Chapter 3

Explaining the 'stickiness' of credit card interest rates

3.1 As explained in the previous chapter, different measures of credit card interest rates offer different insights into whether those rates are fair and appropriate, or whether, as Mr David Koch put it, average Australians are getting 'fleeced at every step on the credit card journey'.[1] During the inquiry, critics of card providers pointed to the 'stickiness' of headline (advertised) interest rates, arguing that for revolvers, this was the most meaningful measure of interest costs. Card providers, however, pointed to declines in the aggregate interest paid on their entire credit card portfolios (the 'effective' interest rate). This chapter outlines and assesses the relative merits of these different perspectives.

3.2 To the extent that credit card rates have not declined in line with the RBA cash rate—and this has certainly been the case with regard to headline interest rates, and to a lesser extent the average rate paid by credit card 'revolvers'—this chapter explores the reasons for this 'stickiness'. Again, the committee received conflicting explanations for this phenomenon. Card providers argued that funding was only part of the cost base of credit cards, and referred to a range of other significant costs influencing credit card pricing. Others, however, argued that the growing gap between the cash rate and credit card interest rates could only be explained by the fact providers were taking advantage of consumer inattention to credit card interest rates. This chapter outlines and assesses these arguments, and considers the need for reforms designed to better focus consumer attention on credit card interest rates.

3.3 Finally, this chapter briefly assesses the profitability of the credit card market in Australia.

'Up like a rocket, down like a feather': Credit cards and the RBA cash rate

3.4 Two related measures of credit card interest rates (that often attract the most public scrutiny), are headline rates and the gap between average headline rates and the RBA cash rate. As noted in chapter two, headline interest rates on standard cards currently bunch around 20 per cent, while low-rate cards tend to be set at 13 per cent or thereabouts. The average headline rate—the effective rate for cardholders who are paying interest on their balances—is around 17 per cent. There is therefore a 15 per cent gap between the average headline rate on credit cards and the current RBA cash rate of 2 per cent. In 2007, the same gap was around 8 per cent.[2]

1 Mr David Koch, Finance Editor, Seven Network, *Proof Committee Hansard*, 27 August 2015, p. 34.

2 These figures were set out in greater detail in chapter two.

3.5 A number of witnesses during the inquiry questioned whether current headline rates and the gap between headline rates and the RBA cash rate (or, alternatively, between headline rates and the costs of funds) could be adequately explained simply as a function of the costs of providing the facility. Dr Edey from the RBA, for instance, suggested that while there was a great deal of variation in interest rates across the credit card market, rates at the higher end of the spectrum could not be easily explained:

> Interest rates in the order of 20 per cent on credit cards are not uncommon. The average rate for borrowers who incur interest on credit cards is currently about 17 per cent. Once you deduct from that banks' cost of funds and the cost of credit losses, that would equate to an interest margin of more than 10 percentage points.[3]

3.6 Professor Valadkhani provided the committee with research he had undertaken indicating that credit card providers appear to behave asymmetrically in response to changes in the RBA cash rate. According to Professor Valadkhani, between 1990 and 2012 the banks had immediately passed on 112 per cent of RBA cash rate increases (the full value of increases, plus 12 per cent), but only 53.7 per cent of rate cuts: but cuts were delayed by an average of two-and-a-half months. Professor Valadkhani has suggested this asymmetry is an example of the 'rockets-and-feathers' effect: credit card interest rates 'shoot up like a rocket' in response to RBA cash rate increases, but 'float down like feather' when the cash rate is decreased.[4] This means that over time the gap between the RBA cash rate and credit card interest rates has grown, and consumers have been left paying higher rates of interest overall.

3.7 Professor Valadkhani took issue with the banks tendency to downplay the relevance of the cash rate to credit card interest rates:

> We do not have enough information about what their funding sources are. The argument they always make is: 'We cannot pass rate cuts on because our sources of funding are different—it is not just the cash rate; it is our external sources.' My argument to banks is: if that is the case, how come, when the cash rate goes up, you immediately lift your rates? You may have other external sources that are not related to the cash rate, but you increase your rates anyway. When the cash rate goes down, though, you resort to the argument of external sources.[5]

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3 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 27 August 2015, p. 10.

4 Abbas Valadkhani, Sajid Anwar and Amir Arjomandi, 'Downward stickiness of interest rates in the Australian credit card market', *Journal of the Asia Pacific Economy* 19(1) (2013), pp. 52–53; Professor Abbas Valadkhani, Department of Accounting, Economics and Law, Swinburne University of Technology, *Proof Committee Hansard*, 3 September 2015, p. 27.

5 Professor Abbas Valadkhani, Department of Accounting, Economics and Law, Swinburne University of Technology, *Proof Committee Hansard*, 3 September 2015, p. 30.

3.8 CHOICE noted that despite a falling cash rate, average credit card interest rates had gone up for both standard-rate and low-rate cards in recent years. This was of particular concern to CHOICE, because:

> …if you must have a credit card and you are on a low income that means you cannot pay off your balance every month, a low-rate card is the best option. So to see banks taking advantage of drops in interest rates to dip their hands deeper into the pockets of low-income consumers is of deep concern.[6]

The role of behavioural biases in informing credit card interest rates

3.9 An important finding of this inquiry is that consumers do not appear as focused on the interest rates on credit cards as they are for other lending products (such as personal or home loans). In fact, CHOICE told the committee that its consumer survey suggested that 64 per cent of people do not even know their credit card interest rate, up from 48 per cent in 2013, suggesting a 'growing problem'.[7]

3.10 The committee received evidence suggesting consumers' apparent inattention to credit card interest rates was likely a factor in the prevalence of high-interest credit cards, reducing pressure on card providers to compete on interest rates. Treasury suggested that the 'large and widening spread between funding costs and headline credit card interest rates' could be explained in part by consumer inattention:

> The spread appears not to just reflect pricing of credit risk or non-performing loans and funding costs. Rather, the spread seems to incorporate as well a premium reflecting consumer inattention to headline rates.[8]

3.11 Bank Australia made a similar point, telling the committee that the spread likely reflected the fact that people are 'not terribly rate sensitive' when they choose a card, because they expect to pay off the card balance in full each month. In this sense, the spread was as large as it could be without affecting the market's ability to sell credit card products.[9] Likewise, Mr Greenwood remarked that consumer inertia reduced the need for card providers to lower their average rates:

> There is clearly room for the banks to move these credit card interest rates down. They have chosen not to do so and they have justified it in all sorts of ways—in terms of the services they provide and the rewards they provide. And they will give you an idea of the bad debts that are there as

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6 Mr Alan Kirkland, Chief Executive Officer, CHOICE, *Proof Committee Hansard*, 27 August 2015, p. 51.

7 Ms Erin Turner, Campaigns Manager, CHOICE, *Proof Committee Hansard*, 27 August 2015, p. 53.

8 Mr Michael Willcock, Acting Deputy Secretary, Markets Group, Department of the Treasury, *Proof Committee Hansard*, 22 September 2015, p. 55.

9 Mr John Yardley, Chief Operating Officer, Bank Australia, *Proof Committee Hansard*, 3 September 2015, p. 20.

> well. But the bottom line is that, clearly, the consumer is not acting to try and find a better deal.[10]

3.12 Drawing on insights provided by behavioural economics, ASIC suggested that people may give insufficient attention to a card's interest rate at the point of application because they are naively optimistic about their ability to pay their balance off in full each month.[11]

3.13 Credit cards are multifaceted products, with features that have a significant bearing, real or perceived, on the value proposition for a particular consumer. For some consumers, the tendency to prioritise card features such as rewards points may be entirely rational. As CANSTAR explained, for big spenders who consistently pay off their full credit card balance each month, the interest rate is irrelevant. For these customers, features such as rewards programs are likely to be given a higher priority than interest rates. However, CANSTAR emphasised that customers who do not consistently pay off the entire card balance each month 'should not even consider rewards. The interest rate will blow the rewards away'.[12]

3.14 Despite evidence that interest rates are often the most salient feature of a credit card, Treasury stated that competition is generally more intense on other aspects of the value proposition, including balance transfer offers, interest-free periods on purchases, rewards programs, and other benefits such as insurance and concierge services.[13] CHOICE made a similar point, telling the committee that the banks were not competing on interest rates, but instead on other generally less important card features such as rewards points and balance transfers. To focus more competition on interest rates, and thereby put downward pressure on them, CHOICE suggested it was necessary 'to force the banks to give people the information they need when they need it'.[14]

3.15 The Customer Owned Banking Association (COBA) also argued that consumers were more focused on credit card 'bells and whistles', and 'are not looking at that interest rate as a key factor in deciding what product to take up'. This also meant that card providers 'are not really competing on price in that space'. The problem with this situation, COBA told the committee, was that while consumers

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10 Mr Ross Greenwood, Business and Finance Editor, Nine Network, *Proof Committee Hansard*, 27 August 2015, p. 42.

11 Australian Securities and Investments Commission, *Submission 16*, p. 10.

12 Mr Stephen Henry Mickenbecker, Group Executive, Ratings and Financial Services, CANSTAR Pty Ltd, *Proof Committee Hansard*, 22 September 2015, p. 35. Mozo made the same point to the committee. Mr Rohan Gamble, Managing Director, Mozo, *Proof Committee Hansard*, 22 September 2015, p. 35.

13 Treasury, *Submission 17*, p. 4.

14 Ms Erin Turner, Campaigns Manager, CHOICE, *Proof Committee Hansard*, 27 August 2015, p. 54.

might generally expect that they will not be paying interest on credit card debt, in fact a relatively high percentage of people (about 30 per cent) end up paying interest.[15]

Committee view

3.16 The committee believes there is strong and compelling evidence to suggest that part of the reason credit card interest rates are so high is that card providers know consumers often pay little attention to their significance. Disclosure requirements in credit card advertising and other marketing could be enhanced, and the committee considers that card providers should be required to disclose the ongoing headline interest rate on a credit card in any advertising or marketing material clearly and prominently. This requirement would be established as part of additional disclosure requirements set out in recommendation 1 in chapter four. These additional disclosure requirements are intended to focus consumer attention on headline interest rates, and more broadly enhance the ability of consumers to value and compare credit card products in what is a very complex market.

Should credit card interest rates be regulated?

3.17 A number of submissions argued for limiting or otherwise regulating credit card interest rates. The WA Consumer Credit Legal Service (CCLSWA), argued that in order to protect low income, vulnerable, and disadvantaged consumers, legal reform was required to 'limit the gap between cash rates and credit cards rates'.[16] It argued that absent such action:

> …it is likely that when cash rates rise, credit card interest rates will rise considerably also. This will increase the already unfair and disproportionate costs placed on low income, disadvantaged and vulnerable consumers and will ultimately result in further long-term and severe damage to these consumers' financial and emotional well-being. Further, with more consumers experiencing serious financial hardship, there would be an increase in demand on government and community services.[17]

3.18 Similarly, the St Vincent de Paul Society recommended a legislative requirement that 'credit card interest rates align with changes in RBA cash rates'.[18] Good Shepard Australia New Zealand argued that a failure to pass on the full benefit of RBA cash rate cuts to credit card customers 'should be seen as an exception, with credit providers being made accountable to the regulator and consumers to apply for an exception to this rule'.[19]

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15 Mr Luke Lawler, Head of Public Affairs, Customer Owned Banking Association, *Proof Committee Hansard*, 3 September 2015, p. 20.

16 Consumer Credit Legal Service WA, *Submission 12*, pp. 2, 8.

17 Consumer Credit Legal Service WA, *Submission 12*, p. 2.

18 St Vincent De Paul Society, *Submission 4*, p. 6.

19 Good Shepherd Australia New Zealand, *Submission 5*, p. 3. Good Shephard did not specify which regulator it was referring to.

3.19 While Australia does not regulate interest rates, ASIC explained that the United States had adopted an approach characterised by 'a strong commitment to the direct regulation of fees and interest rates'. For example, increases on interest rates, fees and other charges are banned in the first year of an account being opened. Moreover, the United States has banned 'interest rate increases on outstanding amounts except at the end of an introductory rate period, if the rate is pegged to another rate that is not controlled by the provider or if the borrower is more than 60 days delinquent'.[20]

3.20 Asked about the possibility of regulating prices in the credit card market, CHOICE sounded a note of caution:

> As an organisation we are inherently cautious about anything that involves price controls or price-fixing. Ideally, the best way to protect consumers is to have effective markets that are supported by effective competition. We would much rather think about how you protect consumers from the negative effects of a market that is not working properly than price interventions, because they tend to ultimately produce other distortions in the system that have unintended consequences.[21]

Committee view

3.21 The committee acknowledges and shares the legitimate concerns raised by some witnesses regarding the apparent unresponsiveness of credit card interest rates to declines in the RBA cash rate. However, the committee does not agree that credit card interest rates should be regulated. Rather, the committee considers that the best way to put downward pressure on credit card interest rates is through regulatory and policy interventions designed to improve the competitive dynamics of the market and enhance the ability of consumers to measure and compare the value of products within that market accurately and easily.

Card providers: headline rates are steady, but effective rates have fallen

3.22 While much of the evidence received by the committee focused on headline interest rates, credit card providers argued that the average effective rate is a better measure of credit card interest rates. As explained in the previous chapter, this is calculated as the percentage of gross interest paid on balances outstanding. According to the RBA, this figure currently stands at 11.6 per cent, which is not only significantly lower than the average headline rate of about 17 per cent, but also 2 per cent lower than the average effective rate in 2011 when the current easing cycle for the RBA cash rate began.[22] These figures were supported during the inquiry by

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20 Ms Fiona Maguire, Senior Specialist, Australian Securities and Investments Commission, *Proof Committee Hansard*, 27 August 2015, p. 32.

21 Mr Alan Kirkland, Chief Executive Officer, CHOICE, *Proof Committee Hansard*, 27 August 2015, p. 56.

22 The 11.6 per cent figure is from the March 2015 quarter. For more detail, see chapter two.

evidence provided by the banks. For example, Westpac told the committee that the current effective interest rate for its entire card portfolio was 11.27 per cent, which was down from over 13 per cent in 2010.[23] Westpac also advised that its current return on capital (the primary measure of profitability) for its credit card portfolio had remained flat over the past five years, despite the declining cost of funds.[24]

3.23 In large part, the difference between headline rates and effective interest rates was influenced by three industry-wide factors which had offset the benefit of a reduction in the cash rate. As Westpac explained:

> First, more customers are spending more and paying off their cards in full [each] month. This means that banks are funding higher balances that are in the interest-free period. In the last three years, interest-free balances have grown by around 45 per cent. In industry speak, the revolve rate has declined. Second, a higher percentage of balances are being held in lower rate cards. This means that the effective average interest rate has declined relative to the headline rate on these products. Finally, low or zero rate balance transfers are becoming a much larger component of the market, with zero for 18 months becoming the industry standard. Balances in this category earning no interest have grown considerably.[25]

3.24 Similarly, NAB explained that the effective interest rate on its credit card portfolio had been falling, in part due to the increasing numbers of cardholders moving to low-rate cards and taking advantage of zero per cent balance transfer offers (which are discussed further in chapter five).[26] ANZ also noted that trends in consumer behaviour in recent years have had 'the combined effect of reducing the total amount of interest bearing debt in the Australian credit card market and lowering the net effective interest rate that credit card providers receive on the lending they provide'.[27]

3.25 The ABA referred to data from July 2015 showing that while the number of cards and value of transactions had continued to grow in recent years, the gross amount of outstanding credit card balances accruing interest was actually at the lowest level in six years. Repayments over the year to July 2015 had exceeded transactions

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23 Mr David Robert Lindberg, Chief Executive, Commercial and Business Bank, Westpac Group, *Proof Committee Hansard*, 16 October 2015, p. 25. ANZ provided similar figures to the committee. Mr Graham Hodges, Deputy Chief Executive Officer, ANZ, *Proof Committee Hansard*, 16 October 2015, p. 60.

24 Mr David Robert Lindberg, Chief Executive, Commercial and Business Bank, Westpac Group, *Proof Committee Hansard*, 16 October 2015, p. 15.

25 Mr David Robert Lindberg, Chief Executive, Commercial and Business Bank, Westpac Group, *Proof Committee Hansard*, 16 October 2015, p. 15.

26 Mr Antony James Cahill, Group Executive, Product and Markets, National Australia Bank, *Proof Committee Hansard*, 16 October 2015, p. 32.

27 ANZ, *Submission 27*, p. 2.

by $8.6 billion, and 'the excess of repayments over transactions is now at a record high level and continues 10 years of strong repayment activity'.[28]

3.26 While effective credit card interest rates have fallen in absolute terms in recent years, the spread between credit card effective interest rates and bank funding costs has increased from a relatively stable average of 6.7 per cent in the years prior to the GFC to an also stable average of 8.7 per cent in the years since (see Figure 5 in chapter two). Several witnesses said that this shift could be explained by the global repricing of risk following the GFC. This repricing, the ABA remarked, was by no means unique to the credit card market, but was in fact reflected in a widening in the spread between cash rates and a range of lending and deposit products, both in Australia and internationally.[29]

3.27 Treasury indicated that the general repricing of credit across advanced economies in the aftermath of the GFC:

> …may be attributable to a general under-appreciation of credit risk prior to the crisis, particularly on unsecured lending, but may also reflect a failure to properly price default correlations across asset classes and their propensity to increase following a shock to the financial system.[30]

3.28 While measuring credit card interest rates using the effective interest rate might appear a logical approach, it must be emphasised that this measure is of little relevance to cardholders who are actually paying interest on their balances. The average rate paid by revolvers (17 per cent) has only fallen about 1 per cent since 2011, against declines in the average effective rate of 2 per cent and in the cash rate of 2.75 per cent, which would suggest an increase in the extent to which 'revolvers' are subsidising 'transactors'. This cross-subsidisation in the credit card market was raised by Dr Edey from the RBA, who noted that 'different kinds of customers incur different fees and different levels of interest expense'. [31] Mr Greenwood was more direct in his criticism of this cross-subsidisation, declaring that 'we have a system where some of the poorest and most vulnerable in our community subsidise the wealthiest in our community'. [32]

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28 Mr Anthony Pearson, Chief Economist and Executive Director, Industry Policy, Australian Bankers' Association, *Proof Committee Hansard*, 22 September 2015, p. 10.

29 Mr Anthony Pearson, Chief Economist and Executive Director, Industry Policy, Australian Bankers' Association, *Proof Committee Hansard*, 22 September 2015, pp. 9, 11.

30 Treasury, *Submission 17*, p. 8.

31 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 27 August 2015, p. 15.

32 Mr Ross Greenwood, Business and Finance Editor, Nine Network, *Proof Committee Hansard*, 27 August 2015, p. 37.

Card providers: funding costs only one component of credit card costs

3.29 Beyond emphasising the importance of focusing on effective interest rates instead of headline rates, card providers asserted that the RBA cash rate was one of many components of the cost base of credit cards. CBA and NAB advised the committee that the cost of funds only accounted for approximately 22 per cent of the costs of providing a credit card; similarly, ANZ reported that it was less than 25 per cent.[33] The industry average of the costs of fund as a proportion of the overall cost base, as reported by the ABA, was slightly higher, at about one third. As a relative proportion of the cost base of providing credit cards, the ABA added, this figure had 'fallen substantially over the past six years'.[34]

3.30 Westpac also maintained that the 'link between Credit Card headline (advertised) rates and the official cash rate is low'. Westpac added:

> The RBA's discussion paper, 'The Evolution of Payment Costs in Australia', confirms that funding costs are a low component of overall Credit Card issuing costs and consequently the official cash rate has a negligible impact on card economics. Rather, the highest Credit Card costs are associated with high operation costs, payments functionality (such as real-time systems) and the rich bundle of benefits associated with Credit Card products.[35]

3.31 While public commentary often focuses on the low correlation between the cash rate and credit card interest rates relative to the correlation between the cash rate and mortgage lending rates, the banks asserted that the comparison was misleading. ANZ stated that whereas funding costs only accounted for less than 25 per cent of credit card costs, they made up about 85 per cent of the cost base for mortgages. Given this difference, ANZ continued, it was not surprising that the relationship between product interest rates and the cash rate is less direct for credit cards.[36] The ABA made a similar point, aruging it was misleading to compare credit card pricing with interest on straight loan products. Credit cards, the ABA submitted, are a more complex product that other loan products:

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33 Mr Matthew Comyn, Group Executive, Retail Banking Services, Commonwealth Bank of Australia, *Proof Committee Hansard*, 16 October 2015, p. 9; Mr Antony James Cahill, Group Executive, Product and Markets, National Australia Bank, *Proof Committee Hansard*, 16 October 2015, p. 32; Mr Graham Hodges, Deputy Chief Executive Officer, ANZ, *Proof Committee Hansard*, 16 October 2015, p. 60.

34 Mr Anthony Pearson, Chief Economist and Executive Director, Industry Policy, Australian Bankers' Association, *Proof Committee Hansard*, 22 September 2015, p. 9.

35 Westpac, *Submission 21*, pp. 12–13.

36 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ, *Proof Committee Hansard*, 16 October 2015, p. 60.

> …because of their payment convenience, the fact that they have 24/7 access to what is a rolling credit facility and the fact that they involve third parties, such as the providers of the credit card infrastructure.[37]

3.32 NAB advised that banks have had to 'change their funding mix over time and move to more stable funding mixes', observing that deposit rates have increased in relation to spreads and wholesale funding costs have also increased.[38] For non-bank card providers, the correlation between the RBA cash rate and credit card interest rates is weaker still. For example, GE Capital explained that its interest rates are not directly influenced by the RBA cash rate, and depended on the state of wholesale funding markets, rather than the deposit funded market.[39]

Credit risk and loss rates

3.33 Card providers also emphasised that because credit card lending is unsecured, it is subject to higher risk profiles than many other forms of lending, arguing that the pricing of credit cards (including interest rates) is in part a reflection of this higher risk, and the fact that credit card lending attracts higher risk weights than secured forms of lending. As ANZ advised:

> This risk dynamic is well recognised by both the banks and regulators as evidence by the risk weights applied to credit card limits (APRA defined). While recent increases in mortgage lending requirements increased risk weights to 25 per cent to account for the potential risk borne by banks, the risk weights applied to credit card balances is significantly higher at 40 per cent.[40]

3.34 CBA explained that this higher risk, and the fact that credit is available on an ongoing basis rather than for a fixed period, meant that the pricing of credit cards was 'sensitive to market pressures and the economic environment, particularly the unemployment rate'.[41] According to CBA, this need to price risk through the economic cycle was a 'much more significant contributor' to credit card pricing than funding costs,[42] and while credit card portfolios might look profitable over the short-term, profitability needed to be considered over the entire economic cycle:

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37 Mr Anthony Pearson, Chief Economist and Executive Director, Industry Policy, Australian Bankers' Association, *Proof Committee Hansard*, 22 September 2015, p. 19.

38 Mr Antony James Cahill, Group Executive, Product and Markets, National Australia Bank, *Proof Committee Hansard*, 16 October 2015, p. 32.

39 Mr Duncan Berry, Chief Executive Officer, GE Capital Australia & New Zealand, *Proof Committee Hansard*, 16 October 2015, p. 58.

40 ANZ, *Submission 27*, p. 9.

41 Commonwealth Bank of Australia, *Submission 23*, pp. 2, 7.

42 Mr Matthew Comyn, Group Executive, Retail Banking Services, Commonwealth Bank of Australia, *Proof Committee Hansard*, 16 October 2015, p. 1.

> Whilst we have been fortunate to have periods of economic growth in Australia, many markets have demonstrated that losses increase quite dramatically in times of stress. So our default rates, for example, tend to be in the range of two to three per cent; if you look at the US experience over the last five years, they peaked at more than 10 per cent. So in any given year the credit card business can look very profitable. Over the long term, there is likely to be a year where it is distinctly less profitable—possibly unprofitable—and our role of running a credit card business is trying to ensure that we run it profitably over the long term.[43]

3.35 Westpac made a similar point, submitting that credit card pricing adjustments 'reflect broad changes over the economic cycle rather than as a frequent, point-in-time response to individual movements such as changes in the official cash rate'.[44] ANZ also noted that interest rate movements on unsecured credit products like credit cards 'must take account of through-the-cycle loss rates and the underlying economic factors driving reductions in cash rates (e.g. unemployment)'.[45]

3.36 Higher default risk on credit cards was also identified by some as a factor in determining interest rate settings. For example, Bank Australia stated:

> Pricing still has to take into consideration that credit card default risk and fraud risk is higher than with secured debt. Unsecured debt forms the bulk of the bank's write-offs.[46]

3.37 As the RBA outlined in its submission, the Australian Prudential Regulation Authority's (APRA) non-performing loan (NPL) rate on banks' credit card debt (that is, where repayment is more than 90 days past due or otherwise doubtful) was 1.5 per cent in early 2015:

> However, the overall loss rate for credit card issuers is probably higher than suggested by the NPL rate. Unlike some other types of household loans such as residential mortgages, credit card loans are unsecured, with little prospect, in some cases, of recovering a significant portion of the debt if the borrower defaults. As a consequence, some credit card debt may be written-off directly to an issuing institution's profit and loss account, without first being recorded as a non-performing loan.[47]

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43 Mr Matthew Comyn, Group Executive, Retail Banking Services, Commonwealth Bank of Australia, *Proof Committee Hansard*, 16 October 2015, p. 6.

44 Westpac, *Submission 21*, p 15.

45 ANZ, *Submission 27*, p. 2.

46 Mr John Yardley, Chief Operating Officer, Bank Australia, *Proof Committee Hansard*, 3 September 2015, p. 19.

47 Reserve Bank of Australia, *Submission 20*, p. 16.

3.38 The RBA advised that the current 'loss rate' on credit cards was about 2.5 per cent.[48] This corresponds with Westpac's advice to the committee that the annual level of credit losses for credit cards is around 2.52 per cent of outstanding balances, compared to around 0.02 per cent for secured loans.[49] Other banks also advised that proportional defaults and losses were significantly higher for credit card lending than for secured forms of lending.[50]

Additional cost drivers

3.39 Card providers and the ABA referred to a range of factors contributing to credit card costs that were unrelated to funding costs. According to the ABA:

> …the cost of funds has become less important as a component of overall expenses for credit cards. Scheme fees, value-added services and rewards programs, and security and fraud management now comprise a greater proportion of credit card product costs. There have also been additional costs associated with improved technology such as contactless technology and regulatory change.[51]

3.40 ANZ presented the following breakdown of industry-wide credit card operating costs, drawing on data provided by Argus Information and Advisory Services:

- Funding costs are about 35 per cent of total credit card operating costs. While RBA rates influence funding costs, funding must also take into account credit risk, and liquidity characteristics of credit card financing.
- Credit management and fraud comprise around 30 per cent of costs. These costs include credit related losses, consumer protection and protection against fraud.
- Rewards and product benefits are around 27 per cent. These include scheme administration, points reward, discounts and travel insurance.
- Scheme fees are around nine per cent. Banks pay for services such as infrastructure, processing, settlement, foreign exchange services and customer service and support.[52]

3.41 ANZ commented that these operating costs do not include material additional costs of providing credit card services, including: the capital investments associated

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48 The RBA explained that the 'loss rate' was a more useful measure than the non-performing loan rate, as non-performing loans can become performing again and even if a non-performing loan is written off there may be some recovery. Dr Anthony Richards, Head, Payments Policy Department, Reserve Bank of Australia, *Proof Committee Hansard*, 27 August 2015, p. 13.

49 Westpac, *Submission 21*, p. 13.

50 For example, Mr Antony James Cahill, Group Executive, Product and Markets, National Australia Bank, *Proof Committee Hansard*, 16 October 2015, p. 35.

51 Australian Bankers' Association, *Submission 15*, p. 2.

52 ANZ, *Submission 27*, pp. 13–14.

with technology and regulatory requirements; contact services for customers; research and intellectual property costs; marketing costs; innovation and product development costs, and so on. Once these other costs were taken into account, ANZ wrote, funding costs fell to 'well below 25 per cent of total costs'.[53]

Profitability of credit card portfolios

3.42 In determining whether current interest rate settings on credit cards are justifiable, the committee sought to ascertain the profitability of the credit card market.

3.43 The RBA explained in its submission that credit card issuers earn revenue on their credit card portfolios from three major sources:

- Fees: which the RBA estimated accounted for about $1.4 billion in revenue in 2014, or $90 per account;
- Interchange revenues: or issuer fees, in the case of American Express 'companion' card transactions, which based on incomplete data the RBA estimated at approximately $1.5 to $1.75 billion in 2014; and
- Interest payments: which APRA reported were around $5.4 billion in 2014.[54]

3.44 Beyond the fact that this data is imperfect, revenues are of course distinct from profits but it is apparent that interest payments, as the largest source of revenue for card providers, are a major driver of credit card profits.

3.45 Three of the four major banks advised the committee that they were unable to publicly disclose the profits earned on their credit card portfolios, as they roll credit card outcomes into broader divisional outcomes before those divisional outcomes are disclosed to the market.[55] In contrast, ANZ was willing to share its net profit after tax on its credit card portfolio. ANZ Deputy Chief Executive Officer, Mr Graham Hodges, told the committee the bank's credit card business accounted for approximately $400 million, or 5 per cent, of group profit. He added that this profit also:

> …accounts for five per cent of risk weighted assets, which is the balance sheet adjusting for the risk profile. So the consistency there is good. A credit risk weighted asset is that you get your product and then you risk

53 ANZ, *Submission 27*, pp. 13–14. Westpac also suggested that innovation costs were a significant cost driver. Westpac, *Submission 21*, p. 14.

54 Reserve Bank of Australia, *Submission 20*, p. 3.

55 Mr Matthew Comyn, Group Executive, Retail Banking Services, Commonwealth Bank of Australia, *Proof Committee Hansard*, 16 October 2015, pp. 4–5; Mr David Robert Lindberg, Chief Executive, Commercial and Business Bank, Westpac Group, *Proof Committee Hansard*, 16 October 2015, pp. 19–20; Mr Antony James Cahill, Group Executive, Product and Markets, National Australia Bank, *Proof Committee Hansard*, 16 October 2015, p. 29.

> adjust it according to the risk characteristics of the product. So you have to look at it in risk adjusted terms.[56]

3.46 As noted earlier, Westpac, while not disclosing its actual profits on its credit card portfolio, advised the committee that its return on capital for its credit card portfolio had remained stable over the past five years:

> The Westpac Group's current net margin for Credit Cards is in line with 2010, with small movements up and down over the period. Therefore, while funding costs have declined the overall profitability of the product has not improved as funding cost reductions have been offset by declining revolve rates, higher promotional rates and changes in product mix.[57]

Committee view

3.47 The committee does not dispute the banks' contention that the effective interest rate on the total sum of outstanding credit card debt has fallen slightly since 2011. However, the committee also suggests that the effective rate provides little insight into how credit card 'revolvers' are affected by credit card interest rates. Ultimately, the committee is less concerned with the aggregate interest being paid by Australians on their credit cards, than the fact that many Australians appear to be paying interest that is well above what might be expected in a properly competitive market. This is particularly concerning as it appears those cardholders paying interest are often those who can least afford it.

3.48 The committee accepts that funding costs are only one component of the cost base of credit cards, and acknowledges that it is neither realistic nor reasonable to expect a direct correlation between the RBA cash rate and credit card interest rates (however those rates might be measured). The committee does not accept that high interest rates can be explained by cost alone. Rather, it appears credit card providers are taking advantage of the relative inattention of consumers to credit card interest rates, and earning significant profits in the process.

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56 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ, *Proof Committee Hansard*, 16 October 2015, p. 60. ANZ explained that while it typically did not disclose unit profits, 'in a sense it is not a material profit for the group', which is why they could disclose it without having to do a market disclosure. Mr Graham Hodges, Deputy Chief Executive Officer, ANZ, *Proof Committee Hansard*, 16 October 2015, p. 62.

57 Westpac, *Submission 21*, p. 14.