

## **Retail Financial Products, Housing Loans, Disclosure and Literacy**

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21 February 2008

Incompatibility between financial product complexity and financial literacy levels is a hot topic, reflected in the recent conjecture of the Chair of ASIC's Retail Investor Task Force that "...many [retail investors] must be investing in products they don't understand". But finding solutions is difficult, and it is not clear that ASIC's tripartite approach of improving disclosure, education and advice has worked successfully.

Housing finance is a good example which emphasizes that it is not just complex investment products where the problems lie.

Here, disclosure has been tried. Lenders are required to provide a "comparison rate" figure which incorporates the effect of any non-optional fees into an augmented borrowing cost. This single figure is meant to reflect the overall loan cost, making loan shopping easier. Does it enable an accurate comparison? Not really! Is there evidence that customers pay attention to it? Who knows?

A major weakness is that the comparison rate is calculated using the 25 year contractual loan life, spreading up-front (and other) fees over the life of the loan as if they were an additional interest charge. But the average life of a mortgage loan is perhaps as low as 5 years. Spreading a fixed up-front fee over 5 years rather than 25 years substantially increases the annual interest rate effect.

Consider a standard variable rate loan for \$250,000 at a quoted interest rate of 9.14% p.a. and an up-front fee of \$660. Using the 25 year maturity, the comparison rate is 9.17% (or three basis points higher than the quoted rate). If an actual maturity of 4 years is used, the comparison rate becomes 9.22%. The impact of using the actual maturity increases with the size of up-front fees.

How much do up front fees vary? Information on 109 standard variable interest rate loans was available from Cannex on Feb 21, 2008. For 20 loans there were no up-front fees, 67 were over \$500 and 2 of those had fees over \$1,000.

The additional cost of borrowing is positively related to the size of up front fees, but ongoing account fees also have a significant effect even though the fees might appear small.

For example, an apparently modest monthly fee of \$20 adds around 12 basis points to the effective cost for the \$250,000, 25 year loan. Why so large an effect? Over time, as the

loan size declines, the fee of \$20 becomes large relative to the outstanding balance. However, if the borrower pays the loan out in a few years (such as by selling the house) the effective cost calculation overstates the impact of the ongoing fees.

The comparison rate also does not take into account any additional fees of early termination to transfer to another lender, a focus of recent political attention. And sensible switching decisions require effective comparison of all-up borrowing costs, which the preceding example suggests is problematic.

Of course, consumers might be sufficiently well-informed such that market pressure forces those lenders with higher fees to quote lower interest rates to get business! But the Cannex data shows no obvious negative relationship between quoted rates and fees charged, and the comparison rates ranged from 7.87 to 9.24 per cent.

What lessons should we take from this?

First, there is little evidence that lenders trade-off lower quoted rates for higher fees. This could mean that the comparison rates work (since consumers don't fall for the lure of lower quoted rates and ignore the impact of fees). Or it could be that customers don't properly take fees into account!

This is suggested by the second observation, that there is a large spread of quoted (and comparison) rates (close to 150 basis points) for a standard housing loan product. Those differences could reflect other non-price features of the loan, but may also indicate poorly informed (or poorer credit quality) borrowers not flocking to (or eligible for) the cheapest rate. Ascertaining the extent to which the higher rate lenders provide higher loan-valuation loans or apply lower credit standards would be necessary to answer this question.

Third, comparison rates do not accurately reflect the true impact of up-front fees on borrowing costs, because of the 25 year loan life assumption. The real impact is substantially greater, and borrowers anticipating a quick loan repayment should steer well clear of high up-front fee loans.

Fourth, account fees significantly increase the comparison rate, but if the borrower expects to pay the loan out early, this type of fee may be preferable to up front fees.

Finally, variable rate borrowers are exposed to future idiosyncratic interest rate changes made by lenders. Until the recent financial crisis, this may not have been a major risk. But with even major banks now willing to risk the wrath of the Federal Treasurer by loan rates different to official cash rate changes, this exposure is potentially important.

Given the current concerns about the compatibility of complex financial products and low financial literacy, the case of housing loans is salutary. A simple, albeit imperfect, indicator of all-up borrowing costs is probably better than nothing, but the current one is far from adequate. And while lenders set, and market, loan terms based on their

understanding of consumer behavior, there is little publicly available analysis to guide policy makers on how retail consumers interpret and react to such information, and thus on how to implement an effective disclosure regime. Nor is it obvious that commission-based mortgage-sellers have the right financial incentives to provide the best advice.