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There's no such thing as a free lunch

Why fees are the future for current accounts

January 2015

Introduction

PwC's research into what customers think about their bank suggests that seven years after the financial crisis, trust remains at an all-time low.* PwC's research, based on a poll of 2,015 adults in the UK, suggests that fewer than one in three customers trust their bank – and just one in 10 say their level of trust has increased over the past 12 months.

Against that backdrop, now might not seem the most obvious time to be making the case to move away from the free banking model, one that has become a cornerstone of the relationship between banks and their customers. The evidence, including PwC's consumer research, suggests doing so is necessary – for the good of customers and the banks who serve them.

* Source: How Financial Services Lost its mojo – and how it can get it back. Oct 2014. http://www.pwc.co.uk/financial-services/financial-services-risk-and-regulation/how-financial-services-lost-its-mojo.jhtml

No such thing as a free lunch

Compared to other countries, the UK is an anomaly in the 'free banking' model it has adopted for personal current accounts. In other countries, customers routinely pay directly for current accounts in some form, e.g. ATM usage or monthly fees, whereas in the UK customers have come to perceive a free bank account – rich in functionality – as an entitlement. The problem is that while customers perceive their bank account to be 'free', it is of course not free. Free banking has led banks to recover the cost of running current accounts through other less direct and transparent means e.g. other products or penalty fees and charges. This has led to a lack of transparency for how customers really pay for their bank account and has also impacted innovation and competition.

Our free banking model can be traced back to the 80s and it has proved both popular and very hard to resist. For some customers, the current account is not a free product at all – they have paid for it through overdraft charges, particularly on unauthorised borrowing, penalty fees and uncompetitive or zero rates of interest on credit balances. These charges can end up being disproportionately levied on specific groups of customers, including those who are more likely to find themselves in debt to their banks, or breaching their account terms and conditions. In that sense, current accounts are a product for which the minority can end up subsidising the majority.

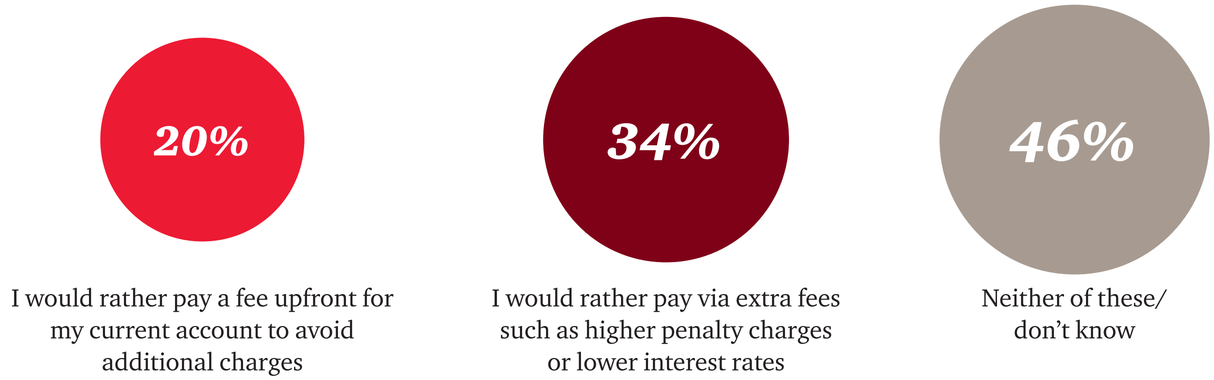
The irony, PwC's research reveals, is that a clear majority of the banks' customers understand the unspoken bargain operating here. As Figure 1 shows, two-thirds of consumers know their bank makes additional charges in order to sustain the 'free' current account. Nevertheless more of them prefer this model to the idea of paying an upfront fee – possibly because those most likely to understand the banks' charging structures include many customers who don't expect ever to fall foul of them.

Figure 1: Consumers know how their banks charge...

The most commonly held types of current accounts in the UK are 'free' in that you do not pay a monthly fee. Were you aware these types of accounts sometimes have additional charges such as higher penalty charges or lower interest rates than fee paying accounts?

...And many of them are content to pay this way

Which of the following statements about current accounts best applies to you?



The free current account results in some customers being served at a loss to the bank. If a sustainable approach is that customers are asked to pay a fair price in return for reasonable services, this would also reduce the risk that banks seek to recover these costs by pushing other products and services that the customer does not want or need. We can trace the history of this problem through the various mis-selling scandals that have impacted the industry over the last decade.

Moreover, the free banking model stifles innovation and competition in the current account market. It requires new challenger banks to achieve scale very quickly if they are to survive and it fails to reward banks that come up with new ideas. Why develop an innovative new current account banking product when the costs cannot be recovered?

The poor bank switching rates revealed in Figure 2 are a direct result of these problems – just 17 per cent of consumers have changed bank in the past two years and more than a third have never switched. Trust in current account providers is low, and customers do not have any expectation of finding a better deal elsewhere, or of being able to move to it painlessly. When they do move, it tends to be to another large bank offering a very similar type of product. Most of the time, they do not expect the hassle of switching to be worth the potential gain.

Figure 2: Switching rates remain disappointing...

Packaged accounts are not the answer

Packaged accounts represent a potential alternative. In the main, these products still levy no direct charges for the underlying basic banking services but do carry monthly fees, which are justified by the provision of additional benefits alongside the current account – anything from travel insurance cover to preferential rates of interest. As Figure 3 shows, packaged accounts have achieved some market penetration, with almost a quarter of customers now holding one.

Moreover, as Figure 4 illustrates, many of the features already offered as part of a packaged current account – or which could be – are popular with a sizeable proportion of the market.

Figure 3: The rise of fee-charging current accounts

Do you currently pay a monthly fee for your current account?

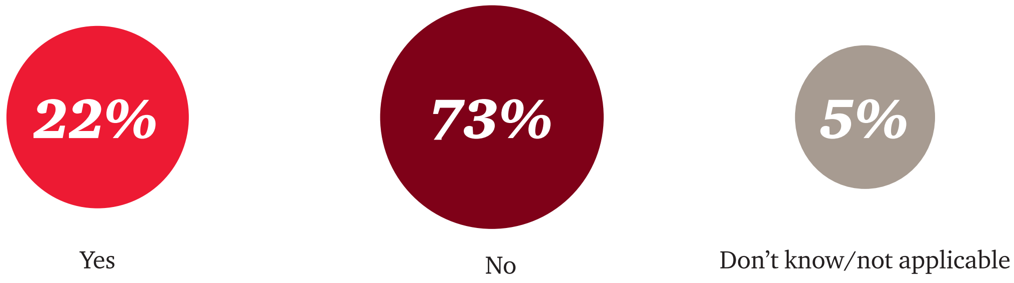
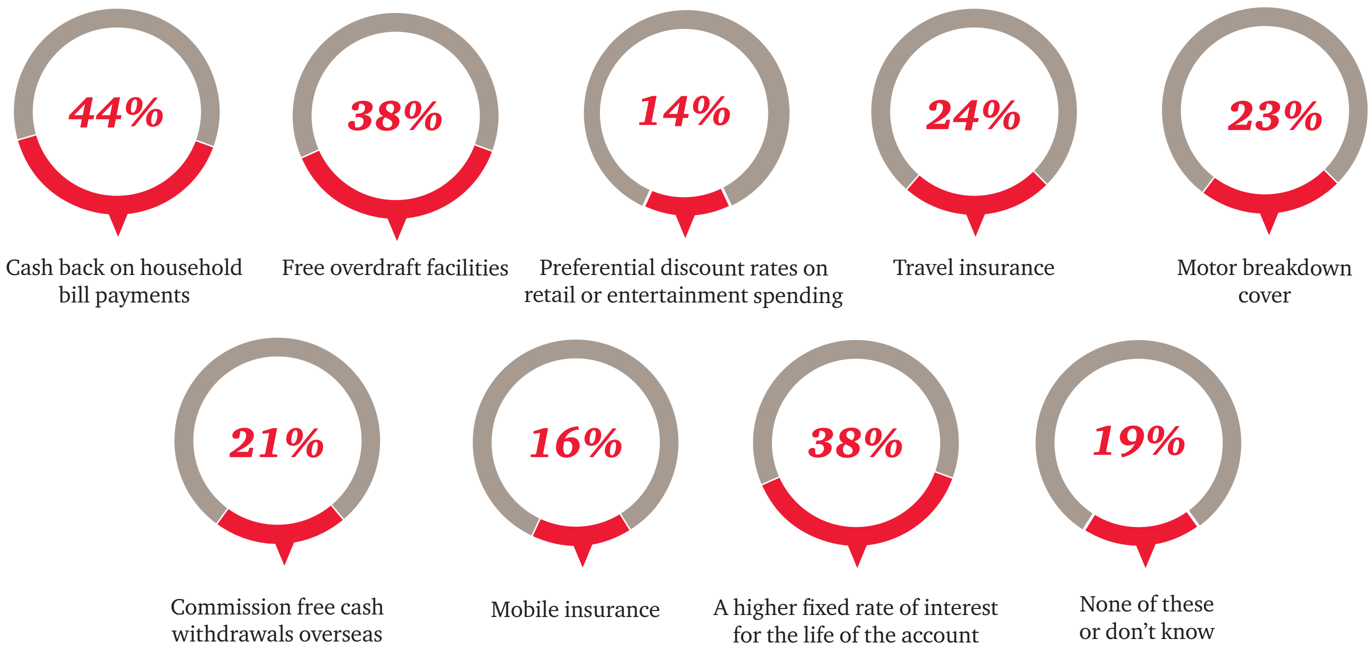


Figure 4: What services customers want from a paid-for bank account

If you had a current account you had to pay for, which services would you most want included?



Nevertheless, Figure 5 reveals problems with the idea that packaged accounts might finally offer the industry a way to move away from the free banking model. Almost two-thirds of customers say they are not prepared to pay anything upfront for their current account, suggesting that they would never be prepared to move to a packaged deal where part of the charge explicitly represented the cost of the basic service. A further 27 per cent say they would not pay more than £10 a month – existing packaged account products tend to be more expensive than this.

If customers do not want to switch to a packaged account where they will need to pay for the core banking service it seems hard to conclude that they offer a way out of the current model.

Furthermore, customers need to make use of the packaged account features to get value from the fees paid. Where customers don't use those features the bank can come under regulatory pressure to show that the product remains suitable and hasn't in fact been mis-sold. It is evidently not the case that the bank can take the unused fees from under utilised features to fund the cost of the core banking service.

Clearly, packaged accounts are an extension of the concept of free banking. They do not appear to be the way out of this issue.

Figure 5: What customers will pay for banking

How much would you be willing to pay up front for your current account?

Conclusion: How to move towards sustainable banking

Free Banking goes to the heart of the trust issue. Banks and their customers should be expected to enter into a transparent and fair bargain for these services. We should expect banks to enjoy a fair but not excessive return for offering a good and essential service in a consistent manner, and for customers to clearly understand what they are paying without having to worry about tricks and traps.

So where do we go from here? If free banking isn't sustainable and packaged accounts are a miss-step rather than an intermediate stage in the journey towards fair bank charges, the short answer must be that the banking industry needs to move towards a more transparent way of charging and offer true innovation and differentiation in the products they offer. Indeed, this would put us on the same footing as many other countries.

In the short term, it is difficult to see how an individual bank would remove its free banking product – the risk of being left on its own would pose a considerable risk of losing customers and business. Indeed, Figure 6 suggests more than one in two customers would be very likely or likely to change bank if an upfront fee was introduced; there is no reason to think the figures would be any different were a bank to move to transaction charges rather than a monthly fee.

It is possible that the regulator could intervene. Several banking inquiries and members of those inquiries have noted that the free banking model has not supported competition and innovation. Moreover, there are alternative precedents for such an intervention, including, for example the Retail Distribution Review of 2012. An objective of this regulation aimed at investments and advice is that customer will be able to understand how much it will cost and how it will be paid for. These appear to be good principles to be applied in the current account market too.

Despite the principles and the benefits, it seems unlikely regulators will intervene, not least due to the overwhelming customer sentiment noted in our survey.

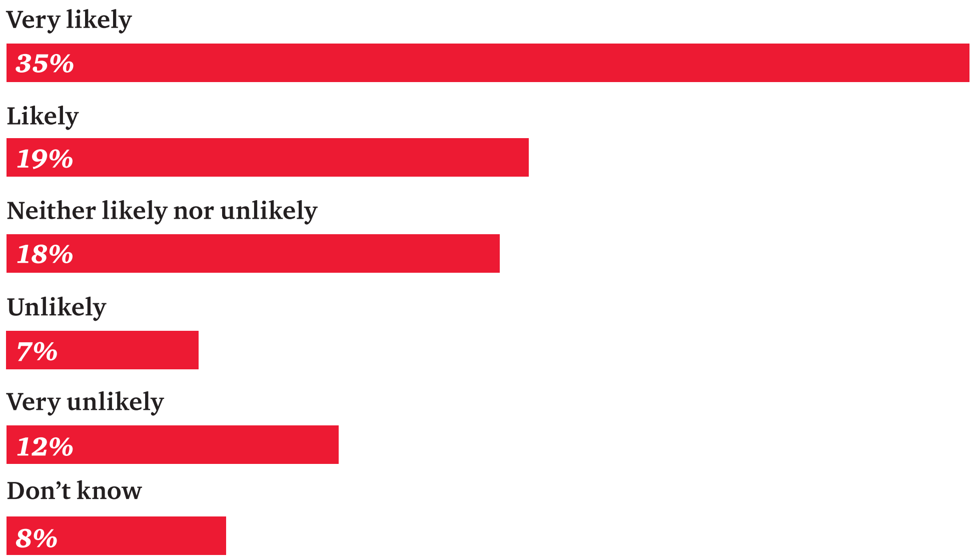
The most likely outcome is the gradual decline of the free-if-in-credit model. In this scenario packaged accounts may gain some ground but there will also be a move towards tiered pricing and the retention of a very basic free product. We are also likely to see innovative new digital models that challenge the current account approach – these may come from tech companies, mobile providers, payments companies or a combination of these.

Better transparency between service, costs and fees can only help to address the trust challenge.

The banking industry needs to move towards a more transparent way of charging and offer true innovation and differentiation in the products they offer.

Figure 6: Will compulsory fees prompt customers to leave?

How likely or unlikely would you be to consider moving to another bank if you had to pay an upfront fee for your current account?



Methodology

This point of view is based on a survey of 2,015 adults (aged 18+) in the UK, carried out online between 25 June and 30 June 2014. The results were weighted according to nationally representative criteria. The survey was carried out by Opinium Research (www.opinium.co.uk).

Further reading

How financial services lost its mojo – and how it can get it back

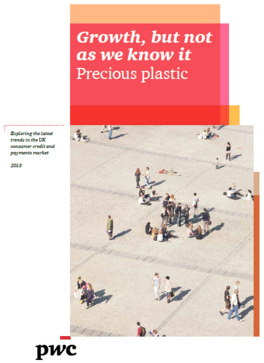
Consumers have lost their trust in the financial services industry. They feel both frustrated and apathetic towards financial services firms and think they're all the same. But all is not lost for banks, financial advisors, insurance providers and fund managers.

Our latest survey findings reveal what UK consumers want from their financial services providers and outline the key steps firms should take to repair the damage and to get their mojo back.

To download the publication visit:

http://www.pwc.co.uk/financial-services/financial-services-risk-and-regulation/how-financial-services-lost-its-mojo.jhtml

Precious plastics – growth but not as we know it



Our Precious Plastic report reveals that UK households are still wary of taking on more debt despite low base rates and improvements in the economy.

As a consequence lenders will be forced to compete more vigorously for a limited pool of business rather than relying on top line expansion. As we explore in the report, the businesses that come out in front will have the sharp customer understanding needed to deliver good customer outcomes.

To download the publication visit:

http://www.pwc.co.uk/financial-services/publications/precious-plastic-growth-but-not-as-we-know-it.jhtml

Retail banking 2020

Powerful forces are reshaping the banking industry, creating an imperative for change. Banks need to choose what posture they want to adopt – to lead the change, to follow fast, or to manage for the present. Whatever their chosen strategy, leading banks will need to balance execution against six critical priorities and have a clear sense of the posture they wish to adopt. However, each of them is important, and success will come from a balanced execution across these priorities – and a balance of tactical initiatives and longer-term programs, all coming together as an integrated whole.

To download the publication visit:

http://www.pwc.com/gx/en/banking-capital-markets/banking-2020/index.jhtml

Sunshine on a rainy day – why complaints can turn into competitive advantage

In this article, Mark Gossington, Partner in our Financial Services Risk and Regulation practice talks about how after years of struggling to keep complaints at bay, smart firms are coming to recognise that being able to handle complaints well improves customer outcomes and strengthens your reputation. How can your business turn criticism to your advantage?

To download the publication visit:

http://www.pwc.co.uk/financial-services/regulation/other/sunshine-on-a-rainy-day-why-complaints-can-turn-into-competitive-advantage.jhtml

Contact

Steve Davies

Retail and Commercial Banking Leader

steve.t.davies@uk.pwc.com

+44 (0) 131 260 4129


SEPHORA
Café DEL ARTE
DEL ARTE Presto

www.pwc.co.uk/financial-services

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