Banks at the crossroads in treating their customers fairly

South African banks have been waiting, perhaps with some anxiety, for final details of how a new financial services watchdog will expect them to treat their customers fairly, and what they can expect if they don't.

Nearing the end of the legislative pipeline is a process the initiators have named "Twin Peaks". One aspect of it will deal with the retail banking sector, while the other tackles the prudential.

Both issues would have been at the heart of talks between the banks and Finance Minister Pravin Gordhan yesterday. The Treasury's own summation of the talks speaks volumes for what it thinks: "The minister noted progress the banks had made in meeting some (our italics) of the recommendations of the banking inquiry," it said, referring to what was once better known as the Jali commission.

Facing the retail banks is a package of cause and effect regulations unambiguously called Treating Customers Fairly (TCF), and it could be a bitter pill to swallow.

Regulators are reluctant to affirm that the TCF initiative is necessary because of shortcomings in implementing the recommendations of the Jali banking inquiry panel, which sat six years ago. Its timing, however, is significant for it is emerging as the next step in a drive to secure a better deal for bank customers. As a mission, TCF is beyond recall. All it awaits are the finishing touches to its regulatory package including, significantly, the legal teeth with which to bring offenders into line.

Between 2006 and 2008, the banking inquiry panel appointed by the Competition Commission and chaired by Judge Thabani Jali probed a range of widely held public concerns, including the high level of bank charges, a need for better service, and greater access to financial services for poor communities, while preserving the stability of the banking system.

The panel subsequently made 28 recommendations, falling into five categories: three addressed market conduct, one interbank arrangements and the last the National Payment System.

The banks' adjustments in response to these recommendations yielded some relief for customers, but addressed just 19 of the specific ailments identified. These included the lowering of penalty fees on dishonoured debit orders, improving the management of the debit order system, greater transparency in ATM fees and charges, the implementation of a standard switching code to promote ease of switching bank accounts between banks, and improving customer education.

The banks' response to the panel's recommendations has been considered so lacklustre and "tardy" that in 2010, Mr Gordhan called their heads together and read the riot act.

"So whilst the banks implemented a number of the banking inquiry panel's recommendations, it seems that market conduct in transactional banking continues to be a concern, in particular high bank charges and a lack of transparency in the setting of bank charges, notwithstanding the banking inquiry panel's having highlighted the weakness and opacity in market conduct practices," notes the ombudsman for banking services, Clive Pillay.

"Clearly there is a need to strengthen market conduct standards, particularly in the retail banking sector, and so promote appropriate market conduct, thereby protecting the consumer," he says.

Such a need resulted in a shift to the "Twin Peaks" model of regulation, which creates a dedicated banking services Market Conduct Regulator (MCR) within the Financial Services Board (FSB).

The MCR will provide guidelines on how banks should set their fees, report their fees and what will constitute fair or unfair behaviour. At the same time, the FSB has launched the Treating Customers Fairly initiative, which could force the pace of improving protection for consumers of financial services.

"Whereas the banking inquiry panel's recommendations were previously simply that (recommendations), the Twin Peaks proposals as well as the TCF initiatives will be enshrined in legislation," says Mr Pillay.

Just how much headway has been made in the intervening years since the Jali panel depends on whom you ask.

By and large, retail banks believe encouraging progress can be reported, while those in the regulatory arena feel more is required, a sentiment borne out by the TCF's raft of new regulatory measures to encourage fee reductions more strongly. The initiatives could make it more difficult for banks to set high fees and charges without having reasons acceptable to regulators for doing so.

"TCF was originally proposed as a consumer protection approach in respect of the nonbanking financial services sector, of which we are currently the regulator," says Leanne Jackson, head of the TCF initiative at the FSB. The FSB does not now regulate transactional banking (although under the Financial Advisory and Intermediate Services Act it regulates the financial advice activities of banks). "Transactional banking will fall under the FSB's jurisdiction and TCF will, once the necessary legislation is in place, also apply to the market conduct of banks."

On the enforcement powers of regulators, the intention is to bring infringement into the regulatory framework, "so we certainly intend to have all the enforcement powers that would apply to any regulatory breach", Ms Jackson says.

"We intend to build this into legislation. Exactly which mechanism we use, which piece of legislation, and when, is work in progress. A TCF regulatory framework steering committee is in place to set up recommendations on how best to do that, understanding that it would have to fit into the regulatory and legislative changes that need to take place in order to move towards the Twin Peaks model."

The transactional regulator (the effective head of the TCF initiative) can do three things: on default he can issue a compliance notice. Failure to comply with that notice can result in a substantial financial penalty. He can also order a suspension of the offending activity.

Banks have tried to draw the sting from government-led criticism by reducing the charges they levy on the accounts of the very poor, but fees have remained largely unchanged for banks' mainstream clientele, while new charges, for example a cheque deposit fee for paying into a home loan or credit card account, have been introduced.

Indeed, across the spectrum, banks have made impressive inroads into the legions of this country's unbanked, financially illiterate, and those otherwise marooned from traditional banking services.

The banking community still awaits the new measures' full import, but they insist they will work with regulators and contribute to the initiative's aims.

"Nedbank is committed to working with the Financial Services Board and the industry in shaping a TCF policy to suit the unique conditions in SA," says Anton de Wet, Nedbank's managing executive, client engagement. "We were a full participant in the pilot self-assessment project and we regularly meet with the FSB to share progress."

Jo-Ann du Plessis, head of pricing at FNB core banking solutions, says: "FNB has worked very closely with the finance ministry and the Department of Trade and Industry to ensure that we understand the government's developmental goals, and have considerably changed our business models to meet these mutual goals."

Standard Bank CEO Sim Tshabalala says the bank submitted a formal response to the Treasury regarding the Twin Peaks document. "This included the following: price regulation is not supported. We are committed to engaging with government about banking fees building on the constructive work undertaken with government to implement the recommendations from the banking inquiry. Pricing cannot be properly considered without also looking at product innovation and service levels which serve to make banking more affordable and accessible to consumers," he says.

For the banks, the ruckus over fees is happening at the worst possible time. SA, not only caught in the first world's vortex, may so far have escaped the tornado itself but must weather its own blustery economic climate. Financial services institutions say they are getting the worst of it.

The tightening fists of Twin Peaks and Treating Customers Fairly on their fee revenue, or non-interest revenue, loom at a time of a double whammy: income loss and increased investment. Banks' commitment to social responsibility, their obligation to a partnership with the government to help grow the rural economy by extending financial services to the unbanked, and the organic need to nurture a more extensive customer base, mean an investment of no small measure to establish banking services where none or very few existed before, with no quick return.

"The underbanked segment is generally quite unprofitable to service, and notwithstanding there has been a lot of political regulatory pressure to serve this segment," observes Imran Moten, financial services lead adviser in KPMG's management consulting advisory division.

What other income avenues are available to the banks? Obviously there's opportunity to increase income from their proprietary book, but markets have been generally depressed.

Another area has been wealth management revenue, the insurance and investment space where income has generally been down since 2010 due to the low interest environment and volatile equity market.

What's left to take up the slack? Fees, from the noninterest income point of view, have been the easier piece of the pie to control and maintain profitability as interest margins have declined.

And it is precisely the extent to which this can be advantaged by the banks that the current brouhaha is all about.

The FSB's Ms Jackson says that although TCF will have some explicit "rules-based" components, the primary intention is to protect financial services consumers by requiring financial services firms to develop their own governance processes and management information tools, to demonstrate that they are in fact delivering the six TCF fairness outcomes to their customers.

"As such," she says, "TCF does not seek to introduce pricesetting or to be prescriptive on product design. However, having said that, there are instances where the market conduct regulator may need to intervene in cases where products or product features pose unacceptable risk to customers - particularly vulnerable customers."

The TCF transactional regulator will tell banks how to set their fees and will oversee the conduct of banks in three ways:

developing principles on how banks should set their fees;

indicating how these fees should be reported; and

indicating what constitutes fair or unfair behaviour on the part of the bank.

"The effect of the TCF on the one hand and that of the transactional banking regulator on the other dovetails into consumer protection," says Mr Pillay, "not just in their conduct in how they treat customers but also in how they set their fees."

He says full details should be available before the end of this year, and the relevant legislation passed in the new year.

For its part, Standard Bank takes strong exception to reports that South African bank fees are among the highest in the world.

Mr Tshabalala maintains that local banks are better regarded when compared to their international peers.

"According to the World Economic Forum Global Competitiveness Report 2011, South African banks came second in the world, behind only Canada, on soundness of banks, and 39th out of 142 for affordability, which is not bad, and is a very long way from 'most expensive in the world'," he says.

"One of the gravest challenges to the Jali committee was how to compare bank charges between the South African banks, let alone between nations. Comparison of bank charges is as subjective and futile as trying to compare prices for any other service, because there are so many variables and subjective judgments that would have to be made," Mr Tshabalala says.

The ways a fees framework will be established, by whom, and what such fees will be, and how much wriggle room will be available to suspected transgressors, are yet to emerge.

"I don't know if the TCF will get down to that granular level; it is, in part, about ensuring transparency of fees," says KPMG's Mr Moten. "I don't think you will find regulations moving back to the point where the regulator will specifically mandate fees."

At issue is whether or not the banks went far enough in meeting the Jali recommendations, and, if they were heading that way, why a big stick is now needed to beat the banks over fees.

"That depends on the vantage point you're looking at the recommendations from," says Mr Moten. "The key question is: what was the underlying purpose of the Jali commission?

"If it was to reduce fees and heavily regulate, this would potentially have taken us back to where banking was 20 or 30 years ago.

"If it was more broadly about reining in fees without being prescriptive, then I think it has achieved success to some degree. Standard Bank, for instance, would argue they have complied with 15 or 16 of the 28 recommendations - those that were within their power to do so. Across the board they have made attempts to keep fees low, but I don't think they are at the point that the Jali commission would have intended, in terms of significantly reducing fees."

A big point of contention is that most fee reductions are for entry-level accounts and for lowincome customers.

While many of these are at zero, or else the bare minimum, the more affluent account holders have felt little in the way of fee relief, an issue particularly irksome to the Competition Commission.

"Take a step back," says Mr Moten, "and look at the different stakeholders in the industry. Take the big four banks, more specifically around banking profitability. Start with the prospective that net interest margins have declined, and therefore banks have responded broadly in two ways to either maintain or increase profitability.

"Their aim has been to increase noninterest revenue, such as fee income, among other sources of income. The fee issue, in part, has also been around subsidising one segment because the underbanked segment is generally unprofitable. There has obviously been a lot of regulatory and political pressure to serve the underbanked segment and the banks have made the attempt to service them."

The nutshell question for the more cynical then becomes: is it possible for banks to treat customers fairly and grow their noninterest revenue at the same time? Mr Moten believes it is.

"Treating Customers Fairly is largely around fee transparency and protecting customers from mis-selling, and brings us to the point of customer service. A lot of affluent customers would be prepared to pay the bank's charges for assistance, convenience and meaningful service. And when one looks at fees one must look at the level of service customers would be willing to pay for. So TCF leads us to the other side of the fee coin, which is 'what am I actually getting for the fee I'm paying?' And that's the crux of the fee question."

The banks bristle at suggestions that they manipulate fees to top up noninterest income while elsewhere free banking is becoming common.

Nedbank's Mr de Wet calls it a myth. "In fact, just the opposite is the case," he says, and he highlights a comment in May this year by Andrew Bailey, executive director of the Bank of England, who said that free in-credit banking in the UK was a dangerous myth. "It is a myth because nothing in life is free," said Mr Bailey. "Rather, it means that we pay for our banking services in ways that are hard to link to the costs of the products we receive."

"There really is no such thing as free banking," says FNB's Mr du Plessis. "FNB and other banks in SA are structured differently to those in countries such as the UK - where banks cross-subsidise transaction fees with huge penalty fees (also known in the UK as 'sin fees'). For example, customers can be charged the equivalent of over R300 (£25) for a single unpaid cheque or debit, or over R60 per day (£5) for being over limit."

The myth of free banking in the UK is being challenged by UK regulators following the various enforcement actions taken by the UK's Financial Services Authority against retail banks, says Standard Bank's Mr Tshabalala.

"There is an increasing view in the UK that the 'free' banking model has incentivised banks to seek to generate revenue from practices that are less fair to customers and much less transparent: including high penalty charges; unauthorised overdraft fees; and even, in the extreme, the mis-selling of products."

"The best way to make banks cheaper, more accessible, transparent and less reliant on fees is for banks to become more competitive," says ombudsman Mr Pillay. "And the way for banks to become more competitive is by encouraging them to be more innovative. At present, there is no regulator that oversees the market conduct practices of the retail transactional banking sector.

"The policy document provides for the creation of a retail Market Conduct Regulator to develop principles on how banks should report and set their fees and what constitutes fair and unfair behaviour. Given SA's historical neglect of market conduct regulation, the proposed model is one way of giving sufficient priority to transparency, market integrity and consumer protection," he says.

Mr Pillay also sees TCF as another impetus. "TCF aims to ensure an efficient and effective market and help consumers achieve a fair deal by maintaining market confidence, promoting public understanding of the financial system and securing the appropriate degree of protection for consumers," he says.

A third impetus would be to permit banks to engage in comparative advertising, allowing them to compare their own prices and product offerings directly and explicitly with those of their rivals "and comparative advertising is already possible, albeit with strict rules to protect registered trademarks".

On a more cautious note, he offers that "one must be wary of not over-regulating and so emasculate an industry which is at the heart of economic activity".

But beyond the more comfortable urban retail banking environment is SA's real mass market in the making.

The rural millions beckon the banks with both the promise of multiplying customers, and the headache of costly development. The banks appear agreed that new energy and initiative are required to open and nurture this market.

FNB sees it as "a new customer base to tap into" in the process of making financial inclusion available to all.

"To us, banking the underbanked and unbanked has two key elements," says Line Wiid, CEO of FNB Smart Solutions.

"First, it's the complexity in the designing of easy-to-understand products and solutions, and second, in educating the customers on how to effectively manage their finances.

"Financial inclusion is not only about ensuring that all South Africans have a bank account ... it is about making financial services available to all, even those who can't afford a bank account."

Absa's Arrie Rautenbach, head of retail markets, says the segment is valuable because of the opportunities it offers.

"We are committed to meaningfully partner with government. Absa has the largest network consisting of alternative channels through which to provide both lending and investment products and services."

"Financial inclusion is a strategic growth area for our Personal and Business Banking division," says Standard Bank's Mr Tshabalala. "At present the inclusive market customer base is 5.4-million consumers. Despite great progress in reaching the unbanked market, a third of South African adults still do not have a bank account and an estimated R12bn is still saved 'under the mattress'."

Yes. South African banks are making headway in their drive to "bank the unbanked".

What the authors of the Twin Peaks initiative want to see is a commitment as energetic for the rest of their customers.

Standard would argue they have complied with 15 or 16 recommendations- those within their power

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