The Effectiveness of Mandatory Comparison Rates: Information, capacity and choice

First Issues Paper

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Friday, November 11, 2005

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1. Introduction

Financial de-regulation and significant innovation within financial markets has seen a rapid increase in the type and number of consumer credit products available. What is not known is how consumers, and particularly low-income and vulnerable consumers, have adjusted to this changed environment. From little choice in products and suppliers twenty years ago, consumers now have an enormous range of choices available to them. From relatively straightforward calculations based on a loan repayment schedule, consumers now also have to contend with a variety of different charges on top of the loan repayments. For many, credit is a lot easier to secure than it once was. One obvious symptom of this increased complexity is the increasing importance of mortgage brokers as an intermediary between consumers and providers.

Arguments for more flexible and responsive consumer markets rely on the importance of consumer sovereignty for their persuasiveness. Such markets, it is argued, are directed by consumer preferences. Firms operating in these markets have no choice but to deliver products that consumers want, at prices they are prepared to pay. Failure to address consumer demand will lead to those firms becoming unprofitable and ultimately, to their demise. Flexible and responsive markets, it is argued, are the best mechanism for delivering the greatest consumer benefit.

Consumer sovereignty in turn requires informed consumers with the capacity to act in their own best interests and choose between products on offer. It also requires credit providers to be relatively powerless, and unable to shape the conditions and terms on which credit is available. A key current public policy issue is how to ensure consumers are well informed and have the capacity to make effective evaluations of products on offer. Equally important is how best to protect the interests of consumers trying to make informed choices in markets involving complex and technical information, which might be beyond the capacity of many people to understand.

While on the one hand the explosion in the number of credit providers and available products certainly points to there being a competitive market, the very complexity of the products on offer means that there is an asymmetry of knowledge between consumers and providers. That is, providers have specialists who develop and sell these products, who have an intimate knowledge of how they operate. Consumers on the other hand, often have low levels of financial literacy and many make consumer credit decisions very rarely.

One recent means of addressing the supposed asymmetry of knowledge between finance providers and consumers in the Australian context has been the introduction of mandatory comparison rates. This is a method of measuring the total cost of a fixed term loan, including interest and all fees and charges, by using a single percentage rate. This, it is argued, enables consumers to more easily compare the overall cost of loan products.

This research project is an exploratory investigation of the effectiveness of mandatory comparison rates in guiding consumer choices. Mandatory comparison rates have been in force for two years (1 July 2003) and are due to sunset 30 June 2006 (dependent on the outcome of a Regulatory Impact Statement currently being undertaken). This project will look to related fields
in Australia (eg telephony) and the application of comparison rates in other jurisdictions to gauge their effectiveness in enabling consumers to make informed choices.

Key research questions that will guide this project include the following:

• How has the finance industry understood and implemented mandatory comparison rates and what have been the implementation issues?
• How have consumers understood and used comparison rates in their decision-making?
• Given the information to hand, how effective are the comparison rates implemented in Australia relative to other forms of comparison rate and other means of informing consumers in making decisions regarding credit?

The key methods to be used in this project will be literature and policy document review, interviews with key individuals, focus groups and a sample survey of consumers. Evaluating the impact of interventions to assist consumers in navigating complex markets is challenging. It requires understanding the operation of the particular markets and the ways in which different consumers go about making their decisions.

As already noted the consumer credit market is marked by increasing product proliferation and differentiation. In addition, fixed term credit products span a broad variety of type from relatively short term personal loans, through to longer term personal loans for items such as cars and boats, on to home mortgage finance.

In the public realm, consumer decision-making is often treated as a black-box; how people go about making choices and the key factors in those choices is little understood. Developing regulations aimed at improving information available to consumers and thereby increasing their capacity to make decisions poses a number of challenges including the greatly differing capacities of consumers to understand and use financial information. This research, funded by the Victorian Consumer Credit Fund, will provide an evidence base for strategic analysis by Consumer Affairs Victoria and other interested parties including the Ministerial Council for Uniform Credit Laws. The central question addressed is: have mandatory comparison rates proven to be an effective regulatory option to ensure that consumers are able to make informed choices between different credit options?
2. The Introduction of the Mandatory Comparison Rate

The original consumer credit code legislation (1994) had a number of objectives as set out in the explanatory notes to Consumer Credit (Queensland) Act 1994:

The objectives of the Bill are to provide laws which apply equally to all forms of consumer lending and to all credit providers, and which are uniform in all jurisdictions in Australia. The legislation is based on the principle of truth-in-lending which will allow borrowers to make informed choices when purchasing credit.

The Bill applies rules which would regulate the credit provider’s conduct throughout the life of a loan, but without restricting product flexibility and consumer choice. The policy of the legislation is to rely generally on competitive forces to provide price restraint but to provide significant redress mechanisms for borrowers in the event that credit providers fail to comply with the legislation.

The Bill is designed to apply to a deregulated credit market and provide standards for the provision of credit which will not be overtaken by changes in the financial marketplace.

This legislation made reference to a ‘comparison rate’ that was ‘designed to take into account not just the interest charge based on the annual percentage rate but also all additional fees and charges relating to the particular product so that customers can more easily compare the true cost of competing products’ (Owens et al, 1994). In relation to pre-contractual information, disclosing the comparison rate was optional. If it was disclosed however, it had to be calculated in the manner prescribed in the accompanying regulations.

In relation to advertising of credit, all references to the cost of credit had to be accompanied by an Annual Percentage Rate (APR) and if there were fees and charges payable there had to be a statement to this effect. If a comparison rate was to be included it again had to be calculated in the manner prescribed in the regulations.

There is little available in the public domain to help us to understand the thinking behind the development of the current mandatory comparison rate regime. It is clear that the push for a new regime originated in New South Wales, with a draft bill being tabled in the NSW Parliament on 22nd June 2000. From here the issue was taken up by the Ministerial Council on Consumer Affairs, culminating in the bill (Consumer Credit (Queensland) Amendment Act) passing through the Queensland Parliament on 18 April 2002.

The relevant section of the Act is as follows

146A Object of Part
(1) The object of this Part is to assist consumers to identify the true cost of credit offered by credit providers
(2) In order to achieve that object, this Part-
   a. makes it mandatory for credit providers to include the comparison rate in advertisements for consumer credit (other than under continuing credit contracts) if an interest rate is advertised; and
   b. requires credit providers, linked suppliers and finance brokers to supply consumers with schedules of comparison rates for any such consumer credit.
The comparison rate will reflect the total cost of credit arising from interest charges and other prescribed fees and charges.

It would appear that there were two distinct but related issues underlying the establishment of the mandatory comparison rate regime:

- A concern about the increasing reliance of finance providers on fees and charges allied with the increasing complexity of financial products available;
- A desire for a simple basis of comparison to assist consumers in choosing between providers and products.

A media release from the Financial Services Consumer Policy Centre (24th June 1999) captures this nicely.

This is long overdue reform. Displaying true interest rates will force the banks to compete on an equal footing with new mortgage lenders. They will no longer be able to drop their headline interest rates to match new competitors while raising application fees and monthly fees. In addition, new borrowers will be less likely to be seduced into loans which they cannot afford by ‘honeymoon’ rates.

Elizabeth Lanyon in her keynote address more fully sets out an initial tension in the legislation that the MCR regime was designed to address.

One point of contention was the solution that the Code arrived at to accommodate product and pricing flexibility. Unlike its predecessor, the Code encompasses variable lending and long term contracts, particularly home mortgages. The Code separates disclosure of interest from that of credit fees and charges, and permits unilateral variation. In contrast, the previous legislation required disclosure of a calculated annual percentage rate that factored in credit fees and charges and did not permit variation. The policy debate revolved around whether the Code truly provided for “truth in lending” when credit fees and charges could be separately itemized. Even at the time the Code commenced, it seemed likely that the objectives of truth in lending and product flexibility were not wholly compatible. Debtors would find it difficult to use disclosure to shop around, if credit fees and charges needed to be factored in by debtors to determine the cost of credit. In so far as there was a conflict, the policy tension was not articulated and its resolution was deferred to regulation making powers under the code which permit the proscription of particular credit fees and charges. No regulations have been made.

On this reading it would seem that adoption of the MCR was a ‘back to the future’ intervention, a means of addressing a gap that the new legislation had opened up relative to the previous system.

Later in her paper Lanyon addresses the adoption of MCR more directly

… the Code provisions, together with the permission to charge fees and charges did not resolve the debate on the balance between product flexibility and consumer choice. That debate re-emerged in the Post Implementation Review and was repeated in the debate on comparison rates leading to the insertion of Part 9A of the Code. The case for more rigorous disclosure was enhanced by credit providers offering honeymoon rate loans and an argument that credit providers of medium term loans were advertising low interest rates and introducing credit fees and charges to maintain their profit margins. As a result, extensive comparison rate provisions were introduced which apply to
pre contractual disclosure. Opinions still remain divided over whether they have improved consumers’ capacity to shop around and whether the costs outweigh those benefits.

The MCR regime that was adopted was similar to those operating in other jurisdictions such as the United Kingdom, United States and New Zealand. Like the UK and US regimes it made it compulsory to advertise a standard annual percentage rate with any advertising that included reference to an interest rate.

Distinctively the Australian legislation also makes it mandatory for comparison rate schedules to be provided in certain circumstances (this is the pre-contractual disclosure alluded to in the quote from Elizabeth Lanyon above). The regulations nominate set amounts and borrowing periods for which comparison rates must be included in these schedules. Comparison rate schedules are to be provided at any premises where consumers may be asking for credit (ie credit provider, finance broker or linked suppliers), at any internet site advertising credit and with the provision of any application for credit.
3. Research on the Impact of Comparison Rates and Similar Interventions

There has been no work to date on the effectiveness of the Australian MCR regime. The remainder of this section reviews work that has been done in other jurisdictions on similar interventions. All of this work, in one way or another is addressing the challenge of whether it is possible to convey complex information in a simple and accessible manner, i.e. can a single number be comprehensive?

3.1 New Zealand

New Zealand had an ‘annual finance rate’ for 21 years that was abandoned in 2002 with the introduction of the Consumer Credit Bill. It should be noted that this regime differed significantly from the Australian regime. In practice the annual finance rate was rarely used in advertising.

The Credit Contracts Act requires those lenders that advertise an interest rate to also advertise the annual finance rate, but only if it can be calculated at the time of the advertisement. Because the calculation of the annual finance rate generally depends on the particular loan being arranged, lenders rarely disclose the annual finance rate in advertisements. (NZ Ministry of Consumer Affairs, 2000 p32)

In practice then, the annual finance rate was only calculated when all the details of the loan had been arranged by which time ‘the borrower is likely to be psychologically committed to the contract (ibid p32)

MacPherson and McBride (unpublished p8) set out two main limitations of annual finance rates:

- They are ineffective in advertisements due to their ‘generic’ nature i.e. not the actual rate for the intended borrower
- The difficulty of determining which charges and fixed costs are included. Some charges (for example valuation fees in the case of home mortgage) vary considerably from case to case. Excluding them underestimates the cost of borrowing but including them requires an estimation that will likely prove inaccurate.

The NZ Ministry of Consumer Affairs (April 2000) deals with this issue in greater detail. The report sets out the following main areas of concern about annual finance rates:

- they do not include all relevant charges
- they can be misleading in certain circumstances
- they are disclosed too late in a deal to be really useful for comparison shopping
- they do not suit modern credit products or the goal of pricing flexibility
- they make credit law over-complex
- they are not straightforward to interpret and poorly understood by consumers. (NZ Ministry of Consumer Affairs p24)
In terms of consumers’ understanding of finance rates the report acknowledges that ‘There are no New Zealand empirical studies that measure consumer understanding of the annual finance rates’. Instead the report relies on work undertaken in the US and the UK (which we will review below). Interestingly both jurisdictions in which there was consumer research conducted have maintained (although in modified form) their regimes while NZ abandoned theirs, ostensibly on the basis of this research.

### 3.2 United Kingdom

The UK Annual Percentage Rate regime is comparable to the Australian Mandatory Comparison Rate regime. Advertisements for relevant consumer credit products must contain a ‘typical’ annual percentage rate or a range over which the annual percentage rate will vary. There are no pre-contractual disclosure requirements but the annual percentage rate must be included in any contract for consumer credit to which it applies.

As part of the British government’s Deregulation Initiative the Office of Fair Trading was asked to review the Consumer Credit Act 1974. To inform the review the OFT commissioned a survey exploring consumers’ appreciation of ‘Annual Percentage Rates’, the results being published in an Office of Fair Trading report entitled *Consumers’ Appreciation of ‘Annual Percentage Rates* (1994).

A random sample of 3,832 people across Britain was interviewed with the aim of investigating the following:

- Consumers’ understanding of the purpose of the APR;
- Their awareness of the warning statement required to be included in credit advertisements for loans secured on debtors homes
- The extent to which consumers bother to request written quotations.

As a preliminary question the researchers asked respondents to recognise some common symbols: 81% named a division sign correctly; 84% named an ampersand/‘and’ sign correctly; and 91% named a percentage sign correctly.

When asked which of four statements on a showcard best explained what a percentage was, 77% chose the correct answer of ‘a rate per hundred’, 4% thought it was a rate per thousand, 4% thought it was ‘a short way of writing down large numbers’, 3% thought it was ‘a mathematical expression of per year’ and 11% didn’t know.

After having the term percentage defined for them respondents were asked to calculate 10% of 500. Seventy-eight percent of respondents gave the right answer, 7% gave another answer and 16% said they ‘didn’t know’.

Forty-six percent of respondents were able to correctly tell the interviewer what the acronym APR represented. When asked which of four statements best explained the APR, 11% of respondents chose the most appropriate answer ‘you can use it to compare credit deals’. Over half (53%) chose ‘it tells you how much interest will be charged’, 8% selected ‘you can use it to work out your monthly payments’, 3% picked it tells you how much commission the credit broker will receive and 25% didn’t know. The findings from this question are somewhat
ambiguous (like those of the US study) as the majority response is not strictly incorrect and it does suggest that well over half of respondents (64%) could be expected to draw the conclusion that a lower APR, prima facie, represented a better value loan. Interestingly for those who had used a credit product in the last five years, the proportion who nominated the correct response to this question increased slightly (12%) yet the proportion choosing ‘it tells you how much interest will be charged’ increased from 53% for the sample as a whole to 66%.

Overall, 43% of respondents who had used credit in the previous five years reported considering the APR when looking at credit or loan arrangements. This looks to be an encouraging, if not overwhelming level of use.

A general demographic pattern prevailed throughout the survey. This was that male respondents, those between the ages of 25 and 54, professionals, those who continued schooling above the age of 16 and those who had used some form of credit during the previous five years generally had a better understanding of the APR (and the other matters considered in the survey).

More recent related survey work in the UK context by Collard (2000) found that 70% of recent financial purchases were made using just one source of information and usually with minimal shopping around. (see CFLT, p46)

### 3.3 United States

In the United States, and arguably the rest of the world, the landmark legislation in the field of consumer credit is the Consumer Credit Protection Act of 1968 which has become synonymous with its most well-known section ‘Truth in Lending’. This legislation includes provision for an Annual Percentage Rate (that includes certain fees, charges and other fixed costs) to be included with any advertising that includes interest rates and on the Federal Truth in Lending Disclosure Form that is given to customers applying for credit.

There was a flurry of research activity just before and just after its introduction (see Durkin, 1975 for a summary of some of this research). Durkin goes on to introduce his own research which found that while low income consumers accessing very small loans had a low awareness of the APR (2.5%), almost two thirds were aware of the finance charge in dollars.

In 1996 the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (HUD) were directed to simplify and improve the disclosures given in transactions subject to the Truth in Lending Act relevant to closed-end mortgages. The resulting Joint Report to Congress (1998) considers the APR and puts forward some research that was conducted as part of the review.

Lee and Hogarth (1999) summarised the research undertaken on the APR as part of the preparation of the Joint Report. This work was based on analysis of a series of additional questions commissioned by the Federal Reserve Board to be appended to the Michigan Survey of Consumers. Overall 219 households with recent mortgage lending experience (in the last five years) were asked questions related to their knowledge of the APR, in particular the relationship between the APR and contract interest rate (CIR). It is worth noting here that five years is a long period over which to be asking respondents to recall their decision-making.
Respondents were asked “When a home mortgage is described as having an 8.9 percent APR - that is an 8.9 annual percentage rate - does that mean that the interest rates is actually 8.9 percent, or would the interest rate be higher than 8.9 percent or lower than 8.9 percent?”

Given that there was some ambiguity regarding whether the APR is actually the interest rate the measure’s validity was tested by asking 104 households this same question followed by ‘Would you describe what the APR and the interest rate are?’ For the latter question only 16 respondents (15.4%) correctly identified the relationship between the APR and the CIR.

They found that over 70% of consumers reported comparing the APR of a closed-end loan. However, at least 40% of mortgage borrowers did not understand the relationship between the CIR and the APR which the authors felt indicated a significant gap between awareness and understanding.

In their Joint Report to the Congress, the Board of Governors and HUD acknowledged that the APR has limitations as a benchmark. Much of this debate centres on the trade-off between the simplicity of a single figure and complexity of the information being conveyed. The report makes the point that the single APR figure can not assist consumers with all aspects of their decision. For example, the APR cannot help consumers to decide whether they are better off paying fixed charges and fees associated with a mortgage upfront or rolling these into the loan repayments, the financial impact of the repayments on their budget or those factors unrelated to costs such as pre-payment penalties or various features of the loan.

In relation to preserving the APR as a benchmark the report has this to say

With the enactment of TILA in 1968, the APR was viewed as the key benchmark figure that consumers could rely on to evaluate credit costs. Its preservation as a benchmark for consumer shopping has considerable support. A single figure is simple to use. For example, consumers can evaluate competing products using one variable rather than having to consider multiple figures such as discount points and interest rates. Also, the APR has a nearly thirty-year history in consumer finance disclosures. The value of its familiarity was supported by consumers participating in the Board’s focus group meetings of February 1998. In addition, the APR concept deters hidden or “junk” fees to the extent that the fees must be included in the APR calculation. (p9)

The Report then goes on to examine ways in which the APR could be improved, most notably that the finance charge (and correspondingly the APR which is based on the finance charge) be defined as “the costs the consumer is required to pay to get the credit”.
4. Existing related research in Australia

In Australia there is no consumer research specifically on the effect of the mandatory comparison rate and little (publicly available) on consumer credit decision-making more generally.

4.1 Consumer and Financial Literacy Taskforce

There has been recent policy and research interest in consumers’ financial literacy. The Australian Government established a taskforce to investigate this issue, that has put forward a number of preliminary recommendations to the government (see http://www.cfltaskforce.treasury.gov.au/content/home.asp?NavID=1).

The taskforce’s discussion paper (June 2004) is of interest to us for a number of reasons. They make the point very early in the paper that ‘…despite the amount of money that is spent, we know very little about the decision-making processes that occur when Australian consumers spend or invest their money’ (pxi). They go on to discuss work done by Daniel Kahneman (2002) indicating that consumer decision making was not as rational as is often assumed (bounded rationality). They make the point that consumer difficulties with financial products are related not just to information asymmetry but also to attitudes and behaviours (p8).

The taskforce developed a Consumer Behaviour Model in an attempt to understand consumer decision-making and to enable measurement of consumer and financial literacy over time. Overall the taskforce is understandably mostly interested in consumer education and awareness.

The taskforce identified the following key differences between purchasing financial products and consumer goods:

- Financial products are not usually purchased frequently, so we develop limited experience in selecting products;
- The value of the purchase (for example, an investment product) is often not clear at the time of purchase; products cannot be tested prior to purchase and often we cannot appreciate the value of a financial product until some time later (and sometimes, too late);
- It can be difficult to verify claims made by financial suppliers. (CFLT, 2004, p4)

4.2 The ANZ Survey of Financial Literacy in Australia

This survey conducted by Roy Morgan was a major piece of work in the area. It involved 3 stages:

Stage 1 Developing a framework for measuring financial literacy in Australia;
Stage 2 A telephone survey of 3,548 adult Australians, comprising 145 finance and 25 demographic questions; and
Stage 3 An in-depth survey of 202 people including a self-completion component and in-depth interview of 1–1.5 hours each.
The survey found that the following groups were strongly over-represented in the lowest twenty per cent in terms of financial literacy:

- Those with education of less than Year 10 and no occupation;
- Unskilled workers and non-workers;
- People in households with incomes less than $20,000 pa;
- Those with savings less than $5000;
- Those looking for work;
- Younger adults (18-24 years) and those over 70 years of age.

For the purposes of our study it may be useful to try and capture enough demographic data to be able to use this research’s socio-economic categories of financial literacy.

### 4.3 Taking Credit: A survey of consumer behaviour in the Australian credit market

This research was commissioned as part of the Ministerial Council on Consumer Affairs review of the Uniform Consumer Credit Code. The research was undertaken in three stages: first, collecting samples of and information on consumer credit advertising and interviewing 20 credit providers; second, a national telephone poll of 1,600 consumers who had borrowed under the Code; third, six focus groups.

The report is described as ‘research into consumer behaviour when purchasing credit’ and outlines its particular interest as ‘the use consumers make of information available to them for assisting them to decide which loan to take out.’ (p9)

Unfortunately for our purposes the MCR was not then in operation, but clearly the report is of great general interest to our study.

The researchers found that that consumer credit market was best understood by splitting the market into three sub-markets: housing and personal loans; credit cards and linked credit loans\(^1\) (Malbon, 1999 p9).

In relation to housing and personal loans Malbon found that this market was ‘highly competitive. There are a large number of lenders, there is visible and aggressive advertising on interest rates and most consumers shop around for their loans before deciding to make a purchase. Typically consumers will consider 3 to 4 lenders before making their purchase.’ (p10)

In relation to the linked credit market Malbon had this to say:

> The linked credit market presents a different environment. It tends to segment between loans offered for major purchases like cars, and loans for other consumer goods in which an ‘interest free’ period is offered for the repayment of the loan. The latter sector is a relatively new and

\(^{1}\) This category is defined in the report as ‘made up of loans which are provided to consumers when they purchase goods. The seller of the goods provides the loan on behalf of the credit provider. Loans arranged by car dealers and ‘interest free’ loans for the purchase of goods are typical examples’ (Malbon, 1999, p9)
emerging one. Because our research broadly examined the consumer credit market, it was unable to consider in detail the operation of the ‘interest free’ sector. There are, however, a number of concerning indicators about its operation. A substantial number of consumers stated that they were either unaware or were unable to compare interest free products. Although consumers appear to be aware of the interest free component of the loan, partly because of extensive advertising, it was difficult to determine the extent to which consumers were aware of the consequences of not paying loans within the interest free period. The potential for crosssubsidisation by lower income groups to higher income groups, which occurs with credit cards, arises with linked credit arrangements with interest free periods. (p10)

Overall the researchers found that income category, gender and location made little difference to the behaviour of consumers. They did find from their focus group discussions that low income consumers may be more likely to take a loan offered without question as they believe it is the only one that will be offered.

The report analyses the three market segments identified in relation to consumers’ use of information. In relation to the housing and personal loans market the author is relatively sanguine, describing these markets as healthy and competitive. A majority of respondents to the telephone survey reported shopping around for their housing loan (58%), with 77% of these people reporting that it was relatively easy to compare loan products. Despite this, 51% of those who shopped around found at least one aspect of the loan that they found difficult to compare including: loans were so different they were confusing to compare, the information didn’t allow comparison (22%), interest rates were difficult to compare (15%); it was difficult to find the information wanted (8%); and, it was difficult to compare fixed and variable rates.

It would seem from this that the report is possibly unjustifiably sanguine about the housing and personal loans market. A significant proportion of respondents reported not shopping around for their home loan (42%) which given its importance to the household budget both in income and duration seems on the face of it, cause for some concern. The author’s position is that this proportion combined with other factors points to a competitive market. Unfortunately the questionnaire did not ask respondents who didn’t comparison shop why this was the case. It’s possible, for instance, that a large proportion of these respondents had an existing relationship with a bank, had built up trust with the institution and felt comfortable dealing with them. Alternatively, it could be that these consumers were so overwhelmed or intimidated by the market that they simply took the first loan offered to them.

Taking the information presented in a slightly different way you could say that 55% of respondents either did not make a comparison when choosing a home loan or found it relatively difficult to do so.

In looking at linked credit, only 55% of respondents found it relatively easy to compare linked credit loans, which the report notes ‘means that linked credit borrowers have substantially more difficulty in comparing loan products than those purchasing other forms of credit’ (p12). On the face of it this seems an inappropriate conclusion as this line of questioning did not filter out people who did not compare loans as was the case with the other forms of credit. The researchers also found out that a high proportion of linked credit borrowers seriously considered taking out the loan on the day they signed up for it (32%).
In conclusion Malbon finds the following in relation to the linked credit market:

The truth in lending objectives face a number of hurdles in the linked credit market. Consumers are either engaged in shopping for the goods that they want, and therefore tend not to focus on comparing credit products or they are interested in the interest free period for the loan and tend not to focus on the consequences of not paying within the interest free period. It appears that this situation may [disproportionately] operate to the detriment of consumers who are unable to repay their loans within the interest free period. (p13)

This report makes the point that

The disclosure requirements are also designed to promote confidence in the market. It is assumed that if the market is rife with deceptive practices, consumers will become overly cautious and reluctant to engage in the market. This would hinder the operation of an efficient and effective market, as well create injustice. (Malbon 1999, p18)

The report makes useful points on the issue of consumer information and competitive markets

The challenge for the policy maker is to reduce search costs for consumers to the extent necessary to achieve a competitive market without unduly adding to the cost of providing that information (which will eventually be passed onto consumers). Judging whether the market is competitive is usually extremely difficult because there are many variables to take account of, including each firm’s fixed costs to determine whether they are taking abnormal profits. Consequently, the policy maker often has to act partly on the basis of an intuitive sense of where the policy settings should lie. This intuitive sense can usefully be informed by hard data. (Malbon 1999, p21)

Using the work of Schwartz and Wilde Malbon posits that the question for the public policy maker ‘is not whether each individual in the market is maximising their own utility, but rather whether competition amongst firms for particular groups of searchers is sufficient to generate optimal prices and terms for all consumers.’

The report also finds that ‘our snapshot of the consumer credit market between October 1998 and February 1999 showed that while there was a substantial degree of advertising regarding housing interest rates, credit cards were not advertised a great deal.’ (Malbone 1999 p24)

4.4 Information and Consumer Credit Decisions (Avram 1997)

This earlier piece of research involved a consumer survey (597 telephone interviews) investigating the main types of information used by consumers in choosing a personal loan. It was undertaken for the Consumer Credit Legal Service in 1996.

In relation to the time devoted to research, 53% of respondents had thought about the loan for four weeks or more, with 13% deciding ‘on the spot’. Only thirty-four percent of respondents had compared alternative lenders.

The questionnaire asked respondents to nominate the most important aspect of the loan and also to rate the importance of these nominated aspects. The results are presented below. It would appear from these results that asking people to nominate a ‘most important’ factor for a relatively complex decision provides little insight. When these results were cross-tabulated against characteristics of respondents it was found that those with the highest education levels (sic) were more likely to place emphasis on interest rate and the total cost of the loan. Respondents with
loans of less than $20,000 were more likely to view the amount of repayment as important, than those accessing loans of more than $20,000.

This latter finding is not really that surprising. Smaller loans are more likely to be accessed by people on lower incomes for whom the key issue is whether they can service the loan.

Table 4-1  Aspects of loan that were most important and those that were assessed as very or fairly important in making a loan decision

<table>
<thead>
<tr>
<th>Aspect of Loan</th>
<th>Most important (%)</th>
<th>Proportion who assessed the aspect as very or fairly important (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of each repayment</td>
<td>29</td>
<td>85</td>
</tr>
<tr>
<td>Interest rate</td>
<td>21</td>
<td>79</td>
</tr>
<tr>
<td>Total cost of loan</td>
<td>21</td>
<td>78</td>
</tr>
<tr>
<td>Length of repayment period</td>
<td>12</td>
<td>76</td>
</tr>
<tr>
<td>Repayment intervals</td>
<td>5</td>
<td>67</td>
</tr>
<tr>
<td>None- each equally important</td>
<td>12</td>
<td></td>
</tr>
</tbody>
</table>

Source: Avram 1997

The study concluded that a relatively small proportion of consumers shop around for personal loans, possibly because of ‘consumers’ lack of understanding of interest rates and charges, other reasons could include the accessibility of information and the related search costs faced by consumers” (p16).

4.5 Consumer capacity, consumer decision-making and potential approaches to information provision

This study will include a short investigation of consumer capacity, consumer decision-making and potential approaches to information provision. Credit is not the only complex product about which consumers (and particularly vulnerable and disadvantaged consumers) are required to make choices, and this component will include consideration of related areas such as financial services including insurance, telephony (particularly mobile phones) and other utilities.

For example, work is currently being undertaken by the Corporations and Financial Services Division of the Federal Treasury to refine aspects of financial services regulation. Part of this work is grappling with similar issues to that addressed by this study. One approach suggested for dealing with ‘information overload’ is to enable shorter product disclosure forms than are currently required and providing additional information on a website or some other easily accessible location.
5. Primary Research Component

5.1 Methods

The primary research component of the study needs to examine two inter-related themes:

- Consumer credit decision-making in relation to the specific forms of credit to which the MCR applies. There is limited publicly available research, although there would be a lot of market research undertaken for credit providers. (Morgan work for ANZ in Australian context)
- Within that broader framework we need to try and isolate the role of the MCR in decision-making. This necessitates consideration of
  - ‘brand awareness’ (i.e., do consumers recognize the MCR and understand what it is?);
  - is it useful in assisting consumers in their decision-making?

One method for improving our understanding of these issues is to interview credit providers. This is being done both one-to-one and in focus groups. The one to one interviews will be conducted with senior staff to investigate compliance and implementation issues, formal feedback from operational staff on the MCR and more general information on their organisation’s understanding of consumer decision-making.

Focus groups are being conducted with operational staff (those responsible for assisting consumers with their credit decisions and selling credit) to get a better understanding of how consumers make their decisions. This involves consideration of the following:

- the concepts and procedures consumers have difficulty understanding;
- the information consumers request and use; and,
- the extent to which the MCR is perceived as useful in making decisions.

We have worked with Ian Gilbert at the Australian Bankers’ Association to identify willing participants in such a process.

Consumer feedback has initially been gathered through interviewing consumer advocacy groups and holding a number of focus groups with consumers to gauge their understanding and use of the comparison rate in decision-making.

In the focus groups and interviews conducted to date examining people’s experience of shopping for credit it was clear that the comparison rate had played no part in any of the participants’ decision-making. Even when the concept was explained, participants did not recall receiving a comparison rate schedule (a number of participants had lodged multiple applications).

The next sections outline some preliminary analysis of research conducted to date. Particularly in relation to the consumer research, given the small number of people interviewed to date the results are very preliminary and should be treated as ‘early indications’ of consumer attitudes.
5.2 Interviews with providers

To date this has largely been undertaken as part of the Hawkless research. A common theme with suppliers is that the ‘generic’ nature of the schedules makes them of little interest to consumers.

There are a number of strands to this argument. First, many consumers are so overwhelmed by the choices and information available to them, that a schedule of rates for amounts that they are not actually negotiating seems to be ‘beside the point’. Common responses to this information are claimed to be ‘but how much will I pay?’

Second, the increasing sophistication of the consumer finance sector means that increasingly there is not a ‘standard’ interest rate for products. The interest rate is tailored to the individual customer based on their specific risk profile (eg their level of income, the quantum of the loan, their level of equity etc). Therefore the schedules become of much less use when they are based on an interest rate that will not necessarily apply to the consumer receiving the schedule.

This clearly is a problem for advertising as well, where there does appear to have been a strong shift away from advertising interest rates. To what degree this has been driven by changes in industry practice (ie increasingly tailored approaches to negotiating with consumers), increasing competition in the consumer finance market or a response to the MCR legislation is difficult to disentangle.

As one informant put it:

It (MCR) worked on different basis to the code: the existing code was based on disclosure for a particular credit contract whereas the comparison rates was asking for a generic disclosure at a point where it is not clear what credit product the customer is interested in, the term and quantum of the loan and the financial position and credit-worthiness of the client. The MCR is predicated on a known interest rate whereas credit products are increasingly priced for risk so that even when all other factors are known there is still variation in the interest rate dependent on customer. It’s a pre-pre stage- the normal system is set to run on customer disclosure. Assumes every product has an APR ie ‘the old fashioned notion’ of a personal loan at x%- now it depends on who you are and what other products you are using (bundled packages).

In addition, suppliers found the calculation of the rate, at least initially, to be difficult and their responsibility under the regulations to be unclear. As is almost unavoidable with an intervention such as MCR, there was confusion about what should be included as ‘ascertainable fees and charges’ although the impression was that over time approaches between different suppliers had become more consistent.

A focus group held with home loans officers (7 officers) found that while comparison rates were playing almost no role currently, this group at least were not prepared to discount them completely. One officer said that over the last two years he had seen around 400 clients and only one client had asked for an effective rate, by which they meant one that included fees and charges.

There was a consensus that customers are not aware of the concept of comparison rates and that explaining it to customers was very difficult given all of the other information that needs to be
conveyed. There was clearly confusion amongst some members of this group about how comparison rates were calculated.

There was also a concern that if competitors are not highlighting and explaining comparison rates then for them to do so risked putting themselves at a commercial disadvantage. However there was general agreement that if consumer understanding of comparison rates improved that it would be a useful tool with a number of participants quite emphatic on this point.

This group emphasised that one of the challenges for the comparison rate regime is that both interest rates and fees and charges are highly negotiable. It was suggested by one participant that advertised terms and conditions are in fact a ‘worst case scenario’ from which customers could negotiate depending on their individual circumstances.

Suggestions to improve the usefulness of comparison rates included changing the name to something less confusing such as ‘effective rate’, ‘actual rate’ or ‘annual percentage rate’. It was also suggested by a number of participants that a public education campaign was needed. This was both to improve understanding but also to put pressure on all institutions to provide this information to consumers and to treat the provision of such information seriously.

Participants also suggested improvements to the bank’s own practices that would increase the usefulness of comparison rates. One was to include calculation of the comparison rate as part of the banks internal calculation software and another was to present comparison rates side-by-side with contract rates to help make them clearer.

5.3 Interviews with Consumer Advocates

As a general starting point it needs to be acknowledged that those representing financial counsellors and consumer advocates more broadly are at something of a disadvantage in discussing the MCR regime, given that it is a pre-contractual and contractual disclosure instrument. When consumers present to counsellors, it is after a protracted period of financial stress by which time they are likely to have forgotten any role that a comparison rate may have played in their initial credit decision. One interviewee made the point that in casework they didn’t have people presenting saying that the comparison rate would have saved them and in thousands and thousands of calls there has been no mention of the comparison rate.

To balance this one financial counsellor did say that since the introduction of the MCR they had received fewer complaints from consumers saying that they didn’t realise how much their home loan would cost. Another commented that she had fewer people seeking assistance to understand the various fees and charges.

Generally there was agreement that the introduction of the MCR regime had seen a significant fall in the quoting of interest rates in fixed credit advertising but that, given how misleading such rates were prior to the introduction of the MCR (particularly for loans for smaller amounts and those of short term nature) this was no bad thing. There was a view that this would encourage providers to compete on other factors such as services and the ease of the process of acquiring a loan (this view is supported in results from consumers reported below).
There was also a feeling amongst the consumer advocates that we spoke to that the introduction of the MCR had led to an increase in those fees and charges not covered by the regulation (such as deferred establishment fees and fees and charges that were triggered by a particular event such as early repayment of the loan or missing payment dates) and that this needed to be addressed.

One respondent in particular, made the point very strongly that the MCR as a concept had the potential to provide some degree of empowerment to consumers through its role in simplifying and clarifying the issues that consumers were attempting to consider in their decision-making.

In responding to the proposition that mortgage brokers could play a role in assisting consumers to navigate the increasingly complicated world of consumer finance, the consensus was that brokers were in fact part of the problem, adding an extra layer of confusion by stressing to consumers the difficulty and complexity of the mortgage market. In relation to the MCR directly, it was put forward that the comparison rate tool would still be useful for the brokers as part of the comparison they provide to consumers.

The role of commission in framing brokers’ advice was a concern for the consumer advocates and at the very least they would like to see regulation to make brokers’ commission structures more transparent to consumers.

5.4 Interviews with Consumers

Focus groups and personal interviews have been undertaken with respondents who had recently arranged a fixed term loan. The purpose of these interviews is both to inform the project generally and also to provide input to the development of the proposed survey.

Focus groups have been conducted at Swinburne University and at Docklands in central Melbourne. There were nine participants at the Swinburne focus group. Five had negotiated a home loan in the previous 12 months, 5 a personal loan and one person had arranged a personal loan to consolidate debt (3 participants had negotiated more than one fixed credit loan over the period). At Docklands there were six participants, with all having negotiated some form of loan related to their housing, however it was not clear that all participant’s loans would have been covered by the Consumer Credit Act as they were also related to investment properties. In addition a number of personal interviews were conducted at the Boardwalk Primary School in Point Cook.

The focus groups and interviews were semi-structured with the discussion encouraged by the moderator using the following prompt questions.
Table 5-1  Consumer Focus Group/Interview Questions

What credit have you negotiated in the last 12 months?
• Start with general introduction from each participant- form of credit, what for etc

General impression of looking for credit?
• Confident/unconfident
• Confusing market place

Extent of the search period?
• Time period
• Number of providers
• Number of products

What were the key factors you were considering in your search?
• Interest rate
• Fixed charges
• Reputation of lender
• Role of advertising

How easy did you find comparison across lenders and products?
• Did you use any third parties (brokers/information providers)

What was the key factor in the actual decision-making?  (Was this any different to ‘original search factors’?)

Are you familiar with the term ‘comparison rate’?  If so, what do you think it refers to?

Thinking about the process of looking for and negotiating your loan do you remember receiving a schedule of comparison rates from any of the lenders you approached?

How important was the ‘comparison rate’ in making your decision?

How important is having a single comparable interest rate when searching for credit?

Searching for a loan

There was a sharp split between the two groups with participants in the Swinburne group generally finding the home loan market confusing while the Docklands participants were more sanguine.  As one participant in the Swinburne group said:

Nothing was clear- absolutely nothing.  Nothing was really explained particularly well and they (the provider) seemed to assume I knew what I was doing- which I didn’t

Of the five participants who had arranged a home loan in the Swinburne group, all five had used a broker at some point in their search process with four successfully negotiating a loan with a provider suggested by a broker.  One of the participants said that:

Using a broker made it easier after trying to get and getting confused by the information given to me.  Broker made it accessible and clarified issues.

This response was typical of those who had used a broker.  All agreed that it had made a complicated task much simpler and that they had confidence in the broker that they had used.  The participant who had not gone with a broker-suggested provider was because the provider
refused their request. In the Docklands group only one participant had used a broker and they too were mostly happy with their experience. They saw the key advantage of using a broker as being that it saved them time.

The experience of those searching for a car loan was more varied, with one participant in particular undertaking a lot of research, mostly online while others relied on credit provided (or facilitated) by the dealer. One participant arranged finance through a dealer with a well known retail provider only to find that she had contracted with a less well known associated company.

**Key factors in decision**

P1 That I was able to service the loan, so went for a longer term with a fixed rate over the period of the personal loan as I wanted certainty.

P2 The interest rate, overall cost and the ability to make extra repayments off principle. The interest rate was surprisingly low but this was determined during negotiation and was dependent on my level of equity. Twenty years ago as a single mum it was murderous trying to get a loan. In addition, one provider required a lot more paperwork than the one I ultimately chose. For example, I have three different jobs and they needed full details of each (when I started, pay slips etc) whereas the provider I chose was satisfied with my annual tax return.

P3 Interest rate and ability to make extra payments

P4 I wanted to deal with an institution I liked (a credit union) rather than a bank.

P5 Interest rates, types of account (offset), extra repayments and little bit influenced by service

P6 How long to pay back and extra payments without penalty.

P7 Looked at houses first. Couldn’t get enough money but then this year circumstance changed- wanted to use a particular credit union but their valuer didn’t think it was worth what was being paid and I couldn’t afford to pay residual. It was getting close to settlement so the estate agent said here’s our broker use him. Broker was helpful and gave a number of options- interest rate was key and that I can pay extra. Can’t remember everything but seemed like the best deal.

P8 That I could get the loan. I had negotiated three previous loans and confident in the system. Interest rate needed to be competitive, and features such as offset etc

P9 Interest, loan application fees, ongoing fees. To compare I just listed down everything and used comparison site on internet. Ability to make extra repayments and would vehicle be used as security.

P11 Key factors were interest rate although they all seem much of a muchness and will change anyway with Reserve Bank settings. Service was important, particularly the quantity and quality of the information provided, which I was very impressed with.

**Role of advertising**
The two groups were unanimous that advertising played little or no part in their search and decision-making process.
Awareness of comparison rate

Two participants said that they had heard of the comparison rate but neither had a clear idea of what it was. One participant said that:

I’ve heard it, I’m not sure I know what it means- I’m assuming it just means the difference between one rate and another

While another said that:

I am familiar with it (the term) and I’ve had a bit of read of your material. I’m familiar with the concept in the advertising media- talking about it in terms of airfares so that you’re comparing apples. I don’t think I heard it used in relation to the loans I was offered. Nobody said this was our comparison rate.

Following this discussion the comparison rate legislation was explained to the groups. This triggered two participants’ memories. No-one could distinctly remember receiving a comparison rate schedule, despite the fact that all participants had negotiated a loan and a number had made more than one application. No participant had used the comparison rate at all in making their credit decision.

In explaining the concept to the groups there was a little confusion about what the comparison rate was ‘compared to’ in the material provided by credit suppliers. This indicates a problem with the term ‘comparison rate’. There was also some confusion over the term ‘standard variable rate’ which a few participants seemed to think was somehow standard across providers. A few of the participants thought that the comparison rate sounded like it may have been of use to them in their credit search and decision-making if they had been aware of it.

Explaining the comparison rate and trying to get respondents to outline what role, if any, it played in their decision-making also proved difficult in the one-on-one interviews. Requiring the respondents to differentiate between use of ‘the comparison rate’ and simply comparing interest rates was problematic.

A few one on one interviews with consumers have been conducted to this point using a draft questionnaire (included as attachment 1). This prompted the first consumer to recognise the term ‘comparison rate’ and be able to explain it as ‘a rate that includes fees and charges’. The consumer in question was someone re-financing their home. Their knowledge of the comparison rate came through regular reading of the financial pages.
6. Lessons from the consumer research to date for the survey

6.1 Discussion of Issues

In the consumer research conducted to this point the most outstanding result is the low level of awareness and use of the comparison rate.

Consumer research has underlined the complexity of the mortgage market and thus the difficulty of designing a questionnaire to be administered generally to consumers. Whether consumers used a broker or not is clouded by providers such as Wizard that are both broker and lender in their own right. Many, particularly older consumers, are accessing products that are

In terms of key factors in choosing their loan, the consumers we have spoken to have stressed the importance of service in choosing their provider. Key service aspects mentioned have been the efficiency and flexibility of the provider’s lending process particularly in relation to the paperwork and information needed from the customer. The other key aspect of service was the quantity and quality of information provided by the lending institution.

Given that to date only one consumer has had an understanding of the comparison rate it is probably important to ask people how they came to be aware of the comparison rate. Allied with this, it appears that general financial literacy and experience in negotiating credit is an important factor in people’s decision-making and likely use of the comparison rate so that potential questions might be framed around the following:

- Recognition of a percentage sign?
- Do you read financial papers?
- Do you listen to financial advice on radio/tv?
- Experience in negotiating loans?

Another issue that piloting the draft questionnaire has highlighted is the importance (and challenge) of designing a questionnaire that is appropriate for all forms of loan. In addition our work has suggested that asking people to nominate precisely how long ago they arranged their credit may be important in testing people’s recall of the comparison rate (ie it would be interesting if people with more recent experience were more likely to recall the comparison rate).

In terms of the practical concern of sampling frame, the organisation of focus groups and piloting the survey has identified the potential difficulty in efficiently locating respondents who are ‘in-scope’. To date we have been limiting our consumer research to those people who have negotiated a fixed-term loan in the past twelve months. This is to ensure that respondents have adequate recall of the process that they went through and the role of the comparison rate in their decision.

The draft questionnaire initially designed was to be administered by an interviewer, either over the phone or face-to-face. The major advantages of an administered approach include:

- that the respondent can seek clarification from the interviewer;
• the interviewer can prompt and draw out more information where appropriate and seek clarification from the respondent;
• that information can be ‘kept back’ from respondents (eg response categories can be developed but respondents can be simply asked the question so that they provide a ‘top of the head’ response rather than one led by the available responses).

This latter factor is particularly important with the initial questionnaire as respondents are first asked whether they had heard of the comparison rate and whether they could explain it and then given a definition of the comparison rate to see if this ‘jogs’ their memory and also if it potentially would have been of use to them if they had known about it. This type of questioning is not possible with a mail-out survey.

Face to face interviewing is very expensive for a large sample, particularly if the sample is to be drawn randomly from across Melbourne or even more so, the whole of the state. Telephone interviewing is less expensive but we have a particular problem for this sample population. There has not been a database capable of reverse-searching telephone numbers (ie choosing numbers randomly or choosing numbers by fields other than name) on the market for around eighteen months. A large proportion of our sample will have new numbers and therefore not be included in this database.

Even if we had access to all residential telephone numbers in Melbourne we selected randomly, the odds of calling someone who had arranged a home loan or refinanced their home in the last twelve months would be approximately 14%. At a success rate per call of 30%, this would put the likelihood of phoning someone who was in-scope and obtaining a response from them at 4%. This means that from every 100 phone calls made, we would obtain 4 responses. To achieve two hundred responses would require making nearly 5,000 calls.

In relation to a mail-out survey we have had discussions with Australia Post regarding their Database Update services. Eighty four percent of people who move house use Australia Post’s redirect mail service. Of these 80% give permission to be direct mailed and 20% provide an email address. This could be an important resource in developing a sample although initial pricing information makes the mail-out option unfeasible (there is a fixed $15,000 set-up cost). The email option is much cheaper but there is a greater issue of sample bias given the relatively small proportion of Australia Post clients who provide an email address and the systematic bias that would be introduced by excluding those without access to email.

A further option that has been discussed has been to include a small number of questions in Westpac’s regular consumer survey. This has a very large sample (around 20,000 Australia-wide) but would necessitate including only a small number of questions on the MCR. The next survey is conducted in September.

6.2 Preferred Approach
Following a Steering Committee meeting on the 16th June it was decided to adopt the following approach to the primary research component of the study. A very short telephone survey of the general public would be conducted to test general awareness of comparison rates and their role in decision-making. A draft of this questionnaire is attached.
This survey would be supplemented with in-depth interviews with participants who have recently arranged a home loan. The concentration on home loans is based on the recognition that this is the form of consumer credit for which comparison rates are likely to play the largest role. These interviews could be arranged in a similar fashion to those conducted to date, by targeting newly developed residential areas. These interviews (between 20 to 40 respondents) would be semi-structured using the general outline in Table 5.1.
Reference List


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