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

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**Response to Interim Report and Consultation on Reform Options**

## Introduction

The Consumer Panel welcomes the interim report of the ICB and in particular its approach to evidence collection by conducting public sessions throughout the country to gather evidence, enabling a broader and more relevant perspective than the usual consultation approach. The Panel supports the emphasis on ensuring consumers, as well as the economy, are protected through proposals to improve stability and enhance competition.

The Panel is concerned that in an environment where the second tier of the banking industry has effectively been wiped out by building society demutualisation and industry consolidation, it is essential that competition is maintained in the market, and that new entrants are able to join the industry to fill the gaps, delivering better results for consumers.

We are broadly supportive of the findings of the interim report. Our response focuses on the need for competition powers for the regulator as well as an effective toolkit and resources to deliver consumer protection and access to financial services. In particular we support the proposals that promote a market that provides choice and value for money, specifically:

- Removal of barriers to entry and a sustainable diversity of providers;
- Ease of switching;
- Greater transparency about products and prices and facilitation of comparisons;
- Access to financial services for all;
- An independent and active regulator.

**Answers to questions**

**Chapter 4: Reform options – financial stability**

*Q 4.3 Do you agree that bank debt should be made more loss-absorbing using some or all of contingent capital, bail-inable debt and/or depositor preference? If so, which of these tools do you support and how should they be designed?*

The existence of Government guarantees implicitly supports risk taking by stakeholders, management and creditors. Whilst ring fencing if adopted should prevent this, we support the proposal for depositor preference and the subordination of the claims of all other creditors. Depositors are least able to protect their assets or to influence bank risk taking and should therefore be prioritised. Further consideration should be given to extending the preference beyond those that are FSCS insured.

*Q 4.4 In relation to structural reforms to promote stability, do you agree that the Commission should focus its work on a UK retail ring-fence?*

The Panel welcomes attempts to improve the stability of banks' retail operations, which are of fundamental importance to millions of ordinary customers. The solution should be the best available to achieve good outcomes for consumers and taxpayers, including access to retail banking services such as current account deposits and payment systems at all times. In the event of failure, there must be an orderly process whereby payment systems are protected, consumers face minimum disruption or short term loss, and are compensated in full.

Ring fencing may contribute to such stability, although risks posed by regulatory arbitrage, shadow banking and unstable sources of funding would remain areas of concern.

**Chapter 5: Reform options - competition**

*Q 5.1 Do you agree with the three broad measures proposed in this chapter (structural change, improvements to switching and barriers to entry, and pro-competitive financial regulation)?*

We support these three broad measures, subject to the matters considered below.

*Structural change*

Plans for divestment need to genuinely enhance competition, providing access to 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 has occurred in the sale of RBS branches to Santander. It is not clear that enhanced divestiture will promote significant competition or diversity in financial services, save but to introduce another big player. We are aware that the risk of incentivising a diversity of players is the loss of economies of scale and the potential for costs of services and products to go up. However current banking models deliver little in the way of choice, service or appropriate products.

We have previously called for an independent monitoring, audit and review of the divestment process to ensure that divestment conditions are being met and that good consumer and economic outcomes are achieved, through oversight, supervision and approval of the divestment process by an appropriate body. We urge the government to set conditions for the sale of branches to ensure that enhanced competition is achieved.

*Switching*

Actual and perceived barriers to switching have a significant effect on competition in the market. Consumers perceive the cost of switching outweighs the benefits, with little differentiation between the banks.[1] The prevalence of electronic transactions, particularly for essential services such as accommodation, power and water, amplifies the risk involved with transfer.

The agreement secured by the OFT with Bacs, subsequent to their personal current account investigation, included steps to reduce both the problems arising from the transfer of direct debits and their impact on consumers, and the introduction of a new consumer guide. OFT initially reported some progress in reducing error rates but it appears from their latest update that this trend has been reversed and error rates have in fact gone up.[2]

Issues around errors in switching are particularly a concern given the consumer has little control over payments mechanisms and their transfer. Where errors result in consumer detriment, such as direct debits being missed, responsibility for remedying this must lie with the bank(s) concerned. We support the introduction of full account number portability, an initiative that has had positive impacts on competition in the mobile telephone market, to remove the risks associated with transfer. When this proposal was previously mooted in 2001, of the major banks, only Barclays opposed the plan as being too expensive.[3] It is time to revisit the proposal, particularly given developments in technology are likely to make this exercise easier and more efficient. We note that Lloyds Banking Group, which had previously backed the introduction of portable account numbers, continues to be supportive of a fully automated system for transfer.

There is scope for significant improvements in payment options in financial services. It is vital that the Payments Council is pro-active in encouraging innovation and that new payment methods are supported within the system, not left to develop outside it. In addition to the introduction of portable bank accounts, consumer controlled payment mechanisms and real time payments would go some way to removing risks in switching and improving the

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[1] '*Stick or Twist, An analysis of consumer behaviour in the current account market*', Consumer Focus, October 2010.
[2] '*Personal current accounts in the UK'*, Progress Update, March 2011
[3] http://www.independent.co.uk/news/business/news/Barclays-baulks-at-portable-account-plan

consumer experience.[4] For example, there is no reason why consumer initiated direct debits, usual in other countries, should not be the norm in the UK, transferring control to the consumer.

*Barriers to entry*

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.[5] Consolidation has stifled diversity and provided us with one predominant banking model, that of the combined or mixed commercial model.

The authorisation process is complex and lengthy. Whilst the FSA aims to process all applications within 6 to 12 months of receipt the reality is that most take a year or longer. This will have an impact on securing and sustaining necessary resources for a start up, including finances and staff. A recent Deloitte study[6] also refers to the difficulty in negotiating the necessary third party contracts required to operate a bank. There are estimated to be around 20 of these third parties, including Bacs, Chaps and the LINK network, and the study points out they are "unwilling to connect new banks to their network without a banking licence or approval in principle, yet the FSA will not grant a licence until systems are tested."

For new entrants to the industry, it is easier to get authorisation if you buy 'off the rack' rather than tailor systems and processes to needs. Assessments favour those who take over existing networks and systems, in effect stifling innovation and creating the further challenges of integrating systems and updating technology.[7] While bank launches are uncommon in Britain, they are not unusual in the US where it's possible to purchase off-the-shelf technology packages that offer all the transactional capability of modern banks at low cost.

The regulator should consider ways of speeding up the authorisation process, whilst maintaining its robustness, perhaps through better use of technology, and whether more flexibility of systems and operational requirements may encourage more start ups.

The big banks have been able to see off competition through access to 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

[4] '*Opportunity Knocks, Providing alternative banking solutions for low income consumers at the Post Office*', Consumer Focus, January 2010.
[5] Lloyds TSB, Natwest (now RBS), Barclays and HSBC have 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 June 2010.
[6]'*Opportunity Knocks, Considerations for new entrants in UK retail banking'*, Deloitte, 2010..
[7] Virgin bought Church House Trust and Walton and Co were looking to purchase Hampshire Trust.

to switch. [8] "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."[9]

*Q 5.2 Should the Commission pursue any other measures to promote competition?*

The interim report itself provides evidence that wholesale markets are not either competitive or efficient "with services being selected as much on the basis of established relationships, provider reputation and non-price elements". It is imperative that the efficiency of wholesale markets is considered as part of any proposals for structural reform and we strongly encourage the Commission to investigate these markets further. There are significant implications for ordinary consumers related to the performance of pension funds and other aggregated consumer investments and in recent years pension funds have struggled to achieve adequate returns. We believe there are inefficiencies in wholesale markets evidenced by rent extraction and raised in connection with the social usefulness of some activities which could result in significant detriment to consumers.

*Q 5.4 Where are the limitations on customers' abilities to understand banking costs, compare different accounts, and switch between them?*

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, costs and contingent fees continue to prevail. Information asymmetries and unfairness in costs and charges need to be tackled in order to assist customers in making appropriate choices and to remove some of the barriers to entry. We support the work currently being done by the European Commission, in conjunction with the European Banking Industry Committee, to improve transparency and comparability of personal current account fees, and are encouraged that the issue is being considered both at UK and European level.

The number of consumers enjoying genuinely free banking is limited to those who use their current account frequently, have small balances and never go overdrawn. The rest pay through interest forgone and penalty charges that are often not disclosed in advance.

We need to see competition on total cost. The Panel suggests mandating a summary statement about the total cost[10] to raise awareness of the real cost of banking by providing comparative information relevant to the individual customer's circumstances. Where contingent charges are incurred (such as fees on unauthorised overdrafts) these must reflect a reasonable estimate of costs of the additional administration undertaken by a firm, rather than being

[8] '*Stick or Twist, An analysis of consumer behaviour in the personal current account market'*, Consumer Focus, October 2010.
[9] '*Opportunity Knocks, Considerations for new entrants in UK retail banking'*, Deloitte, 2010.
[10] Including quantifiable fees and charges, estimates of likely fees and charges.

used as a vehicle to generate further profit.[11] In the light of recent legal cases the regulator must have to power to require this.

The growth of packaged products has added to the complexity for consumers. Research by Which?[12] has shown that only 12% of those who used a packaged account said they used all the benefits it offered. Increasingly credit cards or loan facilities are being offered at a preferential rate only if the customer has a current account with the same provider. Major players have an advantage in cross selling because of access to customer information and the ability to take advantage of customer inertia. 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.

We support a legislative presumption in favour of transparency to promote competition, to set minimum standards of disclosure and as a regulatory tool to provide information on the practices and products of financial institutions.

*Q 5.7 How could small banks' ability to offer a national network of cash handling services be improved?*

Our research has underlined the importance of branch networks and personal contact in banking for consumers and how preferences are likely to be influenced by these factors.[13] The current authorisation process favours those which have established branch networks. It is possible that encouragement of payment innovation and regulation of restrictive practices, such as interchange fees, may help to overcome or provide realistic alternatives to the local branch and that changes in habits can be incentivised with genuine competition. We are also supportive of the expansion of Post Office services as a way to overcome branch network issues. We would like to see an exploration of the costs and benefits of making all bank and credit union accounts accessible through Post Offices. We also support the ICB's proposal to investigate further sharing of cash-handling services with larger banks.

*Payments System*

The Cruickshank Review identified profound competition problems and inefficiencies in the market for payment services.[14] Issues such as slow clearing cycles for cheques and automated payments, high charges for cash withdrawals and interchange fees levied by monopoly providers still prevail despite some improvements facilitated by the Payments Council. Barriers to entry include agency arrangements and the need to contract into payments services, which are controlled by the major financial institutions, and interchange fees covering ATM access. In 2009 these problems persisted

[11] 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, *CP 10/16, Responsible Lending*, FSA July 2010.
[12] http://www.which.co.uk/money/bank-accounts/guides/finding-the-right-bank-account/should-i-pay-a-fee-for-my-bank-account
[13], "*Consumer Perceptions of Fairness in Financial Services*" Opinion Leader for the Financial Services Consumer Panel, June 2010.
[14] *Competition in UK Banking, A Report to the Chancellor of the Exchequer*, Don Cruickshank, March 2000

with the European Commission deciding against Mastercard in relation to price controls in the use of interchange fees on payment cards[15] The US Federal Reserve has proposed new rules to regulate interchange fees so that these are not used as another way of extracting profit but reflect actual cost. Major changes to interchange fee arrangements and fee levels are expected as the result of the implementation of the Single Euro Payments Area (SEPA) but these factors will need to be monitored.

The Faster Payments Service (FPS) is the first new payments service to be introduced in the UK for 20 years. However despite 4 years of operation it still does not do what was intended, providing commitments for electronic payments to be made in real time. It is not universally available for all payments, there is no consistency of application across banks, and some banks do not provide FPS at all. The imminent implementation of the Payment Services Directive, requiring electronic payments to be processed within a day, will cause headaches for some banks. Where financial institutions are not prepared there is a real risk that payments will be processed through CHAPS and charges passed on to consumers.

The Payments Council itself is dominated by the major financial institutions and needs to do more to lead the future development of services. The developments that have taken place, eg prepaid cards and mobile and online payment providers, have largely occurred outside the system whilst entry to the system for small providers is often by way of agency arrangements that can be restrictive or costly.

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.[16] 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.

We support the independent monitoring of the payments system and oversight of the Payments Council and individual UK retail payment schemes by the FCA.

*Coverage*

The prevailing banking models standardise operations across their branch networks in pursuit of a 'single customer view'. This can make it too costly or difficult for banks to service hard to reach parts of the market or assess and respond to the needs of local communities and enterprises. There is little differentiation according to needs of different communities or different segments of the population. The recession and failures of firms have seen services increasingly being withdrawn from less profitable areas, evidenced by branch closures and rationing of credit provision.

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[15] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:264:0008:01:EN:HTML

[16] *OFT1071, Review of the operations of the Payments Council*, March 2009, 25.

It is no longer possible to function outside the financial services system, not only in relation to transactional services but increasingly in pensions and insurance, as responsibilities in these areas pass from the Government to consumers. Access to financial services is a precondition of functioning in society and needs to be intermediated. Other sector regulators have a range of social duties and for most of these this includes a primary duty to further the interests of consumers.[17] Further work needs to be done on both the desirability and nature of a universal service commitment in financial services and the role of the regulator in ensuring essential services are delivered.

We are aware that the ICB has received evidence on access to financial services and encourage it to include in its final report proposals for ensuring the market provides appropriate access for all, and ensure that providers comply with the spirit rather as well as the letter of the law. In particular access to basic banking services and to personal current accounts need to be assured, and the availability of these services clearly communicated to customers and potential customers.

*Q 5.8 How should the Financial Conduct Authority discharge its duty to promote competition?*

We believe the regulator should be focused on consumer protection and should act to protect and uphold the interests of existing and future consumers in relation to the provision of financial services to ensure that all persons have access to financial services which are fair, transparent and competitive. We do not support the proposal for competition to be the primary duty of the FCA. We acknowledge, however, that greater competition has the potential to deliver good consumer outcomes and we welcome the greater emphasis on competition, both through the operational objective and in that the FCA must discharge its general functions in a way which promotes competition. The FCA should have similar powers to regulators in other sectors in terms of competition. We endorse the sentiments of the recent BIS consultation on the competition regime that it is necessary to maximise the ability of the competition authorities to secure vibrant, competitive markets that work in the interests of consumers and to promote productivity, innovation and economic growth. In allocating the FCA a competition function its powers and authority have to be clear and equivalent to those of the other sector regulators.[18]

We therefore propose that the competition operational objective be strengthened as follows:

"The FCA must, wherever appropriate, promote effective competition that improves consumer outcomes in retail and wholesale markets."

[17] As above, p 72
[18] '*A Competition Regime for Growth: A consultation on options for reform*', BIS, March 2011, p6.

*The PRA and competition*

Whilst the FCA is expected to have a competition objective, there is a danger that regulatory intervention undertaken by the PRA may have a damaging impact on competition and consumers' welfare. Concentration or a regulatory preference for larger institutions raises concerns about barriers to entry and creates the risk of imperfect competition. It is no doubt easier for a regulator to regulate a small number of firms with similar operating models. If the PRA only focuses on financial stability it may lose sight of the long-term impact of its activities on the competitive structure and behaviour of financial firms.

We have proposed adding the current "have regards to" applying to the FSA to the PRA's regulatory principles:

"the need to minimise the adverse effects on competition that may arise from anything done in the discharge of the PRA's functions".

*Price discrimination*

The pricing of banking services, including the erroneously named "free banking" model, is another barrier to competition. There is a perception that so-called free banking has become a basic customer and market expectation and this has the potential to restrict the development of different models by fledgling market participants. In other retail sectors, where effective competition prevails, consumers benefit from lower costs and genuinely innovative products designed to meet their needs. Free banking makes it hard for new entrants to offer fee-based current accounts even though this might provide some customers with better value for money overall. This is an example of a market with ostensibly competing businesses where competition is ineffective in achieving good consumer outcomes.

We have suggested above that the regulator should ensure that charges are related to the cost to the bank in providing a particular service and that the pricing and charges should be transparent. The way they are presented and calculated also needs standardisation along the lines proposed by the Competition Commission in its investigation into personal current account banking services in Northern Ireland[19].There is a clear case for regulatory intervention when pricing and charges are unfair or disproportionate. The prevailing model in retail banking shows clear variation in prices according to usage in a way that results in the poor paying more. National Consumer Council research has estimated that low income consumers have paid on average £129 a month in interest, representing 11% of their income on interest charges alone.[20]

We have called for the regulator to have an effective toolkit that will enable it to address the economic dimensions of regulation. The toolkit needs to be supported by adequate resources and expertise, particularly in the area of market analysis and consumer experience. The FCA should have the power

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[19] May 2007.
[20] *Affordable Credit Fact Sheet*, NCC and POLICIS, 2005

to make rules in the area of inappropriate cross subsidies and charges which do not reflect underlying costs.

*Conflict of interest (Volcker Rule)*

We support a role for the FCA to monitor conflicts of interest arising from non-retail banks trading both on behalf of their clients and their own accounts. We propose that this is supplemented by the principle that all authorised firms have a prescribed duty of care to their clients.