Who really PAYS *for* FREE BANKING?

An emotive debate today is about the assumption that some – often poorer – personal current account users may be unwittingly cross-subsidising the "free" banking of the better-off. Professor JOHN K ASHTON discusses new research that illuminates the issue.

Personal current accounts provide a gateway to the monetised economy for the majority of the UK population. Despite this essential societal role, significant uncertainty exists about who pays for the provision of these services. While most personal current account customers use the payment services provided by personal current accounts at no direct cost, certain customer groups may be paying more for these services either consciously or otherwise. Consequently, some customers may be cross-subsidising other personal current account users.

Personal current accounts are used by 90% of the UK population (OFT 2008). And, across the European Union, their customer base is greater than that using telephone services (Commission of the European Communities 2009): so, clarity and comprehension as to how customer costs are incurred in this market is essential.

Unsurprisingly, this question has been the subject of much public speculation, punctuated by contributions from consumer protection bodies, politicians and policymakers. Recent work at Bangor University, funded by Friends Provident Charitable Foundation, has cast light on this issue.

This debate hinges on three potential outcomes. First, it's suggested that customers who overdraw their current accounts pay substantial fees and interest and subsidise all other personal current account customers. This scenario has drawn commentary from both consumer lobbyists and politicians.

For example, the House of Commons Treasury Committee (p201, paragraph 80) reports: "… so-called free banking has important distributional consequences. A minority of consumers, often those on lower incomes, pay explicit charges associated with overdrafts. This results in high prices and poor outcomes for a sub-set of consumers. Meanwhile, other consumers, often on higher incomes do not pay explicitly for their current account provision".

Second, in the rush to meet concerns about financial exclusion, including the provision of tailored services for less wealthy customers, relatively low income personal current account customers may receive a cross-subsidy from all other customers.

Third, the cost of offering payment services to all customers may fall disproportionately on less diligent and inattentive customers. Specifically, the many customers who do not switch their personal current accounts frequently may end up using less appropriate services.

Despite the importance of these debates, only limited UK academic empirical investigation of this issue has been undertaken to date. To correct this, an examination of the presence or otherwise of cross-subsidies in the customer cost of using personal current accounts was undertaken by myself at Bangor University and Robert Hudson from the University of Hull. The assessment uses a near population of 395 personal current accounts from Moneyfacts PLC which includes details, interest rates and costs of these accounts monthly between 1995 and 2011.

"THERE ARE CLEAR 'BANKER-BASHING' INCENTIVES FOR CUSTOMER ADVOCATES TO CLAIM CROSS-SUBSIDIES EXIST IN ORDER TO CHANGE PRODUCT-PRICING TO AID THEIR SUPPORTERS."

This analysis developed approaches previously used by regulators to examine the total cost of using personal current accounts for customers' representative of how personal current accounts are used by the wider population. These costs included both the explicit and much discussed overdraft fees and interest costs, as well as the often overlooked implicit costs of using current accounts including the relatively low levels of interest paid on personal current account balances and 'packaged' fees applied by providers.

Whether overdraft customers subsidise all other customers was examined by considering the difference between personal current accounts offering this service or otherwise. If such a cross-subsidy is as ubiquitous and sizable as predicted by many commentators, the pricing of accounts will vary substantially between current accounts offering these overdraft services and those that do not.

It is reported that the differences between the pricing of personal current accounts with and without overdrafts does not support the hypothesis that overdraft users cross-subsidise all other personal current account users. Indeed the reverse may be more probable.

So, do other forms of cross-subsidies still exist? It is reported that the bulk of customer costs of using UK personal current accounts arise due to customer inertia and a lack of diligence. Specifically, the interest paid for holding funds in personal current accounts has been so low relative to other financial services such as instant access current accounts, that customers accumulating large balances in their personal current accounts are supplying funds to banks at an artificially low cost.

> **"THE PRICING OF** PERSONAL CURRENT ACCOUNTS DOESN'T SUPPORT THE HYPOTHESIS THAT OVERDRAFT USERS CROSS-SUBSIDISE ALL OTHER PERSONAL CURRENT ACCOUNT USERS."

For all personal current accounts and months we observe an average 0.77% return for £1,000 deposited in a personal current account; this compares poorly to the average 2.30% paid on £1,000 deposited in an average instant access deposit account provided contemporarily by the same current account supplier.

While these costs vary substantially between banks supplying current accounts, the annual customer costs of these low personal current account interest rates relative to sweeping these funds into an instant access deposit account vary between £5 and £29 for three representative customer profiles used in this and other studies. Therefore, the key benefit for providers from the personal current account market appears to be the provision of low cost funding from less diligent customers.

This result is important. In times where banker-bashing has become a popular pastime, we need to recognise there are clear incentives for different customer advocates to claim cross-subsidies exist in order to change the pricing of products to aid their supporters. Indeed this specific issue could also be viewed to be part of a wider redistributive policy, as cross-subsidy is believed to flow from poorer to richer customers.

These claims are assisted by the use of imprecise and emotive language, the use of less rigorous measures of cross-subsidy and the on-going challenges to the measurement of cross-subsidies. In light of these findings we would hope further academic and empirical research on this topic is forthcoming and crucially access to data in this area is improved. Claims such as cross-subsidies in the personal current account market need to be investigated and this debate needs to progress on considered rather than impassioned lines.

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The full report is available from: http://www.friendsprovidentfoundation.org/how-much-does-free-banking-cost-an-assessment-of-the-costs-of-using-uk-personal-current-accounts/