Further evidence to the Treasury Committee Inquiry into Competition and Choice in the Banking Sector January 2011

1 The Financial Services Consumer Panel's current statutory role is primarily focused on advice to and scrutiny of the regulator and our involvement in competition issues has been limited to where these issues are related or create issues for the regulator's role. Our interest in competition is twofold:

- Is competition delivering good consumer outcomes and if not is there a need for regulation
- Can regulation be used to stimulate competition that will deliver good consumer outcomes?

1.1 The Panel has therefore focused on a regulatory path to delivering fairness for the consumer. The Panel provided evidence to "The Future of Banking Commission" and had the benefit of considering the extensive evidence provided by Which? to this inquiry, which we support as providing a comprehensive consumer view on competition and barriers to entry issues.

1.2 The Panel is also providing with this further evidence our recent responses to the OFT's inquiry into the Review of Barriers to Entry and Exit in Retail Banking and our submission to the Independent Commission on Banking.

2 **"Free" banking – costs and implications**

2.1 There is no such thing as free banking and in the interests of transparency and comparability this notion needs to be dispelled. The number of consumers enjoying the benefits of the current "free" banking model is small and limited to those who use their current accounts frequently, have small balances and never go overdrawn. The rest pay through interest foregone and penalty charges that are often not disclosed in advance.

2.2 Because charges are hidden they present a barrier to comparison. A consumer is unlikely to make comparisons on the basis that they may encounter financial difficulties, and even if they do have this expectation then the charges are often not disclosed in advance[1] and labelled in different ways that prevent comparison.[2]

[1] Eg Information about overdraft charges does not have to be specifically disclosed to a customer opening an account, it is enough that the charges are made available via a telephone helpline, a website; or by asking staff.. Lending Code, 64. The voluntary agreement by the major PCA providers to introduce further transparency initiatives in response to the OFT's personal current accounts study extends only to information after the event on monthly statements or annual statements of cost that an illustration of charges is available on the website. Personal Current Accounts in the UK, Progress Report, September 2010, para 3.4.

Financial Services Consumer Panel
25 The North Colonnade Canary Wharf
London E14 5HS United Kingdom
Tel +44 (0)207 066 9346
Fax +44 (0)207 066 9728
Website www.fs-cp.org.uk

2.3 The nature of the financial services market; long term, often complex products purchased irregularly; means that competition tends to be based on a headline characteristic which is usually the immediate cost. Where competition exists it is in areas such as mortgages with low start interest rates or savings products with high interest rates for the first year. Consumers are then locked in because of the difficulties and cost of switching.[3] The current free banking model is the genesis of the long running competition cases and inquiries into PPI and bank charges.

2.4 Free if in credit banking and its associated fee structures form a barrier to low income consumers entering the market or using mainstream financial services providers. The lack of transparency undermines budgetary control and planning for those who need to be micro-managers of their money. Many consumers choose high cost options such as Pay Day lending because they find the fee structure easier to understand.[4]

2.5 Another feature of free banking is "free" advice. However there is a very real danger that products sold benefit sales staff and the bank more than the consumer and this may lead to sales of products that are not always suitable, as happened with PPI and may be happening with investment bonds. It is hard to see compliance with the Treating Customers Fairly principles regarding the selling of products that are suitable to consumers' needs and circumstances when limited options are presented. [5] Free banking is also a significant impediment to competition.

2.6 The Retail Distribution Review recommendations will go some way towards dealing with this problem and restoring consumer confidence. It is imperative that the momentum behind the RDR is not lost, as it will deliver significant consumer benefit. Alongside this, we have been promised a more active role by the regulator in delivering on TCF through monitoring products and services designed, marketed and sold to ensure that they are safe and fit for purpose. More intelligent regulation that involves scrutinising products at an early stage to ensure they are fit for purpose will be a significant step forward. We hope the proposed new CPMA will embrace this important aspect of regulation.

2.7 The current model presents a barrier to new entrants and new models. Existing institutions maintain a competitive advantage through the cross subsidies in place. They have the established business from which to divert resources and therefore are

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[2] Office of Fair Trading, Personal Current Accounts in the UK, 2008, p2.

[3] Consumer Focus, Stick or Twist, An analysis of consumer behaviour in the personal current account market, October 2010.

[4] Consumer Focus, Keeping the Plates Spinning, August 2010.

[5] Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances.
http://www.fsa.gov.uk/pages/doing/regulated/tcf/

able to compete on a below cost basis (at least in the short term) for business, knowing that subsequent changes to the product will recoup their investment and that customers are unlikely to switch once signed on. There is the further advantage of utilising the customer's information and inertia to cross-sell products. Often customer inertia reflects the consumer's inability to differentiate in any significant way between retail banks' products.

2.8 Another issue in moving to the option of fee based accounts is determining the costs. It is a significant indictment on the current combined model of banking that there is a tendency to run the retail banking business without reference to the cost of its components and that the level of the cross-subsidy is not even clear to the banks themselves.[6] This increases risk and undermines market efficiencies.

2.9 The Panel doesn't underestimate the difficulties of improving effective competition in banking. It is commercially and reputationally very difficult for a bank to unilaterally start charging for a "free" service. HSBC offered a fee based current account and was pilloried in the media. It has had little take up, perhaps because the monthly fee seemed high. New entrants are similarly unlikely to attract business to a current account that charges fees where the option is no upfront fees.

2.10 A transparent summary statement about the total cost including interest on balances foregone could help raise awareness of the real cost of banking by providing comparative information relevant to the individual customer's circumstances so facilitating value for money comparisons between banks.[7] The most recent work was the OFT's study in 2006 which demonstrated that in 2006 a current account cost the average customer £152 a year, two thirds of this coming from interest foregone. The OFT's update of this work in 2009[8] concluded that:

"While the OFT found that consumers could generally understand the concept of interest forgone, we found that 80 per cent of consumers did not know their credit interest rate and further research conducted for the OFT revealed that out of a small sample of consumers the majority underestimated their average balance, some by 40 per cent or more."

2.11 There is a place for both fee and free products and an assessment of these products for different segments of the market. In the move to greater transparency in pricing and cross-subsidies there also needs to be a recognition that some areas of the market are not profitable and are not provided for. The Panel has called for a system of simplified

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[6] Competition commission, Personal current account banking services in Northern Ireland market investigation, May 2007.
[7] Eg The Carphone warehouse has established league tables in relation to mobile phones which rank products taking into account the range of variables and not just up front costs.
[8] Personal current accounts in the UK A follow up report October 2009

advice and simplified products for low income consumers which would help address some gaps in the market.

2.12 Greater capital requirements and regulatory controls may have the effect of restricting access to services and products because the consumers or products are considered too risky. The essential service nature of banking also demands a policy and regulatory response to ensure access to services and control of prices. There has been great support for the development of services currently provided by the Post Office, a trusted institution, into a fully functional payment system accessible to all.[9] But the Post Office alone will not meet the potential requirement.

2.13 In the new regulatory environment a regulator would ideally have responsibility for regulating all aspects of retail banking with a duty to promote competition and an ability to intervene where the market is not working. In doing this, it will need to consider economic aspects and be able to limit the scale of cross-subsidy in order to reduce barriers to entry.

3 Current models and culture

3.1 We would like to see the banking industry driven by and responsive to the needs of customers. Good retailers succeed by being sensitive and responsive to the needs of their customers and will differentiate on customer service, safety and quality of their products. Their existence does not eliminate the need for statutory regulation, but reduces it. The UK banking market is essentially characterised by one model – the mixed, commercial model – with retail or 'high street' banking often being overshadowed by the more profitable activities of investment banking; in effect, creating a tension between deriving profit from the commercial strategies employed for risky banking services and the delivery of retail services to consumers and SMEs that are of 'value'. Where the culture has become sales driven, it is undesirably so with widespread mis-selling and poor value products being cross-sold to existing customers.

3.2 New entrants are promoting difference. Metro Bank refers to itself as a retailer and to its branches as stores, and will be competing on service and convenience. Tesco claims they will offer a different retail experience to the traditional banks, based more on customer satisfaction. A more effective competitive market, facilitating new entry, would not only allow but also encourage businesses to adopt a reputational and value for money approach to financial services.

[9] Financial Services Consumer Panel, Submission to Independent Commission on Banking, November 2010.

4 Transparency

4.1 Transparency in charging and costs is essential in providing customers with a basis on which to make a choice, but this transparency will simply result in information overload if the complexity of charging and costs and contingent fees continue to prevail. We need to see competition on true costs and where other charges are relevant these must reflect a reasonable estimate of costs of the additional administration undertaken by a firm as a result of a customer being overdrawn, rather than being used as a vehicle to generate further profit.[10]

4.2 The growth of packaged products has added to the complexity. Research by Which? has shown that only 12% of those who used packaged accounts said they used all the benefits it offered. Increasingly credit cards or loan facilities are being offered only if you have a current account with the same provider. These packaged products are more difficult to compare and the value to consumers is dubious; competition and choice is reduced. The current right of set-off provides an incentive to offer these products to the potential detriment of consumers.

4.3 A legislative presumption in favour of transparency in the regulation of retail banking could do a lot to support effective competition providing consumers with real information about the practices of financial institutions.

5 Barriers to switching

5.1 Actual and perceived barriers to switching such as exit fees on mortgages or long time scales for switching have a significant effect on competition in the market. It should not require a super complaint for the industry to finally co-operate in make switching easier.[11] Consumers perceive the cost of switching outweighs the benefits with their being little differentiation between the banks. The prevalence of electronic transactions, particularly for essential services such as accommodation, power and water, makes the risk of error crucial. Issues around errors in switching are particularly a concern where the consumer has little control over payments mechanisms, such as direct debits.[12] Consumer controlled payment mechanisms would go some way to removing that risk.[13] The Panel has added its voice to the call for portable bank account numbers which would bring the convenience which

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[10] The FSA's Mortgage Market Review has proposed this in relation to arrears charges on mortgage lending. Additionally firms should only include costs that they can objectively justify and the can be identified with reasonable precision., FSA, CP 10/16, Responsible Lending, July 2010.

[11] Consumer Focus, http://www.consumerfocus.org.uk/news/consumer-focus-issues-super-complaint-to-office-of-fair-trading-about-uk-cash-isa-market

[12] Consumer Focus, Stick or Twist, An analysis of consumer behaviour in the current account market, October 2010.

[13] Consumer Focus, Opportunity Knocks, Providing alternative banking solutions for low income consumers at the Post Office, January 2010.

consumers have experienced in the mobile telephone market to the account transfer process.

6 Lack of confidence in the sector and promoting trusted models

6.1 There is a serious lack of confidence in the sector which has potential implications for the economy and long term savings goals. Lack of trust and confidence also presents a significant impediment to being banked amongst low income consumers.[14] It is an environment where consumers will be wary of new start-ups, particularly given they know that the existing big banks will be underwritten by Government.

6.2 The lack of confidence amongst consumer is not without significant justification. Whilst realising banking inclusion has been a central social policy goal for more than a decade, half of those who are newly banked are not benefiting from the move. "The gains from any savings they make from paying bills by direct debit have been all but entirely outweighed by the costs associated with penalty charges, resulting in a net loss for the lowest income households."[15]

7 Too big to fail

7.1 The market share for the three key retail banking services; personal current accounts, savings and mortgages; continues to be dominated by the "big four" with the addition of Santander after a series of mergers and acquisitions to make it the big five. It is notable that all demutualised building societies have seen their businesses fail, and have either been taken over by traditional banks or nationalised.[16] Consolidation has stifled diversity and provided us with one predominant banking model, that of the combined or mixed commercial model.

7.2 The big banks have been able to see off competition through the control of information and cross-selling opportunities as well as attracting implicit loyalty because of the widely held view that they are all the same and it is too difficult to

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[14] HM Treasury, Financial Inclusion Taskforce, Policis, Realising Banking Inclusion; the achievements and challenges, May 2010.

[15] HM Treasury, Financial Inclusion Taskforce, Policis, Realising banking inclusion: the achievements and challenges; www.hm-treasury.gov.uk/d/fitf_research_unbanked.pdf

[16] Lloyds TSB, Natwest (now RBS), Barclays and HSBChave all increased their market share since the Cruickshank review in 2000 with personal accounts collectively at 71%, deposit savings accounts at 59% and mortgages at 67%, The Future of Banking Commission Report, commission.bnbb.org/banking/sites/all/themes/.../commission_report.pdf, June 2010.

switch.[17] A recent report by Deloitte comments that the ability to attract current accounts with their cross-selling potential will be a key feature of most new entrants' plans, but current account focused business models have not been straightforward for those seeking to take market share in the past.[18]

7.3 The concentration of the sector in a time of crisis led to a Government bail out for some of the major players and managed take-over for others, with the perception that some organisations were too big to fail. Government subsidies for the large and unsuccessful has had a significant impact on competition. In a time of economic downturn, the small and successful are struggling against the formidable combined resources of State and multi-national.

7.4 Plans for divestment need to have both a market focus in fostering real and different competition and also a public focus in providing access to basic retail banking services at an affordable cost and minimal risk. These aims will not be achieved if we merely see a passing of the baton from one big player to the other, as occurred in the sale of RBS branches to Santander. There needs to be an independent monitoring, audit and review of the divestment process to ensure that divestment conditions are being met.

7.5 Section 172 (1) (d) of the Companies Act 2006 provides that in promoting the success of their company directors must have regard to "the impact of the company's operations on the community and the environment" and this seems to provide a useful starting point for conditions associated with divestment in the common good.

8 Too Big to Innovate

8.1 Established banks are like tankers and slow to respond to change. They do not have much to gain from change and need considerable time periods to adapt to external factors such as changes to legislation. In particular there has been little development in alternative payment models within the regulated sector and existing payments systems restrict new entry into financial services. Payments are not made in real time and clearing fees provide real hurdles for small providers. The developments that have taken place, eg prepaid cards and mobile and online payment providers, have largely occurred outside the system.

8.2 The Cruickshank Review identified profound competition problems and inefficiencies in the market for payment services.[19] Issues such as slow clearing cycles for cheques

[17] Consumer Focus, Stick or Twist, An analysis of consumer behaviour in the personal current account market, October 2010.
[18] Deloitte LLP, Opportunity Knocks, Considerations for new entrants in UK retail banking, 2010.
[19] *Competition in UK Banking, A Report to the Chancellor of the Exchequer*, Don Cruickshank, March 2000

and automated payments, high charges for cash withdrawals and interchange fees levied by monopoly providers still prevail despite some improvements leveraged by the Payments Council. The Payments Council is dominated by the major financial institutions and needs to do more to lead the future development of services. The Faster Payments Service (FPS) is the first new payments service to be introduced in the UK for 20 Years. Historically, innovations have disproportionately arisen from small companies, however small stakeholders expressed a measure of dissatisfaction with the access and support they received from the Payments Council when proposing innovations.[20] A monitoring body that is more pro-active in supporting innovation and enforcing adoption and has a more open membership structure is needed to remove barriers to innovation and market entry.

8.3 In an ideal world, new entrants are more likely to have an advantage in IT systems and new payment technology, but the authorisation process favours those who have established branch networks or who buy an authorised body off the rack and the Payments Council has not been particularly supportive of small companies proposing new innovations[21]. However buying into existing architecture may mean outdated systems less responsive to new models of operating. It is illustrative that a recent report records that firms' investment plans for information technology are broadly flat for the next 12 months while the balance for those planning to spend more on marketing in the coming year has risen to +53 % , the highest in 10 years. [22] New payment methods need to be fostered within the system, not outside it, in order to provide the safety that consumers need along with products that meet changing times and deliver more efficient service.

9 Too poor to be serviced

9.1 Combined banking models standardise operations across their network by way of a "single customer view". There is little differentiation according to needs of different communities or different segments of the population. The recession and failures of firms has seen services increasingly being withdrawn from less profitable areas, evidenced by branch closures, rationing of credit provision, and withdrawal of products that were less risky propositions for low income consumers such as the National Savings and Investment scheme.

9.2 Barriers such as the application of money laundering legislation with its inconsistent and sometimes onerous requirements for identification can act as barriers for consumers and new entrants (particularly those offering e-commerce models).

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[20] OFT1071, Review of the operations of the Payments Council, March 2009, 25.
[21] OFT 1071, Review of the operations of the Payments Council, March 2009.
[22] CBI/PWC Financial Services Survey, 28 June 2010

Financial capability presents another barrier, even if there was clarity and transparency in charging practices.

9.3 There has been rapid growth in payment cards, micro-finance models, peer to peer lending, and high cost lending, which require less onerous entry requirements than mainstream banking products but regulation, fraud, theft and compensation remain a problem with many of these services. We are concerned that customers will increasingly have to seek services outside the regulated market because the market does not provide for them.

See attachments:

- Financial Services Consumer Panel Submission to Independent Commission on Banking
- Financial Services Consumer Panel's response to the OFT Call for evidence to the Review of Barriers to Entry, Expansion and Exit in Retail Banking.