



# Free or Fee: Are ‘free’ products good for consumers?

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## Introduction

The cross-subsidy business model — the shifting of costs from one product to another - occurs in a wide variety of markets. For example, a free or discounted handset is often included when a customer commits to a mobile phone contract and printer manufacturers discount printers hoping to generate a revenue stream from the repeat purchase of consumable inks. Equally, in a competitive marketplace financial firms have chosen to provide some services ‘free of charge’ to consumers, such as current accounts, money withdrawal from ATMs, credit cards and financial advice paid for by commissions paid by providers. These services have an underlying cost which firms must absorb or recover from elsewhere.

But, in the financial services sector the cross-subsidy model may have contributed to market problems. For example, it has been argued that “free” financial advice funded by commissions paid by product providers has led to bias in what has been sold in a way which is not good for consumers. The FSA was concerned enough by this that it proposes to ban independent financial advisers from being remunerated by provider determined commissions and to move to a model where advisers are paid a fee by the customer.

In the case of current accounts the competition authorities have been concerned about costs of overdrafts and other products associated with banking for a long time. It is likely these costs are associated directly with cross subsidies and free products. The banks have said that, if ultimately successful, these challenges could signal the end of free banking.

This discussion paper has been written to explore some of these issues in more detail, and to form the basis of further debate.



## Is there such a thing as a free financial product?

Many financial products are presumed by consumers to be free. Take, for example, current accounts. They are usually free to set up and maintain, deposits and withdrawals are usually free and it is free to close them. Credit cards, so long as credit is paid off in full and on time, are also often free. But both of these products attract costs which are either passed on to the consumer in the form of hidden charges or are cross subsidised from other products or revenue streams related to that product (such as merchant fees).

There is perhaps one group of consumers who enjoy free banking: those who keep relatively small amounts in their current accounts, use their current accounts frequently but do not go overdrawn. For those who keep a lot of money in their bank accounts the situation is different – low (often near zero) interest rates on positive balances are a hidden ‘cost’ of current accounts. Likewise customers who go overdrawn are subjected to high charges. A current account is not therefore necessarily free – overdraft charges and low interest rates are just some of the less transparent costs associated with current accounts.

## Why do we have free products?

The reason that we might be concerned about some products appearing to be free in financial services is, of course, that nothing is free in the end. There is either cross subsidy or hidden charges. But why is there this proliferation of free products and services, such as bank accounts, free ATMs and financial advice in the first place?

**“The main driver of the proliferation of free products is the structure of competition in retail financial services”**

Arguably, the main driver behind the abundance of free products is the structure of competition in retail financial services. Competition in this market for retail financial services tends to be on the basis of a headline characteristic, often its immediate cost. Demand is less responsive to the longer term product cost, which in many cases is quite difficult to calculate.

An obvious real-world example of this tendency is mortgages that offer cheap rates for the first year but which revert to a higher rate after the introductory period and



may have large exit fees. David Miles commented on this in his 2004 report for HM Treasury *The UK Mortgage Market: Taking a Longer-Term View*:

“When choosing between mortgages a great many households attach enormous weight to the level of initial monthly repayments. Consideration of where short-term interest rates might move in the future, and of what this implies for affordability, seems to play a far smaller role than it would if households considered the likely overall costs of borrowing over the life of a loan.”

The structure of mortgage pricing generates cross-subsidisation from many existing borrowers, a significant proportion of whom are paying standard variable rates (SVR), to new borrowers taking out discounted variable and short-term fixed-rate mortgages. This creates unfairness and makes the market less transparent than it could be. It plays to a tendency of many borrowers to focus on the initial monthly payments on a mortgage and it makes medium-term and longer-term fixed-rates appear expensive.

Other examples are savings products marketed with high interest rates for the first year but with much lower interest rates in subsequent years. In both cases, banks have made an assumption that competition is structured on short term costs and up front benefits rather than the longer term value of the product.

Interestingly this is an area, given the way it currently works, where more competition is not always going to be necessarily beneficial to consumers. Where new entrants compete on the basis of low or free up front charges, and recoup their money later on, increased competition can even enshrine the cross subsidies and differences between headline rates and back books.

Consumer demand is often less responsive to the long term cost and value of a product for three main reasons:

1. Transparency – longer term costs, such as overdraft charges, are often hidden;
2. High switching costs – many consumers are disinclined to switch between, for example, bank accounts and other financial products, because of actual or perceived costs in doing so;



3. Individuals tend to place more value on benefits that are immediate than those that are crystallised over the long-term (even if the long-term benefits outweigh those in the short-term).

### **The costs and benefits of free banking**

So, if a perhaps inevitable concomitant of free banking is cross subsidy and hidden charges, the question naturally arises as to whether apparently free banking is a good thing at all. One consequence of the current pricing structures, whereby banks apply charges to certain services at apparently high levels, perhaps in part to cross subsidise “free” services, has been a series of long running competition cases and OFT enquiries – for example into overdraft charges and PPI – most of which are still to be resolved.

In addition this model creates a lack of transparency that often goes with financial services. The costs are opaque. Where costs are opaque, it is more difficult for effective competition to prosper. Moving away from apparently free goods could improve the transparency of the retail financial services market and help competition.

It is possible that free banking may also encourage retail banks to increase their wholesale exposures.

There is a counter-argument, of course, which invokes the social function of basic financial services. Without access to basic banking services it is difficult to secure accommodation and gain meaningful employment. On this basis some have argued that charging up-front fees for basic banking services will exacerbate social and financial exclusion because it will be a barrier to opening a bank account – an undesirable outcome. Should the Government therefore be mandating free access to bank services?

### **Change**

The government mandates some other services, such as mail and utilities through explicit economic regulation. The price of water and the cost of a postage stamp are tightly controlled by the regulators. (In the case of water it is impossible for a water company cut off water supply to a defaulter. There has recently been some talk of allowing the household water supply to be reduced to a trickle in cases of extreme



non-payment, but it is still the case that water is seen as an essential utility, the provision of which is subject to tight regulation and control).

There is a debate to be had as to whether basic banking services should be treated in a similar way with economic regulation to control price and access for social reasons, possibly with appropriate and explicit leeway for banks to claw those costs back from other charges.

One issue is that there is currently a multitude of regulators and quasi-regulators dealing with retail financial services with different, if not conflicting, objectives – financial stability, consumer protection, competition. In addition there is more or less formal pressure from government and others to keep services like bank accounts and ATMs free. The question certainly arises as to the extent to which a clearer and more consistent regulatory structure is required. Water regulation where competition, environmental concerns and consumer priorities are explicitly balanced against one another in a well understood structure, is one example of where a range of potentially conflicting priorities are internalised.. Despite all the work of recent years we are not there yet with financial regulation.

Clearly it is commercially very difficult for a bank to unilaterally start charging for hitherto free services. Competition and demand is structured on headline costs and benefits. If a bank were to start charging its consumers for current account and credit facilities that they have until now enjoyed free of charge, this would likely be damaging to that institution, making it hard for it to win new business and possibly leading to an exodus of existing customers. We are in a market equilibrium in which it is hard to see how any significant moves away from the current model of 'free' services (with hidden costs and cross subsidies) will happen without some major external impetus.

### **Conclusion**

This paper is intended to provoke debate by highlighting some of the issues and arguments around the causes and consequences of free products in financial services. It does not seek to provide a definitive answer, nor does it try to argue a single position or point of view. It is hoped that some of these issues, particularly the consequences of providing certain banking products for free, will be expanded in future debates.



## Focus on Finance

The apparent prevalence of free goods in the retail financial services market is a reflection of the way competition actually works. Competition is skewed towards headline issues such as upfront costs and benefits. There is a lack of transparency in the way costs are applied and recouped. Switching costs, implicit or explicit, are high.

As a result change will not come from market participants reacting to their own incentives. If we want it, it will require well thought out and careful public action. We need greater clarity over roles and objectives for the regulation of retail financial services, and we need to base decisions on an understanding of how competition works and what the consequences of decisions in one arena are likely to be across the piece.