Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

Telephone: 020 7066 9346
Email: enquiries@fs-cp.org.uk

Banking Reform Bill Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

6 September 2012

Dear sirs

Banking reform: delivering stability and supporting a sustainable economy

This is the Financial Services Consumer Panel's response to the joint HMT - BIS consultation on reforming the banking sector. The White Paper covers a number of detailed proposals to reform the banking sector. In our response we have focused on those areas on which we are best placed to provide comments.

Overview

The Panel has long been concerned that problems in the retail banking market are leading to poor outcomes for both consumers and businesses that rely on these essential services. The excessive risk taking culture within a number of the UK's largest banks directly threatened their survival and necessitated a significant taxpayer bailout. Yet the banking scandals of recent months indicate that little has changed in banks' operating models and outlook since the start of the financial crisis.

The Panel strongly supports the Government's intention to insulate retail banking services to protect them from shocks in the financial system and ensure firms can be more easily resolved. However, we feel the Government should revisit the Independent Commission on Banking's (ICB) ring-fencing recommendations in light of recent scandals to consider whether greater separation of day-to-day banking services would better protect consumers.

The Panel believes the Government should introduce the proposed reforms sooner than the 2019 deadline. Given the wider global financial difficulties, we feel it would be prudent to proceed with reforming the banking industry as quickly as possible. This will help ensure the UK banking sector is able to survive wider shocks in the financial system and better protect consumers earlier than currently planned.

The Panel also urges the Government to use this unique opportunity to correct wider problems in the retail banking sector which are creating consumer detriment. These market failures are seen most noticeably in the Personal Current Account (PCA) market where the more vulnerable consumers are subsidising the 'free-if-in-credit' model and inappropriate incentive structures are leading to poor consumer outcomes. We firmly believe greater priority should be given to ensuring the retail banking market works more effectively and in the best interests of consumers.

Ring-fencing

For consumers and businesses, holding and operating a bank account has become an essential part of participating in a modern society. Any interruption to day-to-day banking services could have a significant impact both on account holders and the wider economy. The Panel therefore strongly supports the intention to insulate critical services from wider shocks elsewhere in the financial system.

However, the Panel feels the Government should revisit the ICB's recommendations, in light of the recent and well documented banking scandals, to consider whether ring-fencing retail banking services is still the most appropriate course of action. In its final report, the ICB considered the advantages and disadvantages of requiring greater separation of retail banks. This report cited a number of benefits to full separation including allowing the retail and investment banks to be dealt with in isolation. It also set out four disadvantages to full separation which we feel, given recent developments, may now be overstated:

- Firstly, the report suggested there might be economies of scope between retail and investment banking which can be preserved within one financial group. Yet as recognised in the ICB's interim report, most studies have not found strong evidence of scope economies.

- Secondly, the report suggested full separation would remove all intra-bank diversification benefits. We feel the 2008/9 collapse of the UK's largest banks demonstrates that these benefits could be overstated as banking failures typically affect the whole company group.

- Thirdly, the report suggested consumers that require both retail and investment banking services would benefit if able to access them from a single provider. We note from the interim report that this was suggested by banks and the Panel is not convinced by this argument. The interest-rate swaps mis-selling scandal has highlighted how consumers and businesses can be materially disadvantaged by retail banks selling complex products developed by their investment banking arms.

- Lastly, the final report suggested operational infrastructure and branding could continue to be shared. We feel that close sharing of back office systems between the different banking arms would undermine attempts to ensure retail banks are insulated from shocks in the wider group. Shared branding could also cause confusion among consumers as to whether they are transacting within or outside of the ring-fencing requirements.

The Panel also believes the Government should give greater consideration to the corporate governance arrangements within retail banks and the institutional culture which stems from this. It is essential that the governance arrangements and incentives employed in retail banks encourage executives to act in the best interests of their customers. We have a particular interest in improving the consumer input at Board level, ensuring that the consumer interest is taken into account in all areas of a firm's business, while of course noting how important it is that any proposed interventions are proportionate and do not impede the sound recovery of the financial services sector

Loss-absorbency

The financial crisis has highlighted the importance of ensuring banks are well capitalised to survive shocks in the financial system and are easily resolved where they do fail. The UK taxpayers were exposed to unacceptable costs when bailing out a number of major high street banks. To prevent a reoccurrence of these events, the Panel supports steps already taken, and extended under the Government's proposals, to increase banks' capacity to absorb losses.

The Panel firmly believes it is appropriate to change the creditor hierarchy so that insured deposits are preferred in insolvency. While this will not have a direct impact on consumers, who will still be entitled to deposit protection under the Financial Services Compensation Scheme (FSCS), this will reduce the possibility of customers of other financial institutions footing the FSCS bill when a bank fails. However, we feel the depositor preference should be extended to non-insured deposits to provide an additional layer of security for depositors and further encourage investors to exert discipline over banks' behaviour.

The Panel feels the Government, working with the Financial Services Authority (FSA), should also use this unique opportunity to introduce two essential improvements to the deposit compensation arrangements:

- Firstly, provide deposit protection cover by brand on a trading name basis rather than by 'FSA authorised institution'. The Panel appreciates this is still under consideration at EU level, but we feel it is unreasonable to expect customers to realise which firms form part of a wider company group. Cover per brand is more logical and sensible as this is how products are sold and the basis on which consumers buy them. This would also make for clearer statements about the level of consumer protection in the event of a future bank failure.

- Secondly, the £85,000 deposit protection limit should be increased for consumers with temporary high balances to protect consumers who are, for example, in the process of purchasing a house.

Competition

The Panel has expressed concerns about failures in the retail banking market for some time. We have witnessed how market stagnation and ineffective competition has led to poor consumer outcomes. This is seen most obviously in the PCA market where many consumers are not well served by the 'free-if-in-credit' banking model.

In March 2012, the Panel published a report into this market which identified a number of significant market failures. This also a called for the regulator to take forward five important steps to increase competition to the benefit of consumers:

- remove opaque charging by requiring transparency on the true cost of different banking services;
- empower consumers to shop around much more and switch their bank account provider without any hurdles or delays;
- tackle the inappropriate cross-subsidisation within retail banking at the expense of financially vulnerable consumers;

- bring an end to the inappropriate incentive structures which reward one-off sales rather than developing a long-term customer relationship; and
- make it easier for new competitors to enter the retail banking market in order to increase consumer choice.

A copy of this report has been provided as an appendix to this letter. The Panel urges the Government to encourage the new Financial Conduct Authority (FCA) to prioritise this work to ensure consumers benefit fully from the banking reforms.

Yours faithfully,

Adam Phillips
Panel Chair

APPENDIX 1 – FINANCIAL SERVICES CONSUMER PANEL BETTER BANKING POSITION PAPER

Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

Better banking services and the myth of ‘free’ banking: Towards a dynamic Personal Current Account market

Consumer Panel Position Paper

1. Introduction

In September 2011, the Independent Commission on Banking (ICB) published their final report into the UK banking industry. This highlighted significant failures in the UK’s retail banking sector.[1] Following the publication of this report, the Government has confirmed that a number of reforms will be introduced by 2019.[2]

2. Panel’s position

2.1 The Panel is concerned that problems in the retail banking sector are creating consumer detriment, most noticeably in the Personal Current Accounts (PCA) market.

2.2 The Panel welcomes the Government’s commitment to take forward the ICB’s recommendations which we believe will lead to improvements in the retail banking sector. However, we believe regulatory action is also needed to fully deliver the ICB’s vision.

2.3 The Panel believes the creation of the new Financial Conduct Authority (FCA) represents a once in a generation opportunity to ensure better banking services for consumers by using its powers to:

- remove opaque charging by requiring transparency on the true cost of the different parts of banking services;
- empower consumers to shop around much more by switching their current account provider without any hurdles or delays;
- tackle cross-subsidisation within retail banking at the expense of financially vulnerable consumers;
- insist banks act honestly, fairly and professionally by bringing an end to the inappropriate incentive structures which reward one-off sales rather than developing long-term customer relationships; and
- make it easier for new competitors to enter the retail banking market in order to increase consumer choice.

2.4 The Panel urges the regulator to help deliver greater banking competition, more choice and fairer, transparent true cost banking for consumers.

---

[1] Independent Commission on Banking, *Final report: Recommendations* ¸September 2011 see http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf

[2] HMT & BIS, ‘The Government response to the Independent Commission on Banking’, December 2011 see http://cdn.hm-treasury.gov.uk/govt_response_to_icb_191211.pdf

3. Failures in the retail banking sector

3.1 In 2011, the ICB, chaired by Sir John Vickers, published their report into the UK banking industry.[3] This highlighted a number of failures in the UK banking sector. The Panel is concerned that these failures are preventing the market working effectively for consumers.

3.2 The ICB's report identifies a number of specific problems in the retail banking sector which includes:

- *the high market concentration* with the largest four banks dominating the retail banking market. The financial crisis led to further market concentration following the acquisition of HBOS by Lloyds TSB and Nationwide and Santander absorbing smaller rivals;
- *a lack of new market participants* which has been exacerbated by ineffective market competition and difficult funding conditions;
- *the biggest banks have become so fundamental* to the UK economy and society more generally that they are considered too big to fail;
- *low levels of market competition*, with weaknesses in both supply and demand, which reduces firms' incentive to innovate and increase their efficiency;
- *banks have become reliant on a small number of income streams to subsidise their wider service proposition*. This includes high overdraft charges and the inappropriate cross-selling of high margin products; and
- *a lack of transparency around the true cost of banking services* which creates weaknesses in consumer demand by restricting people's ability to shop round and assess whether they are receiving value for money.

3.3 Many of these failures are interlinked and require changes to the UK's retail banking model to ensure the market is working effectively for consumers. For this reason, the Panel supports the ICB's key recommendations.

4. Personal Current Account market

4.1 The Panel believes problems in the retail banking sector have manifested in the free-if-in-credit PCA market, leading to stagnation and ineffective competition. Given that holding and operating a PCA is an essential part of participating in a modern society, the Panel believes these failures need addressing urgently.

---

[3] ICB, *Final report*

4.2 The most common form of PCA in the UK is the 'free-if-in-credit' PCA model.[4] When this model emerged in the 1980s it was an innovative and radical development which led to fundamental changes in the market. The Midland Bank, which developed the free-if-in-credit model, gained almost half a million customers in the first full year. However, after 25 years of free-if-in-credit PCAs dominating the market, there is now widespread stagnation with little market innovation.

4.3 The Panel believes that stagnation in the PCA market, along with wider problems in the retail banking sector, has created a number of failures which prevents the PCA market working effectively for consumers. This includes:

- The misconception among consumers that there are no costs associated with using a PCA - providing they remain in credit.

  Many consumers incorrectly believe there are no costs associated with managing their day-to-day finances through a PCA providing they remain in credit. In reality, not only are PCAs explicitly not free for anyone who is overdrawn but the interest forgone on in-credit balances means they have a cost to all users.

- The true cost of PCAs falls disproportionately on financially vulnerable consumers who are subsidising the free-if-in-credit model.

  There is significant and inappropriate cross subsidisation of costs in the PCA market, with the minority of vulnerable consumers, including those on low or variable incomes and those in financial difficulty who are more likely to incur overdraft charges, subsidising the costs for the majority of consumers. This is evidenced by an OFT study which found that banks received over 30% of their revenues from insufficient fund charges in 2006, costs most likely borne by the minority of their customers.[5]

- The structure and level of overdraft charges prevents consumers who find themselves in difficulty from regaining control of their finances.

  The overdraft charging structures commonly operated by the different PCA providers can accrue quickly, restricting the consumers' ability to return their account to credit. This is highlighted by a Money Box investigation in December 2011 which identified the 'eye-watering rates

[4] Alternative PCA models are available, including basic bank accounts and pre-paid cards, however the free-if-in-credit model is the most common. Customers that hold a free-if-in-credit PCA do not pay any direct charges for using the account or accessing core services providing they remain in credit. Any direct charges applied to the account typically relate to interest for borrowing money through an overdraft facility, charges levied for unauthorised overdrafts or penalties where the bank refuses to make a payment due to lack of available funds. There are also indirect costs associated with these accounts, such as forgone interest payments as interest rates are typically very low for in-credit balances

[5] Office of Fair Trading, *Personal current accounts in the UK,* July 2008 see http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf

of interest' customers are forced to pay when they exceed their overdraft limit.[6]

- The current free-if-in-credit model threatens the wider financial inclusion objectives.

  According to independent research, nearly two-thirds of consumers without a bank account were previously account holders, but fell out of the system due to the penalty charges levied.[7] This suggests that continuing to promote banking to low income consumers, without tackling the penalty charge risk associated with free-if-in-credit PCAs, creates a risk of setting up a revolving door in-and-out of banking for vulnerable consumers.

- Rise in the number of packaged bank accounts which may not be offering value for money.

  According to the FSA, 20% of UK adults hold a packaged bank account.[8] However, despite consumers paying a monthly fee to access a package of additional insurance policies, such as travel insurance or breakdown cover, independent research shows a significant number of consumers do not use these policies.[9]

- Barriers to entry for new firms and operating models.

  The current free-if-in-credit banking model is restricting the development of different PCA models which limits market competition. For both existing firms and prospective market entrants, there is little potential to develop innovative models which appeal to consumers, when consumers perceive day-to-day banking to be free.

- Lack of switching within the PCA market as consumers perceive switching PCA providers to be time consuming, risky and not worth the effort, given how little differentiation there is in the market.

  According to research conducted by Quadrangle, only 23% of customers have ever switched current account providers, with only 9% switching in the past five years.[10] This supported by a 2009 Ofcom consumer survey which showed the proportion of people that switched banks in the last year was significantly lower than utility providers. This is shown in Figure 1 below.

[6] See: http://news.bbc.co.uk/1/hi/programmes/moneybox/9653882.stm

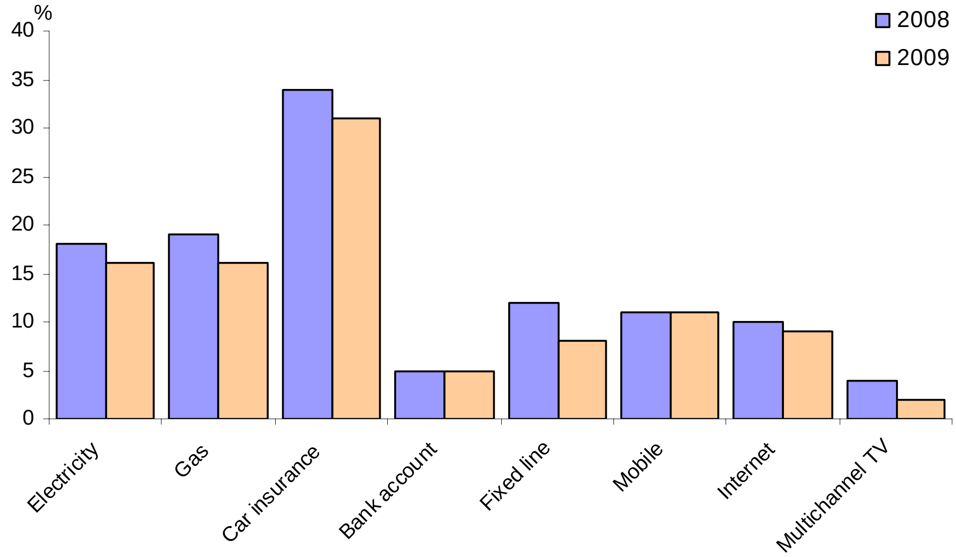
[7] Anna Ellison, Claire Whyley and Rob Forster on behalf of HM Treasury and the Financial Inclusion Taskforce, *Realising banking inclusion: The achievements and challenges*, August 2010

[8] Financial Services Authority, *Packaged Bank Accounts: New ICOBS rules for the sale of non-investment insurance contracts*, October 2011 see http://www.fsa.gov.uk/pubs/cp/cp11_20.pdf

[9] See http://www.which.co.uk/money/bank-accounts/guides/finding-the-right-bank-account/should-i-pay-a-fee-for-my-bank-account/

[10] Quadrangle, *PCA Consumer Research Findings: Consumer attitudes to switching personal current accounts and response to a proposed new switching process*, August 2011 see http://www.quadrangle.com/PCA_switching_consumer_research.pdf

Figure 1: Proportion of customers who have switched providers in the last 12 months



Source: Ofcom, The consumer experience 2009: research report, December 2009

5. Action to tackle failures in the PCA market

5.1 The Panel supports the Government's intention to take forward a number of reforms, as recommended by the ICB, which will help tackle the failures in the UK banking sector. This includes increasing market competition through the disinvestment in Lloyds Banking Group; investigating the barriers facing new market entrants; and increasing transparency to help consumers make informed decisions. However, we believe further regulatory action is needed to fully deliver the ICB's vision.

5.2 The Panel recognises the steps being taken by the industry to help ensure the retail banking market is working well for consumers. This includes providing customers with an annual statement detailing how much they paid for their PCA over the previous 12 months. While the Panel welcomes this initiative, we do not believe increasing transparency alone will tackle the failures identified. Evidence from other financial markets, such as the retail investment sector, has demonstrated that disclosure largely fails to create informed consumers.

5.3 The industry has also pledged to introduce a new free guaranteed seven-day switching service by September 2013. Again, the Panel welcomes this initiative. We hope this will tackle both the perception among consumers that switching providers is cumbersome, complicated and risky and the reality that where consumers do switch providers, many experience problems. This is demonstrated by research undertaken by Consumer Focus in 2010 which found that 44% of consumers that switched PCA providers experienced difficulties, with the transfer of Direct Debits the most common cause of problems.[11]

5.4 While the Panel welcomes the reforms being introduced by the Government in light of the ICB report and these industry led initiatives, their success has not yet been evidenced and we believe further regulatory action is needed.

5.5 We believe changes to the structure of UK financial services regulation and the formation of the new FCA present a unique opportunity to provide better banking services. We believe the regulator should use its powers to:

- Remove opaque charging by requiring transparency on the true cost of the different parts of banking services.

  The regulator, working closely with the Money Advice Service, should raise consumer awareness of the true cost of banking services. This would require firms to move away from the current opaque charging model, so consumers are clear how much they are paying for their banking services. This should include, for example, the value of any forgone interest on their PCA.

- Empower consumers to shop around much more by switching their current account provider without any hurdles or delays.

  The regulator should investigate the barriers which restrict consumer's ability to shop around and change banking providers. This includes tackling both the real and perceived barriers to switching, as well as empowering consumers to compare the costs of different banking services.

- Tackle cross-subsidisation within retail banking at the expense of financially vulnerable consumers.

  We believe the current level of overdraft charges bears no relation to the actual cost of unauthorised transactions. In reality, vulnerable consumers, that are more likely to incur overdraft charges, are subsidising the PCA model. The regulator should take action to bring an end to this unfair and unsustainable model, which we believe is inconsistent with Treating Customers Fairly principles 6 (fairness) and 8 (conflict between customers).

- Insist banks act honestly, fairly and professionally by bringing an end to the inappropriate incentive structures which reward one-off sales rather than developing long-term customer relationships.

  The regulator should take action to ensure both monetary and non-monetary incentive structures used within banks are aligned with the best interests of consumers. This includes, for example, tackling the

[11] Oliver Morgans on behalf of Consumer Focus, *Stick or twist?: An analysis of consumer behaviour in the personal current account market,* 2010 see http://www.consumerfocus.org.uk/files/2010/10/Stick-or-twist-for-web1.pdf

incentives which have led to the inappropriate cross-selling of products as seen with the recent Payment Protection Insurance (PPI) mis-selling scandal.

- Make it easier for new competitors to enter the retail banking market in order to increase consumer choice.

  The regulator should review, and where appropriate take steps to remove, the barriers facing perspective market entrants. This should include any obstacles facing both retail banking organisations and payment services providers. Ensuring new entrants are able to enter the retail banking market will help increase competition and consumer choice.

6. Risks of migrating away from the free-if-in-credit PCA model

6.1 The Panel do not believe the regulator should ban the free-if-in credit PCA model, but we do query whether the dominance and sustainability of this model is in the best interest of consumers.

6.2 If the industry migrated away from the free-if-in-credit model, we consider it essential that any alternative models are truly in the best interests of consumers. We therefore believe the industry should work to overcome the following risks:

- The risk that the market migrates to a single alternative PCA model which will fail to increase consumer choice and market competition.

  There are a wide range of different PCA models available throughout the world. This includes models where charges are levied for payments (bank transfers, bill payments and point-of-sale charges) and models where consumers pay a regular account management fee.[12] Despite the variety of PCA models which exist around the world, one single model usually dominates in individual countries. The Panel believes this requires further investigation, to understand what drives this trend.

- The risk that alternative PCA models are not designed around the needs of consumers leading to new market failures.

  If the industry develops new PCA models, the Panel believes it is essential that these are built around the needs of consumers. This includes the emergence of payment service facilities which replicate a PCA through the use of a mobile phone or software application (App). We have also already seen growth in packaged bank accounts, yet it is

[12] Cap Gemini/EFMA, *World Retail Banking Report 2009*, see http://www.capgemini.com/insights-and-resources/by-publication/world_retail_banking_report_2009

not clear whether these are designed around and meeting the needs of consumers.[13]

- The risk that consumers will be unable to access basic banking facilities.

  Given that holding a PCA is an essential part of participating in a modern society, it is important that all consumers are able to access essential banking services. This includes, for example, access to a basic bank account and the ability to withdraw money easily to pay for goods and services.

7. Conclusion

7.1 The Panel believes that failures in the retail banking sector are directly leading to consumer detriment in the free-if-in-credit Personal Current Account (PCA) market. Once a revolutionary concept, the domination of the free-if-in-credit banking model has led to market stagnation and ineffective competition. This does not benefit consumers or the banks that offer these services.

7.2 The Panel strongly welcomes the Government's intention to take forward the Independent Commission on Banking's (ICB) recommendations. This should drive improvements in the retail banking market. However, we firmly believe further regulatory intervention is needed to fully deliver the ICB's vision.

7.3 The creation of the Financial Conduct Authority creates a unique opportunity to ensure consumers are able to access better banking services and dispel the myth that day-to-day banking is free. We believe the regulator should take forward reforms to create a more dynamic PCA market that truly operates in the interest of consumers.

[13] A packaged bank account is typically a PCA bundled with a range of insurance policies, access to preferential terms for other financial services and sometimes non-financial products and services, for which the customer often pays a monthly fee.