



The Effectiveness of Mandatory Comparison Rates

Information, Capacity and Choice

FINAL PAPER

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May 2006

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Acknowledgements

This study was funded by the Victorian Government's Consumer Credit Fund. I would like to thank Ivan Zwart and Andrea Sharam for their contribution to this study. Ivan was responsible for conducting and analysing interviews with consumers and also wrote the section on superannuation. Andrea contributed the section 'Price disclosure issues in the competitive electricity industry'. Denise Meredyth, Bev Kliger and David Hayward all provided valuable feedback on various drafts. Ian Clyde from Consumer Affairs Victoria was an encouraging and helpful project manager while Pam Criddle and Christine Rowley both provided useful information during the course of the study. Caroline Hawkless and John Hawkless, who conducted the Regulatory Impact Statement on the Comparison Rate legislation shared information from their project and cooperated to arrange common interviews where appropriate. Any mistakes are mine.

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Friday, May 12, 2006

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Executive Summary

Introduction of the mandatory comparison rate

1. The mandatory comparison rate (MCR) regime was introduced in 2002 to address perceived problems with the new Consumer Credit Code (1994).
2. It would appear that there were two distinct but related issues underlying the establishment of the MCR 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.
3. The comparison rate (which was an optional part of the original consumer credit code) is an interest rate for the duration of a fixed term loan that includes both interest charges and ascertainable fees and charges. The legislation requires suppliers of fixed term consumer credit to include a comparison rate when advertising credit using interest rates, to provide customers with a schedule of comparison rates for 'typical' loans when offering credit products to consumers and to include the comparison rate in the loan contract.
4. The introduction of the consumer credit code was a significant component of the deregulation of the financial system. The claimed benefit of deregulation is that it will deliver flexible and responsive markets directed by consumer preferences. Maximising these benefits requires informed consumers with the capacity to make evaluations of the products on offer. This research was an attempt to test the degree to which the MCR assists in this outcome.
5. Given that diverse and complex markets are a feature of modern economies, what are the issues that arise for consumers when choosing between alternative products in any complex market? How do they make choices about products or services, and is it inevitable that they will struggle with comparison where complexity exists? Do independent measures such as the MCR used in the consumer credit market have an important role to play in helping to improve decision making?
6. Most of our models for understanding consumer decision making assume that consumers are rational. The dominant explanation of search behaviour works on the basis of an internal cost-benefit analysis undertaken by consumers 'until the perceived marginal benefit of search is equal to the perceived marginal cost' (Klein and Ford 2003: 30). This assumption of rationality has been questioned by work undertaken in the field of behavioural economics, notably that of Daniel Kahneman and others.

Consumer research on comparison rate type interventions

7. Prior to our research there has been no research undertaken in Australia on the effectiveness of the MCR and little relevant research on consumer credit markets and consumer decision making.

8. A consumer survey undertaken in the UK to test consumers' appreciation of the Annual Percentage Rate (1994) found a reasonable level of recognition of the term (46% of respondents knew what the acronym represented) but a fairly low level of understanding of the concept. When offered a number of definitions of the APR, only 11% chose the most appropriate response, though it could be assumed from their answers that most of the sample (64%) understood that a lower APR was 'good'. Overall, 43% of respondents who had used credit in the previous five years reported considering the APR when looking at credit or loan arrangements.
9. Consumer research undertaken in the USA found that a the vast majority of those who had arranged consumer credit in the previous five years (over 70%) reported using the APR to compare loans, although again there was doubt about consumers' understanding of the concept.
10. In their review of the Truth in Lending Act, the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, while recognising that the APR has limitations, found that it was worth persevering with as a benchmark for consumer shopping, particularly given its nearly thirty-year history and the resultant familiarity.

Findings for related markets and other research

11. Our review of work undertaken in the UK by the Financial Services Authority and the sparse research undertaken in Australia found that many consumers in complex markets might consider that they had sufficient information and searched adequately, but their behaviour does not bear this out. Many simply assume that all providers are the same and therefore do not undertake extensive search. Those who do search are often overwhelmed by the information provided to them, have difficulty understanding terms used and have trouble accessing comparative information on products. Typical problems that consumers had with existing information sources included lack of specificity, complicated data, information not being up to date, too many options and inability to apply information to their own situation.
12. Our review of complex markets has shown that regulators across these markets are grappling with a similar problem: how to ensure that consumers are presented with sufficient information in as simple a form as possible. The message from consumers is consistent: they want clear, simple information tailored to their situation. Of course the nature of these markets militates against the provision of simple information without the risk of misrepresentation. The trade-off between comprehensiveness and simplicity will be different for each consumer and each market.
13. Not only do consumers want simple information, it is clear from the South African study we reviewed (Bertrand et al. 2005) that the simpler the information provided, the greater the take-up rate for any particular credit offer (in this case, where the increased information was simply a greater variety of loan amounts and term for the same loan conditions). Consequently it is in credit suppliers' interests to provide the least information consumers need to make a decision in their advertising and applications.

Findings from our primary research

14. We found that people's experience and knowledge of consumer credit markets was varied. Certainly consumers are aware that there is almost unlimited choice of provider and products for those with the requisite income and/or security. For many, this choice is initially overwhelming, but for the most part it appears that consumers are eventually able to navigate these markets with some success.
15. For some consumers, the trick is to close down options by concentrating on a few providers, particularly those with which they already have a relationship or with which they feel comfortable. There was a feeling amongst many interviewees that there is not a lot of difference between most mainstream providers in terms of interest rates and that there were limits to the potential returns from a long search process. The need to expedite the search process to complete purchase was an important factor in some participants limiting their search.
16. Many of the people we talked to used brokers to assist them in their decision making and for most this has been a positive experience. Brokers, it was claimed, were able to simplify and focus decision making, explain the various elements of different products and provide specialist advice. For a number of our informants it appears that brokers were effectively a user-friendly customer interface to a complex web of financial providers. For many, having someone on 'their side' who appeared to understand the system and was 'independent' from it was a source of comfort.
17. In relation to the comparison rate itself, we found a low level of awareness and an even lower level of understanding of the concept. In our survey, 37% of our sample claimed to recognise the term but only 12.5% could define it as being a rate that includes fixed fees and charges. Awareness was higher amongst recent decision makers but understanding did not increase at a corresponding rate. Our one-on-one interviews supported the finding that the concept is poorly understood.
18. However, the comparison rate is clearly a tool that most consumers have confidence in. A majority of those respondents who had organised credit in the past two years and were aware of the comparison rate found it helpful in making their decision (62%). Those respondents who had a university education were much more likely to describe it as helpful than those without (85% to 37.5%).
19. An overwhelming 70% of respondents who already knew about the comparison rate but had not made a credit decision in last two years felt that it would definitely be helpful in making a decision. Those who had made a decision but were not aware of the comparison rate were also enthusiastic about its usefulness, with 56.4% saying it definitely sounded useful and a further 28.2% that it would perhaps be useful.

Conclusions

20. Our research suggests that there are three broad approaches available to regulators for improving information provision in complex markets:

- Setting out broad parameters for suppliers in terms of what information is to be supplied and relying largely on industry self-regulation;
 - More prescriptive approach with more detail requiring information to be provided as an attempt to make comparison easier (this is where the MCR regime would fit);
 - Direct collection and provision of information in a comparable form. This is the approach adopted, for example, by the Financial Services Authority in the UK in developing an online mortgage comparator.
21. The central regulatory issue in relation to information provisions is the trade-off between simplicity and comprehensiveness. No regime, and certainly no component of a regime, will be both perfectly comprehensive and simple. The issue is whether the overall regime or specific components assist consumers to make informed decisions. Our research found that once consumers understood the comparison rate, most felt that it would be useful in helping to make consumer credit decisions. Given the complexity of consumer credit, the issue is not whether a single indicator can encapsulate all aspects of products but whether it is helpful to consumers in decision making.
22. Our research has demonstrated that many consumers are uncertain and confused when searching for and negotiating credit. The MCR is a tool used by those who know about it. However, it is considered potentially useful by those who do not. There are two main challenges to improving its usefulness:
- Improving consumer awareness and understanding of the measure through public information and consumer education campaigns. This is particularly important if it remains mandatory to include the comparison rate when interest rates are advertised for fixed term consumer credit;
 - Adjusting the current pre-contractual provision of the MCR so that consumers are provided with a comparison rate for the loan amount in which they are interested. The importance of pre-contractual disclosure is unclear, given that many consumers have effectively made their decision by this stage.
23. There is a need for more research on patterns of information seeking and options for information dissemination by various modes, including word of mouth, family networks, print and online. People's search behaviour and comprehension of information is not predictable, underlining the importance of conducting usability type research on different options for information provision. The work undertaken by the Financial Services Authority in the UK provides an example of this type of approach.
24. Ensuring that consumers negotiating complex markets have access to comprehensible and comprehensive information is an endemic issue for public policy. Whether the MCR is retained or not, the issue will remain. In this review we have found that the MCR is a useful tool for consumers and have made some pragmatic suggestions for improving its usefulness, as well as pointing to the need for more research on how consumers go about information search and, in particular, testing different approaches to information provision with consumers.

1. Introduction

Financial deregulation 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 to 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 that 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 their capacity 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 and 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 (MCRs). 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 since 1 July 2003. Originally the legislation was to sunset on 30 June 2006 but this

has been postponed for a further twelve months. The Ministerial Council on Consumer Affairs will decide whether the MCR continues beyond this date and in what form, based on work undertaken in a Regulatory Impact Statement and other relevant material (including the research on which this paper is based). This project examines related fields in Australia (e.g. telephony), the application of comparison rates in other jurisdictions to gauge their effectiveness in enabling consumers to make informed choices, as well as primary research undertaken for this project.

Key research questions that have guided this project include:

- 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 used in this project were 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, provides 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 assist consumers to make informed choices between different credit options?

2. Consumer decision making in complex markets

However it is described – the rise of neo-liberalism, Thatcherism (in the UK in an earlier period), Third Way politics or economic rationalism – one of the key themes in public policy in the last ten to twenty years has been the move away from state provision (and regulation) of services and products to market-based approaches.

Services formerly provided directly by the state have been outsourced to the private sector, often with some state subsidy. For example, there has been a (not entirely successful) attempt to provide a greater proportion of housing assistance to low-income Australian households through the private rental market with subsidy in the form of a welfare payment (rent assistance) to households. In this case it is recognised that some households require assistance to access affordable and appropriate housing but it is not necessary for the state to directly provide this housing. The key problem is the lack of households' purchasing power; once this is solved (the role of the state), they can be left free to access their housing in the private market. Theoretically, households can then choose the form, size and location of their housing rather than relying on an administrative system of allocation. The underlying assumption is that individuals (and households) are best placed to make the necessary calculations required to allocate resources to required uses. In other words, rather than the state spending \$100 on behalf of a household, it is allocatively more efficient for the state to provide the household with the \$100 and for the household to decide how it is to be spent.

Deregulation has a similar theoretical underpinning. Regulation shapes and constricts the products and services offered by suppliers, thereby limiting choices available to consumers (and increasing cost pressures on suppliers). A better outcome, it is argued, is to have as little prescriptive regulation as possible and to assist consumers to make informed choices between the products offered.

2.1 Choice and credit

One of the assumed benefits of a deregulated financial system is that an increasing range of choices will empower consumers by allowing them to choose products that best suit their needs. If the benefits of deregulation are to be realised by consumers, however, they must be both able and prepared to undertake a considerable search process, and have the ability to process and compare highly complex information. Without this, consumers may be no better off than if their choices were far more limited. As Maity et al. (2002: 30) argue in relation to the credit card market:

More choices do not always mean that consumers are better off. Consumers will be able to make the *right* choice only when they evaluate the terms and conditions of different credit card alternatives.

Our research on consumer credit and related markets illustrates that consumers do not always have a good understanding of the products and options that are available, and do not always choose to search widely for the best products for them.

Given that diverse and complex markets are a feature of modern economies, what are the issues that arise for consumers when choosing between alternative products in any complex

market? How do they make choices about products or services, and is it inevitable that they will struggle with comparison where complexity exists? Do independent measures such as the mandatory comparison rate used in the consumer credit market have an important role to play in helping to improve consumers' decision making?

In addressing these questions, this paper will outline some of the key factors that affect consumers' search behaviour and decision making, and highlight the inherent difficulties and barriers that exist to providing and regulating information designed to benefit consumers in the choices they make. In doing so, it will draw on the consumer information search literature, examine recent work undertaken in the UK in developing a new approach to financial services regulation, and examine a number of related markets for complex products in Australia.

2.2 Factors influencing consumer search

Most models for understanding consumer decision making assume that consumers are rational. The dominant explanation of search behaviour works on the basis of an internal cost-benefit analysis undertaken by consumers 'until the perceived marginal benefit of search is equal to the perceived marginal cost' (Klein and Ford 2003: 30). Precisely what is a benefit and a cost for consumers is clearly subjective, although it has been suggested that the biggest costs associated with search effort are time and the 'cognitive costs' of understanding large amounts of information and comparing alternatives (Klein and Ford 2003: 30).

This assumption of rationality has been somewhat undermined by work done in the field of behavioural economics, most notably with the popularisation of the work of Daniel Kahneman and his colleagues. His work on 'bounded rationality' has explored, among other things, the difference that framing (how information is presented) makes to people's decisions and the importance of accessibility (the ease with which people are able draw on the concepts and theories needed to make sense of information) in guiding people's decision making.

Over the past thirty years, many studies have been conducted regarding consumer information search which may be understood as 'the degree of attention, perception, and effort directed toward obtaining environmental data or information related to the specific purchase under consideration' (Lee and Hogarth 2000: 334). These studies reveal considerable difficulty in measuring and understanding how consumers make decisions.

The consumer information search literature identifies two interrelated ways to think about information search: whether the search is 'ongoing' or 'pre-purchase', and whether it is 'internal' or 'external'. Ongoing search concerns information or knowledge that is acquired but is not specifically related to imminent purchases, while pre-purchase search involves search activities with a specific purchase under consideration (Lee and Hogarth 2000: 334). Alternatively, some researchers have distinguished between internal and external information search. Internal search is the ability to draw on memory of previous search activity, acquired either through a deliberate search activity or the passive accumulation of knowledge. External search involves the deliberate acquisition of new knowledge from sources outside of the memory (such as friends, advertising etc.) (Guo 2001: 506).

These different aspects of search behaviour are important because a person's memory and product knowledge has a considerable influence on their subsequent search behaviour, and influences the degree to which they are prepared to search for and process complex information from a range of sources. This, in turn, is likely to affect whether consumers will discover and use a tool to assist in decision making such as the MCR.

Many variables have been used to describe the external search process. These include measures that demonstrate total effort (e.g. time spent), breadth of search (e.g. number of sources used), patterns of search (e.g. sequence of access) and outcomes (e.g. satisfaction with decision) (Klein and Ford 2003: 31). A large array of variables have been identified as having an effect on consumers' external search, with Guo (2001: 508-9) outlining almost sixty. These include variables related to particular individuals (e.g. enjoyment of search), knowledge and experience (e.g. objective or subjective), market environment (e.g. complexity of alternatives), situational variables (e.g. time) and potential pay-off (e.g. price differences).

Individual factors are frequently cited in the literature as being related to consumers' search behaviour, with a common observation being that people's knowledge is a strong indicator of search efforts. People who have a moderate knowledge of a product or market tend to undertake the most search effort. Those with greater knowledge search a little less, but efficiently and widely, given that new information is easier to process. Those who have little product knowledge tend to search the least because they lack understanding of the nuances of the purchase decision and are likely to oversimplify as a result (Klein and Ford 2003: 31) or be overwhelmed. In areas such as investment, they are more likely to use professional advisers, given a lack of confidence in their own knowledge (Lin and Lee 2004: 321).

Another important consideration is that people change their preference structure for evaluating products when they become more informed. As Sainfort and Booske (1996: 50) argue about consumer search for health plans:

After viewing even a limited amount of information, individuals tend to change their preference structure in terms of the attributes deemed important in selecting health plans. Not only do they add or remove attributes, but they also tend to modify and adjust the ratings of the importance of attributes before making decisions.

Further to this, people who consider more information are more likely to change their preference structure and consider more attributes, while also feeling more positive towards their decisions (Sainfort and Booske 1996: 50).

In their work for the Office of Fair Trading, London Economics brought a lot of this literature together to develop a model of consumer decision making to investigate consumer detriment and imperfect information.

They posited three information sets as follows (London Economics 1997: 31):

- **Actual beliefs (A)** describe the information a consumer has when actually making a purchase. The amount of information available to the consumer at the time of their purchase will have been refined and updated through the process of search and so may

differ from their initial beliefs. The set of actual beliefs serves as a description of *what the consumer knows* at the time they make their purchase decision.

- **Rational beliefs (R)** describe the amount of information (the subjective probability distribution over possible states of the world) which rational consumers should have after search. The set of rational beliefs describes what the consumer would (or should) know if they had conducted a rational search, given the optimal way of updating beliefs. The set of rational beliefs describes *what the consumer ought to know* at the time they make their purchase decision.
- **The true distribution (T)** describes the best possible information about the world. The true distribution may be equal to perfect information (in which case, the value of each variable that is important in the consumer's decision is unique) or imperfect in cases where some uncertainty about (future) events remains. The true distribution describes *everything the consumer could possibly know* (in principle) at the time they make their purchase decision.

In this conceptualisation, when we say that consumers are uninformed, we are saying that A does not equal R. The authors use these information sets to explore imperfect information. They suggest that differences between actual beliefs and rational beliefs may exist due to information lags, that is, as markets change due to technological advancement or deregulation, it takes time to learn about these differences. Differences between A and R can be persistent where behaviour is boundedly rational, that is, where consumers' learning is not perfect due to the application of rules of thumb or ways of thinking that are not perfectly rational. One example of this is that people are likely to give undue weight to recent events in making their decisions. For example, an airline crash is likely to dissuade many people from flying, even though logically airline travel is no (or not much) riskier than it was prior to the crash.

Rational beliefs (R) and the true distribution (T) may also differ. Firstly, because there are search costs in terms of time taken, travel and communication, there is a rational end to searching for the best outcome. Of course, where this 'rational' endpoint is actually located is never clear. From our research, one attitude clearly expressed by some consumers in relation to providers is that 'They're all the same,' therefore putting a great deal of effort into discriminating between them was not considered necessary or productive by these consumers.

Secondly, the future is unknown, and so with decisions that have long-term ramifications there is the possibility (if not the certainty) that even the most rationally based decision will not be optimal with the benefit of hindsight.

The authors use this framework to analyse consumer detriment. Any difference between (A) Actual Beliefs and (R) Rational Beliefs gives rise to concern. In cases where there is a difference between (R) and (T), True Distribution things are more complicated as there can be good reasons (e.g. high search costs or unknown future events) that do not necessarily constitute an avoidable consumer detriment. Of course, high search costs may be avoidable or at least able to be mitigated. The MCR is an example of an intervention that, by providing a consistent basis of comparison, seeks to simplify consumer search.

London Economics identify six indicators of markets where consumer detriment is likely to occur:

- The existence of price dispersion for seemingly similar products or services;
- The existence of focal points of competition, that is, single measures that are used to sell products that may hide other relevant information;
- The bundling of primary and secondary purchases, or the existence of after-markets such as proprietary toner for photocopiers or mortgage insurance in the case of consumer credit;
- The existence of commission payments, particularly from upstream suppliers to retailers or advisers;
- ‘Complex’ goods or services;
- Goods and services which are either purchased infrequently or which possess credence characteristics.

The authors identify all but the first indicator as being present in the mortgage market. In relation to consumer credit more generally, interest rates may become the focal point of competition, so that other considerations such as fixed fees and charges are not considered. It becomes possible for suppliers to advertise a low rate loan (often referred to as a ‘headline rate’) but not to refer to hidden ‘nasties’, for example, a high loan initiation fee. This is the policy problem that the MCR was designed to address by forcing suppliers to provide a single interest rate figure that included fixed fees and charges, but it is also a criticism of the intervention. It is argued that over-reliance by consumers on the comparison rate can lead to other factors such as the flexibility of the loan being overlooked.

The third factor is also important in the consumer credit market. Sometimes credit itself is a ‘bundled’ or linked product, as in car finance or credit obtained through stores. This may mean that consumers may not really make a decision about credit but simply take what is offered as part of their purchase. In addition, there are products such as credit insurance and income insurance that may be bundled with credit offers.

Commission payments are a major issue in the consumer credit field, particularly in relation to brokers. Consumers may think they are receiving independent advice on the best product available to them, not realising that brokers may only have access to a small number of suppliers, have special agreements with certain suppliers, or receive different commissions from different suppliers.

Consumer credit is indeed a complex product, making it difficult for many consumers to understand and compare products. Lastly, for most people, fixed consumer credit products are purchased infrequently, so the consumers do not gain extensive market experience to guide their choices, and the suppliers are not necessarily focused on repeat custom.

2.3 Implications for consumer credit

When we say that consumer credit is a ‘complex’ product, what does this mean? There are three key pieces of information that consumers need to know about a product or service to make a good decision (London Economics 1997):

- The price of the product itself, and of other products (substitutes and complements);
- The quality of the product (relative to substitutes);
- The terms of trade (location of the supplier, date of delivery, terms of the lease etc.).

Unlike most consumer products, the actual cost of consumer credit is difficult to calculate. Issues such as interest rate increases, triggering of payments or penalties, and future restructuring of debt make its total costs unascertainable at the time of purchase. We know that many people are not comfortable dealing with risk (i.e. trying to evaluate possible future outcomes) and, as Kahneman has demonstrated, framing has considerable influence on their decision making in such conditions.

Calculating the cost of credit also requires a basic understanding of financial mathematics. This raises the issue of accessibility, ‘the ease with which particular mental contents come to mind’ (Higgins 1996 as quoted in Kahneman 2002). For some consumers it will be easy to deal with numbers and rates, for others it will require some effort, and for others a great deal of effort. Consequently consumers will view the same marketplace (and the information provided) in greatly different ways.

In relation to the quality of the product, on the surface it is relatively undifferentiated. Consumers are ‘buying’ money, and a dollar is a dollar. Relative to consumer durables such as cars and washing machines, the product is similar across providers. Increasingly, however, credit products involve more than just the simple provision of money, but have various features or options. For example, a home loan may have flexible repayments, have a draw-down facility or it may be a revolving line of credit. Kahneman’s (and others’) work on framing effects suggests that people’s valuing of these features will be highly contingent on the way in which they are presented (or framed).

Also complicating this ‘undifferentiated’ nature of credit is its role as an intermediary product, i.e. it is usually used to purchase consumer products that are differentiated. For example, a consumer may decide on credit provider on the basis of the credit available through the car seller that has the car they wish to purchase.

Given the ongoing nature of credit products, the terms of trade are also more complicated than most consumer products. Consumers enter into long-term contracts with suppliers that often give the supplier the right to raise the price (interest rates) and, in the case of secured loans, give the supplier certain rights over the property securing the loan. Credit contracts can be long and complicated. This is an important source of information asymmetry in the market, as the credit suppliers draw up the contracts and have day-to-day experience of dealing with them, whereas the consumer may have very little experience dealing with contracts generally and have never seen this particular one before.

The next section describes the introduction of the mandatory comparison rate.

3. 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 the 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 and its introduction in 2003. It is clear that the push for a new regime originated in New South Wales, with a draft bill being tabled in the state parliament on 22 June 2000. From here the issue was taken up by the Ministerial Council on Consumer Affairs, culminating in the 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 (24 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 (2002), in her keynote address to the Australian Credit at the Crossroads conference, more fully set 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 itemised. 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 addressed 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 UK, USA and New Zealand. Like the UK and USA regimes, it was 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 by Lanyon). 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 (i.e. credit provider, finance broker or linked suppliers), at any internet site advertising credit, and with the provision of any application for credit.

3.1 Pre-contractual disclosure and the Uniform Credit Code Review

One of the key functions of the MCR is its mandatory use in pre-contractual information. The final report of the Post Implementation Review (PIR) undertaken after the Uniform Credit Code was introduced (but before the mandatory comparison rate was put in place) raised two questions in relation to pre-disclosure:

- Whether the disclosure requirements have resulted in the provision of information which is useful to consumers in making choices between credit products and credit providers;
- Whether the disclosure information could be presented more simply and yet still comply with the requirements of the Code.

The PIR noted that there were three key questions in relation to disclosure: timing, complexity and comparability. The Ministerial Council on Consumer Affairs (MCCA) is currently calling for responses to its recently released consultation package.¹ The package puts forward changes to the pre-contractual regime suggested by the NCP review. These changes are aimed at providing information for consumers that is simpler and easier to understand. For fixed term credit, providers will be required to provide a *financial summary table* that includes (only) the amount of credit to be provided, the annual percentage rate, ascertainable fees and charges, the repayment amount and the term of the loan. A comparison rate is not to be included in this proposed financial table – the package does note that there is currently a national review being undertaken on the effectiveness of comparison rates.

¹ Ministerial Council on Consumer Affairs (2005) *Pre-contractual Disclosure and the Uniform Consumer Credit Code Consultation Package*

In addition to the *financial summary table* there is also a proposed *summary of other information table* that is intended to act as a ‘bridge between the financial summary table and the credit contract. It amplifies some of the entries in the financial summary table while for others, it simply refers to the relevant provision(s) of the credit contract’ (MCCA 2005: 05).

The MCCA is currently collecting responses to this consultation package prior to making any changes. Interestingly, the package states that ‘There are no plans to test the new scheme by simulation or survey prior to its implementation’ (MCCA 2005: 03).

4. Research on the impact of comparison rates and similar interventions

This project (in tandem with the Regulatory Impact Statement) is the first formal work undertaken 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?

4.1 New Zealand

New Zealand had an ‘annual finance rate’ for twenty-one 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 (New Zealand Ministry of Consumer Affairs 2000: 32).

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.

MacPherson and McBride (2002: 8) 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 New Zealand Ministry of Consumer Affairs (2000: 24) 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 are poorly understood by consumers.

The report acknowledges that ‘There are no New Zealand empirical studies that measure consumer understanding of the annual finance rates’. Instead it relies on work undertaken in the US and the UK (which we will review below). 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.

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

A random sample of 3,832 people across the UK 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 (&) 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 per cent gave the right answer, 7% another answer and 16% didn’t know.

Forty-six per cent 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% 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% ‘You can use it to work out your monthly payments’, 3% ‘It tells you how much commission the credit broker will receive’ and 25% didn’t know. The findings 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. For those who had used a credit product in the previous 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 a credit product in the previous five years reported considering the APR when looking at credit or loan arrangements. This appears 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 product 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. (Consumer and Financial Literacy Taskforce 2004: 46)

4.3 United States

In the USA, 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 contains 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. Durkin (1975) gives a summary of some of this and 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 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% APR – that is, an 8.9 annual percentage rate – does that mean that the interest rate is actually 8.9%, or would the interest rate be higher than 8.9% or lower than 8.9%?’

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 cannot assist consumers with all aspects of their decision. For example, it 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 prepayment 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 (Board of Governors 1998: 9).

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’.

5. Relevant Australian research in the field of consumer credit

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. This section provides an overview of some relevant research and policy work undertaken in Australia, and concludes with a detailed summary of some recent research undertaken in South Africa investigating the impact of ‘non-rational’ or psychological factors on consumer behaviour in relation to credit.

5.1 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, and it has put forward a number of preliminary recommendations (see <http://www.cfltaskforce.treasury.gov.au/content/home.asp?NavID=1>).

Their discussion paper is of interest to us for a number of reasons. They note very early 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’. They go on to discuss work 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 (Consumer and Literacy Task Force 2004: xi, 8).

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 they are 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 (Consumer and Financial Literacy Taskforce 2004: 4).

5.2 The ANZ Survey of Financial Literacy in Australia

This survey conducted by Roy Morgan Research (2003) was a major piece of work in the area. It involved three 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;

Stage 3 An in-depth survey of 202 people including a self-completion component and in-depth interview of 1 to 1.5 hours each.

The survey found that the following groups were strongly over-represented in the lowest 20% 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 of less than \$20,000 p.a.;
- Those with savings of less than \$5,000;
- 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.

5.3 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. It was undertaken in three stages: first, collecting samples of and information on consumer credit advertising and interviewing twenty 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' (Malbon 1999: 9). 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 the consumer credit market was best understood by splitting it into three sub-markets: housing and personal loans, credit cards, and linked credit loans² (Malbon 1999: 9).

In relation to housing and personal loans, Malbon (1999: 10) 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.'

In relation to the linked credit market, Malbon (1999: 10) had this to say:

² 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: 9).

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 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 cross-subsidisation by lower income groups to higher income groups, which occurs with credit cards, arises with linked credit arrangements with interest free periods.

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 it as healthy and competitive. A majority of respondents to the telephone survey reported shopping around for their housing loan (58%), with 77% of these reporting that it was relatively easy to compare loan products. Despite this, 51% of those who shopped around said that at least one aspect of the loan that they found was 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 is possible, for instance, that a large proportion had an existing relationship with a bank, had built up trust with the institution and felt comfortable dealing with it. 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' (Malbon 1999: 12). 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 32% of linked credit borrowers seriously considered taking out the loan on the day they signed up for it.

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 (Malbon 1999: 13).

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: 18).

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: 21).

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' (Malbon 1999: 24).

5.4 Information and consumer credit decisions (Avram 1996)

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, 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 34% 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 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 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 5-1 Aspects of loan that were most important and those that were assessed as very or fairly important in making a loan decision

Aspect of loan	Most important (%)	Proportion who assessed the aspect as very or fairly important (%)
Amount of each repayment	29	85
Interest rate	21	79
Total cost of loan	21	78
Length of repayment period	12	76
Repayment intervals	5	67
None – each equally important	12	

Source: Avram (1996)

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’ (Avram 1996: 16).

5.5 Researching the impact of psychological cues in the consumer credit market

A recent research project in South Africa provides an illuminating demonstration of the impact of ‘non-rational’ or psychological factors on consumers in the credit market (Bertrand et al. 2005). A micro-finance lender sent out loan offers to over 50,000 people who had been clients in the previous twenty-four months. The offer was for short-term loans at randomly selected interest rates between 3.25% and 11.75% per month (the lender’s standard rate at the time was 7.75% to 11.75% per month). South Africa has a very large micro-finance sector supplying small, high interest and short-term ‘cash loans’ for the ‘working poor’ population.

Five framing or psychological treatments were tested:

- The description of the offer was varied in the letters. Some letters had only one example of a loan at the offered interest rate, while others included a number of examples of loan size and period at the offered rate;
- Some offers included a generic industry comparison interest rate and some did not;
- Some letters included a photograph of a person, and the race and gender of the person were varied;
- Some offers included a promotional giveaway;
- There were shorter and longer deadlines for taking up the offer.

The way in which the research was designed made it possible to not only measure the effect of various factors in terms of likelihood of take-up but also to equate the impact to changes in the interest rate. That is, it was possible to not only say that a particular factor influenced the take-up of a credit offer but how many interest rate points this change equated to.

As would be predicted by conventional economic theory, there was a strong relationship between interest rate and loan take-up. A one percentage point drop in the interest rate offered roughly equated to a 3% rise in take-up. However, a number of framing treatments had a significant effect upon take-up, and this was more important the higher the interest rate offered, i.e. psychological cues were more important the less attractive the offer in terms of interest rate. There was no discernible difference across income or education groups in relation to the effect of the psychological cues. (It is not made clear in the paper but, given the population being studied, it is unlikely that many had tertiary qualifications.)

In relation to our work, the most interesting cues tested were the description of offer and whether a comparison type rate was included (this was not the same as the MCR but rather a generic industry standard). In relation to the first framing effect, a simple description for the offer had roughly the same effect on take-up as drop of 2.3 percentage points of interest. This is quite a stunning result as the more complicated tables simply had more examples of loan sizes and loan term for the offered interest rate. It underlines consumers' strong preference for simple information and the attractiveness to lenders of being able to provide minimal information to prospective clients. It also indicates the importance of market testing potential approaches to information provision, as from a purely 'rational' perspective you would think it more helpful to provide more examples in the material.

Some offer letters also included a rate for comparison from an unnamed generic competitor. Provision of the comparison rate (which was set at 20% per month so that it was less attractive for all of the bank's offers) had no impact on people's likelihood of taking-up the offer. Given that the rate of comparison had no real status (i.e. it was not an industry average or the rate of a named competing institution), it may be that they dismissed it as offering no additional information.

The research also found, somewhat alarmingly, that whether a photograph of a person was included in the loan brochure and the characteristics of that person could significantly affect take-up. In particular, men were more likely to take up an offer that was accompanied by a

picture of a woman, the impact of the photo being equivalent to a drop in the interest rate of around 4.5%.

The final finding of interest to our study is that ringing people and suggesting uses for the loan had a large impact on take-up. Again this reinforces how ‘suggestible’ consumers can be in the realm of consumer finance.

Overall this research has a number of implications for our work. Firstly it underlines consumers’ preference for simple and clear information. This is clearly recognised in the work currently being undertaken to simplify pre-disclosure information. The research also indicates that consumers do not behave in a ‘textbook’ rational manner, but also that their behaviour is difficult to predict. Some psychological cues had significant impact on take-up, others very little. For some market segments, particular cues were important, for other segments they were not. This suggests that interventions aimed at assisting consumers to make more informed or better choices need to be market-tested if we are to be confident that they will have the desired impact.

The next section describes work undertaken in the UK over the past decade as part of a wide-ranging reform of financial services. The newly created regulator has gone back to first principles in designing its approach (the first in its series of occasional papers was entitled *The Economic Rationale for Financial Regulation*). Since 2000 it has published forty-six consumer research reports alone. Given its methodical and research-intensive approach, tracing the development of the Financial Services Authority’s regulation of information provision for mortgage lending provides useful insights for the Australian context.

6. Mortgage information provision in the United Kingdom

The last five years have seen a great deal of activity in the UK investigating consumer behaviour and financial decision making. An overhaul of consumer credit regulation in the form of the UK Credit Bill is currently being undertaken, following the publication of the White Paper, *Fair, Clear and Competitive: The Consumer Credit Market in the 21st Century* (Department of Trade and Industry 2003). In addition to work undertaken in this process and by the Office of Fair Trading, financial services regulation has had a major overhaul with the creation of a new regulator in 1997 that became the Financial Services Authority (FSA). The FSA became responsible for mortgage regulation in 2004. The rest of this section provides an overview of the research undertaken in the UK and the development of the FSA's approach to mortgage regulation.

The FSA (2000a) began their research with a general sample survey of consumers, investigating their decision making and information needs in relation to financial services. This identified two key groups amongst consumers:

- Most receptive: these are higher educated, higher income consumers who shop around and have access to independent advice;
- Least receptive: effectively the 'hard to reach' in terms of financial advice and information.

The report also identified that, although the majority of respondents who had taken out or considered a product in the last five years were not dissatisfied with the information available, the relatively low level of shopping around suggested that many consumers would benefit from more information but were unaware of this (i.e. consumers don't know what they don't know). This goes to a major weakness of consumer surveys of this type (or more accurately, relying too heavily on consumer self-reporting). It is possible that some consumers simply aren't aware of the information required to make an informed decision in a particular realm. This finding led the FSA to identify a major task as 'getting consumers to recognise that they have information needs in the first place'.

Qualitative research done alongside this work did, however, reveal common information problems:

- Not knowing what products are available or appropriate for their needs;
- Being overwhelmed and confused by information in leaflets;
- Not understanding the jargon and terminology in the information and advice received;
- Being shocked, surprised or disillusioned by the small print for financial services taken out;
- Being unaware of how to access comparative information on products

This research then set for the agenda for research to follow. As part of the restructure of the approach to regulating consumer credit, it was decided to pass the responsibility for mortgage regulation on to the FSA. This led the FSA to develop a mortgage specific strand of its consumer research.

Table 6-1: A provisional picture of consumers' approach to mortgage buying

	Regulatory objectives	Categories of information or tool
Stage 1: Consumer is trying to find out about mortgages and do some basic shopping around (i.e. make comparisons). They are not providing information to potential lenders and/or intermediaries at this stage.	<ul style="list-style-type: none"> • To help the consumer in assessing affordability and risk • To assist in shopping around • To assist in financial planning 	<ul style="list-style-type: none"> • Financial promotion materials provided by firms (advertisements, marketing brochures etc.) • Comparative information tables • Consumer education/public awareness initiatives
Stage 2: Consumer is certain that they want a mortgage. They are now willing to provide information to potential lenders and/or intermediaries. Any shopping around might be over a restricted product range.	<ul style="list-style-type: none"> • To help the consumer in assessing affordability and risk • To assist in shopping around • To help the consumer understand what range of products is being considered in any advice given and what commission is being paid to the adviser 	<ul style="list-style-type: none"> • Specified (and personalised) disclosure document provided by lender or intermediary
Stage 3: A mortgage offer is made by the lender.	<ul style="list-style-type: none"> • To help the consumer in assessing affordability and risk • To help the consumer to check that the product details match those previously agreed 	<ul style="list-style-type: none"> • Updated specified (and personalised) disclosure document provided by lender, as a part of the mortgage contract
Stage 4: Post-sale confirmation of the product bought (and initial payments due etc.) is provided by the lender.	<ul style="list-style-type: none"> • To provide the consumer with a definitive reference document • To help the consumer to check that everything has been set up correctly 	<ul style="list-style-type: none"> • Updated specified (and personalised) disclosure document provided by lender
Stage 5: Post-sale, the lender provides regular information about the status of the mortgage and advance information where mortgage features change. The consumer may consider shopping around again, i.e. going back to Stage 1 or 2.	<ul style="list-style-type: none"> • To help the consumer to avoid arrears • To help the consumer to check that payments and charges are correct • To assist the consumer in shopping around (i.e. to remortgage) 	<ul style="list-style-type: none"> • Annual specified (and personalised) disclosure document provided by lender • Event-driven letters from lender

Source: FSA (2000b: 31)

The FSA outlined its general approach to mortgage regulation in a consultation paper entitled *Mortgage Regulation: The FSA's High Level Approach* (2000). In terms of information provision it set out the following:

There are a number of ways in which consumers can be provided with information and over which the FSA has some control. The types of information fall into the following categories:

- information that the industry can provide to consumers – in the form of financial promotions or advertising, and standardised disclosure at the point of sale and afterwards;
- information that the FSA can provide directly to consumers – in the form of comparative information on mortgage products; and messages and materials designed to raise public awareness and to educate consumers (2000: 29).

In addition the FSA developed a useful table (Table 6-1) that identifies five stages that consumers undertake in searching for a mortgage, the regulatory objectives of each stage, and categories of information or tool.

The FSA's approach included the development of 'a mortgage information package using the different information tools at its disposal to assist consumers in making informed choices about mortgages'. It then set out a program of research to help identify the information needs of mortgage consumers. The first of this work was published in *Choosing a Mortgage*. This reported on two studies, the first a research review undertaken by Centre for Housing Policy at York University and the second some qualitative research of ninety consumers at varying stages in the mortgage buying process.

The review estimated that around half of consumers shopped around (either themselves or using an intermediary). Apart from lack of time and avoiding effort, reasons for not shopping around were confusion caused by the amount and complexity of available information and being comfortable with their existing lender or the reputation of the prospective lender. The authors make the point that those consumers lacking financial knowledge were most likely to either decide it was all too complex and rely on an intermediary or the lender themselves, or alternatively decide that mortgages were straightforward homogenous products and that there was little benefit to shopping around.

The qualitative research identified the following reasons why consumers were unable to use existing information sources to assist with their choice of lender and/or product:

- The information was not specific to their needs; in particular, it did not show them how much the mortgage was going to cost;
- The information was too complicated to understand;
- The information was not up to date because of rate changes;
- There were too many options;
- They were unable (or not sufficiently confident) to apply the information to their own situation.

The FSA acknowledged the difficulty in encouraging consumers to shop around and, to help guide its approach, differentiates three types of consumer who have difficulty in acquiring mortgages:

- Those who are obtaining information from different sources but not able to process it;
- Those not obtaining information prior to meeting a lender;
- Those using an intermediary but still unable to use information to narrow choices.

Each of these groups requires clear comparable information that is personalised. More specifically, the research findings offer a number of pointers for the development of the proposed pre-application disclosure requirements:

- They emphasise the need to include initial monthly payment information to meet the information requirement that consumers perceive they need the most, but also highlight the difficulty and challenge of focusing consumers on the broader terms and conditions and the longer-term implications (e.g. redemption penalties) of mortgages with low initial costs.
- Given that some consumers are making choices between repayment and interest-only options, it is important that any disclosure material caters for these comparisons by reminding consumers of the additional cost of the repayment vehicle in the case of interest-only mortgages.
- Any disclosure requirements also need cater for some consumers making comparisons between different interest rates (e.g. fixed rates with discount rates).
- Finally, the research suggests that where consumers are presented with a choice of products they are able to make trade-offs (albeit limited ones) between different features of mortgages. So, presenting features in a clear, comparable way should aid selection. It was decided to commission research to test whether consumers are able to use the proposed pre-application disclosure document to compare between mortgages effectively.

At the same time the FSA released its Draft Mortgage Source Book. This included an appendix that summarised consumer research undertaken to ‘test selected aspects of the proposed financial promotion requirements and the pre-application process’. The research was designed as a qualitative exercise (seventy-two consumers) to help understanding of what consumers notice and understood from material presented to them. The basic method was to show participants original versions of advertisements and lenders’ leaflets and test various changes by ‘mocking up’ revised versions to observe how differences were reflected in consumer’s understanding.

In relation to advertising, the main finding was that consumers only took in a limited amount of information, with detail going unnoticed. For example, where interest rates were presented, it was the first rate that caught consumers’ attention, despite what other rates were included. In addition, they were often unable to distinguish which percentage figure was the annual percentage rate, often assuming all figures presented were. Where advertisements showed an initial interest rate it was assumed that the APR was the rate to which the loan reverted, and

the use of the word 'typical' in relation to the APR led some consumers to think it was an industry average.

Currently there is a mandated risk warning for mortgage advertising in the UK: 'Your home is at risk if you do not keep up repayments on a mortgage or other loan secured on it.' Two other warnings were trialled (one broadly more severe, one less so). Consumers preferred the less severe version but overall the researchers concluded that risk warnings tend not to be noticed by consumers. When consumers were asked to read the small print in the advertisements, they identified information that they thought should have been in the main body of the advertisement.

As set out in the main body of this report, the FSA through its work had identified that 'if specified disclosures are to influence a consumer's choice of product they are very likely to be needed in the first instance at an early stage in the mortgage buying process'. In response it developed a 'pre-application illustration' that was both personalised (as this was of most interest to the consumer) and where the format and content was as standardised as possible to enable comparison across providers.

Following this, the FSA commissioned further research to test different approaches to presenting the APR in advertising and consumer reaction to the pre-application illustration. Of interest to us was the testing of the following explanatory statements for the APR:

- Overall cost for comparison;
- Shopping around rate;
- Rate for comparison;
- Rate to compare;
- Cost measure for comparison.

Overall none of the descriptions was entirely satisfactory, with 'cost measure for comparison' clearly the least useful of the five.

The research on the pre-application illustration (PAI) provided more encouraging results. Participants (who were in the market for a mortgage) were sent PAIs specially created by financial institutions who had agreed to participate, along with the usual material that they would typically send to prospective customers. This ranged from seventeen documents or 115 A4 pages for one provider, to five documents or twenty-eight A4 pages for another.

While many first time buyers and 'those less interested in finance' found the volume of material off-putting, overall the PAI tended to be the main point of reference and across the entire sample it was considered the most useful part of the packs. Consumers were then taken through a detailed questioning of the layout of the PAI to help with the design and content of the form.

In a separate exercise, consumers' ability to use the PAIs to make comparisons between different mortgages was tested. This included criteria nominated by the consumers themselves as important, and by the researchers. Each participant was sent four PAIs prior to

being interviewed. The criteria most often mentioned by consumers as being important to them were level of monthly payments and the absence of penalties. Consumers had difficulty using the PAIs to differentiate mortgages on these criteria.

Consumers were then asked to use the information in the four PAIs to do the following:

- Compare the overall cost;
- Work out monthly payments (both initial and subsequent);
- Understand initial rates and how long they last;
- Work out how much of the mortgage has been repaid over a number of years;
- Work out the position with regard to fees;
- Work out the position with regard to buildings insurance;
- Work out the position with regard to other insurance;
- Work out the difference between types of interest rates;
- Work out the position on changing the mortgage or moving to another lender;
- Work out the position with regard to overpayments;
- Work out the position with regard to underpayments and payment holidays;
- Work out the position with regard to additional borrowing.

This provides a useful checklist of the categories of information consumers need to be able to consider to compare mortgage products. In the main, consumers were able to use the PAI documents to undertake these tasks.

6.1 Comparison tables

The FSA as part of its general approach to fulfilling its duties, and in particular dealing with the problem of information asymmetry, recognised the potential for the provision of comparative information. It released a Consultation Paper in 1999 outlining the arguments for this initiative and a general approach. The ways in which such a scheme could help were outlined as:

- Provision of clear and accurate information would improve the efficiency of the financial system by enabling more consumers to make decisions themselves and improving the advice provided by various intermediaries;
- Provision of assistance to consumers in dealing with advisers by providing a second source of information (FSA 1999: 25).

As set out in its Response to Consultation Paper no. 28, the response was strongly positive, with three quarters of the 120 (mostly industry) responses broadly supportive.

In June 2001, the FSA released a paper outlining its approach and progress to developing comparative tables for the mortgage industry. The development and implementation of the tables were outsourced. General criteria for indicators developed earlier and knowledge of the pre-sale and post-sale disclosure requirements were considered in the development of criteria.

To handle the large number of mortgage products available, filters were developed to enable consumers to concentrate on the products relevant to their situation.

It was decided due to their greater complexity (in terms of decision making by lenders about the conditions) that impaired credit/non-status mortgages would be excluded from the comparative tables initially, with a further information option to deal with them.

In developing its disclosure regime, one of the controversial proposals was to make reference to the comparison tables mandatory in what became the Key Facts Illustration. Many suppliers felt that this was tantamount to advertising their competitors, but the FSA came down on the side of consumer advocates who saw it as an appropriate mechanism to encourage consumers to shop around. The comparator enables consumers to compare mortgage products online, choosing options and features that they want.

The table requires consumers to answer relatively straightforward questions about their prospective loan including whether it is their first loan, purchase price, borrowing amount and whether they want a fixed or variable interest rate. Once they have made their choices, all loans available to them are presented in a table. While there is no attempt to rank them, consumers are able to order the loans by the APR for the length of the loan.

It should be noted that there are currently similar privately maintained services like this in Australia, two of the better known being Cannex and Infochoice. The Cannex site (www.cannex.com.au) includes their star ranking of mortgage products which is done twice a year using a method set out clearly in the document. This ranks products (in a number of categories) from five star (superior) to one star (satisfactory).

An important component of this ranking is the two year average Annual Average Percentage Rate (AAPR) which is calculated to comply with Consumer Credit Code's comparison rate.³ According to their website:

In 1993 CANNEX was first to introduce the comparison rate methodology to the Australian mortgage market and established an industry standard (AAPR = Annual Average Percentage Rate) which is now widely understood by some estimated 49% of the Australian population according to a recent survey (ANZ Newspan April 2003).

The Cannex site presents information on mortgage products available, including rates and other terms and conditions for products offered by various financial institutions. It has a tool that enables consumers to find products, given fairly simple criteria (price of house, loan

³ On their comparison rate calculator, Cannex provides the following information:

This *AAPR Comparison Rate Calculator* has been prepared by CANNEX (Aust) Pty. Ltd., (ABN 21 053 646 165) Australia's leading financial services research group and is under Copyright 1999. Whilst every effort has been made to comply with the Consumer Credit (Queensland) Act 1994 and Consumer Credit Regulations 1995 and Consumer Credit Regulation (No. 1) 2003, the results provided by this calculator are an approximate guide only, and do not correspond to any particular product. As such, the information appearing on this site is for preliminary and general information only and neither the credit providers, Rice Walker, CANNEX, or its directors or employees warrant that the information is complete, accurate or up-to-date and accept no responsibility for any losses arising from any use of or reliance upon any calculations or conclusions reached using the calculator.

amount, loan term and income). This information does not include their AAPR calculation or enable consumers to compare products directly and is presented in alphabetical order. Cannex also provides an AAPR calculator that enables consumers to input the information about their prospective or current loan and calculate an AAPR.

The Infochoice tool enables consumers to choose loans with certain characteristics and then presents all loans that meet your requirements, in alphabetical order. There is a capability to choose up to three loans for a side-by-side comparison.

The Australian Consumers' Association 'Choice' website includes an online home loan calculator that, once you have chosen a loan amount and type of loan, provides the 25 'best' home loans ordered by comparison rate and including Cannex's star rating.

The Australian Securities and Investments Commission provides a calculator for a number of financial products, including superannuation, although it is not strictly online (they are Excel spreadsheets that can be downloaded), requires some familiarity with Excel and does not provide market information. Users need to input all data from information they have collected.

This section has provided a detailed account of the development of the FSA's approach to mortgage regulation in the UK. This is particularly illuminating because the FSA started from first principles and developed their approach to information provision from here, undertaking substantial consumer research throughout the process.

Some of the key lessons for Australia are:

- Many consumers in complex markets might 'feel' that they had sufficient information and searched adequately but their behaviour does not bear this out;
- Many consumers are overwhelmed by the information provided, have difficulty understanding terms used and have trouble accessing comparative information on products;
- Typical problems that consumers had with existing information sources included lack of specificity, complicated, not up to date, too many options, and inability to apply information to their own situation;
- A fully satisfactory explanation of the comparison rates (APR in the UK setting) is difficult to develop;
- Online comparative tables are one promising means for assisting consumers to make informed decisions. In this context, an objective measure such as the comparison rate can be a useful means for consumers to order the information.

The next sections examine consumer decision making and regulatory options in a number of markets for complex products in Australia. Unlike the process undertaken by the FSA, there is little publicly available policy documents to explain the various approaches adopted and, with a few exceptions, no research of consumer's information needs. Despite this, the various markets examined do provide a base of comparison and some insight into the options available in regulating information provision.

7. Related markets in Australia

7.1 Health insurance

Recent research conducted in the area of health insurance illustrates the inherent difficulties of informing and educating consumers about complex decisions. A range of issues is apparent from this research, including limited knowledge, reliance on friends and families for advice, and difficulties in providing useful information about highly complex decisions.

In 2004 research was undertaken for the Australian Department of Health and Ageing to explore consumer information needs in relation to private health insurance and to evaluate the effectiveness of existing consumer products. Using interviews and focus groups with a cross-section of the population (both with and without private insurance), the findings were largely consistent with research undertaken in the USA by Gibbs et al. (1996) which used a similar methodology to address indicators for comparing health plans.

How informed are consumers about health insurance?

It is clear that consumers are generally quite ill-informed about the area of health insurance. The Australian research found that, when making decisions about whether to take out private health insurance and which fund or policy to choose, knowledge ranged from 'almost total ignorance to a basic understanding of most concepts'. The researchers concluded that most people were relatively uninformed about the choices they made (Blue Moon 2004: 19).

This lack of understanding became particularly evident when people were presented with independently produced information materials, as they learned about a range of issues they did not know existed. There was confusion around many issues, including:

- The fact that treatment as a private patient was not always fully covered by private health insurance and that out-of-pocket payment was dependent on what was charged by the hospital and treating doctor;
- That different funds and products had different arrangements for waiting periods (many thought that a standard twelve month waiting period applied for all types of cover);
- That being privately insured did not preclude being treated as a public patient;
- That no-gap arrangements are in place between funds and some private hospitals and doctors, and that the out-of-pocket expense would depend on whether these hospitals or doctors were used;
- That waiting periods would apply for treatment for pre-existing conditions (Blue Moon 2004: 19-20).

A number of people stated that it was only the experience of having and using private health insurance that improved their knowledge of the details of their policy (Blue Moon 2004: 16).

How are decisions made?

When making decisions about private health insurance, insurers were viewed as offering similar products, and thus decisions were made with little consideration of the finer details of the individual policies. Given this, it is not surprising that consumers responded well to

insurer television advertising. When asked how funds differ, most referred to insurer 'brand positions' rather than the different aspects of the policies. They would tend to choose an insurer first (based on consumer connections with the brand), and then seek information on which product that company offered that best suited them. Where comparison did occur across funds, premiums were typically the only factor considered (Blue Moon 2004: 15).

Despite this general observation, a number of people did make greater efforts to understand the options and to compare the products available to them. However, attempts to compare funds resulted in frustration, and 'it was as though the policy information was deliberately complex to prevent such comparisons being made'. Combined with the bundling of features rather than the ability to individually select, it was concluded that 'people often capitulated, choosing "the best of a bad bunch" without complete confidence they were getting the most appropriate cover' (Blue Moon 2004: 16). This finding is backed by the US research which found that 'in varying degrees, most consumers described the process of choosing a health plan as difficult and frustrating' (Gibbs et al. 1996: 60). This was despite attempts to provide independent comparative information, discussed in more detail below.

Which information sources did consumers use?

Health insurers were almost the only information source people used to make a decision, finding information in television advertising, brochures, policy documents and on websites. Only one person involved in the research had sought out independent information, and had read a government provided brochure called *Insure? Not Sure* (Blue Moon 2004: 17).

Most respondents who were insured had read information provided by their fund, while some had also made phone calls and visited their funds to obtain further information and ask questions. Importantly, although some considered the information provided as helpful in making a decision, others claimed it did not clarify things. In some cases, people claimed that discussions with a number of providers actually left them more rather than less confused (Blue Moon 2004: 17). As research on consumer information search indicates, one reason for this could be that people began to alter their search criteria and to recognise the complexity that was involved in making an informed choice.

It was acknowledged by respondents that information provided by insurers was not independent and that the finer details of policies were not often pointed out. Moreover, it was not always in the interests of insurers to do so, as often this would reveal policy limitations or areas where consumers should exercise care in the choices they made. This was not viewed as deceitful conduct, but simply as bearing out the observation that insurers did not always have the best interests of their clients at heart (Blue Moon 2004: 17).

People considered that they could only rely on word of mouth provided by relatively uninformed friends and relatives as sources of independent advice. Consistent with our findings on consumer credit, people regularly chose their health fund on such recommendations, based on their experience with their own fund. This meant they were relatively happy with their decision, despite acknowledgement that it was not necessarily well informed (Blue Moon 2004: 17). This finding is consistent with the US research which found that not only were trusted friends and relatives often seen as highly valuable sources of

independent information, but their advice was regularly preferred over that of published information (Gibbs et al. 1996: 67).

Was independent information used and appreciated by consumers?

In Australia, a range of independent information is provided by government and non-government bodies to inform people about various aspects of health insurance, although it is clear that it is not as accessible as people would like. With only one exception, people involved in the research were not aware that independent information existed. The researchers argued that:

It is difficult to accurately judge what the net impact would be of making this information more accessible. In particular, it is difficult to say what impact it would have on the take-up of private health insurance (Blue Moon 2004: 26).

Nevertheless, those involved in the research did value unbiased information highly, particularly in a market where confusion is so prevalent (Blue Moon 2004: 18). For example, there were instances where information clarified issues and increased the likelihood of taking out private health insurance, while in other cases it reinforced the decision not to do so (Blue Moon 2004: 26).

In the US, attempts have been made not only to inform consumers about the pros and cons of private health insurance, but also to create indicators to assist in comparison. Many public and private organisations have developed health plan performance measures or 'report cards' which typically combine comparative information on plan features and costs with selected quality indicators (based on member satisfaction surveys and/or administrative measures of plan performance) (Gibbs et al. 1996: 55).

Research undertaken to examine consumer perspectives on this approach highlights the difficulties involved. It is clear that consumers are interested in receiving comparative information on plan characteristics, although producing this can be difficult, given that consumers may conceptualise quality of care in terms very different from those used by providers and researchers. Issues are likely to be defined in terms of the provider-patient interaction, rather than the clinical processes and outcomes (Gibbs et al. 1996: 55).

Consumers were asked to evaluate various health funds using consumer ratings of these funds under six key headings (communication, after hours/emergency care, choice of doctors, technical quality, waiting times and customer service). Generally those involved in the focus groups reacted positively to the evaluative framework, although there were several concerns (Gibbs et al. 1996: 60) which demonstrate the difficulty in producing useful comparisons on issues which can be highly subjective. Many participants required detailed explanation of the basis of the comparisons (for example, how consumer surveys are conducted).

Perhaps the most important finding was that consumer ratings may be useful in assisting consumers to identify which characteristics are important to them (Gibbs et al. 1996: 62). Moreover, where ratings are clustered within a fairly narrow range, they may serve to reassure consumers that their choice of a plan is competitive with all others (Gibbs et al. 1996: 67). Despite this, tests of prototype materials suggested 'that relatively few consumers

would actually tolerate the complexity of such a highly detailed presentation', and thus they may be of limited value to many consumers. It is perhaps for this reason that some people preferred individual stories of experiences rather than aggregated consumer data, feeling more confident of their ability to assess the reliability and judgement of individuals than to evaluate numerical ratings (Gibbs et al. 1996: 62). This would appear to reinforce the fact that, for many people, stories from friends and relatives will always play an important role in making complex consumer choices.

Conclusion and implications for the MCR

Research on consumer decision making in the realm of private health insurance indicates a relatively high degree of consumer ignorance. One reaction to this lack of knowledge is to assume that all providers are basically the same and to choose a provider first and product second. Many of those who do make the effort to understand the market experience frustration at the complexity and lack of comparability between products.

Although there are sources of independent information, both government and non-government, very few consumers are aware of them. While consumers are very interested in accessing independent information, the challenge is how to make this simple enough to be of use to the majority of consumers and still enable a fair assessment to be made of the products on offer. Research in the US found that relatively few consumers would be able to deal with the complexity of health insurance indicators that provided enough detail to be fair and accurate.

7.2 Price disclosure issues in the competitive electricity market

The introduction of competition to the supply of domestic gas and electricity provides the opportunity for the comparison of these new 'complex' retail products with financial services products.

Electricity and gas are complex retail products because end cost is dependent on volume of consumption as well as price. The price can consist of any combination of fixed charges, time of use, seasonal, maximum demand and differential rates for each 'block' of energy consumed. The end use cost can also be affected by choice of energy source (for example, where 'green' or renewable energy is preferred). In addition, these services may be bundled with others or form part of loyalty reward programs.

The industry regulator in Victoria, the Essential Services Commission (ESC), is currently reviewing price information disclosure in the competitive market in the light of its earlier finding that full retail competition in gas and electricity was not yet 'effective'. According to the ESC (2002: 4), there was a 'basis for concern that the complex nature of electricity pricing information, the absence of comparability of that information across retailers and the nature and variety of the contract terms and conditions being offered could be inhibiting competition'.⁴ Oppenheim and Alexander (1998) argue that 'in the absence of "apples-to-apples" price information, consumers are more likely to choose not to choose.' Customer inertia is a widespread feature of deregulated energy markets, although the causes are not limited to information issues.

⁴ An ESC consultation paper on the subject of price comparators and price disclosure labels is available at http://www.esc.vic.gov.au/apps/page/user/pdf/PriceDisclosure_ConsultPaper_Oct03.pdf.

US, Swiss and pan-European research (Oppenheim and Alexander 1998, Markard and Holt 2002, Arvidson 2003) concluded that domestic energy consumers have a low level of understanding about the industry and the basis on which they are charged as customers. Sharam (2005) found that very few of the 576 domestic electricity customers surveyed were able to reproduce details of their old or new tariff even though this could be copied directly from a bill. Only 8% of those who had switched providers since the introduction of competition had compared their existing tariff with the new offer when making their decision.

A common assumption is made that comparing tariffs is a complex and challenging task. The perceived difficulty customers have in making comparisons between offers has led to consideration of mandatory information disclosure. In most cases the task has been seen as how to simplify the comparison process. Truth-in-lending laws in the US have overtly influenced the design of US information disclosure regimes for competitive electricity markets (Oppenheim and Alexander 1998). The need for simplicity has meant the adoption of typical consumption profiles, average prices and/or average consumption benchmarks. In effect, the product comparison process is simplified with a trade-off in accuracy for those customers who do not conform to averages.

The ESC has in part sought to address the issue by establishing an energy ‘comparator’ on its website and developing guidelines for disclosure labels. This follows the establishment of similar comparators and labels overseas, notably by Energywatch in the UK. Their purpose is to enable energy consumers to compare ‘apples with apples’.

Comparators enable consumers to make comparisons between different providers and schemes without undertaking the complex calculations that would otherwise be necessary. The first issue that arises is whether or not the program has the appropriate variables to deal with the customer’s current scheme and the scheme of the competing offer. As the purpose of the program is to make a complex matter simple, accounting for the many variables typically involved engenders choices about trade-offs. The less information the customer has about their own previous consumption and the less they are asked to provide, the greater the danger the comparator will be wrong. For example, the ESC’s comparator does not account for block tariffs when assessing standing offers. This means that, for a customer who consumes more than 4080kwh per annum, the comparator will consistently under-estimate current costs.

The second issue that arises is whether or not the comparator uses information provided by the customer or information the comparator service obtains. In regard to the former, this can be complicated by lack of mandatory disclosure of prices by energy retailers (as has been the case in Victoria⁵), and by poor disclosure by retailers. In regard to the latter, commercial providers present their own dangers to unwary users. In the UK there are many web-based comparator services and a large number of products on the market. The *Guardian* newspaper has claimed that utility ownership of comparator services and the commission system has influenced which utilities are featured on the sites and how services are rated (Brignall 2004). Brignall was critical of the industry and the regulator:

⁵ Legislation passed in December 2004 will require energy retailers to publicly disclose their prices in order to facilitate consumer participation.

Energywatch's own website directs those looking for switching advice to uSwitch. When we showed an Energywatch spokeswoman our findings, she conceded that the accuracy of information on all the sites needs to be examined.

Comparator services are now common for a range of services; however, they are internet based, and access to and use of the web is far from universal. Disclosure labels work in a similar way but provide benchmarks for consumers. The purpose of price comparators and disclosure labels is to rectify perceived market failure. The solution to this market failure is commonly claimed to be better and more consumer education and information.

The following are some observations by Sharam (2005) on the introduction of a retail energy market in Victoria:

- An assumption operates that energy tariffs are complex;
- No research was undertaken to determine how much consumers understood about tariffs at the outset of competition, or what knowledge/skills they would need to acquire;
- No review of literature was undertaken to determine past consumer response to changes in tariffs;
- Little attempt was made to educate consumers about tariffs and charges;
- Consumers' ignorance has been mistaken for incapacity to deal with a complex product;
- It was assumed that the retailers would provide the information. This in turns assumes retailers do not have a vested interest in consumers remaining ignorant/confused;
- Retailers were specifically exempted at the outset of competition from publicly disclosing their prices in any form;
- It was assumed that suppliers should be able to structure their prices in any way they see fit;
- Competition on price occurs not at the level of tariff comparison but lump sum discounts and rebates, for example, a 30% discount on energy charges, a 20% discount on the service to property charge, \$50 p.a. rebate, further dollar rebates for loyalty or payment by direct debit or rewards points.

It is not clear that consumers are being provided with tariff information they can reasonably be expected to understand, and in a format that makes comparison an easy task. This is despite the fact that tariffs are actually made up of a series of simple calculations. It is nowhere as complex, for example, as calculating compounding interest.

Electricity markets in Australia are relatively new. In the case of Victoria, the industry regulator does not yet consider the market to be effective, and poor information disclosure is thought to have contributed to this outcome. Energy is widely regarded as a complex product in pricing terms (despite its relatively undifferentiated nature), and this is seen as contributing to ineffective competition. Accordingly, regulatory attention has turned to methods of providing simpler information.

The experience thus far in the deregulated electricity industry is sobering in relation to options for consumer credit, given the much greater variety of products and suppliers available and the added complexity of understanding financial calculations. It is difficult for regulators to attempt to simplify difficult and complex information for consumers without the danger of misrepresentation. On the other hand, of course, without such attempts it is even more likely that consumers will either not make decisions or make them capriciously.

7.3 Superannuation

The Australian Securities and Investments Commission (ASIC) enforces and regulates company and financial services laws to protect consumers, investors and creditors. Areas covered include superannuation, credit or charge cards, home, personal or investment loans and managed funds. This section starts with a brief overview of the recent reform in the financial services area generally and then considers changes in the field of superannuation.

The Financial Services Reform Act 2001 was the culmination of a major reform initiative. As identified by ASIC, the three key features of the new regulatory and legislative regime were

- A harmonised approach to licensing of financial services providers, including a disclosure and conduct framework;
- A single regulatory regime for financial product disclosure;
- The licensing of financial markets and clearing and settlement facilities (ASIC 2001).

The disclosure regime established through the Act rests on three key documents:

- Financial Services Guide that sets out services offered, who provides the services, and details about remuneration and commissions;
- Statement of Advice where personal advice is provided. This sets out the advice, relevant warnings and remuneration that may accrue to the provider in connection with the advice to assist the consumer in making an informed decision about acting on that advice;
- Product Disclosure Statement setting out fees, risks, benefits and significant characteristics of a particular product recommended or offered.

As set out in FSRB Policy Proposal Paper no. 4, the two primary goals of the Product Disclosure Statements (PDS) regime are to:

- Help consumers make better decisions;
- Make it easier for consumers to compare financial products.

ASIC's general approach is to set out guiding principles and leave the development of PDSs to suppliers. This extends to market testing specific PDSs:

where possible, the PDS should be based on a format that has been consumer tested. Consumer testing may identify areas of the PDS that are potentially misleading and deceptive, or additional information that consumers need. In some cases, issuers should do consumer testing on the actual PDS (ASIC 2001: 22).

There does not appear to be any publicly available research investigating the general effectiveness of PDSs in achieving their goals.

In a consultation paper released by the Australian Treasury, *Refinements to Financial Services Regulation* (Treasury 2005), a number of concerns with the current disclosure regime were identified. The most relevant for our purposes was that the documents being produced were too lengthy and complex and were not consistent with the requirement that information be presented in a 'clear, concise and effective manner'. The paper included fairly general proposed refinements to address this issue, and noted that consumer education was a separate but related government strategy to assist with this issue.

Superannuation had a major change on 1 July 2005, enabling employees to choose a fund for their compulsory superannuation savings and thereby giving increased choice to, and consequently increased onus on, consumers. This highlights some of the dilemmas that regulators and customers face when dealing with relatively deregulated complex markets. The new change effectively moves the responsibility to employees to ensure they are using the best fund for their needs (Nash 2005). While offering considerable choice for consumers, this change is of concern, given that knowledge of superannuation is lower than for any other financial product in Australia (Lane 2005). It has been suggested that many eligible workers simply don't have the background to make an educated choice (Nash 2005).

The move to greater choice in superannuation in Australia is not, therefore, without its dangers. In the UK the introduction of 'pension choice' in the late 1980s resulted in about 12 billion pounds being lost as a result of people making poor choices about where to invest their retirement savings and their pension. This was primarily due to poor advice, where people moved their money from employer-sponsored pension plans that guaranteed income upon retirement, to more risky investment products. They lost money through both poor investment performance and in the higher fees and commissions they were paying (Lane 2005).

An important question is whether the outcomes will be any different in Australia. Catherine Wolthuizen from the Australian Consumers Association has stated that the improved regulations in regard to disclosure of commissions and other checks should alleviate many of the problems experienced in the UK. Nevertheless, she warns:

there remain similar structural conflicts of interest built into our retirement savings and our investment industries, that mean consumers don't always get the best advice (Lane 2005).

A number of related issues are pertinent when considering the information and advice available. Recent research in Australia indicates that superannuation fund members avoided

addressing the issue of super because it lacks immediacy, feels irrelevant and is often not seen as the members' own money (Taylor 2005). Furthermore, they are unsure with whom to discuss superannuation issues, given that there isn't free or cheap independent advice available. Obtaining independent information has also become increasingly difficult, given that recent legislative changes mean that accountants can no longer advise on superannuation structures (Larsen 2004). Moreover, employers are not obliged to talk to their staff about superannuation, and have been warned against providing information that amounts to financial advice (AAP 2005). It seems likely that investment planners will thus become the beneficiaries of the superannuation choice. As one commentator on the deregulation of the superannuation market in the UK explained:

workers are often tempted to forgo in-depth research and defer to 'experts' ... the reality of the situation is that ill-informed workers are often left to deal with self-interested pension sellers. As one could predict, fraud and exploitation are often the products of these unequal relationships (Brown 2005).

Such concerns may also be relevant in Australia, given that ASIC's nationwide test of financial advice in 2002 revealed the standard of general advice among financial planners was poor (Alberici 2005).

Consumer research undertaken for ASIC in 2004, *Consumer Decision Making at Retirement*, found that the vast majority of participants (who had retired in the previous twelve months) thought little about their superannuation until retirement or some other trigger intervened. As is common in this type of research, they felt that they had sufficient knowledge and information at the time of making the decision (although many expressed difficulties with the quantity of information needed to absorb and analyse).

In relation to participant's actual knowledge, the study concluded:

very few people completely understood the key attributes of the main options open to people with regard to their superannuation benefits at retirement, a number of people had a very poor understanding of all options, and a minority failed to appreciate that different approaches, products and indeed a mix of approaches and products may have been optimal for them (ASIC 2004: 14).

If consumers do try to make their own comparisons this will, as one industry education officer recently stated, 'require painstaking research' (Nash 2005). Obtaining reliable comparison information may not, however, come easily. For instance, days before the introduction of super choice on 1 June, most of Australia's 133 retail super funds had not provided key expense data, such as total amount earned in commissions, to the Australian Prudential Regulation Authority (APRA). Given that the APRA statistics are considered the only independent data published, this has made comparison among funds very difficult – unless consumers are willing to trawl through each fund's product disclosure statements, which are complex and generally fifty to eighty pages in length (Tilbury 2005).

Assuming that consumers are willing to do this, comparing product specifications between apparently similar funds can also be difficult, as there is no industry standard governing the names given to different classes of funds in terms of asset allocation. Thus two different

funds branded as ‘balanced’ could include very different defensive-to-growth asset ratios (Holmes 2005). People have also been warned against relying on comparison information such as online superannuation calculators, as many fail to explain how they operate and do not include fees and charges (Sunday Mail 2005).

Given the complexity of superannuation products and the difficulties inherent for individuals in undertaking long-term financial risk analysis, the main public policy option would seem to be consumer education. ASIC has developed a spreadsheet calculator. This is a downloadable Excel spreadsheet, set up to enable users to input information from their superannuation statement and analyse what impact changing key variables would make on their retirement income. The spreadsheet is also designed to enable comparison between two different funds. This approach requires that users have some knowledge of Excel and are in a position to input all the required data for their existing fund and any other fund they may be considering.

The experience to date in the area of superannuation highlights again the public policy challenge of balancing consumer choice with consumers’ capacity to deal with complexity. Superannuation shares with longer-term fixed credit products the requirement to project future risks and needs (although there is less ‘lock-in’ in relation to credit). Developing tools to assist with superannuation decisions is particularly difficult and ultimately requires consumers to undertake some form of risk analysis. While ASIC has developed a calculator it does not enable consumers to shop around and compare products online. Regulators (and private providers) are required to traverse the grey area between consumer information and advice. Realistically, the more conservative they are in defining what is information provision and what is advice, the less useful the resulting tool is likely to be.

7.4 Telecommunications

The Australian Communications and Media Authority (ACMA) is responsible for the regulation of broadcasting, radiocommunications, telecommunications and online content. In relation to telecommunications, its key objective is ‘promoting self-regulation and competition in the telecommunications industry, while protecting consumers and other users’.

The emphasis of the current regulatory framework is largely on service issues of access and technical interconnection, for example, that telecommunications service providers provide access to emergency call services and assistance to government agencies in the national interest. Reviewing a recent ACA (2005) report, *Vision 20/20: Future Scenarios for the Communications Industry – Implications for Regulation*, the dynamic nature of the industry would appear to have raised so many issues for consideration that the way in which consumers navigate their way through the system is currently of secondary import.

In line with this, ACMA does not play a key role in determining the content and form of advertising and consumer information, relying instead on the development of industry codes that require participants to become signatories.

The code developed by the Australian Communications Industry Forum (2004), *Customer Information on Prices, Terms and Conditions*, sets out reasonably general requirements for providers. As set out in the Explanatory Statement to the Code, ‘Minimum standards will facilitate the objective of informed purchasing decisions being made by consumers’. ACMA

does not play a direct role in facilitating comparison between providers but does provide links to a number of non-government websites that assist consumers to do so.

As part of its role, ACMA (and its predecessor, the Australian Communications Authority) undertakes an annual consumer survey to measure satisfaction with various elements of the telecommunications industry. The survey asks respondents whether they found it easy to compare services offered by service providers. The results indicate that the majority of those respondents who attempted to compare products found it difficult. For example, in 2004, of those who had compared mobile phone companies, 60% found it difficult, with an even higher proportion (64.5%) finding it difficult to compare different bundled service providers.

One issue related to this study that has recently been given attention is that of ‘unexpectedly high bills’. This problem is largely seen as the result of new services and variations on existing services. The Australian Communications Authority (2000) identified three outcomes that need to be achieved in order to address this. The first of these was:

Consumers possess a reasonable understanding of the telecommunications products and services they use and have certainty about the costs of telecommunications services, the associated risks and their expenditure on these services.

This is a slightly different issue to the one that the MCR is designed to address, i.e. this is largely about informing existing customers about pricing for new products that they can access without having to change their existing subscription or relationship. When discussing tools available to achieve this outcome, general information provision about products and services and risks of high bills was considered to be of low to medium effectiveness ‘because the abundance of information provided to consumers by carriage service providers reduces the impact of particular messages. Additionally, for particular vulnerable groups for which functional literacy may be low, little value is likely to be drawn from such material’ (ACA 2000: 32).

The issue of ‘unexpectedly high bills’ highlights the different challenges facing regulators in the field of telecommunications from that of consumer credit. The dynamic nature of the technology means that products are changing and expanding at a rapid rate. Technologies are converging so that what were once discrete services (for example, internet service provision and telephony) may now be competing services. Providing consumer advice confronts more directly the issue of quality. The advent of wireless and internet based delivery of telephone services, for example, has meant a wider diversity of quality of service. Internet services providers offer different speeds and forms of access that again make provision of clear consumer advice more problematic.

7.5 Implications for the mandatory comparison rate

Consumer credit is a ‘complex’ product. It is not straightforward for consumers to calculate the ‘price’ of credit given it is paid over an extended time period, the price typically includes a (changing) interest rate and various fees and charges. Loans can have numerous features and options that may or may not be of benefit to individuals, and the terms of trade are complex, technical and typically give the supplier the right to vary over the course of the agreement.

Our review of work undertaken in the UK by the FSA and the little research undertaken in Australia found that many consumers in complex markets might ‘feel’ that they had sufficient information and searched adequately but their behaviour does not bear this out. Many simply assume that all providers are the same and therefore do not undertake extensive search. Those who do search are often overwhelmed by the information provided to them, have difficulty understanding terms used and have trouble accessing comparative information on products. Typical problems that consumers had with existing information sources included lack of specificity, complicated, information not being up to date, too many options and inability to apply information to their own situation.

Our review of complex markets has shown that regulators across these markets are grappling with a similar problem: how to ensure that consumers are presented with sufficient information in as simple a form as possible. The message from consumers is consistent: they want clear, simple information tailored to their situation. Of course, the nature of these markets militates against the provision of simple information without the risk of misrepresentation. The trade-off between comprehensiveness and simplicity will be different for each consumer and each market. Therefore, some form of market testing is required for product disclosure forms being used and those that are proposed to help find the most appropriate balance.

Not only do consumers want simple information, it is clear from the South African study we reviewed (Bertrand et al. 2005) that the simpler the information provided, the greater the take-up rate for any particular credit offer (in this case, where the increased information was simply a greater variety of loan amounts and term for the same loan conditions). Consequently it is in credit suppliers’ interests to provide the least information consumers need to make a decision in their advertising and applications.

Our research suggests that there are three broad approaches available to regulators for improving information provision in complex markets:

- Setting out broad parameters relying on ‘misleading’ conduct type approach and industry self-regulation;
- More prescriptive approach with more detail requiring information to be provided as an attempt to make comparison easier;
- Collection and provision of information in a comparable form.

In reality, the first two options are more like a continuum based on the degree of prescription. Any meaningful instruction about information provision has to have some level of detail regarding the information to be provided and its form. Equally, even the most prescriptive approach will include some discretion on the part of suppliers in how they comply.

The mandatory comparison rate regime is certainly prescriptive relative to ASIC's approach to information provision in relation to financial services. It could, however, be more prescriptive. Some consumer advocates argue that we should return to a system where not only must a comparison rate be included but that it be the only interest 'rate' that is allowed to be advertised.

Critics of the mandatory comparison rate note that they do not provide all the information that consumers need to compare products, particularly more flexible or complex products (for example, Business Council of Australia 2005). While this is undoubtedly a valid observation, it is not particularly useful. As we have discussed, the central regulatory issue in relation to information provisions is the trade-off between simplicity and comprehensivity. No regime, and certainly no component of a regime, will be both perfectly comprehensive and simple. The issue is whether the overall regime or specific components assist consumers to make informed decisions. Our research found that once consumers understood the comparison rate, most felt that it would be useful in helping to make decisions. Given the complexity of consumer credit, the issue is not whether a single indicator can encapsulate all aspects of products but whether it is helpful to consumers in decision making.

At present the key weakness of comparison rates would appear to be that most people are not aware of them. This requires some effort in publicising them. Given the crowded market faced by those trying to inform the general public, this is not an easy task. One possible approach is to take advantage of consumers' reliance on friends and family for information and advice. Tapping into these networks may be a cost effective means of publicising comparison rates. It may be possible to run a telephone campaign to inform a sample of the population of comparison rates and rely on the friendship and family networks for this information to be disseminated more widely.

Our review has highlighted the potential for the further development of online resources to assist consumers in comparison shopping and decision making. In particular, online comparison tables that enable consumers to search for loans have a great deal of potential to assist consumers and encourage 'real' competition between providers. We would argue that one of the strengths of the mandatory comparison rate regime is its use in such online comparison tables (see the 'Choice' approach or the FSA approach) where consumers key in their information and the program provides all loans for which they are eligible that can be ordered by comparison rate. In this situation, the comparison rate is not necessarily the only decision criteria, but it is an important one that can be used by consumers as an initial filter before other elements of loans are compared.

Australian approaches to online comparison have been more cautious, relying on consumers to enter all of the market information and avoiding any guidance in terms of which is the better product (this is true of both private and public sector providers, with the notable exception of the Australian Consumers' Association 'Choice' website).

With limited understanding apparently the norm in many areas where consumers make difficult decisions, it seems that any attempt to provide independent information to inform consumers and assist in comparison of products is beneficial. The degree to which this information is sought out and used for analysis is not, however, straightforward. As the case of health insurance in Australia illustrates, often consumers do not seek out and are not aware that independent information exists to assist them in understanding products. Thus there is a tendency to rely on advertising and trusted friends and relatives. When people are made aware of independent information, many do however find it helpful. Where this assists with comparison it is particularly useful as it allows consumers to identify which characteristics are important to them, and provides confidence that their choice of a plan is (or is not) competitive with others. This finding must be qualified by the observation that the unavoidable complexity of some comparison measures in the area of health, for instance, reduces the likelihood that consumers will make the effort to understand them. In this context, the MCR would appear a relatively straightforward, user-friendly and trusted measure to assist comparison. Our consumer research found that its major weakness was lack of consumer awareness.

8. Primary research component

8.1 Methods

The primary research component of the study was designed to examine two interrelated themes:

- Consumer credit decision making in relation to the specific forms of credit to which the MCR applies. There is limited publicly available research of this type, although there has been some market research undertaken for credit providers (e.g. Morgan's work for ANZ in the Australian context);
- Within that broader framework, the role of the MCR in decision making. This necessitates consideration of:
 - 'brand awareness' (do consumers recognise the MCR and understand what it is?);
 - whether it is useful in assisting consumers in their decision making.

One method for improving our understanding of these issues was to interview credit providers. Mostly this was undertaken as part of the Regulatory Impact Statement. We did talk to a number of representatives of credit staff as well as conducting a focus group 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 involved consideration of:

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

Consumer feedback was initially gathered through interviewing consumer advocacy groups and holding focus groups with consumers to gauge their understanding and use of the comparison rate in decision making. This work helped us to develop the questionnaire used to interview 200 respondents from across Victoria.

8.2 Interviews with providers

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 growing sophistication of the consumer finance sector means that increasingly there is not a 'standard' interest rate for products. The rate is tailored to the individual customer based on their specific risk profile (e.g. level of income, quantum of the loan, level of equity). 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 (i.e. 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 a 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, i.e. '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 approaches between different suppliers had become more consistent over time.

A focus group held with seven home loans officers found that while comparison rates were playing almost no role currently, participants 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 them was very difficult, given all of the other information that needs to be conveyed. There was clearly confusion amongst some of the group about how comparison rates were calculated.

There was also a concern that, if competitors are not highlighting and explaining comparison rates, then doing so risked putting themselves at a commercial disadvantage. However, there was general agreement that, if consumer understanding of comparison rates improved, 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 banks’ own practices that would increase the usefulness of comparison rates. One was to include calculation of the comparison rate as part of their internal calculation software, and another was to present comparison rates side-by-side with contract rates to help make them clearer.

8.3 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 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 who hadn’t realised 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 its introduction (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 (for example, 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 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.

8.4 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 was to inform the project generally and also to provide input to the development of the sample survey.

Focus groups were 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 twelve months, five a personal loan, and one had arranged a personal loan to consolidate debt (three 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 participants' loans would have been covered by the Consumer Credit Act as they were also related to investment properties.

The focus groups were semi-structured, with the discussion encouraged by the moderator using the following prompt questions. The results will not be set out in detail as their major role was to help us to structure and design the sample survey.

Table 8-1 Consumer focus group/interview questions

What credit have you negotiated in the last twelve 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?

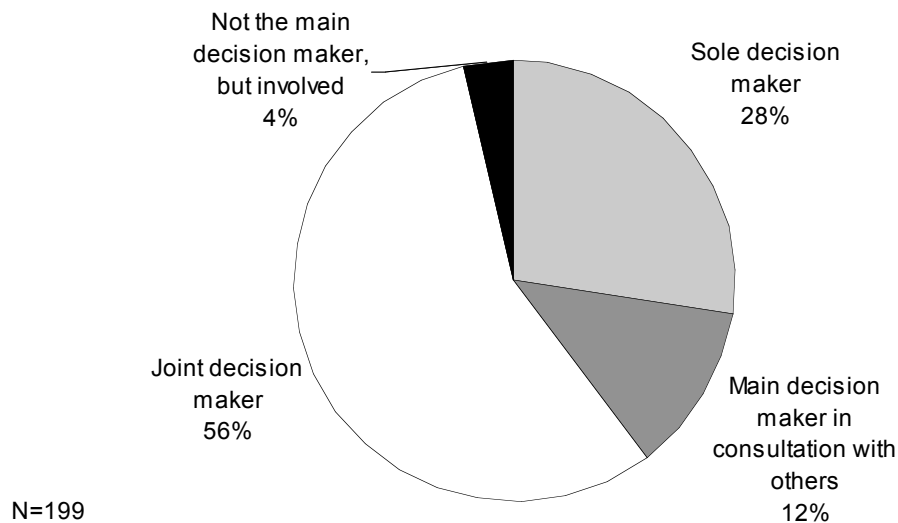
How important is having a single comparable interest rate when searching for credit?

8.5 Findings from the sample survey

The key purpose of the random sample survey was to gauge awareness and use of comparison rates. It was undertaken by telephone and administered by the Australian Centre for Emerging Technologies and Society, located at Swinburne University. The sample of 200 was drawn from across Victoria.

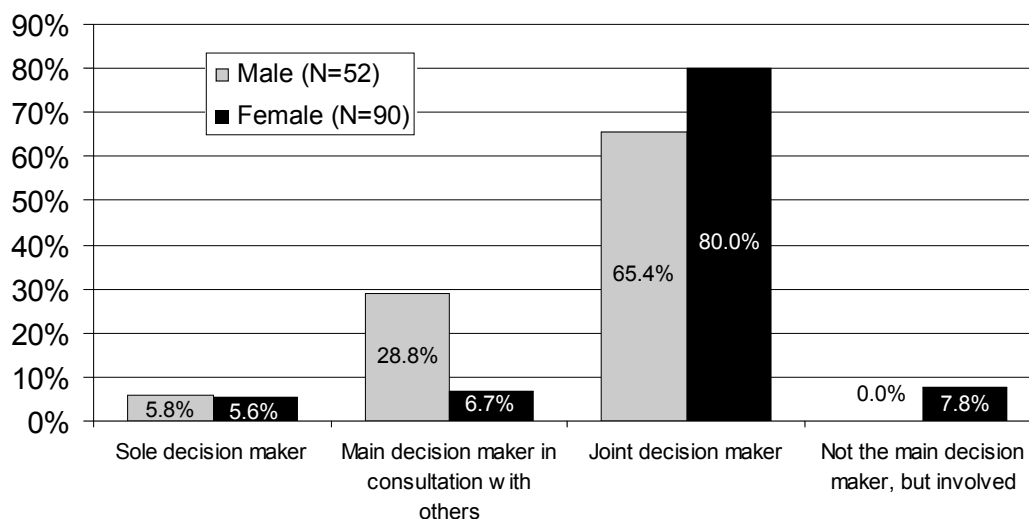
Respondents were firstly asked their role in the household in relation to consumer credit. Those who said that they ‘were not involved at all’ were not questioned further. Figure 1 sets out the responses to this question. Only a small proportion (4%) chose the lowest level of involvement (not the main decision maker but involved). Over half (56%) considered themselves to be joint decision makers.

Figure 1 Respondents' role in consumer credit decision making



Cross-tabulating this question by gender for couple households only reveals that men and women have different perceptions of how responsibility for decision making is shared. Around the same proportion of men and women claim to be the sole decision maker (5.6% of women and 5.8% of men). Almost a third of men (28.8%) said they were the main decision maker, compared to 6.7% of women. Four fifths of female respondents (80%) said they were the joint decision maker (65.4% of men). No male respondent claimed to be involved but not the main decision maker, whereas 7.8% of women made this claim.

Figure 2 Respondents' role in consumer credit decision making by gender, couple households only

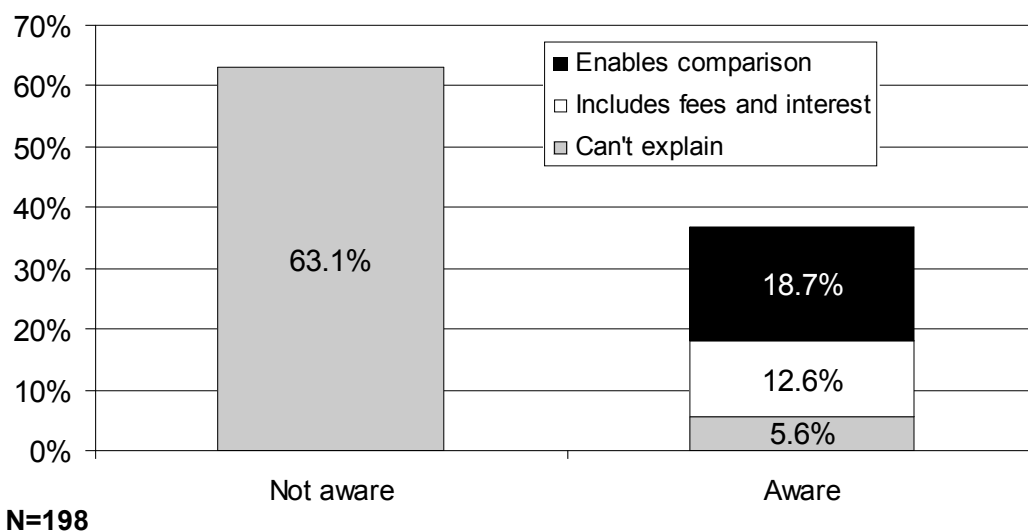


Moving to awareness of comparison rates, 37% of respondents said that they were aware of the term 'comparison rate'. Our experience with focus groups and personal interviews indicates that this should be interpreted with caution, as the term is easily confused with

simply a comparison *between* interest rates. Only 12.5% of our sample was able to tell us that the comparison rate included both interest and fees and charges. A further 18.5% explained it as ‘enabling comparison across providers’. This is consistent with work undertaken in the UK in 1994 that reported 11% of respondents choosing the most appropriate response to define the Annual Percentage Rate, although this ‘test’ was in a sense a little easier than ours as respondents were asked to choose between four options.

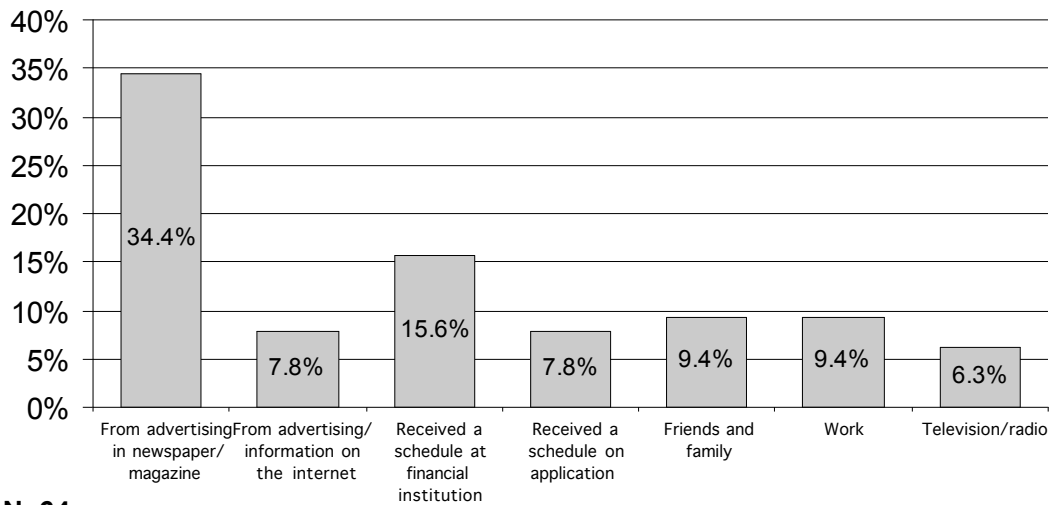
This result does point to a lack of market awareness of the comparison rate. Respondents who had made a consumer credit decision in the last two years were more likely to say that they were aware of the term (45.1% compared to 31.3% for those who had not done so). This was also the case in relation to understanding that the comparison rate included both interest and fees and charges (15.9% to 9.5%). Those who had taken out a recent loan were much more likely to explain the comparison rate by saying that it enables comparison across providers (28% to 13.8%). This implies that consumers are likely to become aware of the term ‘comparison rate’ through their experience of shopping for credit and understand that it enables comparison, although the basis on which it does so is not getting through.

Figure 3 Awareness of the term ‘comparison rate’ and explanation



Respondents who were aware of the term ‘comparison rate’ were asked how they found out about it. The most popular source was advertising in newspapers and magazines (34.4%), followed by receiving a schedule at a financial institution. The role of friends and family (9.4%) and people’s work experience (9.4%) as a resource for making financial decisions was underlined.

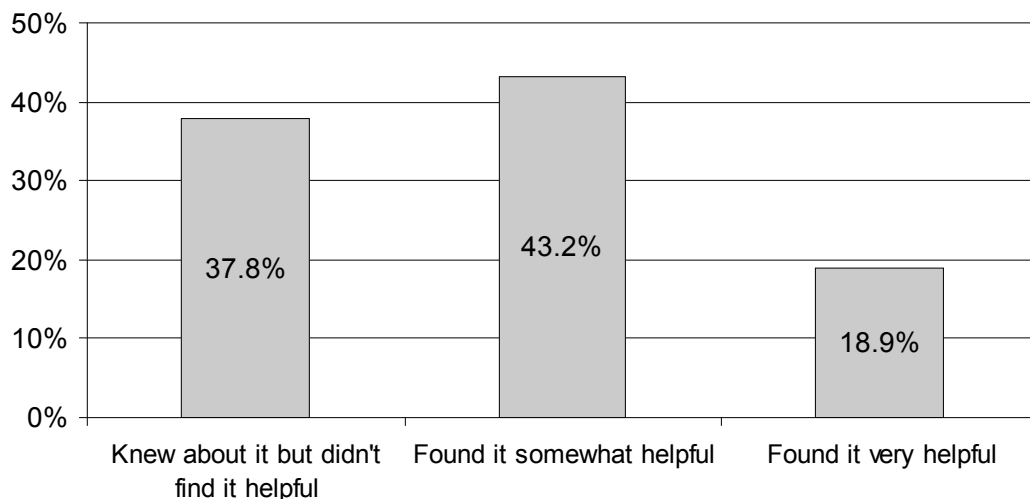
Figure 4 How did you find out about comparison rates?



N=64

Respondents were more likely to have heard of the comparison rate if they had negotiated credit in the last two years. Eighty of our sample (40%) had taken out a loan in the last two years (i.e. since the introduction of the mandatory comparison rate regime). Of these, just over half said that the comparison rate played no part in their decision because they were not aware of it. Of those who were aware of it, a clear majority (62%) described it as somewhat or very helpful in making their decision (Figure 5).

Figure 5 For those respondents who had arranged credit in the last two years and knew about the comparison rate, how helpful was the comparison rate?



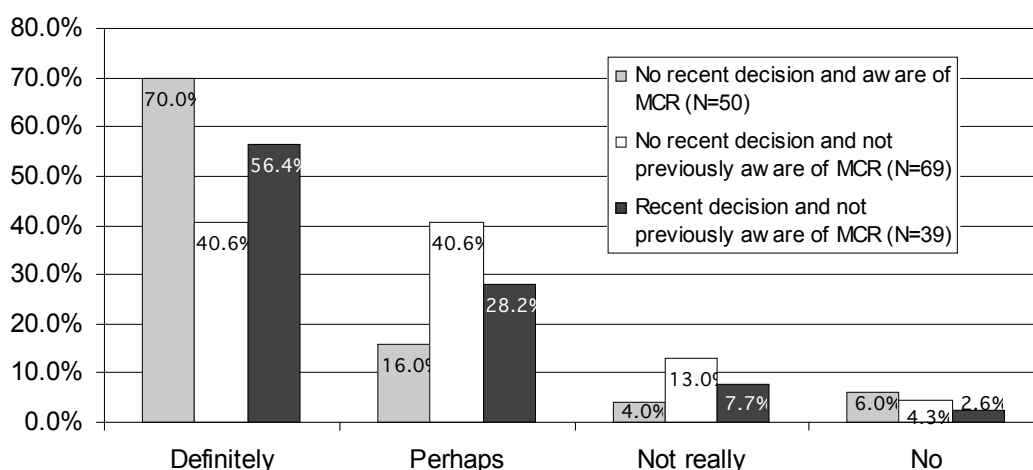
N=37

Those respondents who had tertiary education were much more likely to find the comparison rate helpful. While the numbers are small, the difference is quite stark, with 85% of those with a tertiary education finding the comparison rate helpful (n=20) compared to just 37.5% of those without tertiary education (n=16). This suggests, perhaps unsurprisingly, that people's use of the rate is related to financial literacy, and also related to people knowing about it. Respondents (whether or not they had recently taken out a loan) with tertiary education were more likely to have heard of the comparison rate (50.6% to 27.6%), although the difference was not as great for those who had recently taken out a loan (56.8% to 47.4%). Overall, women were more likely to find the comparison rate useful than men (71% to 50%).

Respondents who had not made a credit decision in the last two years or had made one without being aware of the comparison rates were asked whether it sounded like something that would be helpful in making a decision. Figure 6 shows the results for this question. An overwhelming 70% of respondents who already knew about the comparison rate but had not made a credit decision in last two years felt that the comparison rate would definitely be helpful. This is interesting because they are likely to be a financially literate and aware group (i.e. they found out about the comparison rate without actually making a credit decision).

Those who had made a decision but were not aware of the comparison rate were also enthusiastic about its usefulness, with 56.4% saying that it definitely sounded useful and a further 28.2% that it would perhaps be useful. Those who were not aware of the comparison rate and had not made a recent decision were the most ambivalent about its usefulness, but only a small minority felt that it would be of no use or not really of any use (17.3%). Education was not a major factor in whether respondents who had not made a recent decision thought that the comparison rate would be useful (81.8% without tertiary education, compared to 86.2% with tertiary education).

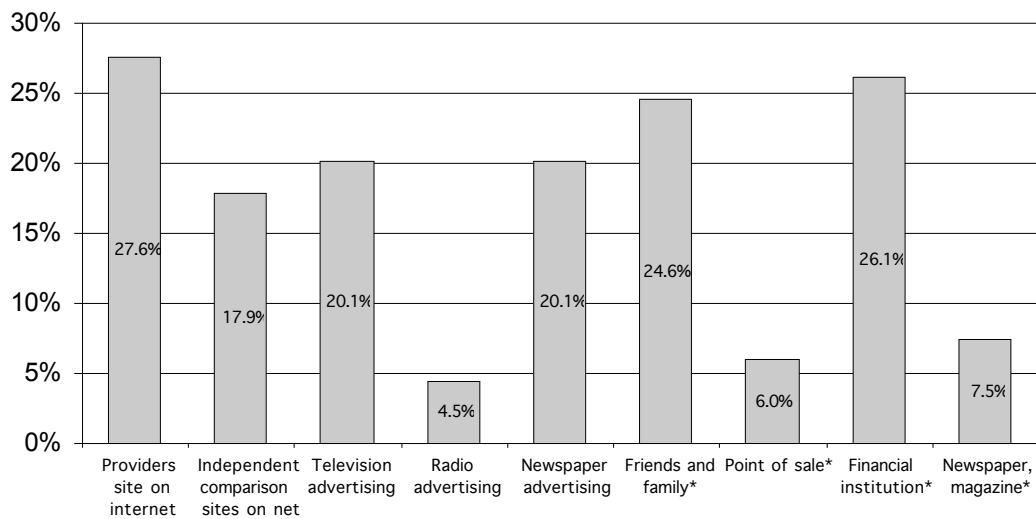
Figure 6 Respondents' rating of the usefulness of comparison rate by whether they had made a recent decision and awareness of MCR



We asked people more generally about researching consumer credit loans. Respondents nominated a number of sources of information other than the six included in the

questionnaire. Providers' sites on the internet were the most popular source (27.6%), followed by financial institutions (26.1%) and friends and family (24.6%).

Figure 7 Information resources used in researching most recent loan

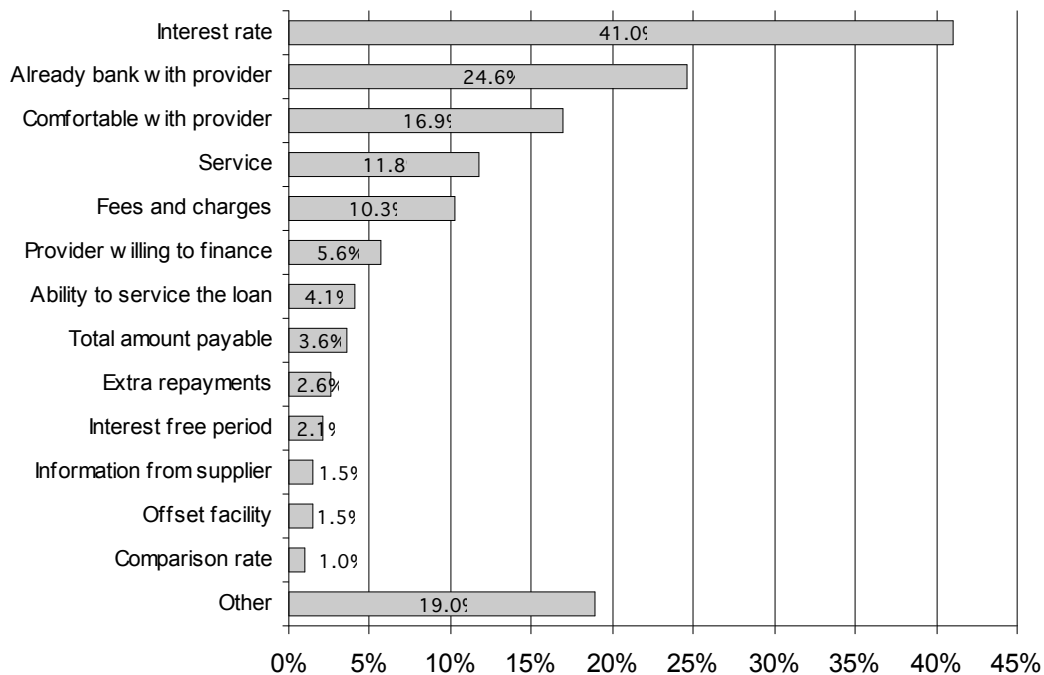


N=134

* Options not provided but included by respondents under 'other' category

When asked 'what were the key factors in choosing their most recent loan?', the most popular factor was 'interest rate' nominated by 41.0% of respondents. Just under a quarter said that a key factor was that they already banked with the provider (24.6%). The next most popular response was similar, that the respondent felt comfortable with the provider (16.9%), with service (11.8%) and the level of fees and charges (10.3%) also receiving significant support.

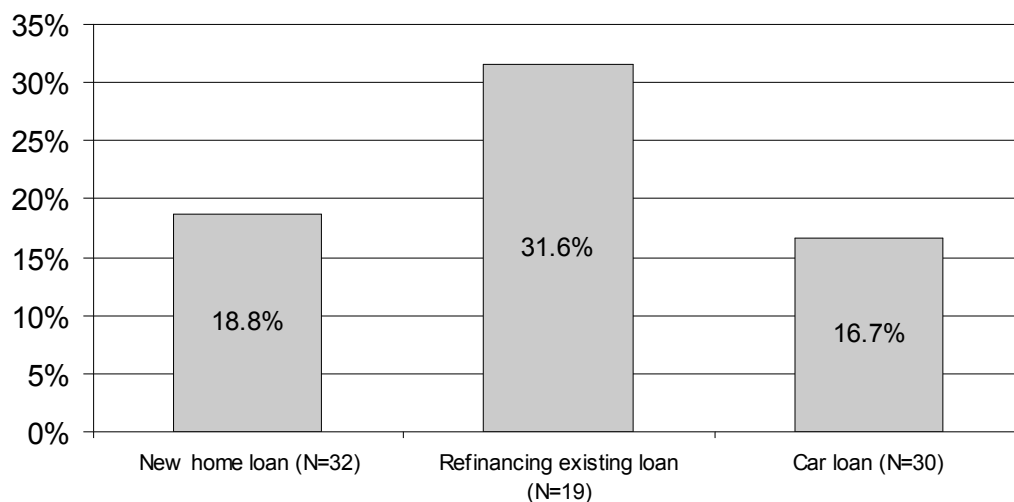
Figure 8 Key factors in choosing most recent loan



N=195

The increasing use of brokers in the consumer credit market has been an issue of debate in recent times. Results from this survey show substantial use of brokers, particularly for those refinancing an existing home loan (31.6%, although this should be interpreted with care, given that there were only nineteen respondents in this category). There was a surprisingly high use of brokers in relation to car loans (16.7%), with 18.8% of those negotiating a home loan using a broker.

Figure 9 Use of broker for those whose most recent loan was less than five years ago by loan type



Those who had used a broker (N=24) mostly found it a positive experience. Only one of these people said that the broker was ‘not very helpful’, with a clear majority (fourteen respondents) finding the broker ‘extremely helpful’ and a further six ‘quite helpful’.

8.6 Findings from the personal interviews

In addition to the telephone survey and the focus groups, interviews were undertaken with individuals who had negotiated a home loan in the previous twelve months. Home loans were chosen as this is the fixed term credit to which people are most likely to devote significant search effort, and consequently the interviewees were more likely to have been exposed to the comparison rate and be able to discuss their search experience in detail.

Interviews were conducted relatively informally, using a set group of questions. Undertaking face-to-face interviews allowed people to respond in a more open manner, and enabled a much fuller discussion of the issues. As a consequence, people provided much greater insight about their personal circumstances, the reasons for the decisions they made, and their knowledge about the comparison rate.

Interviewees were recruited through a variety of means, and with the offer of a gift voucher as an incentive. A flyer was emailed to contacts at four Melbourne local governments and to staff at the Swinburne Institute for Social Research. The flyer was passed on to ten schools in the northern suburbs of Melbourne, some of whom subsequently placed information about the interviews in their school newsletters. Noticeboards at RMIT’s Bundoora campus and Swinburne’s Hawthorn campus were also used to recruit people. Finally, a letter was sent to

100 people who had purchased properties in January and March 2005, via lists available in the *Monday Age*.

These methods recruited twenty-one people, with the interviews conducted in August and September. The interviews were generally held at their homes or workplaces, and were between fifteen and thirty minutes in duration. Each was taped and transcribed to ensure its accuracy.

The following section outlines and discusses the interview responses under the heading of the standard questions that were used to structure the interviews.

General impression and strategy when looking for credit

How long did you search for credit?

People generally searched for credit for a month or two before approaching credit providers. In a few cases, the search period ran over a few years, with initial searching then being followed by a long period of further saving and further searching. A small number who needed finance quickly organised this within a matter of days or weeks.

How did you go about searching for credit?

Most people initially mentioned using the internet, by either visiting individual websites or, in a few cases, using comparison websites such as Cannex. The *Age* was mentioned by a few as a source of information, while some visited their existing bank or credit provider to discuss the options available. About a third relied heavily upon the recommendations of friends or relatives who either worked in the finance industry or who had positive experiences in the past with a lender or broker. Just over half of those interviewed used a number of sources of information to conduct their search, while others simply relied upon one, such as friends or the internet.

How did you decide which providers to approach?

The degree to which people looked at alternatives depended on a number of factors. A small number with the time or inclination undertook an extensive search process. This involved looking at a large number of alternatives, before narrowing down their search and then approaching a small number of favoured providers. People generally started their search using the internet, although often other sources of information such as newspapers and discussions with friends were also used. Some interviewees were forced to search widely because their financial situation made it difficult to obtain credit.

For most, the search process was far less involved. Those who had already purchased houses before looking for credit tended to approach only a few providers, due to time constraints. As a result they chose their existing bank, or quickly found a broker who could narrow down their options. One woman's response was typical of this group:

I had already purchased the property, so I didn't have a lot of time to look around. And I work full time, so there isn't a lot of time to do proper searching and so on. So I talked to my existing lender and looked at what one other had to offer.

Some people did not search widely due to their existing relationship with a credit provider, which in five cases involved already having a mortgage. Those whose friends had made recommendations tended to listen to this advice, and therefore did not search widely.

Additional factors that limited people's search were their knowledge and impression of some financial institutions. While familiarity with a credit provider was not important to some, others would not consider institutions they had not heard of prior to their search. Therefore, smaller, interstate or overseas credit providers were less likely to be chosen by these people. The size of institutions was also a factor for some respondents, given that larger banks were sometimes favoured for security reasons, while smaller banks and building societies were viewed as more 'ethical'. Finally, a few people stated that credit providers offer similar services, products and rates, and thus undertaking an extensive search was not necessary.

How would you describe your search for credit? How 'educated' did you feel about the credit market before you started your search, and had you done this before?

The majority of people interviewed did not feel educated about the credit market, although most (but not all) of those who had taken out a loan previously tended to feel more comfortable with their level of understanding. Confusing, complex or 'mind-boggling' were words frequently used to describe credit searches, although people who had used brokers stated that the search process then became a lot easier. The confusion and complexity stemmed from the large number of credit providers available, and from the difficulty of understanding and comparing information about various products. As one respondent stated:

It gets a bit frustrating because there are so many products out there now, it's extremely hard to weigh the loans up against each other, they all have different features, so you have to look at what your main criteria are ... If some aren't of importance, then you delete those.

Most people who found the search confusing had not taken out home loans before, while a number also commented that they were not 'financially minded' or interested in financial issues. Some even stated that after negotiating the loan they still did not fully understand some aspects of what they were being offered. People who did not search widely were more likely to suggest the process was easy or straightforward, as they undertook relatively little comparison across banks or products.

Despite some people's perceived lack of understanding and experience when beginning their search, the process clearly was an educative one that forced people to learn about the market. Moreover, many came to appreciate that a highly competitive market gave them not only considerable choice, but also the ability to negotiate over interest rates and fees and charges. As one home owner and property investor said:

We don't go to the bank with our cap in our hands any more, we say, if you don't want our business then I'll go somewhere else. And that's what you do. When we first started we may have not taken this attitude, but the Australian public is being educated through these types of property shows and that on the television, and it's terrific. And in essence it can help to make the banks compete even harder to get your business.

This response was typical of people who were in a strong financial position or had previously taken out a loan. However, some first home buyers also learnt through their experience that negotiating could result in a better outcome.

Finally, it is worth noting that respondents occasionally commented that one unwanted aspect of competition was the apparent willingness of credit providers to lend excessive amounts of money. One person expressed the view that:

I knew how much we could afford to repay. But they would have lent us more than we could have comfortably repaid. It could have been tempting, there was no warning from the bank about how much we were borrowing. So we could have bought this and this and this ... They tried to sell us more than we could have comfortably afforded.

Breadth of search

How many providers did you approach, and how many products did you look at with each?

The number of providers approached varied from six to one, with the majority of people visiting or phoning at least two or three providers to discuss their options. Those who used brokers typically started with a larger range of options, from which brokers recommended between one and three for customers to choose from and then approach (although some suggested up to six). Typically, people investigated a range of products with each of the credit providers they approached, with some discussing up to five products with each provider. A small number only looked at one or two products with one or two institutions.

Factors influencing choice of credit provider

What factors were important to you when choosing a credit provider?

A large range of factors influenced people's choice of service provider, with most suggesting they had a number of criteria by which they made a decision. Interest rates, reputation and service factors were all mentioned first by five of the twenty-one people interviewed. Other factors that were mentioned first were 'whether they would lend the money', the 'overall package', fees and charges, and the speed of getting the loan.

The interest rate was the most vital criterion for five people, with fees and charges the next most important factor for these people. Conversely, a number of people did not mention interest rates at all. This was because they had not searched widely or had chosen to use their existing institution. A small number felt that most rates were similar and thus while 'a competitive rate' was important, other factors were more influential.

Five people mentioned the reputation of the credit provider as their most important factor, as they were not prepared to borrow money from unfamiliar institutions. As suggested above, some also chose providers on the basis of their size or reputation. Thus a few considered larger banks were a safer option for lending, while others would only consider smaller providers because they saw the profits of large banks as evidence of excessive interest rates and fees. As one respondent said:

Public image of companies, especially ones where you hear the National has had a huge profit, I don't want to go with them because it means they have high interest rates to get those huge profits.

A small number of people suggested they would only consider their existing institution because of its reputation or the convenience of staying with the same bank.

Service factors were also extremely important to many people. For some, either a history of good service with their existing institution or a particularly good experience with a broker or loans officer swayed their decision. For one person, having an Australian bank was important, while a couple mentioned the need to have a branch locally.

Additional issues of importance included the speed of obtaining the loan, flexibility of the loan, other facilities (such as offset accounts), and internet and twenty-four hour banking. Also mentioned regularly was 'the overall package', as people used a number of factors to weigh up the best arrangement for them. A few suggested their most important criterion was whether the bank would lend to them, given that they had a small deposit or unstable work history.

Factors affecting actual decision making

What factors proved to be most important when deciding on a credit provider? Were these different to the original search factors?

The majority of interviewees stated that the original search factors remained important or similar when they made their final decision, although in some cases experiences with particular lenders or brokers had an impact in both a positive and negative manner. For some, the order of importance of each factor altered when they narrowed down their search and made a decision, as they became more aware of the options available to them.

Given that many people were taking out a loan for the first time, the process of searching was, as suggested above, a highly educative one. Some, for instance, discovered they had only one or two possible credit providers to choose from, and as a result the need for comparison became minimal. For others, the process informed them about products or options that they had not originally considered.

Comparison across lenders and products

How easy did you find this? Did you use any third parties and, if so, why, and were they helpful?

Just over half the interviewees used brokers to assist them in comparing lenders and products. Most who did so had initially found comparison among products and providers difficult or confusing and as a result had sought assistance. Brokers were able to outline a range of options available, assist with comparison, and recommend a small number of providers to suit their needs. Most people who used brokers therefore found them very helpful. According to one respondent:

She recommended two or three options and then I chose one. Using the broker was easier and more convenient, and she came and visited me which was good. I guess I thought I would try this, and it was a good way to see which one was best for me. How to make an informed decision was the issue, and given she collected a commission from all the banks, I think they call it a finder's fee, I felt the advice I was getting was quite independent.

A number of people who used brokers felt that it 'reduced the stress' of such a big decision, while some stated they trusted the broker and felt they were an independent source of advice.

A few were not happy with the service they received from brokers, however, and did not consider them at all helpful. This included some who questioned the independence of brokers, feeling they were likely to ‘push’ some products over others.

Of those people who did not use a broker, some did not undertake much, if any, comparison between products or providers. Two who undertook more extensive searches found comparison easy, by using websites or talking to friends. A few people found comparison websites such as Cannex particularly helpful, while one mentioned that comparison was ‘OK, because when we signed the forms they had to give us a comparison rate ... We then got a comparison rate with both lenders to help us compare’.

Comparison rate

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

One third of the people interviewed answered correctly, stating that the comparison rate was an interest rate that included fees and charges. Some then added that it represented ‘the true cost of the loan’. About a third of had heard of the term and attempted to give an explanation, while another third were not familiar with it at all.

Of those who attempted to give an explanation but were incorrect, most stated that it was a rate that was used for comparison between banks or products, although they were unable to explain how this was different from the normal fixed or variable rates. After an explanation was given by the interviewer, most people said they then understood what the comparison rate meant, although a few appeared to have difficulty with the concept despite lengthy explanation.

When looking for and negotiating your loan, do you remember receiving a schedule of comparison rates from any lenders you approached?

Six of the twenty-one people interviewed stated that they received a schedule of comparison rates from their broker or credit provider, while another remembered seeing these rates on internet sites. He did not receive a schedule from the credit provider he chose, but felt this was probably due to his negotiation of an interest rate lower than the advertised rate. Three people said they couldn’t remember if they had received a schedule or not, while the remainder said they did not receive one from any lenders they approached. It is, of course, possible that some or even all of these received a schedule but did not remember it.

If yes, how important was the comparison rate in making your decision?

For those who received a schedule of rates or were aware of it when making their decision, the comparison rate had a varied impact upon their final choice. For three it was the most influential aspect, with the most adamant stating:

It was the basis upon which we were shortlisting products. We put a lot of faith into comparison rates, the rate to compare products.

One respondent believed that the rate helped to compare products and convinced her that she was ‘getting a good deal’, while for another ‘it was more important than the actual interest rate’.

For a variety of reasons, the other people who were aware of the rate did not see it as particularly helpful or influential. One did not have a choice of lender, another seemed committed to her existing institution, while a third said 'I guess I didn't understand it enough to put much weight in it'. A lender's published variable or fixed rate was more important to one interviewee, although her understanding of the comparison rate seemed poor.

A few who used the comparison rate also mentioned the importance of having trust in the figures that were provided. As one said:

It's a real trust thing, you are really relying on the rates to be a relatively independent benchmark. We had to use that to trust it, because you don't have time to drill down through every single product.

Although not a widely shared view, there was some concern about the comparison rate's validity as a measure of loan cost, given the complexity of factors that lead to its calculation:

Sometimes I get sceptical about a comparison rate, being a figure that is easily manipulated by the financial institution to, you know ... there can be so many provisos with these things – as long as its over \$200,000, as long as it's for thirty years, as long as it's ... – so it was a guide but I put more weight in the actual figures.

This scepticism towards the comparison rate was probably no greater, however, than that expressed towards some sections of the banking industry.

If no, how important would having a comparison rate be when making your decision?

When informed of the comparison rate, respondents expressed considerable support for the publishing of comparison rates and its utility as a comparison measure. Most felt that it would have had a significant impact on the decision they made, viewing it as useful or a 'handy tool'. The most enthusiastic response came from one first home buyer: 'I reckon it would be now that I understand it, that would be huge'. For one person, other factors such as the flexibility of the loan would have been far more important, while another said that comparison rates didn't matter because 'I have the broker doing the work'.

Feeling about the loan now

In hindsight, are you happy with the way you searched for credit and the home loan you negotiated?

The vast majority of people stated they were happy with their credit search and the loan they negotiated. The only exceptions were a person who felt restricted in her options (given her low deposit amount), and another who was unable to obtain an additional service from their bank that they would have liked. However, in answering other questions, the amount of time needed to obtain information and undertake comparison was frequently mentioned as an important factor determining search strategies and people's ability to understand a diverse and complex market. As a result, while most people were happy with the loan they negotiated, people often commented that their search was not as comprehensive as it could have been or they would have liked.

Do you think there is any information or service that could be provided to improve your ability to make a good credit decision?

A number of suggestions were forthcoming about a future service for consumers. One such service was described in the following way:

I relied on the broker to teach me a bit about the whole process, so if there was a service a bit like a broker that did the first half of what the broker does, such as tells you things you should look out for when looking for a home loan, then that would be helpful, particularly if you haven't done it before.

Another person who was unaware of comparison websites such as Cannex was equally keen to have independent information provided:

There's got to be a better way than what there is now. I mean, if you look on the web it's each bank plugging itself. So you can run searches and see how long it would take to pay off with these people or whatever, but if you actually had a website with all of them next to each other, and if it showed that comparison rate because I think that would be really useful, then it might make it a bit easier.

Similarly, a person suggested an internet, phone or email service that could answer questions about various aspects of seeking a loan, while another thought a booklet would be beneficial. The need for any service to be 'in plain English' or 'in layman's terms' was also raised by some respondents. Some suggested a new service was not necessary, as they considered their broker provided the information they required. Finally, one stated that further information was not the primary issue, but rather 'I think it's a case of "buyer beware", it's your money. You have got to educate yourself.'

9.

9. Review of the evidence and conclusion

This section provides a brief overview of the evidence collected and develops conclusions based on this evidence.

9.1 Research undertaken on MCR type interventions

Our review of research undertaken in other jurisdictions on the impact of MCR type interventions found that they were of benefit to consumers.

A 1994 survey undertaken in the UK to test consumers' appreciation of their equivalent of MCR, the Annual Percentage Rate, found a reasonable level of recognition of the term (46% of respondents knew what the acronym represented) but a fairly low level of understanding of the concept. When offered a number of definitions, only 11% chose the most appropriate, though it could be assumed from their answers that most (64%) understood that a lower APR was 'good'. Overall, 43% of respondents who had used credit in the previous five years reported considering the APR when looking at credit or loan arrangements.

Research undertaken in the USA found that the vast majority (over 70%) of those who had arranged consumer credit in the previous five years reported using the APR to compare loans, although again there was doubt about consumers' understanding of the concept. In their review of the Truth in Lending Act, the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development found that, while the APR had limitations, it was worth persevering with as a benchmark for consumer shopping. The main argument was that, due to its nearly thirty year history, consumers had developed a level of familiarity with the measure.

While New Zealand abandoned their 'annual finance rate' in 2002, this decision was not based on primary research but on a review of work done elsewhere and a recognition of the following limits of their mechanism:

- 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 (New Zealand Ministry of Consumer Affairs 2000: 24).

All these limits may apply to the MCR. Aside from the third point (when the rate is disclosed which is a factor that varies between the two regimes), they all relate to the complexity of consumer credit products. As we have stressed throughout this report, there *is* a clear tension between assisting consumers to make credit choices through the provision of simple information, and comprehensiveness. This tension cannot be completely overcome but requires the development of an optimal solution that achieves an appropriate trade-off between two attributes.

Overall consumer research undertaken on MCR style interventions indicates that they can be a useful tool for consumers, without being the entire solution for promoting more effective decision making.

9.2 Related markets and other research

Consumer credit is a complex product. It is not straightforward for consumers to calculate the 'price' of credit, given it is paid over an extended time period, the price typically includes a (changing) interest rate and various fees and charges. Loans can have numerous features and options that may or may not be of benefit to individuals, and the terms of trade are complex, technical and typically give the supplier the right to vary over the course of the agreement.

In Section 7 we looked at a number of markets for products equivalent in complexity to consumer credit. This serves to underline the difficulties inherent in understanding, and responding to, consumer decision making in deregulated markets for complex products.

Our review of work undertaken in the UK by the FSA and the sparse research undertaken in Australia found that many consumers in complex markets might consider that they had sufficient information and searched adequately, but their behaviour does not bear this out. Many simply assume that all providers are the same and therefore do not undertake extensive search. Those who do search are often overwhelmed by the information provided to them, have difficulty understanding terms used and have trouble accessing comparative information on products. Typical problems that consumers had with existing information sources included lack of specificity, complicated data, information not being up to date, too many options, and inability to apply information to their own situation.

Our review of complex markets has shown that regulators across these markets are grappling with a similar problem: how to ensure that consumers are presented with sufficient information in as simple a form as possible. The message from consumers is consistent: they want clear, simple information tailored to their situation. Of course, the nature of these markets militates against the provision of simple information without the risk of misrepresentation. The trade-off between comprehensiveness and simplicity will be different for each consumer and each market.

Not only do consumers want simple information, it is clear from the South African study we reviewed (Bertrand et al. 2005) that the simpler the information provided, the greater the take-up rate for any particular credit offer (in this case, where the increased information was simply a greater variety of loan amounts and term for the same loan conditions). Consequently it is in credit suppliers' interests to provide the least information consumers need to make a decision in their advertising and applications.

9.3 Primary research

We found that people's experience and knowledge of consumer credit markets was varied. Certainly consumers are aware that there is almost unlimited choice of provider and products for those with the requisite income and/or security. For many, this choice is initially overwhelming ('mind-boggling' and 'bamboozling' were two terms used by interviewees to describe their initial feelings), but for the most part it appears that consumers are eventually able to navigate these markets with some success.

For some, the trick is to close down options by concentrating on a few providers, particularly ones that they already have a relationship with or those with which they feel comfortable. There was a feeling amongst many participants that there is not a lot of difference between most mainstream providers in terms of interest rates and that there were clear limits to the potential returns from a long search process. The need to expedite the process to complete purchase was an important factor in some participants limiting their search.

Many of the people we talked to used brokers to assist them in their decision making, and for most this was seen as a positive experience. Brokers, it was claimed, were able to simplify and focus decision making, explain the various elements of different products and provide specialist advice. For some it appears that brokers were effectively a user-friendly customer interface to a complex web of financial providers. For many, having someone on 'their side' who appeared to understand the system and was 'independent' from it was a source of comfort.

In relation to the comparison rate itself, we found a low level of awareness and an even lower level of understanding of the concept. In our sample survey, 37% claimed to recognise the term but only 12.5% could define it as being a rate that includes fixed fees and charges. Awareness was higher amongst recent decision makers but understanding did not increase at a corresponding rate. Our one-on-one interviews supported the finding that the concept is poorly understood.

However, the comparison rate is clearly a tool that most consumers have confidence in. Most respondents who had organised credit in the past two years and were aware of the comparison rate found it helpful in making their decision (62%). Those who had a university education were much more likely to describe it as helpful than those without (85% to 37.5%).

An overwhelming 70% of respondents who already knew about the comparison rate but had not made a credit decision in the last two years felt that it would definitely be helpful in making a decision. Those who had made a decision but were not aware of the comparison rate were also enthusiastic about its usefulness, with 56.4% saying that it definitely sounded useful and a further 28.2% that it would perhaps be useful.

Consistent with research undertaken in the UK and the USA, then, our consumer research found that the MCR was a useful tool for consumers, without being a 'silver bullet'.

9.4 Conclusion

Developing interventions to encourage consumers to shop around for credit while ensuring that information is both comprehensible and comprehensive is a thorny public policy challenge. Many consumers find searching for credit daunting, and processing generic information seems to be adding to their burden. Complicating the matter further, the increasingly tailored nature of credit products means that it is often not until the application stage that the terms and conditions of a loan are set. At this stage, consumers are often 'locked in' to the supplier.

Our research suggests that there are three broad approaches available to regulators for improving information provision in complex markets:

- Setting out broad parameters for suppliers in terms of what information is to be supplied and relying largely on industry self-regulation;
- More prescriptive approach with more detail requiring information to be provided as an attempt to make comparison easier (this is where the MCR regime would fit);
- Direct collection and provision of information in a comparable form. This is the approach adopted, for example, by the Financial Services Authority in the UK in developing an online mortgage comparator.

In reality, the first two options are more like a continuum based on the degree of prescription. Any meaningful instruction about information provision has to have some level of detail regarding the information to be provided and its form. Equally, even the most prescriptive approach will include some discretion on the part of suppliers in how they comply.

The mandatory comparison rate regime is prescriptive in that its method of calculation is stipulated and how it is to be presented is tightly defined. It could, however, be more prescriptive. Some consumer advocates argue that we should return to a system which not only stipulates that a comparison rate is mandatory but also insists that this is the only interest rate that can be used.

Critics of mandatory comparison rates note that they do not provide all the information that consumers need to compare products, particularly more flexible or complex products (for example, Business Council of Australia 2005). While this is undoubtedly a valid observation, it is not particularly useful. The central regulatory issue in relation to information provisions is the trade-off between simplicity and comprehensiveness. No regime, and certainly no component of a regime, will be both perfectly comprehensive and simple. The issue is whether the overall regime or specific components assist consumers to make informed decisions. Our research found that once consumers understood the comparison rate, most felt that it would be useful in helping to make consumer credit decisions. Given the complexity of consumer credit, the issue is not whether a single indicator can encapsulate all aspects of products but whether it is helpful to consumers in decision making.

At present the key weakness of comparison rates would appear to be that most people are not aware of them. This requires some effort in publicising them. Given the crowded market faced by those trying to inform the general public, this is not an easy task. One possible

approach is to take advantage of consumers' reliance on friends and family for information and advice. Tapping into these networks may be a cost effective means of publicising comparison rates. It may be possible to run a telephone campaign to inform a sample of the population of comparison rates and rely on the friendship and family networks for this information to be disseminated more widely.

Our review has highlighted the potential for the further development of online resources to assist consumers in comparison shopping and decision making. In particular, online comparison tables that enable consumers to search for loans have a great deal of potential to assist consumers and encourage 'real' competition between providers. One of the strengths of the mandatory comparison rate regime is its use in such online comparison tables (see the 'Choice' approach or the FSA approach) where consumers key in their information and the program provides all loans for which they are eligible and that can be ordered by comparison rate. In this situation, the comparison rate is not necessarily the only decision criteria, but it is an important one that can be used by consumers as an initial filter before other elements of loans are compared.

With limited understanding apparently the norm in many areas where consumers make difficult decisions, it seems that any attempt to provide independent information is beneficial, but it will be difficult to control the extent to which this information is sought out and used. In many cases, the unavoidable complexity of some comparison measures reduces the likelihood that consumers will make the effort to understand them. Compared to equivalent initiatives, the MCR would appear a relatively straightforward, user-friendly and trusted measure to assist comparison. Our consumer research found that its major weakness was lack of consumer awareness.

There appear to be two problems in the MCR's role in advertising. Firstly, there is confusion over what it is. Through our focus groups it became apparent that some consumers, when faced with a quoted interest rate and a comparison rate, assumed that the latter was an industry standard. So if the quoted rate was 6.5% and the comparison rate was 7.2%, this is interpreted as the advertising supplier's interest rate being lower than the market average. This is partly about the confusing nature of the name itself, although UK research suggests that it is difficult to develop a name and simple explanation that is entirely satisfactory.

The second problem is that a response by suppliers to the requirement to include the MCR when advertising interest rates for fixed term credit has been fewer advertisements including interest rates. This is difficult to address. It is possible to mandate that only the MCR be used, which would assist in lessening confusion referred to above, but would be unlikely to encourage suppliers to advertise rates and would probably exacerbate this problem.

The pre-contractual component of the MCR regime does not appear to be effective in its current form. Requiring suppliers to have comparison rate schedules available at their premises is of little use, given the low level of consumer recognition. Many consumers have difficulty comprehending the information specific to their actual loan without having to digest information related to hypothetical loan amounts. This bears out the importance of conducting consumer research on how people are likely to react to different approaches to information provision. For financially literate people, it may seem that examples of typical

loan amounts could only be helpful; for many, however, more information simply adds to their confusion. As the research undertaken in South Africa demonstrates, consumers are likely to be confused or put off by the provision of extra information.

Provision of schedules upon application is also problematic without increased consumer awareness. Even if more information is provided and understood at the application stage, many consumers are 'locked in' to the current supplier and so are not in a position to comparison shop. The schedules set out typical loan amounts that may not relate directly to the loan being applied for by the consumer. In addition, consumers will receive a lot of information at this point and, if they are not aware of the MCR and what it is, they are unlikely to pay much attention to it.

The recently released *Pre-Contractual Disclosure and the Uniform Credit Code Consultation Package* did not consider whether the MCR should be part of the pre-contractual financial and other information to be provided to consumers, as it was felt that this issue would be covered in the Regulatory Impact Statement. It would, of course, be possible to include the MCR in this information, providing consumers with an MCR relevant to their proposed loan and thereby overcoming one of the drawbacks of the current regime.

Our research has demonstrated that many consumers are uncertain and confused when searching for and negotiating credit. The MCR is a tool used by those who know about it. However, it is considered potentially useful by those who do not. There are two main challenges to improving its usefulness:

- Improving consumer awareness and understanding of the measure through public information and consumer education campaigns. This is particularly important if it remains mandatory to include the comparison rate when interest rates are advertised for fixed term consumer credit;
- Adjusting the current pre-contractual provision of the MCR so that consumers are provided with a comparison rate for the loan amount in which they are interested. The importance of pre-contractual disclosure is unclear, given that many consumers have effectively made their decision by this stage.

There is a need for more research on patterns of information seeking and options for information dissemination by various modes, including word of mouth, family, networks, print and online. People's search behaviour and comprehension of information is not predictable, underlining the importance of conducting usability type research on different options for information provision. The work undertaken by the FSA in the UK provides an example of this type of approach.

Ensuring that consumers negotiating complex markets have access to comprehensible and comprehensive information is an endemic issue for public policy. Whether the MCR is retained or not, the issue will remain. In this review we have found that the MCR is a useful tool for consumers and have made some pragmatic suggestions for improving its usefulness, as well as pointing to the need for more research on how consumers go about information search and, in particular, testing different approaches to information provision with consumers.

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