

Free of Fee: Are 'free' products good for consumers?

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The debate

Introduction

This paper offers a thematic summary of discussions from the third event in the Focus on Finance series which was on the topic of 'Free or Fee: Are "free" products good for consumers?' Our paper author, Paul Johnson, Senior Associate at Frontier Economics, set out the main issues around free banking and product cross-subsidy in a discussion paper which can be downloaded from www.focusonfinance.org.uk.

The debate is part of a series of seminars exploring some of the issues arising out of the financial crisis from the consumer's perspective. The debates are being used to inform Consumer Focus' policy development, but the summary below should not be taken as Consumer Focus policy.

Previous seminars have looked at product regulation and competition within retail financial services and this seminar was an opportunity to look at the practicalities of free banking, such as product cross-subsidy, price transparency, and competition.

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. More recently, Chris Anderson has described the phenomenon of 'freeconomics', whereby technological developments, such as the internet, cause the marginal cost of providing goods and services to reduce towards zero and

so firms like Google provide search for free, relying on revenue from advertising.

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 independent advice paid for by commissions paid by providers. These services have an underlying cost which firms must absorb or recover from elsewhere.

Arguably, in the financial services sector the cross-subsidy model has contributed to serious problems that have led to consumer distrust. For example, IFAs rely on commission paid by the product provider, not a fee paid by the client, which creates the risk of mis-selling. In the case of current accounts, the banks have chosen to recover costs partly by charging penalty fees; the OFT has deemed these fees as excessive and mounted a legal challenge. The banks have said that the OFT's litigation, if ultimately successful, could signal the end of free banking.

Are products free?

'Financial 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.'

Paul Johnson, Paper Author

'The issue about free banking is that with the provision of free current accounts you have the opportunity to sell your customers other services.'

Adam Phillips, Panellist

A large part of the third seminar in the focus on finance series focussed on a discussion of whether financial products are actually free. It was noted that although many products are presumed by consumers to be free, there are often hidden costs and charges that sometimes apply to supposedly free financial products. One of the most obvious examples of this are overdraft charges, where consumers exceeding their agreed overdraft limit, even by a relatively small amount and for a very short period of time, incur disproportionate charges. The discussion was particularly pertinent as it came at a time when the new Supreme Court is about to issue its final ruling on the test case into the fairness of unarranged overdraft charges.

It was noted at the seminar that the amount of consumers enjoying the direct benefits of free banking is very small, and is limited to consumers who use their current accounts frequently, have small balances, and never go overdrawn. In this

sense most products are not actually free, even though they do not attract an upfront cost to the consumer. Either the cost is hidden or other products are subsidising free basic banking services.

Free Advice

A recurring theme at the seminar was the concept of 'free' advice. Although advice may appear to the consumer to be free, advisers or sales people are often paid through commission. An adviser, therefore, is not likely to advise a consumer to open a standard free savings account or an offset mortgage as they do not attract a commission.

Participants drew a sharp distinction between free banking and free advice however, as the cost of commissions were ultimately passed back to the end customer, whilst in banking this was not necessarily the case.

Participants felt that reforms of financial advice planned by the FSA would help some of the worst problems with commissions. There were some calls at the seminar to see a simplified advice regime with basic, free financial guidance made available to all consumers.

What are the real costs of 'free' banking?

'We have all got very used to paying through direct debits, taking money out of ATMs, having our current account run for nothing as long as we remain in credit. There is a price to be paid for that – if we go overdrawn, if we break the rules then we will be charged and charged quite heavily. For people who manage their account well it is free and it is also very important for another group of people – who have very little money – it very important that they can pay into an account, pay their bills, without incurring a charge. We have got this model and it would be very hard to change it.'

Paul Lewis, Panellist

The consensus was that although certain products may appear to be free – basic current accounts, certain credit cards (so long as the consumer clears the balance in full and on time), and some banking payment facilities linked to the current account such as direct debit facilities and free ATM withdrawals – there is a cost to the provider associated with the provision of these free services and this cost needs to be recuperated in some way. These pressures have encouraged providers to design increasingly complex products with hidden costs and charges. Although these products appear to be free, they attract costs which are passed on

to the consumer in the form of hidden charges or are cross-subsidised from either other products within the provider's portfolio or from revenue streams. Disproportionate overdraft charges (where the charge far exceeds the cost incurred by the provider) and unattractive interest rates are just a couple of ways where consumers lose out to pay for the provision of 'free' banking services.

This leads to a much wider question which was left open at the seminar: do policy makers want people to have access to free financial products and to what extent, if any, should government mandate this?

Competitive Pressures

'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.'

Paul Johnson, Paper Author

'The banks need to be clear competition will lead to the withdrawal of cheaper banking services from people who have not much money. This is a public policy issue... we need to set up a process to discuss how we are going to solve this problem.'

Adam Phillips, Panellist

Paul Johnson, author of the seminar discussion paper, was particularly keen to highlight the competitive pressures within retail financial services, which are often skewed towards attractive headline rates. This leads to greater cross subsidy both within and between products and results in less transparent long term costs.

Competition is structured in this way as consumers often focus on the headline rate, such as an initial attractive interest rate or low set-up cost, without paying as much attention to the long term cost of a product or without understanding or being able to easily compare the long term implications of certain products. This is exacerbated by a lack of lifetime price transparency and high implicit switching costs – consumers are often reluctant to search for better deals during the lifetime of an existing financial product.

New entrants in particular are forced to compete on headline rates. This is not necessarily a good thing for the consumer as it leads to greater complexity and higher charges or hidden costs on the long run.

Cross subsidy

'Because we have free banking we have a lot of cross subsidy going on, we have a lack of transparency in the banking system and we certainly have a system where the prices are not clear to consumers and they are not reflective of the costs'

Paul Johnson, Paper Author

Examples of intra-product cross subsidy are savings products which are marketed with high interest rates for the first year but with much less attractive interest rates in following years. Mortgages are a good example of inter-product cross subsidy where many existing borrowers are subsidising new borrowers taking out short-term fixed-rate and discounted variable-rate mortgages.

Paul Lewis, broadcaster and seminar panellist, argued that it may actually be unfair to charge for all financial products – why should responsible consumers pay for the actions of those who manage their financial affairs in a less prudent way? It was also noted at the seminar that overdraft charges may be an effective way of encouraging more responsible consumer behaviour and attitudes to managing personal financial affairs.

Whatever the result of the overdraft charges test case it is unlikely that banks will start charging their customers for basic bank accounts. Banks will have to cross subsidise using different and probably more innovative (and less transparent) methods but it would be very difficult for a bank to suddenly start charging for basic banking services – the effect of competition and the public policy implications would discourage this. Cross subsidy is therefore a natural consequence of 'free' banking as providers seek to recuperate some of their costs – the consumer, in the end, always pays.

Transparency and product design

'The free basic banking model may also distort the way the actual market functions. Without hidden charges and product cross subsidisation, retail banks may be encouraged to increase their wholesale exposures to cover the cost of providing free retail services.'

Paul Johnson, Paper Author

'There is immense complexity in financial services generally and in many other services – such as gas, electricity, mobile phones- the number of choices we have far outstrips anything that the human brain can

cope with. One of the dangers of charging for current accounts would be that you would then see this level of complexity in financial services. Instead of having one simple system that we all understand and can use we will have thousands of choices and we would all end up paying a great deal more'
Paul Lewis, Panellist

Adam Phillips, Chair of the Financial Services Consumer Panel and panellist at the seminar asked the question, where do we want to get to in retail financial services market? The provision of mortgages and insurance is highly competitive but this is not the case when it comes to many portfolio products. This is because, he argued, it is easy to 'bamboozle' the buyer. A wholesale review of product design should be undertaken to ensure that retail financial products are transparent and understandable. If the consumer fully understands the product, he or she is more likely to exercise an informed choice when purchasing a financial product – informed choice is one of the keys to ensuring competitive pressures are aligned with the consumer interest.

Is the retail financial service market functioning as it should?

One of the key concerns raised at the seminar was a general view that the retail financial services market is not working in the same way as the retail market for more tangible goods, such as, for example, clothes and cars.

Most products can be returned, after purchase, if they do not meet the needs of the consumer. The case of financial services is very much different where:

- It is harder for the consumer to make an effective judgement about the suitability of a product to satisfy their financial needs;
- Consumers are more reluctant to 'return' financial products that they deem unsuitable after purchase.

For a properly functioning retail financial services market to flourish consumers need to be better informed of the products on the market and be able to make a rational judgement as to their suitability. This requires better financial capability on the part of the consumer but it can also be helped through more transparency about the longer term costs, performance and effectiveness of financial products.

It was also noted by participants at the seminar that there are various challenges to the current market model: cross selling and cross subsidisation will become increasingly more difficult, new entrants, and new technology

(particularly in the form of electronic and micro payments) all challenge the existing model.

Are basic financial services an essential utility? There was an interesting debate at the seminar as to whether society should mandate free basic banking services and how this should be regulated. Some were of the opinion that a suite of safe, basic products and simplified advice should be mandated by policy makers. But should these necessarily be free? It was also noted that even essential utilities such as water attract a charge, and indeed some argue that water charges are actually too low. If policy makers agree that basic financial services should remain free it will be necessary to revisit how the industry is regulated. Currently multiple regulators are trying to address often conflicting outcomes of 'free' banking, such as adverse competitive pressures, cross-subsidisation and unfair pricing. Going forward, a single economic regulator may be a more successful way of regulating the industry as it can address the outcomes of 'free' banking as a whole, with a single, coherent approach.

Summary

The general consensus of the discussion was that although many basic financial products appear to be free, they are only free to consumers who act within the rules and keep very little money in their current accounts. A free basic service (such as current accounts, free withdrawals and free direct debits) is seen by many to be a public necessity. Paying bills by direct debit often attracts a discount and so the removal of free banking may hurt the poorest in society disproportionately. Providers of basic banking services do incur a cost and this is recuperated mainly through product cross-subsidies. The big drawbacks, therefore, are that free banking leads to increasing complexity and hidden charges which many consumers often find hard to properly understand. This undermines competition and may be of detriment to the consumer in the longer term.

The big question, therefore, is what public policy makers would like to see when it comes to basic banking services. A concept of utility banking needs to be properly defined and clarified. Should products be free or priced fairly? If basic banking services should be free how should the market be regulated? Utilities are often regulated by a single economic regulator – should this regulatory model be applied to retail financial services?

You can listen to an exclusive podcast from the second debate at:

www.focusonfinance.org.uk/debate3.html