Solutions for Compliance

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Project Manager
Retail banking market investigation
Competition and Markets Authority
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Dear Sir/Madam

I greatly welcome the CMA's market investigation into the supply of retail banking services to PCA customers and SMEs in the UK, and the opportunity to submit evidence.

I should state at the outset that I am convinced that action to remedy market defects that restrict and distort competition in these markets, and that have had other pernicious effects, is long overdue.

My evidence is largely based on my background of many years in a wide range of management roles in the UK and overseas in one of the UK's largest banking groups, culminating in ten years as Compliance Director in the 1990s, and subsequently from 2000 until 2009 as Compliance Director of the Banking Code Standards Board (BCSB)[i]. Following the reorganisation of the BCSB and the transfer of a large part of its functions to the FSA, now the FCA, I have been working as an independent consultant. My recent work has been mainly concerned with the provision of free debt advice and the monitoring of standards of conduct in the high cost short term credit market in the UK.

This note draws heavily on consultation responses I submitted to the Independent Commission on Banking (the Vickers Commission) in 2010 and 2011. My welcome for your investigation was anticipated by a comment I made to the ICB in November 2010: *The cost of a thorough inquiry by the Competition Commission, or a successor body, does not appear disproportionate to the consumer protection, competition and economic efficiency issues at stake here.*

I also had the opportunity to appear on behalf of the BCSB before the Competition Commission group which investigated the Northern Ireland PCA banking market, reporting in 2007. The findings of Sir Donald Cruickshank's review of retail banking, published in 2000, were a major factor taken into account when we were setting up the BCSB at the same time. These experiences helped me develop the thinking put forward in this submission.

1. The key issue: the flawed 'free-if-in-credit' banking model

In the UK retail market, the banks seem to have staggered from one mis-selling scandal to another: pension transfers, endowment mortgages, precipice bonds and PPI. All of these have reinforced the ever more strident calls for the banks to treat their customers fairly, the clear implication being that they have been failing to do this. The banks narrowly escaped (only in the Supreme Court) from being brought to book by the OFT, at a potential cost of several billion pounds, for levying unfair and excessive overdraft penalty charges over a number of years. And of course the Court did <u>not</u> rule that the charges had been fair. Since then the big banks threw in the towel on PPI, perhaps influenced by the fact that they were already on central bank life support and therefore had little more to lose.

A glaring reason why the banks have consistently over-sold poor value or excessively risky products to their customers is that they have not been charging their personal customers a realistic price, if any, for the core service that their customers need, namely a secure and reliable system for keeping money safe, for making and receiving payments, and for cash handling. If the money transmission charges <u>per transaction</u> for small business banking in 2000, as collated by the Competition Commission, were any guide to the banks' costs, then it would appear that banks could be 'losing' around 50p, and possibly up to 75p or more, for each cheque, automated payment or cash handling transaction processed free for a personal customer. Even if the true costs of such transactions were only one tenth of the amounts charged to small business customers, the volumes of personal banking transactions are such that this would still represent a massive unremunerated cost burden.

A clear picture emerges of an industry that seeks to cover the cost of providing its core service almost wholly on the basis of cross-subsidisation from the selling of over-priced peripheral products and services. It is no wonder that the regulators, and the Financial Ombudsman Service, have been engaged in a constant struggle to deal with the latest mis-selling scandal. Often it has been the less sophisticated customer that has been the victim of the mis-selling and, in the case of overdraft and credit card penalty charges, a case can be made that the banks have been harshly overcharging their more vulnerable customers in order to subsidise those more sophisticated and wealthy, acting more as the Sheriff of Nottingham than as Robin Hood.

Your *Statement of issues* refers in paragraph 49 (d) to "the ability of incumbents to use PCAs and BCAs as a gateway to cross-sell other products". Sadly, 'cross-sell' should all too often be replaced by 'mis-sell'.

In economic terms, failure to charge a reasonable price, or indeed any, for a core service militates against rational and efficient behaviour on the part of customers as well as providers. Why worry about making repeated small withdrawals from cash machines, or writing cheques for tiny sums, if it costs you as the customer nothing to do so? What would happen if gas companies charged nothing for gas but relied on sales of ancillary services such as insurance and boiler servicing, or charging draconian penalties to customers who pay late, to recoup their costs? The outcome would certainly not be environmentally friendly.

I wrote to the ICB that not charging a reasonable price for the core service also limits the scope for competition and is therefore a barrier to entry, whether or not it is intended as such. Why shop around for current account services if the price is the same everywhere, ie nil (so long as you do not attempt to withdraw money beyond your credit balance or any agreed overdraft facility)? This clearly chimes with your *Statement of issues*:

> *Hypothesis 1b (Assess): Product and pricing structures exploit customers' cognitive limitations and behavioural biases and inhibit their ability to compare offers and understand true costs of banking products.*

Paragraph 36 in the *Statement of issues* acknowledges that customers' cognitive limitations and behavioural biases "may be caused or exacerbated by free core current account services (debit accounts and money transmission services) for PCAs and equivalent initial offers on BCAs".

It is evident that I would add to *Theory of harm 1* that there are weak or negligible incentives for customers to shop around for PCAs because of the absence of a transparent price comparator, or indeed any basis for price comparison, for the core services they need to purchase.

I appreciate that this is a complex and politically sensitive issue. The banks have argued that being the first to re-introduce charging for standard personal current account money transmission services would be 'suicidal', but in response one could point out that some of the lengths they have gone to in attempting to avoid this have also been hugely damaging to their reputations and bottom line. Government or regulatory agencies will not want to be seen to be forcing the banks to charge for services that the public seems to believe can be provided without cost, and there are clearly risks that ill-considered change would replace one situation of inadequate competition with another. However the amounts at stake are high, with questionable charges and sales of unsuitable products having run into £ billions in the last decade and more.

It is clear that the PCA business model in the UK, based on cross-subsidising free-if-in-credit banking for personal customers by over-charging (and over-selling) on other products has not at the end of the day worked financially for the banks. Nor has it worked for the millions of customers 'ripped off' to pay for those people, often the better-off or more sophisticated, who enjoy free banking.

The ICB asked whether pricing patterns should be regulated. While such interference with free markets can inhibit competition, it ought to be considered where the market cannot be relied upon to bring about fair pricing, which can include where there is a monopoly or an oligopoly. The FCA has now entered the field of price-regulation, by price-capping high cost short term credit market, so the precedent is there, with plenty of comparisons available from the utility and transport sectors.

A related question I posed back in 2011 was: should more be done to educate and prepare some banking consumers, who have enjoyed a free or unrealistically cheap ride for years, that the health of the industry and fairness to other customers mean that this unfair and economically unsound advantage must come to an end? Rendering the products of other industries safer has often imposed costs which have at least partly been transmitted through to their customers, and no one who seriously wants to see better protection for those who have bailed out the banks, or those who have been exploited by the banks, should expect such vital improvements to come without cost. I was heartened to hear Andrew Bailey at the FSA, and subsequently Martin Wheatley as future CEO of the FCA, questioning the future of ‘free’ banking in the UK, and at least one personal finance journalist entering the debate.

2. Financial stability and promoting competition

There are tensions between creating financial stability and promoting competition, but neither unbridled competition (the law of the jungle) nor totally stability (a cartel in a cosy relationship with the central bank, or even a nationalised banking system?) is the right answer. Competition can deliver great benefits in terms of consumer choice and market efficiency (if there is a route for weak or incompetent players to leave the game), but the world of sport clearly exemplifies the need for clear and effectively enforced rules and the same applies in the financial markets.

3. An over-concentrated retail banking market

My comments on the flawed ‘free-if-in-credit’ personal current account model in the UK are intended to make a specific contribution to addressing what is an over-concentrated UK retail banking market when compared with almost any other industrialised nation. This over-concentration has had adverse implications both for competition and for addressing or even alleviating the ‘too big to fail’ issue.

4. Comparative analysis with other banking markets

The Statement of issues recognises the scope for comparative analysis with other banking markets (paragraphs 41 and 45), and I would like to endorse the value of learning from experience elsewhere.

5. Opacity of bank pricing and costing

If an adverse effect on competition (AEC) is found to exist, and I appreciate this comment may be premature, the evaluation of possible remedies will be made challenging by the opacity of bank pricing and costing, pointing to the need for very thoroughgoing analysis of any cost estimates that are provided.

CONCLUSION

I hope these comments are helpful and I would of course be happy to elaborate to the extent I can on any of the points I have made.

Yours sincerely

Adrian Lloyd

Adrian Lloyd
Managing Director

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[i] While, as stated, my views and analysis were based on my experience in banking and latterly at the BCSB, and I made some similar points in my evidence on behalf of the BCSB to the Northern Ireland PCA banking market investigation, the evidence I have submitted in this letter is my personal responsibility and it does not carry the endorsement of the BCSB, its successor the Lending Standards Board, or any other organisation.