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THE PROVISION OF A BASIC BANKING SERVICE

7.1 Underlying the analysis of personal banking markets is the assumption that effective competition will deliver the range and quality of services consumers want, at an affordable price. In practice, there may be some consumers for whom this is not true. A large number of people in the UK currently purchase no banking services. This group generally has low income and may be excluded from affordable banking services because they lack:

- appropriate proof of identity to open a current or savings account; or
- a transaction or credit record that might help a potential lender calculate a default risk.

7.2 Others may exclude themselves, preferring to pay and be paid in cash, to avoid the costs of accidentally getting into debt or simply because they find banks too intimidating.

7.3 Access to credit is clearly also a problem. Banks ration credit through the use of automatic scoring techniques. So having no transaction or credit history often means no loan from mainstream providers, at any price. The credit that is available for riskier customers - often those on low incomes - is therefore usually available only from informal sources, at extortionate rates of interest. But this is not a problem that can be considered in isolation. The current account - specifically money transmission services - provides a gateway to many other banking services, including loans. This chapter therefore focuses on this issue of access to money transmission services.

Scope of the problem

7.4 The lack of access to money transmission services causes a number of problems. Increasingly, cash is not the most convenient method of payment. More importantly, cash transactions can be more expensive than non cash, notably in paying bills, where automated payments often attract a discount. Even where there is no discount, automated payments offer a means of spreading payments and hence facilitating the management of a limited budget. Cashing a personal cheque may also be both difficult and expensive without a bank account. As money transmission technology and e-commerce develop, this trend is likely to continue. The ability to use the full range of money transmission services and to gain access to widespread cash distribution systems - particularly ATMs and cashback - will become more important if individuals are to participate effectively in the economy.

7.5 At present, a bank current account is required to gain access to a number of money transmission services. Estimates of the number of adults in the UK without any

form of bank account vary between 2.5 and 3.5 million¹. Most of these people have low incomes, the main source of which is likely to be state benefits. Research by the Office of Fair Trading² indicated that up to a quarter of applications for a current account may be refused. The main reason given by banks for refusal was that the account might become overdrawn through the use of cheques supported by a guarantee card, or from debit card transactions that were not authorised in advance.

7.6 This suggests that to participate fully in the economy, a consumer's minimum requirements for basic banking services are to be able to:

- receive electronic credits;
- make electronic payments;
- deposit cash or cheques;
- get cash from ATMs or use retail cashback facilities.

For many people, there is an additional requirement that they should not stray inadvertently into debt.

Access to information

7.7 The problems of access to information identified in personal retail markets bite particularly hard on those who do not currently have access to these markets. The Office of Fair Trading³ found that individuals without a bank account were less exposed to direct sales approaches than those with. It is also less likely that those on low incomes will subscribe to independent sources of comparative advice, like *Which?* or *Moneyfacts*. This means that the main source of information on banking services is likely to be the banks' media advertising campaigns. These compete on image rather than on information about products and prices.

Meeting demand

7.8 Basic banking requirements are included within a current account, the elements of which are well established and used by a majority of the population. Until recently, the technology did not exist to guarantee that a customer's account would not slip into overdraft. Given the high administrative costs to banks of providing 'accidental' credit, this prevented them from offering basic banking services via current accounts to people they regarded as a bad credit risk. The technology necessary to prevent accidental overdraft is now available and becoming more widely distributed. Electronic money transmission systems also potentially give customers access to services such as bill paying without the need for a bank account. The PayPoint service in the UK is one example. However, being able to deliver the services customers want is not enough. Suppliers also need an economic incentive to provide them.

¹ Access to Financial Services. Report of PAT14. HM Treasury. November 1999

² Vulnerable Consumers and Financial Services. Report of the Director General's Inquiry. January 1999.

³ *ibid*

Existing price structure

7.9 Current accounts are priced in a way which recovers total costs but does not reflect the underlying costs of any one account. There are significant fixed costs in providing a current account, as well as transaction costs. Face to face transactions are more costly to provide than their internet or telephone equivalents so banks usually lose money on them overall. To give an idea of actual costs, ATM withdrawals cost up to 30 pence, automated credit transfers about 10 pence and cashback transactions about 15 pence. Paying in cheques, by whatever method, costs on average 45 pence. Using a branch counter for transactions costs about £1. In round terms, the incremental set up cost of a current account is about £25. Incremental fixed maintenance costs, including quarterly paper statements, add around £10 a year.

7.10 Banks make money by using the positive balances held in current accounts, on which little or no interest is paid. Accounts in credit in the UK in 1998 had an average positive balance of £1,175, each generating up to £75 income for the suppliers. Banks also charge interest and fees on overdrafts. This implies that, overall, the provision of current accounts is a profitable activity. However, there is significant cross subsidy between different types of customer. The banks do not seem to have the data needed to quantify the degree of cross subsidy, but the direction is clear. The beneficiaries are customers who maintain low positive balances and make heavy use of high cost transactions for which they are not charged. The losers are customers with high positive balances who make few face to face transactions. Because prices are set nationally, there is also likely to be a cross subsidy between geographical locations with different cost bases. Busy urban branches are likely to subsidise small rural ones, for instance.

7.11 As a result, the banks have no incentive to provide the bundle of services which constitutes a current account to customers who are likely to be beneficiaries of cross subsidies. This incentive changes for customer groups who are likely to prove profitable in the future, for example, students. Under current, relatively uncompetitive, market conditions it is worth providing a current account to individuals in this group at a loss, because they are unlikely to switch accounts and will be a source of profits later on, both from the account itself and other products cross sold through it.

7.12 In conclusion, banks do not have an incentive to provide a standard current account to low income customers: a current account needs an average balance of about £1,000 a year to make a profit. However, it is highly likely that supplying the bundle of basic banking services described above would be a profitable activity if no interest were paid on balances and the number of face to face transactions were low. Moreover, this assessment does not take account of the fact that people on low incomes do not necessarily stay that way. It is likely that a number of people currently excluded from banking services would turn out to be highly profitable customers.

Market dynamics

7.13 The current degree of cross subsidy would not persist in a competitive market. Although historically weak, there are signs that competition is developing in the supply of banking services to personal consumers. In particular, the increase in the supply of high interest instant access savings accounts is likely to lead to the average balance held in

current accounts reducing. This in turn is likely to force banks to adopt a more cost reflective price structure for current accounts.

7.14 At the same time, the costs of providing money transmission services is likely to reduce significantly, from the current £50 to £100 a year cost of providing these services through a branch based bank account. Technology offers new entrants the opportunity to provide a range of basic services at lower cost. This will increase the range of choice for consumers who want access to basic banking services, and reduce costs as banks compete for this business.

7.15 The unwinding of cross subsidies is likely to lead to some charges for services which are currently free at the point of use. This should not be a deterrent for those on low incomes, however. These charges would be more than offset by the savings from paying energy bills by direct debit or standing order. Assuming low energy consumption, a low income household could save £50 a year by paying its energy bills this way. For the poorest households, who generally use prepayment methods, the savings would be even higher - around £75 a year.

7.16 But access to basic money transmission services would do more than just save the poorest consumers money on energy. It would open up access to a range of other financial services, including savings and affordable credit.

Government as purchaser and provider of services

7.17 The lack of universal access to money transmission services also imposes unnecessary costs on the providers of services including the Government, which makes extensive use of money transmission systems to pay benefits. Currently, these services are supplied to a large number of consumers through a benefit book and cash collection at a post office: about 14.5 million transactions a week are conducted in this way, in addition to 1 million giro encashments. This is inefficient. The technology is now widely available to introduce electronic information systems and a variety of means of delivering cash.

7.18 For benefit recipients with a bank account, payment by electronic transfer is straightforward and widely in place. But the Government will need to take care that it does not add to the future exclusion problems of people who want to continue receiving benefits in cash, whether or not they have a bank account. To do this, the Government should define the service it wants to deliver in response to customer needs and not by reference to what producers think customers should have.

7.19 If the Government wants to deliver a 'cash in hand' service, then developments in money transmission systems - aided by this report's earlier proposals - should make this much easier. By using the same identifiers as at present (magnetic stripe or smart card, PIN or signature), this could be done through the existing cash distribution infrastructure. For those benefit recipients who do not want a personal bank account, the Government could purchase an account for these consumers. As this proposal does not rely on using an existing retail banking service, consumers would not have to open a bank account if they did not want one.

CONCLUSIONS AND RECOMMENDATIONS

Basic banking services

7.20 It should become easier for those who do not have a current account to get access to basic banking services. The technology for preventing unauthorised credit is in place, so banks can no longer credibly refuse to open an account on the grounds it may go accidentally overdrawn. The implementation of the recommendations in chapters 2 and 3 of this report should also help because:

- a more risk based interpretation of money laundering guidelines will allow more flexible requirements for identification; and
- this will open up the market for low cost technology based entrants who will be able to make a higher profit from basic banking services. This dynamic is likely to drive more high street banks into competing for this business.

7.21 However, the Review considers that the recommendations on improving access to information in the personal sector require particular attention for people currently excluded from a range of financial services. This group is much less likely to be the target of marketing information, or to have access to clear and impartial sources of advice on different services and prices.

7.22 The Review recommends that *the FSA should rebalance the resources it devotes to consumer awareness, to give more attention to the information problems experienced by people on low incomes, especially those currently excluded from banking services.*

7.23 The lack of information on the provision of basic banking services is a particular problem. To remedy this, and to help speed the delivery of this service, the Review also recommends that *the Government should give top priority to developing a benchmark for basic banking services.*

7.24 If the Government still considers it necessary to intervene to provide universal access to basic banking services, such intervention should seek to bring competition gains, and not distort competition by engineering permanent cross subsidies. Nor would it be beneficial to consumers if the Government sought to negotiate with the banks to deliver a 'free' service, for the reasons outlined in chapter 2. The Review therefore recommends that *if the Government considers it necessary to intervene in the provision of basic banking services, it should define a universal service and tender for the lowest subsidy required to deliver the defined service.*

7.25 The Government has said that it will move to a more modern and efficient way of paying benefits. However, there is a tension between pursuing the most cost effective method of payment and very valid concerns to preserve the network of post offices for social reasons. It is considered that the Post Office needs time to develop new lines of business to replace the lost income from processing benefit payments.

7.26 Everyone will gain from using electronic technology. Most importantly, benefit recipients would be best served by:

- having their payments made directly into a bank account if they wish, and being able to access these funds through existing ATM and cashback networks. They, and the banks, want a bank account which does not allow accidental overdraft. As discussed above, there is no reason why such an account should not now be widely available at an affordable price and on a basis that is also profitable for the banks;
- being able to access payments in cash without a bank account, again using existing ATM or cashback networks.

7.27 In neither case is it necessary for the taxpayer to subsidise banks to provide an over the counter service at post offices, through agency arrangements. The competitive effect of such arrangements, especially if exclusive to one firm, would be a matter for the payments regulator. Some benefit recipients may of course prefer a face to face transaction, but this could be done using cashback, either in a sub post office or at any one of the many retail outlets that offer this service. The recommendations in chapter 3 should have the effect of not requiring a purchase to be made to withdraw cash.

7.28 The Government has said that benefit recipients who wish to continue to collect benefits at post offices will be able to do so. The technology and access rules are now available to install ATMs or cashback facilities in sub post offices. The social and economic benefits of capturing the network externalities would be considerable, and the investment required is a fraction of the net present value of the cost savings to the Benefits Agency and the Inland Revenue. In line with the recommendation in chapter 3 that the Government should develop a strategy for acting as an intelligent consumer of payment services, the Review recommends that *the Government should ensure that:*

- *the delivery of benefits, where not made through automated credit transfer, uses existing electronic networks - for example, ATM and cashback;*
- *Government agencies which make payments to individuals are allowed to make the investment necessary to allow all recipients the option of receiving benefits through ATMs or cashback facilities.*