How much does 'free banking' cost? An assessment of the costs of using UK personal current accounts

The pricing methods of personal current accounts have been scrutinised and criticised in recent years, and it has been suggested that low income customers are bearing most of the costs of providing current account services for all other current account customers, through a disproportionately high use of expensive overdraft facilities. This study used 17 years of data to explore the total cost to customers of current account use, and whether any distributional cross-subsidy exists between customers with different levels of income.

Key findings

The total cost to customers of using current account services (i.e. taking into account both the more obvious, explicit costs and the more hidden, implicit costs involved) were found to be highly dispersed, with a wide range between the highest and lowest cost accounts. Costs varied between supplier, and between different types of current account:

- High street banks were the most expensive providers overall, although their current accounts also offered more payment services and were accessible through more distribution channels. Building and friendly societies and demutualised building societies were the least expensive.
- Fee-charging packaged current accounts and 'free banking' current accounts were the most expensive types of personal current account.

The costs of current account use increased over the period covered by the data. This increase was persistent and long-term rather than a temporary phenomenon.

Cross-subsidy between customers of different incomes was found to be a function of how costs are estimated:

- When only the overdraft and package fees of current accounts were emphasised during the analysis, there was evidence of cross-subsidy from lower income customers to other customers.
- However, when the 'cost' of poor levels of interest provided on current account deposits was emphasised, no such cross-subsidy was present, as these types of costs were incurred disproportionately by higher income groups.

Key recommendations

Customers must be made aware that overdrafts are a high cost form of borrowing. Instead of 'opting out' of overdraft services, customers should instead have to actively *opt in* to using such overdraft services. If providers reduced the number of current accounts they offered, this could improve customer decision making. The presentation of the total customer costs of current account use should also be standardised.

What's inside

Policy context

There has been increasing regulatory disapproval and public criticism of the pricing methods used in personal current account markets, and in particular the 'free banking' model for pricing current account use. The presence of a distributional cross-subsidy has been suggested, in which lower income customers bear most of the costs of providing current account services for all other current account customers through a disproportionately high use of overdraft facilities.

As current accounts are essential for modern life, a clear understanding of the costs of using these services is a policy priority. Further, investigating the presence or otherwise of a distributional cross-subsidy is important in ensuring that the costs of using current accounts are equitable and don't act to disadvantage one part of society disproportionately.

The regulation of this market is currently fragmented, with the deposit or banking elements regulated by the Financial Conduct Authority, the credit element of overdrafts regulated by the Office of Fair Trading and the payments system considered by the Payments Council. These regulatory arrangements have led to piecemeal oversight, and influenced how the pricing of current accounts has been assessed in past legal judgements.

About the study

This research, by Dr John Ashton of Bangor University Business School and Professor Robert Hudson of the University of Hull, explores the customer costs of using current accounts, and what evidence there is of a distributional cross-subsidy between low income customers and other customers. The study is based on a monthly data set for 1995 to 2011, covering 395 current accounts in total, offered by 72 different banks/firms, and obtained from Moneyfacts (an independent website comparison company with extensive market coverage). It includes 'free banking' current accounts, basic bank accounts, packaged current accounts and 'other current accounts without overdrafts'.

Ten 'representative customers' were defined to represent common forms of current account use in the UK and different levels of customer income (lower, middle, higher). A costing approach was then developed to measure a total cost for each customer type.

First, the explicit customer cost of current account use (i.e. the visible fees and charges) was calculated.

Second, the implicit costs were calculated in two different ways:

- the financial impact on customers caused by their deposits attracting interest lower than the Bank of England Bank Rate ('base rate') and overdrafts being charged at rates higher than the base rate;
- the financial impact on customers of keeping money in a current account at rates of interest lower than those offered by the same firm on their deposit accounts, and the costs of using overdrafts at rates higher than those offered by the firm on their small, short-term unsecured loans.

The customer costs of current account use

Substantial variation was found in the total (i.e. explicit plus implicit) customer costs of current account use between the highest and lowest cost accounts.

Middle income customers had relatively lower costs, which reflects their assumed moderate use of current account deposit and overdraft services. Lower income customers had high costs, particularly for overdrafts. Costs for higher income customers varied, depending on whether they had large deposits or large overdrafts (or both).

Overall, the customer costs of current accounts have increased over time, and the recent increase in current account costs has fallen disproportionately on overdraft users.

The costs of current account use varied significantly with the type of firm supplying the service:

- On average, high street banks were the most expensive providers of current account services. However, relative to other suppliers the accounts, on average, offered more payment services and were accessible through more

distribution channels, such as by telephone and the internet and through extensive branch networks.
- Building and friendly societies and the converted building societies provided, on average, the least expensive current accounts over the sample period.

The customer costs of current account use also varied significantly by the type of current account:

- Packaged current accounts and 'free banking' current accounts were the most expensive types of personal current account. They also offered a range of added features and benefits, but no comprehensive data on their actual value to customers appears to be available.
- Basic bank accounts and other current accounts without overdraft facilities were cheaper to use, but offered fewer services.

Even for identical forms of current account, there was a wide range of costs, depending on how the account chosen was used.

Distributional cross-subsidies

The study explored whether the customer costs of using personal current accounts were consistent with cross-subsidies flowing from one group in society to another.

Some cross-subsidies were identified, but these altered depending on how the costs of customer current account use were quantified:

- When only the *explicit* fees of current accounts were emphasised during the analysis, there was evidence of cross-subsidy from lower income customers to other customers.
- However, when the *implicit* costs of current accounts were explored and, critically, the costs of little or no interest provided on current account deposits, this cross-subsidy from lower income to other customers was not present: these implicit costs were incurred disproportionately by higher income groups.

While the costs of current account use were not equally shared between customers of different incomes, all customers who use overdraft and current accounts deposit services intensively paid higher costs for using current accounts, regardless of income level.

No systematic differences were found for customers with different incomes between the payment services offered and the methods through which customers accessed current account services.

There was, therefore, no clear evidence that the customer costs of using personal current accounts were consistent with cross-subsidies flowing from low income customers to other customers. (But, clearly, how the customer costs of using current accounts are defined is central to this determination.) Further, there were few differences between the quality of current account services provided to lower income customers and those provided to other customers.

Conclusions

Substantial variation in customer costs was found between different types of current account, across different types of firm supplying current accounts, and over time. This variation was persistent even when identical current account use was examined. While this variation could reflect differences in service quality, the wide range of customer costs indicated that further factors could also be important, such as consumers finding it challenging to choose the best account for them.

With regard to a distributional cross-subsidy, the study found no evidence of lower income customers disproportionately bearing the costs of current accounts. While lower income customers bore the burden of overdraft costs, many higher and middle income customers also incurred costs from briefer overdraft events and also from the tendency to hold larger deposits in current accounts. Some cross-subsidy was found to flow from both the low income customers incurring large and long-duration overdraft loans and the inattentive customers of all incomes accumulating large current account deposits and using overdrafts occasionally, *to all other customers not displaying these behaviours*. Indeed, the most affordable form of current account use in this market is to keep low current account deposits and not to use overdraft lending if at all possible.

Recommendations

- Customers must be made aware that overdrafts are a high cost form of borrowing. While changes to the Lending Code enabling customers to opt out of unauthorised overdrafts is a positive step, customers should instead have to actively opt in to using such overdraft services.
- The regulation of current accounts should be more joined up, with oversight at product level rather than focused on each distinct service such as credit, deposit and payment services. This would overcome the present piecemeal regulation.
- Providers could reduce the number of current accounts offered, to improve customer decision making and ease customer costs of searching for new accounts.
- The presentation of the customer costs of current account use should be simplified and standardised, using the concept of representative customer groups as an illustrative tool. Standardisation of current accounts themselves would also be welcomed. Recent efforts to make it easier for people to switch accounts may be beneficial if they enhance competition.
- Information on the benefits and utility of additional services provided within packaged current accounts should be collected to enable clearer consumer understanding.
- Customers persistently accumulating very large current account deposits should be offered ‘sweeping’ facilities, whereby excess funds could be automatically moved to a deposit account offering a higher rate of interest.

Further information

This summary and the full report, *How Much Does ‘Free Banking’ Cost? An assessment of the costs of using UK personal current accounts* by John K. Ashton and Robert Hudson, can be downloaded from the Friends Provident Foundation website (www.friendsprovidentfoundation.org).

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