Cross-subsidisation in the Personal Current Account Market – Financial Services Consumer Panel Discussion Paper

Introduction

The Financial Services Consumer Panel is an independent statutory body. The Panel's main job is to advise and challenge the Financial Conduct Authority's strategy and policies in the interests of consumers. It also undertakes two or three proactive projects each year, in pursuit of its aim of helping to increase trust, accessibility and competition in financial services markets. This paper describes one of these projects.

The Panel was concerned that 'free if in credit' (FIIC) personal current accounts masked the true cost to consumers, and had a differential impact on different groups of people. It also considered the lack of transparency may prevent effective competition.

The Panel commissioned a literature review by Collaborate Research and Tooley Street to examine the evidence on cross-subsidies and held discussions with industry experts. This paper considers how the market may develop; what alternatives to the current FIIC model exist; how beneficial (or not) these might be for UK consumers; and how desirable they might be from the perspective of regulators, the industry, and consumer groups.

The Panel is not wedded to any particular model of PCA provision, but it is clear the current model does not serve all consumers well. This paper therefore draws together that evidence, and poses a number of questions the Panel believes should be answered by the Competition and Markets Authority and debated by others, with the aim of generating a PCA market which serves consumers well.

Background

Most UK consumers expect their bank account to be free whilst in credit. This firmly established model emerged during the mid-1980s. At that time it was an innovative and radical development in personal current account (PCA) provision, which led to fundamental changes in the market. The Midland Bank, which developed the FIIC model, gained almost half a million customers in the first full year. Other banks quickly followed its lead.

For many years this model has been the focus of some criticism. Most recently, the Vickers Independent Commission on Banking[1] said that the lack of transparency about the true cost of banking services meant people could not assess whether they were receiving value for money, or whether they would get a better deal elsewhere. This has inhibited switching, and led to muted competition in the market – currently the largest 4 providers account for over 77% of the PCA market in the UK. In 2012 Andrew Bailey, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority, said "In short, I think that the reform of retail banking in this

[1] http://www.parliament.uk/business/publications/research/briefing-papers/SN06171/the-independent-commission-on-banking-the-vickers-report-the-parliamentary-commission-on-banking-standards

country cannot move ahead unless we tackle the issue of free in-credit banking, and have a much better sense of what we are paying for and how we are paying"[2]. The model has also been blamed by some for encouraging banks to cross-sell products PCA holders do not want or need, leading to mis-selling, notably of Payment Protection Insurance (PPI).

Yet, despite some recent changes, this is a market which has not changed fundamentally since the Cruickshank report in 2000 identified many of the same problems[3]. The UK competition authorities have examined the PCA market on several occasions since 2000, but fought shy of a market investigation reference, despite finding competition problems[4]. The Competition and Markets Authority (CMA) is now consulting on its provisional decision to launch a full market investigation into the PCA and SME banking markets.

Competition authorities are often hostile to cross-subsidies, being rightly concerned about the possible presence of predatory pricing by dominant firms seeking to deter entry by competitors. However, cross-subsidisation may enable the provision of services that have social value; and may arise as a result of efficient pricing structures designed to recoup fixed, joint or common costs.

Cross-subsidisation in the PCA market

Free if in credit PCAs do not attract annual or monthly charges. Some transactions, for example, ATM or point of sale cash withdrawal within the UK, are generally free as well. Profits from FIIC customers therefore have to be generated elsewhere, and the costs to consumers are not always transparent. Interest rates on balances are often low and charges are high, particularly on unauthorised overdrafts. Which? has estimated as much as £9 billion a year is generated from PCAs in charges and forgone interest[5]. Charged for transactions, such as foreign remittance transfers or cash withdrawals from overseas ATMs, may not reflect the cost of providing the service.

New entrants have begun to offer different account types[6] suggesting the FIIC model may lose some of its dominance. However, many banks believe that customers are resistant to paying charges and will go elsewhere if they abandon FIIC. So there is no incentive for a major bank to be the first to move to an alternative model. There are also those that argue that the current status quo should be retained. For example, the Guardian describes calls to end free banking as "an insult". It ignores consumers, "who have already paid a high price for the financial crash and who, with an end to free banking, would pay an even higher one"[7].

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[2] http://www.bbc.co.uk/news/business-18186363

[3] Competition in UK Banking: A Report to the Chancellor of the Exchequer, by Don Cruickshank, March 2000

[4] See, for example, the Office of Fair Trading *Review of the Personal Current Account Market*, January 2013.

[5] http://conversation.which.co.uk/money/bank-account-charges-current-accounts/

[6] See for example Tesco's £5 a month account, which is not paid if more than £750 a month is deposited and earns clubcard points: http://www.tescobank.com/current-accounts/?atlassource=paid&cmpid=search/google/brand

[7] http://www.theweek.co.uk/uk-business/47116/should-era-free-banking-come-close

The Panel set out to understand which groups benefit the most from the FIIC model and which groups are most disadvantaged. We commissioned Collaborate Research and Tooley Street Research to conduct a literature review of the PCA market (see annex), and supplemented this with discussions with industry experts and regulators.

The nature of cross-subsidisation

The literature review found various definitions of cross-subsidy. The Office of Fair Trading (OFT) has defined it as: "funding the loss or low return from one line of goods or services from another more profitable activity.[8]"

Based on this definition the reviewers postulated three potential hypotheses of cross-subsidy within the UK PCA market:

> **1** - ***Overdraft fees subsidy***: those who go overdrawn subsidise everyone else;
> **2** - ***Money to the middle subsidy***: those with low but always in credit balances are subsidised by everyone else;
> **3** - ***Diligence subsidy***: consumers who understand the costs and shop around for the best deal are subsidised by those who do not.

Vertical cross-subsidy

The three hypotheses relate to vertical cross-subsidy (i.e. within PCA product offerings). The literature suggests that, for some time, most commentators believed hypothesis 1 to be dominant. This hypothesis – essentially that the poor subsidise the rich – has not held up over time. A highly influential previous proponent of this view – the Office of Fair Trading – changed its mind in 2013[9]. A Friends Provident Foundation 2013 study[10] also found against the hypothesis once forgone interest was taken into account. Peer reviewed academic studies – especially the study by Hill[11] - in the US market have come to an agnostic conclusion.

More recently, with the regulation-led decline in overdraft charges along with better notification of those charges, hypotheses 2 and 3 have been given more prominence in the debate.

Having tested the hypotheses with industry experts the Panel believes that the hypotheses are not mutually exclusive. A mixture exists within most banks' PCA product lines. Further, the cohorts identified are not static. Individual circumstances at particular times in peoples' lives will determine whether they are subsidised or subsidisers in one or more of these scenarios. Currently, the consumers in the "money to the middle" group benefit the most from the FIIC model. Those that are often overdrawn or don't understand the costs and shop around for the best deal, lose out.

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[8] Literature review on cross-subsidisation in the personal current accounts market (p4)
[9] OFT (2013) reversed its influential 2008 position based on its assessment of the incidence of overdraft charges. The OFT did not account for forgone interest.
[10] John K Ashton and Robert Hudson, How Much Does Free Banking Cost? An Assessment of the Costs of Using UK Personal Current Accounts, (Friends Provident, 2013). The study, which accounted for forgone interest, concluded that net regressivity within the PCA market was "not present".
[11] Julie Andersen Hill, "Transaction Account Fees: Do the Poor Really Pay More than the Rich?" *University of Pennsylvania Journal of Business Law* 65 (2012 – 2013),

The literature review concludes that vertical cross-subsidies are not unique to the UK banking market. Nor is the debate around their merits. In the US and Australia, as in the UK, the prevalence of "free banking" models in the market sparked a debate as to the existence of underlying cross-subsidies. This has led to customers in Australia challenging the fairness of charges in the courts[12]. In the EU context, cross-subsidy has taken second place to a wider discussion about transparency, switching, and the overall level of fees"[13].

The Netherlands raises a different perspective on cross-subsidy. The literature shows that where a cross-subsidy exists in the PCA market, it is likely to be progressive[14]. This is due to the Banking Covenant of 2001, which was adopted by the industry and the Salvation Army. The banks agreed to provide current account services free of charge to those who could not afford them.

Key questions:

- *To what extent do consumers understand the extent of vertical cross-subsidy and the impact it has on them as individuals?*
- *What information would enable consumers to understand, and how might they use it?*
- *Should the Government consider the income distributional consequences of banks' pricing?*

Horizontal cross-subsidy

It is difficult to isolate PCA profitability from the revenue and cost profiles of other banking products. PCA customers are also subsidised from other product lines (i.e. horizontally), such as mortgages, loans and credit cards. It is likely that profits from mortgage books - in particular from mortgage 'prisoners'[15] on standard variable rates (SVRs) - and margins on other saving accounts are currently the most significant. Net interest spreads are higher than has historically been the case: up to 350 basis points, whereas traditionally they have been closer to 50. These margins will be squeezed when wholesale borrowing costs rise, a likely consequence of the end of the Funding for Lending[16] scheme in January 2015, and a rise in the Bank of England base rate. The effect will be to shift the dynamics of banking profitability. *Key questions: -*

- *How will higher wholesale borrowing costs affect the profitability of different banking products?*
- *What will be the impact on horizontal cross-subsidies in the FIIC PCA market?*

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[12] http://www.abc.net.au/news/2013-12-02/class-action-over-anz-bank-fees/5126286

[13] Literature review on cross-subsidisation in the personal current accounts market

[14] i.e. a state of play that benefits the poor at the expense of the rich; the antonym of "regressive"

[15] Borrowers unable to get an alternative mortgage elsewhere, for example because of tightened affordability criteria.

[16] In July 2012 the Bank of England launched Funding for Lending. This scheme allowed banks and building societies to borrow from the Bank of England at cheaper than market rates for up to 4 years. It helped to increase lending to businesses by lowering interest rates and increasing access to credit.

The cost and profitability of PCAs

According to industry experts, there is little data available to demonstrate the extent and form of cross-subsidies in the PCA market. This is not surprising as most banks do not even know how much it costs to provide a PCA. This is evident from the literature review. In giving evidence to the Treasury Committee, the Cooperative Bank came up with a rough average of £85[17] per annum and one UK challenger bank has suggested that it could provide an account viably for £3 a month. The banks argue that they incur significant costs in providing the payments infrastructure, the branch and ATM estate, IT systems, telephony services, staffing, funding of overdrafts, various customer support services and marketing. Many of these costs are fixed, and most are shared across different products and services. Because of the common cost base, the major UK banks say they cannot allocate these costs meaningfully across different PCA products or services. By contrast, there are estimates of what it costs to provide PCAs in the US, typically ranging from $200 and $400 (£120-£140[18]) a year[19]

The contribution of PCAs to overall profitability is likely to vary from institution to institution depending on the other products they provide and their overall strategy. Some banks have openly stated that their PCAs are loss making, but they provide an opportunity for cross-selling other, more profitable, products to the account holder[20]. The FCA recently found that many people save with their PCA provider, despite the fact that the largest PCA providers on average pay lower rates than other providers[21]. Many consumers will also take out mortgages or credit cards with their PCA providers, as they are offered special deals and incentives.

The lack of information about costs makes it hard to gauge whether or not the PCA market is efficient and competitive. A recent report by the University of St Andrews Centre for Responsible Banking and Finance concludes that: "When a market is as economically and socially important as the current account market, clarity and comprehension as to how customer costs are incurred and the efficiency and transparency of pricing is essential"[22]. Furthermore, the CMA has stated that "it is also possible that, particularly for PCAs, there is a degree of cross-subsidy, which may be distortive of competition"[23].

Key questions:

- *How can competition be measured in the UK PCA market when there is a significant lack of data on costs and revenues at product level?*
- *How are US banks better able than UK banks to offer reliable estimates of what it costs to provide current accounts?*

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[17] House of Commons Treasury Committee, *Competition and Choice in Retail Banking*, 27-28
[18] Currency conversion by www.xe.com as of 14 August 2014
[19] Literature review on cross-subsidisation in the personal current accounts market
[20] https://www.gov.uk/government/news/personal-current-accounts-and-small-business-banking-not-working-well-for-customers
[21] http://www.fca.org.uk/your-fca/documents/market-studies/ms14-02-interim-report
[22] http://www.st-andrews.ac.uk/business/rbf/workingpapers/RBF14_007.pdf
[23] https://www.gov.uk/government/news/personal-current-accounts-and-small-business-banking-not-working-well-for-customers

Future development of the market

In the near future, changes in the PCA market are likely to be driven by an increase in interest rates. Some banks may pass on rate rises in full to depositors: there is likely to be political pressure on institutions to do this. If this is the case, other banks are likely to follow. As has happened in the past, it is likely that banks will offer higher interest rates to new depositors, leaving existing depositors on the current very low interest rates. In order to benefit from higher rates on new products, consumers need to research regularly the rates on offer across providers (including their existing bank), and then switch their accounts to those new products. Consumers are therefore expected to continually monitor the product development in their bank, and whether or not their existing deposit is now considered an "old account" on which a derisory rate of interest is paid.

If banks pass on full rate rises to SVR mortgage holders, people are likely to shop around for lower fixed rate mortgages. Higher interest rates may increase the number of mortgage prisoners. Furthermore, the recent announcement that no more than 15% of mortgages issued by a particular supplier should exceed a loan-to-income ratio of 4.5:1 could also lead to the number of trapped borrowers increasing. The Resolution Foundation estimates that 770,000 people could find themselves in this situation when rates rise[24]. The Panel has long been concerned about mortgage prisoners. Normal market forces of competition and consumer choice do not apply to them.

Key question:

- *When interest rates rise, how can consumers be transparently and timeously informed about the return on their deposits, whether they are held in PCAs or savings accounts?*

Charged for accounts

Banks in many overseas markets offer fee-based accounts. With the exception of packaged accounts this has not happened to any significant extent in the UK. Packaged accounts consist of several products bundled together with a PCA. A fee is then charged for the whole package.

There are suggestions that packaged account provision in the UK may have reached its peak. There has been an increase in the number of complaints from consumers and hence concern about conduct of business risk. Packaged account complaints to the Financial Ombudsman Service have increased by 248% since 2013[25], generating speculation that it could be the next mis-selling scandal. At least one provider has indicated that they will provide packaged accounts on request, but no longer actively markets them.

Some UK banks are introducing standalone PCAs that charge a fee when certain conditions are not met by the account holder. For example, a new Tesco account

[24] http://www.resolutionfoundation.org/publications/mortgaged-future-modelling-household-debt-affordab/
[25] http://www.financial-ombudsman.org.uk/publications/ar14/ar14.pdf

charges a £5 monthly fee for those paying in less than £750 per month. This type of account is common in several other countries reviewed in the literature, including Ireland, Germany and much of the United States. If fee-based accounts become more established in the UK market, they must be transparent, easy to understand and enable easy comparison between providers. Mike O'Connor of StepChange debt charity has suggested that "What must not happen is that consumers end up with the worst of both worlds: paying for accounts but still enduring unfair charges, opaque and complex products…"[26] This seems to be the prevalent model in France, where charges are expensive and remain opaque.

Where fees for PCAs are charged, then the Panel would expect higher interest to be offered on balances. At the very least it would expect consumers to be made aware of interest forgone. Vickers recommended this in his 2011 review. The literature review suggests that some banks are now routinely providing this information. However, it does not appear to be having any significant effect on consumer behaviour. Banks are also responding to pressure from consumer groups and regulators to provide greater early warning to consumers if their accounts are in danger of incurring penalty costs from going overdrawn. This is a positive development to be welcomed. Again the Panel does not believe this is widespread industry practice.

Key questions:

- *How likely is it that paid-for accounts will establish a foothold in the UK PCA market?*
- *If paid-for accounts do become more widespread what should be the safeguards to ensure that they don't become more opaque?*
- *How could a measure of interest forgone be best displayed to consumers?*

Basic bank accounts

The recently published Payment Accounts Directive requires that basic bank accounts are made available to all consumers, free of charge or for a reasonable fee. This requirement will need to be implemented by September 2016. Although basic bank accounts are widely available in the UK, if not often actively promoted, the Panel is concerned about the quality of the products on offer, and the 'soft' barriers which deter people from opening accounts. A universal service obligation could lead to a race to the bottom, where banks offer the absolute minimum in terms of account functionality. Were any cross-subsidies from banks' profitable lines of business (such as credit card and mortgage business) to decline, it is likely that further pressure would come to bear on the basic account offer.

Key questions:

- *To what extent can the needs of vulnerable[27] consumers be met in a competitive PCA market?*

[26] http://www.independent.co.uk/news/business/news/call-to-end-free-bank-accounts-7784571.html
[27] In this instance– people new to banking; on low or variable income; people experiencing debt problems or who have experienced a sudden income shock.

- *How could the quality of basic bank accounts be safeguarded in the context of a decline in cross-subsidies?*

Distribution channels

Banks continue to seek cost reduction through increased digitalisation and innovation. Industry experts suggest that on average they expect a 3-5% cost/income ratio improvement from digital banking. Cost reductions are largely achievable through branch closures. This raises concern about access to banking services for the digitally excluded. The FCA recognises this risk. Between 1997 and 2012 there was an estimated bank branch network reduction of 25% in the UK. This is justified by reduced numbers of over the counter transactions. In April RBS cited a 30% fall in branch transactions since 2010. Nationwide anticipates branch interactions to decline from 61%of the total in in 2014 to 15% of the total in 2019.

While established banks seek to shrink their branch numbers, the lack of an established network continues to be a barrier to entry for new entrants. This is potentially why supermarkets and other big retailers are tipped as the most likely to be able to challenge the status quo.

Key Question:

- *How does a shift from branch to digital delivery impact on the FIIC model and cross-subsidisation?*

Conclusion

PCA provision in the UK is changing. Whether or not there will be a significant shift away from the FIIC model remains to be seen. PCA markets in other countries offer some insight into alternatives and potential models that may emerge. While the Panel does not have a preferred model for the UK PCA market it believes that whatever models are developed in the future need to be transparent to the consumer and deliver value for money. This should be a key outcome from the CMA's market investigation, should it go ahead.

Vertical and horizontal cross-subsidisation are features of the UK PCA market and retail banking more widely. It is difficult to isolate PCA costs and revenues from other banking products, and therefore to analyse PCA profitability and whether or not PCAs deliver good value for consumers. This creates a significant challenge in assessing the competitiveness of the market and is an area the CMA will need to consider carefully. Furthermore, the PCA market cannot be divorced from wider macro-economic conditions. While this exercise primarily focused on the PCA market, concern has again emerged for the fate of mortgage prisoners. The Panel continues to have apprehensions about the robustness of provisions to ensure they are treated fairly. It urges the regulator to keep this area under close observation.

Numerous technical developments have delivered practical benefits for consumers. While the vast majority of consumers have embraced these innovations, some are unable or unwilling to participate in the digital banking models. Their access to banking remains a concern. The Panel recognises that branch reduction is an inevitable outcome of banks' desire to cut costs and improve profitability. However, it is unclear what impact this will have on the FIIC banking model and the UK PCA market.