



**Consumer  
Focus**  
Campaigning for a fair deal

# **Consumer Focus response to the Independent Banking Commission consultation on reform**

**July 2011**

# About Consumer Focus

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Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

## Introduction

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There is currently great uncertainty surrounding the regulation of financial services. Fundamental reforms to the way the area is regulated are occurring at various levels. It is essential that all those with a stake in financial services consider carefully what they want the market place to look like once these reforms settle down. In our view, the consumer experience must be put at the heart of the changes. It is vital that the financial services sector offers products that are good value, simple to understand and trustworthy. Our goal is the creation of a marketplace where the companies that prosper are the ones that offer such products, with consumers switching to take advantage of the best offers.

To ensure consumers receive products that fit the bill we need fundamental changes to occur to the banking sector. There may never be a better time for Government to ensure that in the future the sector meets consumers' and society's needs. In this paper we offer our vision for a fundamentally different, and more diverse, market place. We believe reforms for improving competition, ensuring real choice and universal provision of financial services will make the sector fit for purpose moving forward.

# Executive summary

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We strongly support efforts to improve competition, most notably in the Personal Current Account (PCA) market. Our research with consumers on this market means we have strong evidence-based arguments to support our position. We agree with efforts to automatically transfer Direct Debits in order to reduce error rates. This is the largest cause of consumer fears around switching. We sound a note of caution however, about the reforms to increase the speed of switching. Our evidence found 'length of time to switch' was of limited importance to consumers. Therefore we feel the reforms in this area offer little benefit but a high cost to banks that will ultimately be passed on to consumers.

We must be realistic about the benefits of reforms to improve switching. We found three in four consumers have never even thought about switching; therefore efforts to promote switching as the primary tool to improve the consumer experience are unlikely to be successful. With pricing structures as they stand, consumers simply do not trust the market enough to engage with differing offers. The market produces complex products and pricing strategies where consumers experience difficulty determining value and distrust the product and the supplier. This means many opt-out of mainstream provision. If we wish to encourage consumer engagement, radical simplification of pricing and design structures is required, as is a fundamental rethink about how firms compete.

It has long been recognised that lower income consumers simply are not profitable enough for firms to take an interest in providing more appropriate products.

Previous efforts to provide appropriate non-market products have left a lot to be desired due to the lack of prescription in the design. The primary example is with the Basic Banking Account (BBA). These have been provided on a voluntary basis by industry but the lack of prescription in design means they have not been appropriate products that lower-income consumers can trust. The needs of low income consumers are not being met, and millions of consumers simply go without an operational bank account. The banking sector must serve, as well as profit from, our society and to do that it has to be truly universal. Consequently, we believe now is the moment to call time on the voluntary approach and prescribe BBAs design.

Following the financial crisis, consolidation of the market has massively increased. It is currently dominated by a small number of banks and a building societies, which in cases such as the merger of Lloyds and HBOS has seen these institutions accumulate significantly increased market share<sup>1</sup>. Such concentration of market share has led consumers to perceive that the market is characterised by an insufficiently small number of participants, and a sense that the major retail banks are 'all the same'<sup>2</sup>.

The Independent Commission on Banking (ICB) must consider its options for promoting competition – and by competition we don't just mean more of the same. We need a range of providers and this paper sets out options including promoting credit unions and post office banking.

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<sup>1</sup> For example, the three largest providers of current accounts hold 60 per cent market share, with Lloyds HBOS holding a 30 per cent share. Office of Fair Trading (2010) *Review of Barriers to Entry, Expansion and Exit in retail banking*.

<sup>2</sup> ICM (2010) *The Banking needs of low income consumers at the Post Office*. Commissioned by Consumer Focus

Finally we challenge the ICB to consider whether it is time to explore a Universal Service Commitment (USC) in banking for providers with large market share. Currently challenger banks face far higher operating costs than large banks. Most notably, there is the cost of borrowing off whole-sale markets. The on-going subsidy for the banks in terms of their reduced lending costs is, by ICB estimates, '*considerably in excess of £10 billion a year*'<sup>3</sup>. A USC could aid competition by reducing barriers of entry to new entrants/fringe providers who will not be subject to a USC and increasing diversity.

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<sup>3</sup> IBC, *Interim report*, p152

# Our response

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## Improving competition

In its interim report the ICB stated ‘Besides increased concentration, conditions are generally poor for consumer choice in the banking sector, due to (real and perceived) difficulties in switching accounts, difficulties in understanding and comparing products, and barriers to entry facing new players who might have a better customer offering.’<sup>4</sup>

We agree with the above analysis and believe strong interventions are needed beyond the current OFT reforms, which have failed to deliver either consumer protection or an effective market place. Unfortunately, the OFT appears to lack the powers to deliver the necessary change<sup>5</sup>.

## Switching process

The OFT attempted to facilitate wide ranging reforms of the current account market following its 2008 report. Reforms included improving the consumer experience in switching; most notably on ensuring Direct Debit transfers do not incur errors. BACS also introduced an originator education strategy to ensure those firms who use Direct Debits have adequate systems in place to amend them.

In addition, in December 2009, BACS promised that no consumer would lose out financially because of errors in the switching process from the bank or a Direct Debit originator. As consumers shift payments more and more to Direct Debits, it is vital reforms radically reduce the problems consumers face when switching in order for trust in the process to increase. Unhappily, and demonstrably, this is not the case.

## Error rates in switching

We believe error rates in switching remain too high and are undermining consumer confidence in the switching process. The ICB paper suggests error rates are falling in Direct Debits during transfers of PCAs (2.63) and ‘*only a minority experience technical difficulties with the process*’.<sup>6</sup> The evidence the ICB uses to support this claim comes from the OFT’s findings based on BACS research in the OFT paper Barriers to Entry (p134). As the ICB notes, Consumer Focus undertook research with consumers and discovered a far higher rate of errors in Direct Debits, a substantial difference from the BACS research upon which the OFT relied upon for its conclusions in that report<sup>7</sup>.

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<sup>4</sup> Para 5.46, p130

<sup>5</sup> For example, it lost the case to assess UOCs for Fairness in the Supreme Court, and its broader efforts have all been on the basis of voluntary reform by the banks.

<sup>6</sup> Para 5.15, p123

<sup>7</sup> The ICB paper suggests the time period over which our research questions were asked was unclear. (Footnote 35, p35) We do not accept that finding. Our paper *Stick or Twist* sets out in detail the nature of the questions. On page 11 we set out that the questions were asked on 5-11 February 2010 and asked about consumers experience of switching in the last two years (February 2008-2010) in order to ‘*see how consumer behaviour has evolved since the 2008 OFT report*’ (*Stick or Twist*, p11).

## More recent OFT data suggests error rates are on the rise

We note the most recent OFT PCA update paper in March 2011 looks at technical data of Direct Debits sent to the old bank, one important error a consumer may suffer. Their paper states:

*'the OFT notes that since June 2010, the data indicates a slight increase in the number of Direct Debits being incorrectly sent to the 'old' PCA account rather than the 'new' PCA account (8.5 per cent in January 2011 compared to 7.6 per cent in June 2010). The OFT will continue to monitor developments to see whether progress in reducing errors is made.'*

Furthermore, wider consumer research from Mintel also suggests problems remain in the switching process<sup>8</sup>.

It is three years since the OFT report into current accounts and still the error rate remains stubbornly and consistently high. We do not believe BACS leadership on this issue, or indeed OFT's, has achieved the goal of ensuring the switching process is free from errors. Consequently, we welcome the following statement by the ICB:

The ICB suggests: 'the creation of a redirection system to transfer debits and credits from the old (closed) account automatically to the new account without inconveniencing the customer. Such an improvement to the switching process could increase both consumer confidence and the ease of the switching process for consumers.'<sup>9</sup>

We concur with this remedy and for the reasons described above we believe these reforms are vital. This was one of our key recommendations in our *Stick or Twist* paper.<sup>10</sup> Such an improvement will radically improve the efficacy of the switching process from the consumer perspective. The evidence in the most recent OFT report, alongside our data, suggests these reforms are needed to prevent errors in transfers.

An automated system works in the Netherlands. There, consumers are offered the option of an automatic transfer system (overstapservice) when they start switching a current account. This automatically redirects all Direct Debits and credit transfers from the old account to the new account to ensure that no payment is lost. If this can be implemented then the largest barrier to switching current accounts will be removed.

## Mandating a seven working day switching period

We see less evidence for the ICB's proposals on reducing the time taken to switch to seven working days from the current 18 working days. Our research did not identify consumer dissatisfaction with the time it currently takes to switch.<sup>11</sup> Our survey only found 11 per cent thought the process took too long.<sup>12</sup> The more significant concerns consumers experienced were around hassle, burdens, security checks and transferring Direct Debits.

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<sup>8</sup> Mintel, Retail Banking overview 2010, p66

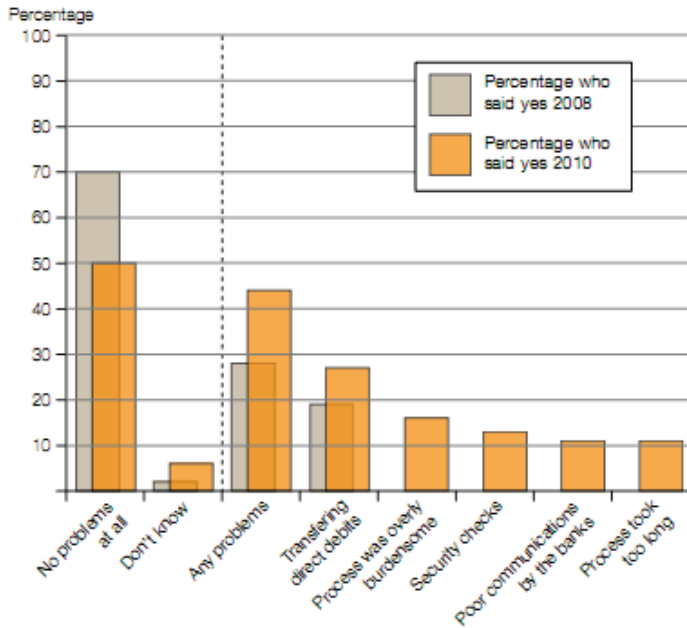
<sup>9</sup> Para 5.16, p123

<sup>10</sup> Consumer Focus, *Stick or Twist*, p28

<sup>11</sup> Defined by BACS switching guide, and the EBIC code. This includes the when the new account must be operational (10 days) and when all automated payments must occur <http://bit.ly/mBkiPt>

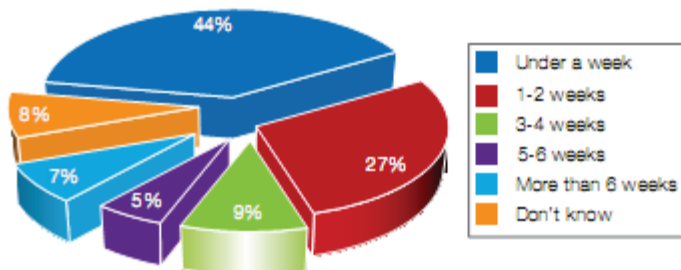
<sup>12</sup> Consumer Focus, *Stick or Twist*, p27

Graph 10 – When transferring your current account from one provider to another, did you have problems with any of the following?



Looking in detail at how long it took to switch, 12 per cent took more than five weeks to switch (five-six weeks, more than six weeks combined).

Graph 8 – How long did it take to switch?



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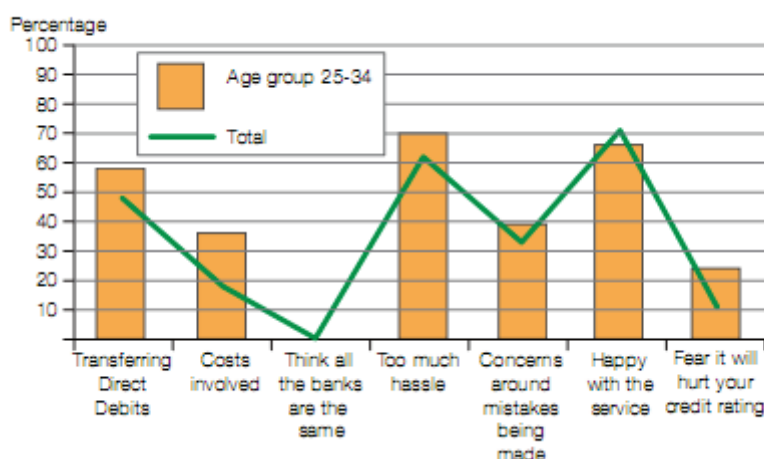
That is remarkably similar to the 11 per cent who thought it took too long in graph 10 above. Since those who waited less than five weeks did not express a concern about the length of time it took them to switch, we see little consumer demand for a maximum of seven working days rules for switching. Consumers seem content with the length of time it takes as long as that is within the current rules as set out by BACS underpinned by the EBIC code.

Equally, among those that had not switched but had thought about it, time taken to switch was not mentioned as a concern that put them off.

The graph below suggests consumers' concerns lie in fears of errors in transferring Direct Debits, hassle and in the effect to their credit score by switching. It is these issues rather than length of time to switch that should be addressed to encourage consumers to act and switch.

<sup>13</sup> Consumer Focus, *Stick or Twist*, p26

Graph 6 – Have you not switched for any of the following reasons?



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Lloyds Banking group has apparently measured the costs of a seven day switching service at between £1.5 and £2 billion<sup>15</sup>. Without judging the accuracy of that claim, it is still clear that there will be costs which will naturally be passed on to the consumer in some manner. We do not believe the benefits of a speedier process justify such a cost.

We would support the ICB proposing turning the time limit in the voluntary BACS switching timeline (10 working days for the new account to be operational, alongside an 18 working day limit for all automated payments to be transferred) into a mandatory code.

## Wider recommendations to improve the switching experience

### a Compensation

In the long run the success of persuading more consumers to consider switching will depend on actual consumer experience, which as we note above, is far from clear. Trust in the process can also be helped if consumers were confident that if things did go wrong they would be adequately compensated. This message would then be passed on by word of mouth. Trust in the process would then be likely to grow.

We recommended compensation (as well as restoration of any money lost) to a consumer who has suffered an error or if the above timelines are not adhered to. That would encourage businesses to improve their performance and it would fairly compensate consumers who have had to chase up mistakes. This builds on the OFT's finding in its response to our super-complaint on cash ISAs that:

*'providers should think more broadly about whether there is asymmetry in their relationships with consumers if they levy fees when consumers miss a payment date for example, but are not prepared to offer redress voluntarily, without being asked, when their own processes are delayed or go wrong'*<sup>16</sup>

We do not see any prospect of banks willingly introducing such provisions under the voluntary regulatory framework currently in place. Consequently, we call for the additional safeguards of mandatory compensation for any errors to restore consumer trust in the switching process.

<sup>14</sup> Consumer Focus, *Stick or Twist*, p21

<sup>15</sup> <http://bit.ly/ijzuoT>

<sup>16</sup> OFT, *Cash-ISAs: Response to super-complaint by Consumer Focus*. June 2010. <http://bit.ly/crFrCh>, p.86

## b Consumer information

In 2009, the BACS working group established a guide for switching, a Direct Debit help centre, a consumer website with tools and advice for switching and template letters for consumers to use. We do not believe the reforms to date are adequate. The promotion of switching could be better undertaken than under the current voluntary approach.

The 'switching service', is only on the BACS website, which is largely aimed at industry not consumers, so unsurprisingly just 7,000 people looked at the site between September 2009 and 2010.<sup>17</sup>

We found many banks' websites do not refer to this website and nor is the documentation available in branches. Many banks do have dedicated switching services but the last time the OFT examined these, in 2008, it found error rates were higher for the consumers who used these sites than those who did not.<sup>18</sup>

In reality, it is unrealistic to expect consumers to research the BACS website, download various forms and send them off – consumer apathy is likely to be too strong and the hassle factor too high. We would like to see the switching service information disseminated in a consumer friendly and hassle free way. It should be made available to all customers, on banks' websites and in branches. Tools to encourage and support switching need to be accessible and crystal clear, with easy-to-read scenarios that consumers can relate to their own circumstances.

Finally, consumer information must not require them to spend time filling in onerous forms. Only then will the numbers '*put off by the hassle*' be reduced. The BACS guides should be simpler. If automated payment transfers are implemented we believe the requirements placed on consumers could and should be radically reduced and the consumer information should follow accordingly.

Recently, the Financial Services Authority (FSA) has undertaken a review of consumer facing information and produced a 'Know Your Rights' consumer facing document which we endorse. The FSA has deliberately not drawn attention to the BACS switching site since it believes the information is not consumer friendly. We call for radical improvements in the information provided to consumers to navigate the switching process.

As detailed in the section below consumers will soon get an annual summary of charges and interest. One way to keep '*plugging away*' to tell consumers about switching would be to include a reminder that consumers have the right to switch on this annual summary. It could include a reference to a website where consumers can compare offers.

This proposal has already been recommended and implemented by the Competition Commission following its investigation into the current account market in Northern Ireland.<sup>19</sup>

It seems appropriate for similar reminders to be available to consumers in Great Britain on the annual summary. This may strengthen efforts to promote switching and, importantly, could be done at minimal cost.

This is also becoming best practice across other industries. For example, Ofgem has already introduced this in the energy sector following its Energy Supply Probe in 2009.

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<sup>17</sup> OFT, PCA update, September 2010

<sup>18</sup> OFT, 2008, p103

<sup>19</sup> Competition Commission, 2007, Personal current account banking services in Northern Ireland market investigation p184. Remedy f) <http://bit.ly/c2wAoG>

## Consumers' difficulties in understanding and comparing products

The ICB concludes that an increased willingness to switch '*would need to be accompanied by greater transparency so that customers can better compare the products on offer*'<sup>20</sup>. We strongly support that statement. We believe creative thinking is needed to ensure consumers can more easily compare products on offer and we do not believe the OFT reforms to date adequately resolve this problem.

As part of its wider efforts to reform the current account market, the OFT has tried to ensure consumers are given greater transparency over the cost of their account. This includes potential charges if they go into an unarranged overdraft in their new and old account (scenario testing) and an annual summary of all charges.

We do not believe the scenario testing tools provided by the OFT are likely to transform the market place for consumers who suffer unarranged overdraft charges (UOCs). Those most likely to suffer UOCs (23 per cent of the market according to the OFT in 2008) are least likely to switch generally and remain disengaged from the market place.<sup>21</sup> The OFT first discovered in its market study that consumers stubbornly refuse to engage with pricing in the PCA market even when repeatedly facing UOCs, because the pricing remains so opaque that they find it hard to make a decision about whether another account would offer them a better deal.

The 2008 OFT report highlighted that 'although over half of the interviewees had experienced insufficient funds charges, almost none had anticipated going overdrawn, having payments rejected, or paying bank charges. The conclusion of the psychological analysis was that some consumers are overconfident when it comes to their finances and probably underestimate the cost of banking'.<sup>22</sup>

It is clear this pricing model inherently causes consumer detriment. When the consumer is so poor at anticipating their use of UOCs, is so overconfident and fails to engage with the market it appears unlikely that they would switch banks based on variable behaviour they do not yet know. Those who do face these charges are not able to calculate which account suits their needs best using these scenarios because they simply do not plan to suffer from UOCs. Furthermore, recent empirical work by the OFT on Price Framing suggests that so-called 'drip-pricing' and excessive charges on ancillary aspects of the product lead to wide scale consumer detriment.<sup>23</sup> This backs up wider work by DG Sanco, that complexity in tariff structure means consumers are very poor at ensuring they receive good value.<sup>24</sup>

In addition, there are strong accessibility and quality issues about the scenario testing which need to be addressed. The OFT notes in its September report that the scenario testing documents are difficult to find on the banks' websites.<sup>25</sup>

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<sup>20</sup> Para 5.15 p123

<sup>21</sup> <http://bit.ly/i1GJmh>, p5

<sup>22</sup> OFT, *Personal Current Accounts: A Market Study*, 2008, p70

<sup>23</sup> *The impact of price frames on consumer decision making*, May 2010, <http://bit.ly/mUgJRg>

<sup>24</sup> <http://bit.ly/inei5g>

<sup>25</sup> <http://bit.ly/aYzxQ6>

We have yet to see any evidence from the OFT, Consumer Direct or the banks about how many consumers have used the charging scenarios either on the web, phone or face-to-face to inform switching decisions. Nor have we had any qualitative assessment undertaken about how useful consumers who suffer UOCs have found the scenario testing when considering switching. These scenarios are also not available for those consumers with BBAs. As they stand, we do not believe the scenario tests provide the transparency required.

For consumers with free in-credit accounts (who do not suffer UOCs) comparing the price of accounts means principally looking at the loss of interest from not having an alternative account with a higher interest rates on balances (so called interest foregone). This has changed substantially since the original 2008 OFT report. Interest rates have plummeted so many accounts now offer no in-credit interest on balances but also little interest foregone for firms to take as profit.<sup>26</sup> Of late, a further set of accounts have sprung up offering more attractive offers – from £5 per month<sup>27</sup>, to £100 for switching<sup>28</sup>, to a high interest rate on deposits up to a limit for a time limited period<sup>29</sup>. These deals often depend upon having a certain balance deposited each month and some are temporary deals only (teaser rates). Finally, packaged accounts with monthly fees have also grown. These accounts provide several add-on features such as insurance and free overdraft facilities and make comparison harder still.

There are private price comparison sites that do a fair job in making clear the relative value of each account. However, there is no industry standard for the independence and objectivity of the sites. We would be interested to see whether a website could be produced or accredited that provides objective assessments of value.

In *Stick or Twist*, we stated: ‘We would like to see greater consumer access to objective comparative price and quality information on bank accounts on internet comparison sites. That would allow consumers to compare their provider against its rivals both on total costs and on consumer service. We believe the money made clear website ([www.moneymadeclear.org.uk](http://www.moneymadeclear.org.uk)) should step in to fill this consumer need (something the OFT has already called for<sup>30</sup>).

For all customers of current accounts (BBA users, PCA customers who suffer UOCs, and those who stay in credit) achieving transparency and comparability is difficult at the moment because an assessment of value very much depends on one’s own personal circumstances, how much money you have and how you use it. With packaged accounts comparison is harder still since there are multiple products to compare. Therefore, there are limits even to the power of price comparison sites to inform consumers. We would like to see an online facility that allows consumers to put in their own financial details to see which account makes sense for them based on past behaviour.

It is noteworthy at this juncture to compare what is being done in other sectors. In energy, consumers can ‘plug in’ details of their bill into online price comparison sites to see which tariff is cheapest based on their usage patterns. Consumer Focus accredits the Confidence Code which ensures that the online calculators are accurate. There are differences that need to be worked through to ensure that industry specific problems are addressed are taken into account. The largest one being how consumers accumulate charges can vary enormously in banking, whereas in energy it is simply by usage.

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<sup>26</sup> Though having access to cash does save the banks on borrowing costs on the wholesale market which has a value to firms.

<sup>27</sup> Halifax, £5 a month

<sup>28</sup> First Direct, £100 for switching, HSBC £50

<sup>29</sup> Santander – 5 per cent for 12 months up to a balance of £2,500, Lloyds 4 per cent

<sup>30</sup> OFT, 2010, p16

Potentially, a better comparison comes from the mobile phone sector. That industry also has complex pricing structures. As a result Billmonitor offer a service that allows consumers to see which tariff best fits their phone usage.

Consumers simply have to consent to Billmonitor's software reading the monthly electronic bill. The software then scans the market based on actual usage of differing services (minutes, peak and off-peak, texts, and mobile internet).<sup>31</sup> Each month it generates a list of the best value tariffs for consumers based on actual usage. We believe further work could investigate the viability of such a comparison tool in the PCA market so consumers could base their assessment on which account offers best value based on actual evidence of how they have used their account in the past.

## Problems in retail banking that improved competition will not solve

The favoured policy solution in many market errors is to increase switching. It is hoped consumer pressure will ensure firms to produce more appropriate and better-value products. This strategy has not worked in retail financial services. The FSA discussion paper on product intervention shows consumers are poor at disciplining market participants, so-called 'demand-side weaknesses'.

Consumer Focus strongly endorses the comments of Lord Turner, Chair of the FSA, when he suggests that competition-based solutions, although a critical component of any healthy financial system, may be 'less powerful in financial services than has been conventionally assumed'<sup>32</sup>. That is to say, competition should be seen in terms of the plurality of approaches and providers: it should not be assessed, and is unlikely to deliver significant consumer benefits, if it simply means an increased proliferation of market entrants operating according to a conventional and broadly similar banking model.

According to Lord Turner: '...if both policymakers and existing markets are imperfect, the appropriate response might seem to be to concentrate policy initiatives on making markets more competitive. It is unclear, however, that this will be as powerful a lever as often supposed. In retail financial services it is, for instance, notable that some of our greatest concerns about high distribution margins and inappropriate advice have arisen in activities characterised by huge numbers of competitive firms'.

The recent Discussion Paper from the FSA on Product Intervention made the case that the regulator should be able to intervene in product design where it judges detriment is likely to be caused.<sup>33</sup> We fully agree that more radical policy options need to be considered to ensure markets deliver desirable outcomes. This includes direct intervention in product design to prevent detriment before it occurs.

Preventing complexity is not simply about removing toxicity from products but is also about allowing consumers to understand and gain maximum value from the market place. Competition, as it currently operates in Financial Services, tends towards an increasing number of very similar products. For example, the HM Treasury paper on Simple Products has drawn attention to the ever growing proliferation in the number of savings products. According to most recent estimates the numbers keep on rising to record levels.<sup>34</sup>

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<sup>31</sup> [www.Billmonitor.com](http://www.Billmonitor.com)

<sup>32</sup> Financial Services Authority (2011) Reforming Finance: are we being radical enough? Clare distinguished lecture in economic and public policy, speech given by Lord Turner

<sup>33</sup> FSA, *Product Intervention, DP11/1*, 2011

<sup>34</sup> [www.Moneyfacts.co.uk](http://www.Moneyfacts.co.uk) Press Release, <http://bit.ly/mhX44x>

Number of savings accounts available	
Today	2,385
1 Year Ago	2,219
3 Years Ago	2,197
5 Years Ago	2,088

Source: Moneyfacts.co.uk 8.6.11

As a result of this growing proliferation in product complexity the evidence shows consumers lack trust in financial products.<sup>35</sup> With so much variety and complexity in products – such as bundled current accounts, multiple charges and interest rates for credit cards and even complex savings accounts it is unsurprising consumers do not trust the huge variety of products on the market.

Consumers are unable to make informed choices about what best suits them and they believe the complexity is there to catch them out. All this means consumers are turned off from engaging in the marketplace.

Our report on switching found three quarters of consumers had never even thought about switching their bank accounts in the last two years.<sup>36</sup> Recent research also indicates 31 per cent of consumers have never switched bank accounts, far higher than for any other utility market place.<sup>37</sup> Thus, problems of ‘*demand side weaknesses*’ are even more pronounced in the PCA market than in any other, so efforts to improve switching are unlikely to help.<sup>38</sup>

Furthermore, wider academic work on financial services suggests even when consumers are engaged complexity in pricing structures prevents them from gaining maximum utility.<sup>39</sup>

In the PCA market, we call on the ICB to reflect not just on tools for transparency and comparability but to suggest improvements in the design of PCAs to deliver that goal. We believe radical improvements in transparency and comparability can only occur with radical prescription over the pricing mechanisms available to banks to ensure unfair and manipulative pricing strategies do not undermine efforts to improve competition. Without changes to pricing the effective discipline of market forces cannot apply, leading to detrimental outcomes for consumers, market inefficiencies and productive losses.

It is becoming increasingly clear that industry too recognise the problem. Recently, the head of retail banking at RBS, Brian Hartzer, said: *‘the way the industry was going about its business was unsustainable. For a retail bank to be successful it has to have a balance between customers, shareholders, communities and employees. The industry and RBS had become so focused on profit that it pursued policies that damaged all four of those stakeholder groups.’*<sup>40</sup> The recent case of Payment Protection Insurance should be a lesson heeded. Firms competed hard to sell loans, credit cards and mortgages and attach these insurance products to them. The problem was not a lack of competition but in the method of competition. If new entrants simply emulate that model then there is little value to be gained from the consumer perspective from more competition. Instead, we need to reshape how firms compete.

<sup>35</sup> HM Treasury provides ample evidence of this in their recent paper on Simple Products

<sup>36</sup> Consumer Focus, *Stick or Twist*, p31

<sup>37</sup> GoCompare.com Press Release, 6 June 2011.

<sup>38</sup> Consumer Focus, *Stick or Twist*, 2010

<sup>39</sup> OFT, Price Framing, 2010, DG SANCO, Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective <http://bit.ly/inei5q>

<sup>40</sup> <http://ind.pn/mRiUFh>

A recent think piece has made the point that across the financial services industry complexity leads to a negative cycle of consumers 'opting out' of mainstream products since they do not trust the nature of the product or the industry<sup>41</sup>. This then reduces the demand for mainstream products hurting both industry profitability and consumers, who do not benefit from the protections and advantages coverage grants them.

If and when consumers begin to trust the financial services industry not to offer unfair and risky products it is likely that trend will be reversed. Consumers may then begin to purchase other products off that bank, allowing the consumer to use a wider range of products that bring benefit to them.

## A larger problem for lower income consumers

Consumer Focus evidence on current accounts and cash ISAs shows it is the minority, those in higher social categories, who switch more and are more likely to switch when these deals come to an end.<sup>42</sup> Consumer Focus research also shows that low-income consumers are poorer at using their consumer choice to seek better value products. Our report *Stick or twist* found the young and social grades D or E have switched less and thought about switching current accounts less than other consumers.

Retail banking for low income consumers is a market where demand does not discipline supply by switching providers. Nor does supply follow demand since there is insufficient profit motive to incentivise the provision of appropriate products. The dynamic of market competition (supplier profit incentives and consumer choice) simply does not apply to ensure banking products meet lower income consumers' needs.

## We don't have truly universal service provision in banking

Unfortunately, while it has been recognised that low income consumers have specific needs in the financial services sector, to date those products designed to alleviate consumer detriment have not worked as effectively as planned. Basic bank accounts provide an excellent example of an area where clear Government intervention has proven necessary. But the scope of efforts to drive take-up of transactional accounts has been restricted by the speed and quality of the products available.

Consequently, many consumers opt out of mainstream banking partially or altogether. Our research into consumers without bank accounts and consumers using payday loans has shown that the risk of overdraft charges are a significant factor in the decision making of these consumers. Marginalised consumers without bank accounts were wary of opening accounts because of the perceived risk of spiralling debt as a result of unauthorised overdraft charges, particularly due to the lack of control over Direct Debits. Over half of those interviewed had previously had bank accounts and their experience of getting into debt through bank charges meant they were extremely nervous about having another account.

Consumer Focus found 82 per cent of low income consumers prefer cash because they 'know where they are'<sup>43</sup>. Our papers *On the Margins* and *Opportunity Knocks* drew attention to the endemic lack of trust among low income consumers for mainstream providers. The central cause was inappropriately designed products.<sup>44</sup> Consequently, many consumers choose to remain without a bank account to retain that control.

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<sup>41</sup> Liz Coyle, *Breaking the Downward Spiral: Why Improving Financial Capability is important to our industry*, Chartered Insurers Institute, <http://bit.ly/kFFFYZ>

<sup>42</sup> Research in switching in *Stick or Twist*, October 2010, research in Cash ISAs, February 2011.

<sup>43</sup> Consumer Focus, *On the Margins*

<sup>44</sup> Consumer Focus, *Opportunity Knocks*, 2009

Poor product design leads to a rejection of mainstream banking either through closing their account or through increased levels of dormancy. BBAs are clearly not fit for purpose and greater prescription is required.

The Financial Inclusion Taskforce (FIT)<sup>45</sup> claims that the numbers opening a BBA have expanded. Yet, there remain 1.75 million people without a functional transactional bank account. The specific failure to require a minimum set of account standards meant that each bank was able to set the specific features of its account.

As a result, very few BBAs offer everything that consumers identify as being essential to them<sup>46</sup> eg one account may offer a debit card, but not ATM access.

Consumers are therefore required to choose from a range of suboptimal products and make tradeoffs on the basis of those features – which should arguably be core for any account – they value and prioritise most. Due to a lack of sympathetic and appropriate design, the FIT research shows that any savings are offset by an average loss of £140 per annum in penalty charges – a burden borne mainly by the poorest households.

The net effect of a suboptimal product design due to a lack of product specification that reflected consumers' needs has been a high dormancy rate for BBAs.<sup>47</sup> Many consumers have stopped using their new accounts altogether (15 per cent, including 19 per cent for those on the lowest incomes.)<sup>48</sup>

The introduction of basic bank accounts therefore presents an excellent example of where greater state intervention and prescription could be beneficial in order to specify the precise requirements of products that effectively meet consumer needs, but which would be unlikely to develop purely as a result of market competition.

Without a requirement for consistency across all providers there is no incentive for banks to offer well-designed products that meet consumers' needs because it would result in them carrying an undue burden. Indeed, those providers, such as the Co-operative Bank that offer such accounts – characterised by a lack of risk, greater control, and which incorporate the range of features that consumers consider essential have typically seen a larger market share than other market participants.<sup>49</sup> Consequently, by offering the fairest, most comprehensive product, they are actively disadvantaged in a competitive market place by carrying a larger sunk cost in the BBA market as against those firms who offer a worse product. Greater prescription in the design of BBAs would prevent some market providers carrying an undue burden.

Greater prescription is likely to deliver a range of product improvements that benefit low-income consumers without bank accounts or those that have accounts but don't use them. This would include improved product functionality; the scope to improve take-up among consumers; the potential to stabilise or reverse high dormancy rates; and to increase the number of account holders who are using the full range of transactional account features offered by BBAs.

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<sup>45</sup> Financial Inclusion Taskforce, Banking services and poorer households <http://bit.ly/hNYtOt>

<sup>46</sup> Consumers identify a range of transactional features as being essential to them, including but not limited to the ability to receive all payments, access to High Street bank and Post Office branches, ATM access, a debit card, bill payment, and access to account information. Consumer Focus (2010) *Opportunity Knocks: Providing alternative banking solutions for low income consumers at the Post Office*

<sup>47</sup> Figures provided by the Financial Inclusion Taskforce indicates 40 per cent of BBA accounts may be dormant or that consumers use only limited functionality

<sup>48</sup> Financial Inclusion Taskforce (2010) *Banking services and poorer households*

<sup>49</sup> For example, the Co-operative Bank has a much higher percentage of the BBA market than the PCA market. Co-operative Financial Services (2010) ICB Issues Paper: Call for evidence

A recent report by Social Finance has estimated the numbers who are not being served by the current banking system. It adds those who currently use BBAs, Post Office Card Accounts (POCAs), those who don't have a bank account and those who pay more than £100 in UOCs. They have found that 800,000 have a POCA; 950,000 have a BBA (some of which will be dormant); and 6.6 million pay more than £100 for a PCA. When put alongside the continuing 1.54 million who remain without any transactional account<sup>50</sup> It estimates more than 9 million people are not being served by the current banking system.<sup>51</sup>

A prescribed BBA would allow those with current PCAs who pay too much, and those with BBAs or POCAs to have access to a fully functional and safe transactional account. For those unwilling to migrate to the 'big banks' the post office could provide an alternative (see below).<sup>52</sup>

We do not underestimate the impact that such a product would have on the marketplace: if BBAs became so wonderful then why wouldn't everyone want one? There would need to be tradeoffs between the full functionality that low income consumers want and the costs to industry of providing it. Other options could be explored such as charging customers a small fee or expecting the larger banks to take a leading role under a form of universal service commitment (expanded on later in this response). What is important is that we set a level playing field and minimum standards.

## Other public policy goals

As more and more firms offer cheaper and easier payment methods online, or via Direct Debits, extending the fully functional bank account to a wider section of the population will allow a greater range of consumers to take advantage of lower prices, better deals and increased ease of operating their finances. Martha Lane Fox, as the Government's UK Digital Champion is targeting the 9 million who are not online and access to current account which allows Direct Debit payment for internet access is key to achieving this goal.

The Government is committed to ensuring consumers are financially capable. One key aspect is the *money made clear* financial health check and advice network. However, it remains to be seen how far low income consumers can become 'capable' when the essential service of a current account endangers their financial wellbeing. We believe any efforts to make consumers more capable of managing their financial affairs is not feasible unless consumers have an account to safely store money, and receive and give payments.

If consumers could trust the BBA it will ensure greater take up which should in turn ensure greater financial capability as consumers get used to taking advantage of the added benefits available through a fully functional account. This should bring benefits to the individual person concerned, businesses and also to society more generally.

## Lack of competition

The IBC report draws attention to the lack of competition in the retail banking market. We fully support the IBC in its efforts to resolve the lack of competition in the market. This problem takes the form of too few providers and too few banking models.

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<sup>50</sup> According to the Financial Inclusion Taskforce, Banking services and poorer households, December 2010 <http://bit.ly/hNYtOt>

<sup>51</sup> <http://bit.ly/lzfKvI> p3.

<sup>52</sup> Consumer Focus (2010) *Opportunity Knocks: Providing alternative banking solutions for low income consumers at the Post Office*

First of all, we support the recommendations to break up Lloyds Banking group beyond the divestments already proposed. Yet, as discussed in the section on switching, there are severe limitations as to how far an improved switching process alone can improve the consumer experience in retail banking when charging methods are so complex and consumer switching is so limited. This is particularly the case for low income consumers.

Furthermore, in light of the financial crisis it is becoming increasingly clear consumers are even less willing to switch provider than ever. Small banks are now seen as riskier than large banks and more likely to fail.

The OFT Barriers to Entry work found: *'consumers to be wary of switching to an unfamiliar banking brand. Across the UK there is a wider reluctance to consider non-UK retail banking providers following the financial crisis'*<sup>53</sup>.

Consequently, consumers naturally tend towards the big brands as they are risk averse thus giving the larger banks yet another competitive advantage. The market is currently dominated by a small number of consolidated banks and building societies, which in cases such as the merger of Lloyds and HBOS has seen these institutions accumulate significantly increased market share<sup>54</sup>.

Large banks, receive a competitive advantage by having lower lending costs. This trend becomes more apparent the larger the bank, its strategic importance and whether it is state owned.<sup>55</sup>

It has also been suggested that small banks face large obstacles overcoming the significant fixed costs required to enter the market. Capital requirements, infrastructure, branches and payment systems are all hurdles that prevent easy access to the PCA market. If anything therefore, the barriers to entry and gaining market share are growing.

There are various estimates of the on-going subsidy for the banks in terms of their reduced lending costs. The Bank of England estimated that this subsidy was worth some £100 billion to the major UK banks in 2009 alone.<sup>56</sup> The ICB's estimates the subsidy, *'considerably in excess of £10 billion a year'*<sup>57</sup>. Whatever, the historic or current subsidy, undoubtedly, this provides a competitive advantage and a significant moral hazard. For example, Virgin Bank told the Treasury Select Committee their higher lending costs vis-a-vis the large banks makes competing difficult.<sup>58</sup>

## Introducing genuine choice for consumers

While any competition is welcome in our highly concentrated banking industry, it is important that we don't just have more of the same. A healthy market place needs diversity. The ICB should consider what role Credit Unions and the Post Office could play.

### Credit unions

Credit unions are a growing provider of accounts, savings and affordable credit, with over 350,000 people on low incomes having used a credit union access to simple financial services over the last five years<sup>59</sup>.

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<sup>53</sup> OFT, *Barriers to Entry, Expansion and Exit in Retail Banking*, November 2010, p11

<sup>54</sup> For example, the three largest providers of current accounts hold 60 per cent market share, with Lloyds HBOS holding a 30 per cent share. Office of Fair Trading (2010) *Review of Barriers to Entry, Expansion and Exit in retail banking*.

<sup>55</sup> Thomas Heurtas, Director, Banking Sector, FSA <http://bit.ly/lcTMEQ>, p9

<sup>56</sup> Andy Haldane, Bank of England, *Financial Stability Review*, 2010

<sup>57</sup> ICB, *Interim report*, p152

<sup>58</sup> <http://bit.ly/inYBjS>

<sup>59</sup> Figures provided from DWP

Although geographic coverage of credit unions remains limited, in many parts of the country credit unions are mainstream parts of the financial services landscape – for example, in the west of Scotland, Northern Ireland and many parts of Wales<sup>60</sup>.

A mature credit union sector could also offer wider benefits in terms of expanded competition; the range and quality of products and services available to consumers; and more broadly, it could also deliver improvements in the functioning of the wider retail banking market as a whole.

Research from other countries demonstrates this strongly: for example, in the United States, where credit unions are a typically mainstream provider, studies suggest there is an inverse relationship between the credit union share of a local financial market and the rates charged on loans by banks in that market. In effect, consumers therefore benefit from more favourable loan rates when there is a strong presence of credit unions in that local market<sup>61</sup>.

Interestingly, these benefits appear to be most pronounced in consolidated markets where the major retail banks have significant market shares. Research suggests that as the market share of the major banks goes up, the constraining influence of credit unions on bank rates also increases, with the most significant market constraints exerted in local financial markets where the largest retail players have the most significant market shares<sup>62</sup>.

This presents considerable implications which we urge the ICB to consider carefully. If, as the research suggests, the presence of credit unions typically results in lower loans rates for their members, and across the banking sector more widely, this suggests there is considerable scope for the ICB to explore how it could promote an expanded credit union sector in the UK, in order to promote a more effective and competitive retail banking market for consumers.

## Post Office

There is a strong consumer appetite for the Post Office to perform an expanded role in offering financial services across its 11,500 branches. Consumer Focus sees clear potential for the PO to become a 'neighbourhood bank', drawing on its unparalleled reach and its attributes as being trusted, local and personal, to offer a range of universal banking services:

- Access to current accounts operated by the major High Street banks: HSBC and Santander continue to refuse their customers the option to make withdrawals and deposits over the Post Office counter.
- Expanded access to credit union services: we have strongly welcomed Department for Work and Pensions's (DWP) £73 million funding for credit union services, announced in March this year, which includes a feasibility study on developing a shared banking platform between credit union and post offices. This could enable consumers to access credit union services, including bank accounts and affordable credit, across the entire post office network

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<sup>60</sup> For example, over 20 per cent of people in Glasgow are members of a credit union (Glasgow City Council)

<sup>61</sup> Feinberg, R (2001) *The effects of local credit unions on bank rates in local consumer lending markets*. Prepared for the Center for Credit Union Research and University of Wisconsin

<sup>62</sup> *ibid*

We welcome the IBC's recommendation, as part of its interim report, that Post Offices could perform an expanded role in respect of small business banking<sup>63</sup>, but argue that the scope for Post Office banking could be widened considerably as part of the final report.

In particular, Consumer Focus envisages that an expansion of Post Office banking could:

- put transactional banking services in communities that banks have neglected or deserted
- deliver better access to low-income consumers, including those in rural and urban deprived locations<sup>64</sup>
- deliver improved access to counter services, to which consumers attach immense value<sup>65</sup>
- drive financial inclusion through offering a range of transactional products, including but not limited to the transactional POCA set out earlier

Consumer appetite for an expanded Post Office financial services offering is strong. Importantly, is not limited to low income segments that have traditionally used the Post Office to access cash or undertake financial transactions. According to forthcoming Consumer Focus research, 59 per cent of consumers, and 58 per cent of consumers in social grades AB, support the likes of the Post Office and National Savings and Investment (NS&I) being encouraged to offer a wider range of financial products.<sup>66</sup>

Similarly, almost half of consumers (44 per cent, and 45 per cent of social grades AB) would expect to see benefits for them and the wider market, if new market entrants, such as the Post Office and Tesco, were to offer additional banking services. Only 15 per cent and 17 per cent respectively disagree<sup>67</sup>.

Take-up of Post Office banking products appears to be strikingly consistent across consumer groups: 38 per cent say they would actively consider opening an account at the Post Office, with 37 per cent in social grades AB and 37 per cent in social grades DE saying they would be actively likely to do so. 37 per cent specifically say they would be interested in opening a current account at the Post Office, although this needs to be seen in the wider context of high levels of customer inertia and a wider resistance to switching in the PCA market.

## Funding the changes: Time for a Universal Service Commitment?

At the ICB event co-hosted with Consumer Focus in December last year, the idea of imposing a Universal Service Commitment (USC) on large banks was raised and widely supported<sup>68</sup>. The idea of a USO in financial services is not a new phenomenon in the UK.

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<sup>63</sup> The interim report found that Post Offices could play a greater role in supporting cash handling for small businesses

<sup>64</sup> Research for the Commission for Rural Communities (2007) found that access to cash is a major problem in rural areas: 300,000 people in rural England do not have access to a bank account, and less than 10 per cent of ATMs are located in rural areas in England

<sup>65</sup> Consumer Focus research finds that 80 per cent of consumers value having a bank branch nearby. TNS (2011) survey of 2,014 adults. This confirms the importance of counter access demonstrated by the OFT's study (2010) into the Personal Current Account market. Separately, the OFT review into barriers to entry, expansion and exit in retail banking (2010) found that branch networks were important to consumers and SMEs, when determining where to open accounts, and the lack of a branch network was therefore a significant barrier to entry for new market entrants

<sup>66</sup> TNS (2011) survey of 2,014 adults commissioned for Consumer Focus

<sup>67</sup> *ibid*

<sup>68</sup> The point was originally raised by Peter Eisenegger of the National Consumers Federation

The Treasury Select Committee looked into the idea in 2006 and provisionally rejected the idea on two grounds:<sup>69</sup>

1. the Banking sector was more competitive than other sectors where there was a such an obligation
2. the then voluntary approach under the Financial Exclusion Taskforce should run its course before opting for the tougher option if and when necessary

Our predecessor body at the time supported that approach. The National Consumer Council, did not consider that a legislative obligation upon banks would be appropriate '*at this stage*', although we suggested that it was '*something that may be appropriate further down the line*'<sup>70</sup>. Since that time the increased concentration in the banking sector and the problems low income consumers experience with bank accounts mean that neither of the two above arguments is now at all valid. Therefore we believe the time has come for further consideration of a USC in banking.

The concept of a 'universal service commitment' is generally associated with services that have been provided in the public sector or in sectors where licensing or high barriers to entry confers a particular market advantage. More prescriptive USCs or USOs operate in other markets in the UK where access is a necessity and where competition cannot ensure appropriate access and value. Most notably they come in different forms in the regulated industries of Telecoms, Post and Energy. We believe with the consolidation of the banking sector and the proven inability for supply to ensure appropriate access and value the time is right to explore a USC in banking as is the case in other countries such as Canada and France.

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<sup>69</sup> <http://bit.ly/lbb1Fm>

<sup>70</sup> National Consumer Council, in *Select Committee on Treasury Thirteenth Report* minutes *ibid.* See also NCC, *Basic Banking*, 2006 <http://bit.ly/iREWkj>



**Consumer Focus response to the Independent Banking Commission consultation on reform options**

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