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

A report for the Financial Services Consumer Panel by Collaborate Research in partnership with Tooley Street Research

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1. Executive summary

We put forward three hypotheses of ways in which cross-subsidies might exist between consumer groups in the retail personal current account market in Britain; each of which is supported to a greater or lesser extent by the literature:

- Hypothesis 1 - Overdraft fees subsidy: those who go overdrawn subsidise everyone else.
- Hypothesis 2 - Money to the middle subsidy: relatively low income customers in credit are subsidised by everyone else.
- Hypothesis 3 - Diligence subsidy: consumers who understand the costs and shop around for the best deal are subsidised by those who do not.

Comparing the UK experience with that in other comparable countries provides a useful perspective. In the US, the rapid fall in free banking as a result of regulatory pressure gives a glimpse as to the direction that the UK may be heading in; in continental Europe the lack of a free banking tradition points us towards what a progressive model of paid-for banking might look like. Throughout there is emphasis on the need for transparency and competition to allow the market to function properly and provide real choices for consumers.

Looking to the future, anticipated regulatory changes, the experience in other markets and the existing direction of travel in the UK put pressure on the model where current accounts are offered free to those who are in credit. The losers are likely to be low income thrifty consumers, who no longer gain the benefits from hypothesis 2 - money to the middle; the winners are likely to be the slightly more affluent consumers in the mainstream middle who will benefit from increased competition and fees that represent the true value of servicing their accounts.

The question for groups representing the consumer interest revolves around which group of consumers most need their interests representing. In the final section we present some questions for the future designed to expose these choices more clearly.

2. Introduction

2.1 Background and aims

There is little consensus in Britain on what role, if any, there is for public policy in regulating the cost of current account banking services.

Reasons in favour of action include concerns that the poor are subsidising the affluent, epitomised by the attempt in 2007 by the Office of Fair Trading (OFT) to obtain a legal judgement against overdraft charges, and separately that those who do not shop around are subsidising the diligent, leading to attempts to make it easier to compare costs and switch provider.

Meanwhile banks argue that any attempt to impose a standard utility-style business model with uniform costings will stifle market innovation in a competitive market. Against this background, the new Competition and Markets Authority is due to report imminently on whether the current structure of the market for personal current accounts acts against the interests of current account holders such that a full two-year market investigation is required.

The aims of this report are to:

- Provide a conceptual framework with which to consider the issue of cross-subsidisation in the retail current account market;
- Describe ways in which cross-subsidisation between different groups of consumers can occur in the market;
- Describe the current consensus as to where cross-subsidisation currently exists, as evidenced by existing public sources;
- Compare the situation in the UK with other comparable countries;
- Describe areas in which interested parties are advocating for change; and
- Suggest areas of future research to push the debate forward.

2.2 Structure of report

We start by describing the nature of the personal current account market in the UK, and then explore the extent to which cross-subsidisation exists drawing on academic and industry sources (Chapter 3). By way of context we then compare this with selected other OECD countries as well as describe the impact of recent EU-wide initiatives (Chapter 4). We then briefly explore ways in which the picture outlined in the earlier chapters might be expected to alter due to known regulatory, market and NGO pressures at the time of writing (Chapter 5), before concluding with some future questions that interested parties may wish to consider (Chapter 6).

2.3 Methodology

This report is primarily a literature review. We have drawn on public and academic sources including evidence to parliamentary committees and the work of the regulatory and competition authorities. All of our source documents are referenced throughout the text. As part of the research we contacted companies, trade bodies and consumer groups that might be expected to have an interest in the research to invite them to point our research team to any published material that they wished us to consider.

The main methodological issue we encountered was the fast-moving pace of change in the market. Only a year ago, for example, the OFT decided not to refer the market for personal current accounts to the (then) Competition Commission in recognition of the ongoing efforts of the Financial Conduct Authority (FCA) to promote the consumer interest in this market. Banks, for example, are now not only routinely providing information to customers on the amounts of interest foregone but 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. At the time of writing the CMA is considering a full market investigation of its provisional decision to refer personal current accounts and SME banking services for in-depth investigation.

In the meantime, technology and market pressure are independently forcing change. Banks are sophisticated in segmenting their consumers to offer different products to different cohorts, often using the current account as a basis to offer a wider portfolio of services. New products are emerging that are altering the landscape for consumers: Clear Account, for example, offers an overdraft insurance service where consumers can pay to keep their account in credit to avoid penal charges from banks; Paypal provides a new way to charge up an account in the confidence that payments can be made only for as long as balances are available; smart phones enable customers to check balances as they stand at the till. Different regulatory responses in other countries give clues to the sector as to ways in which the market may adjust.

This report attempts to shed light on the various pressures that affect the market to tease out the key questions and enable choices to be made.

3. The nature of cross-subsidy

3.1 Retail banking market

The retail banking market in the UK is concentrated, with 94 per cent of current accounts held with six banking groups, of which Lloyds TSB is the largest provider of current accounts[1]. The trend is for smaller banks to close: data from the British Bankers' Association shows that the total number of retail banks fell from 590 thirty years ago to 298 today. Between 2011 and 2013, around a tenth of banks ceased to trade.[2] There are a number of mainstream challenger firms that are making an impact at the margins: Metro Bank, M&S Bank, Post Office[3], Virgin Money and Tesco Bank and there is evidence that competitive pressure is increasing: advertising expenditure on personal current accounts is rising.[4]

Data from the British Bankers' Association shows that there were around 141 million current accounts and deposit accounts in the UK at the end of 2012. Mintel data suggest that over a third of current account holders have multiple accounts, and that holders of multiple accounts are more likely to have switched in the past year; a quarter hold a joint account; one in seven have a packaged or premium account, and that packaged accounts are more likely to be jointly held. Half of all account holders have never switched; one in twelve has done so in the past year.[5]

Between 2007 and 2012, the number of non-interest bearing accounts tripled to around 37 million, while the number of interest-bearing accounts fell from 107 million to 90 million in the same period. The main shift from interest-bearing to non-interest bearing accounts happened in 2009-10.[6]

Basic bank accounts are also on the rise: from 7.2 million in 2007 to 9.3 million by the end of 2010, remaining steady thereafter.[7] A Special Eurobarometer Report released in 2012 noted that, as of 2011, the UK had a financial inclusion rate of 92 per cent.[8]

While Credit Unions are a fast (and consistently) growing member of this market, they do not make up a significant share of the total. The Association of British Credit Unions Ltd (ABCUL) notes that there were 232 credit unions by September 2013 with total membership numbers (savers and borrowers) of just over one million, up from 650,000 in 2008. Over the same period, savings held in credit unions grew from just under £500m to over £900m and the average credit union grew its membership by 14 per cent[9].

[1] Mintel, *Packaged and Current Accounts*, July 2013
[2] British Bankers' Association, *Abstract of Banking Statistics 2013 Volume 30*, (2013).
[3] Post Office current accounts are provided by Bank of Ireland (UK) plc.
[4] Mintel, as above
[5] ibid
[6] BBA, as above
[7] BBA
[8] European Commission, *Special Eurobarometer 383: Retail Financial Services Report*, (2012), 13
[9] ABCUL, *Annual Report 2012-2013* (2013), 9

In the savings market for deposit accounts, around a quarter of the market is held by building societies and other mutually-owned retail financial service companies which hold deposits of around £250bn in 2012.[10]

3.2 Definition of cross-subsidy

Insofar as cross-subsidy between different cohorts of consumers exists, not only is the nature of that cross-subsidy disputed but neither is there a consensus on the definition of cross-subsidy, either in academic literature or elsewhere.

An influential starting point is the definition provided by the UK economist Gerald Faulhaber in a 1975 article entitled "Cross-Subsidization: Pricing in Public Enterprises"[11] which considers there is a subsidy-free environment if, and only if: *"(1) no group of consumers pays more than the stand-alone cost of providing account services to that group of consumers, and (2) each group of consumers paid a price equal or greater to the incremental cost to the bank of providing the transaction account service."*[12]

Ashton and Hudson in the 2013 Friends Provident report also examined cross-subsidy based on costs to consumers, noting that *"the examination of pricing and profitability of services appears to be preferred over traditional accounting based approaches due to concerns with the veracity of accounting data produced by banks for the purpose of cross-subsidy measurement"* and also referring to the difficulty in obtaining these definitions.[13]

According to this analysis, for example, it follows that, in the authors' words:

> *"If there are no cross-subsidies within 'free banking' current accounts, for example, we would expect the customer costs of using these accounts to be similar to the customer costs of using other types of current account."*

And also that:

> *"if there is a distributional cross-subsidy flowing from lower income to other customers, we would expect significant differences to exist between the customer costs of using personal current accounts identified for lower income representative customers relative to other customers."*[14]

However, because the specific costs of providing current accounts to particular groups of customers is not publically known, this practical use of a cost-based approach is limited.

[10] Simon Rex, "Savings Market Statistics," *Building Societies Association*, http://www.bsa.org.uk/information/statistics/savings-market/
[11] Gerald Faulhaber, "Cross-Subsidization: Pricing in Public Enterprises," *The American Economic Review* 65 (1975) 5: 966-977
[12] 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), 79
[13] 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), 40
[14] Ashton and Hudson, *How Much Does Free Banking Cost? 40*

Indeed the banks are reluctant to offer information on costs and revenues either from specific customer cohorts or product lines. Retail bank representatives giving evidence to the Treasury Select Committee[15] were not able to offer a specific figure comprising the costs of ATM networks, branch networks, IT, and all the other associated costs of providing current accounts. The only estimate we get from the banks is a blunt annual average provided by the Cooperative Bank of £85.[16]

Another definition of cross-subsidy that may be more useful is much broader – that of Kenneth Fjell, presented in his 2001 article, "A Cross Subsidy Classification Framework."[17] Fjell defines cross-subsidy, most simply, as "*the transfer of resources from one product line or consumer group to another.*" Fjell himself notes that his is one of the only definitions of cross-subsidy between consumer groups.

The OFT's definition of cross-subsidy is similar to Fjell's, but is based on the revenue generated by the product. Their definition is as follows: cross-subsidy is *"funding the loss or low return from one line of goods or services from another more profitable activity."*

3.3 Is there cross-subsidy between holders of personal current accounts?

Even if definitions of cross-subsidy vary, there is little dispute that at some level it exists. However, there are differences in opinion as to the form that it takes.

One of the first works in recent years to ask this question was the Competition Commission's Review of Personal Current Accounts in Northern Ireland.[18] While the report did not focus on cross-subsidy explicitly (it was more concerned with opacity of charges), it did note that free-in-credit accounts benefitted some consumers, and meant higher charges for others.[19]

Exactly how those charges play out – who pays for whom – has been a matter of debate since. We have identified three main hypotheses in the recent literature as follows:

- Hypothesis 1: Overdraft fees subsidy (those who go overdrawn subsidise everyone else). This was the dominant hypothesis between 2008 and 2012.
- Hypothesis 2: Money to the middle subsidy (relatively low income customers in credit are subsidised by everyone else). This is supported by some - but not all - low income consumer groups and by recent research undertaken by Friends Provident.
- Hypothesis 3: Diligence subsidy (consumers who understand the costs and shop around for the best deal are subsidised by those who do not). This has been a popular theme throughout the last decade, and is of particular concern to the

[15] House of Commons Treasury Committee, *Competition and Choice in Retail Banking*, April 2011
[16] House of Commons Treasury Committee, *Competition and Choice in Retail Banking*, 27-28
[17] Kenneth Fjell, "A Cross Subsidy Classification Framework," *Journal of Public Policy* 21 (2001) 3: 265 – 282
[18] Christopher Clarke et al, *Personal Current Account Banking Services in Northern Ireland: A Market Investigation*, (Competition Commission: 2007)
[19] Clarke et al, *Northern Ireland*, 9

competition authorities, although it is often presented implicitly, suggesting that taking advantage of the financially illiterate or non-diligent to provide free current accounts to the diligent is wrong.

Below we discuss each of these in turn.

3.3.1 Hypothesis 1: Overdraft fees subsidy

The OFT conducted a market study on the personal current account market in 2008[20], followed by periodic updates[21],[22],[23],[24], leading to a full-scale re-review of the market in 2013[25].

In their initial report, they concluded that a cross-subsidy flows from *"those consumers who incur insufficient funds charges to those who do not; and to a significant extent from 'vulnerable' low income and low savings consumers, to higher income, higher saving ones."* This conclusion is based on the premise that low-income customers are more likely to go into overdraft and incur non-sufficient funds (NSF) fees. Their analysis, while noting the existence of interest foregone as a charge on more affluent account holders, did not include such opportunity costs within its definition of cross-subsidy.[26]

A report in 2010 by Policis, "Realising Banking Inclusion: The Achievements and Challenges,"[27] for the Financial Inclusion Taskforce, argued that the system operated a regressive cross-subsidy - *"free banking for the many combined with punitive charges… is weighted strongly against the interests and well-being of those on lower incomes... the poor are effectively subsiding the better off"* - and that this had a significant impact on financial inclusion: ***"****More than half of the newly banked and almost two thirds of the remaining unbanked have previously been banked but have fallen out of banking"* because they could not afford to pay the overdraft, NSF, and other penalty fees that would arise on their accounts. [28],[29]

They also contended that penalty fees fall more harshly on the newly banked than they do on others, writing *that "around half of the newly banked have been exposed to penalty fees, six in ten of these having paid charges within the last twelve months. Individuals who do incur charges tend to be charged multiple times, averaging 5.6 times p.a., with one in 3 of the newly banked incurring more than 5 charges in the previous year."*[30]

[20] OFT, *Personal Current Accounts in the UK*, 2008
[21] OFT, *Personal Current Accounts in the UK: A Follow Up Report*, (2009)
[22] OFT, *Personal Current Accounts in the UK: Unarranged Overdrafts*, (2010)
[23] OFT, *Personal Current Accounts in the UK*: *Progress Update* (2010)
[24] OFT, *Personal Current Accounts in the UK: Progress Update* (2011)
[25] OFT, *Review of the Personal Current Account Market*, (2013)
[26] ibid
[27] Anna Ellison et al, *Realising Banking Inclusion: The Achievements and Challenges: A Report to the Financial Inclusion Taskforce,* August 2010
[28] Ellisson et al, *Realising Financial Inclusion*, 64
[29] Ellisson et al, *Realising Financial Inclusion*, 4
[30] Ellisson et al, *Realising Financial Inclusion*, 5

The following year, the House of Commons Treasury Select Committee enquiry on retail banking came to a similar conclusion, noting *"a minority of consumers, often those on lower incomes, pay explicit charges associated with overdrafts...Meanwhile, other consumers, often on higher–incomes do not pay explicitly for their current account provision, in spite of the fact that their PCA provision clearly does incur a cost to the provider."* [31]

In the evidence heard by the Committee, this view was supported by two witnesses in particular: Adam Phillips from the Financial Services Consumer Panel stated that free banking is *"notionally free [...] it's not actually free".* He said the effect of this was "*to favour certain kinds of people against others."*[32]

John Fingleton, the then chief executive of the OFT supported this view in his evidence, stating that the beneficiaries under the current model are *"people who have average balances that don't go into overdraft and who manage their accounts very well*" and, furthermore, that *"people with average balances of less than £1,000 a year are far more likely to go into overdraft."*[33] However his evidence also opened up the existence of Hypothesis 2 (see below).

A number of other organisations and academics have referred to the existence of a regressive subsidy without providing additional substantiation. For example:

- Citizens' Advice, in its 2010 *Consultation on Access to a Basic Payment Account* to the European Commission cited the OFT's evidence that there was a regressive cross-subsidy.[34]
- Citizens' Advice Scotland, in its 2010 report *Fully Charged,*[35] quotes the OFT on cross-subsidisation directly, concurring that free banking for the wealthy is subsidised by low income consumers.[36] This report argued that low-income consumers are more likely to incur an overdraft, and to be more adversely affected by overdraft fees, *"as the margin for error in their budgets is much smaller."*[37] The same report explained that while overdraft charges are the same for rich and poor, they are a far higher proportion of the income of the latter: a client on the Job-Seeker's Allowance of £257 per month, even if they go overdrawn by a very little, could pay up 33% of his monthly income.[38]
- The Financial Services Consumer Panel**,** in its 2010 response to the Department of Business Innovation and Skills' call for papers on consumer credit and personal

[31] House of Commons Treasury Committee, *Competition and Choice in Retail Banking: Ninth Report of Session 2010-11*, March 2011
[32] Ibid p30
[33] Ibid p30
[34] Citizens Advice Bureau, *Consultation on Access to a Basic Payment Account: Citizens Advice Response to the European Commission*, November 2010
[35] Citizens Advice Scotland, *Fully Charged: Evidence on Overdraft Charges from Scottish Citizens Advice Bureaux*, 2010
[36] Ibid p.6
[37] Ibid p.25
[38] Ibid p.22

insolvency, concurred with the OFT's assessment in 2008 that there was a regressive cross-subsidy in PCAs.[39]

Professor Andrew Mullineux has written multiple articles criticising the "reverse Robin Hood" arrangement of current account charges:[40],[41],[42]. In all three of these pieces, Dr. Mullineux assumed a regressive cross-subsidy between the rich and the poor (as well as a rudimentary version of Hypothesis 2,) and asserts *"the poorer and less financially literate customers are more likely to overdraw their accounts, to smooth their consumption in the face of typically more erratic income, and less likely to have agreed overdrafts due to low credit ratings."*[43]

The OFT launched its test case against the industry in 2007 (OFT v Abbey National et al). The case was based on the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs). The argument, in brief, was that the fees charged by banks for delinquency were so high that they did not form a substantive part of what bank clients were agreeing to – that they were being subjected to fees that were not a part of the core service. Ultimately, in 2009, the Supreme Court handed down a verdict in favour of the banks, ruling that the charges were not unfair because they constituted such a high source of income for the banks, that they must therefore be a core and essential part of the agreement between bank and consumer.

More recently there has been an acknowledgement that, to the extent that a regressive subsidy exists through overdraft fees, it has been ameliorated by recent reductions in the absolute level of overdraft fees and action by banks to alert consumers to the risk of incurring charges.

In 2011 the Department for Business, Innovation, and Skills, cited the OFT's 2010 update,[44] which shows that the average level of *"unpaid item charges levied by the major PCA providers have fallen from approximately £34 in 2007 to £17 in 2010, and per transaction paid item charges for using an unarranged overdraft from approximately £30 to £22."*[45]

By 2013, the OFT had concluded that *"overall, the evidence indicates that overdraft charges now fall more evenly across consumers with different income levels, without a significant cross-subsidisation from those with low incomes that was the case at the time of the OFT's 2008 market study.*"[46] The FCA in 2014 concurred with the OFT in terms of the cross-subsidy between cohorts, noting the progress in informal frameworks agreed between the

[39] Adam Phillips, *Letter to Peter Lovitt*, December 2010
[40] Andrew Mullineux, "The Regulation of British Retail Banking Utilities," *Journal of Financial Regulation and Compliance* 17 (2009) 4: 456 – 466
[41] Andrew Mullineux, "The Public Duties and Social Responsibilities of Big British Banks," *International Advances in Economic Research* 17 (2011) 436 – 450
[42] Andrew Mullineux, "Taxing Banks Fairly," *International Review of Financial Analysis* 25 (2012) 154 – 158
[43] Mullineux, "Public Duties," 442
[44] OFT, *Personal Current Accounts in the UK: Unarranged Overdrafts*, March 2010
[45] Department for Business, Innovation, and Skills, *Consumer Credit and Personal Insolvency Review*, November 2011
[46] OFT, *Review 2013,* 40

OFT and the industry but also made that point that *"a significant number of overdraft users are still potentially paying too much."*[47] Mintel research also showed that the margins obtained by banks on overdraft lending remained buoyant in recent years partially explained by low base rates in the same time, allowing a greater spread.[48]

In a series of evaluation reports, the OFT concluded that there were a number of reasons why the cross-subsidy element has diminished, ranging from regulatory pressure forcing greater transparency, increased consumer awareness of the dangers of unauthorised bank charges and greater risk aversion amongst consumers as a result of the financial crisis.[49]

Before leaving Hypothesis 1, it is worth noting a dissenting view. Hans Zenger, in a 2012 report for *Competition Policy International,* argued that, actually, a "skewed" price structure with low annual fees and high overdraft charges *"aligns biased consumer perceptions with the true costs of borrowing. In essence, high overdraft charges provide a financial incentive for myopic consumers to improve their ex-ante financial dispositions and can thereby benefit social welfare."*[50]

With the heat taken out of the overdraft fees subsidy hypothesis, attention has shifted to the possible existence of a 'money to the middle subsidy' whereby low income consumers receive free banking despite generating little income for the bank, and a 'diligence subsidy' where those who don't bother to test the market subsidise those who shop around. We now deal with each of these in turn.

3.3.2 Hypothesis 2: Money to the middle subsidy

If hypothesis 1 was essentially that the banking market was operating a regressive redistribution through excessive penalties on the poorest, hypothesis 2 is far more distributively benign, namely that people receiving free banking without having high balances or high transactions on their accounts do not generate significant income for the bank in question - either through interest foregone or direct debit fees - and so are effectively subsidised by those with higher activity and balances.

This view was epitomised by the OFT in 2013 which argued that:

> *"in 2011, the average revenue per active customer was higher for accounts with greater incoming funds. On average, the revenue from accounts that paid in less than £5,000 a year was just over half that on accounts that paid in between £5,000 and £15,000 a year, and around a third of that from accounts that paid in over £15,000 a year."*[51]

[47] FCA, *Consumer Credit Insights: Overdrafts (2014)*
[48] Mintel, 2013
[49] OFT, *Evaluating the impact of the 2008 OFT market study and UTCCR test case into personal current accounts*, (January 2013)
[50] Hans Zenger, *The Pitfalls of Regulating Retail Banking Overdraft Charges*, (2012)
[51] OFT, *Review 2013,* 37

The measurement of "average revenue per customer" in this OFT study takes into account net credit interest, arranged overdraft charges, unarranged overdraft charges, and other revenues. However, if interest foregone is taken into account, the extent of subsidy to non-users of overdrafts with low balances becomes even greater.

Indeed Ashton and Hudson, in their 2013 report for Provident Financial, "How Much Does Free Banking Cost,"[52] held that it is entirely possible there never was a regressive cross-subsidy between consumers even before overdraft charges were reduced if net credit interest forgone is taken into account.

The Ashton and Hudson report used a dataset (provided by Moneyfacts PLC) that covered 395 current accounts offered by 72 banks/firms with a monthly frequency between 1995 and 2001. In total there are 21,827 monthly observations of current account details and prices.[53] The methodology was to apply three costing methods – the net customer cost of current account use (fees and other overt charges), the implicit customer costs of interest forgone relative to base rates, and the implicit customer costs of interest forgone relative to other rates offered by the same bank.

They concluded:

> *"Cross-subsidy between customers of different incomes is a function of how costs are estimated. If just the actual or net costs of current account use are considered, emphasising overdraft costs and packaged fees and considering deposit interest as a benefit, evidence consistent with a cross-subsidy from lower to higher income customers is present. If we acknowledge the implicit costs of current account use (that holding deposits in current accounts has a cost and overdraft services are provided at a cost to the banks), a cross-subsidy from lower to higher income customers is not present."*[54]

Indeed, although not explicit in their 2013 report, the then head of the Office of Fair Trading, John Fingleton had made a similar observation when giving evidence to the Treasury Select Committee in 2010, saying "*perhaps some people at the higher end of the distribution with high average balances, on the foregone interest, are also cross-subsiding some of the people in the middle.*"[55]

3.3.3 Hypothesis 3: Diligence subsidy

This possible source of cross-subsidy is not contingent on income levels. Rather it argues that consumers find it difficult either to understand the real costs of banking services or to take action where there is an advantage from doing so, and as a result may be charged more both for overdrafts and in-credit services, due to inertia, complexity in switching or

[52] 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)
[53] Ashton and Hudson, *The Cost of Free Banking,* 9
[54] Ashton and Hudson, *The Cost of Free Banking*, 80
[55] *Competition and Choice in Retail Banking* 30

opacity. This rewards diligent consumers who take the trouble to understand the market and shop around for the best deal.

There is a broad consensus that this type of subsidy exists, although views are less clear on the extent to which it matters as a cross-subsidy per se or rather because it indicates that innovation is being stifled through having a market with weak competitive pressures. However the two are linked: high costs are "permitted" by the market because of low levels of understanding and difficulties in (or other lack of disposition towards) taking action.

The OFT has long been concerned about this issue. Their 2008 report outlined a number of problems, namely that:

- over a fifth of consumers were unaware of insufficient funds charges until they had incurred one;
- over 12.6 million accounts (23 per cent of active accounts) incurred at least one insufficient funds charge in 2006; and
- those consumers who incurred an insufficient funds charge in 2006 were more likely to incur at least six charges than just one.[56]

The OFT also commissioned a report on “The Psychology of Personal Current Accounts”[57] in the same year. The report found, among other things:

- Interviewees were overconfident in their financial management, and underestimated the likelihood that they would become overdrawn and be charged.
- Interviewees reported spending little time thinking about their finances.

Consumer Focus published a report focused on bank account switching in 2010, entitled *Stick or Twist?*[58] In this report they concurred with the OFT that *“consumers do not base their selection of bank to hold a current account with on the nature and size of the unauthorised overdraft charge. This was because consumers do not expect to pay these charges and therefore do not include them in assessments.”*[59] This, in turn, leads them to conclude that *“the true cost of banking, most notably for those who suffer from these charges, remains hidden from consumers even if they feel confident comparing accounts.”*[60]

The report from the Which? future of banking commission, published in 2010, called for increased transparency for people with overdrafts, and supported an “opt in” system for overdrafts[61]. Mainly, however, it was concerned with broader issues affecting the ring-fencing of banks, and did not address current account concerns at any length.

[56] OFT, 2008 Report, 5
[57] OFT, “The Psychology of Personal Current Accounts,” *Annex E of Personal Current Accounts in the UK,* 2008
[58] Consumer Focus, *Stick or Twist?* (2010)
[59] Consumer Focus, *Stick or Twist?* 22
[60] Consumer Focus, *Stick or Twist?* 22
[61] Which? The Future of Banking Commission, 2010

The Social Market Foundation, in a 2011 report entitled *A Confidence Crisis? Restoring Trust in Financial Services*[62]*,* argued that, for banks, “it pays to be confusing.” This is because the high degree of customer inertia *“encourages providers to focus their marketing strategies predominantly on those entering each product market for the first time. They therefore engineer prices to attract new entrants.*”[63]

This strategy, according the report, *“comes at the expense of the quality of products, as hidden charges and small print proliferate. It also entails huge cross-subsidy: choosers (predominantly new consumers) are subsidised by the inert.”*[64]

PricewaterhouseCoopers (PwC)*,* in a 2012 report entitled “Precious Plastic,”[65] wrote of the end of free banking in line with increased transparency. They concluded the model was based on a cross-subsidy from those who regularly pay overdraft fees or maintain high credit balances to those who do neither (compatible with Hypothesis 2):

> “*The issue in the case of banks is the lack of transparency in the cross-subsidisation and the resulting difficulty for consumers in understanding what and how they are actually paying. The knock-on effect is to make comparisons between providers difficult. When added to the limited differentiation between providers of current accounts and a cumbersome switching process, the result is low switching, which, in turn, reduces the incentive for banks to innovate or provide exceptional levels of service.*”[66]

In other words, the customers subsidising the rest would likely not choose to do so if they were able to compare products more effectively.

According to PwC, those who cannot, or do not, pick the best service for themselves are likely to be cross-subsidising those who can.

In 2013 the FCA published an occasional paper on the insights that the study of behavioural economics can offer to the retail financial services market, the authors conclude that *“behavioural problems can cause less sophisticated consumers to pay more than others, effectively cross-subsidising the more sophisticated, so prioritisation also needs to consider these distributional effects.”*[67] and in particular that *“the market for bank current accounts is a prime example”* of one that could benefit from regulation informed by behavioural economics, because *“firms can exploit these behavioural effects and lower the quality of products and/or charge higher prices, without the threat of losing consumers to their rivals.”*[68]

[62] John Springford, *A Confidence Crisis? Restoring Trust in Financial Services* (Social Market Foundation, 2011)
[63] Springford, *A Confidence Crisis?* 43
[64] Springford, *A Confidence Crisis?* 43
[65] PwC, *Precious Plastic*, 2012
[66] PwC, *Precious Plastic*, 38
[67] Kristine Erta et al, *Applying Behavioural Economics at the Financial Conduct Authority* (April 2013).
[68] Erta et al, *Applying Behavioural Economics*, 22

Mark Armstrong and John Vickers, in their 2012 article, "Consumer Protection and Contingent Charges",[69] eschew the regressive subsidy thesis in favour of a model that differentiates between consumers on the basis of their relative sophistication: "[*The sophisticated] benefit from the presence of the naive because competition between firms causes some profit from the naive to be channelled to them, which in turn harms the naive. Whether, and to what extent, one regards such redistribution as bad depends on the respective welfare weights of the two consumer types in the market in question, but in many settings (which plausibly include bank accounts) it may be reasonable to accord a higher welfare weight to naive consumers."*[70]

Armstrong and Vickers' viewpoint – that high costs are "permitted" by the market because of low transparency and unforgiving contingent charges is widespread.

The Fairbanking Foundation, jointly with The RSA in its 2013 report, "A Better Kind of Banking,"[71] blames the culture within retail sales divisions at banks. Again, they hold the position that customers who fail to understand their products subsidise those who do.

They write that the banks can "get away with" offering free banking that depends on some customers failing to understand the products they are being sold because of *"the asymmetrical relationship at the heart of banking: bankers know a lot more about the products and services they sell than their customers, especially when those products are packaged together – a current account with an overdraft and various forms of insurance – with interest rates expressed in percentages that change over time, under different conditions."*[72]

A project on current account charges carried out by Which? in 2014 noted that *"our volunteers were bamboozled by trying to calculate unauthorised overdraft fees. Only six of the eighteen volunteers thought that, based on their experience of doing the test, a typical customer would be able to compare the charges."*[73] They concluded *"it's virtually impossible for ordinary people" to correctly compare accounts and understand their charges.*[74] This may at least in part explain the finding that complaints on current accounts rose by a third in 2012-13[75].

The FCA commissioned a qualitative assessment of consumer perceptions of overdrafts in 2014[76]. They noted, in particular, that one major issue connected to overuse of overdrafts by vulnerable consumers was the presentation of overdrafts and credit balances as "funds available." This meant that *"consumers tended to view an overdraft that has been agreed with their bank, as money they are entitled to...so that someone with a balance of £100 and*

[69] Mark Armstrong and John Vickers, "Consumer Protection and Contingent Charges," *Journal of Economic Literature* 50 (2012) 2: 477 – 493
[70] Armstrong and Vickers, *Consumer Protection and Contingent Charges*, 493
[71] Charles Leadbeater and Antony Elliott, *A Better Kind of Banking*, (The RSA, 2013)
[72] Leadbeater and Elliott, *A Better Kind of Banking*, 10
[73] "Bank Charges; Calculation Impossible," *Which?* (February 2014), 25
[74] "Bank Charges," 25
[75] Mintel 2013
[76] FCA, *Consumer Credit Qualitative Research: Credit Cards and Unauthorised Overdrafts*, (2014).

an overdraft facility of £500 will be told that their 'funds available' equals £600. It is therefore easy to see how consumers quickly come to view the whole amount as an entitlement."[77]

At the conclusion of its 2013 report, the OFT noted that it decided not to make a market investigation reference for the current account industry, but also decided not to let the issue rest, and planned to revisit it by 2015. The OFT concluded that "empowered consumers drive competition," and empowered consumers will demand more fair, transparent charges on their current accounts.[78]

Packaged accounts

An example of a sub-section of the market that is particularly prone to the existence of a diligence subsidy is in the market for packaged accounts. A packaged account is a product where, for a monthly fee, consumers have access to a current account with a number of add-on benefits, usually various forms of insurance, credit facilities, discounts, and so forth. The debate has focused on whether or not these products are either mis-sold to consumers or unnecessarily confusing. As an example, the *Financial Times* notes one anecdote where Macmillan (cancer charity) had been approached by cancer sufferers who claim they were sold packaged bank accounts that included travel insurance for which they were not eligible.[79]

The landmark report in this debate was issued by the FSA in 2011.[80] It found that the market for packaged accounts had increased to 10m accounts as of 2010 from 8.5m in 2009. It concluded that packaging many services together with a current account "can make it difficult for consumers" to focus on the information that is relevant to them, and that consumers are often paying for products they cannot use. In 2012, the FSA published a number of new rules to prevent mis-selling of these accounts – banks are required, according to the FSA, to check whether the consumer is eligible for every aspect of the package, and inform them if they are not.[81]

The Financial Ombudsman Service notes that it had 1,629 complaints in the full year between 2012 and 2013 - a rise of around 50 per cent - and 1,846 complaints in the first half of 2013 alone. The uphold rate is also very high, at 79% for the most recent data.[82] As a result of these complaints, and the new disclosure rules introduced in 2012 (enforced in 2013), the FCA is committed to review packaged bank accounts over the course of 2014 and 2015.[83]

[77] FCA, *Consumer Credit*, 20
[78] OFT, *Review 2013,* 162
[79] Elaine Moore, "Banks fear new mis-selling claims," *Financial Times* (2012) http://www.ft.com/cms/s/0/82f01daa-45f5-11e2-b780-00144feabdc0.html#axzz31gGZrqy2
[80] Financial Services Authority, *Consultation Paper: Packaged Bank Accounts*, (2011)
[81] Financial Services Authority, *Consultation Paper: Packaged Bank Accounts*, (2012)
[82] Financial Ombudsman Service, *Issue 113*, http://www.financial-ombudsman.org.uk/publications/ombudsman-news/113/chart_issue113.pdf
[83] Financial Conduct Authority, *Business Plan: 2014-2015*, (2014), 19

3.4 Conclusion

In summary, there are three possible ways in which cross-subsidies emerge in the retail and personal current account market. The consensus in existing literature is that the potentially most regressive form of subsidy is where people who go overdrawn subsidise those who do not through paying fees that are excessive. However in a landmark court case, the scale of overdraft fees was not proven to be unfair, at least according to the law, and the level of fees has since reduced due to consumer and regulatory pressure.

A second potential cross-subsidy exists that benefits thrifty consumers on low incomes whose current accounts cost the banks money to service, but from which no income is extracted in terms of interest foregone on high balances or fees extracted from overdrafts. This is a progressive subsidy that supports levels of financial inclusion.

Finally, and across all income groups, there is a subsidy from people who do not take the time to shop around to those who do. This is less of a concern in terms of its distributional impact (except insofar as for poorer consumers the opportunity costs represent a higher proportion of their income) but has potentially large significance as a measure of whether the market is operating efficiently in the overall consumer interest.

In the next section we compare this situation with that existing in other countries before moving on to discussing the potential implications.

4. Brief international comparisons

In order to put the British system in context, and spur a debate as to the extent to which policymakers in Britain have something to learn from experience elsewhere, this section of the report gives an overview of the debate on cross-subsidy in other similar jurisdictions. For illustrative purposes we look at the US, Australia, the EU-wide debate and the particular situation in Germany, France, Ireland and the Netherlands.

Each of these countries has experienced a recent debate around the extent to which retail banking effectively (or not) serves the consumer market, including legislative change. 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. In the EU context, cross-subsidy has taken second place to a wider discussion around transparency, switching, and the overall level of fees. We have examined the EU to identify a number of markets that are of particular relevance to the UK context. France and Germany are the markets closest in size to the UK market. Ireland shows how fees and interest foregone can have a substitution effect, and some of their reports offer direct comparisons to the UK. The Netherlands has a progressive cross-subsidy in place where the subsidy flows from higher- to lower-income consumers.

Of the three hypotheses presented in the previous section, all crop up to a greater or lesser extent in these non-UK markets. The US is also a useful comparison for the UK – it has taken a similar legislative journey, in many ways, and some recent literature from the US has advocated the existence of “money to the middle” subsidies over overdraft-based regressive subsidies. In Australia, however, the debate is still fixed on whether overdraft fees on the poorest subsidise the costs of servicing more affluent consumers but, as in Britain, public outrage over bank fees and a protracted legal battle have caused fees to lessen in recent years.

In the EU countries we have looked at, it is harder to conclude whether hypotheses 1 and 2 hold, partly due to lack of information and partly because of the higher level of fees charged to all account holders. However, at the very least, it seems likely that hypothesis 3 - diligence subsidy - holds simply due to the complexity and diversity of the market.

4.1 The US

The shape of the American market for current accounts (called “checking accounts”) has changed significantly in the last two years. Typically “free checking” is available to consumers “if they maintain a minimum balance, arrange for direct deposits, or use credit cards,” or other packages of services.[84]

[84] Deloitte, *Retail Bank Pricing*, 5.

However, there is a widespread question as to whether "free checking" is a sustainable model: see for example Bankrate (2014),[85] and Deloitte (2013)[86]. Bankrate data showed that free checking accounts declined from 76 per cent of all accounts in 2009 to 39 per cent in 2012 but there may be indications that the rate of decline is now slowing; the equivalent figure for 2013 is 38%. Free checking, according to Bankrate, is down, but not out.

Deloitte offerred a similar point of view – many institutions stopped offering free checking in 2010, but, in at least one instance, customer defection inspired a switch back to a fee-free option. Even so, Deloitte concluded that the massive fall in "fee free" accounts suggests it *"may no longer be as viable a strategy for many banks. In short, retail bank fee structures will likely have to change; the only real question is how."*[87] Deloitte argued this is because regulatory interventions have increased transparency, and therefore made it more difficult to extract fee income from free checking customers.

A recent article from the Wall Street Journal,[88] however, argued that banks, squeezed for revenue and facing higher compliance costs, are looking to checking account fees as a new source of income, rather than a substitution for "hidden" fees associated with free accounts. The article quoted statistics from Moebs, namely that 41 per cent of American institutions no longer offer "unconditional" free checking, 8 per cent less than the previous year.

Whether free checking in the US is disappearing as banks attempt to grab fees, or whether free checking is disappearing as banks attempt to replace old "hidden" fees that were largely regulated away with new "overt" fees, is still up for debate.

The structure of the American market – much more decentralised than the UK's, and more dependent on smaller banks – has affected this debate. American Banker, in 2011, argued that small banks *have* to continue offering free checking in order to stay competitive with nationwide banks. Free checking plunged between 2009 and 2011 for banks with assets greater than $50bn, but stayed relatively constant (losing only 8%) at all other banks.[89] A report from the Congressional Research Service[90] maintained that free checking, and therefore a possible cross-subsidy, is still more popular at small banks for reasons of competitiveness.

[85] Claes Bell, "Checking Account Fees Rise, But Less Steeply," *Bankrate.com*, http://www.bankrate.com/finance/checking/checking-account-fees-rise-but-less-steeply-1.aspx, (2014)
[86] Deloitte Center for Financial Services, *Retail Bank Pricing: Resetting Customer Expectations*, (2013)
[87] Deloitte, *Retail Bank Pricing,* 3
[88] Anna Maria Andriotis and Saabira Chaudhuri, "Free Checking is a Disappearing Perk," *Wall Street Journal*, http://finance.yahoo.com/news/free-checking-disappearing-perk-001500631.html (2014).
[89] Maria Aspan, "Free Checking Thrives at Smaller Banks, Durbin Notwithstanding," *American Banker* (2011), http://www.americanbanker.com/issues/176_168/free-checking-durbin-debit-interchange-1041641-1.html?ET=americanbanker:e7931:2280326a:&st=email&utm_source=editorial&utm_medium=email&utm_campaign=AB_Daily_Briefing_082911
[90] Darryl Getter, *Recent Trends in Consumer Retail Payment Services Delivered by Depository Institutions*, (Congressional Research Service, 2014)

Costs

Unlike in the UK, there are many estimates of what it costs to provide current accounts in the US; most fall in the range of between $200 and $400 annually.

An article from the Wall Street Journal in 2010 indicated: *"More than half of all checking accounts are currently unprofitable, according to a report issued last month by Celent, a unit of Marsh & McLennan Cos. It costs most banks between $250 and $300 a year to maintain one of the roughly 200 million checking accounts, according to industry estimates."*[91]

An article in the American Banker from 2011 stated that "*the average checking account cost banks $349 [annually] in 2011, says Mike Moebs of Moebs Services Inc., a research firm. But the average revenue per account is just $268, implying a loss of $81."*[92]

Legislative Journey

The changes in the US market away from free banking are arguably driven by regulatory pressure to increase cost transparency:

- The Truth in Savings Act (1991) required depositary institutions to disclose fees, as well as any conditions under which they might be imposed. Also, this regulation prevented accounts from being called free unless they were "unconditionally free" (no fees for "ordinary" use, no minimum balance conditions, but there could be fees for overdrafts, NSF items, etc.). Banks got around this by offering normal accounts with "fee waivers" so long as multiple products were held, minimum balances maintained, and so forth.
- The Joint Best Practice Guidance on Overdrafts (2005) required banks to make it clear that overdraft protection is not a line of credit, and that banks should not promote free accounts AND overdraft protection in the same advertisement.
- The FDIC Regulatory Update (2009) required banks to set daily limits on overdraft charges, and waived fees for minimal overdrafts (so going a few dollars overdrawn would not entail fees).
- Regulation E (2010) required customers to opt in to overdraft services. A CFPB study[93] found that 44.7% of previous people with overdrafts opted in, whereas only 11% of people who had not previously had overdrafts opted in.[94]
- Regulation DD (2010) required all institutions to disclose total overdraft fee charges on statements.

[91] Robin Sidel and Dan Fitzpatrick, "End is Seen to Free Checking," *Wall Street Journal*, http://online.wsj.com/news/articles/SB10001424052748703513604575311093932315142 (2010)
[92] Victoria Finkle, "Free Checking Isn't Cheap For Banks," *American Banker*, (2011) http://www.americanbanker.com/issues/176_238/checking-account-free-checking-debit-fees-1044756-1.html
[93] Consumer Financial Protection Bureau, *CFPB Study of Overdraft Programs: A White Paper of Initial Data Findings*, (June 2013)
[94] CFPB, *Study of Overdraft Programs*, 30

The regulation of overdraft fees has in recent years shifted to the Consumer Finance Protection Bureau[95] but, as at the time of writing, this of itself has not caused changes in the regulatory requirements faced by firms.

Support for Hypothesis 1: Subsidy through overdraft fees

Anti-capitalist movements in the United States, through social media, have popularised the idea that there is a regressive subsidy through excessive overdraft charges on the least well-off[96]. There was a major crop of articles arguing this fact in June 2010, for example in the aftermath of Regulation E and Regulation DD which ended covert charges.

One of the most quoted articles of this type is a post on *Reuters*[97] by Felix Salmon. Salmon argued that *"checking is never free, but in recent years banks have been able to conjure the illusion of free through a system of regressive cross-subsidies, where the poor pay massive overdraft fees and thereby allow the rich to pay nothing."* Salmon also elaborated that debit card interchange fees are a part of this subsidy (where banks charge merchants for accepting debit cards).

He is quoted by Kevin Drum, who wrote in *Mother Jones*,[98] that overdraft fees are a way for the poor to subsidise the rich – "*there's no law against that…but the practice is grotesque."* He believes that banks fool financially illiterate, less well-off customers into paying fees.

Further support for the position that the poor pay more in overdraft fees comes from the Center for Responsible Lending[99] and the FDIC.[100] Both studies found users of overdrafts were "low income, single, non-white renters," using overdraft facilities as a line-of-credit substitute.

However, the suggestion that those who pay overdraft charges are necessarily poor is disputed in the academic literature. Moebs (2010) found the only correlation was the credit score ("FICO score"): *"Gender, age, occupation, income, and wealth were found not to correlate to overdraft behaviour."* The lower the FICO score the higher the incidence of overdraft behaviour and the more overdrafts," and that all other factors (including income level) have no correlation at all.[101]

[95] The CFPB is a regulatory agency of the US Federal Government (created by the Dodd-Frank Act in 2010), and responsible for consumer protection in the financial sector. It consolidated the employees and responsibilities of a number of other agencies (including some from the Federal Reserve, the Federal Deposit Insurance Corporation, and others) under one roof
[96] Jonathan Morduch and Thomas DiLorenzo, "The Debate Room: Bank Fees Exploit the Poor," *Bloomberg Businessweek*, (2009), http://www.businessweek.com/debateroom/archives/2009/05/bank_fees_exploit_the_poor.html
[97] Felix Salmon, "Interchange and Free Checking," *Reuters*, (June 2010), http://blogs.reuters.com/felix-salmon/2010/06/17/interchange-and-free-checking/
[98] Kevin Drum, "Robbing the Poor to Give Air Miles to the Rich," *Mother Jones* (June 2010), http://www.motherjones.com/kevin-drum/2010/06/robbing-poor-give-air-miles-rich
[99] Lisa James et al, *Overdraft Loans: Study Finds Growing Problems for Consumers*, (Center for Responsible Lending 2006)
[100] FDIC, *FDIC Study of Bank Overdraft Programs*, (2008)
[101] Moebs Services, *Who Uses Overdrafts?* (September 2009) http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/194/Default.aspx

Sharing this conclusion was Professor Marc Anthony Fusaro, whose paper "Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks,"[102] found no correlation between income level (or any other socio-economic characteristic) and propensity to use overdrafts.

Support for Hypothesis 2 in the US: Money to the middle

Other analytical research provides a more nuanced view which is more in line with Hypothesis 2 in the previous chapter - that the winners in the cross-subsidy debate are those who do not incur large charges nor provide the banks with opportunities to earn returns on high balances.

In a seminal 2013[103] article, the academic Julie Andersen Hill noted that there is no significant literature on cross-subsidy within the US checking account market, and attempts to fill that gap.

In brief, she argued that *"contrary to common assumption, there is little reason to believe — either theoretically or empirically—that regressive cross-subsidization exists in the transaction account market."*[104] Her conclusion was: "*some consumers who pay numerous overdraft fees may pay more than the stand-alone cost of providing overdraft service to high overdraft accounts…most high-balance accounts generate enough investment income to cover the incremental cost of transaction account services."*[105]

However, like in the UK, she noted that there is a "dearth" of actual evidence and scholarship on cross-subsidisation in bank accounts, and that it is very difficult to calculate the costs to the bank of providing each account (Andersen Hill used the costs estimated above, pegging the average account at an annual cost of $250 to provide account services).

Andersen Hill concluded *"although it is easy to conclude that many low-income consumers pay a significant amount in fees associated with their transaction accounts, there is not enough information to establish that the poor systematically pay more than the stand-alone cost of their transaction accounts."*[106]

However, given that the availibility of free-if-in-credit banking is shrinking in the US, even if there was a subsidy that favoured low-income thrifty consumers (in line with hypothesis 2) it is likely to be small, and eroded by the trend towards universal paid-for banking.

Support for Hypothesis 3 in the US: Diligence subsidy

Transparency of costs is a major issue in the US debate, and it is a common view that the naive and uninformed subsidise the sophisticated.

[102] Marc Anthony Fusaro, "Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks," *Journal of Family and Economic Issues* 29 (2008) 2: 251 – 263
[103] 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), 65 – 130
[104] Hill, "Transaction Account Fees," 72
[105] Hill, "Transaction Account Fees," 72
[106] Hill, "Transaction Account Fees," 128

In a 2008 article for the *Chicago-Kent Law Review*, entitled "Carrying a Good Joke Too Far,"[107] Peter Alces and Jason Hopkins used the concept of a "guerrilla term" to argue that bank boilerplate contracts exploit naivety *"to the benefit of form sophisticated consumers and also to the benefit of form drafters who incorporate guerrilla terms."*[108] A guerrilla term, according to Alces and Hopkins, is *"a term whose presence or effect is inadequately advertised so that the result is...an exploitation of unsophisticated consumers."*[109]

However, this may be lessening as regulatory change spurs a decline in fee-free checking leading to greater cost transparency and, crucially, greater control by consumers of the costs that they face.

Nevertheless, it seems that there is still further to go. The most recent legislative changes were in 2010 but the following year, in an open letter to the consumer financial protection czar published in the Harvard Business Review entitled "Making Financial Markets Work for Consumers,"[110] John Campbell et al argued that the naïve cross-subsidise the sophisticated. They wrote: *"In a competitive market for financial services, these profits are typically passed on to other customers in the form of reduced bank charges and lower mortgage rates. Naïve (often poor and uneducated) customers can end up subsidising sophisticated customers."*

The Pew Foundation wrote in its 2011 report, *The Case for Safe and Transparent Checking Accounts*,[111] that the median bank disclosure length of 111 pages did not provide customers with an easily understandable comprehension of how and when they would incur overdraft charges.[112]

4.2 The EU

The EU debate is less about overt considerations of cross-subsidy within retail banking. This is largely because the "free if in credit" model is far less common. Some markets, for example Germany and Ireland, offer free current accounts to those with sufficient income, or other products with the bank, but the thresholds are relatively high.

In general, the banks in Europe capitalise on an information asymmetry between bank and consumer, and a non-competitive environment between banks, in order to extract high and often confusing fees, although the Netherlands provides a powerful exception to this rule.

As such, it is most profitable to think of the EU in terms of Hypothesis 3: if any cross-subsidisation is going on (and it is not clear that there is), then cross-subsidies flow from poorly-informed consumers to well-informed consumers.

[107] Peter Alces and Jason Hopkins, "Carrying a Good Joke Too Far," *Chicago Kent Law Review* 83 (2013) 2: 879 – 907. [Note – this article is accessible only in a 2013 reprint of a number of prominent articles from the journal's past. The original article was from 2008.]
[108] Alces and Hopkins, "Carrying a Good Joke Too Far," 889
[109] Alces and Hopkins, "Carrying a Good Joke Too Far," 889
[110] John Campbell et al, "Making Financial Markets Work for Consumers," *Harvard Business Review* July-August 2011, 1-9
[111] The Pew Health Group, *Hidden Risks: The Case for Safe and Transparent Checking Accounts*.
[112] Pew, *Hidden Risks*, 1-2

The debate is focused instead on fee transparency, at both EU and national levels – it is therefore not unreasonable to infer that some degree of cross-subsidy in the current account market is *possible*.

At an institutional level, the legislative journey since 2005 has seen the EU determine that all residents have rights to a “basic bank account,” with full/standardised fee transparency (disclosed in a way the customer will understand), and easy switching, as follows:

- 2005: White Paper: Financial Services Policy 2005-2010 (set the goal to remove all “undue barriers” associated with bank accounts).
- 2007: Payment Services Directive (transparency obligations to payment services providers; legislative logic would be repeated in the Payment Accounts Directive).
- 2008 – 2009: Evidence gathering (Commission found that price structures were opaque, switching difficult).
- 2010 - 2011: Self-regulatory framework developed by banks, but discarded for being insufficiently consistent and clear.
- 2012: Public consultation on bank accounts sets the evidentiary basis for the Payment Accounts Directive.
- Payment Accounts Directive finalised by Commission (all citizens with a right to an account, all accounts standardised/transparent, all accounts switchable).
- 2014: Payment Accounts Directive receives assent from Council and Parliament and will enter into force later this year.

European Commission reports also provide a good source of information on the situation in individual countries. In the discussion that follows we draw in particular on the following documents, alongside information from national consumer organisations: The 2012 Special Eurobarometer Report 383 (on Financial Inclusion),[113] the Financial Services User Group Public Consultation Response,[114] the Final Report of the Market Study of the Current State of Play in Member States Regarding Initiatives in Bank Fee Transparency and Comparability in Personal Current Accounts,[115] and Data collection for prices of current accounts provided to consumers.[116]

[113] European Commission, *Special Eurobarometer 383: Retail Financial Services Report*, (2012)
[114] Financial Services User Group, *Response to the Consultation on Bank Accounts*, (2012)
[115] European Commission, *Final Report of the Market Study of the Current State of Play in Member States Regarding Initiatives in Bank Fee Transparency and Comparability in Personal Current Accounts*, (2012)
[116] European Commission, *Data collection for prices of current accounts provided to consumers*, (2009)

4.2.1 France

The dominant model in France is one of extremely high fees across the board; one of the highest in Europe according to the 2009 report by the European Commission.[117]

The 2012 Eurobarometer report stated that a basic bank account[118] user in France pays €91.21 annually, with a passive user paying only €0.14 more. An average bank account user pays significantly more, however, at €154.11, and active users yet more at €232.15.[119] There are very few members of the French public not in banking, with financial inclusion, defined as the proportion of the population with a bank account, measured at 96 per cent as of 2012. [120]

Complexity is also an issue: the average French bank brochure is up to 24 pages long, and includes more than 300 fees for different types of transaction[121],[122].

France's main consumer watchdog group, UFC-Que Choisir, suggests that the high fees charged to the poor did not subsidise free banking for the rich, but rather consisted of a major cash grab for the bank:

> *"With more than 300 charged services I can't say that there is a systematic cross-subsidy between different users, but it's clear that banks take [advantage of consumer weakness] to charge high fees. And that wealthy consumers with big amounts of savings can [easily] negotiate discounts on their fees, which is impossible for poor users."*[123]

On the surface, this practice is consistent with a subsidy-free environment according to Faulhaber's definition (no one group pays more than the cost of providing service; each group pays a price equal to or greater than the incremental cost of providing service). However, the existence of complexity suggests that in France's case Hypothesis 3 is likely to hold (a diligence subsidy) and, moreover, given that the costs are high, they are likely to be regressive as a proportion of income. It seems that each group pays much more than the cost of providing the service, and no group receives the service for free.

It is, however, worth noting that there have been recent legislative changes that have started to alter the way in which the market works. Legislation passed in July 2013 set a ceiling on how much banks can charge for different banking operations, at €8 per transaction and €80 per month. For so-called "vulnerable" consumers this falls to €4 per transaction and €20

[117] European Commission, *2009 Report*, 23
[118] A "Basic Bank Account" as defined by the EU is a payment account held with a financial institution that allows a user to carry out the "core" transactions (including making payments, depositing funds, withdrawing cash, receiving payments, use of a payment card, and so forth), but does not necessarily include credit services of any kind. This account is not free, though it is left up to member states to determine if it should be subsidized, and to what degree
[119] European Commission, *2009 Report*, 23
[120] European Commission, *Special Eurobarometer 383,* 13
[121] UFC-Que Choisir, *Tarifs et Mobilite Bancaires: Le Desolant Palmares des Ba*, (2010)
[122] BEUC, *Consultation on Bank Accounts*, (2012), 5
[123] E-mail conversation with Tooley Street Research Ltd

euro per month. Moreover, the consumer must now be notified before any charges are made, and a basic bank account without cheque books at a monthly fee of €3 must now be offered to all vulnerable consumers[124].

Initial indications are that competitive pressures are highest in the on-line banking sector, where charges are lowest, but that there is a huge discrepancy in charges between more traditional banks and even between regions in some national banking networks, as well as some evidence that charges are rising for unregulated activities to compensate for the new price caps for certain services. Overall, this supports the view that it is lack of transparency and competition that is of primary concern[125].

4.2.2 Germany

The characteristics of the German market for personal and current accounts could be described as lying somewhere in between those of France and the UK. Like France, most accounts command relatively high fees.[126] But unlike France banking is free if consumers deposit sufficient income every month.

The 2012 European Commission report noted that German accounts are highly comparable in terms of charges – there is an effective comparison tool available from the statutory consumer protection agency, *Stiftung Warentest,* that, according to the European Commission, *"offers a kind of guarantee of quality and reliability."*[127]

German basic bank account users pay €78.92 per year, whereas passive account users can pay as little as €62.85 per year, with average users paying €89.13, and active users paying €114.71.[128] Germany also has extremely high levels of financial inclusion, with 95 per cent of the population holding an account.[129]

It may be therefore that there is less cross-subsidisation in the German market: those with incomes sufficient to render their bank accounts profitable for the bank pay in terms of interest foregone; others pay directly for the service they receive, including those on low incomes.

4.2.3 Ireland

Irish banks operate a model not dissimilar from the German model – according to a 2011 report[130] from the Central Bank of Ireland, customers can qualify for free banking if they take on a number of products and secure minimum deposits each month.[131]

[124] UFC Que Chosir*, Palmarès des banques françaises 2014 : tarifs et sécurité, « SEPA » le Pérou !* (2014)
[125] ibid
[126] European Commission, *2009 Report*, 23
[127] European Commission, *2012 Report*, 25
[128] European Commission, *2009 Report*, 23
[129] European Commission, *Special Eurobarometer 383,* 13
[130] Central Bank of Ireland, *A Review of Personal Current Account Charges*, (2011)
[131] Central Bank of Ireland, *Review*, 11

This report describes four main consumer profiles:

- Standard: Regular user of most facilities offered in online banking, debit cards would incur limited out of order charges.
- Non-Standard: Similar to the standard customer, but a frequent incurrer of out-of-order fees.
- Sophisticated: Heavy user of all online and mobile functionality, uses little in the way of over-the-counter services; the customer would rarely use his overdraft, and never incur out of order fees.
- Non-Sophisticated: Primarily relies on cheques and cash; does not have an overdraft, and does not typically incur out of order charges.[132]
- (In addition, there are a significant number of people who are unbanked; financial inclusion in Ireland is lower than in France and Germany at 82 per cent.)[133]

The profiles were then split into those that qualified for free banking and those that did not.[134] Of those who qualify for free banking, standard customers can expect to pay between €39 and €67, non-standard between €169 and €232, sophisticated between €5 and €31, and non-sophisticated between €3 and €6. Of those who do not qualify for free banking, standard customers can expect to pay between €111 and €121, non-standard between €241 and €281, sophisticated between €74 and €96, and non-sophisticated between €22 and €79.[135]

The same report also compared the Irish system with the "free if in credit" UK system, and implicitly denied there was a cross-subsidy in that market, concluding that *"charges are mostly driven by customer usage and behaviour,"* and higher out-of-order fees attracted by some customers are *"a reflection of the higher cost in managing such cases."*[136] They argued further that, in comparison to the UK, *"charges imposed on Irish bank customers would appear to be more evenly distributed across all customer profiles [than they are in the UK] especially where there are penalties imposed on customers whose accounts go out of order."*[137]

A 2013 report[138] by the Irish Department of Finance on the regulation of bank charges made no mention of cross-subsidisation between accounts except for raising briefly the possibility that regulation of bank charges, which have been capped to an absolute maximum by Section 149 of the Companies Act of 1995, can lead to cross-subsidisation between

[132] Central Bank of Ireland, *Review*, 8
[133] European Commission, *Special Eurobarometer 383,* 13
[134] It is also important to remember that the word "sophisticated" has been used differently elsewhere in the report; here, it is used to compare users of mobile banking technology versus those who still rely on physical transactions
[135] Central Bank of Ireland, *Review*, 13
[136] Central Bank of Ireland, *Review*, 11, 18
[137] Central Bank of Ireland, *Review*, 18
[138] Department of Finance, *Report of the Review of Regulation of Bank Charges in Ireland*, (2013)

products.[139] However it discusses in some depth the possibility of substitution between interest foregone and fees – as income to the banks from deposit interest foregone waned in an era of low global interest rates, banks turned to charging fees by tightening their requirements for fee free banking.[140]

The situation in Ireland is possibly similar, therefore, to that in Germany in that fees (or interest foregone) tend to correspond to usage and so there is no clear-cut cross-subsidisation in existence. However, it looks like the Irish market is increasingly using packaged accounts to market certain cohorts of customer, leading to cross-subsidisation between product lines but not between groups of people. This is a trend we will return to in Chapter 5.

4.2.4 The Netherlands

The Netherlands gives an example that might be considered best practice in the market - relatively low fees, high transparency, near-universal access to bank accounts (the financial inclusion rate is 99 per cent[141]) and, insofar as a subsidy exists, it is highly progressive.

The Dutch Ministry of Finance, in a report to the European Commission,[142] notes that online comparison tools offered by the Dutch consumer interest organisation, and third party services, allow consumers to compare charges for both regular and one-off fees.

This may be what is driving lower fees than elsewhere in the EU: in 2009, basic bank accounts cost €28.85 annually; passive users paid little more at €30.13, average users at €45.95, and active users €55.60 annually.[143]

If there is a cross-subsidy in the Netherlands, it is likely to be a progressive cross-subsidy. This is due to the Banking Covenant of 2001 adopted by the industry and the Salvation Army, where the banks agreed to provide current account services free of charge to those who could not afford them.[144] The European Commission Financial Services User Group noted in 2012 that *"as [the Covenant] is a mostly a market approach, self-regulated, it is financed by the relevant banks themselves."*[145]

As a result we conclude that insofar as there is a cross-subsidy in the Netherlands it supports Hypothesis 2: the money to the middle subsidy.

[139] Department of Finance, *Report*, 22
[140] Department of Finance, *Report*, 12-13
[141] European Commission, *Special Eurobarometer 383,* 13
[142] Gita Salder, *Response from Dutch Ministry of Finance to the EC's Consultation on Bank Accounts*, (2012)
[143] European Commission, *2009 Report*, 113
[144] Salder, *Response from Dutch Ministry,* 7
[145] Financial Services User Group, *Response to the Consultation on Bank Accounts*, 33

4.2.5 Australia

Unlike in the EU countries discussed above, in Australia the issue of cross-subsidy between different cohorts of consumers has had moments of prominence in the public debate since the 1990s.

In the mid-2000s there were three influential reports that supported hypothesis 1: the overdraft fees subsidy, and other forms of regressive subsidy, namely:

- Nicole Rich, *Unfair Fees: A Report into Penalty Fees Charged by Australian Banks*, (Consumer Law Centre Victoria, 2004), also ed *The Rich Report* after its lead author),
- Chris Connolly, “Do the Poor Pay More for Financial Services?” in *Do The Poor Pay More? A Research Report* comp. Anna Stewart (Consumer Law Centre Victoria, 2005), 6-15.
- Paul Gillett, *Debt Before Dishonour: Penalty Fees and the Australian Consumer*, (Consumer Action, 2007).

Connolly, in “Do the Poor Pay More?” explained how there could be a cross-subsidy in the Australian market: *“Wealthy consumers (people with mortgages, people with term deposits or other investments, and members of professional associations) all receive generous fee exemptions…this means that poorer customers who do pay fees subsidise their wealthier counterparts on a per transaction basis, although the banks would argue that they still make more income from their wealthy customers through their other business with the bank, despite the lost fee revenue.”* Poorer customers, according to Connolly, do not only pay transaction fees, but also are more likely to slip into default, and are generally not paid interest[146].

Gillett, in *Debt Before Dishonour* gave some insight into the unique nature of the Australian cross-subsidy. Banks offer, as a public service, exemptions from fees and charges “*to many customers who might be disadvantaged,”* (usually students, pensioners, recipients of social security, and so forth), but does not exempt these customers from penalty fees in order to maintain profitability.[147]

Rich, in *Unfair Fees*, suggested that this arrangement constitutes a regressive cross-subsidy. She cites an Australian Banking Association submission to Parliament[148] which argued that deregulation of the banking market in the 1990s ended cross-subsidy between products by allowing bank accounts to become profitable (a situation where borrowers subsidised savers turned into a situation where borrowing and saving were independently profitable). And, the ABA went on, *“banks have moved to a user-pays system in which*

[146] Connolly, “Do the Poor Pay More?” 8
[147] Gillett, *Debt Before Dishonour*, 31
[148] Australian Bankers Association, *Electronic Banking and Financial Services: Providing Convenience and Value: Submission to the Inquiry by the Parliamentary Joint Statutory Committee on Corporations and Securities into Fees on Electronic and Telephone Banking*, (July 2000).

consumers pay for the transactions they make."[149] The same document, however, suggested that 30-75% of those customers do not pay transaction fees. She concluded that *"this means, implicitly that, in fact, banking fees are not imposed on a strictly user pays basis at all but rather that some consumers are paying fees whereas others are not."*[150]

"Low-income consumers," she concludes, even when they eligible for fee waivers, "*are most likely to incur penalty fees on their accounts. This is because penalty fees are levied for defaults that usually relate to a lack of funds or lack of ability to pay, a situation inherent to the nature of being a low-income consumer… Given that a large proportion of other consumers are not paying fees, low-income consumers who pay penalty fees must, in a sense, be cross-subsidising the transactions of other consumers."*[151]

It is worth noting in passing that these three reports were written in support of consumer advocacy groups; unlike the US and Britain, there is no corresponding regulatory or academic study that takes a different approach. Although the poor may pay more, it may also be the case that the costs of servicing those accounts are correspondingly greater and so the actual value of any cross-subsidy is less: this has not been conclusively proven.

The Legal Battle

However support for the consumer position was provided in the form of a recent legal case. After a four year class action case between consumers and the major Australian banks, (Paciocco v. ANZ) one of the largest collective actions in Australian history, the judge ruled in March 2014 that fees charged for late payment on credit cards were penal in nature and that *"this means the bank was not simply recovering its costs in administering late payments, but unfairly charging its customers extravagant fees,"* and thus their activites were illegal.[152]

She ruled that fees count as penal if they are charged *"upon breach of contract, but also in respect of fees payable to secure an obligation or performance of a party*". She ruled that overdraft fees were the result of a request for credit from the bank by the customer, and therefore not penal or discouraging in nature.[153] However the matter is being appealed and so, again, is not yet fully resolved[154]

4.3 Conclusion

The prevalence of free-if-in-credit banking in other countries (or the lack of it) gives a helpful perspective on the choices that UK policy-makers may face as they consider the structure of the UK market. In the US, the rapid fall in free banking as a result of regulatory pressure gives a glimpse as to what might happen in the UK; in continental Europe the lack of a free

[149] Rich, *Unfair Fees*, 53
[150] Rich, *Unfair Fees*, 53
[151] Rich, *Unfair Fees*, 54
[152] Emily Portelli and Karen Collier
[153] Are Bank Fees Penalties? Paciocco v ANZ, *Mallesons*, (2014)
[154] Amy Bainbridge, "ANZ class action: Lawyers lodge appeal against Federal Court ruling," *ABC News*, http://www.abc.net.au/news/2014-03-06/appeal-lodged-against-ruling-in-bank-fees-case-against-anz/5301888

banking tradition points us towards what a progressive model of paid-for banking might look like - and the importance of transparency and competitive forces within it to allow the market to function properly in the first place. Finally, the opposing conclusions of the two legal cases around unfair charges brought in the UK and Australia demonstrates the difficulty of disentangling the extent to which cross-subsidy actually matters.

5. Pressure for change

The retail banking sector is subject to a number of external and internal pressures that mean the scenario that has been laid out in the previous chapters is subject to change, even before any value judgement is made as to the desirability - or otherwise - of any cross-subsidies that exist. In this section we outline where these pressures might come from and discuss what that means for the level of cross-subsidisation in the UK retail banking sector.

The pressure for change comes from three main sources: UK regulatory pressure, NGO and political pressure, and external pressure both from the EU and through an understanding of changes in the US. These changes are already leading the banks to alter the way in which they market retail personal banking services, and through choice or necessity will continue to do so.

5.1 UK regulatory pressure

The UK competition authorities have long been concerned that competition in the personal current account market is not operating as efficiently as it should be. In January 2013 the Office of Fair Trading recommended that its successor bodies should conduct a review of the ease of switching accounts, including perceived risks amongst consumers, and made other recommendations designed to improve transparency of bank account charges, with a view to deciding by 2015 if a full-blown competition investigation should take place. The outcome of these reviews is due imminently.

At the very least this pressure will reduce the relevance of Hypothesis 3 - the diligence subsidy - because it will make it easier for consumers to compare costs and switch accounts. If there is a full competition investigation it will raise the question of whether firms should be required to make available to regulators the precise costs of providing current account services to different cohorts of consumers, in order to make a judgement as to whether the profits realised by firms are excessive in a way that suggests market dominance. If this occurs, then the market is likely to switch fairly rapidly to charging all services at cost plus an agreed mark-up, which will eliminate all cross-subsidies between different groups in a way that is not necessarily distributively progressive, to the extent that hypothesis 2 - the money-to-the-middle hypothesis - may no longer hold.

Separately, the FCA is tightening the policy framework around the regulation of consumer credit. This could in time bear down on the revenues available to banks from offering credit cards, giving a greater incentive to find other ways of extracting profit from middle-income consumers that might include attempts to raise fees or push more consumers towards more profitable profit lines such as packaged accounts (see below).

NGO and political pressure

The organisation with the strongest history of campaigning against bank charges is the consumer group Which?. In 1967 they highlighted the difficulty in working out how much a

bank account would cost, leading to campaigns in the 1970s against the practice by some banks of charging for each transaction. They have been extremely active in the debate and are expected to continue to argue that bank charges are complex and difficult to compare in the weeks ahead in support of a full market investigation into the sector: this will increase the likelihood that bank charges will come into the focus of politicians looking out for decisive action to take in response to debate on the cost-of-living crisis, which in turn will accentuate a media back-drop that is supportive of a competition authority reference.

A more nuanced view might come from other campaign groups. The Citizens Advice Bureau, for example, expressed concern to us during the research for this project that basic bank account holders, who are among the most financially vulnerable, may lose out from an end to all types of cross-subsidy as they tend to be beneficiaries of the current system. And ABCUL has previously published research that shows credit union customers are broadly content to pay charges because they understand that the full service provided by a local credit union - which often includes money advice and access to credit that might be denied elsewhere - is something that needs to be paid for[155].

External pressure

We judge that there are two main sources of external pressure on the UK personal current account market. The first comes from legislative change at the European level, specifically the requirement that all EU consumers regardless of where they live should be able to access a 'basic bank account' in any EU state. The extent to which this will impact the UK market, where there is already a right to a basic bank account, is confused by the differences in what constitutes a basic bank account. In the EU debate the phrase means an account with transparent, lower charges and basic functionality (including no overdraft facilities); in Britain the phrase has the same connotation of basic functionality but also implies a bank account where services are provided for free - although there are penalty fees if there are insufficient funds for a direct debit transaction. If the European definition becomes prominent, then that may make it more acceptable to impose a small charge in the UK market.

The second source of external pressure comes simply from market players looking to the changes taking place in the US. Although the structure of the US retail banking market is substantially different from the UK, with a far greater number of much smaller geographically-based banks and a few national players, the rapid reduction in the number of free in credit current accounts in operation could be seen as a desirable market innovation in the eyes of banks operating in the UK. Insofar as this leads to more profitable business models, companies with exposure in both markets may seek to replicate the changes in the US market in Britain. As shown in the previous chapter, there are also developments in other markets that firms may seek to replicate in Britain, such as the continuing roll-out of

[155] *The Credit Union Current Account*, ABCUL 2008

packaged accounts which might charge a fee but throw in wider financial services than simply access to current account services

Alterations in the market

Whether driven by external sources or not, the UK retail current account market is changing rapidly. As previously noted, there is some evidence from advertising spend that competitive pressures are increasing and there are a number of high profile market-entrants even if their market share is small. Product innovation is evident, most notably through the introduction of packaged accounts, although the fact that consumers find it hard to distinguish between products means it is not clear if these innovations are increasing overall competitive pressure. Meanwhile, technology is driving consumers to change their behaviour: account balances can be checked instantaneously via smartphones, accounts can be set up to provide alerts of activity, and web-based complementary payment mechanisms where credit balances can be held (Amazon, Paypal) give consumers the ability to undertake day-to-day budgeting in different ways. In future, the ability of technological and social media platforms to understand more about the spending patterns of consumers through the way they use web-based and payment technologies could broaden further the type of companies seeking to enter retail financial consumer markets.

5.2 Conclusion

There are a number of pressures, both market and regulatory, that are causing the dominant UK current account charging model to alter. Taken together, these point to a situation where costs to a particular cohort of consumer are more likely to reflect the actual costs to the bank of providing the service, rather than the current situation where various cross-subsidies exist to a greater or lesser extent between different consumer groups.

The effect on the operation of the three hypotheses we laid out in the earlier section is likely to be as follows:

- **Hypothesis 1: overdraft subsidy.** The prevailing trend where unauthorised overdraft fees fall to levels that feel more in line with the actual costs to the bank is likely to continue, with a corresponding increase in softer measures to encourage better budgeting such as alerts when balances reach a threshold minimum. This will continue to reduce bank profits (alongside separate decreases in the profitability of other consumer credit bank products) putting more pressure on other product lines.
- **Hypothesis 2: money to the middle.** Free banking to people with low balances is under threat since servicing these accounts costs money to the banks in question. Following examples in other countries, banks are likely to attempt to shift this cohort onto packaged accounts where a small fee is charged in return for a wider basket of services, which may or may not be desired by consumers. There can be expected to be a corresponding rise in complaints and accusations of mis-selling which may settle down into universal low-level charging for customers with low levels of balances.

- **Hypothesis 3: diligence subsidy:** Increasing pressure by regulatory authorities concerned about the effective operation of markets is likely to lead to greater transparency and comparability of costs between accounts, coupled with improvements in the ease of switching accounts. This can be expected to reduce the potential benefits available to those who take the trouble to shop around and so decrease the cross-subsidy available to this group. In a perfectly operating market, there will be little to differentiate competitor products: standard economic theory suggests the market will tend to providing products at a cost that equates to the real cost to the company of providing the services. Since that cost is greater than zero, this would imply that consumers pay for the banking services they use regardless of whether they switch either through a fee or through interest foregone.

These trends pose an important question to those who represent the consumer interest: **is having a situation where costs to consumers are more reflective of the actual costs of providing the service an improvement on the current situation?**

The concluding section to this report explores ways in which interested parties might want to consider this question.

6. Future questions

The purpose of this concluding chapter is to sketch out possible questions that interested parties might want to consider as the debate on the nature, and desirability, of cross-subsidy between different cohorts of consumer in the retail personal current account market develops.

The previous sections have highlighted the possibility that the main losers from anticipated regulatory and market changes are those who currently receive free banking services despite having low levels of balances. This group is likely to be thrifty and to have well-developed budget coping strategies, such that they do not pay fees to the bank from going overdrawn. They may be basic bank account customers but are just as likely to have regular current accounts. They may make regular small withdrawals, take advantage of direct debit discounts and have little appetite for broader financial services products such as travel or other forms of insurance.

The main winners, however, are more affluent users of current accounts who currently find it difficult to navigate their way through a relatively complex market. Regulatory pressure will increase transparency and portability, and at the same time competition in the packaged account market may make it possible to purchase a bundle of services that better satisfies their own consumer preferences. These are typically not the super-rich, and may still make up the cohort included in any definition of the "squeezed middle", but neither are they living hand-to-mouth: they are likely to have a mortgage and are interested in other insurance and consumer credit products.

Those who regularly incur penalty fees from unauthorised overdrafts are unlikely to be affected by the expected changes: fees have come down recently and are likely to remain within the purview of the regulatory authorities.

The question that follows from the review of evidence in this paper, therefore, is the extent to which there are acceptable trade-offs between the interests of these two main consumer groups. As a prior step it may therefore be useful to be able to categorise the different segments of the consumer market more clearly and explore the extent to which they understand and are willing to accommodate any future changes.

Ways in which the groups could be segmented might include likely average credit balances, the number and/or type of financial products held, the size of a typical cashpoint transaction, and the average time they are overdrawn, either with an agreed overdraft facility or with an unauthorised overdraft.

Once the nature of the different consumer segments is better understood, including their relative sizes as groups, it might be useful to explore their attitudes through deliberative research. Do thrifty low-income consumers understand they are receiving a service for free and are they prepared to pay for this? Do more affluent bank account holders understand how they are paying for their bank accounts and the extent to which they may either be

being subsidised by people with unauthorised overdrafts or subsidising thrifty low income consumers?

Within the more affluent consumer segment there may be a value in exploring attitudes to packaged bank accounts: what is the real value to the consumer of add-on services and do people understand the extent to which they are paying for them? Would they pay the same amount for add-on services if they were offered outside the wrapper of a bank account?

Separately and without prejudice to any future market investigation it may be fruitful to explore why it is that levels of bank account switching are so low. Are there still perceived barriers to switching or is it simply that consumers attach a monetary value to having a bank account that is already greater than the costs that they are paying; that is, that the consumer surplus is high? If the latter is true, that might imply that the potential to charge some segments of the population is higher than previously thought, which may reduce the need for cross-subsidy either between different cohorts or between different product lines without jeopardising the efficient operation of competitive markets. In a similar vein, it might be interesting to test through research the extent to which consumers feel they can compare products or determine value for money.

Overall, however, the main gap in the current research is a quantification of the relative sizes of different groups between which there may currently be cross-subsidies, or indeed a common understanding of the definition of cross-subsidy in the first place. This might appear to be a first step before considering the extent to which they may, or may not, be in the public interest.

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