also noted, in his speech of the 15th of June, that "the nature of banking services – the kinds of financial products that are offered and the fees that are charged – has a very broad impact and the rights of consumers should be protected by law and, not as is currently the case, by self regulation of the banking industry".

MARKET FAILURES 1 : NETWORK EXTERNALITIES

Network externalities refer to the situation where the utility of a user increases with the number of users of the network. The typical situation is a telecommunication network where the subscription of new users permits the existing users to reach more people. In these situations, users do not internalize the externalities they exert on other users so that

[1] Tobin's argument is sometimes criticized because it violates consumer sovereignty in judgments.

participation is too low compared to the social optimum. A USO can increase participation and welfare by providing access to the network at a reduced price.

Network externalities exist in the banking industry. For example the utility of an account-holder increases as new accounts are opened because money transfers become easier. More generally, payment card markets have usually a two-sided feature: the utility of a cardholder is increasing in the number of merchants accepting the card and the utility of merchants is increasing in the number of persons holding the card. In such a context, economic theory shows that from a social point of view, it may be interesting to subsidize one side of the market (Rochet and Tirole, 2003)

MARKET FAILURES 2 : INFORMATION AND IMPERFECT COMPETITION

The products offered by the banking industry involve bundling of different services. Some services of the bundle cover basic needs of account-holders (deposits, withdrawals, transfers) while other may be more sophisticated (savings accounts yielding interests, credit card, loans, mutual funds). Some services are directly related to banking while other services may concern other aspects such as insurance or telecommunication. In general, consumers must pay an annual or monthly account fee to acquire the bundle and be an account-holder. Using specific services of the bundle may induce the payment of extra charges and any breach to the contract also entails penalty fees. The fact that banking services are usually bundled has several consequences:

- Banks can use product bundling strategically to obtain some market power : by offering bundles of different qualities or scopes, banks are able to differentiate from rivals. Competition is relaxed and the markup of prices over unitary costs of production increases.
- It is not easy for consumers to acquire information about the prices charged by the banks for the various services in their different bundles. That also makes the market for banking services less competitive.

Imposing a USO may solve the two problems: facing very similar sets of basic banking services makes it easier for consumers to obtain information about their characteristics and their prices. Furthermore, banks are less able to differentiate because they have to offer at least the basic banking services. The stronger competition for basic services should lead to lower prices for this quality level and also, by spillover effects, for higher quality levels (bundles with more services) (Vaubourg, 2003).

To sum up, there are several normative arguments supporting the introduction of a USO in the banking sector:

- Specific egalitarism, horizontal equity.
- Network externalities.
- Better information about product characteristics and prices.
- More competition and lower prices on banking services by limiting banks' differentiation.

Nevertheless, I think that too many services are included into the "basic banking services" defined by the amendment (see the appendix for a comparison of basic banking services in the UK, France and in the amendment) and the text may actually go against the interests of consumers (and banks). In my opinion, a reduction of the scope of the USO is desirable to retrieve its favorable effects. I see two problems with including too many services in the basic bundle:

Possible difficulties to fund the USO. The will of the legislator is to make all banks and financial institutions participate to the universal service obligation. It seems to be a good solution that permits to avoid the situation where operators not submitted to the USO exert "cream skimming" behavior at the expense of the operators submitted to the USO. However there is still the problem of funding the USO. It seems politically complicated for the state to subsidize the banks to apply the USO. Hence the banks are left to cross-subsidize the basic account and mortgage loan services through other activities. But it seems that providing a USO including so many services will affect banks' profitability very negatively: while the USO will not yield any revenues for banks (nil account service fees), it will be very costly to provide and furthermore, its features will attract many customers.

Desirability of the services proposed by the amendment. Points (3) (a), (b), and (f) of the amendment are very desirable and do not pose any problem. Point (3)(e)(ii) (protecting the account-holder against transgressions of third parties (inward cheque dishonor) and points (5) and (6) (capping penalty fees) also permits to protect the account-holders against unjustified and excessive punishments' in case of a breach to the contract. Unduly high penalty fees needlessly exacerbate the existing difficulties of some households. Table 1 shows that in 2009, these exception fees represent 20% of the total fees paid by an average Australian household and they are probably higher for poor households. Capping penalty fees by costs would induce substantial savings for many households.

Table 1. Annual Fees paid by an average Australian household in 2009 (in Australian dollars)

(exception fees are part of total fees)

	Loans			Deposits	Other	Total
	Housing	Personal	Credit Cards			
Total Fees	147	66	171	204	12	600
Exception fees (% of total fees)	5 (3.4%)	3 (4.5%)	56 (33%)	56 (28%)	-	120 (20%)

Source : RBA and author's calculations (for 8,4 millions Australian households in 2009).

In my opinion, the previous points permit to satisfy Tobin's requirement of specific egalitarism. However, point (3)(d) seems very counterproductive: the basic account being notably aimed at poor households or households with poor credit history, it seems that it is dangerous to include a direct access to credit in the scheme! Table 1 shows that exception fees represent 33% of the total fees paid by an average household and the figure must be higher for households facing difficulties.

To solve the previous problems caused by the inclusion of too many services in the basic account, I would first recommend to make the definition of basic banking services more restrictive. The basic bundle of services becomes more specifically aimed at favoring the financial inclusion of poor households. Some features are voluntary restrained compared to the amendment to protect consumers. This account is free of monthly or annual account service fees. It features

- Basic transaction of deposit, withdrawal and transfer,
- Direct direct. The bank should offer the possibility to spread the monthly payments to debitors over the four weeks of the month, amounting to weekly payments. (see the report of the British National Consumer Council, 2005)
- Internet access to the account
- An ATM card to freely access cash *through the bank's ATM network.*
- No penalty fees for actions and transgressions of third parties
- Cost-based cap for penalty fees in case of a breach to the contract.

- Limited mortgage loans ($1000 to $2000 ?) .

Second <u>for the other contracts</u>, I would also extend consumers' protection against penalty fees:

- No penalty fees for actions and transgressions of third parties.
- Penalty fees closer to costs in case of a breach to the contract.

As noted before, table 1 shows that in 2009, penalty fees represent 20% of the total fees paid by account-holders.

I am more skeptical about capping the ATM fees. It would push ATM deployers to withdraw many off-site machines. The Australian direct charging reform is still young and in my opinion, there is still some room for (small) decreases in ATM fees. In fact, empirical evidence and theory show that pricing schemes where the ATM owner chooses the level of the fee boost deployment at the cost of high ATM fees (see for example Donze & Dubec 2010).

Regarding mortgages, it seems there a lack of competition probably because of the concentration of the banking sector in Australia ("four big banks"). Offering limited mortgage loans ($4000-$5000?) in which the interest rate is fixed at a negotiated margin above the institution's cost of funds could be a way to discipline the market and inform consumers. Any loan above these amounts would be realized at interest rates freely chosen by banks.

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Appendix

Comparison of the features of the basic banking services in the United Kingdom, France and Australia.

Characteristics of basic banking services	United Kingdom	France	Australia
deposits, withdrawals, transfers	Yes	Yes	Yes
Internet Accessibility	Yes	Yes (Checking Balances)	Yes
Cheques	No	Limited	No ?
ATM Card	Yes (sometimes Debit Card)	Yes	Yes (Debit Card)
Off-us ATM withdrawals	Depending.	No	Yes, with a price cap
Account fees	Zero ?	Zero	Zero
Credit line	No	No	Yes
Fair price mortgages defined as a USO	No	No	Yes

Various sources