Competition & Markets Authority Retail Banking Market Investigation:
Provisional Findings Report* and *Notice of Possible Remedies

Supplementary comments from Virgin Money on free-if-in-credit (FIIC) banking, market concentration and profitability analysis

1. In this submission, we discuss in greater detail some of the issues which we raised in our letter in response to the CMA's *Provisional findings report,* submitted to the CMA on 18th November 2015, as well as in previous submissions to the CMA. In particular:

    - we agree with the CMA that free-if-in-credit (FIIC) banking contributes to low levels of consumer engagement;
    - we believe that FIIC also contributes to low levels of switching in the personal current account (PCA) market;
    - we are concerned that FIIC leads to significant cross-subsidies;
    - we believe that well-targeted interventions by the CMA could encourage a market-driven move away from FIIC;
    - we think that the CMA should consider whether there may be tacit coordination between the 'effective oligopoly' of four large incumbent banks; and
    - we think that it would be helpful to resolve the issue as to whether PCAs are profitable (on a standalone basis) or are loss-leaders.

FIIC banking

We agree with the CMA that FIIC banking contributes to low levels of consumer engagement

2. In paragraph 178 of the CMA's *Notice of possible remedies*, the CMA says that, "it is possible that FIIC has some impact on the lack of customer engagement". In paragraph 7.176 of the CMA's *Provisional findings report*, the CMA says that, "FIIC reduces to some extent awareness of costs (direct and indirect) that customers are incurring". We agree with the CMA's analysis, but think that it presents an understatement of the negative impact on customer engagement of the complexity and opacity of PCA pricing.

3. We fully agree with the CMA that large parts of the PCA market are characterised by low customer engagement, but believe that the blame for this should not fall on customers. We believe that customer disengagement results from the FIIC model, which makes it very hard for customers to understand the true cost of their PCA banking, or the costs of PCAs of other banks. This is because of their complexity and opacity and because of the limited degree of financial literacy of many people using PCA products, including overdrafts. We note that the *UK Financial Capability Strategy*, published in October 2015, found that 36% of the UK population cannot calculate the impact of a 2% interest rate on £100 in savings, and that 22% cannot read a bank statement.

4. In paragraph 7.72 of *Provisional findings report*, the CMA says that, "Despite the general accessibility of information, we found that customers' ability to assess this information and identify the best-value PCA for their needs was likely to be impaired by the complexity involved in comparing different PCAs". Furthermore, in paragraph 53 of the Summary in *Provisional findings report*, the CMA says that, "we found that overdraft charges are particularly difficult to compare across banks, due to both the complexity and diversity of the banks' charging structures but also customers' difficulties in understanding their own usage".

5. We note that, in paragraph 59 of the Summary in *Provisional findings report*, the CMA says that, "Rather than the FIIC model itself, the lack of triggers and customers' perceptions of the lack of benefits of searching and switching are the most significant factors for low customer engagement". We accept the CMA's point that the evergreen nature of PCAs is very likely to lead to lower switching rates than, say, motor insurance, where customers have to renew each year.

6. However, we think that "customers' perceptions of the lack of benefits of searching and switching" are a direct result of the FIIC model itself, through the complexity and opacity of its pricing.

We believe that FIIC is a major contributor to low levels of switching in the PCA market

7. Given the above analysis of the impact of FIIC banking on customer engagement, we are surprised that the CMA says, in paragraph 59 of the Summary in *Provisional findings report*, that, "we have not found that the FIIC model is contributing to low switching rates". We are disappointed that, looking at FIIC banking through the narrow prism of its perceived impact on switching, the CMA is minded not to consider possible remedies in relation to problems arising from the complexity and opacity of PCA pricing.

8. We note and consider below, in paragraphs 9, 10 and 11, the reasons that are given by the CMA for not finding that the FIIC model is contributing to low switching rates. However, we do not consider these reasons convincing or adequate to support the CMA's provisional decision not to consider possible remedies for FIIC banking. This is all the more surprising given that serious concerns about FIIC banking have been raised in previous reviews and by leading authorities such as Sir Donald Cruickshank, Lord Turner and Andrew Bailey, and in the input from a range of banks, including the large incumbent RBS, which is set out in paragraph 7.41 of *Provisional findings report*.

9. In paragraph 178 of *Notice of possible remedies*, the CMA points out that switching rates in countries such as the Netherlands, where FIIC is not the prevailing model, are very similar to the UK. However, other things being equal, we would expect PCA switching rates to be higher in the UK, because of the availability of CASS and the extent to which mobile and online banking is being adopted by customers in the UK. This is evidenced by the CMA's observations, in paragraph 30(a) of the Summary in *Provisional findings report*, that, "The UK has one of the highest rates of mobile banking adoption in the world" and, in paragraph 54 of the Summary, that, "The internet and increasing digitalisation of banking has facilitated customer engagement with their own account".

10. In paragraph 178 of *Notice of possible remedies*, the CMA points out that switching rates for BCAs, where pricing is mainly transaction based, are also low. We believe that BCA switching rates are likely to be depressed relative to PCA switching rates because SME customers have relationship managers and may well believe, whether justified or not, that having a long-term relationship with the same bank will help them to be able to borrow from the bank, if and when they need to do so. Also, in the absence of Account Number Portability, SMEs are likely to be reluctant to switch BCAs because of the inconvenience of having to ask their customers to change their payment instructions.

11. In paragraph 59 of the Summary in *Provisional findings report*, the CMA says that, "banks have an incentive to set high overdraft charges due to the lack of customer engagement on overdraft charges and the existence of barriers to searching and switching for overdraft users, whether or not banks operate an FIIC model".

12. We accept that this is a true statement, and think that it supports the case for considering possible remedies to address poor outcomes for many overdraft users, who under FIIC banking subsidise other customers who enjoy genuinely free banking. This seems especially concerning because, in paragraph 53 of the Summary, the CMA says that "heavy overdraft users were in particular less likely to switch but as our pricing analysis suggests have the most to gain from switching".

13. We therefore find it hard to agree with the CMA's findings that the FIIC model has some impact on the lack of customer engagement, but that it does not contribute to low switching rates.

We are concerned that FIIC leads to significant cross-subsidies

14. Whether FIIC banking contributes to low switching or not, we believe that other distortions arising from the widespread use of the FIIC model merit further and more detailed consideration by the CMA. In particular, we think that the CMA should examine cross-subsidies between different groups of PCA customers, bearing in mind the view expressed by Sir Donald Cruickshank to the Parliamentary Commission on Banking Standards that the continued existence of such cross-subsidies is evidence that the PCA market is not competitive.

15. In paragraph 7.37 of *Provisional findings report*, the CMA says that 54% of PCA customers did not incur charges for usage of their PCAs in the last quarter of 2014, whilst 46% incurred charges, the most common being overdraft charges. The average amounts quoted in paragraph 51(c) of the Summary in *Provisional findings report* - £70 a year overall, £140 a year for overdraft users and £260 a year for heavy overdraft users - are potential savings rather than total costs to customers, but they indicate the burden borne by almost half of PCA customers, including in particular overdraft users.

16. However, as noted in paragraph 53 of the Summary in *Provisional findings report*, overdraft users are less likely to switch, and heavy overdraft users are, in particular, even less likely to switch. We also note that, in paragraph 52 of the Summary, the CMA says that, "Our quantitative analysis of the characteristics of customers who searched or switched had higher income, higher balances and higher education levels than those who did not. Customers with higher income and higher education levels were also more likely to switch".

The combination of these findings suggest that a significant proportion of the £8.7 billion per annum income which banks derived from PCAs in 2014 came from customers who were less affluent and less financially literate, and more likely to use overdrafts.

17. The continued existence of cross-subsidies stems from the FIIC banking model. In addition, under FIIC banking, the headline offer of free banking appeals to, or even takes advantage of, consumers' bias towards optimism. In paragraph 53 of the Summary in *Provisional findings report*, the CMA says that, "Our quantitative analysis of actual versus perceived behaviour found that many overdraft users believed that they did not use an overdraft or underestimated their usage".

18. This finding is consistent with the comment made by the PRA, in considering how banks might pass on the costs of ring-fencing. The PRA stated that "behavioural biases can lead to failure by customers to take into account the costs of non-prominent fees and add-on products". It is also consistent with the comment made by the FCA, based on research on mortgage customers carried out by ESRO, that, "they [customers] tend to place excessive focus on short-term costs and have a potentially over-optimistic view of what the mortgage market and their financial situation might look like in two years' time. Such short-termism conflicts with the long-term commitments and risks associated with a mortgage".

19. Although, as the CMA says in paragraph 180 of *Notice of possible remedies*, free banking meets the requirements of many customers, it seems unfair that customers who enjoy genuinely free banking should be cross-subsidised by users of overdrafts. We think that the CMA should do further analysis on the extent and scale of cross-subsidies within the PCA market, and consider whether these cross-subsidies are excessive, unfair and/or regressive.

We believe that well-targeted interventions by the CMA could encourage a market-driven move away from FIIC

20. We note the CMA's comment, in paragraph 179 of *Notice of possible remedies*, that, "even had we taken a different view of this matter, it was not clear to us what specific remedies might be proposed in order to prohibit or restrict FIIC". We have therefore considered possible remedies which might address problems associated with the FIIC model in ways that would lead to better outcomes for consumers and would offer an appropriate degree of protection for consumers who may, in some cases, be less affluent and less financially literate.

21. We think that a market will work best for customers where firms compete on headline prices which customers can easily understand, and service quality, rather than on non-prominent and complex fees and charges. We continue to believe that a move away from FIIC banking would be good for customer engagement, switching and competition in PCAs.

22. We believe that it is preferable for such a move to occur as a result of market forces rather than regulatory intervention. In previous submissions, we have expressed the view that such a move seemed unlikely to occur through market forces: we thought that it would be difficult for any one bank to introduce charges on their own and that an agreement between the banks to introduce charges could be seen as collusion.

23. More recently, there have been some positive signs related to reward accounts, as was discussed in paragraph 37 of the Summary in *Provisional findings report*. The Santander 123 account, with rewards and charges, has been very successful, and responses by other banks, such as RBS and Barclays, may lead to a broader move away from FIIC banking.

24. We think that possible remedies should be designed to encourage this trend, provided that they lead to good outcomes for consumers and offer appropriate consumer protection.

25. As stated above, we think the CMA should carry out further analysis on the extent and scale of cross-subsidies between different groups of PCA customers. We also think that the CMA should introduce remedies that restrict any charges that are found to be excessive, unfair (in the sense that they are not consistent with treating customers fairly) and/or regressive. Such an approach would be consistent with interventions to limit debit and credit card interchange fees, and to limit and then ban mobile roaming charges, and we think it would encourage a move away from complex and opaque pricing and towards more transparent up-front pricing.

26. We note, in this regard, the comments on FIIC banking made by John Fingleton, former OFT Chief Executive, in evidence to the Parliamentary Commission on Banking Standards:

    our view at OFT was that explicit, transparent pricing should be on the things where the banks make all their money; forgone interest and overdraft charges were the least transparent and least visible to the customer…Our preferred solution would have been to try to stem all of the alternative sources of revenue and channel competition into up-front charges.

27. We believe that the imposition of limits on such charges would act as an important 'nudge' to the four large incumbent banks to consider moving away from FIIC banking and towards simpler and more transparent headline pricing and charges.

28. If the CMA is unable to restrict charges that are found to be excessive, unfair and/or regressive, either because of limitations on its powers, or because of the limitations of its financial analysis, an alternative approach, which we have already suggested, is that banks should pay credit interest on PCAs at or above a minimum level.

29. We think that this would lead to PCAs similar to reward accounts, but easier for most customers to understand than new complexities introduced by the need to assess and compare reward benefits with attractive headline rates, but with limits. In suggesting this, we note that the ESRO research on mortgages says that, "Many consumers found cashback deals and other rewards appealing, and particularly eye catching. [...] Most, however, found the process of calculating the cost of a particular product relatively difficult, and were therefore content to make more rudimentary comparisons, such as between rewards offers themselves, rather than between different products".

30. Whether through the options we suggest, or through alternative remedies, we believe the CMA should give further consideration to ways in which PCA providers could be encouraged to restrict their reliance upon complex and opaque fees and charges, and to compete with one another on headline prices that are clearer and easier for consumers to understand. We believe this would be more effective in encouraging customer engagement, switching

and competition in PCAs than a package of remedies that accept the status quo in relation to FIIC banking and instead aim to bring more transparency and comparability to the existing array of complex charges.

31. We recognise that a move away from FIIC banking would be resisted by customers who currently enjoy genuinely free banking. However, many of these customers would themselves benefit from moving to a reward account, or to a PCA with credit interest at or above a minimum level.

32. We further recognise that many customers and the media may react negatively to the fact that banks were now 'explicitly' charging for PCA services that were previously 'free'. We therefore suggest that the CMA might ask the Financial Conduct Authority (FCA) to monitor, and ensure, that the banks do not gain from a broader move away from FIIC banking.

33. Consideration might be given by the CMA to a rule, equivalent to Article 3 of the Interchange Fee Regulations for credit and debit cards, which prohibited card issuers from introducing new fees to offset reductions in their income arising from the capping of credit and debit card interchange fees.

34. These possible remedies do not address the lack of prompts arising from the evergreen nature of PCAs. This could be addressed by requiring customers to renew their PCA periodically - say, every five years. We recognise that, in the short term, many customers would probably opt to renew their existing PCA arrangements. However, over time, this remedy might be a significant prompt to at least consider switching, especially if remedies such as those suggested above lead to simpler and more transparent pricing of PCA products.

Market concentration

We think that the CMA should consider whether there may be tacit coordination between the 'effective oligopoly' of four large incumbent banks

35. In paragraph 7.10 of *Provisional findings report*, the CMA says that, "we also found that PCA markets in GB and NI remain concentrated with the four largest providers in GB and NI having a combined market share of around 70% in 2014 and an estimated HHI of about 1,550 both in GB and NI".

36. In paragraph 40 of the Summary in *Provisional findings report*, the CMA says that, "the PCA markets in both GB and NI are concentrated but not highly concentrated". We agree that the HHI of about 1,550, for the four largest banks, is in the middle of the range of index values that would generally be regarded as indicating that the market is concentrated, but the addition of Santander and Nationwide and other smaller providers takes the HHI close to the threshold of 1,800 above which index values are generally regarded as indicating that the market is highly concentrated.

37. In any case, we are more concerned about the impact on competition and innovation of the four large incumbent banks having a combined market share of about 70% than about their HHI being about 1,550. Many reviews have observed that the PCA market is dominated by an 'effective oligopoly' of four large incumbent banks which look very similar to each other.

38. The view that many customers perceive the large incumbent banks to be very similar to each other is supported by the CMA's comments, in paragraph 7.51 of *Provisional findings report*, that, "the perception by customers that there is no differentiation between banks may also reduce incentives to engage" and, in paragraph 7.52, that, "The Gfk PCA qualitative research found that some respondents viewed PCAs as generic products that had little differentiation. Tesco research found that 43% of current account holders thought that PCAs were all the same, and a further 42% saw only small differences between them".

39. In paragraph 46 of its *Statement of Issues*, the CMA said that, "Neither of the Market Studies found evidence of coordination between the banks". We agree that explicit coordination is very unlikely, given that collusion is illegal, but we think it possible that there is tacit coordination. This concept was explained by the FCA in its recent paper *Calls for Inputs on competition in the mortgage sector*:

    Coordination between firms generally means that firms interact with each other with the aim of increasing or protecting profits. At its most extreme, this can be in the form of explicit agreements aimed at fixing prices, sharing markets or allocating consumers. But coordination can also take place when firms are able to anticipate, and follow, other firms' behaviour (known as 'tacit' coordination).

40. As we have observed in previous submissions, the large incumbent banks have an understandable self-interest in maintaining the status quo in PCAs, since this provides them with good prospects for augmenting their profits by cross-selling other retail financial products to their PCA customers. While tacit coordination not to compete may be hard to prove, banks may have encouraged low customer engagement by jargon and legalistic language in communications and by the complex and opaque pricing of FIIC banking. That is, the blame for low customer engagement should possibly fall on the banks themselves, rather than on their customers.

41. We therefore think that the CMA should investigate the possibility of tacit coordination between the four large incumbent banks, bearing in mind:

    - firstly, that, according to paragraph 40 of the Summary in *Provisional findings report*, "Apart from the impact of mergers and divestments, market shares by volume in both GB and NI have remained broadly stable since 2005"; and

    - secondly, that the two banks that have been most successful in growing their market share in PCAs are two firms that are different from the four large incumbent banks - Santander, which is different because it has behaved like a challenger bank, and Nationwide, which is different because it is a building society.

We think that it would be helpful to resolve the issue as to whether PCAs are profitable (on a standalone basis) or are loss-leaders

42. In paragraph 39 of the Summary in *Provisional findings report*, the CMA says that, "We found that PCAs or personal banking, depending on how each bank assesses profitability, are profitable".

43. In paragraph 7.160 in *Provisional findings report*, the CMA says that, "As discussed in Appendix 5.3, most PCAs are individually profitable and therefore banks do not need to sell additional products to ensure PCAs are profitable, but it may benefit their overall business performance". The CMA then concludes, in paragraph 7.165 of *Provisional findings report*, that, "selling additional products to PCA customers, while an important source of revenue for banks, is not a fundamental driver of PCA competition".

44. We are surprised by these findings and this conclusion. The finding that most PCAs are individually profitable is based on information supplied by banks, and it contradicts previous comments by Lord Turner, who thought that PCAs were a 'loss-leader' for the large incumbent banks. The finding that banks do not rely on cross-selling, and the conclusion that the prospect of cross-selling other products does not drive competition in PCAs, is contrary to our understanding and experience.

45. We note that the Market Study Update commented on these matters. For example, paragraph 2.66 said that Credit Suisse had reviewed the profitability of UK retail banking, and thought that current accounts were loss-making. Paragraph 2.70 said that, according to Mintel, cross-selling to PCA customers was particularly effective for cash savings, cash ISAs and credit cards.

46. We therefore consider it important that the CMA should seek to determine, on its own reasonable assumptions:

    - whether banks make excess profits and returns from PCAs;
    - whether PCAs make returns which are below banks' hurdle rates but which are augmented by profits arising from cross-selling other products to PCA customers;
    - or whether PCAs are loss-leaders.

47. We realise that this exercise would require the CMA to carry out the financial analysis which, according to paragraph 32 of the Summary in *Provisional findings report*, it found difficult because of uncertainties relating to "the appropriate allocation of common and shared costs, equity capital and revenues".

48. However, such challenges also exist in other industries and we think that the CMA is uniquely well-placed to carry out a PCA profitability analysis, because of its experience in other industries and because of all the information that it has received from many banks, including RBS.