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30 July, 2004

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To Whom it May Concern

Improving financial literacy in the community is a necessity if Australia is to better realise economic opportunities and improve social cohesion. As such MasterCard International is supportive of any government measures aimed at addressing this issue. However, if change is to occur it needs to happen in the full context of the broader issues of debt in Australian society and missed economic opportunities.

Improving consumer literacy is only one part of the change required to resolve the problem. Financial literacy is about empowering Australian consumers with the right information to make the right choices. Full and accurate information is vital not only to help the consumer make these important decisions, but also to allow the lender to make the right decision when they are faced with the choice of providing (or not providing) credit to an applicant.

MasterCard supports the Taskforce's efforts to improve the financial literacy of Australia's consumers. Indeed MasterCard conducts, sponsors or supports similar financial education programs all over the world. The end goal of such initiatives is to help consumers help themselves. We need to realise, however, that while 'help yourself' programs like those recommended by the Taskforce will assist the great majority of Australian consumers there will always be a significant number that "fall through the cracks" of all financial literacy programs. It is the role of government not only to promote and implement education programs, but to create safety nets for those that miss out on the education. It is in this light that MasterCard advocates a much needed overhaul of a very important safety net – the Australian centralised credit reporting regime.

MasterCard believes a robust financial services industry which serves the needs of its consumers requires three essential pillars:

1. A level playing field to promote competition;
2. Bankruptcy laws to deal with moral hazards; and
3. Access to positive credit information.

The Australian financial sector, more or less, provides the first two pillars, however an antiquated privacy regime has held back the provision of the third essential pillar. In this light the existing credit reporting model, regulated by the Commonwealth *Privacy Act 1988*, leads to unnecessarily high levels of risk in assessing finance applications and is clearly out of step with international best practice.

Incomplete Information

MasterCard accepts and supports the discussion paper's recommendations that there needs to be developed a pragmatic course of action in relation to improving consumer literacy. However the paper assumes that the lender always has a complete understanding of its products and the customers that use them. This is simply not the case.

While the lender understands the financial products that they sell, they are fairly illiterate when it comes to understanding whom they sell to. A lender relies almost exclusively in some instances on a customer's declaration as to their current financial position. A lender in Australia is not afforded the same tools of customer risk assessment that are available in almost every other country in the world, including countries such as the United States, United Kingdom, Canada, Hong Kong, and Singapore. The lack of comprehensive credit reporting in Australia means debt defaults are much higher than they should be¹, and according to a study commissioned by MasterCard, the Australian economy is forgoing up to \$5.3 Billion² in GDP over the next ten years.

MasterCard, and other members of the credit provision industry, believe that the Government is better able to manage the fortunes of the economy by facilitating an improvement in the quality of consumer credit, while at the same time ensuring consumers are not entering into never-ending cycles of debt. Comprehensive credit reporting is an essential ingredient in the sustained achievement of these objectives.

Although MasterCard does not have a view on the long term prospects of the Australian economy, the existing issues with managing household debt will blow-out significantly when the inevitable economic downturn eventuates. Hong Kong unfortunately learnt this lesson too late, but it (together with other Asian economies), has hastily moved to implement a positive credit reporting system, coming in line with the other developed countries mentioned above. In our view it would be an extremely beneficial move for Australia to follow in step with this change, ensuring that it is better able to engineer a soft landing if such a downturn eventuates.

¹ *The Value of Comprehensive Credit Reports: Lessons from the US Experience* by Prof. Barron (Purdue University Illinois) and Prof. Staten (Georgetown University, Washington D.C) November 2001, found that credit defaults could be reduced by up to 63% if comprehensive credit reporting was available in Australia.

² *Dealing with Debt Default - An Analysis of the Economic Benefits of Allowing Comprehensive Credit Reporting in Australia*. ACIL Tasman March 2004

The Importance of Positive Credit Information

Credit markets are notoriously information inefficient with asymmetries existing across the spectrum of lenders and borrowers. This asymmetry prevents lenders from knowing enough about the borrowers, and from borrowers knowing enough about the lenders' willingness to lend at different risk premiums. This common environment severely hampers the efficiency of the credit markets. The resulting inefficiencies impose high costs on both the financial industry and consumers in the form of lower returns for the former and higher costs in getting credit for the latter. This information asymmetry could be partially addressed when "negative" credit information is made available – information on delinquent behaviour which includes credit in arrears, court judgments on debts, personal bankruptcy and the like. This information asymmetry can be said to have been closed, however, only when "positive" information is also made available – information related to prospective borrowers' outstanding debt obligations, types of credit and their histories, even when the borrower has never defaulted or gone bankrupt.

In virtually all advanced economies such positive credit information is made available to close the information asymmetry through the establishment of a comprehensive positive credit information system, usually known as a positive credit bureau. The operations of the positive credit bureau are usually regulated to protect consumer privacy, as is demonstrated in the privacy sensitive United Kingdom.

The net effect of the availability of such positive credit information has been a lowering of the credit risk inherent in such markets. In a study³ conducted on 43 countries, including most OECD countries, it was estimated that the sharing of positive credit information reduced credit risk by between one third and one half. It has been found that securitisation of mortgages, which depends on positive credit information, had lowered mortgage rates by up to two percentage points in the US,⁴ a very significant benefit to US consumers and the financial industry. The positive credit bureau thus allows credit provision to be more targeted and priced appropriately. Likewise, it has allowed borrowers to better signal their credit worthiness to the lending community.

Furthermore, discussions MasterCard has had with financial counselling organisations also reveal the social costs associated with debt defaults. A number of these groups support a move to positive credit reporting, as they see a direct correlation between the problems being experienced by consumers today, with the lack of credit information available to lenders at the application assessment stage. On the face of it, it is quite clear that the economic and social arguments point in favour of change.

Consumer Empowerment

An individual's credit record is a very valuable tool. It allows the consumer to understand which behaviour they need to undertake in order to influence their record, and therefore their risk profile. The better one's risk profile, the better their ability to access better and cheaper financial services. Under the existing Australian negative regime, only current lenders have a complete picture of a particular consumer's credit record. Neither the consumers themselves, nor prospective lenders have access to such a vital asset. This not only inhibits competition amongst lenders, but deprives consumers of the facts they need to know to maximise their negotiating power with financial services providers. The only solution to this lack of consumer empowerment, and restraint on competition, is the amendment of privacy laws to allow more comprehensive credit information to be held by credit reporting bureaus.

³ Japelli, Tullio and Pagano, Marco, 2000, "Information Sharing in Credit Markets: The European Experience", *CSEF Working Paper No. 35*, Centre for Studies in Economics and Finance, University of Salerno

⁴ Kitchenman, Walter, 1999, *US Credit Reporting : Perceived Benefits Outweigh Privacy Concerns*, Tower Group, Needham.

Overall recommendation

Any government and industry efforts aimed at understanding and changing consumer behaviours in regard to financial decision making will be flawed unless they are accompanied by structural changes in the way in which we provide access to financial products. Eliminating the potential to enter into bad debt should work hand in hand with programs geared to deliver long term behavioural change.

MasterCard would be reticent to join efforts to effect this change unless this structural change occurs.

We would be delighted to discuss this matter with you in greater detail at a time convenient to you, or to respond to a government review of credit reporting in Australia.

Sincerely



Leigh Clapham
Senior Vice President &
General Manager – Australasia