20 March 2018

Competition in the Australian Financial System: Draft Report

Submission to the Productivity Commission

ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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INTRODUCTION

CHOICE welcomes the Productivity Commission's Draft Report on Competition in the Australian Financial System. As we stated in our first submission, competition should not be pursued solely for competition's sake.[1] Competition policy should serve to benefit the long-term interests of Australian consumers. It should provide consumers with access to the best financial products at the lowest price and facilitate easy comparison of, and switching between, products.

Right now, the banking system is failing to deliver good value to many Australian consumers. This is particularly apparent in the residential home loan market where there is a stark lack of competition driving good consumer outcomes, although plenty of activity that appears to be adding extra costs to consumers and padding lenders' bottom lines. Purchasing a mortgage is typically the biggest financial decision an Australian consumer will make in their lifetime. Borrowers rely on mortgage brokers motivated by perverse and uncompetitive commission structures, and who are not required to act in their best interest. People who are entering the housing market with a small-deposit, a growing group in some East-Coast housing markets, are hit with a lump-sum amount for an insurance product that offers them no actual protection, but acts as a substantial barrier to switching in the future.

When it comes to home loans, bankers and brokers have built a system that works well for them but poorly for consumers. We need to tip the scales so that consumers have more power to find and move to a better deal. CHOICE is calling for:

1. Lender's Mortgage Insurance (LMI) to be abolished. LMI masquerades as a consumer-facing product, but it only protects the lender. There are so few providers of LMI that there are no competitive drivers pushing down the price of the product. Consumers are forced to accept the uncompetitive product without any negotiation. Instead, banks should price the risk of default into the value of the loan.

2. A 'best interest' duty that applies to all mortgage brokers. Consumers need to have peace of mind that their brokers are acting in their best interests, and the current legislative framework of providing only a 'not unsuitable' loan fails to provide this.

[1] CHOICE 2017, 'Competition in the Australian Financial System' submission, https://www.pc.gov.au/__data/assets/pdf_file/0018/222174/sub042-financial-system.pdf

3. Mortgage brokers to charge a fixed fee for service for any advice they give. The current commission structure creates a number of perverse effects, including encouraging borrowers to take a bigger loan than required, and minimising switching. Brokers should be incentivised to look after their customers rather than get them to borrow more for longer periods.

Recommendations

1. Abolish lender's mortgage insurance. Banks should price the risk of default into the value of the loan.
2. Amend the National Consumer Protection Credit Act 2009 so that all mortgage brokers have to act in the best interests of their clients. This should mirror the obligations for financial advisers in the Corporations Act 2001.
3. ASIC should require that mortgage brokers disclose key information to customers before they recommend a loan. The exact nature of these disclosure requirements should be rigorously consumer tested. As a minimum they should disclose, in plain English:
   - the number of lenders available to the customer, the number of lenders that broker has used in the last year and the top six lenders and percentage of business written in the last year;
   - how much the broker will be paid for arranging the loan with different lenders;
   - any ownership relationships between lenders and the aggregators.
4. Remove up-front commissions for mortgage brokers and replace these with fixed fees for service to better serve the needs of consumers. These fixed fees could either take the form of lump sum payments or rates based on hours of work required to arrange a loan.
5. Ban mortgage brokers and aggregators from receiving trail commissions for arranging home loans.
6. Increase the scope of financial advice to include some credit products only if the 'best interest' duty is extended to that advice.
7. ASIC should develop an online tool that provides information about median interest for different categories of new residential home loans, with the data available to third parties in a machine-readable format.
8. Make the ePayments Code mandatory for any entity that intends to send or receive electronic payments.
9. Amend the ePayments Code to clarify that consumers can share their information with an ASIC-accredited list of secure third-party services without losing any protections provided by the Code.

10. That the Payment Systems Board (PSB) drive continued reductions in interchange fees, with a view to ultimately phasing them out. The PSB should be aware of and prevent any retaliatory or anti-avoidance fee increases by banks or other parties in the payments system.
11. Merchants are given the ability to choose the default network to route cardless transactions as long as payments products offer a consistent service to consumers. Routing arrangements should be clearly disclosed to consumers at the point-of-sale, and consumers should retain the right to choose their desired network.
12. Renewal notices for general insurance products transparently include the previous year's premium and the percentage change.
13. ASIC assess applicants before they're granted a regulatory exemption or entry into the sandbox, ensuring that sandbox participants are genuinely innovative, will benefit consumers and are ready for testing.
14. The regulatory sandbox should not be extended to prudentially regulated fintechs that want to take retail deposits or to any fintech wanting to issue products that could cause short or long-term harm to consumers, this includes SACCs (payday loans) and superannuation products.
15. That financial institutions are required to ensure that it is at least as simple and accessible to end a financial product, as it is to take it up.
16. The Open Banking system be implemented in a manner that enables the full suite of rights for consumers to access and use digital data, and to ensure that it is securely managed.
17. ASIC mandate a deferred sales model for all sales of add-on insurance.
18. The proposed 'champion of competition' should be well-resourced and have the ability to promoting the long-term welfare of Australian consumers.
19. ASIC should have competition added to its mandate to ensure that competition remains at the forefront of its activities. The change to ASIC's mandate should drafted in a way that reflects the purpose of competition, to promote the long-term interests of consumers.

1. The residential home-loan market

Abolishing lender's mortgage insurance

Consumers should not have to pay for Lenders Mortgage Insurance (LMI). LMI masquerades as a consumer-facing product, yet it exists to benefit the banks while providing no real protection to consumers. It also makes it more difficult for consumers to compare the true cost of mortgage products from different lenders.

A more effective policy response would be to price the risk of default into the value of loan. This would allow consumers to shop around based on price, and would empower them to find a mortgage that best suits their needs. This would also remove an existing barrier to switching, and would consequently increase demand-side competition for mortgage products. Abolishing LMI would bypass the logistical challenges of calculating refundability and portability. Portability or refund options tinker with, but do not fix, the root issue with LMI.

As the Draft Report notes, there are only four providers of LMI, two of whom are banks themselves.[2] With so few insurance providers, there are very limited factors to drive price-based competition. Banks simply pass on the costs of LMI to consumers; leaving consumers forced, without any negotiation, to accept whatever amount the banks nominate. This happens late in the transaction, when the borrower has invested a lot of time, and is a position where they are less likely to opt out of the deal. Borrowers can be drawn in by an attractive rate for a mortgage, only to be hit at the last minute with thousands of dollars for LMI.

Further, the pricing structure of LMI is opaque. It is unclear on what basis LMI premiums are determined. It is also unclear whether banks are earning an added profit on top of the LMI they negotiate either with their own internal insurance arm or with an external insurance provider. LMI can be capitalised over the life of the loan, making it a significantly expensive product that consumers have to pay even at the latter stages of the mortgage, even when the risk of default is negligible.

There are also serious disclosure issues with LMI. A 2014 survey of 26,000 borrowers found that a majority of respondents thought that LMI either protected themselves or were unsure who it protected.[3] The confusion is even worse for first-time borrowers. Over 50% of first-time

[2] Competition in the Australian Financial System: Draft Report, p.239
[3] Martin North, 2014, 'DFA Household Survey 2013', http://digitalfinanceanalytics.com/blog/is-lenders-mortgage-insurance-a-good-thing/

borrowers incorrectly believed that in the event of a default, LMI protected themselves, rather than the bank.[4] If there is a downturn in the economy, with a resultant drop in house prices and rise in interest rates, there will be a number of borrowers, particularly first-time borrowers, who are likely to find themselves in serious trouble and without the protection they assume that LMI provides them.

The provision of LMI also creates a moral hazard. That is, banks who engage with LMI providers might be encouraged to lend to borrowers without serious consideration of their repayment ability. In a 2015 Parliamentary hearing, Genworth claimed that LMI aids the "great Australian dream of homeownership" and allows borrowers to, "actually get to buy the property instead of waiting the many years that it would otherwise take to access the property".[5] This raises alarm bells. Solving the current housing affordability crisis must be achieved in a safer way than insuring borrowers who have a lower loan-to-value ratio than what is typically safe.

In January 2018, CHOICE undertook a survey of 2820 Australian consumers asking them to share their experiences and concerns about the financial services sector before the commencement of the banking royal commission.[6] A prominent issue raised by consumers were problems associated with the provision of LMI. One respondent wrote,

"[I was] told that mortgage insurance was mandatory but it wasn't explained that this insurance covered the bank NOT us in the event that something went wrong."

Another respondent described their negative experience with LMI:

"*Having to pay mortgage lenders insurance that protects that bank only i.e. I pay the premium on their insurance policy – no risk for them and thousands of extra dollars on my mortgage."*

There will be certain circumstances where it is prudentially sound for a bank to have an insurance policy against a risky borrower. Banks are still welcome to do this. However, they should not be allowed to disguise it as a consumer-facing product. Instead, banks should price the risk of default into the price of the loan, and not confuse consumers with an insurance product that offers no protection to them.

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[4] Ibid.

[5] Mrs Comerford, CEO of Genworth appearing before the House of Representatives Standing Committee on Economics, Homeownership, 7th August 2015 https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Home_Ownership

[6] The survey was a self-selecting online survey, and not nationally representative. Data was collated 10 January – 5 February 2018.

Extending the “best interest” duty to all mortgage brokers

CHOICE welcomes Draft Recommendation 8.1 that a ‘best interest’ duty be imposed on mortgage aggregators owned by lenders. However, this best interest obligation should apply to all mortgage brokers, not aggregators owned by lenders.

It is important that the obligation to act in the best interest of a customer sits with the party that has direct contact with that customer, in this case the broker. Customers need to be able to have certainty that the person providing them advice is acting for them and putting their interests above all others.

Advertising for mortgage brokers services claim that brokers will find customers a good quality or even the best loan, even though there is no obligation to do so. CHOICE conducted a brief review of online claims made by mortgage brokers and we found advertisements that they stated that brokers would:

- “Fight to Get You a Great Home Loan Deal.”[7]
- “choose the best loan for your needs – all free of charge!”[8]
- “choose the perfect loan for their personal financial situation”[9]
- “help you navigate through the array of options in the home loan market to find the loan that best suits your needs.”[10]

In all of these statements, there is an implication that brokers act for the customer and help them get a good quality loan based on their individual needs, or even the “perfect loan”. With advertising like this, it’s no surprise that consumers think brokers will get them a good quality loan or act in their interests. What’s needed is a tangible, legal obligation to make brokers live up to the promises they make to their customers.

Any new obligation should apply to all mortgage brokers. CHOICE is concerned that applying a best interest duty only to a certain class of mortgage broker would encourage practices that bypassed the duty whilst still providing banks with the same benefits – such as exclusive agreements or banks engaging in partnerships with independent brokers. The proposed recommendation would likely reduce the incentive for banks to own mortgage aggregators but it would not remove the incentive for brokers to recommend loans by the big four banks, while they have the greatest capacity to pay. This would undermine any temporary effect that the Commission’s proposal might have in boosting competition.

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[7] Google advertisement from mortgagechoice.com.au All images sourced on 18 March 2018.
[8] Yourmortgage.com.au/brokers
[9] Claims about eChoice made on finder.com.au/mortgage-brokers/echoice-mortgage-brokers
[10] Claims about Finsure Mortgage Brokers made on finder.com.au/mortgage-brokers/finsure

The Draft Report notes that "there is a strong in-principle case" for the duty of care to apply to all brokers.[11] CHOICE agrees. Vertical integration is not the single motivator of bad advice for consumers. Consumers can receive poor-quality mortgage advice from independent brokers, as well as lender-owned aggregators. Ensuring that all mortgage brokers act in their customers' best interests will improve consumer outcomes and promote competition in the industry.

Streamlining the best interest duty across all mortgage brokers would also reduce complexity for consumers. It would be expecting a lot from consumers to understand the different duties that apply to different types of brokers. Consumers should be able to trust that their brokers are truly acting in their best interest and are not motivated by ulterior motives, such as recommending a specific mortgage product just to enable a broker to attend an all-expenses-paid junket to the Caribbean.[12]

CHOICE notes that industry groups have collectively defined "good consumer outcomes" that should be delivered by mortgage brokers through the Combined Industry Forum process. While we have welcomed an industry proposal that would see brokers lift standards, we do not think it goes far enough. The CIF proposal is that mortgage brokers would need to ensure that they arrange loans that:

- Are an appropriate size and structure,
- Meet the customer's stated requirements and objectives,
- Is affordable for the customer, and;
- Is applied for in a compliant manner,[13]

If thoroughly implemented, this requirement would see brokers having to meet higher requirements than currently set out in the law as they would arrange loans that are affordable (as opposed to not unaffordable) and that meet the customer's stated requirements and objectives. This test is not as high as a clear duty to act in the best interests of a customer. Notably, the CIF test does not require a broker to place customer interests ahead of their own or a lender's interests.

In response to Information Request 8.1, the best interest duty can be included in the current legal regime through amendment of the *National Consumer Credit Protection Act 2009* (Cth). This duty should mirror obligations financial advisors are subject to under the *Corporations Act*. Having a uniform duty of care across all mortgage brokers would also remove the potential

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[11] Competition in the Australian Financial System: Draft Report, p.227
[12] ASIC Report 516: Review of mortgage broker remuneration, p.12
[13] Combined Industry Forum (2017), p. 8. https://www.ausbanking.org.au/images/uploads/CIF_Report_Submitted_281117.pdf

confusion in creating a separate regulatory regime for mortgage aggregators and brokers. Additional requirements should be legislated and ASIC should prepare regulatory guidance on the application of the new law.

Mortgage broker disclosure requirements

CHOICE welcomes Draft Recommendation 8.2 that mortgage brokers should be legally required to disclose important information about the mortgage product before recommending a loan. This is an important step forward, especially with the prevalence of opaque white-label loans and lender-owned aggregators. We have recommended similar disclosure obligations to the Combined Industry Forum – this area is one where industry has put forward a constructive recommendation and committed to consumer testing as part of implementation.

It is important to note that disclosure of a conflict does not remove a conflict. Research by the Federal Trade Commission found that mortgage broker disclosure of commissions can actually increase trust in a broker, when it should have led customers to be more critical about the advice.[14] Any proposed changes to disclosure should be rigorously consumer tested to mitigate the risk of a perverse outcome.

Improved disclosure is only a small part of the solution to solve the systemic issue of poor mortgage advice. Without the removal of payments that incentivise brokers to put their or lender needs first and mandating a best interest duty for brokers, such changes to disclosure will likely have a negligible effect on both consumer outcomes and competition.

Reforming mortgage broker remuneration

The current broker remuneration structure incentivises brokers to act in ways that puts customer interests well behind their own commercial interests and the interests of lenders. This undermines any potential that might exist for brokers to assist in driving stronger demand-side competition by helping consumers to find the best offer.

As the recent ASIC Review concluded, broker commissions create two different kinds of conflicts:

[14] James Lacko and Janis Pappalardo, 2004, 'The effect of mortgage broker compensation disclosures on consumers and competition: a controlled experiment", Federal Trade Commission, https://www.ftc.gov/reports/effect-mortgage-broker-compensation-disclosures-consumers-competition-controlled-experiment

1. Product-strategy conflict: where a "broker could recommend a loan that is larger than the consumer needs or can afford to maximise their commission payment".[15]
2. Lender-choice conflict: where a broker "could be incentivised to recommend a loan from a particular lender because the broker will receive a higher commission, even though the loan may not be the best loan for the consumer".[16]

The commissions brokers receive directly affect the quality of recommendations they provide to consumers. Brokers are incentivised to provide a loan that maximises their commission, rather than one that is in the best interest of their customers.

In 2015 CHOICE conducted a shadow-shopping exercise into mortgage brokers.[17] In this exercise, we witnessed examples of recommendations that were not based on quality. For example, one mortgage broker pushed his own company's product, even while acknowledging that other lenders offered a cheaper loan.[18]

CHOICE welcomes the Commission's Draft Finding 13.1 that the current commission structures weaken consumer switching. To receive ongoing trail commissions, all a broker has to do is ensure that a borrower does not switch loans. Brokers are paid to not act. This constrains the ability of consumers to refinance their loan, and limits competition in the home loan market.

CHOICE strongly recommends that mortgage brokers move to a fee for service model instead of a commission-based model. This fee could be either a lump sum payment or rates based on hours of work required to arrange a loan. Under this transparent system, consumers are aware of the real cost of the service and can properly shop around. A fee for service would also encourage competition between brokers based on fees and quality of advice. There are no factors in the current remuneration arrangements that encourage competition based on quality of service provided to the consumer.

In response to Information Request 13.1, the rationale for the current commission structure is, to put it simply, to maximise revenue for the least effort possible. In regards to trail commissions, there is minimal evidence that mortgage brokers provide continual support to all their clients. Clients who require no additional advice are still charged trail for 'support' they did not draw upon nor require. If a broker wishes to provide additional support to a customer, then

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[15] ASIC Report 516: Review of mortgage broker remuneration, p.10
[16] Ibid, p.10
[17] CHOICE 2015, 'Mortgage broker investigation', https://www.choice.com.au/money/property/buying/articles/mortgage-broker-shadow-shop
[18] Ibid.

they should charge a fee for the service, rather than receive opaque and high-cost trail commissions.

Increasing the scope of financial advice

In response to Information Request 12.1, CHOICE supports increasing the scope of financial advice to include some credit products. However, this should only be extended if financial advisors are subject to a best interest duty in relation to any advice they give. This would provide consumers with the minimum necessary protections. Consumers are unlikely to be aware of any different duty of care requirements for financial advisors providing advice on products captured under the Corporations Act (2001) and credit products so the obligation should be consistent.

Interest rate transparency for home loans

CHOICE supports Draft Recommendation 8.4 that ASIC develop an online tool that provides consumers access to median interest rates and details about fees and charges. Increased transparency in the home loan market is long overdue. The pricing of home loans is marked by its opacity, and this prevents consumers from finding the loan that best suits their needs. The ACCC's recent Interim Report on residential mortgage pricing found a, "lack of transparency in the pricing of residential mortgages".[19] Having increased transparency around interest rates will aid consumers in navigating the complex home loan market. To maximise the utility of this data, it is essential that third party operators – such as comparator websites – are able to access it in a standardised and machine-readable format.

Recommendations 1 - 7

1. Abolish lender's mortgage insurance. Banks should price the risk of default into the value of the loan.
2. Amend the National Consumer Protection Credit Act 2009 so that all mortgage brokers have to act in the best interests of their clients. This should mirror the obligations for financial advisers in the Corporations Act 2001.
3. ASIC should require that mortgage brokers disclose key information to customers before they recommend a loan. The exact nature of these disclosure requirements

[19] ACCC 2018, 'Residential mortgage price inquiry', Interim Report, https://www.accc.gov.au/system/files/Residential%20Mortgage%20price%20inquiry%20interim%20report.PDF

should be rigorously consumer tested. As a minimum they should disclose, in plain English:

- the number of lenders available to the customer, the number of lenders that broker has used in the last year and the top six lenders and percentage of business written in the last year;
- how much the broker will be paid for arranging the loan with different lenders;
- any ownership relationships between lenders and the aggregators.

4. Remove up-front commissions for mortgage brokers and replace these with fixed fees for service to better serve the needs of consumers. These fixed fees could either take the form of lump sum payments or rates based on hours of work required to arrange a loan.
5. Ban mortgage brokers and aggregators from receiving trail commissions for arranging home loans.
6. Increase the scope of financial advice to include some credit products only if the 'best interest' duty is extended to that advice.
7. ASIC should develop an online tool that provides information about median interest for different categories of new residential home loans, with the data available to third parties in a machine-readable format.

2. Competition in the Payments System

Making the ePayments Code mandatory

CHOICE welcomes the Commission's Draft Recommendation 10.2 that the ePayments Code (the Code) be made mandatory for any entity that intends to send or receive electronic payments. The Code offers a number of strong consumer protections, and helps promote trust in the electronic payments system.

In response to Information Request 10.1, further consultation and debate around the burden of liability and dispute resolution schemes is needed. It is a difficult juggling act between security and competition. It is not in the banks' interests to allow third parties to access their customers' data. Such access opens them up to increased scrutiny and competition. Consumers need to have easy access to their data. They should not be penalised or discouraged from using third-party providers to help improve their financial position. As a first step, third-party providers should be able to gain accreditation by an impartial and appropriately qualified third-party, such

as ASIC, if they meet certain standards. These standards should take into account a third party's security and data management systems and procedures.

Interchange fees

The interchange debate is about who pays for our payments system. Do we want a high-cost payment system with some of the funds going towards "special" features like rewards points that only high-spending customers can benefit from? Or do we want a lower-cost payment system that will reduce costs for all merchants and should lead to lower costs for consumers across the economy?

CHOICE supports reducing or removing interchange rates to increase transparency in the payments system and to decrease overall costs.

As the Reserve Bank of Australia noted recently, "interchange fees are often not transparent; cardholders and merchants do not typically see them. But they have an impact on the fees that cardholders and merchants pay".[20] Australian consumers, irrespective of whether they are paying cash or card, ending up footing the bill for interchange fees by paying higher prices for goods and services. This is not an efficient nor competitive system.

Consumers have no ability to work out the interchange fee component of a product they purchase. They have little opportunity to respond nor pick the lowest cost option. Instead it is hidden in business-to-business interactions. It is a more transparent and competitive market if consumers are aware of the specific fees and interest rates they are liable for.

For over a decade, CHOICE has raised concerns that interchange fee-setting arrangements are opaque and lead to a large group of consumers cross-subsidising benefits for a small group.[21] Reducing interchange will lead to a small cost reduction for every merchant in Australia. It will also likely see a reduction in the value of rewards cards schemes.

Rewards schemes are designed to encourage spending on credit cards and tend only to benefit higher-income consumers who are able to spend significant amounts on cards but also are able to pay off their full balance each month to avoid interest and fees. While only a small group of consumers benefit from rewards points, all consumers pay for them. RBA statistics demonstrate

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[20] RBA submission to Senate Standing Committee Inquiry on Matters relating to credit card interst rates, 2015

[21] See Australian Consumers' Association (2002), Response to the Reserve Bank of Australia's Draft Standards and Access Regime for Credit Card Schemes, Australian Consumers' Association, Sydney.

that consumers in the top quartile of income are ten times more likely to have a premium credit card (with rewards points) than consumers in the lowest income quartile.[22] CHOICE statistics support this, finding that only 19% of consumers earning under $50,000 per annum strongly agree that they are more likely to use a card with rewards points, compared to 32% of consumers who earn over $100,000.[23]

Similar card rewards cross-subsidisation issues have been observed in other countries. In the United States, where interchange rates are significantly higher than in Australia, it was estimated that 54% of low and middle income families paid for the cost of interchange without receiving the benefits of any credit card. 59% of high income card holders received rewards financed by these fees, compared to 25% of low income card holders and 39% of middle income card holders.[24]

It is important to note that rewards schemes have never offered good value to most consumers. In 2003 consumers with a MasterCard and Visa rewards cards needed to spend an average of $12,400 to get a $100 voucher.[25] This increased to $14,400 in 2004 and $16,000 in 2006.[26] In 2015, the average spend required for a rewards credit card to receive a $100 voucher was $17,926.[27]

Phasing out interchange fees does not necessarily create an opportunity for banks to gouge customers by excessively raising interest rates or fees. Some countries – such as New Zealand and Canada –have set interchange fees to zero and also have a range of low-interest cards on the market. This demonstrates that fees and interest rates should not excessively rise if interchange fees are banned.[28] We encourage the Commission to recommend that the Payments System Board monitor any potential retaliatory behaviour by the banks.

Further, recent research from Monash University found that, "it is clear that any regulation of the interchange fee can be circumvented by channelling payments through the system provider".[29] As a result, the researchers call for 'anti-avoidance' regulation to be tied to any changes to the

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[22] Ibid p.5.

[23] CHOICE, survey into consumer use and understanding of credit cards, July 2015. N=1679. For further information see CHOICE, (2015) Submission to Inquiry into matters relating to credit card interest rates p.13.

[24] Shapiro, R. J. and Vellucci, J., *The Costs of "Charging It" in America: Assessing the economic impact of interchange fees for credit card and debit card transactions.*, February 2010. Consumers for Competitive Choice, p. 13.

[25] Stillman, Robert, William Bishop, Kyla Malcolm and Nicole Hildebrandt, 28 April 2008, Regulatory Intervention in the payment card industry by the Reserve Bank of Australia, Analysis of the evidence. CRA International, London, p.16.

[26] Ibid.

[27] See CHOICE, (2015) Submission to Inquiry into matters relating to credit card interest rates p.13.

[28] Federal Reserve Bank of Kansas City, *Credit and Debit Card Intechange Fees in Various Countries,* August 2017

[29] Stephen King and Rodney Maddock, 2017, 'Direct Charging of Card Fees', Working Paper, Monash University, Australian Centre for Financial Studies, https://australiancentre.com.au/wp-content/uploads/2017/05/2_Direct-charging-of-card-fees.pdf

interchange fee system. The Payment Systems Board should be also aware of the potential for actions that circumvent interchange fee regulation.

Merchant Choice of Default Routing.

CHOICE sees merit in the Commission's Draft Recommendation 10.4 that merchants be given the ability to choose the default network to route contactless transactions for dual-network cards. However, this recommendation can only proceed if payment options offer equivalent services to consumers. Merchants should only be replacing apples with apples, rather than apples for oranges.

The current system of routing is costly and inefficient, and this adds costs to our economy. Previously, CHOICE has opposed merchant routing because of practical differences between payment systems for consumers including different surcharges at the point of sale and different security guarantees in case of fraud.

This situation has evolved somewhat. For example, previously, Visa and Mastercard payment options offered a chargeback option for consumers; Eftpos did not. Now, Eftpos offers chargeback options for customers so they can recoup funds in cases of fraud or merchant failure to deliver.[30] Chargeback protections are important to consumers, who often rely on them if a product fails, a service isn't delivered or in instances of fraud. In these cases, a chargeback is the simplest and most effective remedy for many people.

We encourage the Productivity Commission to carefully assess the different payment options from the consumer perspective. Merchant routing should only be allowed if merchants are switching between equivalent services for the customer.

Consumers should retain the final right to choose with network they want to use. The Reserve Bank of Australia recently noted that "it would be desirable for a merchant implementing least-cost routing to disclose this to customers".[31] CHOICE supports this idea. Disclosure could be in the form of a physical sign indicating that the merchant has chosen a particular network over another and informing the consumer of how they can manually choose the network they prefer.

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[30] https://www.eftposaustralia.com.au/products/eftpos-disputes-chargebacks/

[31] Tony Richards, 2017, 'Merchant payment costs and least-cost routing', Reserve Bank of Australia, https://www.rba.gov.au/speeches/2017/pdf/sp-so-2017-12-13.pdf

Merchants should give consumers an opportunity to override the decision. This would allow merchants to set the default payment option, ideally driving use of low-cost options, but would still see consumer choice and control respected.

Recommendations 8 - 11

8. Make the ePayments Code mandatory for any entity that intends to send or receive electronic payments.
9. Amend the ePayments Code to clarify that consumers can share their information with an ASIC-accredited list of secure third-party services without losing any protections provided by the Code.
10. That the Payment Systems Board (PSB) drive continued reductions in interchange fees, with a view to ultimately phasing them out. The PSB should be aware of and prevent any retaliatory or anti-avoidance fee increases by banks or other parties in the payments system.
11. Merchants are given the ability to choose the default network to route cardless transactions as long as payments products offer a consistent service to consumers. Routing arrangements should be clearly disclosed to consumers at the point-of-sale, and consumers should retain the right to choose their desired network.

3. Competition in General Insurance

Comparative pricing information

CHOICE strongly supports Draft Recommendation 11.1 that renewal notices for general insurance include the previous year's premium and percentage change. This is an important and common-sense improvement. Consumers need to have easy access to how much their premium has risen by. This will encourage switching and facilitate consumer being better able to find the insurance product that best suits their needs

As noted in our first submission, there is ample evidence that comparative pricing encourages switching. In 2015, the United Kingdom's Financial Conduct Authority (FCA) undertook a trial of 300,000 customers to test improved renewal notice formats.[32] The trial found that disclosing last

[32] Financial Conduct Authority, 2016, Occassional Paper No. 12, *Encouraging consumers to act at renewal: evidence from field trials in the home and motor insurance markets.*

year's premium caused 11%-18% more consumers to either switch insurance products or renegotiate their increase. It found that improved disclosure, 'likely helps some consumers secure better value for money'.[33] As a result of that trial, the FCA announced new rules for general insurance renewals. The rules required general insurance companies to:

- disclose last year's premium at each renewal;
- include text to encourage consumers to check their cover and shop around for the best deal at each renewal;
- identify consumers who have renewed with them four consecutive times, and give these consumers an additional prescribed message encouraging them to shop around.[34]

CHOICE encourages the Commission to use the example of the Financial Conduct Authority as the basis of its final recommendation.

Recommendation 12

12. Renewal notices for general insurance products transparently include the previous year's premium and the percentage change.

4. Retail banking

Extending ASIC's Regulatory Sandbox

In response to Information Request 4.1, the regulatory sandbox should not be extended to prudentially regulated fintechs that want to take retail deposits and issue other eligible financial products without additional consumer protections being put in place.

While CHOICE is supportive of encouraging competition to create new services for consumers, we are extremely concerned about the risks that this approach involves. Innovation can produce significant benefits to consumers. However, not every product innovation is necessarily in the consumer's best interest. This is particularly the case in complex markets such as financial services, where the risks of bad product design and mis-selling can have catastrophic consequences on consumers. In essence, much like competition, innovation should only be pursued when it will lead to long-term good consumer outcomes, not as a stand-alone goal.

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[33] Ibid, p.6
[34] Financial Conduct Authority, 2016, PS16/21, *Increasing transparency and engagement at renewal in general insurance markets*

CHOICE has raised concerns about the approach ASIC has taken to the Australian fintech sandbox.[35] The sandbox allows any business that meets criteria to use the regulatory exemption. In comparison, other sandbox initiatives involve an assessment of whether services are innovative and good for consumers before a regulatory exemption is granted.

	United Kingdom	Singapore	Hong Kong	Australia
How do businesses enter the sandbox?	Applicants must apply to the regulator (FCA) for regulatory exemptions. [36]	Applicants must apply to the regulator (MAS) for regulatory exemptions.[37]	Applicants must apply to the regulator (HKMA) for regulatory exemptions.[38]	No assessment, businesses instead notify ASIC that they will be selling a product unlicensed.
What are the evaluation criteria?	Only applicants that are genuinely innovative, aimed at the UK market, will benefit consumers and are ready for testing are accepted.	Applicants should use new or emerging technology, should show that there are few or no comparable services in Singapore, address a problem or bring benefits to consumers or an industry, define the test, assess risks and demonstrate an exit or transition strategy.	Applicants must demonstrate a clear boundary for their sandbox test, that there are adequate consumer protections for the trial, that there are risk management controls and that systems and processes are ready for trial.	Any business that has insurance and is a member of an EDR scheme can enter. There is no consideration of whether a business is innovative, useful to Australia, has the right consumer protections for an experimental test or is ready to test.

The model chosen for Australia increases the risk that businesses that aren't willing or able to comply with the law will begin to sell services to consumers. For example, financial advice services will not need to meet all regulatory requirements tied to licensing that ensure consumer

[35] See CHOICE submission to ASIC's proposed sandbox (2015) and CHOICE (2018) Treasury Laws Amendment (2018 Measures No. 2) Bill 2018: FinTech Sandbox Regulatory Licensing Exemptions

[36] https://www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox

[37] http://www.mas.gov.sg/Singapore-Financial-Centre/Smart-Financial-Centre/FinTech-Regulatory-Sandbox.aspx

[38] http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2016/20160906e1.pdf

protections. Under the existing ASIC sandbox arrangements (and the proposal to expand the sandbox), any new advice businesses wanting a regulatory exemption will be exempt from requirements to prove that they:

- Have adequate arrangements in place to manage conflicts of interest.
- Take reasonable steps to ensure that people working for the company comply with financial services law.
- Maintain the competence to provide the financial services.
- Adequately train the people working for the company to ensure they are competent to provide the financial service.
- Have adequate risk management systems.[39]

We believe it is likely that the sandbox regulatory exemption will be used by some unscrupulous parties to sell products that are harmful to consumers. This is a risk to consumers and the fintech industry's reputation.

Recently, small and large financial service providers have demonstrated appallingly low regard for consumer needs and protections. CHOICE is concerned that providers invoking a halo of 'innovation' may fall through gaps of consumer protection requirements. The sandbox must be made safer by requiring that ASIC assess applicants before they're granted a regulatory exemption or entry into the sandbox, ensuring that sandbox participants are genuinely innovative, will benefit consumers and are ready for testing.

In addition, some products should not be subject to testing in a sandbox environment under any circumstances because of the likely harm to consumers in the long or short-term. One category of product that should not be subject to testing is small amount credit contracts (SACCS or payday loans). These are high-cost credit products that consistently led to poor-outcomes for consumers, largely for people on low-incomes or in vulnerable situations. CHOICE's concern is that innovation in this area will focus on more effectively selling high-cost credit – we cannot see a positive outcome for consumers from this arrangement. In addition, products that have long-term importance to consumers should not be the subject of sandbox testing. For example, superannuation products are essential to the long-term retirement outcomes for Australians. New products in the sandbox should be expected to fail – the nature of innovation and testing means that some tests won't work. Consumers on the receiving end of these tests should not have their retirement at risk.

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[39] These are all current requirements of AFSL holders providing financial advice. These obligations are set out in ASIC (2016) Regulatory Guide 36: Licensing: Financial Product Advice and Dealing, page 32-33. http://download.asic.gov.au/media/3889417/rg36-published-8-june-2016.pdf

‘Red tape’ barriers to consumer switching

Red tape barriers to switching exist right across the financial services market. CHOICE research has found that even minor barriers can hold consumers back from switching to a better deal or opting out of products they do not require. For example, in the superannuation context a number of respondents to our qualitative research cited exit fees as a barrier to switching to a better deal.[40] Others had difficulty switching due to a lack of access to an easy online switching portal, or repeated mistakes on the part of superannuation funds in processing documents.

With many of the contractual restrictions on switching, such as exit fees, CHOICE questions their small value to a business as a cost recovery tool, versus the large barrier they can pose to a consumer contemplating a switch. For example, while REST Super does not charge for the first transfer from its fund, any subsequent transfers are charged at a rate of $25.[41] In the home loan market, while exit fees have been banned, lenders still charge cost related fees, such as discharge/settlement fees, as an example CBA charges a discharge fee of $350 on its mortgage products.[42] While this may be a small amount relative to the savings achieved through a better rate this is a huge psychological disincentive to switching.

Discharge and settlement costs relate to the cost involved in hiring an agent to conduct the settlement transaction with a new lender. While these may be a legitimately incurred cost, there is no incentive for established lenders to move to potentially more efficient low cost processes, such as online settlements or the use of block-chain. All-in-all there are a number of costs and processes in switching that are barriers to consumers acting on better deals. In many cases competition outcomes may be better served by banning these types of barriers across the board.

For many years, CHOICE had been concerned with the ‘red tape’ and asymmetry associated with credit card cancellations. The big four banks have quick online application forms to get a credit card or increase debt limits, sometimes with answers provided in a matter of minutes. Yet, the process of cancelling a credit card has been particularly onerous for consumers. In order to cancel a credit card, an individual would have to go into a branch or call up a customer service representative. The Federal Government recently passed legislation so that from January 2019, credit card providers must now provide an online option to both close a credit card or to reduce

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[40] The survey was sent to a group of CHOICE supporters who have previously expressed an interest in financial services policy. The survey ran from 9/08/2017 to 21/08/2017. 2508 responses were recorded.
[41] REST, 2018, ‘REST Super Product Disclosure Statement’, p.10,
[42] CBA, 2017, ‘Fees we charge for consumer mortgage products’, p.5

their limits.[43] Yet this took years of consumer harm and lobbying to enact change. CHOICE believes that it must be at least as easy to get of a rid of a product at a bank as it is to take it up – this principle could be embedded in a code or through regulation so that institutions are required to consider exit processes constantly.

Open Banking

CHOICE strongly supports efforts to enable open banking through a consumer data right. We were also strong supporters of the Productivity Commission's original call for the creation of this right in its Data Availability and Use Inquiry. There is significant potential for this right to improve access to data and allow consumers to harness it for better purchasing decisions. It will allow for new businesses models to develop, particularly in the space of third party switching which should enable consumers' frictionless access to the best deals on the market. However, we expect this right will need to be carefully guarded in the coming years to ensure this potential is not lost to the self-interest of uncompetitive incumbents.

Deferred sales model for add-on insurance

CHOICE strongly supports a deferred sales model for add-on insurance. As ASIC reported in 2016, the add-on insurance market is failing consumers.[44] There is particularly egregious practices in the add-on insurance sold through car dealers. With the levels of commissions given to dealers far outstripping benefits paid to consumers. Problems identified in this sector include the use of high pressure sales tactics to sell add-on insurance as well as consumers being misled, sometimes by omission, as to a loan being contingent on purchasing this type of insurance. A deferred sales model is a good solution to this problem, as it allows consumers to assess the value and their need for these add-on products separate from the pressure of the main transaction.

Recommendations 13 - 17

13. ASIC assess applicants before they are granted a regulatory exemption or entry into the sandbox, ensuring that sandbox participants are genuinely innovative, will benefit consumers and are ready for testing.

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[43] Treasury Laws Amendment (Banking Measures No, 1) 2017

[44] ASIC, 2016, 'Report 492 - A market that is failing consumers: The sale of addon insurance through car dealers'

14. The regulatory sandbox should not be extended to prudentially regulated fintechs that want to take retail deposits or to any fintech wanting to issue products that could cause short or long-term harm to consumers, this includes SACCs (payday loans) and superannuation products.
15. That financial institutions are required to ensure that it is at least as simple and accessible to end a financial product, as it is to take it up.
16. The Open Banking system be implemented in a manner that enables the full suite of rights for consumers to access and use digital data, and to ensure that it is securely managed.
17. ASIC mandate a deferred sales model for all sales of add-on insurance.

5. The financial system regulators

‘Champion of competition’

CHOICE welcomes Draft Recommendation 17.1 that an existing regulator should have a competition function. CHOICE does not have a definite view on who should be the ‘champion of competition’. Both ASIC and ACCC have their relative strengths and drawbacks in fulfilling the proposed role. The regulator that is eventually chosen needs to be well-resourced and have the capabilities to properly achieve its goal of promoting competition and the long-term welfare of Australian consumers.

Regardless, ASIC needs to have competition added to its mandate. This was recommended by the Murray Inquiry, and the Federal Government has recently announced this change, but is yet to enact it.[45] Currently, ASIC is tasked with improving, “the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy”.[46] The drafting of this change should reflect the fac that the purpose of competition is to promote the long-term interests of consumers.This change combined with Draft Recommendation 17.1 will place competition at the forefront of financial regulators decision-making.

Recommendations 18 - 19

18. That the proposed ‘champion of competition’ should be well resourced and have the capabilities of promoting the long-term welfare of Australian consumers

[45] Financial Services Inquiry 2014, Recommendation 30
[46] Australian Securities and Investments Commission Act 2001 (1)

19. ASIC should have competition added to its mandate to ensure that competition remains at the forefront of its activities. The change to ASIC's mandate should drafted in a way that reflects the purpose of competition, to promote the long-term interests of consumers.