Price discrimination in the cash savings market

A response by the Building Societies Association to the Financial Conduct Authority's Discussion Paper, DP18/6

25 October 2018

Building Societies Association

Introduction

The Building Societies Association (BSA) welcomes the opportunity to respond to the FCA's Discussion Paper, DP18/6. We represent 47 members including all 43 UK building societies. Building societies have total assets of over £396 billion and, together with their subsidiaries, hold residential mortgages of over £312 billion, 23% of the total outstanding in the UK. They hold over £276 billion of retail deposits, accounting for 18% of all such deposits in the UK and 37% of all cash ISA balances. They employ approximately 40,000 full and part-time staff and operate through approximately 1,550 branches.

Executive summary

The BSA supports the FCA's aims of promoting competition and improving consumer outcomes in the cash savings market. From our members' perspective, the cash savings market is highly competitive and building societies compete by providing high standards of customer service and interest rates which are, on average, significantly higher than their competitors, on both front and back books. While building societies compete across all distribution channels, the sector remains predominantly branch-based.

We concur with much of the FCA's analysis although we would observe that the 'harm' it identifies is confined to certain areas of the market, rather than spread evenly across all providers or savers. Accordingly, we challenge the blanket nature of the remedies the FCA is contemplating. We fear the proposed basic savings rate, while superficially alluring, would have unintended negative effects that would outweigh any potential benefit. These would likely be felt especially by building societies and their members and could impact the viability of the branch networks so highly valued by many building society members.

We are urging the FCA, instead, to adopt a more targeted and proportional approach, focused on those consumers which it identifies as suffering substantial detriment and the firms which are responsible for that.

Responding to the FCA's questions

The remainder of this response is devoted to addressing the questions posed in the Discussion Paper.

Q1: What are your views on the nature and scale of harm outlined above? Does it merit some form of intervention in the cash savings market?

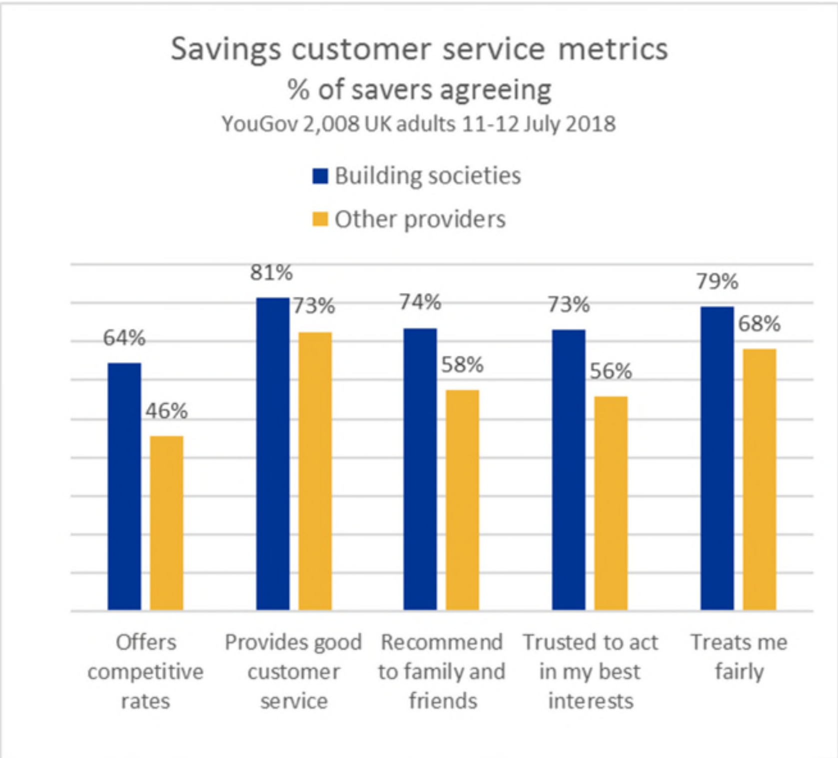
We would not seek to dispute FCA's analysis of the differential between interest rates paid on back book and front book accounts in aggregate and on average. However, there is of course a considerable range of practices across the market, with building societies generally paying higher rates of interest to their longer-standing savers, than their competitors. Several societies do not distinguish at all between the interest paid on new accounts (the front book) and older accounts (the back book) and others have schemes that reward loyal savers.

We also suggest that the extent to which customers are suffering 'harm' is more nuanced than the FCA suggests. As noted in FCA's previous analysis, the average balance on these accounts is relatively low, with data from the Cash Savings Market Study (CSMS) showing that for easy access accounts the average balance for an account opened between five and ten years ago was £2,960 compared to £13,379 for accounts opened within the previous year. To the extent that there is material harm, we judge this is likely to be concentrated among relatively small subsets of savers; ie vulnerable customers and those with large balances in longstanding accounts with certain providers. It would be helpful if the FCA could provide more clarity on this, by sharing its data - either in its feedback statement to the DP consultation or separately. We consider that in contemplating remedies, the FCA should be concentrating its efforts on these customers, rather than seeking to apply blanket 'remedies' that carry a high risk of unintended adverse consequences.

Research by price comparison service, Savings Champion, has shown that a significant percentage more building society accounts (73%) paid a higher rate than the base rate, compared to banks (54%). This includes accounts closed to new business, and continues a trend evident over the last six years, which has endured throughout the first half of 2018.

Moreover, FCA's analysis takes no account of customer service. Building societies consistently score better than their competitors on this, as indicated in the chart below. The current very low interest rate environment is also a factor, and some customers are judging the marginal benefit of moving account to be so small as to be not worthwhile.

So, we have no doubt a substantial proportion of customers stay with an account in full cognisance of higher interest rates being available elsewhere in the market.



We would also observe the advent of open banking has the potential to help mitigate the harm which the FCA identifies, for example, by facilitating products which ensure consumers are transferred to accounts paying competitive interest rates.

Q2: Do you agree with our analysis of the demand-side remedies? Are there any further considerations we should make?

Broadly, yes. We acknowledge that, in terms of the objectives set by the FCA, there does not seem to be much evidence so far of changes to consumer demand or firms' behaviour having been modified by the remedies. However, it may be premature to judge the effectiveness of remedies, such as the summary box, promulgated by all banks and building societies under the CSMS. The summary box facilitates comparison on a like-for-like basis of all savings accounts and was introduced at significant cost to the industry. It is disappointing that there is no attempt to evaluate the summary box in the DP.

We suggest there could be a role for further sunlight remedies to play in helping to promote consumer awareness. The initial pilot did increase visibility of the lowest rates being offered in the market - and while the reasons for a lack of measurable impact on consumer behaviour may be open to debate, we think there is scope for revisiting and building on the sunlight remedies.

As noted above, we consider that, rather than applying a blanket measure such as the BSR, the FCA should be considering a more targeted approach, concentrating on cases of significant harm. One option might be to require firms to identify within their back books accounts with high balances earning relatively low interest, and to deploy a contact strategy to inform customers with these accounts of their options, which would include transferring their balance to a new account.

Q3: Do you think we should require the publication of any service metrics that relate specifically to cash savings? If so, please suggest metrics that you think we should consider.

We think the publication of service metrics could have a role in promoting non price-based competition. However, we suggest the decision whether to impose new publication requirements should be informed by an evaluation of the effectiveness of the publication of service metrics for personal current account providers which, the FCA suggests, have direct read-across to cash savings products. Key learnings from that initiative can then help shape any similar requirements in the cash savings market or inform a decision not to proceed.

Q4: Do you agree with our analysis of the supply-side options considered in this chapter? We welcome views on the impact of these options and any risks and benefits that we have not captured.

Broadly, yes. Our members have experience of applying the superseded accounts rule and although this did have the merits you identify, it was not without shortcomings. All the other three options considered involve an element of price regulation and we largely concur with your assessment of the potential adverse consequences, although we think you have underestimated these in the case of the of the basic savings rate: we comment in more detail below. A further supply side option the FCA may wish to consider would be to restrict the use of the term 'savings account', so that only accounts that pay interest above a certain, specified, level on both front and back book, would be allowed to be called a savings account or be marketed as such. The implications for 'payment accounts' would also need to be considered.

Q5: Do you have any views on our analysis that a BSR should apply after 12 months of an account being opened?

We can see that the 12 month threshold has a certain logic within the FCA's theoretical construct, which is based on data from a time when introductory bonuses were more prevalent in the market. However, imposing such a relatively short qualifying period is likely to magnify some of the undesirable elements we fear would accompany the introduction of a BSR. These include restrictions on:

- liquidity management,
- interest rate risk management,
- funding and resilience planning,
- ability to reward loyalty, and
- flexibility to price differentially according to the costs of different distribution channels.

Moreover, FCA's analysis tends to assume relatively low levels of activity on easy access savings accounts. It would be wrong to characterise these accounts as generally having one-off deposits, which then lay untouched for the duration of the account. While this may be the case for some easy access accounts, others have significant flows in and out of the account intra-year. This suggests that an artificial step down after 12 months may be inappropriate.

Q6: Do you have any views on our analysis that there should be a maximum of 2 BSRs per provider (ie limiting providers to 1 BSR for easy access savings accounts and 1 for easy access cash ISAs)? What impact would this have on the provision of particular products (for example, loyalty, tiered, branch etc) and how would this affect providers offering such accounts?

The imposition of a maximum of 2 BSRs per provider would constrain the ability of building societies to reward loyalty and thrift; it would also discriminate against branch-based distribution channels.

Several building societies currently have products that reward the loyalty of longer-term members, for example by paying higher rates for more longstanding deposits. If they were to be required to pay a flat rate BSR on all accounts open for 12 months or more, they would no longer be able to reward longer-term relationships with their saving members. Similarly, they would be constrained from rewarding thrift via tiered accounts, which pay higher interest on bigger balances.

The inability of providers to reflect distribution costs in the BSR would discriminate against branch-based provision of accounts. If providers are not able to reflect the costs of more expensive distribution channels in their pricing, this could threaten the viability of such channels. For building societies, which are predominantly branch-based, this is a real concern and risks genuine harm to consumers, particularly vulnerable customers, who tend to value branch-based access more highly than others.

Q7: Should a BSR apply equally to all providers? We are particularly interested in the views of building societies and small deposit takers.

We appreciate the FCA's willingness to consider an exemption for building societies from a requirement to apply a BSR. This reflects the FCA's acknowledgement that building societies are restricted by law in their use of alternative (ie wholesale) funding sources.

Moreover, we note that the FCA's central estimate of the benefit of the BSR that will flow to customers, in terms of higher interest rates, is £300 million per year. This is frankly modest, when placed in the context of the BSA's analysis, which has shown that in 2017 savers with building societies were £775 million better off than if they had earned the average interest rates paid by large monetary institutions, a group mainly comprising the big banks. This figure for the first half of 2018 alone was £480million, so will likely be substantially higher than 2017 for the current year as a whole.

The existence of such a stark differential between interest paid on savings by building societies and their competitors adds weight to the FCA's suggestion that the BSR should not be required to apply to building societies.

However, while an exemption for building societies could be justified on these grounds, we think it would be more appropriate to frame any exemption from a BSR requirement in terms that would be more relevant to consumers. Accordingly, we would suggest that any exemption be based on objective criteria relating principally to the relative pricing of front and back book. This would mean that any building society (or bank) that satisfies the criteria - thereby demonstrating fair treatment of their back book customers - would be able to benefit from an exemption from a BSR. We would be pleased to work with the FCA in developing appropriate criteria, if that would be helpful.

Q8: What are your views on the impact a BSR would have on firms' liquidity requirements and funding models? We are particularly interested in the views of building societies and small deposit takers.

This is one of the key concerns we have about the BSR proposal. Building societies are predominantly (currently, 75%) funded by retail deposits and their ability to access alternative sources of funding is tightly circumscribed under the Building Societies Act. Accordingly, societies are heavily dependent on the cash savings market for both their funding and liquidity. Their ability to manage the interest rates they pay on an account-by-account basis is a key component of societies' liquidity management. If all their accounts are required to revert to the BSR, a single flat rate (or two, with cash ISAs), societies' ability to manage both their interest margins and their liquidity will be constrained considerably as a large proportion of their savings book will then be priced at the BSR. These impacts would be magnified if the BSR was subject to 'cliff-edge' implementation, rather than an orderly roll-out over, say, a twelve month period. Should the FCA decide to proceed with a BSR, we would encourage it to adopt the latter approach.

The restrictions which BSR would entail will likely mean that in order to maintain control of their liquidity building societies would have to focus more on the part of their easy access savings book which they can continue to manage on an account-by-account basis, ie accounts opened within the previous 12 months. This will tend to engender much stronger competition in that part of the market than in older accounts where, contrary to FCA's desired outcome, interest rates seem likely to fall, other things being equal.

The big bank PCA providers are not subject to the same constraints on funding as building societies – and current account balances for them represent a cheap source of liquidity, not available to others. So it is possible their response to the introduction of the BSR would be different to that of building societies. However, we do not think it likely the introduction of the BSR, of itself, would incentivise PCA providers to increase their back book rates, especially if liquidity considerations for their competitors tend to drive competition towards the front book of accounts opened within the previous 12 months.

Q9: What are your views on the impact a BSR would have on lending rates? Are there any other markets that providers may seek to pass costs to?

There are several possible scenarios.

Whether and to what extent lending rates would change would depend on various factors at the time of the implementation of the BSR. For example:

- The prevailing margins in the deposit market at the time, as this affects the extent to which deposit takers could absorb any extra interest cost.
- The price of and availability of alternative funding sources (wholesale, including securitisation).
- The extent of competition for retail funds, including from NS&I.
- The extent of competition in the mortgage, consumer credit and business lending markets, which in turn depends on demand for those loans and the lending objectives of banks and building societies.
- The possibility of recouping margin in other parts of the business, such as fee income, or on PCAs.

- The overall level of firms' profitability, due to operating costs, impairments, etc.

Q10: What is your view of the likely costs of compliance with a BSR, in terms of both one-off and ongoing costs? We will carry out a detailed cost survey as we take forward this work, but we would be interested in any initial views you may have on the costs of a BSR.

While we are not able to estimate the compliance costs of the BSR with any accuracy at this stage, feedback from our members suggests that, for some, the costs may be substantial and include the following:

- An initial implementation project with substantial systems changes: during the implementation period for the BSR, they would either have to migrate all accounts of 12 months or more to a BSR product (or to a duplicated version of their product range with the BSR rate applying) or effect a rate change only for accounts 12 months old or more (which is not operationally possible for some building societies, currently). They would then have to put in place processes so that as and when an easy access account hits the twelve-month mark it would convert to the BSR. Depending on the detailed requirements the FCA put in place, this would have to be a daily, weekly or monthly process.
- Increased mailing costs associated with the need to contact customers in the run up to the 12 month point.
- Increased staffing costs to deal with higher volumes of customer contacts around the 12 month point.
- Costs of building new digital capabilities to support increased customer contact.
- Higher central management costs to oversee the new processes.

Such costs could be significant in the context of the FCA's estimate that the benefit to savers (spread across the wider cash savings market) of the BSR would be equivalent to an average uplift in their interest rate of 8 basis points. For the reasons set out in the DP and elsewhere in this response, the benefit to building society savers would likely be considerably less than 8bps and the cost-benefit case for a BSR correspondingly less convincing.

Q11: Are there any additional impacts and unintended consequences on providers that we have not covered in this section?

As noted in our response to Q8, a key unintended consequence is that the introduction of the BSR may well shift competition even more strongly to the front book, meaning that longer-standing customers receive, on average, lower interest than currently. We are concerned this would erode the longer-term value of savings accounts for customers, which is a particular focus for building societies. As such, we suggest this needs careful reflection by the FCA.

We also share the FCA's concern that the introduction of a BSR would prompt a shift in the market, away from easy access products to those with restricted access.

Q12: What are your views of the impact that a reduced product offering may have on consumers? Please provide views on the impact on specific products (for example, loyalty, tiered, branch etc), where applicable.

If the introduction of the BSR serves to continue the trend of firms rationalising their product ranges, that should aid consumer comprehension of the market. So, to the extent that consumers are currently confused by choice, as the FCA asserts, such confusion should be mitigated. However, this will not be without cost to the consumer. As the question implies, we would expect to see loyalty products, tiered accounts and easy access tracker products either withdrawn or substantially restructured. The continued viability of certain branch-based accounts could be threatened, as could the high standards of service which customers are known to value. As such, we would urge the FCA to think carefully before deciding to commit to the introduction of the BSR.

Q13: Do you agree with our initial view on how a BSR could be communicated to consumers and the market?

Yes, your proposals for communication seem reasonable.

Q14: Are there any additional effects and unintended consequences on consumers that we have not covered in this section?

A BSR regime on the lines contemplated by the FCA would restrict firms' ability to manage their cost of funds, thereby inhibiting their ability to control their profitability and resilience, including in times of stress. This will particularly be the case if, as the FCA hopes, any movement in the BSR will be under a public spotlight. The PRA will no doubt take a close interest in the impact of a BSR on firms' ability to manage their profitability and stress scenario modelling. As noted above, because building societies are more restricted in their funding options, a BSR would likely impact more heavily upon societies.

Q15: In light of the above, do you think we should take forward a BSR?

We think there are risks in pursuing a BSR that the FCA needs to think about carefully. We tend to favour, as an alternative, more targeted measures focused on helping those customers most in need. As we suggest above, these are vulnerable consumers and those with large balances in longstanding accounts paying very low interest. We think that measures aimed at assisting these customers, such as targeted communications and requirements to offer assistance, where needed, would be preferable and have fewer unintended adverse consequences than the BSR proposals the FCA is currently contemplating.

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £387 billion, and account for 22% of the UK mortgage market and 18% of the UK savings market.