

Briefing Paper

Why the 'Free' Banking scam should be stopped

Andrew Bailey, an executive director of the Bank of England and the UK's chief banking regulator in waiting, gave a speech on 24 May 2012 advocating an end to 'free' banking, which emerged in the mid 1980s when the big UK 'clearing banks' began to compete for custom by offering to waive bank charges for payments transactions using cheques and debit cards for customers who maintained set minimum positive balances. Over time the qualifying balance was reduced to zero and small free overdrafts were offered. In parallel, interest rates on positive balances were reduced. Hence, actual interest revenue, on which tax is payable, was reduced and interest was implicitly being paid through non-taxable waived charges. Thus banking was not in fact free and tax revenue was reduced.

Free banking is both inefficient and inequitable. It encourages excessive use of payments services, including drawing cash from ATMs that are free to the user, but costly to provide. Charges which covered the cost of providing these services would discourage wasteful usage and encourage the more rapid adoption of cheaper electronic payments systems based on mobile phone networks. Free banking is also inefficient and inequitable because it encourages cross subsidisation of high volume low balance users ('young professionals') by low volume high balance users ('old widows'). The latter commonly have difficulty, due to sight, hearing or mobility impediments, accessing banking services to move their money to higher interest paying savings accounts and it is noteworthy that banks have not been proactive in helping them do so!

There is also cross-subsidisation of higher income users, who in addition to free banking are offered relatively cheap agreed overdraft facilities, by lower income users, who often have variable and uncertain income flows and are offered overdrafts on less attractive terms, if at all. As a group they tend to pay substantial interest on their overdraft balances and high fees

for exceeding agreed limits, helping to fund free banking for others. The UK competition authorities have curbed excessive charging for credit card debt and late payments, but the banks successfully blocked their attempt to do so for current accounts.

The revenue from penalty charges is not sufficient to cover the costs to the banks of providing free banking, so banks have sought to sell other products linked to mortgage and other loan repayments, such as Payments Protection Insurance. In the case of PPI, they were found to have been selling the product aggressively using bonus induced sales staff to boost bank fee income and not properly informing customers of the policy conditions. Customers were frequently unable to claim on the policies and the banks have been fined for miss-selling PPI and required to compensate customers. Free banking thus encourages the cross selling, and potentially miss-selling of other products and services.

Retail banking should be regulated as a utility to eliminate both miss-selling and inefficient and inequitable products like free banking. Customers should pay for services used in proportion to their costs of provision, VAT should be collected on financial goods and services purchased, and market related interest rates should be paid on current account balances so that income tax is not avoided through implicit interest payments. The proposal is of course controversial and generated a great deal of press coverage and correspondence from those who have come to regard 'free' banking as an entitlement and prefer not to pay VAT on financial services and products and tax on interest income.

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