

Personal current accounts in the UK

An OFT market study



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The following annexes are available on our website: www.offt.gov.uk/pca

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EXECUTIVE SUMMARY

Background

The personal current account (PCA) is a cornerstone of Britain's retail financial system. Its efficient operation is essential for consumers, for banks and for meeting wider public policy objectives. The vast majority of households have a current account and 90 per cent of adult consumers have at least one current account. The UK PCA market is large – there are approximately 64 million accounts in the UK, of which 54 million are estimated to be active. The OFT further estimates banks earned £8.3 billion in revenues from PCAs in 2006. This is equivalent to £152 per active bank account and represents more revenue for the banks than savings and credit cards combined.

PCAs have a wider impact, with a well functioning market for PCAs being crucial for the health of the United Kingdom economy. A PCA is a consumer's gateway to effective participation in the economy and allows access to other products such as mortgages. PCAs are also central to the Government's strategy for greater financial inclusion.

The Office of Fair Trading (OFT) launched this market study into the state of the market for personal current accounts in April 2007. Two previous studies expressed concerns about the operation of the market. The Cruickshank Report in 2000¹ concluded that consumers were not adequately informed about their financial products, that they found it difficult to compare them and that competition was not operating effectively. The Competition Commission's investigation of the personal current accounts market in Northern Ireland² concluded there was a lack of information and transparency about charging structures and practices. This meant that consumers believed that switching banks was more difficult than it was in practice and that market outcomes, such as price and service, were worse than if switching were more prevalent.

The market study also provides additional context for the OFT's Unfair Terms in Consumer Contracts Regulations (UTCCRs) investigation³, which is looking into the fairness of the level and application of insufficient funds charges⁴, and the subsequent test case launched in the High Court, in July 2007. The test case judgment, received on 24 April 2008, confirmed the OFT's view that these charges are assessable under the UTCCRs. This judgment is the subject of an appeal. This market study makes no judgement about whether insufficient funds charges pass such a test of fairness under the UTCCRs.

The market study has sought to establish a complete picture of the market, drawing together current and past strands of work and building on the many developments already achieved in the industry, to examine whether the market is working well for consumers and if not, make recommendations for remedying the problems identified. It has done so against the background of recent and ongoing changes in the way that banks provide their services.

1 *'Competition in UK Banking, a Report to the Chancellor of the Exchequer'*, Don Cruickshank, March 2000.

2 *'Personal current account banking services in Northern Ireland market investigation'*, Competition Commission, May 2007.

3 More information available at:
www.offt.gov.uk/advice_and_resources/resource_base/market-studies/current/personal/personal-test-case/

4 The term 'insufficient funds charges' refers to unarranged overdraft maintenance, paid and unpaid item charges. The term 'fee' refers to the price consumers pay to banks for any given current account transaction: this includes insufficient funds charges and may be zero for some transactions.

Key findings

The OFT has found evidence of competition in the PCA market. Banks can also demonstrate high consumer satisfaction and low fees on many of the more visible elements of current accounts – such as withdrawals from ATMs. Internet and telephone banking have also made it easier for consumers to manage their account.

However, the OFT believes that the PCA market as a whole is not working well for consumers. A combination of complexity and a lack of transparency means that consumers and competition are focused almost exclusively on more visible fees, and not on the less visible elements such as insufficient funds charges and forgone interest⁵ – despite the fact that these make up the vast bulk of banks' revenues. For insufficient funds charges, this effect is exacerbated by a lack of simple mechanisms for consumers to control, or opt out of, an unarranged overdraft. Furthermore, a significant proportion of consumers believe that it is complex and risky to switch⁶ accounts, with the result that switching rates are very low.

As a result, we believe the ability for the market to function well has become distorted in three ways:

- first, there seems to be a substantial cross subsidisation from those consumers who incur insufficient funds charges to those who do not; and to a significant extent from 'vulnerable', low income and low saving consumers, to higher income, higher saving ones
- second, the extent of this cross subsidisation means there is a substantial misalignment between the banks' revenues and their costs on many of their products and services. This may lead to inefficiency through under or over consumption of services by consumers, and
- third, the lack of consumer awareness and switching on the less visible elements provides banks with little incentive to compete on them. This may also have an impact on longer term productivity within the banking sector. Without competition in these areas, banks have lower incentives to create new and innovative services.

Furthermore, given the constraints on competition, and in particular the low switching rates, we are not persuaded that any additional profits made from less visible elements are fully competed away in terms of lower fees in other areas. This raises the possibility that a significant proportion of the profits made on less visible elements are kept by banks rather than passed back to consumers through more intensive competition.

In essence, the OFT believes that the market may be stuck in an equilibrium that does not work well for many consumers. A significant number of consumers do not know how much they will effectively pay in bank fees or how individual elements in the charging structure will be implemented, either before or after they are incurred. This limited understanding of key account elements, combined with low confidence in switching, means that the banks have less incentive to provide better offers on insufficient funds charges and interest. Without better offers from banks, however, consumers have little incentive to switch.

5 The difference between what a consumer could earn in credit interest from their current account and what they could earn using an account that pays a higher interest rate or a savings account. It is in effect the opportunity cost of holding credit in a current account with a low credit interest rate.

6 Where customers face difficulties in switching between suppliers, whether because of monetary costs, administrative hurdles or just plain inconvenience, competition can be adversely affected. We refer to these as 'switching costs'.

Consumers lose in two ways. A minority lose out significantly, but ultimately everyone suffers if the banks have little incentive to compete vigorously by providing better offers on key elements of their current accounts.

In the OFT's view, the status quo is not satisfactory. Markets generally work well for consumers where there is full and effective competition between suppliers, and consumers are able to make informed choices. In the coming months we will discuss our findings and the most appropriate next steps with the banking industry and interested stakeholders. It may be that we can secure agreement on measures that will bring the necessary clarity, transparency and consumer empowerment to assist in making the PCA market function efficiently. We will also need to consider, however, whether other measures, ranging from improved self-regulation to enforcement action or a reference of the market to the Competition Commission, may be appropriate and proportionate.

Our findings in each of the report chapters are outlined in more detail below.

Personal current accounts

A current account is used on a regular basis by 90 per cent of consumers. Banks see PCAs as a gateway to selling other products. Consumers often select additional financial products from a bank with whom they have an existing relationship, without shopping around. Furthermore, current accounts act as a gateway to financial inclusion for more vulnerable consumers. The main banks all offer basic bank accounts, which are particularly helpful for the financially vulnerable.

The most common account model in the UK is the so-called free-if-in-credit model. This model has a cost for consumers, which is not always apparent to them, in the form of interest forgone. This is the interest that consumers could be earning by holding their credit balances in interest-bearing, or higher interest rate, accounts rather than leaving them in a current account that generally pays no, or only minimal, interest on credit balances. We found that 88 per cent of current accounts (47.6 million PCAs) received an annual interest rate of less than 0.5 per cent in 2006.

In 2006 the aggregate revenue of banks from current accounts was approximately £8.3 billion. PCAs generate more revenue for banks than savings and credit cards combined: 31 per cent compared with 17 per cent and 13 per cent respectively. Banks earned over 85 per cent of their revenues on PCAs from two sources: net interest income from credit and debit balances (£4.6 billion), and levying charges associated with insufficient funds (£2.6 billion).

Supply of personal current accounts

Broadly, the PCA market can be characterised by two types of competitor. Barclays⁷, Lloyds, HSBC and RBS (which for convenience we refer to as 'the established banks') all appear to compete predominantly on quality elements rather than price elements – such as credit interest rate and fees. Other banks such as HBOS, Nationwide, Abbey and smaller banks

⁷ OFT has noted the initiative announced by Barclays Bank at the end of May 2008 under which it has replaced the unarranged overdraft facility with what it has described as a 'completely new structure'. While moves such as this suggest that the market for PCAs is changing, it remains to be seen whether this initiative will address all the issues raised within this study.

(which, for convenience, we refer to as the 'challengers'), appear to compete both on price and quality. The PCA industry is moderately concentrated, with the four established banks representing a combined share of 65 per cent of all current accounts (increasing to 84 per cent with the inclusion of HBOS and Nationwide).

The PCA market exhibits some barriers to entry and expansion which limit banks' ability (particularly smaller ones) to become effective competitors to their rivals. These barriers include low levels of consumer switching, the importance of establishing a wide branch network, and the importance of an established brand name. Combined, these seem to have constrained the ability of challenger banks to expand quickly: low consumer switching in particular has reduced incentives to compete.

While these factors have constrained competitive pressures, they have not removed them entirely. HBOS and Nationwide have managed to increase their respective market shares over the last two years largely by providing higher PCA credit interest rates and generating better levels of consumer satisfaction than the established banks. Furthermore, there is evidence that many consumers are satisfied with their accounts, although this may also be evidence of disengaged consumers.

The bulk of consumers pay little or no attention to the key elements of either insufficient funds charges or the interest they earn on credit balances. Only five per cent of consumers surveyed considered overdraft fees – arranged and unarranged – important when choosing a PCA, while only seven per cent of consumers considered a 'competitive interest rate' important when choosing a PCA. Competition has instead concentrated predominantly on the most 'visible' aspects of accounts (for example monthly or ATM fees), in many cases competing them down to zero.

The lack of visibility of insufficient funds charges to consumers has reduced the incentive for the banks to compete on these aspects. As a result some banks appear to see insufficient funds charges in particular as an attractive way to generate additional revenue without affecting demand for their accounts.⁸ Insufficient funds charges have increased by an average of 17 per cent in real terms between 2003 and 2007. The average daily unarranged overdraft balance over the year⁹ in 2006 was £680 million but involved some £1.5 billion in paid item and maintenance fees.¹⁰ This is a return of over 220 per cent on the balances.¹¹

Consumer use and awareness of their personal current account

The OFT has found that many consumers are not familiar with the key fees associated with their PCA. These include fees for arranged or unarranged borrowing and the level of interest they forgo by holding significant credit balances in their current account. Over three quarters of consumers surveyed did not know what the credit interest rate was on their account.

- 8 During the course of this market study, the OFT has seen banks' internal documents on the level of charges that include statements such as: 'in order to maximise fee revenue, whilst maintaining our competitive position, selective increases in [insufficient funds charges] are proposed', and 'Increasing [insufficient funds] charges will have less impact on our marketing position... due to its lower visibility.'
- 9 The sum of daily debit balances divided by the number of days in the year.
- 10 Monthly and/or daily overdraft excess charges levied for each relevant period the balance remains in unarranged overdraft. The period may be a month or may be a day depending on the bank.
- 11 Excluding £1 billion in unpaid item charges, which are insufficient funds charges levied on any unpaid payment that, if paid, would create or extend an unarranged overdraft.

Consumers also had difficulty in understanding and calculating the level of insufficient funds charges they pay, perhaps unsurprisingly given the complexity of their implementation. Indeed, when the banks were asked to calculate how much a hypothetical consumer would have to pay in a given scenario (which included exceeding an agreed overdraft limit) the reported charges varied from £0 to £260. The high levels of consumer satisfaction with the value for money of a product may be questioned if many consumers do not know what it has and will cost them.

Some consumers are not even aware that some fees exist. Even where they are aware of the existence and level of fees, consumers find it hard to judge when and how these fees will be incurred. Indeed, only seven per cent of consumers who exceeded their arranged overdraft limit said it was a deliberate decision. Research¹² also showed that 19 out of 22 banks themselves gave out wrong cheque clearance times or were unable to offer practical advice on this to consumers.

This consumer uncertainty is due to both the lack of transparency of fees – in particular insufficient funds charges – and the complexity in determining when they are and will be incurred. This has had the following widespread effects:

- over a fifth of consumers were unaware of insufficient funds charges until they had incurred one
- over 12.6 million accounts (23 per cent of active accounts) incurred at least one insufficient funds charge in 2006, and
- those consumers who incurred an insufficient funds charge in 2006 were more likely to incur at least six charges than just one.

Furthermore, it appears that consumers either do not learn from incurring insufficient funds charges or that their financial circumstances make incurring charges unavoidable. For example, of those accounts paying an insufficient funds charge in 2006, more than 57 per cent also paid an insufficient funds charge in 2005.

Evidence from consumer organisations shows there is significant potential for slight errors in financial management that can result in hundreds of pounds worth of insufficient funds charges. Over 6.6 million account consumers paid at least £100 while 1.4 million paid at least £500 in 2006. Of those consumers that incurred insufficient funds charges, the average incurred was £205.

When questioned, consumers appear to have some misgivings over their lack of ability to control their accounts. The majority of consumers surveyed expressed an interest in having a greater ability to control whether they incur insufficient funds charges on their account.¹³

Finally it is important to note that consumers who pay insufficient funds charges have, typically, lower incomes, and/or lower savings¹⁴ than consumers who do not pay charges. This is made more serious given the apparent magnitude of the cross-subsidies – we found that the banks earn over 30 per cent of all their revenues from insufficient funds charges.

12 *Themed Review of Cheque Clearing Cycles*, Banking Code Standards Board May 2006.

13 Over 60 per cent of those surveyed said that they would prefer to have their payment refused rather than enter an unarranged overdraft.

14 Consumers on low incomes or with less than £1,000 in household savings were significantly more likely to have been charged in the past 12 months for a refused payment. Furthermore, those with less than £1,000 in household savings were significantly more likely to have been charged in the past 12 months for going into their unarranged overdraft.

In summary, the complexity and application of many of the banks' fees, the lack of transparency and the limited ability for them to predict the incidence and amount of fees makes it substantially more difficult for consumers to make well-informed decisions on how to manage their money and whether they are getting a good deal.

Shopping around for and switching accounts

Consumers who proactively seek better deals, on either price or quality, are the drivers of competition. Without consumers willing to switch between competitors, banks have little incentive to provide better offers. The study shows that relatively few consumers actively monitor the relative competitiveness of their accounts, with 47 per cent of all consumers stating that they have never even considered switching. This lack of active engagement is also demonstrated by the fact that more consumers switched due to bad experiences with their previous bank than to the existence of better offers.

This is a result of several factors. As discussed previously, it is relatively complicated for consumers to monitor the actual cost of their accounts, in particular in relation to interest forgone and the expected value of fees. In addition, key information that consumers need in order to compare offers between accounts and banks and make an informed choice is difficult to obtain. The complexity and lack of transparency on many of the key fee elements of an account means that the visible benefits for switching for most consumers are relatively small, even though for some the actual benefits can be substantial. Furthermore, consumers have valid concerns about the switching process going wrong. Twenty-eight per cent of consumers who did switch accounts reported some kind of problem. However, the perception of anticipated problems in switching accounts is much more prevalent: 45 per cent of those consumers who have not switched were 'not very', or 'not at all', confident that the process would go smoothly if they were to switch.

This raises questions of whether there is a fair and efficient allocation of the risk of switching PCAs. Consumers who use the banks' automatic switching process have little control over its successful conclusion. Furthermore, if the process does go wrong consumers appear to bear a significant proportion of the resulting costs. For example, consumers may face penalties from third parties for not making a payment. This allocation of risk may contribute to the UK having one of the lowest switching rates in Europe, with only six per cent switching in the last 12 months.

Consumers with significant bank credit or debit balances and consumers who persistently incur insufficient funds charges have potentially the most to benefit from switching their accounts. However, banks may find it hard to reach these consumers effectively if they are unengaged or uninformed about the potential benefits to them from switching accounts. This raises the possibility that the PCA market is stuck in an undesirable equilibrium that does not work well for consumers. Without consumers willing to switch accounts and actually doing so, the banks have little or no incentive to compete by offering better terms on insufficient funds charges and forgone interest. Without better competing offers from banks, however, consumers have little or no incentive to switch accounts. Breaking this circle by reducing the actual and perceived barriers to switching would provide banks with the incentive to provide competing offers on both insufficient funds charges and forgone interest. Furthermore, vigorous competition would promote innovation on new services and products with a fair share of the benefits being passed on to consumers.

1 INTRODUCTION

- 1.1 This chapter looks briefly at the mission of the OFT in relation to markets more generally, and its powers to conduct market studies. It also examines some of the key factors that prompted the market study into the PCA market and the outcomes the OFT would like to see develop. It also discusses the approach taken to the study and a brief description of the structure of the report.

OFT mission and powers

- 1.2 The mission of the OFT is to make markets work well for consumers. The OFT believes markets work best when consumers make informed decisions about the products they purchase thus securing value for money. Businesses will then respond by competing to offer the products that consumers want at the best prices. This, in turn, will drive efficiency, innovation and therefore productivity and economic growth.
- 1.3 The OFT has powers under section 5 of the Enterprise Act 2002 to conduct a market study in order to identify whether perceived problems in a market should be addressed through the OFT's other functions or through other recommendations.

Why the OFT conducted this study

- 1.4 PCAs provide consumers with a convenient means of storing and accessing their money, easier payment of bills, receipt of salary and an effective means of money transfer in an economy where a significant proportion of transactions are made electronically. The PCA market is crucially important for the health of the economy as a whole. Both the Government and banks¹⁵ recognised the importance of PCAs' role as a gateway, developing 'basic bank accounts' in order to ensure that all consumers in the United Kingdom have access to appropriate financial services so that they can participate fully in the economy and manage their own finances in a more effective and confident way.¹⁶ This was also a feature recognised in the Cruickshank Report.¹⁷
- 1.5 There are over 64^A million PCAs¹⁸ and 90 per cent of consumers have at least one PCA and use it regularly.¹⁹ The PCA market is also a sizeable market in its own right – the 16 banks who supplied relevant information to the OFT, and which, we believe, together account for around 95 per cent of the PCA market, earned £8.3^A billion in revenue from PCAs in 2006 (an average revenue per active PCA of £152^A). Of this, £4.1 billion^A (50 per cent^A) came from net credit interest income, £2.6 billion^A (31 per cent^A) from income from insufficient funds charges, and £532 million^A (six per cent^A) from net arranged and unarranged overdraft interest.
- 1.6 For the past decade the four established banks have maintained a market share in excess of 60 per cent and there has been no evidence of significant entry.

15 In the context of this report, the term 'bank' will also refer to building societies.

16 HM Treasury, *Financial Inclusion: an action plan for 2008-11*, published December 2007.

17 '*Competition in UK Banking, A Report to the Chancellor of the Exchequer*', Don Cruickshank, March 2000, paragraph 7.4.

18 Eighty four per cent of which are in active use.

19 The number of banks data from which statistics are derived is indicated by the letter in superscript as follows. A: Data from 16 banks. B: Data from 7 banks. C: Data from 6 banks. D: Data is from 5 banks. A '+' indicates that the figure has been prorated up to 16 to ease comparison of figures across the report. Data is for 2006.

- 1.7 A recent report by the European Commission²⁰ shows that the UK banking sector has one of the highest levels of current account gross income per consumer in Europe. While there are many possible economic explanations for this, it does raise a question of whether there are sufficient competitive pressures in the market place.
- 1.8 Over an extended period of time, concerns expressed about the operation of the PCA market have led to two previous investigations. The Cruickshank Report considered the PCA market, as did the Competition Commission's investigation of the PCA market in Northern Ireland.²¹ The Cruickshank Report concluded that 'consumers ... found it difficult to compare financial products and that there was 'clear evidence that consumers are not adequately informed about their financial products.'²²
- 1.9 The Competition Commission concluded that a lack of transparency in the market in Northern Ireland gave the impression that switching banks was more difficult than it was in practice, that the financial gains of switching were not seen as outweighing the risks, and that there was a lack of information and transparency about charging structures and practices. More recently, concerns about the nature and legality of charges incurred as a result of insufficient funds have raised questions about the current market structure in the UK.
- 1.10 A summary of these two investigations is outlined in table 1.1:

20 European Commission sector inquiry on current accounts and related services July 2006.

21 '*Personal current account banking services in Northern Ireland market investigation*', Competition Commission, May 2007.

22 Paragraph 4.67.

Table 1.1: PCA market issues and findings of the Cruickshank and Competition Commission reports

	Cruickshank report – UK	Competition Commission – Northern Ireland
When carried out	The review of banking services in the UK was completed in March 2000. It was announced by the Chancellor of the Exchequer in the 1998 pre-budget report.	The supply of PCAs in Northern Ireland was referred to the Competition Commission by the OFT in May 2005 for investigation. The Competition Commission reported its main findings in May 2007.
Scope of study	<ul style="list-style-type: none"> • Money transmission services • Banking services to personal customers • Banking services to SMEs 	The supply of PCAs in Northern Ireland.
Key findings on personal current accounts	<p>The review found:</p> <ul style="list-style-type: none"> • the sector was highly profitable • the current account holds the key to competition for the supply of other products • consumers perceive significant barriers to switching personal banking products • there were severe information problems • avenues of redress were inadequate. <p>The review further concluded that the competition problems could be resolved through two important changes:</p> <ul style="list-style-type: none"> • establishing a new policy framework between the Government and the banks to encourage more competition • changes to the UK payment systems to enable consumers to switch more easily • the Review concluded that competition was not operating effectively in any of the markets studied. 	<p>The Competition Commission found:</p> <ul style="list-style-type: none"> • a general lack of consumer interest in PCAs, with consumers viewing them as all the same • low annual rates of switching • a perception that switching PCAs is more difficult than is the case in practice • financial gains from switching do not outweigh perceived risks • a lack of customer responsiveness to changes in interest rate or charges • switching is influenced more by push factors rather than pull • customer understanding of insufficient funds charges was low • inherent complexity in charging structures – terminology unclear and inconsistent • insufficient funds charges and debit interest rates are likely to be above the levels of a well-functioning market • in many cases these findings were said to be indicators or outcomes of a lack of competition in the market. <p>The Competition Commission concluded that the following three features prevented, restricted or distorted competition in the Northern Ireland PCA market:</p> <ul style="list-style-type: none"> • banks had unduly complex charging structures and practices • banks did not fully or sufficiently explain their charging structures and practices, and • customers generally did not actively search for alternative PCAs nor did they switch banks.

- 1.11 The market study, which was launched in April 2007, therefore looked to complete and draw together current and past strands of work on this market, building on many positive advances already achieved by the industry and to make recommendations for remedying the problems identified to achieve a lasting improvement in the competitive dynamics of the market.
- 1.12 This study will not only help the OFT consider the wider questions about transparency and switching, it will also provide context for the OFT's investigation into the fairness of insufficient funds charges under the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs). See below for further details.

Approach

- 1.13 In carrying out this study the OFT researched and analysed the PCA market and consulted with a wide range of stakeholders. The main elements of the OFT's approach to gathering evidence for the study include:
- a general invitation to submit evidence when the study was launched in April
 - an in-depth analysis of key data requested from banks, complemented by meetings on strategic issues
 - review of a number of bank web-sites, branch leaflets and price comparison sites
 - a high level look at PCA pricing models in other countries
 - commissioning a telephone-based consumer survey of over 2000 PCA users
 - a behavioural analysis of the consumer survey results by a psychologist
 - discussions with other Government departments, the Financial Services Authority and the Scottish Enterprise, Energy and Tourism Directorate
 - meetings with key consumer groups, and
 - discussions with the Financial Inclusion Task Force and other groups with an interest in the issue of vulnerable consumers.

Outcomes of the study

- 1.14 The OFT believes the best outcome is a market with strong competition driven by consumers who are actively engaged in securing value for money. In order to achieve this, a market typically needs to have a degree of transparency of its products and their conditions and an easy process for switching from one provider to another.
- 1.15 The OFT's objective is therefore to develop outcomes that ensure the PCA market works well for consumers. This means that consumers must be able to understand how much it will cost to have a PCA, and have the confidence to switch to other banks if they are not happy with their own bank or find a better deal elsewhere. This requires active and informed consumers who will help drive competition which in turn will help deliver efficiency and value for consumers.

Report structure

- 1.16 The report begins with a broad level of information on PCAs including the types of PCA models before reviewing how PCAs are provided, how consumers use their accounts and the factors that drive consumers' decisions about choosing a new PCA.
- **Chapter 2** provides factual background on the types of PCA model, the provision and use of PCAs and PCAs in the context of the general retail banking services portfolio
 - **Chapter 3** describes how PCAs are provided, the current market structure, entry and expansion, price and quality competition and the impact of the free-if-in-credit model
 - **Chapter 4** examines how consumers use their account, the costs associated with their account and their awareness of their account features
 - **Chapter 5** explores consumer behaviour, considering the importance of search and switching costs and the factors that drive consumers' decisions about choosing a new PCA, the practicalities of the switching process and compares consumer perceptions and reality in terms of both the switching process itself and the costs and benefits of switching
 - **Chapter 6** sets out our conclusions and next steps in terms of identifying areas of the market where we believe improvements may deliver significant benefits to consumers and the wider economy as well as an outline of our approach to consulting on both the findings in this report and on potential remedies.

Unfair Terms in Consumer Contracts Regulations investigation

- 1.17 Following some complaints about the level and incidence of current account charges in 2006, the OFT identified possible concerns under the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs) with one particular aspect of the PCA market – charges for unarranged overdrafts and unpaid items.
- 1.18 This report considers unarranged overdrafts from a consumer and market perspective and examines how they work in practice. It is not an assessment by the OFT of whether or not insufficient funds charges constitute unfair charges under the UTCCRs. The OFT is considering this matter separately. (see Box1.2 below).

Box 1.2: The Market Study and UTCCRs investigation.

- In April 2007 the OFT launched two parallel pieces of work. One, the market study, to look at the market as a whole including the issue of insufficient funds charges. The second, the UTCCRs investigation, to consider whether there was a case for the OFT to take action about unfair terms in PCA contracts relating to insufficient funds charges.
- Part way through the UTCCRs investigation, the OFT, seven major banks and a building society²³ agreed to a test case in the High Court on the application of the UTCCRs to insufficient funds charges, namely whether such charges are assessable for fairness under Regulation 5 of the UTCCRs. As a preliminary issue the OFT sought a declaration by the

23 Abbey, Barclays, RBS, Lloyds TSB, HBOS, HSBC, National Australia Banking Group and the Nationwide Building Society.

court that the unfairness rules in the UTCCRs applied to insufficient funds charges (which the banks dispute). The case was heard in the High Court in January and February 2008.

- The test case judgment was received on 24 April 2008. It confirmed the OFT's view that charges are assessable for fairness under the UTCCRs. The judgment is the subject of an appeal.

Summary

- 1.19 The main factors that influenced the OFT's decision to undertake a market study of PCAs in the UK are:
- the importance of PCAs to consumers and the UK economy
 - concerns about the level and incidence of current account charges
 - low levels of price transparency; we were influenced, in particular, by the findings of the Competition Commission on the complex charging structures and practices of banks in Northern Ireland, and
 - the limited extent to which consumers were driving competition in the provision of PCAs, again influenced by findings of the Competition Commission on banks in Northern Ireland.
- 1.20 The outcomes the OFT wishes to achieve are:
- a. an increase in active and informed consumers which will increase competition between PCA suppliers, which, in turn, delivers efficiency in supply and value for consumers, and
 - b. increased transparency and competition, with banks treating consumers in a way which greatly reduces the need for high levels of regulatory intervention.

2 PERSONAL CURRENT ACCOUNTS²⁴

Introduction

- 2.1 The PCA is a cornerstone of Britain's retail financial system. Its efficient working is essential for consumers, for banks and for meeting wider public policy objectives. This chapter describes the banks' PCA offerings. It describes the types of products banks offer, the links to other products and the importance of various services in banks' PCA portfolios.
- 2.2 One of the key findings in this chapter is the prevalence of the so-called free-if-in-credit model within the UK. In this model banks earn over 85 per cent of their revenues from two sources: net interest income from credit and debit balances (£4.6 billion) and levying charges associated with insufficient funds (£2.6 billion).

The Personal Current Account (PCA)

- 2.3 A bank account is a vital part of everyday life for the 90 per cent of Britons who use it on a regular basis. It allows them to receive salaries, benefits and other payments and to withdraw their money in cash on demand, either over the counter or through an automated teller machine (ATM or 'hole in the wall'). It also enables consumers to organise their finances more efficiently through the use of direct debits and standing orders. It gives the ability to pay other people and businesses via debit card payments and cheques. Lastly it provides consumers with a gateway to additional financial products and services such as savings accounts and investments, mortgages and other personal loans, credit cards and insurance. Many PCAs also allow the customer to borrow money by way of an overdraft.
- 2.4 Overdrafts can either be 'arranged' or 'unarranged'. This distinction is very important when it comes to the interest rates and charges that apply. Under an arranged overdraft the bank agrees in advance that a customer has a right to accumulate a negative balance on their account up to an agreed level. However when the customer either goes beyond that limit or, where there is no agreement, goes overdrawn at all, this additional lending is known as an unarranged overdraft and the customer is expected to bring the account back within the limit that is agreed. Overdrafts provide some consumers with a means of credit (typically temporary credit). In the UK, around 62 per cent of active accounts have an arranged overdraft²⁵ although not all customers use it. Five per cent of PCA holders consider themselves permanently in overdraft (based on the respondents to the OFT consumer survey).
- 2.5 Banks have traditionally delivered account services through their network of branches. In recent years internet and telephone banking have become important additional channels. This has led to the possibility of a direct banking model where the majority of transactions are conducted either through the internet or by telephone with branches used only by customers making deposits.

Pricing models for accounts

- 2.6 All banks tend to offer a standard package of a cheque book, debit card and, often, an arranged overdraft (which may not have to be expressly requested). However each bank will

24 The number of bank's data from which statistics are derived is indicated by the letter in superscript as follows. A: Data from 16 banks. B: Data from 7 banks. C: Data from 6 banks. D: Data is from 5 banks. A '+' indicates that the figure has been prorated up to 16 to ease comparison of figures across the report.

25 Information received from banks during the course of the market study.

have a different set of interest rates and charges for different aspects of the account whether in credit or overdrawn.

Free-if-in-credit

- 2.7 The most popular pricing model for PCAs is known as free-if-in-credit, which has been predominant in the UK since around 1985. It has been referred to as the 'free banking' model because a consumer who is in credit does not pay any direct fees for having an account or for core services such as cheques and direct debits. Interest is usually charged on any money borrowed and there are usually significant charges on borrowing beyond any arranged overdraft limit or if the bank refuses to make a payment that would take an account beyond such a limit. There may be little credit interest paid on credit balances. Student and graduate accounts are variants of the free-if-in-credit model and may offer special features, such as an interest free overdraft or other more direct inducements such as cash back or an opening credit balance of £100.
- 2.8 Although the free-if-in-credit model does not have any explicit charge for the account for customers who stay in credit, it does effectively have a cost to its users – which may not always be apparent to them – from interest forgone. This is the amount that consumers could earn by putting their positive balances in a higher interest rate account. Banks themselves earn revenues from credit balances by lending this money out at higher rates of interest.

Transaction-based

- 2.9 The transaction-based model charges customers per transaction (or per block of transactions), for example, per direct debit, per cheque or per deposit. Sometimes referred to as the 'pay-as-you-go' model, this was the predominant model in the UK up to around 1985. In 2007, the Competition Commission²⁶ found that the transaction-based model was the second most common pricing model in Northern Ireland, after the free-if-in-credit model. It is now rare in Great Britain.

Monthly (or annual) fee

- 2.10 As the name of this model suggests, consumers pay a regular fee taken directly from the account. Either there are no individual transaction charges or a certain number are provided free with a charge payable for any additional transactions. This model is generally not available in the UK, although First Direct offers an account with monthly charges.

Packaged accounts

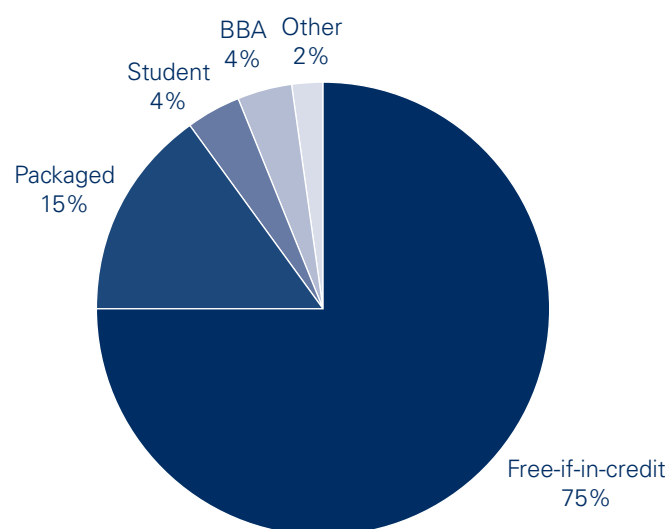
- 2.11 This model has a monthly fee where the fee also covers additional benefits. These may range from travel insurance and road breakdown cover to discounts from a number of retailers and hotels. The packaged account has been described by some banks as 'the account for the busy professional'. It is heavily promoted in the UK.

²⁶ Table 2, page 30.

Basic bank account

- 2.12 Basic bank accounts are based on the free-if-in-credit model and do not carry any charges provided there are sufficient funds in that account to meet the payments made. Holders of this account are not allowed a cheque book or an overdraft. The Government recommended²⁷ that the banks continue their development of basic accounts in order to promote financial inclusion for vulnerable consumers, particularly those receiving income support and other Government benefits. This is discussed in more detail below at paragraphs 2.42 to 2.45.
- 2.13 Chart 2.1 below sets out the split between different PCA pricing models according to the number of accounts held by the established banks. As can be seen, the overwhelming majority of accounts are run on the free-if-in-credit model, with the packaged account providing a large proportion of the remainder. Revenues from transaction charges represent a negligible proportion of overall revenue received from other pricing models. Most banks only levy transaction charges on debit card use abroad and one bank does not levy transaction charges at all.

Chart 2.1: Types of PCA supplied by banks by number of PCA, 2006



Source: OFT analysis of data from banks 2006 ^a

The provision and ownership of PCAs

- 2.14 The main providers of PCAs in the UK are high street banks, although recently credit unions have also begun providing current accounts.²⁸ The five largest banks (Barclays, HSBC, Lloyds TSB, RBSG and HBOS) provide around 80 per cent of PCAs with the remainder supplied by Nationwide Building Society, Abbey and other smaller institutions.

²⁷ 'Access to Financial Services', Report of Policy Action Team 14, HM Treasury, November 1999, page 1 www.hm-treasury.gov.uk/media/F/E/pat14.pdf

²⁸ Credit Unions began providing accounts in 2007.

- 2.15 While nine out of ten people have an account and use it regularly, just under two thirds of those (62 per cent) had only one current account and the remainder had two or more, according to the OFT consumer survey. The qualitative ('in-depth') interviews suggested that consumers with multiple accounts tended to fall into three groups:
- those who had a joint account with a partner as well as their own personal account
 - those who had switched bank and kept the old account open, and
 - those who had a different account for different purposes, for example, one account for personal finances and one for business.
- 2.16 The consumer survey also showed a strong link between multiple accounts and the affluence of consumers. People living in households with incomes of more than £30,000 were significantly more likely to hold multiple current accounts. Consumers in social groups D and E were significantly less likely to hold multiple accounts.

Retail banking services portfolio

- 2.17 In general, two distinct sets of customers make use of retail banking services: personal customers and small and medium sized enterprises (SMEs or small businesses). Both groups tend to use the branch network so the bulk of branch and staff costs are shared between SME and personal customers.
- 2.18 Over a number of years, banks have grown in size and scope and now offer products that were not traditionally part of their portfolio.²⁹ Banks typically provide a range of retail banking services, including current accounts (both for personal customers and for SMEs), savings accounts, credit cards, loans, mortgages, insurance services, and foreign exchange.³⁰
- 2.19 Banks provide PCA services through a range of channels. Staff working in branches provide face-to-face assistance to customers and generate new business across a range of other products. A bank's website or call centre will allow customers to run their mortgage or longer term savings products as well as their current account.
- 2.20 Banks are able to share the costs of a significant proportion of operations – in particular those of the telephone call centre, the branch network and the IT systems – across a portfolio of different products and customers. When examining PCA provision in Northern Ireland, the Competition Commission found that 'the majority if not all operating costs associated with providing accounts are shared with other services and customers'.³¹
- 2.21 When a bank takes on a new customer it has a strong incentive and an ideal opportunity to sell a range of retail banking products to him or her. This enables the bank to benefit from what is known as the 'economy of scope'.³² This means that by delivering a range of

29 The Building Societies Act 1986 enabled societies to offer various financial products in addition to their traditional business of mortgages. The additional products included accounts. Subsequently a number of building societies have entered the current account and other retail banking markets. Conversely banks traditionally focused on deposit-taking and general purpose lending but have expanded the range of their retail banking products to include mortgages.

30 Different banks define 'retail banking' in different ways.

31 Paragraph 20 appendix 4.11.

32 Economies of scope exist when average total cost of production decreases as a result of increasing the number of different goods or services provided.

products through one channel – the branch – banks can spread the large fixed costs of providing banking services across several products. Most banks we spoke to said they provide a full set of financial products to their customers, and referred to this in terms of providing ‘total customer value’. This may explain why no firms provide current accounts without an additional range of retail banking services.³³ Economies of scale³⁴ may also exist in retail banking, with larger banks able to provide accounts at lower cost at least to some extent.

Importance of PCAs in retail banking portfolio

- 2.22 PCAs are pivotal products for banks. They play two roles – first in making a direct financial contribution to revenue and secondly as a gateway product to sell other products.

Direct financial contribution

- 2.23 The credit balances held on PCAs are a significant net provider of funds for the banks. The average daily credit balance over the year for the 16 banks we contacted was around £97 billion.^{A 35} These funds are typically re-used by banks and represent an essential ingredient of the banking business model, providing £4.1 billion ^A in net credit interest income.³⁶
- 2.24 In addition to the revenue generated from interest income on credit and debit balances, banks also generate other sources of revenue. In particular, substantial revenues are derived from insufficient funds charges, ancillary charges, and fees for packaged accounts.
- 2.25 Data collected from banks as part of the market study show that in 2006 revenue from accounts was approximately £8.3 billion.^A On average banks earned a total of £152 per active account ^A in 2006.
- 2.26 As chart 2.2 shows, 31 per cent ^A of retail banking revenue derived directly from current accounts in 2006. To put this into perspective, the revenue to the banks that accounts generate is larger than that generated by savings and credit cards combined.

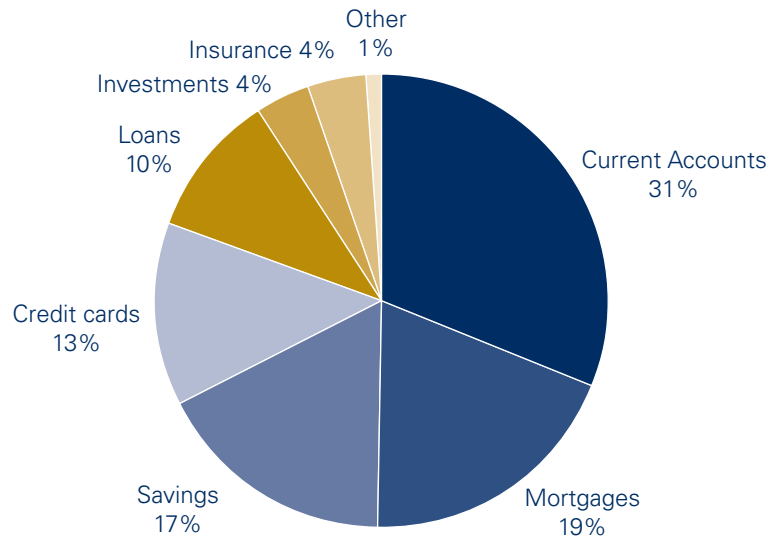
33 Whereas there are instances of banks offering other individual retail banking products. For instance, ING Direct entered the UK market in May 2003 offering savings accounts only.

34 Economies of scale exist when long run average costs of each unit of output falls as output rises. This allows the firm to produce proportionately more for the same unit of input, as volume increases.

35 Average daily credit balance over the whole year – the sum of daily credit balances divided by the number of days in the year. (Sum of daily credit balances for 2006 divided by 365).

36 Net interest income on a current account balance can arise in two ways, representing the difference between income and cost from providing a financial product. On credit balances, it will comprise the difference between the funding benefit earned on the funds held, less any interest paid out to the depositor. On debit (overdraft) balances, it will comprise the difference between interest paid by the borrower and the funding cost from financing the overdraft.

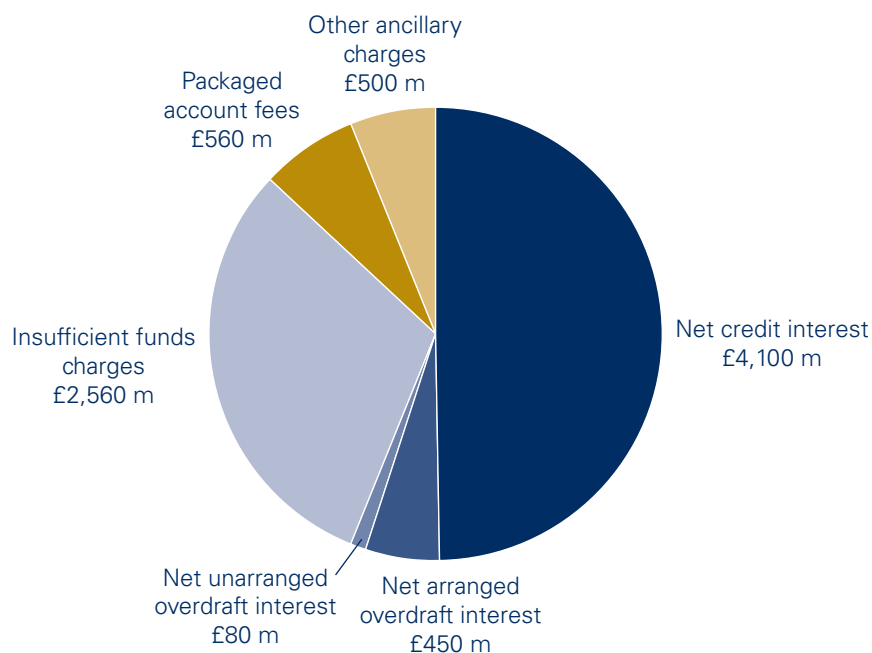
Chart 2.2: Share of retail banking revenue, 2006



Source: Response to OFT questionnaire by banks ^B

2.27 Revenue from PCAs is largely generated through five sources: net interest income, debit interest (from arranged and unarranged overdrafts), insufficient funds charges, packaged fees, and ancillary charges. Chart 2.3 below shows the various contributions made to overall revenue by different price elements. Around half ^A of all revenue generated by accounts derives from net credit interest income and more than 30 per cent ^A comes from insufficient funds charges.

Chart 2.3: Break-down of PCA revenue (in millions), 2006



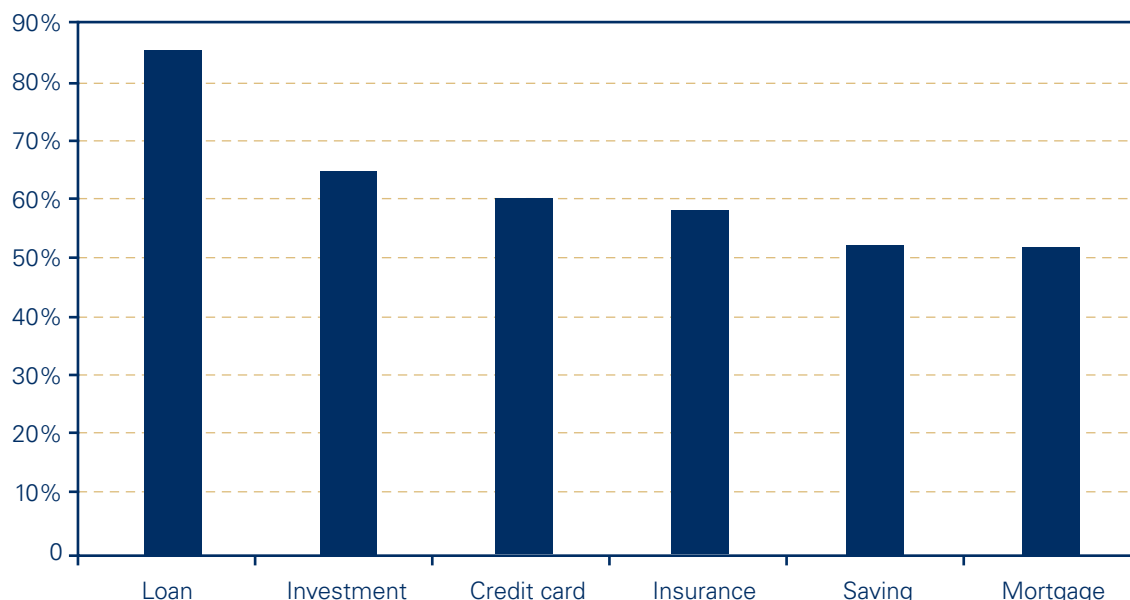
Source: response to OFT questionnaire by banks ^A

Gateway role

- 2.28 As well as their direct financial contribution, PCAs are used as a 'gateway' product leading to sales of other products. This arises from the regular contact the customer has with the bank and the level of customer specific information the bank has:
- a customer applying for a PCA may be encouraged to take additional products, based on the information gathered during the application process.³⁷ One bank commented that a customer opening a PCA is encouraged to take out a credit card too. The bank claimed that 70 to 80 per cent of their new customers did so, although this is not a general trend borne out by Chart 2.4
 - a customer also has, generally, more regular ongoing contact through the branch network, telephone or internet than would be the case with many other financial services products. This interaction offers further opportunities for banks to sell additional products to their PCA customers, helped by what the bank might learn about its customers over time
 - consumers may have a close bond of trust with their banks. One bank told us that customers see them as 'their bank' and the first port of call for financial needs even if they have other products with alternative financial service providers, and
 - the information obtained on the application, together with actual account information, is used to help with assessments such as credit risk, and enables the bank to be selective about which products it chooses to offer and at what rates. This makes banks better able to target products at customers.
- 2.29 Consumers may find the possibility of purchasing additional products from their bank beneficial. It may save time (for instance the bank already has most of the details it needs to process a new application for an additional product) and therefore be more convenient.
- 2.30 Most banks considered the gateway role of accounts to be significant. Data gathered during the course of the market study suggested that the strongest links were between loan products and PCAs (see chart 2.4 below), with banks' data showing that 85 per cent^c of consumers with a bank's loans have an account with the same bank.

³⁷ A typical application form to open an account will provide a bank with a valuable amount of information on the customer, such as income, existing retail banking products, marital status, dependents and so on.

Chart 2.4: Percentage of retail banking product holders who also hold a PCA with the same bank, 2006



Source: Response to OFT questionnaire by banks ^B

- 2.31 One bank stated that it would not offer customers personal loans unless they had a PCA. Therefore, in some cases, customers will be able to get access to other products only if they have an account with the bank.³⁸
- 2.32 Some banks noted, however, that other retail banking products also act as a gateway to sales of other financial services products. Holding a mortgage, for example, may lead to customers opening a PCA. This can be the case in particular for building societies (including those that have converted to banks).
- 2.33 A recent report by the European Commission's Directorate General for Competition indicates that the level of cross-sales in the United Kingdom is the lowest in Europe.³⁹ The report concludes that this could be either because of greater competition in the UK to provide other retail banking products (for example, mortgages) or because UK banks are not as effective at cross-selling as banks in other Member States.
- 2.34 The Cruickshank Report⁴⁰ noted that consumers often select additional financial products from a bank with whom they already have a relationship, without shopping around. Where this is the case consumers may not be securing value for money. In particular, there may be a trade-off between convenience and value for money. Cruickshank found that banks were able to sustain higher prices for products such as personal loans and credit cards than non-banks.

38 This is known as 'tying'. This is less commonly seen in the UK than in other EU states (see EC sector inquiry, footnote 39).

39 Sector Inquiry under Article 17 Regulation 1/2003 on retail banking (published in: Interim Report II, Current Accounts and related Services, 17 July 2006; Communication from the Commission, European Commission, 31 January 2007).

40 Paragraph 4.64.

Understanding product profitability

- 2.35 Profit levels in a particular sector can provide useful clues to the level of competition. For this reason, competition authorities' investigations often include an assessment of profitability.
- 2.36 However, the OFT has not been able to assess accurately the contribution that accounts make to banks' overall profits based on the information that has been made available to it.
- 2.37 One difficulty is the availability of data. The banks have told us that they typically assess profitability at the wider retail banking level rather than for individual product lines (such as PCA profitability). We judged that it would have been disproportionate for the purposes of this market study to require the banks to collect cost data at a product level purely in order to enable us to assess profitability of accounts.
- 2.38 Additionally, as noted above, certain operating costs are shared between PCA and other retail banking products. These common costs would need to be allocated and apportioned between products as part of a sensible assessment of the profitability of PCAs as a whole. While a number of banks recognise, at least in principle, that a basis might be found to allocate costs down to product level, it appears that this might not be a straightforward exercise.
- 2.39 Hence, despite the theoretical attractiveness of looking at PCAs in terms of their profitability as a whole, it has not been feasible to carry out such an assessment for the purposes of this market study.
- 2.40 Several of the banks we spoke to that attempted to measure account profitability did, however, suggest that accounts were profitable on a stand-alone basis.
- 2.41 Where it makes sense to do so, we have used revenue as a basis for comparison of accounts, for example to put the PCAs in context compared with other products. This approach seems to come closer than one based on profits to the way in which the banks review performance. For instance, targets for individual branches are typically based on the volume of products sold rather than the level of profit generated.

Vulnerable Consumers and Public Policy

- 2.42 A major objective of the Government's financial inclusion policy⁴¹ is for the vulnerable to have access to accounts. HM Treasury has set a goal that all consumers should be able to manage their money effectively and securely, by having access to a bank account, and the confidence and capability to get the most from it.⁴² The OFT's role is to ensure that markets work for the benefit of all consumers, including the vulnerable and disadvantaged.
- 2.43 From a public policy perspective, a PCA is seen as a gateway to financial inclusion for more vulnerable consumers. People who do not have a conventional account may find it harder to receive benefits or receive salary payments and will find it harder to access other financial services such as conventional loans. Therefore in relation to the market for PCAs, consumers may be vulnerable if their ability to find, open and make effective use of a PCA is impaired.

41 Further information on the Government's financial inclusion strategy can be found at Annexe F.

42 '*Financial Inclusion: the way forward*', HM Treasury, March 2007.

- 2.44 There is a large number of factors that can contribute to consumers facing vulnerability. Vulnerability is, however, multi-faceted both in its causes and its impact. It would be wrong to generalise that a particular group is vulnerable when it is quite likely that there will be pockets of people who are particularly vulnerable within that group while others that are not. Box 2.5 outlines factors that can contribute to vulnerability:

Box 2.5: Factors that can contribute to consumer vulnerability⁴³

- Age (either young or old) – for example, teenage householders may include a disproportionate number of students (who may have high debts), while the over-80s may include a disproportionate number of those with mobility problems or dementia⁴⁴
- Visual, hearing or mobility impairment – for example, the elderly or disabled can face difficulty in using telephone, internet or branch banking services
- Learning difficulties or confusion (dementia) – limited ability to understand product features or charging structures
- Restricted communication – no access to telephone or (increasingly) the internet means that consumers can be limited in their banking options
- Language – either being unable to speak, read or write English sufficiently well, or those who are comfortable with English but have difficulty understanding the literature used by banks. This is especially important when trying to open accounts or understand the account features available
- People living in rural or deprived areas – may have limited access to, and choice of, branch networks or banks. This problem can be exacerbated by branch closures
- People with difficulties demonstrating permanent residence – for example ex-prisoners or recent immigrants may face difficulty satisfying the identity criteria for opening an account, and
- Those who are financially constrained – including those with debts or who are unemployed, leaving them vulnerable to a sudden change in their financial circumstances.

- 2.45 In 1999⁴⁵ all main banks agreed to introduce a basic bank account ‘specifically designed to address the needs of the financially excluded’. In this report, the OFT is concerned with the proper functioning of the PCA market for vulnerable consumers. The consensus view reached from discussions with consumer groups was that being financially constrained⁴⁶ or having a limited ability to engage in the market⁴⁷ are the key triggers of vulnerability for consumers. As a result, we have focused our vulnerable consumer research on consumers who fall into these categories. This categorisation includes both basic bank accounts and standard accounts. Where evidence specifically relates to basic bank accounts, this has been highlighted.

43 Box 2.5 is not an exhaustive list but illustrative of the factors that can contribute to vulnerability. Some of the groups will also overlap and/or be inter-related.

44 ‘Overstretched: People at risk of financial difficulties’ – Elaine Kempson and Adele Atkinson, November 2006.

45 ‘Access to Financial Services’, Report of Policy Action Team 14, HM Treasury, November 1999, page 1 www.hm-treasury.gov.uk/media/F/E/pat14.pdf

46 That is consumers with low income and low savings.

47 That is consumers with low financial capability and those with communication difficulties or suffering disabilities. A further dimension of limited ability to engage in the market is restricted access for those living in a rural or deprived area which can disadvantage consumers due to a lack of access to Post Offices, PCA branches or ATMs.

Summary

- 2.46 PCAs are a major part of the financial landscape. Ninety per cent of adult consumers have at least one PCA, they generate over £8 billion ^A in revenue for the UK banking industry, and they play an important role for consumers in participating in the economy.
- 2.47 The core elements of an account are a deposit facility, including the right to withdraw the money deposited on demand and money transmission services. Many accounts also have overdrafts.
- 2.48 There are a variety of approaches to charging for PCAs but the dominant model in the UK is the so-called free-if-in-credit model. In this model banks earn revenues mainly by paying low rates of interest on credit balances and levying charges when the account goes into overdraft – particularly when the overdraft is unarranged.
- 2.49 Banks see accounts as the gateway to selling other products. Sometimes banks will not make products available unless the customer has a PCA with the bank. There is evidence that consumers often select additional financial products from a bank with whom they already have a relationship, without shopping around.
- 2.50 While a measure of profit levels can be a useful indicator of the level of competition, the OFT does not have the information that would enable it to assess accurately the contribution PCAs make to banks' overall profits. Instead, where it has been appropriate to do so, we have used revenue as a basis for comparison.
- 2.51 PCAs also act as a gateway to financial inclusion for more vulnerable consumers and the OFT is concerned with the proper functioning of the PCA market for vulnerable consumers.

3 SUPPLY OF PERSONAL CURRENT ACCOUNTS⁴⁸

Introduction

- 3.1 Given the importance of PCAs to consumers, banks and the wider economy, it is essential that there is a well functioning, competitive market, with active consumers and rivalry between firms that combine to deliver good value for money for consumers. When consumers do not shop around and exercise choice suppliers may have the opportunity to raise or maintain higher prices, or to offer a worse service than if consumers were more active.⁴⁹
- 3.2 This chapter considers the structure of the market for current accounts. This includes the ease with which new entrants can join the market, how easy it is for banks to expand, and how existing providers compete in terms of both price and quality. The main findings of the chapter are briefly outlined below:
- first, the PCA market appears to be relatively concentrated and characterised by two categories of competitor. Four 'established banks' which compete predominantly on quality rather than on all price dimensions, and several challengers who compete more strongly on most price as well as quality dimensions
 - secondly, the PCA market exhibits some barriers to entry and expansion. These barriers include low levels of consumer switching which increases the importance of establishing a wide branch network and the importance of an established brand name. Together these have constrained the ability of challenger banks to expand quickly; and low consumer switching in particular appears to have reduced incentives to compete
 - thirdly, while the barriers to entry appear to have constrained competitive pressures, they have not removed them entirely. For example, HBOS and Nationwide have managed to increase their market shares over the last few years by providing some better PCA interest rates and generating better consumer satisfaction than the established banks. Furthermore, there is evidence that many consumers are satisfied with their accounts, although this may also be evidence of disengaged consumers, and
 - finally, consumers appear not to pay attention to some of the key implicit and explicit payments for their accounts. Only five per cent of consumers consider charges important when choosing a PCA, while only seven per cent of consumers consider a 'competitive interest rate' important when choosing a PCA. The lack of visibility of these effective costs to consumers has reduced the incentive for the banks to compete on them, resulting in the free-if-in-credit model described in the previous chapter.
- 3.3 In summary while there is some evidence that challengers are slowly increasing their market share, there remain important and significant constraints on their ability to win consumers. We believe these constraints may limit the ability for greater competition within the PCA market to emerge.

48 The number of bank's data from which statistics are derived is indicated by the letter in superscript as follows. A: Data from 16 banks. B: Data from 7 banks. C: Data from 6 banks. D: Data is from 5 banks. A '+' indicates that the figure has been prorated up to 16 to ease comparison of figures across the report.

49 See, for example, Diamond (1971) 'A Model of Price Adjustment', Journal of Political Economy, No3, pages 156-168.

The market for current accounts

- 3.4 While it is not necessary to define a product market in a market study, to help set the scope we use the PCA definition adopted by the Competition Commission in its Northern Ireland report.⁵⁰
- 3.5 Four established banks have historically provided the majority of accounts in the UK. Following some mergers these are now Barclays, HSBC, Royal Bank of Scotland Group (RBS) and Lloyds TSB. They account for a combined share of 65 per cent of the market for current accounts. We refer to these four banks as 'the four established banks' and other PCA providers as 'challengers'. Table 3.1 shows the market shares of a number of banks.⁵¹ While there has been an increase in the number of account brands in recent years, individually they make up small market shares and many of the new brands now belong to existing groups. Some of these brands, such as Cahoot and First Direct, are based on a slightly different business model from the parent group and rely, for example, on telephone and internet banking.

Table 3.1: Market shares by number of customer, 2007⁵²

		Market share (%)
4 Established Banks	Lloyds TSB	19
	RBSG	17
	Barclays	15
	HSBC Group	14
Challengers	HBOS	14
	Abbey	6
	Nationwide	5
	Others	10
Total		100

Source: Current Accounts, Finance Intelligence, June 2007, Mintel

- 3.6 The remaining banks including HBOS, Nationwide and Abbey we describe as challenger banks. Criteria distinguishing these challenger banks from the established four include the number of accounts they have, the size of their branch networks and the interest rates paid on balances.

50 Four functions of a PCA were defined: (a) to provide a facility to deposit and store money, with quick and easy access; (b) to provide a facility to receive payments by cheque or electronic transfer; (c) to provide a facility to make instant and/or regular payments without using cash, eg through cheques, switch payments, bank transfers, standing orders and direct debits; and (d) to provide the means for short-term borrowing through an overdraft (pages 44-45). This definition includes packaged accounts but does not extend to basic bank accounts, instant savings accounts, credit union accounts, offset/current account mortgages or other personal financial products. For more details see 'Personal current account banking services in Northern Ireland market investigation', Competition Commission, May 2007, page 50.

51 There are a number of ways to measure market share including by number of PCAs, by number of active PCAs and by number of customer. Here we quote publicly available information collected by Mintel on the number of PCA customers.

52 These figures are in lieu of the data we collected from banks on number of active PCA.

- 3.7 Since the merger of Halifax and Bank of Scotland in 2001 HBOS has been able to move closer to the established banks accounting for a market share of 14 per cent by number of customers. Nevertheless HBOS remains comparable to other challengers in terms of the size of its branch network (which is two-thirds the size of the next largest bank), its current account credit interest rate and the distribution of rates paid on credit balances held at the bank⁵³.
- 3.8 There have been a number of significant mergers since the Cruickshank Report, most notably the Royal Bank of Scotland and NatWest (2000) to form RBS Group and Halifax and Bank of Scotland (2001) to form HBOS. In addition there has been a significant foreign entry by takeover (Banco Santander acquired Abbey National in 2004).

Table 3.2: Brands of major UK retail banking groups offering current accounts in UK, 2007

Banking Group	Branch based brands	Online/direct bank subsidiary
Abbey	Abbey	Cahoot
Alliance & Leicester	Alliance & Leicester	None
Barclays Group	Barclays Bank	None
HBOS	Bank of Scotland Halifax	Intelligent Finance
HSBC Bank Group	HSBC Bank	First Direct
Lloyds TSB Group	Lloyds TSB Bank	None
RBS Group	Royal Bank of Scotland Natwest, UlsterBank Coutts & Co Child & Co	The One Account
National Australia Bank Group (NAB)	Yorkshire Bank, Clydesdale Bank	None
Co-op Bank	Co-operative Bank	Smile Internet Bank
Nationwide Building Society	Nationwide Building Society	None

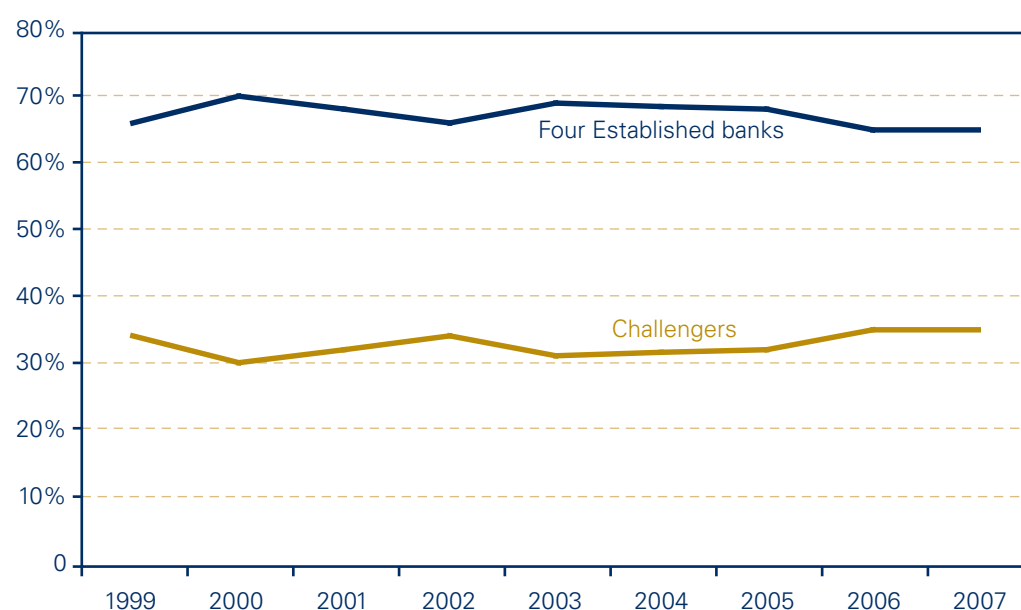
Source: OFT analysis

- 3.9 One key measure of whether new competitors have been able to enter the market and expand significantly is the change in market shares over time. As Chart 3.3 shows the established four banks continue to account for the majority of the market. The relative market shares of the established four and of the challenger banks were almost unchanged in 2007 compared with the position in 1999.
- 3.10 Some challengers (in particular HBOS and Nationwide) have managed to gain some market share. Nationwide, for instance, has increased its share of the market from three per cent to five per cent between 2000 and 2007. HBOS has grown from 11 per cent at the time of the merger

⁵³ See Annexe C.

in 2001 to 14 per cent in 2007. It seems that there may have been an increase in the relative market share of challengers over the last few years, suggesting they are able to gain market share, but it has been a slow process and it is too early to say whether this is an ongoing trend.

Chart 3.3: Challenger and four established bank market share by number of account customers, 1999 – 2007



Source: 'Current Accounts', Finance Intelligence, June 2007, Mintel. Gaps in data for 2001 and 2004 were filled by mid point estimates

- 3.11 The slow progress of challengers is particularly pertinent when seen against the background of the relatively attractive credit and overdraft interest rates offered by many challengers (see below). This suggests that consumers have been slow to respond to take advantage of the better deals offered on both credit and debit interest rates. Indeed, net new accounts represent only four to five per cent of the market.⁵⁴ So even though challenger banks account for a significant share of accounts opened⁵⁵, it may take a very long time for them to win a substantial share of the total market.
- 3.12 The commonly used HHI⁵⁶ measure of concentration indicates that the market can be defined as 'moderately' or 'relatively' concentrated with an HHI of 1410^A. For the reasons discussed above regarding the market shares of the challengers and established four banks, this is about the same as in 1998⁵⁷ and hides underlying changes, in particular the strengthening of HBOS' position.

54 As measured by either net new accounts (opened minus closed PCAs) in 2006 (15 banks), or the average increase in the total number of accounts from 2000 to 2006 (15 Banks). Mintel data shows similar findings – 'Current Accounts', Finance Intelligence, June 2007, Mintel.

55 Challengers accounted for 53^A per cent of net new current accounts in 2006 compared with an overall market share of 35 per cent.

56 The Herfindahl-Hirschman Index, which ranges from 10,000 for a monopoly to just above zero for perfect competition.

57 The Cruickshank report, paragraph 4.14, page 106.

New entry and expansion

- 3.13 This inertia in the structure of a market may have implications for the levels of competition and therefore on the choice between different prices and quality of accounts on offer to consumers. In a fully competitive market, the behaviour of the existing suppliers, in this case banks, is constrained not only by actual competitors but also by the threat of new entrants. This means that existing banks may be deterred from increasing product prices by the threat of new banks entering the market and undercutting them. The same mechanism can also help ensure competition in relation to product quality. If an existing bank were to cut the quality of its products in order to reduce its costs then, all else remaining equal, new entrants would be expected to enter the market with a higher quality offering and to win customers.
- 3.14 Barriers to entry⁵⁸ can therefore hinder competition if new competitors cannot enter to challenge existing suppliers by offering innovative or cheaper products. However the ability of a company to expand is equally important in terms of competition. Therefore even if a new firm is able to enter a market (because there are low barriers to entry) it may not be able to exert any competitive pressure on the incumbents if it cannot expand. Assuming that new entrants will need to build a base of customers to fund expansion, then the reluctance of customers to switch supplier would seriously hinder a new entrant's ability to expand and hence to compete.
- 3.15 Drawing on our meetings with banks and existing reports⁵⁹ on the current account market, we have identified six potential barriers to entry and expansion:
- establishing a branch network
 - acquiring new customers
 - access to payment networks (including debit card schemes) and access to appropriate infrastructure to process transactions
 - obtaining a banking licence from the Financial Services Authority (FSA) and meeting other regulatory requirements
 - developing a successful brand, and finally
 - access to information regarding the credit risk posed by potential customers (required if overdrafts are to be offered).
- 3.16 While obtaining a banking licence is the prerequisite for entering this market, it is the combination of the first two factors, establishing a branch network and attracting customers, along with the need for a successful brand, that should be seen as the most important potential barriers to significant entry by new players.

Establishing a branch network

- 3.17 The number of branches varies widely between the top 10 banks. As table 3.4 shows, the largest bank, RBS Group, operates a network 24 times the size of the smallest bank in this

58 A classical definition of barriers to entry is 'the extent to which, in the long run, established firms can elevate their selling prices above the minimal average costs of production and distribution (those costs associated with operation at optimal scales) without inducing potential entrants to enter the market' Bain, J, 1956, *Barriers to New Competition: Their Character and Consequences in Manufacturing Industries*. See also OFT Guideline on Competition 'Assessment of market power' at www.of.gov.uk/shared_of/business_leaflets/ca98_guidelines/oft415.pdf

59 Including the Competition Commission's Report on PCAs in Northern Ireland and the Cruickshank Report.

sample (The Co-operative Bank). The banks with higher market shares have, broadly speaking, larger branch networks than those with smaller market share (for example the top four banks account for over 70 per cent of branches). On average, banks have 4,900 accounts per branch (4,700 for the established four banks and 5,300 for the challengers).

Table 3.4: Number of branches for significant banks

Bank	UK branches
RBSG	2387
Barclays	2014
Lloyds TSB	1844
HSBC	1492
HBOS	1002
Abbey	712
Nationwide	748
NABG	344
Alliance & Leicester	254
The Co-operative Bank	93

Source: Number of bank branches is taken from Table 5.02 BBA Annual Abstract Statistics 2007, which is based on data from BBA, FSA and individual banks. Nationwide provided its data separately

- 3.18 Branch access remains a vital part of the banking relationship for all but a small subset of consumers, despite the growth in services provided by ATMs, over the telephone and on the internet. The branch network does not necessarily need to be national to be attractive but some banks said that it was sometimes necessary to have a 'critical mass' within the local area of the consumer (for example, a presence near home and work).
- 3.19 The introduction and development of online and telephone banking has raised, to some extent, the possibility of replacing the role of branches. However, most banks without their own branch network have still offered customers the possibility of carrying out some over-the-counter transactions using a branch. For example, Cahoot customers can use the Post Office network, First Direct customers can use its parent's (HSBC) branches and Smile customers can use both the Post Office and its parent's (Co-operative Bank) branches.
- 3.20 Banks told us that the internet has not had as significant an impact on account banking as might have been expected. Telephone and internet banking has complemented traditional branch-based banking instead of replacing it. This is in line with the findings of the Competition Commission report into current accounts in Northern Ireland.
- 3.21 According to our survey, the vast majority of consumers, 92 per cent, still use in-branch banking at least once a year compared with 51 per cent for internet banking and 49 per cent for telephone banking (see Chart 3.6). As the banks had suggested, many customers (42 per cent of respondents to our survey) use more than one banking channel at least once a month and only 27 per cent of regular users of internet banking are not regular users of in-branch or telephone banking.

- 3.22 There are two main sets of reasons for the enduring importance of the branch despite the potential of internet banks:
- consumers like to be able to visit a branch. Our consumer survey revealed that slightly more than half of people who had opened an account in the previous year had found speaking to someone at a branch to be an important source of information.⁶⁰ In addition, across all respondents to the survey, branch location was considered to have been the most important factor when choosing with which bank they should open their main account. These findings are supported by the Competition Commission investigation in Northern Ireland, which showed that consumers believed access to a branch network was important for resolving any problems that might arise and that they attached considerable weight to whether a bank had a branch near them when choosing a bank, and
 - branch networks can raise brand awareness – banks value having a branch network in key catchment areas because it helps them to attract new customers. In Northern Ireland, the Competition Commission also found that a bank would need a branch network (along with marketing) to establish credibility as a current account provider.
- 3.23 Banks have also highlighted the importance of branches in marketing other products to customers. A Mintel report states that sales staff are incentivised to encourage customers to sign up to new accounts when they are using banks for normal day-to-day transactions.⁶¹ A branch network may also, therefore, facilitate cross-selling to achieve economies of scope.
- 3.24 A relatively new entrant, Handelsbanken, puts a particular emphasis on the role of branches in furthering its business model and considers that ‘the branch is the bank’ (see Box 3.5).

Box 3.5: The foreign entrant’s perspective

Handelsbanken

Handelsbanken (the largest retail bank in Sweden) opened its first UK branch in 1984. It now has over 40 branches. Its main strategy has been to open branches in key metropolitan areas and to build a presence at local level (as opposed to trying to market the brand nationally). It appears to attract customers mainly through word of mouth recommendations, for example by tapping into local professional communities (such as lawyers), which overcomes trust issues many people may have about switching to a new bank.

Citibank

Citibank is one of the world’s largest banks. It has a small presence in the UK retail banking market where its first branch opened in 1995.

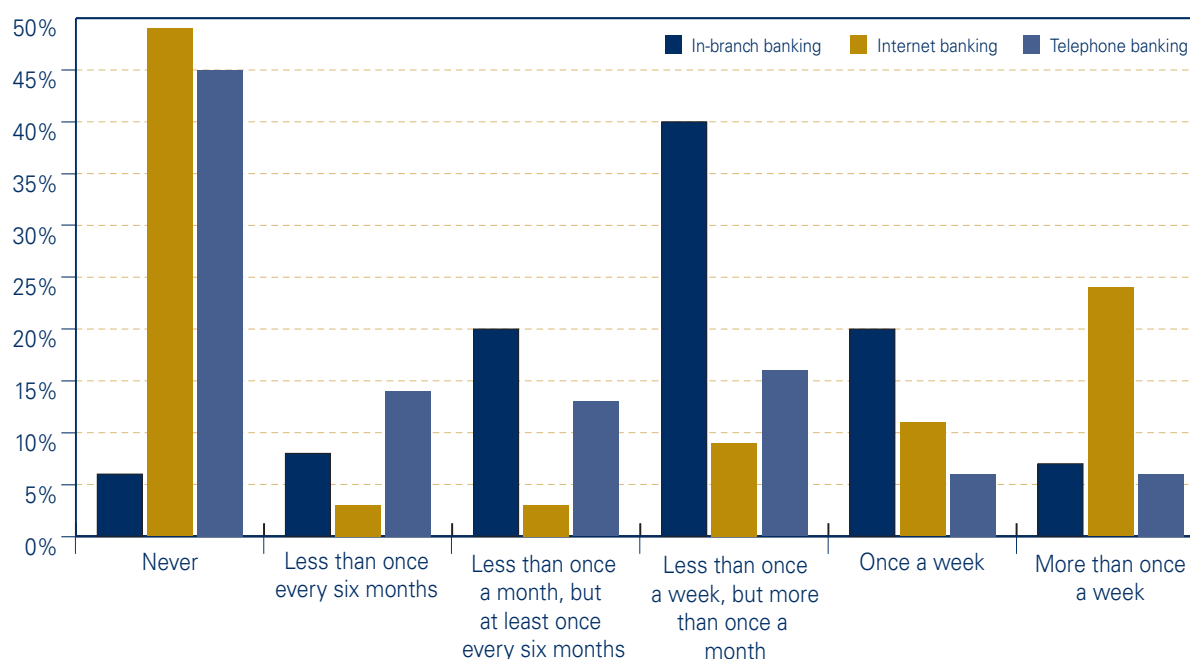
Citibank confirmed that the two main obstacles to the growth of its UK operations are its lack of a large branch network and the low levels of consumer switching. Branch networks are important because they provide a contact point which customers value highly. The low levels of switching were due to a lack of consumer awareness of the account offers available in the market and the perceived and real costs of switching bank.

60 This figure is higher for people from socio-economic groups D and E.

61 ‘Current Accounts’, Finance Intelligence, June 2007, Mintel, page 29.

3.25 The costs associated with establishing a branch network are substantial and at least some of these are 'sunk' costs which will not be recovered if the bank pulls out of the market. Even if new entrants focus on more densely populated areas (as in the Handelsbanken example described above) low levels of customers switching away from established banks would make it hard to recoup initial investment.

Chart 3.6: Frequency with which consumers use different channels to access their PCA



Source: Ipsos/MORI Consumer Survey carried out for the OFT

Acquiring new customers

3.26 A significant feature of the current account market is the low level of customer switching. While switching is not necessarily an end in itself the relatively low number of account users who change bank may be significant. As Chart 3.7 below shows, switching between banks is much lower than the figures seen for the public utilities and other financial services such as home insurance. Results from our survey indicate that around six per cent of account customers had switched in the previous year (this is similar to the National Consumer Council's figure of six to seven per cent in 2006⁶² but higher than the 3.5 per cent found in a 2007 survey by Bacs⁶³ and the three per cent found by Mintel⁶⁴). The Competition Commission found annual switching rates of between two and eight per cent in Northern Ireland.

62 'Switched on to switching: A survey of consumer behaviour and attitudes, 2000-2005', National Consumer Council, November 2005.

63 'Review of Account Switching Process Final Report', Bacs April 2008.

64 'Current Accounts', Finance Intelligence, June 2007, Mintel.

- 3.27 Our survey showed that 13 per cent of people have switched at least once within the previous five years. This proportion is mirrored by others' findings – 15 per cent in a study by the Department of Trade and Industry (now BERR),⁶⁵ while the Competition Commission⁶⁶ found it was 11 per cent in Northern Ireland. Our consumer survey showed this is not just a recent phenomenon, 64 per cent of respondents had never switched⁶⁷ and 74 per cent of non-switchers said they had never even considered switching: this is 47 per cent of all consumers.
- 3.28 Further data from our survey, shown in Table 3.7, demonstrates that even where consumers do switch, the majority of them have done it only once. Chart 3.8 and Table 3.9 show that switching rates are much lower for current accounts than for several other markets⁶⁸.
- 3.29 This low switching means customers use the same account for long periods. In our survey 61 per cent of consumers had held their main account for more than 10 years. This finding is similar to those in the Cruickshank report, where nearly two thirds of people surveyed had held the same current account for over 10 years, and in the Competition Commission's Northern Ireland banking study where average account duration was 11.5 years.

Table 3.7: The number of times consumers had switched the provider of their main current account

Number of times	Percentage (Base = 2,074)
Never	64
Once	24
Twice	7
Three times or more	5

Source: Ipsos/MORI Consumer Survey carried out for the OFT

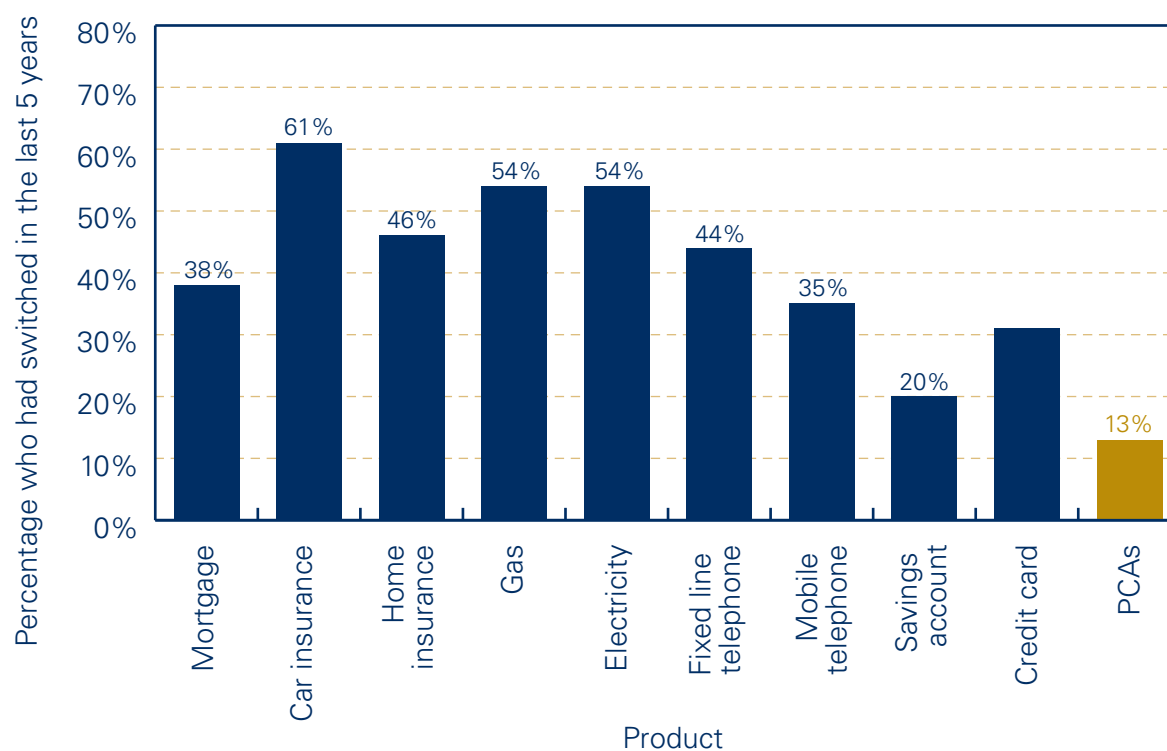
65 *'Switching Suppliers'*. A research study commissioned by the Consumer Affairs Directorate, Department of Trade and Industry, November 2000.

66 *'Personal current account banking services in Northern Ireland market investigation'*, Competition Commission, May 2007, paragraph 3.16.

67 We define 'switching' to include consumers who have switched provider for their primary PCA requirements, even if they have kept their old account open. In our survey over half (53 per cent) of recent switchers said they kept their old account open. Among all switchers, one in five (21 per cent) had opened their main PCA in addition to an existing one.

68 For some of these products this difference may in part be because of the lack of a trigger point to consider switching PCA. For example, unlike house and car insurance, there is no annual renewal with a PCA. However, this is clearly only part of the reason. As shown in Table 3.8, other financial products such as savings accounts and credit cards which also lack such trigger points have significantly higher switching rates than PCAs.

Chart 3.8: The proportion of people with various products who had switched provider in the last five years



Source: Source: Ipsos/MORI Consumer Survey carried out for the OFT, base 2,074

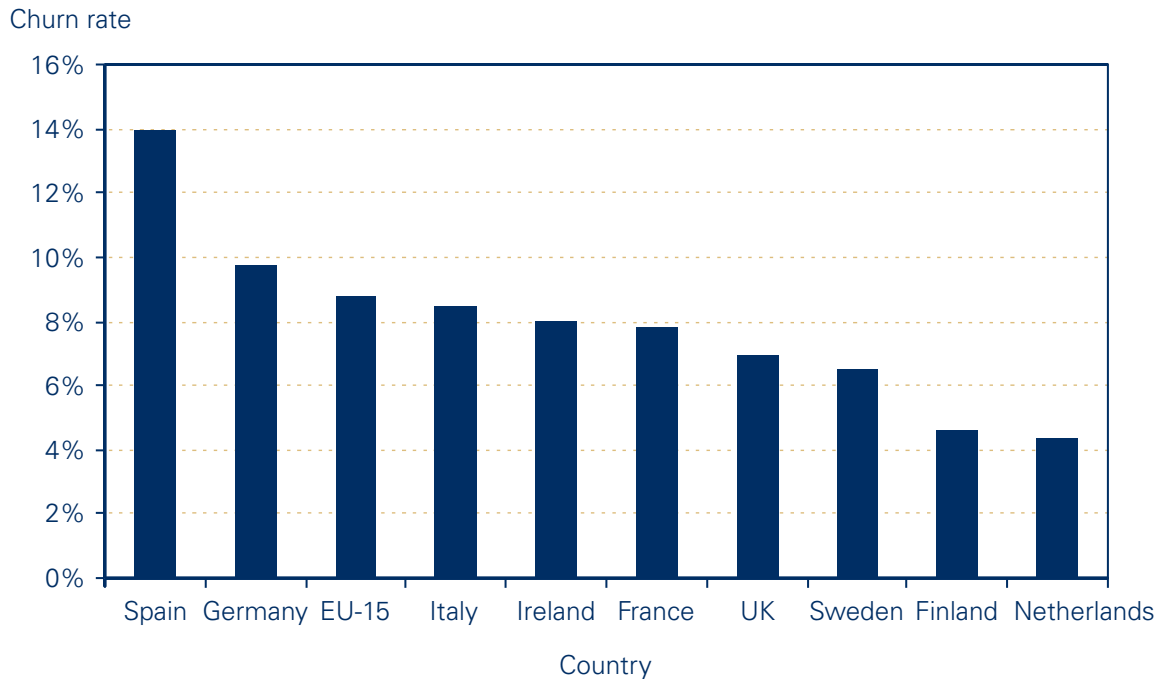
Table 3.9: Percentage of people with various products who had switched provider in the last year

	National Consumer Council – 2005	Department of Trade and Industry ⁶⁹ – 2000
Mortgage	31	12
Car insurance	–	53
Home insurance	28	30
Gas	44	37
Electricity	47	26
Fixed line telephone	20	11
Mobile telephone	17	–
Bank accounts	7	6
OFT survey, 2007		6

69 Now the Department for Business Enterprise and Regulatory Reform (BERR).

3.30 Chart 3.10 shows churn rates⁷⁰ for some EU countries and indicates that the UK rate is below average.

Chart 3.10: Comparison of current account churn rates across various EU states in 2005



Source: European Commission, 2007

- 3.31 The incentives to switch for a consumer who has an account may be rather low if the perceived benefits of switching are less than the perceived risks and the costs. Some banks are trying to overcome this by offering better deals and additional inducements to switch (for example, £100 to every new account customer or introductory interest rates on credit balance and overdrafts).
- 3.32 Given the relatively slow growth of the market, at around four to five per cent since 2000,⁷¹ and the low levels of switching, it seems difficult for new entrants to build a significant customer base quickly. In light of this consumer inertia the costs associated with acquiring customers on a significant scale are likely to represent substantial barriers to expansion and disincentives to new entry.

70 'Churn' rate: based on bank data, source: European Commission, 2007. Churn rate calculation: $(\text{new current accounts} + \text{closed current accounts}) / (2 \times \text{number of current accounts at the beginning of the year})$. The churn rate includes accounts opened by first-time account holders as well as switchers. It is a weighted average, data is for 2005.

71 See paragraph 3.11.

Access to payment networks (including debit card schemes) and access to appropriate infrastructure to process transactions

- 3.33 Banks have to be able to access payment systems in order to provide retail banking services. The Cruickshank Report expressed concerns that access to payment systems was limited to large financial organisations, and that other bodies could get access to systems through them only. Cruickshank found that this put non-members at a commercial disadvantage. He concluded that although there were legitimate reasons for restricting access to payment systems the arrangements at the time involved unnecessary restrictions.
- 3.34 Following the report, and further study by the OFT, the Payment Systems Task Force⁷² was set up to take the work forward. One of the Working Groups set up by the Task Force considered the issues related to access to Bacs, the clearing house responsible for bulk clearing of electronic payments between bank accounts in the UK, run by Bacs Payment Schemes Limited (BPSL). The Working Group considered ways of broadening membership but in view of limited interest from users (including government departments), it recommended changes to the governance structure of BPSL to improve the situation.
- 3.35 When asked about barriers to entry, only one bank expressed concern about the difficulty of processing payments and becoming part of the payment network. In contrast a relatively recent entrant to the UK stated it was quite straightforward to join the payment network by using a clearing bank as an intermediary (agency bank agreement). Although this may result in additional costs, it may also reduce the risk of entry by lowering fixed cost investment. We have not seen evidence that this significantly impedes competition.
- 3.36 In addition to access to payment networks, the provision of accounts requires complex IT systems to handle a large volume of transactions in a secure and reliable manner. There is a high initial investment in IT infrastructure along with the need to keep current systems up to date with a skilled team to operate them.
- 3.37 Most banks have centralised at least some of their 'back office' functions outside branches, which are increasingly being used to secure sales rather than process transactions. This trend has involved setting up call centres and support offices. Although this may be an expensive aspect of entering the account market (and it may favour large banks that can exploit economies of scale) it is unlikely to constitute a barrier to entry or expansion because back office functions, for example, may be contracted out.
- 3.38 We have concluded that the difficulties associated with accessing payment networks and accessing appropriate infrastructure to process transactions can be overcome, especially if the new entrant already provides similar services in other markets.

Obtaining a banking licence from the FSA and meeting other regulatory requirements

- 3.39 In the UK banks and building societies need regulatory authorisation from the FSA before they can accept deposits.⁷³ They must comply with FSA rules and obligations under the Financial Services and Markets Act 2000 and are subject to prudential supervision by the FSA.

72 This comprised representatives from the banking industry, retail, consumer and business sectors, as well as the Bank of England and Treasury acting as Observers. It was chaired by the OFT.

73 The FSA deals only with applications for permission to carry out a regulated financial services activity. The FSA does not issue consumer credit licences or any other type of permission that the Bank may require prior to starting business.

- 3.40 The FSA assesses applications against five threshold conditions.⁷⁴ The type and level of information required will depend on the nature of the application⁷⁵ whether the applicant is already authorised in another country and, if so, the home country's authorisation process. Banks already authorised within the European Union do not need to seek additional authorisation within the UK. For non-EU banks, the extent to which additional measures need to be taken will depend on the nature of the authorisation procedure in the bank's domestic regulatory regime.
- 3.41 For entirely new entrants to the retail banking sector, the FSA sets a higher than average minimum capital ratio, said to reflect the higher risks for new entrants. The impact of this requirement has been considered in the past by both the Cruickshank Report and the Competition Commission (in relation to SME banking). The Cruickshank Report concluded that additional capital ratio regulatory barriers were a significant barrier to entry whereas the Competition Commission found that, in practice, existing banks held ratios significantly above the minimum required ratios, suggesting that the ratios were unlikely to be binding. It concluded that regulatory barriers were not significant.
- 3.42 Potential entrants to the account market, such as supermarkets, confirmed that, in their current view, the regulatory burden related to providing accounts did not constitute a barrier.
- 3.43 Existing evidence therefore suggests that, although obtaining regulatory authorisation may be time-consuming for a new entrant,⁷⁶ it does not represent a major barrier to entry.

Developing a successful brand

- 3.44 In many markets it can be challenging for a new entrant to compete against established brands. Brand matters in the current account market, as customers need to know that their money is in safe hands and that transactions will be processed accurately and in a timely manner.
- 3.45 The vast majority of account consumers (83 per cent) said that they were reluctant to leave an existing bank they trust for one they didn't know. This could mean that the majority of consumers would need a significant inducement to switch banks.

74 These conditions are:

- (i) legal status (whether the firm concerned is an individual, a body corporate, a partnership or an unincorporated association);
- (ii) location of offices (where the firm's head office is located i.e. the location of its central management and control);
- (iii) close links (whether any links firm A has with firm B would prevent the FSA from effectively supervising firm A);
- (iv) adequate resources (whether the firm's resources i.e. capital, provisions against liabilities, holdings of or access to cash and other liquid assets, and human resources, are adequate in relation to the regulated activities that it seeks to carry on, or carries on); and
- (v) suitability (whether the firm conducts its business soundly and prudently and in compliance with proper standards).

75 The information required for regulatory authorisation varies between different classes of credit institutions.

76 The FSA is required by statute to decide any application for authorisation within 6 months from the date it receives a completed application, and the earlier of 12 months from the date it receives an incomplete application or six months from the date an incomplete application becomes complete, whichever is the sooner. Each firm is individual, however, and the time taken depends on factors such as the quality of the application, how complete it is on submission, whether the FSA knows the group and the workload of the relevant specialists at the time the application is made.

- 3.46 A BERR survey on consumer switching⁷⁷ found that two important factors were familiarity and trust. This was particularly the case for banking products. Similarly, a National Consumer Council study⁷⁸ found that 75 per cent of consumers thought that it made sense to use an established, familiar company rather than a new company even if it was offering a better deal.

Access to information regarding the credit risk posed by potential customers

- 3.47 Banks need information, both financial and non-financial, on their potential customers' history to be in a position to choose whether to offer them an account and whether to grant them an overdraft. There are common incentives for banks to collaborate and to share information on customers. One bank said that all banks (with one exception) shared positive credit scoring information. This should make the process of account switching easier. The most recent Independent Review of The Banking Code has suggested that sharing of positive information should become the norm.⁷⁹
- 3.48 In individual circumstances, however, both new entrants and established suppliers will rely on obtaining credit scorings from firms such as Experian and Equifax. As the Competition Commission report on Northern Ireland also concluded, we found no evidence suggesting this to be a particularly complex or expensive process.

Conclusions on barriers to entry and expansion

- 3.49 Although some building societies offer accounts, since 2000 there have been no new entrants that have gained significant market share.⁸⁰
- 3.50 It may be significant that although some supermarkets have entered the financial arena, none currently provides a current account. We asked those supermarkets that had recently started offering retail banking products whether they had considered offering current accounts as well. We were told the set-up and running costs were substantial and that they would need a banking licence. They would also need to hire qualified banking experts and be prepared to endure major financial losses as the new account base was being built up.
- 3.51 The Cruickshank Report found that new entrants had made little impact on retail banking services including current accounts. More recently, the Competition Commission found that it was difficult for new entrants to build market share quickly in the provision of accounts in Northern Ireland. This was primarily due to low consumer switching but also due to the need to have a branch network to achieve high levels of sales.
- 3.52 Barriers to entry and expansion clearly have an impact on the level of competition in a market. While there are some barriers to entry there are also a large number of competitors in the market. However, new entrants and small banks may find it difficult to compete effectively given the barriers to expansion. The main barriers to expansion are consumer inertia, the importance of establishing a branch network and the importance of establishing a brand name. Independently these barriers may not be significant but in combination they present a considerable constraint on the ability of banks to expand and hence compete effectively.

77 'Switching Suppliers': A research study commissioned by the Consumer Affairs Directorate, Department of Trade and Industry, November 2000.

78 'Switched on to switching: A survey of consumer behaviour and attitudes, 2000-2005', National Consumer Council, November 2005.

79 Independent Review of the Banking Code, 2007.

80 Although we acknowledge the change in ownership of Abbey in 2004.

Competition to provide accounts

3.53 Competition to provide accounts, as with most products, tends to take place along two main dimensions: price and quality of service.

Price competition

3.54 Banks have a range of ways to raise revenue from current accounts. The main categories are:

- transaction charges for core money transmission services
- credit interest rate⁸¹
- arranged overdraft interest rate
- unarranged overdraft interest rate
- insufficient funds charges
- monthly fees, and finally
- ancillary charges.⁸²

Core transaction charges

3.55 Under the free-if-in-credit model banks do not charge for core, day-to-day money transmission services. As a result transaction charges form a minimal proportion of total revenues. Instead banks cover their costs for this service through net interest income on credit and debit balances and levying charges for insufficient funds and other items. In effect these other aspects of an account appear to subsidise the core money transmission services.

3.56 In countries such as Germany and Italy, transaction charges are relatively important sources of revenue (see Box 3.17 on international comparison below). Recent attempts to introduce charges for ATM use proved unpopular with consumers and the charges were withdrawn in the UK.

Credit interest rates

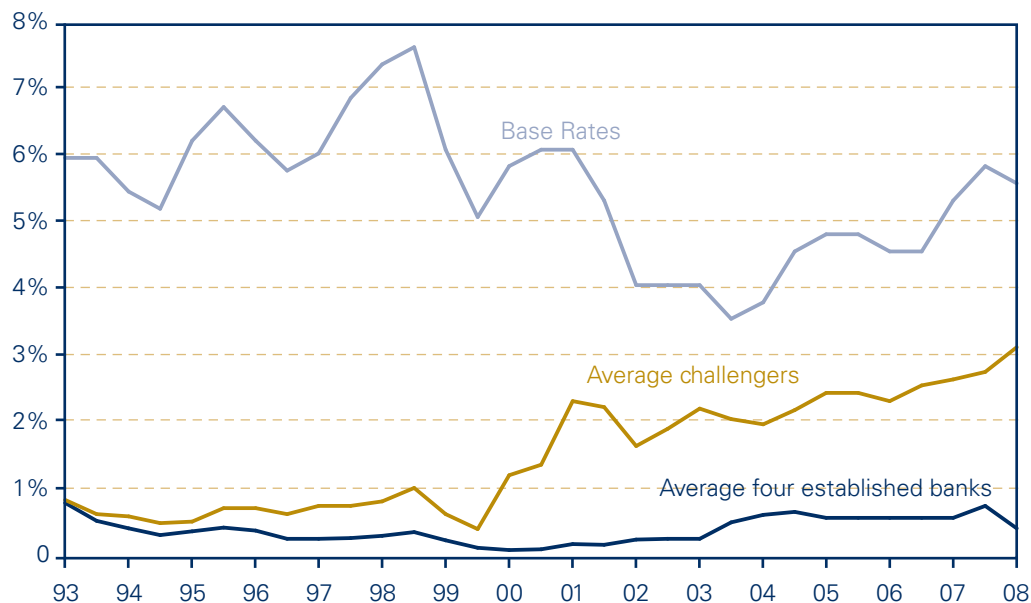
3.57 Most accounts pay consumers interest on credit balances and banks earn interest by using the balances for other business. The difference between these two elements is net credit interest income. In 2006 banks earned £4.1^A billion in net credit interest income.⁸³ It contributes up to 50^A per cent of all revenues from accounts, making it the single largest contributor.

3.58 Interest rates paid on credit balances do not appear to be very responsive to changes in the level of Bank of England base rates. We compared 15 years of price data from Moneyfacts with changes in the base rates (see Chart 3.11). Since banks typically offer more than one type of account, we took at least two products from each bank and calculated averages for the four established banks and the challengers. Banks do generally increase their debit rates if a rise in the base rate level occurs but this does not usually happen with credit rates.

81 As this impacts on net interest income.

82 This aspect is considered in more detail in Annexe C.

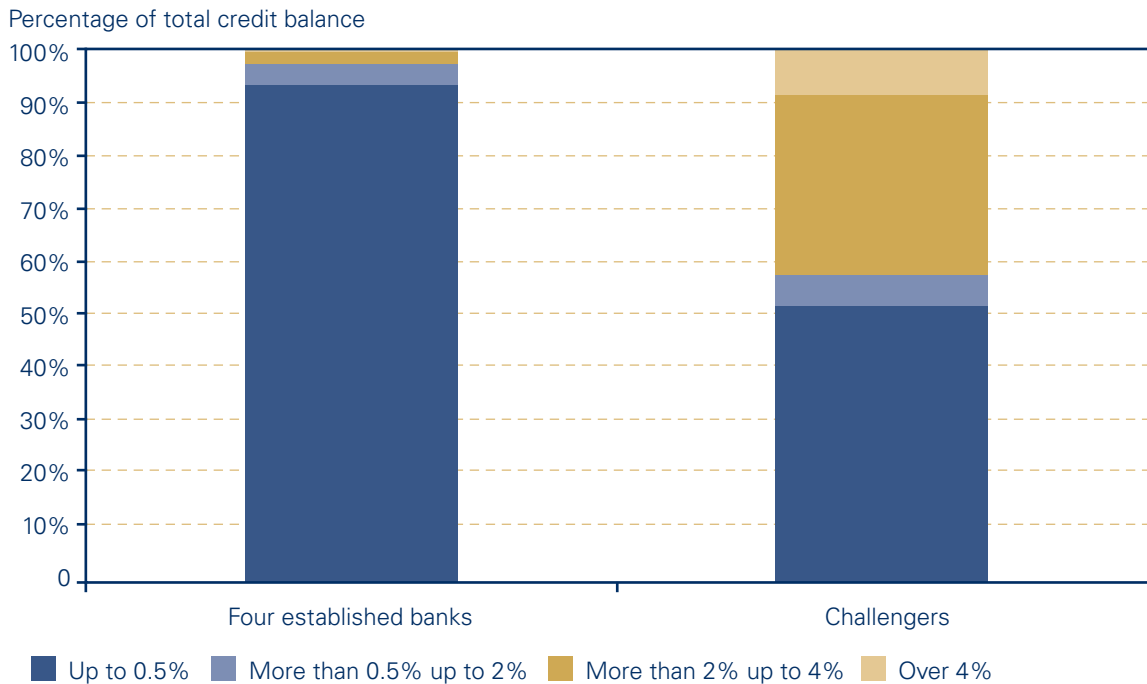
83 The number of bank's data from which statistics are derived is indicated by the letter in superscript as follows. A: Data from 16 banks. B: Data from 7 banks. C: Data from 6 banks. D: Data is from 5 banks. A '+' indicates that the figure has been prorated up to 16 to ease comparison of figures across the report. Data is for 2006.

Chart 3.11: Credit interest rates, January 1993 – January 2008

Source: OFT analysis of Moneyfacts data

- 3.59 More significantly, there has been a marked and widening difference in recent years between the credit rates offered by the four established banks and those offered by the challengers, as Chart 3.11 shows. Until 2000 banks tended to pay less than one per cent interest on money deposited on accounts. In early 2000, however, some challengers introduced higher credit interest rates (for instance Smile offered 4.25 per cent in 2000 and Cahoot 4.9 per cent in 2001). More recently, some of the four established banks have begun to offer new accounts with higher credit interest rates. However, according to our data most consumers received relatively low levels of interest on their credit balance despite higher rates being available.
- 3.60 Despite competition from the challengers, the vast majority of accounts still pay less than 0.5 per cent interest on credit balances. There is a clear difference between the four established banks and the challengers. More than 93^b per cent of all the credit held in accounts provided by the four established banks received a credit rate of 0.5 per cent or less in 2006. The equivalent figure is 52^b per cent for challengers (Chart 3.12).

Chart 3.12: Distribution of credit interest paid across credit balances held with the four established banks and challengers, 2006



Source: response to OFT questionnaire by banks ⁹

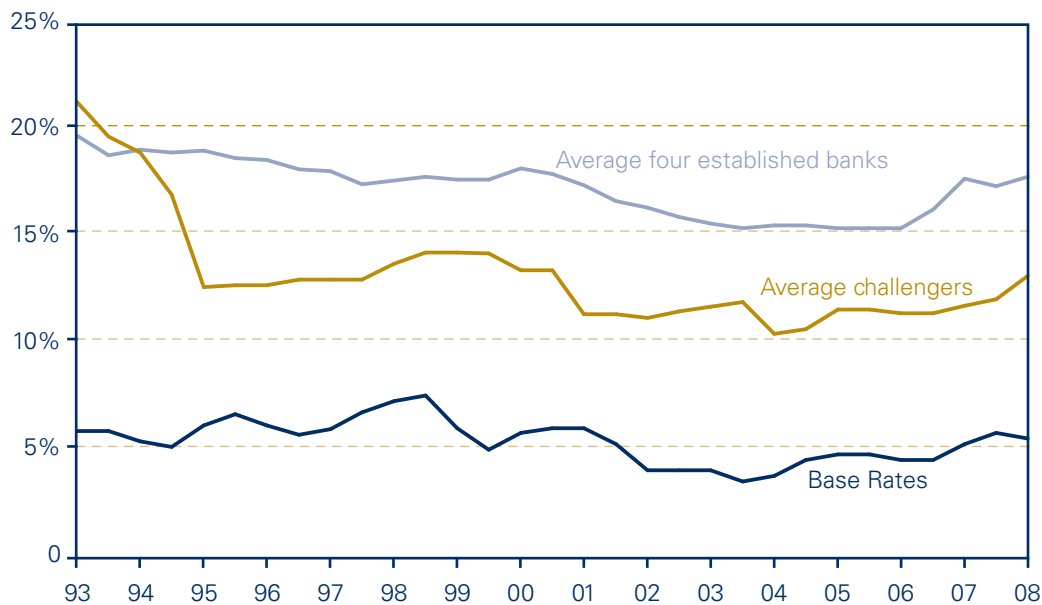
3.61 The consumer survey found that some consumers consider the credit interest rate when opening or switching accounts but this is not as important as other factors such as branch location and recommendations (see chapters four and five).

3.62 While there are signs that some of the four established banks are offering higher interest rates on some accounts, as yet few customers receive higher rates. Overall it appears that the four established banks and challengers have offered distinct pricing approaches to credit interest rates that have shown few signs of being reduced by consumer switching between the two groups.

Arranged overdraft rate

3.63 Consumers who are offered and choose to make use of arranged overdrafts are typically charged interest for doing so. Banks earn money from the difference between the interest they charge and their cost of the funds lent, an element of which may include provision for bad debt. The average daily arranged overdraft balance for the 16 banks was around £8.4 ^A billion in 2006. Net interest income from arranged overdraft balances was £450 ^A million in 2006, five per cent of total account revenue.

3.64 Chart 3.13 shows the trend of arranged overdraft rates over time and also reports the base rate. The chart was compiled using historic data on prices published by Moneyfacts and was put together using the same approach adopted for credit interest rates.

Chart 3.13: Arranged overdraft rates, January 1993 – January 2008

Source: OFT analysis of Moneyfacts data

- 3.65 As with credit rates, challenger banks have tended to offer better overdraft rates than the four established banks (see chart above).⁸⁴ We heard that some (but not all) challengers see this as a potential route for attracting and retaining customers. For example, at least one challenger offers an account with a low overdraft rate aimed at those customers who make use of their overdraft often (the same product does, however, offer a very low credit interest rate).
- 3.66 As Box 3.14 illustrates, there is some evidence challengers have competed more vigorously on overdraft interest rates than the four established banks.

⁸⁴ Aspects such as interest free overdraft on the first £100 overdrawn, for example, are also important but we saw no evidence that the established four banks offer more favourable terms regarding this in general.

Box 3.14: Four established banks slow to respond on arranged overdraft rates

In the first half of 1994 a number of challengers began reducing their arranged overdraft rates from around 20 per cent to as low as 10 per cent, although some rates were increased moderately a few years later. There was no significant price response from the four established banks to the price falls although HSBC's arranged rates declined by a few percentage points. The chart below illustrates a number of challengers and the four established banks' average arranged overdraft rates.

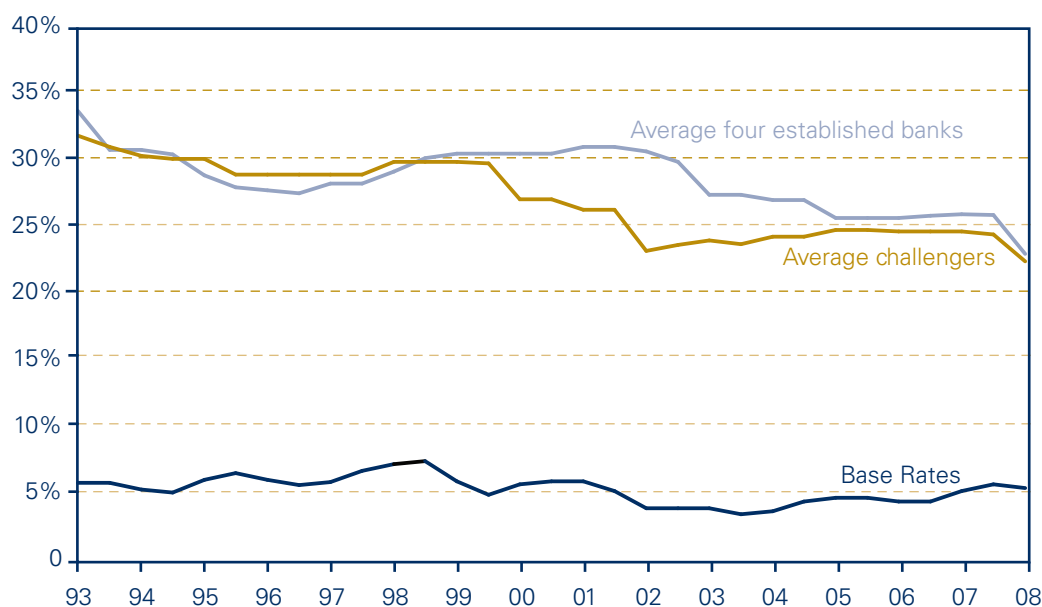
Selected arranged overdraft rates, 1993 – 1996



Source: OFT analysis of Moneyfacts data

Unarranged overdraft rate

- 3.67 Consumers who exceed their agreed borrowing limit are said to have an unarranged overdraft. This may involve charges and higher interest rates. In particular use of an unarranged overdraft is associated with additional charges for paid items and sometimes there is an additional overdraft excess or maintenance charge. When a transaction is rejected due to insufficient funds an 'unpaid item' charge may apply. We refer to all these charges as insufficient funds charges. The daily average unarranged overdraft balances over the year for 16 banks was around £680^A million in 2006. Net interest income from unarranged overdraft balances in 2006 was £79^A million or one per cent of total account revenue.
- 3.68 Chart 3.15 shows the trend of unarranged overdraft rates for the four established banks and the challengers, and also reports the base rate. The chart was compiled using historic data on prices published by Moneyfacts and was put together using the same approach adopted for credit interest rates. It also shows that there is little difference in the unarranged overdraft interest rates offered by the two sets of banks up to 2000 when challengers introduced more advantageous rates. This gap has subsequently narrowed.

Chart 3.15: Unarranged overdraft interest rate, January 1993 – January 2008

Source: OFT analysis of Moneyfacts data

- 3.69 In comparison with arranged overdraft and credit interest rates, unarranged overdraft interest rates do not seem to have been emphasised by banks until recently. Our review of information offered by banks (see Annexe B) showed that it was not necessarily easy to find the unarranged overdraft interest rate in the information for many banks in our first review in 2007. However, this seems to have improved since our work on current accounts began and now the rate, at least, is not difficult to find according to our second review of information in 2008.
- 3.70 Information supplied by banks shows that unarranged overdraft rates are not a feature consumers consider when opening an account. In this sense, this is one area where there has been little competition between banks.

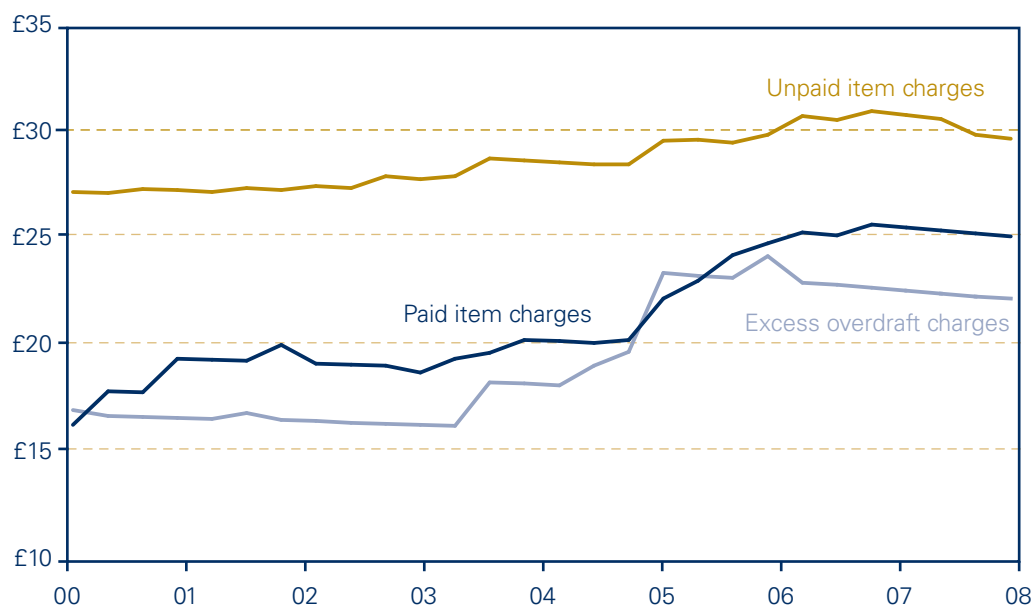
Insufficient funds charges

- 3.71 Insufficient funds charges are a significant source of revenue for banks: in 2006 the total revenue from insufficient funds charges accruing to the banks contacted during the market study was £2.6 billion ^A, or 31 ^A per cent of total current account revenue.
- 3.72 Although banks apply charges in different ways the unit price for charges, where applied, is similar across suppliers.⁸⁵ Overall the level of individual charges has gone up considerably in the last seven years whether adjusted for inflation or not. This is particularly the case for paid item fees, which increased from an average of £16 to £28, a nominal increase of 75 per cent over the period.

85 See Annexe C.

3.73 Chart 3.16, compiled using data from responses to the OFT questionnaire, shows the trend of the three main charges from July 2000 to July 2007 for the seven largest banks, adjusted for inflation.

Chart 3.16: Trends in inflation adjusted insufficient funds charges, July 2000 – July 2007



Source: OFT analysis of responses to OFT questionnaire by seven main account providers and ONS data. Each line is the average of the charges applied by the seven largest banks, where relevant, and adjusted for inflation (CPI, 2000 prices)

3.74 Documents supplied by some banks indicate that they believe that increases in insufficient funds charges do not affect demand for their accounts. In this sense demand does not respond to changes in price. As a result at least some banks appear to see charges as an attractive way to generate additional revenue. For instance, internal documents on the level of charges from three banks stated:

- 'these proposals [to increase insufficient funds charges] deliver substantial revenue growth by increasing the yield from existing overdraft customers'
- 'As the proposals result in no significant worsening in the competitive position of each product, and as demand is relatively inelastic to changes in [insufficient funds charges], there is no forecast reduction in planned business volumes,' and
- 'Increasing [insufficient funds] charges will have less impact on our marketing position than a credit interest changes due to its lower visibility'.

3.75 It may be the case that some banks do not emphasise the importance of charges associated with unarranged overdrafts to customers. It was stated in the judgment of the test case on charges that generally banks 'make no active attempts to publicise unarranged overdrafts or to deploy them in marketing activities as a facility'.

3.76 Our consumer survey supports the suggestion that most consumers do not focus on insufficient funds charges. Many customers do not take these charges into account when choosing a bank and do not typically consider them relevant even when they have paid charges in the past. This suggests that consumers do not exert competitive pressures on any type of account provider on the level of insufficient funds charges.

- 3.77 Indeed, it is fair to say that the complexities of the application of these charges make it extremely difficult for consumers to understand the impact of charges and to compare this impact across banks anyway. This topic is explained in Chapter 4.

Monthly charges

- 3.78 Monthly charges exist in the UK predominantly where a customer has a packaged account, although there are some exceptions. Packaged accounts⁸⁶ are a relatively new product but there are now nearly eight million in the UK, mostly accounted for by the four established banks. For some banks, packaged accounts have become a considerable source of revenue. In aggregate, they accounted for slightly less than seven per cent^A of total current account revenue in 2006.

Other ancillary charges

- 3.79 The final element of the pricing structure of an account is ancillary charges which include charges or fees for
- transactions carried out abroad (whether commission fee or through a less favourable exchange rate)
 - issuing replacement statements
 - making payments overseas
 - bankers' drafts and other special money transfers
 - arrangement fees, and
 - other commission income.
- 3.80 Ancillary charges accounted for £500 million ^A of bank revenue in 2006 amounting to an average of around £9 ^A per PCA per year. One bank offers an innovative account with free card use abroad. According to our survey these price elements are rarely taken into consideration when consumers decide which bank to choose.

Conclusion on price competition

- 3.81 The pricing of accounts is complex, in part reflecting the multiple dimensions of an account. The level of competitive pressure on the various price elements of current accounts seems to vary. Competition has reduced core, or day to day, transaction charges to zero, and there is some competition over credit interest rates as these are more visible to consumers. However, other elements, such as insufficient funds charges have not been subjected to the full rigours of price competition. The ease with which banks feel they can vary charges raises a question as to whether there is sufficient overall competitive pressure on revenue.

86 See Chapter 1 and the glossary for an explanation.

Competition on quality⁸⁷

- 3.82 In competitive markets firms supply products of varying degrees of quality to match the price quality trade-offs made by different consumers. For example, one would expect suppliers to choose between providing an expensive high quality product or supplying a cheaper lower quality version of the good/service in question. Assuming information is clear and easily available consumers would then choose whether to pay more for a higher quality product or not.
- 3.83 Quality, in particular of customer service, is one aspect of competition that almost all the banks we spoke to emphasised and they suggested it was important both to them individually and to competition between banks. This was also reflected in many of the internal documents banks supplied. At least one bank even saw customer satisfaction as its main driver of growth in customer numbers through the advocacy of existing customers, although most saw it as key to retaining existing customers.
- 3.84 We found there were no major differences between the four established banks and the challengers in the quality of their accounts (measured by customer satisfaction), suggesting that competition has raised the general level of quality. However, we found no evidence that spending more on an account (by accepting a lower interest rate or higher charges) resulted in higher customer satisfaction. On the contrary, one challenger, offering very competitive prices, also ranks highest in two of the studies cited below.
- 3.85 In our survey we asked consumers to give a score between one and 10 for the following three customer satisfaction factors: overall value for money, customer service and treating you fairly overall. We then aggregated results for individual banks into two groups: the four established banks⁸⁸ and challengers. Our analysis shows that for the first driver (overall value for money), the challengers had a mean rating significantly higher than the four established banks. For the other two factors (customer service, bank treating you fairly overall) we found no statistical difference between the four established banks and the challengers.⁸⁹
- 3.86 Similarly, GfK's Financial Research Survey⁹⁰ shows that there are no clear differences between the four established banks and the challengers in terms of the percentage of account customers saying they were extremely or very satisfied.⁹¹ The results for all banks fell between 61 per cent and 69 per cent (one exception being the challenger mentioned in the paragraph above).

87 In the context of PCAs, quality of service can mean a variety of things and different consumers may take into account different elements of their PCA when asked about it. However, we take customer satisfaction to be a reasonable proxy for quality. For instance, GfK's Financial Research survey uses the question 'In the last three months taking everything into account would you say you were extremely/very satisfied with your PCA?' This is also why, in this section, we use three different surveys.

88 Subsidiaries were included with the parent bank.

89 This analysis was carried out by combining responses into two groups (established banks and challengers) and using analysis of variance to test for significance between the mean score for each group.

90 This is based on a sample of 5,000 adults per month.

91 The actual question asked was 'In the last three months taking everything into account would you say you were extremely/very satisfied with your PCA?'

- 3.87 Another survey on retail banking customers' satisfaction (conducted by J.D. Power in 2007⁹²) ranked banks on a 1,000-point scale and asked consumers to cast their views on a variety of factors⁹³ driving overall satisfaction. Their results show that Nationwide ranked highest with 742 followed by Royal Bank of Scotland (689), Alliance & Leicester (667), HSBC (660) and Halifax and NatWest (both with 659 points). JD Power found that 'overall retail banking satisfaction levels are low in comparison with other industries'.
- 3.88 Most banks' research showed that the main reason why existing customers switch from their current bank is poor service. In other words the 'push' factor of bad service is more important than the 'pull' factor of a rival's offer. If suppliers exhibited different levels of quality, such as customer service, one would expect low quality banks to lose customers at a faster rate than their competitors. We analysed data on the number of accounts closed supplied by banks and found that, on average, six per cent⁹⁴ of accounts are closed every year. However, we found no significant difference in this rate between the four established banks and the challengers.
- 3.89 When discussing the quality dimension of competition with banks, they told us that they usually achieve good levels of customer satisfaction by getting the basics right (such as mistake-free transactions, a reliable internet site, low or no waiting times for telephone banking) and ensuring that, if a problem does occur, it is soon resolved. One bank argued that satisfaction was closely linked to trust and that, as an important aspect of banking, it works hard to win satisfaction and thus the trust of existing customers. The bank indicated that its main strategy was to generate 'advocates' who would promote its services to other customers. Similarly, the OFT's own consumer survey suggests that customers will take recommendations into account when choosing a bank.
- 3.90 It may be the case that competition has pushed quality, broadly measured, to similar levels across many banks. This also means a consumer need not expect lower quality from an apparently cheaper challenger. It is worth noting that the level of service or quality is not easily observable by most consumers prior to switching and is something that a customer usually experiences only once he has switched bank. Although a number of customer surveys are published it is not clear that the average consumer is able to make informed choices about alternative banks' levels of customer service or quality when considering switching. Recommendations from friends and family may help, but a market wide comparison would require knowledge of people with accounts at a large variety of banks.
- 3.91 While current account quality is clearly significant, price was also generally considered important by consumers, especially those that had switched. For all consumers in the survey, credit interest rates were given a mean rating of eight out of 10 in terms of how important they would be to respondents if they were to open a new account now. Seventy-three per cent of respondents agreed that there were benefits to be gained by switching since charges and interest rates vary between the banks.

92 '2007 UK Retail Banking Customer Satisfaction Study', JD Power.

93 These were: transactions (online, branch, in person, etc); account opening/product offerings; fees; account statement; problem resolution; and convenience.

94 Data from 15 PCA providers.

- 3.92 We found that at least 11 per cent of all respondents stated current account price factors – interest rates and charges – were the most important factor to them when choosing which bank to use. Fifteen to 20 per cent said they make explicit comparisons across current accounts in terms of interest rates and charges and 14 per cent of current account switchers in the last five years cited better interest rates as their main reason for switching bank, the most frequently cited reason.
- 3.93 As for switchers⁹⁵ we found that price was even more likely to be important to them with 32 per cent of switchers citing price factors while 45 per cent mentioned quality factors when asked the main reason why they had switched. This is significant as it is those consumers that are willing to switch between banks that are more likely to drive competition than those that do not switch.

Competition across customer types

- 3.94 The relative importance of price and customer service differs according to customer type. In particular, there are distinct differences in the level of competition for existing customers and those who are new to banking. For the four established banks, price competition for existing account customers seems to be less intense than for those new to banking.
- 3.95 Within those who are new to banking the four established banks actively target students who will usually be offered various incentives – for example an interest-free overdraft. Some banks are trying to attract foreign nationals living in the UK. For example, specific types of account have been introduced especially for foreign nationals and at least two banks employ Polish-speaking staff to help with the process of opening an account. What sets these groups apart is their willingness to choose a new bank as they are not, generally, switching from a long held current account.
- 3.96 In addition the challenger banks seem to aim their marketing strategies mostly at those consumers, usually existing account customers, who are most price sensitive. Such consumers are more likely to respond to the introduction of competitive offers, whereas it is simply too expensive to try and recruit customers who show little price awareness. The bulk of existing account customers, especially at the established four banks, remain on comparatively low credit interest rates (see Chapter 4).

Impact of free-if-in-credit model

- 3.97 Suppliers appear, at least to some extent, to use net interest income and insufficient funds charges to cover the cost of providing core money transmission services and any fixed costs of maintaining the account (for example, maintaining a branch network, internet banking or sending out statements). This results in at least some within-product cross-subsidisation. This point was also noted in the Cruickshank Report.
- 3.98 The vast majority of account balances consist of credit balances (around £97 billion in 2006^A). These credit balances generated a considerable amount of revenue (around £4 billion ^A of net interest income in 2006, a return of around four per cent on the total credit balances). The average unarranged overdraft balance over the year for the 16 banks was less than £700

⁹⁵ Consumers who had switched current account in the past five years.

million ^A but involved some £1.5 billion ^A in paid item and maintenance charges. This is a return of over 220 per cent on the balances, excluding £1 billion in unpaid item charges. This source of revenue dwarfs the £79 million ^A generated through unarranged overdraft interest on these balances.

- 3.99 The predominance of this charging model is unique to the UK (see Box 3.17). For instance, the European Commission's comparison of charges across member states⁹⁶ suggested that the United Kingdom was the only country where banks earned zero estimated revenue per transaction.⁹⁷

Box 3.17: International Comparisons

The evidence the OFT has looked at on account models in other countries indicates that free-if-in-credit model used in the UK is unusual⁹⁸. Other countries tend to use other price models such as transaction-based and monthly fees. This makes international comparisons difficult as most international studies of account prices have not considered all the features of the free-if-in-credit pricing structure.

The European Commission estimated the average account revenue per consumer in 2004 in 20 EU countries. They found that the UK had the fifth highest account revenue per consumer, below Luxembourg, Italy, Holland and Austria.

The proportion of revenue from insufficient funds charges is generally higher in the UK than in other countries. In general fee revenue from excess borrowing is below 10 per cent of total account fee revenue in the majority of EU member states.⁹⁹ The exceptions are France, Spain, the UK and Cyprus where it is over 25 per cent.

There are three main methods of paying for an account,¹⁰⁰ management fees¹⁰¹ where the customer pays a fixed monthly fee in return for PCA services, transaction fees where the customer pays a fee for each transaction made (for example, direct debits) and the UK's free-if-in-credit model.

96 Sector Inquiry under Article 17 Regulation 1/2003 on retail banking.

97 A recent UK report by Datamonitor pointed out that 'overdrafts constitute an important revenue stream for banks because the majority of current accounts are not in themselves highly profitable [...] the majority of current accounts do not generate much in the way of profits, given their low credit balances and heavy number of transactions that necessitate human input and labor. As such, overdrafts are an essential way for banks to make a profit out of offering current accounts.' *'An Overview of the Overdrafts Market in the UK'*, Datamonitor, March 2007.

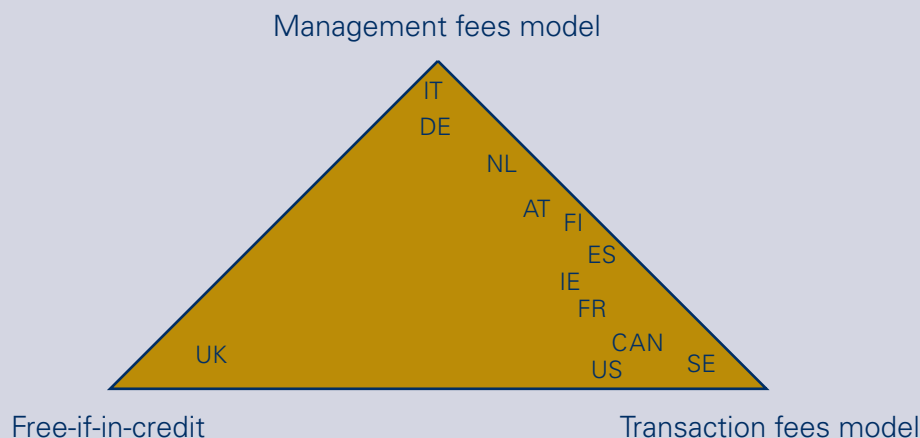
98 'The UK, however, does not fit in either of these (transaction based charges or monthly account fee) categories, but instead features an original pattern that relies on exceptions handling' defined as debit card stop payment, cheque stop payment, document search and banker's draft. *'World Retail Banking Report 2008'*, CapGemini.

99 Sector Inquiry under Article 17 Regulation 1/2003 on retail banking.

100 Sector Inquiry under Article 17 Regulation 1/2003 on retail banking.

101 Including packaged accounts.

The relative importance, by number of PCA, of the different account pricing structures in some countries is illustrated in the diagram below.¹⁰²



Countries: IT: Italy, DE: Germany, NL: Netherlands, AT: Austria, FI: Finland, ES: Spain, IE: Ireland, FR: France, CAN: Canada, US: United States, SE: Sweden

In practice these models tend to overlap. For example, some accounts charge a monthly fee for a fixed number of transactions, with charges levied when this quantity is exceeded. Another example is accounts that do not face charges provided a minimal balance or monthly deposit is maintained.

The relative impact of different components of account price structure varies between countries.¹⁰³ Sweden, France, Ireland and Spain have a high proportion of transaction fees influencing prices of the core banking services. In Germany, Italy and the Netherlands the price mainly consists of account management fees. While Canada has a high proportion of transaction fees, the core banking price of the US is 75 per cent based on transaction fees. In Australia, 'exception handling fees'¹⁰⁴ amount to a similar share as in the UK with account management fees as the second pillar.

3.100 In the current free-if-in-credit model, to understand the total implicit and explicit cost of an account, a consumer would have to know

- his or her average balance, the interest rate applied by the current bank and what rates may be available from other suppliers (or on other accounts offered by the same bank)
- the likelihood of using any arranged overdraft and the respective interest rates, and
- the likelihood of using unarranged overdrafts and incurring charges, the level of rates and charges and how they would be applied.

102 Source: OFT analysis of data from European Commission and Capgemini, 2007. For example almost all PCAs in Italy were classified as falling within the management fees model where as in Spain, for example, some are classified as management fees model and some transaction fees model.

103 Capgemini, 'World Retail Banking Report', 2007.

104 Examples of exception handling fees include debit card stop payments, cheque stop payments, document searches and banker's drafts and unarranged overdraft charges.

- 3.101 Without understanding the implicit and explicit cost of a product it is difficult for consumers to work out whether they are getting value for money or to make comparisons across banks and to choose the most advantageous product in the market.
- 3.102 It may be the case that those consumers who are able to maintain a minimal average credit balance, and who avoid use of arranged and unarranged overdraft and transactions that attract fees, appear to receive a free account. However, it may take substantial effort on the part of the consumer to manage this and the consumer may not be able to maintain this behaviour over the course of their lifetime. Consumers who stray away from this, of which there are millions, do not necessarily enjoy free banking. However where consumers believe their account is free and when there is no clear headline price, there is unlikely to be a great incentive to switch.
- 3.103 Where some aspects of an account are free at the point of use for consumers, such as money transmission, the model must rely, to some extent, on revenue from other sources such as insufficient funds charges and/or net interest income to cover costs.
- 3.104 This matters because the free-if-in-credit arrangement may encourage excessive consumption and/or under-consumption of certain aspects of an account. One effect (pointed out to us by some banks) may be the high use of core money transmission services, which the customer perceives to be free.¹⁰⁵ This may have effects on efficiency, as certain aspects of the account may then be over-used. Customers may also keep disproportionately large credit balances in their accounts to avoid insufficient funds charges and this could increase the amount of interest forgone. Alternatively they may over-use unarranged overdrafts because they fail to realise the costs associated with doing so. However, banks may have little financial incentive to prevent consumers from entering unarranged overdraft as insufficient funds charges represent a considerable share of PCA income. These issues point towards possible inefficiencies from the incentives created by the free if in credit model.

The Basic Bank Account model

- 3.105 Basic bank accounts offer an alternative package aimed at vulnerable consumers. Features typically include the ability for payments such as pensions and benefits to be paid in direct, withdrawals from ATMs and the facility to pay bills by standing order and direct debit. They never include overdraft facilities and typically do not offer a cheque book
- 3.106 Table 3.18 shows the different packages offered by the banks:

¹⁰⁵ An example of this is that the absence of a price for issuing cheques means that, under a different model, customers might switch to a more cost-efficient payment system.

Table 3.18: Different types of basic bank accounts

Bank name and any special name for the account	Minimum age to open an account	Minimum amount to open an account	Free buffer zone	Direct debits and standing orders	Charge for unpaid direct debit	Charge for unpaid standing order	Debit card (Solo, Electron or Maestro)	If any of the following apply, the application may be declined
Abbey: Basic Account	16	None	No	Yes	£35	£35	No	Undischarged bankrupt, record of fraud
Alliance & Leicester: Basic Cash Account	16	None	No	Direct debits only	£25	No standing orders	No	Undischarged bankrupt
Bank of Ireland: Basic Cash Account (Northern Ireland)	16	None	No	Yes	£38 ¹⁰⁶	£38	No	Undischarged bankrupt, record of fraud
Bank of Scotland: Easycash	16	None	£10	Yes	£15	£15	Yes	Undischarged bankrupt, record of fraud
Barclays: Cash Card Account	18 ¹⁰⁷	None	Yes	No	£15	£15	No	Record of fraud
Clydesdale: ReadyCash	16	None	No	Yes	£35	£35	Yes	Undischarged bankrupt, record of fraud
Co-operative Bank: Cashminder	16	None	No	Yes	£19.50 ¹⁰⁶	£19.50	Yes	Record of fraud
First Trust Bank: Basic Bank Account	16	None	£10	Direct debits only	£38	No standing orders	No	Undischarged bankrupt, record of fraud, record of bad debts
Halifax: Easycash	16	None	£10	Yes	£15	£15	Yes	Undischarged bankrupt, record of fraud
HSBC: Basic Bank Account	18	None	£10	Yes	No ¹⁰⁸	No	No	Undischarged bankrupt, record of fraud
Lloyds TSB: Cash Account	18 ¹⁰⁷	None	£10	Yes	£20 (max 3 per day)	£20 (max 3 per day)	No	Undischarged bankrupt, record of fraud
Nationwide Building Society: Flex Cash Card	16	£1	No	Yes	£30	£30	No	Undischarged bankrupt, record of fraud
NatWest: Step Account	16	None	No	Yes	£38 ¹⁰⁸	£38 ¹⁰⁸	Yes	Undischarged bankrupt, record of fraud
Northern Bank: Northern Personal Access	14	None	£10	Yes	No	No	No	Undischarged bankrupt, record of fraud, record of bad debts
The Royal Bank of Scotland: Key Account	16	None	No	Yes	£38 ¹⁰⁸	£38 ¹⁰⁸	No	Undischarged bankrupt, record of fraud
Ulster Bank: Step Account	16	None	No	Yes	£30	£30	No	Undischarged bankrupt, record of fraud
Yorkshire Bank: ReadyCash	16	None	No	Yes	£35	£35	Yes	Undischarged bankrupt, record of fraud

Source: British Bankers Association, January 2008

¹⁰⁶ The account may be closed if a direct debit is refused three times.

¹⁰⁷ 16 and 17 year-olds can open a similar account.

¹⁰⁸ Bank may cancel standing orders or direct debits if the customer doesn't have enough money in their account to pay using these facilities on more than one accession.

- 3.107 In line with users of conventional accounts, the most important factor for consumers of basic bank accounts when they opened an account was a convenient branch location. When asked how important it was to have easy access to a local branch, 55 per cent of low income and basic bank account holders rated it 'extremely important'.¹⁰⁹ In terms of information, 57 per cent of basic bank account holders considered discussions with branch staff most important followed by discussions with family and friends (46 per cent).
- 3.108 The main problem that vulnerable consumers face when choosing an account is their own lack of engagement with the product. Basic bank account holders were unlikely to consider either the products or services (11 per cent stating they considered the product and services on offer) or the level of charges (five per cent stating that they considered the level of charges). However, accounts can vary on the level of charges and interest rates they apply.
- 3.109 Low financial capability could explain consumers' lack of engagement with the product, services or level of charges available.¹¹⁰ It is also questionable whether vulnerable consumers, if they were to shop around before opening an account, would actually have ready access to alternative banks. Research by the University of Nottingham¹¹¹ showed that the focus of bank closures has tended to be in poorer urban areas meaning some locations may lack convenient branch access for consumers. This is especially pertinent, in light of the importance consumers place on having easy access to a branch when selecting their bank.
- 3.110 Furthermore, consumer organisations have suggested that banks may be reluctant to provide basic bank accounts and, as a result, make opening an account more difficult than it needs to be. This alleged reluctance can consist of restricting access (either geographically or through restrictive application procedures), not displaying the appropriate literature in branches, not offering the appropriate accounts or restricting the account features available (for example, not offering debit cards, standing orders or buffer zones). There has been much work by the Government, FSA and the banks to address these problems – see Annexe F for more details.

Conclusion

- 3.111 The market is composed of the four established banks and the challengers. The four established banks account for around 65 per cent of the PCA market. There has been little evidence of significant new entry in recent years and, overall, the market is relatively concentrated. Very recently some challengers have grown market share moderately but, generally, growth of most challengers has been neither rapid nor substantial.
- 3.112 Evidence on the inertia of the majority of consumers suggests that the need for a branch network seems to constitute a substantial obstacle that might not be the case if consumers were more willing to switch. New ways of delivering accounts solely through internet or telephone banking still account for only a small part of the market.

109 Respondents were asked to use a scale of 1 to 10 where 10 was 'extremely important' and one was 'not important at all'. The percentage here refers to those who gave a rating of 10.

110 We were not able to quantify the exact affect of low financial capability. Consumer organisations gave low financial capability as a primary reason for vulnerable consumers' lack of engagement with the product.

111 '*The Changing Geography of British Bank and Building Society Branch networks*', 1995-2003. Research funded by the Economic and Social Research Council, February 2006.

- 3.113 Competition in the PCA market involves two key aspects – price and quality of service. All the banks emphasised quality but certain prices seemed to be considered more important by some banks than others. Some price dimensions of the PCA product are subject to stronger competitive pressures (zero transaction charges, credit interest rates) but others (one-off costs such as insufficient fund charges) are not.
- 3.114 All banks focus on the importance of high customer service and quality and PCA providers seem to supply accounts of similar quality (in terms of customer satisfaction). We found no indication that, in general, paying more for an account translates into receiving a higher quality product. While quality is an important aspect of a PCA we found that a significant proportion of consumers, especially switchers, said price factors were more important to them.
- 3.115 There is evidence that competition is stronger for some new-to-banking customers (especially students) as, generally, they do not need to switch accounts.
- 3.116 The free-if-in-credit model is, at least to a large degree, reliant on net interest income and insufficient funds charges to cover the cost of providing core money transmission services and any fixed costs of maintaining the account (for example, maintaining a branch network).

4 CONSUMERS' USE AND AWARENESS OF THEIR CURRENT ACCOUNT¹¹²

Introduction

4.1 A key factor in the assessment of whether the PCA market operates in a way that benefits consumers is how consumers use their accounts and how aware they are of their implicit and explicit costs. The level of consumer awareness forms the basis for understanding how consumers do – or do not – ‘shop around’ for a better deal. This chapter explores consumers' use of their accounts and their awareness of the effective costs. The main findings of this chapter are briefly outlined below:

- first, many consumers are unfamiliar with the key implicit and explicit prices associated with their account. These include charges for arranged or unarranged borrowing and the level of interest they forgo by holding significant balances in their current account. Some consumers are not even aware that insufficient funds charges exist
- second, even where they are aware of the effective charges, our results show consumers find it hard to judge when, and at what level, these charges will be made. Indeed we find that a significant number of consumers either underestimate the likelihood of facing charges, or are unaware of how much their bank charges. This is due to both the lack of transparency of charges, and the complexity in determining when they are incurred. The majority of consumers asked expressed an interest in having a greater ability to control whether they incur the charges, with just over 60 per cent preferring to have their payment refused rather than pay charges, and
- third, it appears that many consumers do not learn from incurring charges or are unable to correct their behaviour. There is evidence that those consumers which habitually incur charges on their accounts are also typically associated with ‘vulnerable’ characteristics. Specifically they are more likely to be on a lower income, or have lower household savings than other consumers.

4.2 In summary, the lack of information, complexity of charges and the limited ability for consumers to control the incurrence of charges has made it substantially more difficult for consumers to make well informed decisions. This leads us to believe that consumers are poorly placed to assess their account's value for money, the potential gains from switching account, or how to manage their money better.

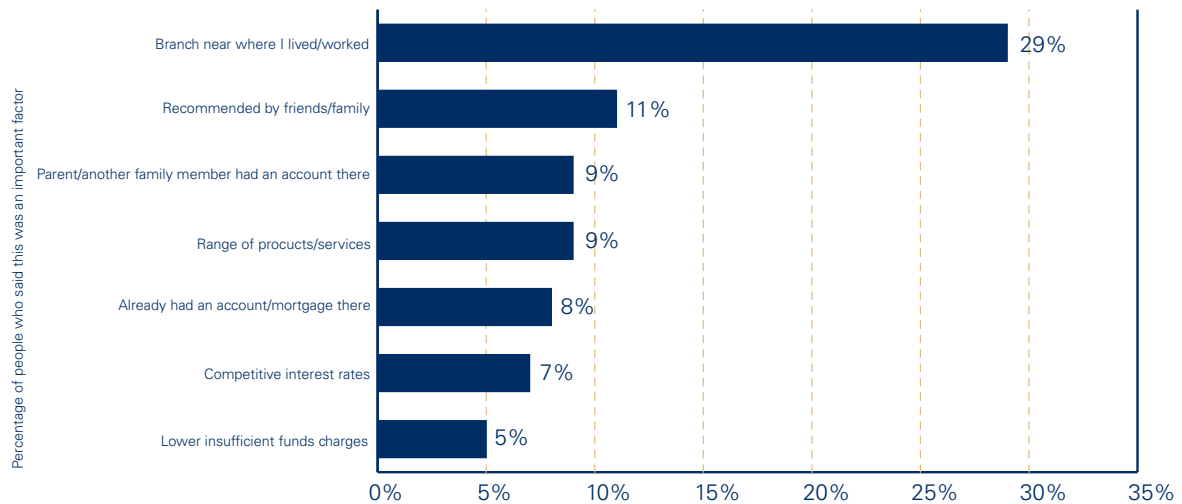
Things that prompt existing customers to look for a new account

4.3 It is clear from Chart 4.1 that branch location was the most important factor for consumers in our survey when considering with which bank to open an account, as it was in the Competition Commission's Northern Ireland study.¹¹³

112 The number of bank's data from which statistics are derived is indicated by the letter in superscript as follows. A: Data from 16 banks. B: Data from 7 banks. C: Data from 6 banks. D: Data is from 5 banks. A '+' indicates that the figure has been prorated up to 16 to ease comparison of figures across the report. Data is for 2006.

113 In our survey 29 per cent of respondents said that branch location had been an important factor when they chose their account. In its study of banking in Northern Ireland the Competition Commission asked people who had never switched what was the main reason for choosing their bank account, the most common reason was 'location was convenient' (31 per cent) page 34.

Chart 4.1: Most commonly given important factors when choosing which bank to use



Base: All current account holders: 2,074

Source: Ipsos/MORI Consumer Survey carried out for the OFT

- 4.4 It is also clear from Chart 4.1 that competitive interest rates are far less important than branch location. We asked consumers to rate how important different factors would be on a scale of one to 10 if they were to open a new account now. We then asked those who rated credit interest rates as less than five why this was so. The most common answers were that they did not keep much money in their account (26 per cent), they did not consider interest on accounts important (26 per cent), and they just did not think about them (13 per cent).
- 4.5 Internal documents provided to us by the major banks also conclude that consumers pay little attention to interest rates when choosing an account and even less attention to charges. Half of the customers of one bank, who said that they had chosen an account based on its credit interest rate, were paid less than one per cent interest. One price comparison site also told us that consumers that use their site show very little interest in current accounts in general, and when they do, they are not especially interested in the interest rates on offer.
- 4.6 There is, however, some evidence that emphasis on branch location may be lower for new customers and for those who have switched. As shown in Table 4.2 while a convenient branch location was important for 29 per cent of respondents overall, this figure was just 17 per cent for recent switchers and nine per cent for those that had opened their first ever account in the last 12 months. It should be noted that these groups of consumers account for a small proportion of all consumers with PCAs. People opening an account for the first time in the past 12 months put greater emphasis on where their parents or other family have accounts than those opening an account in other circumstances. This is probably because they are new to banking and thus rely on guidance from others. Recent switchers focus more on the range of products and services on offer, and on interest rates, an indication that they are more informed than new customers.

Table 4.2: Differences in important factors when choosing a bank

Percentage of people who said that this was an important factor	All (Base: 2,074)	Switched in last 12 months (Base: 52)	Opened first ever PCA in last 12 months (Base: 52)
Branch near where lived/worked	29	17	9
Recommended by friends/family	11	10	17
Parent/other family had an account there	9	2	18
Range of products/services	9	20	11
Already had an account/mortgage there	8	5	6
Competitive interest rates	7	15	6

Source: Ipsos/MORI Consumer Survey carried out for the OFT

Note: switched in the last 12 months refers to respondents that said they had opened their main account by switching from another bank and said that they had opened their main account in the last 12 months

- 4.7 There is evidence that consumers think insufficient funds charges are even less important than interest rates. Internal documents provided to us by some banks suggested that they knew demand was not sensitive to charges and that the bank could thus increase insufficient funds charges without losing market share. The price comparison site referred to above also told us that consumers hardly ever look at how much insufficient funds charges vary across banks.
- 4.8 Chart 4.1 also highlights the lack of importance of insufficient funds charges to many consumers. Only five per cent of people we surveyed said that lower charges were an important factor when they opened their main account, and there was no significant difference between those who had experienced insufficient funds charges in the last 12 months and those who had not. This is a particularly surprising finding as one might expect those consumers who have had to pay charges in the past to be more concerned about how high they are than those that have not.¹¹⁴
- 4.9 In its study of banking in Northern Ireland the Competition Commission also found that consumers did not consider insufficient funds charges when choosing an account because they did not think that they would apply to them. Furthermore, perceptions about future treatment did not vary across groups of consumers that had and had not been charged in the past, and some consumers thought that they had not been charged in the past even though they in fact had.¹¹⁵

¹¹⁴ We asked those who said that it would not be important if they were to open a new account to explain why they had said this. The most frequently given answers were that they had never had an overdraft (32 per cent), that they do not expect to go overdrawn (31 per cent), and that they didn't/don't expect to breach any arranged overdraft (19 per cent).

¹¹⁵ Paragraph 4.230.

Use of Current Accounts

Credit balances

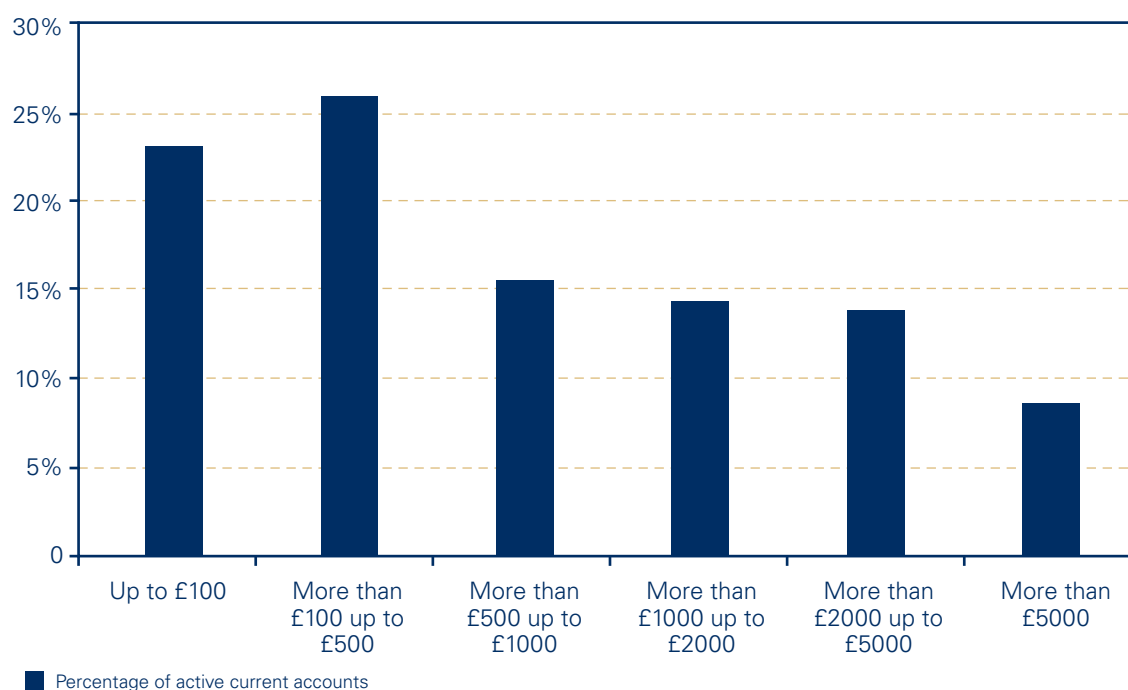
Consumers' usage patterns

- 4.10 There are many factors a consumer might consider when assessing how much money they need to keep in their account including:
- income
 - spending in an average month
 - the variability and predictability of the income and spending pattern (that is, the probability that spending in a month will exceed the average by a certain amount)
 - the availability and price of accessing money in other accounts or the availability of borrowing, and the time needed to transfer these
 - attitude to debt and risk, and finally
 - the transparency of the costs related to an account and of the control customers have over those costs.
- 4.11 Consumers will usually hold a proportion of their cash in their account. Some may hold more than others whatever their monthly income and outgoings. The level might be higher or lower depending on different factors. For example it might be:
- lower for consumers who actively manage their credit interest, for example sweeping money in and out of a higher interest account
 - lower for consumers who regularly use an overdraft
 - higher for those that have a widely varying monthly spend, and
 - higher for those that worry about the risk of charges for transactions that would take them beyond their available funds.
- 4.12 We expect there are many different ways that consumers choose to manage their credit balances. But, given the size of the sums that we found consumers were holding some consumers might benefit from reviewing how much they need to hold in their accounts. The introduction of 'faster payments' in May 2008 may give consumers greater confidence in accessing higher savings rates with the flexibility to move money back quickly if required.
- 4.13 Turning to bank data on account use, the average daily credit balance over the year¹¹⁶ held in an account in 2006 was £1,740.^{117 B} This is a relatively high average but it masks the distribution. Chart 4.3 shows 49^D per cent of all active accounts contained average credit balances¹¹⁸ below £500 when in credit.

116 Average daily credit balance over the year – the sum of daily credit balances divided by the number of days in the year. Sum of daily credit balances for 2006 divided by 365 (also see Glossary).

117 Other sources contain similar figures – JD Power's 2007 UK Retail Banking Customer Satisfaction Study found that respondents report having £1,492.20 in their current account at the end of each month.

118 Average daily credit balance when in credit – (sum of daily credit balances for 2006 divided by the number of days in credit). This gives an indication of a consumer balance when in credit (also see Glossary).

Chart 4.3: Distribution of average daily credit balances when in credit, 2006

Source: OFT analysis of data from banks ^D

- 4.14 A large number of accounts also held much larger positive balances. We estimate that, in 2006, 35 ^D per cent of all active accounts (19 million^{D+}) had an average daily credit balance when in credit over £1,000 (see Chart 4.3). Of these, eight per cent ^D (four million ^{D+}) held £5,000 or more with an estimated average of around £12,400 ^D.
- 4.15 Consumers' aggregate credit balances amounted to £97 ^A billion for the 16 banks¹¹⁹ in 2006. Those accounts with an average of more than £1,000 accounted for at least 91 ^D per cent of this. These are not temporary balances, but endure for most of the year. The average number of days in credit for those with an average daily credit balance when in credit above £1,000 was 332 ^D in 2006. Annex C contains further data on account balances.

Interest Forgone

- 4.16 Most accounts apply a relatively low interest rate. This makes the size of credit balances an important consideration for consumers. Around 88 per cent ^B of accounts (47.6 million ^{B+}) received an annual rate of less than 0.5 per cent¹²⁰ in 2006. There is a risk that some consumers underestimate the impact of this.

119 Average daily credit balance over the year.

120 Within this, 90 per cent of accounts, or 33 million, at the four established banks received less than 0.5 per cent interest.

- 4.17 Millions of consumers choose to hold large balances in these current accounts.¹²¹ It is likely that they could earn greater interest by either moving some of the balance to an alternative account (such as a savings account) or by switching their account to one that offers a higher rate of interest. This loss of income is an implicit cost of running an account. We refer to it as interest forgone.
- 4.18 It is important for consumers to try to assess interest forgone so they can understand what they could gain by switching account or by managing their balances more effectively. This is not to say that there is anything structural to stop interested consumers from managing their balances although high insufficient funds charges can make miscalculations costly. There is no suggestion that banks choose to make it difficult for customers to assess interest forgone, or transfer cash between accounts. To assess interest forgone, consumers need to know both their average credit balance and the difference between the credit interest rate applied to their balance and an alternative account.
- 4.19 Banks typically use these credit balances to earn revenue in other parts of their business. The current account business is usually paid an internal transfer fee by the section of the bank that uses the consumers' funds. The difference between this transfer price and the interest they pay to the account holder is called net interest income. According to data from 16 banks net interest income is the largest source of PCA revenue at 50[^] per cent, or at least £4.1 billion[^] in 2006 (see Chart 2.3 in chapter 2). Net interest income is a key driver of the PCA business model.¹²²
- 4.20 To illustrate interest forgone for individual consumers we estimated how much a consumer could gain by:
- switching PCA to one with a higher credit interest rate, or
 - moving 20 per cent of their credit balance to a savings account (for those with an average daily credit balance of more than £5000).
- 4.21 **Switching PCA** – an illustration. If consumers with an average daily credit balance over the year¹²³ of £2,000 switched their account from one paying 0.5 per cent to one offering an interest rate of four per cent¹²⁴ they could receive £80 a year in interest compared to £10 if they stayed with their existing bank.¹²⁵ These may not seem like large amounts of money, especially to consumers who find themselves holding large credit balances. However over a 10 year period (the average time a consumer holds an account) these savings add up to more than £700. Chart 4.3 indicates that a significant proportion of consumers hold such credit balances. Table 4.4 illustrates further examples for different average daily credit balances.

121 While it is difficult to compare the distribution of average earnings per employee or household income after tax with that for average PCA balances, OFT estimates using ONS data on mean net household income suggest that the mean balance is relatively high in comparison. Both distributions are highly skewed with, for example, a small proportion of current accounts accounting for a large proportion of balances.

122 It is important to note that most PCA customers might not earn interest at the rate of the banks' internal transfer price and so net interest income is greater than the interest consumers forgo. We estimate that the average internal transfer rate for the main six banks was less than five per cent in 2006.

123 Average daily credit balance over the year (sum of daily credit balances for a year divided by 365). For the illustration we assume the consumer is in credit on every day of the year.

124 Banks offering at least four per cent on PCA accounts (some with restrictions) include Abbey, Alliance and Leicester, Coventry BS, Cumberland BS, Halifax, Nationwide, Norwich and Peterborough BS, Wesleyan Bank etc. Source: Moneyfacts January 2008.

125 These calculations take account of typical restrictions including a £2500 limit on which higher interest is paid.

Table 4.4: Potential annual savings from switching from an account paying 0.5 per cent to an account offering various interest rates over one year (and over ten years in brackets)

Average balance over the year	Two per cent	Four per cent	Six per cent
£500	£7.50 (£75)	£17.50 (£175)	£27.50 (£275)
£1,000	£15.00 (£150)	£35.00 (£350)	£55.00 (£550)
£1,500	£22.50 (£225)	£52.50 (£525)	£82.50 (£825)
£2,000	£30.00 (£300)	£70.00 (£700)	£110.00 (£1100)

Source: OFT analysis

- 4.22 While this illustrates the potential gains from switching for individual consumers it is possible that, if the switching rate increased significantly, bank behaviour might also change. For example, further restrictions may be applied to accounts with higher interest rates and/or other charges could rise. In a complex product there are many ways in which banks can raise revenue including monthly charges, overdraft arrangement fees, ATM charges etc. The OFT would be concerned if banks simply increased other charges that lacked transparency. The OFT might not be overly concerned if competition drove changes to emphasise transparent prices that reflect costs.
- 4.23 **Moving balances** – an illustration. A significant minority of consumers, those that hold large balances, could make substantial gains in interest earned if they moved just a fraction of their money to a savings account.
- 4.24 Those with an average daily credit balance over the year of £11,500^{D 126} could each earn over £80^D in additional interest by moving 20 per cent of their credit balance to a savings account with a credit interest rate of four per cent¹²⁷ a year from an account paying 0.5 per cent. Over 10 years (the average length of time a consumer has a PCA) this would be an additional £800. Chart 4.3 indicates that a significant proportion of consumers could hold such significant balances in their account.
- 4.25 We recognise that this forgone interest is part of the implicit ‘price’ that is paid for free-if-in-credit banking. This is evidenced by the fact that at least one bank has accounts which have a monthly charge which is waived if there is a minimum balance in the account and that higher interest rates are typically paid on only a portion of credit balances. Nevertheless it is clear that many consumers could switch to an account offering a higher credit interest rate. If many consumers did switch this could change the pricing of accounts nonetheless in a competitive market we would still expect consumers individually to make the choice to move.

126 Eight per cent of current accounts have an average balance when in credit over £5,000. The average for this group is £12,400 or £11,500 over the year when adjusted for days not in credit.

127 A representative instant access savings rate in Moneyfacts January 2008.

Consumers' awareness of credit balances

- 4.26 In the 'in depth' discussions, we found that consumers tended to understand interest forgone but not to act upon it, perhaps because they do not understand the size of it. There is a growing body of literature that has found that consumers tend to react more to actual losses or costs than to implicit, notional losses, for example interest forgone,¹²⁸ which can explain why consumers do not seem to focus on the credit interest rate despite its significance.
- 4.27 When asked about the credit interest rate on their account, 80 per cent of respondents to the consumer survey did not know the rate and, more generally, 'competitive interest rates' was cited by only seven per cent of consumers in our survey as important when deciding which current account bank to use.
- 4.28 To see why consumers tended not to know the interest rate on their account we undertook two reviews¹²⁹ of account information available from the main banks. Our 2008 review found that, in most cases, credit interest rates were easy to find on bank websites and in literature. This compared favourably with our review in 2007 where we found it was not easy to find interest rates, especially for existing customers, for many banks. However, we understand that, typically, account statements do not state the rate of credit interest applied although there are exceptions.
- 4.29 Knowledge of the credit interest rate alone is not sufficient for consumers to assess the value they receive from their account. Consumers also need to have an idea of the average credit balance they are running to understand the implicit cost of using the account. Banks do not typically provide consumers with this information, and we did not find any exceptions, although in some cases they do now provide spreadsheets of statement information, which would allow sophisticated consumers with internet access to perform the calculation for themselves, but it would be not a trivial exercise.¹³⁰

Borrowing money

- 4.30 Although most customers keep their account in credit, some use their accounts as a source of borrowing. This can be agreed in advance (arranged) or not (unarranged).

Use of arranged overdraft facilities

- 4.31 According to data supplied by the banks 62^B per cent of active accounts had an arranged overdraft in 2006 (that is, the bank agreed the customer may borrow up to a certain amount). This ranged from 48 to 68 per cent of accounts depending on the bank (see Annexe C).

128 For example, Hanemann, M. 'Willingness to pay and willingness to accept: How much can they differ?' AER, Vol. 81, No. 3. (June 1991), pages 635-647.

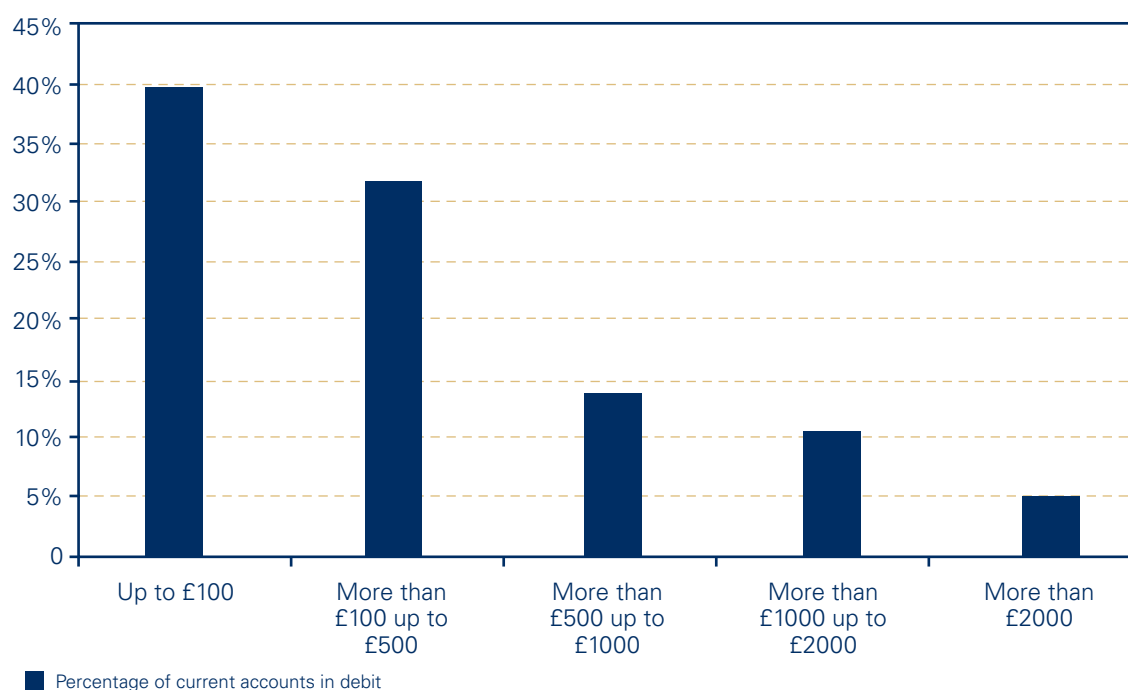
Kahneman, D et al. 'Anomalies: The endowment effect, loss aversion and status quo bias'. JEP, Vol. 5 No. 1 (1991), pages 193-206.

129 See Annexe B. During the period of the market study bank terms and conditions and other information were updated regularly.

130 For example it is not as simple as subtracting outgoings from salary as that would calculate the minimum balance which might be much less than the average monthly balance unless payments are all on the first day after the salary is paid.

- 4.32 Of those accounts that had an arranged overdraft about half became overdrawn at least once in 2006. So around 32^B per cent (or 17^{B+} million accounts) of all active accounts used an arranged overdraft at least once in 2006.
- 4.33 The amount borrowed by individuals is commonly less than £100 (Chart 4.5). However, many consumers are borrowing large amounts via an overdraft; at least fifteen^D per cent (four^{D+} million consumers) maintained an average debit balance of more than £1,000 when in debit. These consumers accounted for a large proportion, £6.6^{D+} billion, of the £9^A billion average daily debit balance over the year for the 16 banks.¹³¹

Chart 4.5: Distribution of average daily debit balance when in debit for those current accounts overdrawn, 2006



Source: OFT analysis of data from banks^D

- 4.34 Net debit interest income (defined as the difference between the interest earned by the banks and the cost of borrowing the money to lend¹³²) from arranged overdraft interest in 2006 was £450^A million, or five^A per cent of total PCA revenue for 16 banks.
- 4.35 There is a wide variety of arranged overdraft interest rates available, from just over five per cent to 20 per cent. While not everyone would be able to secure lower overdraft interest rates, some consumers may be able to do so by switching account or else using another form of borrowing.

131 Average daily debit balance over the year – (sum of daily debit balances for 2006 divided by 365).

132 The number used for the cost of borrowing in calculating the net interest income is usually the transfer price the PCA business unit pays the rest of the organisation for use of the funds.

- 4.36 The length of time consumers remain overdrawn together with the size of borrowing will determine the amount of interest charged. Data from the main banks suggest that the duration of an overdraft is related to the amount borrowed. Consumers with an average daily debit balance when in debit of less than £100 were overdrawn for an average of 82^D days a year in 2006 but if they borrowed more the number of days increased significantly.
- 4.37 Of those survey respondents with an arranged overdraft who had used it 15 per cent said that they were usually overdrawn and 12 per cent said that this was permanently the case. This would equate to around 2.6^{B+} million usually overdrawn¹³³ and 2^{B+} million accounts permanently overdrawn. These numbers would suggest that some consumers are not considering all their borrowing options or are unable to borrow elsewhere.
- 4.38 Analysis of our survey for consumer types shows that those with an agreed overdraft who are in social categories D and E are significantly more likely than others to be overdrawn either usually, or permanently. The same was true for 16-24 year olds and those with savings of less than £1,000.

Why consumers use arranged overdrafts

- 4.39 Consumer 'in depth' interviews suggest that consumers with arranged overdraft facilities can be divided into three groups:
- usually or permanently overdrawn
 - occasionally overdrawn, and
 - never overdrawn
- 4.40 Consumer survey responses show that 40 per cent of those with an arranged overdraft never use the facility. Of those that do use the facility 73 per cent use it occasionally and 27 per cent use it permanently or usually (see Table 4.6).

Table 4.6: Frequency with which account holders with an arranged overdraft facility find themselves using it

Use of arranged overdraft	Of respondents with an arranged facility	Of overdraft users (with an arranged overdraft facility used at least once in the last 12 months)
Permanently or usually	16%	27%
Sometimes	20%	33%
Rarely	24%	40%
Never	40%	-
Total of respondents with facility	100%	-
Total users	-	100%

Source: Ipsos/MORI Consumer Survey carried out for the OFT

133 Separate research by uswitch.com (quoted in DataMonitor p55 'UK Personal Lending 2007') estimated that 3.5 million consumers were permanently overdrawn in 2006.

Awareness of the cost of arranged overdrafts

- 4.41 The findings of our reviews of information on arranged overdraft rates were similar to those for credit interest rates. The rates were usually easy to find in our later review but this was an improvement on our first review in 2007.
- 4.42 We understand that consumers are told in their statements the amount of interest they have been charged where relevant. However, this does not mean that they are told either the debit interest rate applied or their average debit balance, although some banks do state the former.
- 4.43 Among those consumers who do not use an overdraft facility, the qualitative work based on the 'in depth' interviews revealed two types of consumer, distinguished by their reason for not using the facility. They are
- those that dislike borrowing as a rule, and
 - those that suggested they had no need to borrow through an overdraft.
- 4.44 A typical comment from those non-users opposed to borrowing was:
- 'I don't do debt, that's why I don't have a credit card. I don't do overdrafts, cheque books, nothing like that.'*
- 4.45 In both the non-user cases the arranged overdraft facility appears to have been set up automatically or had been used sometime in the distant past.
- 4.46 Some non-users seem to value the option of a 'safety net' aspect of arranged overdraft facilities. This was similar to the opinion of 'occasional' users. The differentiating feature between occasional users and these non-users seemed to be their spending and income circumstances at the time. For example:
- 'It's kind of different phases in your life really... I'm not currently working at the moment, so I'm all prepared for the statement to come in when it does next week to say that yes, we are in the overdraft. But yes, I think really, it's when for whatever reason, your regular income is reduced.'*
- 4.47 Some occasional users described an overdraft as convenient or, occasionally, better value for money than, for example, a credit card. There was, however, a realisation that other forms of borrowing might be more appropriate.
- 'If you've got a personal loan... I know exactly how much is going out every month... I know that I'm going to repay that loan in a specified time.'*
- 4.48 Those consumers who are regularly or permanently overdrawn, on the other hand, described a feeling of helplessness, perhaps reflecting the fact that they were concerned about using an overdraft for long term borrowing:
- 'Well I suppose in a sense I am a little bit trapped.'*
- 4.49 From the 'in depth' interviews it seems that use of an arranged overdraft facility depends on consumers' attitudes to debt generally and their circumstances at the time of use. It appears that those consumers who are not opposed to debt will use their overdraft facility as a safety net when necessary although some note it is not appropriate for long-term borrowing.

Indeed, some banks have told us that they do not consider an overdraft to be a suitable method for long-term borrowing. Many banks describe an overdraft as a temporary or short term borrowing facility in their account information. Despite this some consumers do become permanently overdrawn.

Unarranged overdrafts

- 4.50 This section considers unarranged overdrafts from a consumer and market perspective and examines how they work in practice. **It is not an assessment by the OFT of whether or not insufficient funds charges constitute unfair charges under the UTCCRs.** The OFT is considering this matter separately.
- 4.51 According to data from the main banks 26^B per cent of accounts with or without an arranged overdraft facility exceeded their limit in 2006. This is a significant minority estimated as 14 million accounts^{B+}.
- 4.52 Our consumer survey suggests that there is no significant difference between those with and without an agreed overdraft facility in terms of their likelihood of having used an unarranged overdraft in the previous 12 months. About a quarter of each group (22 and 26 per cent respectively) said they had used an unarranged overdraft at least once in the previous year.
- 4.53 According to data supplied by the main banks the average number of days per year an account is in unarranged overdraft is lower than for overdrafts in general. An account in unarranged overdraft was in it for an average of 16 to 61 days in 2006 depending on the bank.
- 4.54 Unarranged overdrafts generally, but not always, attract higher interest rates; typically more than 25 per cent and as much as 30 per cent. Net debit interest income derived from unarranged overdrafts was £79^A million in 2006 or just under one per cent of total PCA revenue for 16 banks. The 16 banks lent £680^A million as unarranged overdrafts in 2006.¹³⁴

Charges associated with unarranged overdrafts

- 4.55 Unarranged overdrafts often incur additional charges for paid items and sometimes involve an additional overdraft excess, or maintenance, charge (see also Box 4.12, glossary and Annexe C¹³⁵). When a bank refuses to process a payment because the transaction will exceed the limit, it may levy a further charge, known as an unpaid item charge.

Incidence and value of charges

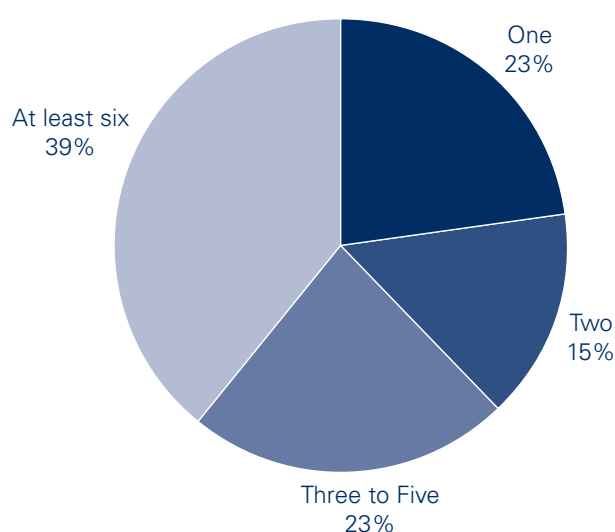
- 4.56 Twenty three^B per cent of accounts (12.6^{B+} million) incurred at least one insufficient funds charge in 2006.

¹³⁴ Average daily unarranged overdraft balance over the year – (sum of daily unarranged overdraft balances for 2006 divided by 365).

¹³⁵ **Unpaid item charges** are unarranged overdraft charges that are levied on any unpaid payment that, if paid, would create or extend an unarranged overdraft. **Paid item charges** are unarranged overdraft charges that are levied when a bank pays a transaction that creates or extends an unarranged overdraft. **Maintenance charges** are monthly and/or daily overdraft excess charges levied for each relevant period the balance remains in unarranged overdraft. The period may be a month or may be a day depending on the bank. Charges are not levied in every insufficient funds incident – see Box 4.13 for a discussion of caps and buffers. Not all banks levy all three charges.

4.57 Chart 4.7 shows that those consumers who incurred a charge were more likely to incur a charge at least six times (39 per cent of those charged) than they were to incur just one (23 per cent) in 2006.

Chart 4.7: The distribution of insufficient funds charges by number for those accounts that incurred at least one charge, 2006



Source: OFT analysis of data from banks 2006¹³⁶

4.58 This multiple incidence of charges may represent either a 'snowball' effect or a repeated incidence or both (see Box 4.8).

Box 4.8: Multiple insufficient funds charges¹³⁶

Multiple charges may represent either a 'snowball' effect, a 'repeated incidence' effect, or both.

Repeated incidence describes a scenario where a consumer repeatedly enters unarranged overdraft on separate occasions and incurs a charge each time. A **'snowball' effect** is said to occur where a consumer enters unarranged overdraft on one occasion and incurs multiple charges. This may come about in a number of ways:

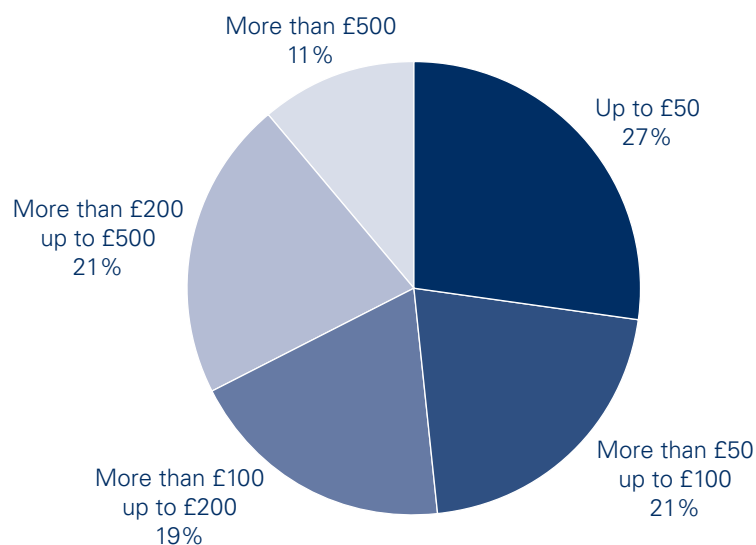
- **one shopping trip** – if a consumer enters unarranged overdraft on a shopping trip and purchases multiple separate items he or she may incur a paid item charge for each item, whatever the value, as well as a maintenance charge
- **multiple direct debits set up for one day** – if a consumer has managed his or her finances so that direct debits all go out on the same day of the month and for some reason the balance is not as high as expected he or she may incur a paid or unpaid item for each direct debit

¹³⁶ We note that in every factor there are exceptions and different practices at different banks. This table is intended to give an overview and is not relevant in every point to every UK bank.

- **order of payment** – the way in which debits due for payment (and credits due to be received) on a given day are processed by the bank may in certain circumstances have a bearing on the type and number of charges incurred. Since the way in which transactions are processed is not explained in terms and conditions, this constitutes an additional difficulty when estimating the total amount payable
- **inability to repay charges** – a consumer might be pushed into unarranged overdraft from a small payment, a payment he or she might be able to repay with interest, but may be unable to repay the unarranged overdraft charges added to this. If the debt is not repaid by the next month further charges may apply, and
- **charges on charges** – the debiting of interest on an arranged overdraft, or other bank charge (as opposed to payment of an item with insufficient funds to cover it), may itself cause an unarranged overdraft, and trigger a further charge or charges.

4.59 Turning to the value of charges, while 27 per cent of customers, by account, who incurred charges only paid up to £50 in 2006, 52 per cent paid more than £100 (see Chart 4.9).

Chart 4.9: The distribution of insufficient funds charges by total value for those accounts that incurred at least one unarranged overdraft charge, 2006



Source: OFT analysis of data from banks ⁸

4.60 As 23 ^{B+} per cent of accounts incurred at least one charge in 2006, and over half of them paid £100 or more in charges, we estimate that around 6.6 ^{B+} million account customers paid at least £100 or more in 2006, of which 1.4 ^{B+} million paid at least £500.

4.61 We found that not only are those accounts that incur charges likely to incur multiple charges but also that the charges seem to persist over time. Of accounts charged in 2006, more than 57 ^B per cent were also charged in 2005. This suggests there is a significant persistence of charges, either implying that consumers are not learning from their mistakes, or that their financial position makes incurring charges unavoidable.

4.62 Our aggregate estimate of insufficient funds charges based on data provided by 16 banks is £2.6 billion^A in 2006 where excess fees and paid item charges accounted for £1.5 billion^{B+} and unpaid item charges £1 billion^{B+}.

4.63 If the insufficient funds charges (excluding charges for unpaid items) of £1.5 billion^{B+} in 2006 were treated as the cost of borrowing on the £0.68 billion^A average unarranged overdraft balance over the year for the 16 banks, we estimate that the annual interest rate would be more than 220 per cent. While short term loans are distinct in their short duration and can be expensive to administer, this level of charging compares unfavourably with many similar forms of lending such as credit cards and personal loans.

Who pays charges?

4.64 OFT analysis of the consumer survey shows a strong relationship between the number of insufficient funds charges a consumer is likely to pay and their age and level of savings, which is itself influenced by income and social status. The incidence of charges is disproportionately high among relatively young and financially constrained¹³⁷ consumers.¹³⁸

Why consumers use unarranged overdrafts

4.65 The consumer survey found that the most common reasons why consumers exceeded their arranged overdraft limit (in the last 12 months) were uncertainties about the timing of transactions and when they would be cleared, rather than a conscious decision. Only seven per cent of consumers in the survey suggested that they chose to use an unarranged overdraft (see Table 4.10). While this statistic may be susceptible to under reporting by consumers, at seven per cent it is still very low.

Table 4.10: Reasons why consumers most recently exceeded their arranged overdraft limit

REASON GIVEN	PER CENT
Uncertainties about timing of transactions ¹³⁹	24
Did not check account	18
Insufficient funds/overspend	17
Forgot about a payment	13
Unexpected payment	9
Knew it would happen but had to make a payment	7

Source: Source: Ipsos/MORI Consumer Survey carried out for the OFT, (Base = 294)

137 In terms of savings and income.

138 See the 'unauthorised overdrafts' section of the Ipsos/Mori consumer survey report. The simple cross tabulation analysis is consistent with our findings using econometric techniques.

139 A combination of – 'I expected to receive a payment that did not come in time' and 'Incoming payment took longer than expected' and 'outgoing payment took less time to clear than expected'.

- 4.66 It is notable that it is not just consumers who have uncertainties about the timing of transactions. A 2006 Banking Codes Standards Board mystery shopping exercise on cheque clearance times found that for 19 of the 22 banks surveyed, their staff did not always give correct information about clearance times. Even when they did they were often unable to convert this into practical advice.¹⁴⁰
- 4.67 The second most frequent reason for exceeding the limit in the consumer survey was that consumers did not check their account. While consumers do have a responsibility to check their balance, this alone is unlikely to be sufficient. Even if consumers did keep track of all their transactions, those consumers with balances close to their limit, or making transactions that might bring them close, would find it difficult to predict whether they were likely to enter unarranged overdraft or incur a charge. When there are uncertainties about credits, debits, the relevant balance and the complex application of charges even repeatedly checking an account may not be enough.

Consumer overconfidence

- 4.68 The findings of our consumer survey, and other evidence, suggest consumers tend not to expect to use unarranged overdrafts.¹⁴¹ Thirty four per cent of respondents to our survey who had incurred an insufficient funds charge, but who did not consider charges to be important¹⁴² when opening current accounts, said that the reason for this was that they did not expect to use an unarranged overdraft,¹⁴³ even though they had done so in the past. But data supplied by the main banks show that 57 per cent of consumers that incurred charges in 2006 had also incurred at least one in 2005. So it seems repeated incidents are not uncommon. In its study of Northern Ireland the Competition Commission found that consumers did not consider charges when choosing a current account because they did not think that they were relevant to them.
- 4.69 Supporting this, the psychologist's analysis of the 'in depth' interviews shows that, although over half of the interviewees had experienced insufficient funds charges, almost none had anticipated going overdrawn, having payments rejected, or paying bank charges. The conclusion of the psychological analysis was that some consumers are overconfident when it comes to their finances and probably underestimate the cost of banking. Overall, there seems to be an element of naivety amongst some consumers when assessing the likelihood of incurring insufficient funds charges.

140 'Themed Review of Cheque Clearing Cycles', Banking Code Standards Board May 2006.

141 We are unable to distinguish between overconfidence about entering unarranged overdraft and overconfidence about incurring a charge.

142 They rated unarranged overdraft charges as being one to four out of ten on an importance scale if they were to open an account now.

143 Including both breaching an agreed limit and simply going overdrawn without an agreed facility.

Box 4.11: Key unarranged overdrafts data (2006)

- **14 million^{B+}** current accounts had an unarranged overdraft (26 per cent^B of all PCAs)
- **£0.68 billion^A** was borrowed as an unarranged overdraft¹⁴⁴ (compared with £8.4 billion^A as arranged overdraft¹⁴⁵)
- **12.6 million^{B+}** current accounts (23 per cent^B of the total) were charged at least once
 - 39 per cent^B of those charged had at least six charges
 - 52 per cent^B of those charged paid over £100
- **£2.6 billion^A** in charges was paid, accounting for 31 per cent^A of total current account revenue
 - £47^B was the average charge across all current accounts
 - £205^B was the average charge for the 23 per cent^B of current accounts that were actually charged
- the **annual interest rate would be around 220 per cent** if the £1.5 billion^{B+} charges (excluding unpaid items) were treated as interest on the £0.68 billion^A advanced
- **16-61 days** was the average duration of unarranged overdrafts (depending on bank)
- **57 per cent^B** of those charged in 2006 had also been charged in 2005
- PCA customers with and without an arranged overdraft facility are **equally as likely** (there is no significant difference) to exceed their limit
- almost as many (14 million)^{B+} current accounts used an unarranged overdraft as used an arranged one (17.1 million)^{B+}

Warnings about charges

- 4.70 Banks are relatively unusual in that they are able to both levy and apply charges without a customer always knowing either will occur. Some other businesses may be able to draw money from a customer through a direct debit, but they must give 14 days' notice and the customer can cancel the direct debit before the amount is paid.
- 4.71 All of the main banks told us that, once a charge has been incurred, even though the Banking Code does not specify it, they inform consumers with at least a letter, or some make a telephone call, in order to warn of the impending debit. However 45 per cent of respondents in our survey who received some kind of charge said that they were not warned before the charges were applied. While consumers may have recollection problems this is a significant proportion and might indicate that banks' attempts to make customers aware of charges are not always effective.
- 4.72 Furthermore, according to information given to us by banks, once customers have been informed that they have incurred a charge, few major banks make substantive attempts to inform them of the options open to them to limit further charges or warn them that they are incurring multiple charges.

144 The average daily unarranged overdraft balance over the year for 16 banks.

145 The average daily arranged overdraft balance over the year for 16 banks.

- 4.73 Some banks may attempt further contact if consumers have not resolved the situation, but it was not clear when or whether this was a systematic approach for most or just for a few customers. Indeed, given the revenue generated from insufficient funds charges, £2.6 billion in 2006, it may be the case that banks do not necessarily have a strong financial incentive to help consumers avoid them.

Consumers' awareness of insufficient funds charges

Knowledge and understanding of charges and the level of charges

- 4.74 Seventy seven per cent of those surveyed, who had been charged in the past 12 months, said that they had heard of such charges before they incurred one.¹⁴⁶ That means that over a fifth did not know about charges before they received one. This varied by consumer type with young people significantly less likely to have known.
- 4.75 Of those respondents who had been charged in the last 12 months, a significant proportion (25 per cent) also said they did not know what their bank's charges were. Of all respondents to our survey, two-thirds (67 per cent) said they did not know what their bank charged for entering the unarranged overdraft. The Competition Commission found a similar figure of 72 per cent in Northern Ireland.
- 4.76 Only five per cent of consumers said that charges were an important factor when choosing their bank. In comparison 23 per cent of customers, by current account, incurred charges in 2006 and 52 per cent of these paid more than £100 in charges.
- 4.77 These findings raise a question of whether consumers can use or compare current accounts effectively if they do not know how much it may actually cost them. Indeed, in Northern Ireland, the Competition Commission found that consumers often said that they had not paid any charges when their bank had already confirmed that they had done so. The fact that consumers do not even realise that they have been charged may increase the persistence of charges.
- 4.78 Reviews of account information by the OFT identified that information on the level of charges is easier to find in 2008 than it was in the 2007 review. However, the information was not sufficient to understand how the charges might be applied. The OFT understands that consumers are generally not told the applicable level of insufficient funds charges on their statement (although there are exceptions).
- 4.79 Separately, the judgment on the UTCCRs test case stated that, generally, banks 'make no active attempts to publicise unarranged overdrafts or to deploy them in marketing activities,' which might help to explain why many consumers lack awareness of these charges and many more are unable to estimate their level.
- 4.80 Internal documents, supplied by some banks, state that consumers focus on other aspects of an account. This was used as evidence to show a proposed rise in insufficient funds charges by some banks would not affect the number of accounts they sold.

¹⁴⁶ The figure was 70 per cent in a similar survey in Northern Ireland (page 103 paragraph 4.234).

Complexity of assessing the likelihood, and cost, of use of an unarranged overdraft

- 4.81 Engaged consumers might sensibly attempt to manage their current accounts so that they minimise their average credit balance to minimise their forgone interest. To do this a consumer must assess the likelihood of entering unarranged overdraft or having an item refused. In this section we discuss consumers' use of tools to monitor their current account.
- 4.82 Almost nine out of 10 respondents to our survey said that they received a paper statement, and one in five an online statement. Of these two groups the majority (66 per cent) said that they read their statements thoroughly. Approximately a quarter checked their statements but did not read them thoroughly. Eight per cent said that they checked or read their statements only if they had a problem.
- 4.83 However, in order to keep on top of their account position and hence their available funds, customers have to keep track of a number of factors and do significant calculations. At any given time to work out whether they have funds available, consumers need to take their current balance, and consider what commitments they have already made (for example, cheques not cashed), what upcoming commitments they may have (such as direct debits) and what known payments are coming in. They also need to understand how the timing of these will affect their balance.
- 4.84 For example, the number of direct debit commitments consumers have may complicate their assessment of the likelihood of becoming overdrawn or exceeding their limit – 14.6 million households had five or more regular direct debit commitments on their main current account in 2006.¹⁴⁷
- 4.85 Even if a consumer does keep track of all these factors, it is not just as simple as saying, 'don't spend more than you have and you will avoid an unarranged overdraft'. Even the margin by which a consumer must avoid use of an unarranged overdraft is uncertain because, for example, it is often not clear which balance a bank may use for the relevant calculation, or when.
- 4.86 Mechanisms for helping people keep on top of accounts do exist, and banks have been introducing more. Text alerts are a recent innovation some banks offer to allow consumers to receive their balance by SMS text although we have not analysed data on take up or price. We understand that some banks contact customers by telephone if they have concerns about a customer's balance but it is not clear if this is a systematic and widespread approach.
- 4.87 It is important to remember that financial capability is a significant issue in the wider population and therefore not all of these tools may be used or indeed useful for all consumers. Our survey showed that internet banking is used by around half of consumers and they use it frequently but it is popular mainly with younger and wealthier consumers. Similarly, ATM use varies significantly by type, with 16-44 year olds much more likely, and categories D and E much less likely, to use ATMs.¹⁴⁸ But even the balance shown at an ATM may not, in fact, be the number with which consumers should work.

147 APACS figures.

148 'The Way We Pay 2007 UK Cash and Cash Machines', APACS.

Assessing the likelihood of use of an unarranged overdraft

- 4.88 A poor understanding of how charges are calculated and applied, and even whether a consumer thinks that they have been charged at all may, in part, be caused by the complexity of the application of charges. In its Northern Ireland study the Competition Commission found that 'unarranged overdraft charges for all accounts... showed considerable, and undue, complexity. We believe that this complexity... makes it more difficult for customers to understand and react to overdraft charges'.¹⁴⁹
- 4.89 The same appears to be true for the rest of the UK. Box 4.12 summarises the key variables a consumer needs to know in order to assess whether they are likely to use an unarranged overdraft. Consumers will not always have this information.

Box 4.12: What consumers need to know in order to determine whether they will use an unarranged overdraft¹⁵⁰

Unarranged overdrafts arise in respect of two types of transaction:

- customer-initiated transactions: the customer issues a payment instruction (for example, a cheque), tries to access funds (for example, an ATM withdrawal), or an instruction previously set up becomes payable (for example, direct debit), and
- bank-initiated transactions: the bank debits interest, charges or fees to the account, or reverses a previous credit (for example, when a cheque previously credited to the account is returned by the paying bank, or when an electronic payment is recalled).

If a customer fails to keep enough money in the account, in order to determine whether she will use an unarranged overdraft she may need to know some or all the following factors, depending on the specific situation:

- **timing of presentation of items.** The customer will normally have little control over when a cheque is presented for payment by the payee. Direct debits (and standing orders) are set up in advance: the customer must keep a record of due dates, which may vary within certain limits. The timing of presentation of debit card transactions may depend on factors unknown to the customer, such as the merchant's floor limit and the method of authorisation used. Other items, such as ATM cash withdrawals are normally under control of the customer. The timing of bank-initiated transactions is determined by the bank: terms and conditions will usually (but not always) specify whether charges are debited when they are incurred (and thus without advance notice), or at a future time (with or without notice). In both cases, an unarranged overdraft may arise if insufficient funds exist to cover the charge
- **what is included in available funds.** The amount of funds available to meet payments may or may not include un-cleared items, depending on the bank. For instance, a bank may count cheques recently paid in over the counter as available funds, while another bank may not. Explicit definitions of what counts as available funds are not common in current terms and conditions, and the customer may have to trawl through several clauses to find an answer

¹⁴⁹ Paragraph 4.131 page 81.

¹⁵⁰ We note that in every factor there are exceptions and different practices at different banks. This table is intended to give an overview and is not relevant in every point to every UK bank.

- **when available funds need to be in place for an unarranged overdraft not to arise.** Available funds may change during the day to reflect cash withdrawals, deposits, arranged debit cards transactions and other items. A bank may reckon funds (and thus determine whether charges arise) at 3:30p.m on the day payment is due, giving customers the opportunity to pay covering funds and avoid charges ('grace period'). Another bank may assess funds at the close of the working day before payment is due. According to OFT research, several banks' terms and conditions do not specify the point in time at which funds ought to be in place for charges to be avoided
- **where to check available funds.** Some means of checking the account balance (such as an ATM or an on-line statement) may or may not disclose the same balance used by the bank to determine whether charges are payable, and
- **which payment types can trigger unarranged overdrafts.** An unarranged overdraft may arise in respect of certain transaction types but not in respect of others. For instance, a bank may allow such overdrafts in respect of debit card transactions, Direct Debits, standing orders, cheques, ATM mobile telephone top-ups, CHAPS payments, international payments, telephone or on-line banking payments, etc. Another bank may allow only unarranged overdrafts in respect of debit cards, cheques, cash withdrawals, Direct Debits and standing orders, and decline all other forms of payment when insufficient funds exist. At present, several banks' terms and conditions do not make explicit which payment types can, and which cannot, give rise to an unarranged overdraft.

Assessing the cost of use of an unarranged overdraft

- 4.90 Once the consumer has tried to assess the likelihood of use of an unarranged overdraft he or she will need to assess the cost of use.
- 4.91 Box 4.13 lists all the necessary factors a consumer would need to take into account, and have information about, in order to understand how much he or she could be charged for using an unarranged overdraft. In all, there are at least seven variables consumers need to know to predict whether they will incur a charge. Customers will not necessarily have all this information.

Box 4.13: What consumers would need to know to understand how much they could be charged for using an unarranged overdraft¹⁵¹

When payment of an item(s) would create an unarranged overdraft, the following variables determine the total amount charged

- **types of charge levied by the bank.** Charges can be classified as 'transaction' charges (paid item, unpaid item charge) and 'maintenance' charges (monthly and/or daily overdraft excess charge), see Glossary. Transaction charges are levied per item presented for payment when insufficient funds are available. Maintenance charges are levied once a month or once a day, when the account is in unarranged overdraft within the relevant period. The majority of banks levy both types of charges on their main account

¹⁵¹ We note that in every factor there are exceptions and different practices at different banks. This table is intended to give an overview and is not relevant in every point to every UK bank.

- **charge combinations.** Several charges may arise in respect of a single transaction. For instance, if payment of an item creates an unarranged overdraft for the first time in the monthly charging period, the bank may levy both a paid item charge (for making the payment when insufficient funds exist) and a monthly maintenance charge (given that the making of the payment necessarily causes the account to overdraw within the monthly period)
- **outcome of the pay/no pay decision, and variable charges.** The amount charged will normally depend on the bank's decision as to whether or not to pay: with some exceptions, the unpaid item charge is higher than the paid item charge. The charge is normally a fixed amount although variable charges are increasingly common: the amount charged may depend on the value of unarranged overdraft when granted, or on the value of the item presented for payment when declined
- **recurrence of charges.** Maintenance charges are levied once in the relevant period, and are incurred again if the account continues to be in unarranged overdraft in the new period, even where there is no new transaction in that period. By contrast, transaction charges cannot arise in the absence of a transaction. For instance, if an account with no overdraft facility and a debit balance of £100 at the end of the month continues to be in debit on the first day of the new month, without any transaction occurring on that day, a new monthly maintenance charge would be incurred, but no new paid item charge would be payable¹⁵²
- **'charges on charges'.** Bank-originated items, such as the debiting of charges by the bank, may give rise to further charges. For instance, if a bank declines a £200 cheque payable on an account with a £15 credit balance and no overdraft facility, it may levy an unpaid item charge. Debiting the charge at that point in time (as several banks do) would create an unarranged overdraft. A monthly maintenance charge (and, possibly, a daily maintenance charge depending on the bank) may also arise as a result
- **internal processing of transactions.** The way in which debits due for payment (and credits due to be received) on a given day are processed by the bank may in certain circumstances have a bearing on the type and number of charges incurred. The total amount payable may depend, for instance, on whether the bank processes certain payments in a pre-defined order (such as cheques first, then direct debits, then standing orders, etc.) or, alternatively, it aggregates them and pays them in ascending order of value, or instead refers payments to a member of staff. Since the way in which transactions are processed is not explained in terms and conditions, this constitutes an additional difficulty when estimating the total amount payable, and
- **refunds, buffers and caps.** The Competition Commission noted in its Northern Ireland Banking Report that '[i]t appears that banks have increased the use of buffer zones and charge capping, and have used discretionary refunds, to limit customer dissatisfaction arising from unarranged overdraft charges. These pricing practices, and the extent to which banks use their discretion, are not normally known to customers'.¹⁵³ Banks' policies prescribe limits on the maximum number of charges that can be incurred in a specified period (known as 'caps'), and/or the amount by which an account may go into unarranged overdraft without incurring a charge ('buffers'). In addition, a bank may refund a charge when a complaint is made, or automatically in certain circumstances.¹⁵⁴

152 Alternatively, when an account in unarranged overdraft is brought back into credit on any one day, and on a later day in the same monthly period a new unarranged overdraft occurs, a new Paid Item charge (but no Monthly Maintenance charge) would arise, if the bank levies a Monthly Maintenance charge.

153 Paragraph 4.267.

154 For instance, when the account has stayed within the overdraft facility for a given period before an unarranged overdraft arises.

- 4.92 It is clear that this complexity of application, along with the lack of information, makes it very difficult and time consuming for consumers to calculate the cost of using an unarranged overdraft.
- 4.93 It may be that some of this complexity is unavoidable and the argument has been made that providing too much certainty may encourage reckless borrowing or involve overwhelming information. However, in the OFT's view, given this complexity, the significant proportion of consumers that are incurring charges, many unintentionally, and the fact that these charges account for around 31 per cent of current account revenue, it can be argued that these charges should be more predictable and easily understood.
- 4.94 More recently, a number of banks have taken steps such as adding warning alerts on ATM screens if a withdrawal will exceed their arranged limit, and offering similar SMS text alerts. Such steps are a positive move to help some customers stay in control.¹⁵⁵

Consumer control over use of unarranged overdrafts

- 4.95 As discussed, of those that entered unarranged overdraft, few stated that they knew they would use an unarranged overdraft; in most cases it was not a deliberate decision. This may, in part, be due to the complexity of estimating the likelihood of entering unarranged overdraft.
- 4.96 In light of this we asked consumers¹⁵⁶ whether they want their bank to process debit card transactions that take their current accounts into unarranged overdraft, and whether they would opt out of an unarranged overdraft if they could. Fifty seven per cent of consumers with an arranged overdraft said that, if they were making a payment using a debit card that would, without them realising, take their current account into unarranged overdraft, they would not want their bank to process that transaction. The figure rose to 71 per cent for those without an agreed overdraft limit, making 62 per cent of all consumers when the two groups are combined.
- 4.97 As a follow up question, we asked respondents to imagine the possibility of agreeing up front with their bank that no debit card transactions that would lead to them going into unarranged overdraft would be processed. Fifty seven per cent¹⁵⁷ of those with an arranged overdraft said they would take this option and that, instead of paying any charges, they would rather have to make alternative payment arrangements. The same option was chosen by 55 per cent¹⁵⁸ of those without an arranged overdraft.
- 4.98 This highlights the lack of control consumers seem to have over this aspect of their current account. Even those who do not want to use an unarranged overdraft, and are willing to have debit items rejected if necessary, are unable to opt out. It is not clear why no bank has offered an opt-out facility, and we do not consider a basic bank account to be a sufficient substitute for a mainstream current account. It may be the case that there is not a strong financial incentive for banks to offer an opt-out.

155 However, the likelihood of use of different methods to access accounts varies by consumer type.

156 In the February 2008 GfK survey, sample size 822 of which 505 had an arranged overdraft limit and 317 either didn't or weren't sure (these were grouped together).

157 This percentage is calculated from a base excluding 63 of the 505 respondents who did not know whether they would take the option or not.

158 This percentage is calculated from a base excluding 69 of the 317 respondents who did not know whether they would take the option or not.

Box 4.14: Summary of issues relating to insufficient funds charges

Consumer knowledge and understanding

- 21 per cent of consumers said they had not heard of the charges before they incurred one
- 67 per cent did not know how much their bank's charges were
- In Northern Ireland, according to the Competition Commission report, many consumers thought they had not been charged when they had
- Some banks' documents reported that consumers focus on other aspects of a PCA and used it as evidence to show a proposed rise in insufficient funds charges would not affect PCA sales (see chapter five)

Complexity of assessing the likelihood of using an unarranged overdraft

- Consumers are not always presented with sufficient information to calculate whether they are likely to enter unarranged overdraft

Complexity of the application of insufficient funds charges

- The way in which insufficient funds charges are applied is complex and most consumers do not have sufficient information on which to assess how much charges could be
- The Competition Commission found that charges were 'unduly complex' in Northern Ireland
- The OFT survey of information found that information on the application of charges was difficult to find

Consumer overconfidence

- Psychological analysis of 'in depth' interviews showed that consumers are overconfident and underestimate the likelihood of incurring a charge
- 57 per cent of consumers that incurred charges in 2006 also incurred at least one in 2005
- Only five per cent of people we surveyed said that lower charges were an important factor when they opened their main account, and there was no significant difference between those who had experienced insufficient funds charges in the last 12 months and those who had not.

Inability to opt out of unarranged overdraft

- In our omnibus survey more than half of the respondents said that they would opt out of an unarranged overdraft if they could and well over half said they would not want a debit card transaction processed that would take their current account into unarranged overdraft.¹⁵⁹

¹⁵⁹ Excluding those who said they didn't know.

Consumers' awareness of warnings

- 4.99 There appeared to be some concern about the timing and lack of warning concerning the impending charges in our 'in depth' interviews, for example:

'If you get a letter it's already too late which is a bit stupid because, although they say in the letter that you can put your current account back in credit today, it doesn't give you any chance because the letter won't arrive the same day.'

- 4.100 There is also evidence from the interviews that consumers do not understand the way multiple charges can accumulate or 'snowball' from, perhaps, one payment:

'I thought I'd be charged maybe £15 or £20 in total, but they walloped me with something like £70 in total.'

- 4.101 More recently we understand that some banks have taken steps to alert consumers when they are about to, or are, using an unarranged overdraft including by text message or on an ATM display.

- 4.102 Consumers also have a responsibility to try to stay informed. Our survey found that while many consumers said that they read their statements, few read other material sent by banks. Forty five per cent of consumers 'rarely' or 'never' read material sent by the banks and a third (33 per cent) only 'sometimes' read the material. Since the information referred to includes interest rate changes and product information we might expect consumers to pay more attention to it than they seem to.

- 4.103 Awareness of the cost of using an account is important as it can vary substantially depending on how the consumer uses it and between different banks. Annexe C illustrates how the cost, or even return, on accounts can vary by broad consumer category. Consumers with larger credit balances will pay significantly less than those with large debit balances and lots of insufficient funds charges but they may forgo interest by holding large credit balances.

Customer satisfaction

- 4.104 We explored customer satisfaction in our consumer survey. Cost is only one aspect in value for money. Another important factor is the service a customer gets for their money. Chapter three explores the significance of customer service to the market more widely.
- 4.105 Specific questions in our consumer survey on customer satisfaction with current accounts show that satisfaction is broadly positive. On a scale of one to ten, where one is poor and 10 very good, customer service and value for money were both rated favourably with each having a mean answer of over seven.
- 4.106 While this is clearly an important result in its own right, the 'in depth' conversations highlighted that satisfaction can reflect an absence of problems rather than a very positive experience. In some cases unless there is a problem consumers tend to be content with the bank, as represented by this quote, 'They make all the payments on time, they seem to be efficient and things seem to run smoothly,' rather than the bank doing anything more than expected. In addition, in the consumer survey satisfaction was lower for those who had incurred an insufficient funds charge.

4.107 The Competition Commission's Northern Ireland report found that satisfaction levels were much lower in their 'in depth' interviews than in the quantitative survey. The Commission stated that 'we consider that the [high] satisfaction ratings in the MORI survey reflect an absence of active and informed customers'.¹⁶⁰ The OFT's Market Study report into Payment Protection Insurance (PPI) and the Department of Trade and Industry's 2001 switching survey¹⁶¹ came to a similar conclusion about the satisfaction levels of uninformed consumers. The extent to which a consumer can be satisfied with the value for money of a product if they do not know what it effectively costs them, as we have found can be the case, can be questioned.¹⁶²

How vulnerable customers operate current accounts

Use of current accounts

- 4.108 The issues that arise for vulnerable consumers are similar to those with conventional current accounts but with some key differences. In line with other consumers from our consumer survey, vulnerable consumers tend to use in-branch banking to deposit cheques (44 per cent), to deposit money (43 per cent), and to withdraw money (41 per cent). They were unlikely to use telephone banking (55 per cent don't use telephone banking compared with 45 per cent of all current account holders) or internet banking (59 per cent don't use internet banking compared with 48 per cent of all current account holders).
- 4.109 The major difference between mainstream current accounts and basic bank accounts is that a basic bank account seldom has a cheque book facility and never offers an overdraft. The lack of an overdraft, whether arranged or not, removes an element of interest rate and charge costs that can affect account holders. However basic banks accounts can still incur unpaid item charges.
- 4.110 Charges are a significant issue for vulnerable consumers. For example, when using a mainstream current account, respondents with savings of less than £1,000 were the most likely groups of consumer to use arranged overdraft. Twenty one per cent of this group said they were 'permanently' overdrawn, and a further 25 per cent said they were 'usually' overdrawn. In other words almost half this group of people is habitually 'in the red'.
- 4.111 Our consumer survey showed that the best predictor of whether a consumer has incurred charges is whether they are financially constrained.¹⁶³ For example:
- those with less than £1,000 in household savings were significantly more likely to have been charged in the past 12 months for going into their unarranged overdraft¹⁶⁴ (48 per cent compared to 18 per cent of those with at least £1,000 of savings)

¹⁶⁰ Paragraph 4.255.

¹⁶¹ 'Switching Suppliers', Department of Trade and Industry, November 2000.

¹⁶² We note that a number of PCA surveys including by the BBC's Watchdog and one by Which? (both 2008) find much lower satisfaction levels on average. JD Power's 2007 *UK Retail Banking Customer Satisfaction Study* found that 'overall retail banking satisfaction levels are low in comparison with other industries'.

¹⁶³ See Chapter 2 for more detail.

¹⁶⁴ This includes both exceeding an authorised limit and also going overdrawn with an arranged overdraft facility.

- consumers on low incomes or with less than £1,000 in household savings were significantly more likely to have been charged in the past 12 months for a refused payment (15 per cent and 31 per cent respectively, compared with 11 per cent and eight per cent of those with higher incomes or more savings). The most common reason for refusal among low income consumers was insufficient funds¹⁶⁵ (48 per cent compared with 45 per cent for all consumers who had a payment refused), and
- nearly one in five (18 per cent) of basic bank account holders have been charged in the last twelve months for having a payment refused (compared with less than one in ten (nine per cent) of standard current account holders).¹⁶⁶ The most common reason for refusal among basic bank account holders was insufficient funds (52 per cent compared with 41 per cent for standard current account holders).

Awareness of costs of using basic bank or current accounts

- 4.112 A significant proportion of consumers who, in the previous 12 months, had been charged for attempting to make a payment with insufficient funds (30 per cent of low income respondents) did not know that such charges existed before they incurred them. Further, according to our survey 44 per cent of basic bank account holders were given no warning that these charges would be taken from their account.¹⁶⁷
- 4.113 For those financially constrained and already facing a tight budget, being unaware of the likely level of charges or when, or indeed if, further charges will be applied seriously jeopardises a customer's ability to manage his or her current account effectively.
- 4.114 The following example shows the disproportionate effect that charges can have on low income consumers:

*'A £38 charge for the typical housing association tenant whose weekly income is £216 gross represents 17.5 per cent of their weekly income. For comparison purposes it equates – in terms of impact – to a typical owner occupier's weekly wage of £592 being charged £103.60 for an unpaid direct debit.'*¹⁶⁸

- 4.115 Evidence from Citizens Advice includes cases where banks, or other lenders, apply charges that have a disproportionate effect and push consumers into debt. Common themes include:
- entering unarranged overdraft by only a small amount (in some instances £1) but incurring insufficient funds charges that snowball to many hundreds of pounds
 - multiple charges, for example a charge of £30 for going £15 overdrawn followed by a further £30 for the increase in the overdraft
 - charges applied at unpredictable times which then trigger further charges – for example between benefit payment dates when there is no money in the account

165 Other reasons included the failure to receive expected payments, direct debits being paid at the wrong time, forgetting that payments were due and needing to make an unexpected payment.

166 According to the main banks 23 per cent of PCAs (inclusive of basic bank account holders) incurred at least one charge, including unpaid items, in 2006.

167 All of the main banks told us that, once a charge has been incurred, even though the Banking Code does not specify it, they inform consumers with at least a letter, or some make a telephone call, in order to warn of the impending debit.

168 *Credit where Credit's Due*, report for National Housing Federation (2007), Niall Alexander.

- incidents of interest charged on arranged overdrafts pushing consumers into unarranged overdraft, resulting in charges
- banks concentrating on recouping their own monies – charges are taken without warning and without permission, to the detriment of other (priority) payments, such as rent, and
- attempts to clear debt hampered by level of charges. For example paying £30 each month to clear unarranged overdraft but faced with maintenance charges of £25 each month.

4.116 Another key message from our discussions with consumer groups was the adverse effect that the fear of incurring charges can have on the vulnerable. This is confirmed in a report by Bacs¹⁶⁹ which refers to customers' perceived fear of:

- losing control of their bank account or balance
- companies being able to remove money whenever they choose
- banks making mistakes, for example with direct debits, taking out too much money or taking money on the wrong date
- the impact that charges would have on their budget, and
- not trusting their ability to save enough money or have the required funds to make regular payments.

Conclusion

4.117 Many consumers hold significant positive balances in their current accounts even though the vast majority of current accounts offer very low interest rates. While this may be a deliberate decision by some, and there is no suggestion that banks make it difficult for consumers to do this, a significant number of consumers could gain substantially if they switched to a better value current account or made use of a savings account.

4.118 A significant minority of consumers (more than 12 million accounts^{B+} in 2006) incur insufficient funds charges, and when they do they are more likely to pay at least six charges than one. The average charge for the accounts that incurred a charge in 2006 was £205^B and many pay more.

4.119 Few consumers know what the credit interest and insufficient funds charges are that apply to their current account and, in the case of charges, many did not know the level of charges even after they had incurred them.

4.120 It is complex for consumers to keep track of their balance and know with certainty whether certain transactions will cause them to exceed their limit. Even if they can work out that they will incur a charge, it is very difficult for them to anticipate how much they will be charged. Information is rarely available and the information that is provided is often not all in one place.

¹⁶⁹ Bacs 'a financial inclusion update – 15 November 2007'. Bacs' research did not reference 'the vulnerable' but explored issues faced by the 'financially excluded', which was the term used in the research to cover younger working people, older people (working and non-working), those on cash income and those on low income.

- 4.121 The complexity of application is made worse by the tendency of those that do incur a charge to incur several charges. This may be because charges have 'snowballed' or because they have tried to go into unarranged overdraft several times during the year. Some consumers seemed unaware of how charges can multiply from one transaction, or even of the level of the charges. There seems to be an element of naivety in some consumers when considering the likelihood of incurring insufficient funds charges.
- 4.122 When consumers cannot easily assess the likely cost of their current account the incentive to assess the benefits of switching current account or of making better use of savings accounts is reduced. This limits consumers' ability to drive competition.
- 4.123 It is not feasible to calculate how much consumers might lose overall from the current system of charges and costs as reductions in one revenue stream for banks might lead to additional charges elsewhere. However, we found that some consumers could miss out on up to £700 interest over the average lifetime of an account by remaining with their existing bank. The consumers who are likely to achieve best value for money from current accounts are those who maintain relatively low credit and debit balances.
- 4.124 In general, vulnerable consumers face many of the same issues that affect other consumers in the current account market, such as poor understanding of current account features and charges. Problems faced by vulnerable consumers can, however, be more pronounced and in some instances unique to this category of consumer.
- 4.125 In summary, the OFT has found evidence to suggest that
- the price and cost to the consumer of current accounts lack transparency, and
 - controlling cost can be complex for some consumers due, in part, to the lack of transparency.
- 4.126 **Transparency** – Many customers are not familiar with the key prices associated with their current account and are therefore poorly placed to assess whether they are getting value for money, the potential gains from switching account, or how to manage their money better. Even if consumers know key prices, such as credit interest rate, most do not have the information necessary to calculate total cost easily. Many consumers could switch to apparently significantly better value current accounts, or make more use of savings accounts, but may be unaware of this because of the lack of transparency.
- 4.127 **Control of cost** – We found that it is complex for consumers to assess both the likelihood of entering an unarranged overdraft and the charges for doing so. Consumers are faced with multiple transactions, direct debits of varying amounts and timing, and insufficient information to calculate possible charges. There is significant potential for slight errors in financial management to result in hundreds of pounds worth of charges. Despite this, consumers are not able to opt out of unarranged overdrafts should they prefer not to use them and some consumers may significantly underestimate the likelihood of incurring these charges. The size of the revenues banks derive from insufficient funds charges could reduce the financial incentive for banks to help consumers avoid charges.

4.128 As a result of these problems, we find that

- the incentive and ability to compare current accounts and drive competition for most consumers is inhibited, and
- many consumers may be less able to use their current account as effectively as they might, which in turn affects the value for money some consumers receive.

4.129 Despite these issues, consumers seem to be generally content with the levels of service that they receive through their current account, although satisfaction is lower for those who have incurred insufficient funds charges. While customer satisfaction is clearly an important outcome, for some consumers, at least, it may result from a lack of clarity about the implicit and explicit costs they are incurring.

5 SHOPPING AROUND FOR, AND SWITCHING, PCAS

Introduction

- 5.1 The previous chapter showed that many customers are not familiar with the key prices associated with their current account. This calls into question whether consumers will be able to make well informed decisions regarding their current account's relative competitiveness. This is key to a well functioning market as consumers who proactively seek better deals, on either price or quality, are the drivers of competition. Without proactive consumers, willing to switch between competitors, banks have little incentive to provide better offers. This chapter examines these decisions in more detail, looking at how consumers monitor the market, the factors that prompt them to start looking for a new current account and their perceptions and experiences of the switching process. The key findings of this chapter are as follows:
- first, there appear to be relatively few consumers who actively monitor the relative competitiveness of their current accounts. Indeed consumer switching appears to be driven more by bad experiences than proactive consumers seeking better offers. This absence of active engagement is at least in part due to a lack of transparency, resulting in the visible switching benefits for most consumers being relatively small, even though for some consumers the actual benefits can be substantial
 - secondly, consumers have some valid concerns about the switching process going wrong. Over a quarter of switchers reported some problem with the process, resulting in poor consumer perception of the ease of the process. The fact that switching consumers have little control over the process, but face a significant proportion of the consequences if the process goes wrong suggests an unequal allocation of the risks from switching, and
 - thirdly, these concerns with the switching process and an unequal allocation of the risk are reflected in the finding that just six per cent switched in the last 12 months – one of the lowest rates in Europe.
- 5.2 In summary banks may find it hard to reach consumers effectively if they are unengaged or uninformed about the possible benefits from switching. This raises the possibility that the personal account market is stuck in an undesirable equilibrium. Without consumers willing to switch, banks have little incentive to provide better offers on charges or interest rates. But without better offers from banks, consumers have little incentive to switch. Breaking this circle by reducing the barriers on consumers switching would provide the banks with the incentive to provide new offers and increase productivity.

The importance of search and switching costs

- 5.3 Consumer behaviour drives competition. The competitive process works best when consumers actively shop around and make informed choices to secure value for money. This does not require high levels of switching. A credible threat that enough consumers are able and willing to switch in response to a better offer will be sufficient. Transparency of competing offers and ease of switching increases consumers' ability and willingness to go elsewhere and this in turn helps drive suppliers to meet their customers' needs. Conversely, while obstacles that reduce consumers' ability and willingness to switch banks will make it harder for banks to win new customers, it will reduce the competitive pressure on them if they have a large customer base that is unwilling to switch and is thus easy to retain.
- 5.4 Search and switching costs can be defined as the real or perceived costs that are incurred when looking for a new supplier and switching but which are not incurred by remaining with

the current supplier. Search costs arise when a consumer has many complex choices to make; finding the best option takes some research. Switching costs occur when, for example, in order to change current account the customer needs to obtain documentation proving identity and financial status to the new bank and to arrange the transfer of salary payments and direct debits to the new current account.¹⁷⁰ While no direct financial cost may be involved, changing supplier can involve effort in researching the different options available and it may be time-consuming and potentially disruptive if there is a problem with the change-over. In the presence of search costs, a customer that has already obtained one price quote will have no incentive to look for a second quote unless they expect that it will be low enough to cover the cost of searching for it. If this is the case, each seller may have an incentive to price slightly above any common price and so even a small search cost could lead to relatively high prices.¹⁷¹

- 5.5 If there are relatively fewer new customers than existing customers and the latter are reluctant to switch, the market power of incumbent firms will be increased as not only will entrants be competing for a small base of uncommitted customers, their offer will also have to be significantly better than that of incumbents in order to attract existing customers. This could lead to a so-called 'fat-cat' effect, whereby firms with large customer bases set higher prices because they have more to gain from harvesting existing customers than winning new ones.¹⁷²
- 5.6 Thus, switching costs may explain why market leaders charge higher prices than their smaller rivals. The more locked-in customers a supplier has, the greater the benefits are of increasing prices to reap the rewards from those customers, rather than reducing prices to compete for uncommitted customers. Such factors could discourage market entry and product innovation other than that related to attracting first-time customers.

Choosing an account

Monitoring the market

- 5.7 Table 5.1 shows the extent to which consumers in our survey compare different banks. Although 69 per cent agree that there may be better alternatives available in theory, and around one third say they keep an eye on the market in general terms, in reality only 15-20 per cent make explicit comparisons across products in terms of interest rates and charges. Indeed, only five per cent of consumers strongly agreed that they were always on the lookout for a better deal and that they made a conscious effort to keep up-to-date with what other banks were offering. Forty seven per cent of respondents to our survey had never even considered switching, so are very unlikely to have compared banks.¹⁷³ Overall the possibility of a better deal does not appear to have motivated many consumers to search more actively.

170 In a survey of the economic literature of switching costs Klemperer argues that there are high transaction costs in closing an account with one bank and opening another with a competitor. Klemperer P (2005), *Network Effects and Switching Costs: two short essays for the New Palgrave*, New Palgrave Dictionary of Economics.

171 For example, see Diamond P.A (1971), *A Model of Price Adjustment*, *Journal of Political Economy*, No3, pages 156-168.

172 Beggs A, Klemperer P.D (1992), *Multiperiod Competition and Switching Costs*, *Econometrica*, 60, pages 651-666.

173 We asked those who had never switched if they had ever considered switching banks. Seventy four per cent said they had not – this is 47 per cent of the total sample.

Table 5.1: Degree to which consumers make comparisons

	Per cent
Agree to at least some extent that there are probably better alternatives to existing PCA	69
Agree to at least some extent that a conscious effort is made to keep up with what other banks have to offer	35 ¹⁷⁴
Agree to at least some extent that always on the look out for a better deal	31 ¹⁷⁵
Have compared charges across range of products offered by current bank in the last 12 months	17 ¹⁷⁶
Have compared charges across range of products offered by other banks in the last 12 months	15 ¹⁷⁷
Have compared interest rates across range of products offered by current bank in the last 12 months	20
Have compared interest rates across range of products offered by other banks in the last 12 months	19 ¹⁷⁸

Base: All current account holders: 2,074

Source: Ipsos/MORI Consumer Survey carried out for the OFT

- 5.8 The findings in Table 5.1 need to be interpreted with care, however, as people may be reluctant to admit that they do not keep up with what is on offer. If this is the case, these figures may overestimate market engagement, and this would seem to be suggested by low switching rates, despite the variety of offers available.

Things that prompt existing customers to look for a new account

- 5.9 Given that the vast majority of customers stay with their current bank in any year, factors that prompt them to start looking for a new current account will have important implications for competition in the market. Evidence suggests that existing consumers often start looking for a new current account only when things go wrong – they tend to be pushed away from their current bank by a problem rather than pulled towards another bank by a better deal. In our survey, we asked about the main reasons for switching. The results are shown in Table 5.2, divided into ‘push’ factors (those that make consumers want to leave their current bank) and ‘pull factors’ (those that attract customers to alternative banks).

174 There was little variation across consumers.

175 This was more likely to be the case for the young (42 per cent of 16-24 year olds, compared with just 26 per cent of those over 65) and those in lower social groups (38 per cent of respondents in social category DE compared with 29 per cent in social category AB).

176 Those who had switched in the last 12 months (27 per cent) and those with a high income were most likely to do so (26 per cent of those with a household income in excess of £75,000 compared with just 14 per cent of those where it was less than £20,000).

177 Groups most likely to were those that had switched their account in the last year (35 per cent), those with savings in excess of £75,000 (22 per cent). The group least likely to was those in social group DE (12 per cent).

178 Those more likely to were people in social category AB (28 per cent), those with household income in excess of £100,000 (34 per cent), and, among those with an agreed overdraft facility, those who said they are never overdrawn (28 per cent).

Table 5.2: Main reasons for switching banks¹⁷⁹

Factor	Per cent	'Push' or 'pull'?
Better interest rate	14	Pull
Problems/bad experience with previous bank	12	Push
Charges too high	11	Push
Poor customer service	9	Push
All push factors	40	
All pull factors	33	
Other factors ¹⁸⁰	29	

Base: 269

Source: Ipsos/MORI Consumer Survey carried out for the OFT

Note: percentages in the table do not quite sum to 100 per cent as a few respondents gave more than one reason

- 5.10 Three out of the four most frequently given reasons for switching were 'push' factors. Our qualitative study supported the contention that push factors tend to dominate the motivation to start searching. Consumers indicated that they would change bank if they felt that they were being treated unfairly but they were less clear about what fair treatment meant. On the other hand, better interest rates, a 'pull factor', were also a common reason for switching and, overall, push factors did not exceed pull factors by a large margin. Other studies have also concluded that push factors dominate pull factors:
- an internal document provided to us by a major bank explicitly stated that push factors dominated
 - the Competition Commission's banking study in Northern Ireland concluded that customers' dissatisfaction prompted them to switch and that they were not strongly influenced by pull factors¹⁸¹
 - a National Consumer Council study found that the current account market was the most static of those that it considered because consumers found it difficult to identify pull factors when considering switching,¹⁸² and
 - Mintel also concludes that poor service is most likely to prompt people to switch. A third of respondents in its survey cited it as a decisive factor.¹⁸³
- 5.11 The relative importance of push factors compared with pull factors could have important implications for competition as it may mean that banks place more emphasis on trying not to upset existing customers rather than trying actively to attract new customers with better deals.

179 This question was asked only of respondents that had switched in the last five years.

180 Twenty nine per cent of respondents cited factors that were not clearly push or pull, for example, 'personal reasons'. Percentages in this table do not quite sum to 100 per cent since a few respondents gave more than one reason.

181 Page 9, paragraph 38.

182 Switched on to switching, a survey of consumer behaviour and attitudes 2000-2005, National Consumer Council, November 2005, page 7.

183 'Current Accounts', Finance Intelligence, June 2007, Mintel, page 6.

- 5.12 Our survey indicated that consumers who monitor the market more closely are more likely to be swayed by 'pull' factors. Those who tended to be more engaged in the market, in particular those who claimed to know what the charges were on their current account, were more likely to agree that there were better alternatives available. Those that had switched banks at least once were less likely to agree, probably reflecting that they had already switched to what they thought was the best deal.
- 5.13 One factor that may reduce incentives to search is that there is no natural break in a PCA contract, unlike products such as house or car insurance. This may mean that consumers are more likely to stay with a bank unless something goes wrong acting as a trigger for them to compare other products and banks. Furthermore, if consumers are unaware of the total cost of their current account they are less likely to think that they are paying too much.

Factors consumers take into account when choosing a new account

Ease of comparison of accounts

- 5.14 When deciding whether to switch to another bank, consumers need clear readily available information that they can understand, as well as the financial capability and desire to evaluate it. Ease of comparison will be affected by the structure of current account pricing. The ease with which consumers are able to compare current accounts is likely to affect their desire to do so and thus feed through to the competitive pressures that banks face. Consumers will also need to make a judgement about differences in quality of service.
- 5.15 As outlined in Chapter 3, under the free-if-in-credit price model the two potentially most significant costs for consumers are those that are least transparent – interest forgone and insufficient funds charges. It is hard for consumers to access the information they need in order to work out the cost of running their current account. Lack of transparency regarding charges may mean that consumers have a lack of awareness about them and are therefore overconfident about the likelihood of incurring them. Some of the challenger banks are trying to help consumers make comparisons. For example, Abbey's website provides a facility that shows how much extra interest a consumer could make by switching to it based on extra interest for a given average monthly balance. A comparison provided by Nationwide also takes account of various charges, but neither includes any insufficient funds charges.
- 5.16 Packaged accounts comprise a range of products that are bundled together. Here, comparisons are further complicated by the need to look across a range of services and compare the costs of the account to the alternative of purchasing them separately or purchasing different combinations of services.

Availability of Information

- 5.17 Chapter 4 highlighted the lack of readily available practical information on important features of current accounts such as credit interest rates, average balances (which would be very useful, for example, when using price comparison sites) and insufficient funds charges. The difficulties caused by lack of information are exacerbated by the fact that different banks use different terminology and present interest rates and charges in different ways.¹⁸⁴ Furthermore, many consumers make use of limited sources of information.
- 5.18 A lack of information not only makes it difficult for consumers to work out if they are currently getting value for money but also means it is hard to make comparisons across banks. In order to help us assess how easy it is for consumers to access and compare the information they need to assess value for money, we considered the type of information consumers would need and looked at the main bank websites and promotional materials that are provided in their branches.
- 5.19 When we undertook our analysis of bank websites we found that it typically took two or three clicks/pages before a link to the necessary information could be found. Such information tended to be behind other links. Information on terms and conditions was not only hard to find, but also not easily accessible given its length and format. We are pleased to note that since we undertook this exercise several banks have amended their websites to make the location of such information more prominent. However, the information on charges that is available does not tell the consumer exactly what is needed in order to know whether charges will be incurred. We also found that most promotional leaflets contained no information on charges other than a telephone helpline number.
- 5.20 OFT research of packaged accounts offered in the UK found that while packaged accounts are prominently featured in advertising and promotions, only limited information on each current account was easily accessible and terms and conditions could be hard to find.

Complex application of charges

- 5.21 Consumers need to take account of an extensive list of factors in order to understand if, and how much, they will be charged.
- 5.22 There are particular difficulties in comparing charges. Although the unit charge is often similar across banks, application of those charges varies widely, in part because of the discretion that banks have. During the OFT's UTCCRs investigation, several banks were asked to compute how much a hypothetical customer would be charged if a particular set of events took place (which involved exceeding the agreed overdraft limit) – for more details see Box 5.3. The result was that the given scenario resulted in different charges across banks, ranging from £0 to £260. This further demonstrates the degree of complexity of the charging structure.¹⁸⁵

184 For example, the Competition Commission found that in Northern Ireland pricing leaflets provided interest rate information in very different ways across banks (pages 81-82, paragraph 4.133). We reached similar conclusions in our analysis of bank websites and promotional materials – see Annexe B.

185 Since this exercise was undertaken some banks have changed some of their terms and conditions. However, for the given scenario significant differences across providers remain.

Box 5.3: OFT charges scenarios

In its parallel UTCCRs investigation the OFT asked the banks to calculate charges for a hypothetical customer going overdrawn in June 2007 and correcting the position later the same month. Banks were asked to explain the number and amount of insufficient funds charges they would levy in June and in subsequent months in the following scenario:

- a series of nine direct debits with a total value of £245.81 puts the customer into unauthorized overdraft
- after four days a cash deposit over the counter puts the customer back into credit
- the customer holds the most common account in terms of the number of accounts held on 31 December 2006
- the customer opened the account in June 2003, has never been overdrawn, and does not have any other product with the bank
- all transactions (direct debits) causing the account to go overdrawn are honoured
- the customer does not have a pre-arranged overdraft facility
- there are no further transactions on the account after 2 July 2007
- the customer does not contact the bank to complain about the charges, and
- the bank applies any 'buffer', 'cap' or refund policy contained in its terms and conditions and tariff of charges. If its policy is not contained in the bank's terms and conditions, it debits all charges to the account.

Charges ranged from £0 to £260

- 5.23 Despite the variation in charges demonstrated by this exercise, our qualitative interviews indicated that there was a perception among consumers that all PCA offers are essentially very similar. For example, one consumer said 'looking at the charges, what other banks offer.... they are charging roughly the same'.
- 5.24 Furthermore, there is evidence at least for Northern Ireland that the banks themselves have difficulty in calculating what charges they apply, in part because of the flexibility in the way they do it. In its study of banking in Northern Ireland the Competition Commission carried out a similar exercise to that in the OFT's UTCCRs investigation. Coming to an agreement about the scenarios required numerous exchanges with the banks and a further round of adjustments to the charges and the way they were applied. The Commission noted¹⁸⁶ that many of the banks found it difficult to complete the exercise without additional time and guidance.

Quality of service

- 5.25 In addition to comparing accounts in terms of costs and prices, consumers also need to compare quality of service. Evidence from our survey suggests that consumers find this difficult. A significant proportion of consumers tend to assume that all banks are the same in terms of quality of service and when comparing banks consumers tend to rely on recommendations from bank branch staff, family, friends and colleagues. Furthermore, as noted in Chapter 3 all banks seem to supply accounts of similar quality (in terms of customer service) and we found no indication that paying more for an account translates into receiving a higher quality product.

Barriers to existing customers considering choosing another account

Expectations about the potential gains from switching

- 5.26 Our analysis of the psychology of current account usage showed that consumers tended to focus on the present more than the future, suggesting that they would have to expect there to be significant future benefits from switching in order for them to be willing to put in the time and effort required to switch in the present.
- 5.27 Furthermore, consumers also say they are generally happy with their current bank, thus, further reducing the inclination to switch. When those who had not switched were asked why this was so, the most popular answer was that they liked their current bank (48 per cent).¹⁸⁷
- 5.28 The potential gains from switching can be broadly split into two categories; direct financial gains and improved levels of service.

The direct financial gains of switching

- There is mixed evidence about consumers' perceptions of the financial gains from switching. Our survey suggested that the majority (73 per cent) thought that charges and interest rates varied so that there might be something to gain from switching, while other surveys have suggested that consumers think that the gains from switching are likely to be low. For example, a National Consumer Council survey found that in 2005 just 12 per cent of consumers thought that savings from switching would be major, 53 per cent thought they would be minor, and 23 per cent thought there would be none.¹⁸⁸ As shown in Table 5.14, a consumer who uses his or her free-if-in-credit account wisely will have relatively little to gain from switching due to having little interest forgone and not paying many bank charges.

Improved levels of service offered by competing banks

- In our survey 43 per cent of consumers agreed that there was nothing to gain from switching because the level of service at all banks was the same. There was a significant difference between switchers and non-switchers, with 48 per cent of the latter agreeing

187 It is not clear, however, whether consumer perceptions about satisfaction are based on an assessment of value for money, or whether they are rationalising their lack of engagement in the market by saying that they are happy.

188 'Switched on to switching, a survey of consumer behaviour and attitudes 2000-2005', National Consumer Council, November 2005, page 5.

compared with just 33 per cent of the former. Similarly, in the Competition Commission's Northern Ireland banking study 55 per cent of non-switchers said that they hadn't switched because 'all banks are the same'.¹⁸⁹ Unsurprisingly banks told us that there were differences in quality of service.

- 5.29 To summarise, there is mixed evidence concerning perceptions about the gains from switching. Consumers on the whole feel happy with their current bank but this may be due at least in part to a lack of transparency making it hard to identify differences between banks. Consumers tend to focus more on current costs than potential future benefits and, as we have seen, comparing costs is difficult.

Loss of a trusted banking relationship

- If consumers value the relationship that they have established with their current bank there will be a cost of losing this relationship by switching. In our survey, 83 per cent of people agreed that they were reluctant to leave a current bank they trusted for one they did not know¹⁹⁰ despite the fact that 73 per cent also agreed that there were benefits to be gained by switching as a result of better interest rates and charges.
 - Other studies have identified the importance of trust. The National Consumer Council's study found that 75 per cent of consumers thought that it made sense to use an established familiar company rather than a new company, even if the new one was offering a better deal.¹⁹¹
- 5.30 These findings suggest that there is a significant element of trust involved in banking, that branding is very important and that consumers may be reluctant to move away from a known high street bank to a new entrant or less well known rival. This may be one reason why the established banks have been able to maintain their market share over time.
- 5.31 Consumers may also fear they will have difficulty getting an overdraft on the same terms as with their current bank, or indeed getting one at all. The Cruickshank Report noted that consumers thought that staying with the same bank would make it easier and cheaper to secure credit when they needed it.¹⁹² The Competition Commission found that consumers in Northern Ireland were concerned that if they switched it would be harder to borrow, particularly on favourable terms. However, evidence from our survey suggests that such fears are not so evident in Great Britain. When we asked consumers who had never switched why that was the case, just one per cent mentioned concerns about the effect on their credit rating, one per cent cited not being able to get the same size overdraft, and one per cent not being able to get an overdraft at all.

189 Northern Ireland Personal Banking Inquiry Consumer Survey Results, ORC International, January 2006, page 19. In a prompted question about reasons for not switching, one of the options was 'banks and building societies are basically all the same'.

190 Older people are particularly reluctant, with 89 per cent of those aged at least 55 agreeing, compared to just 75 per cent of those aged 16 to 24. This may be because older people are likely to have been with their bank for longer and thus may have opened their PCA when there was more direct contact with banking staff and more of a personal relationship has developed. Eighty seven per cent of those that opened their PCA over ten years ago agreed that they would be reluctant to leave their current bank for one they didn't know, compared with 71 per cent of those that opened their account less than a year ago.

191 'Switching on to Switching – a survey of consumer behaviour and attitudes, 2000-2005', National Consumer Council 2006, page 8.

192 Page 128.

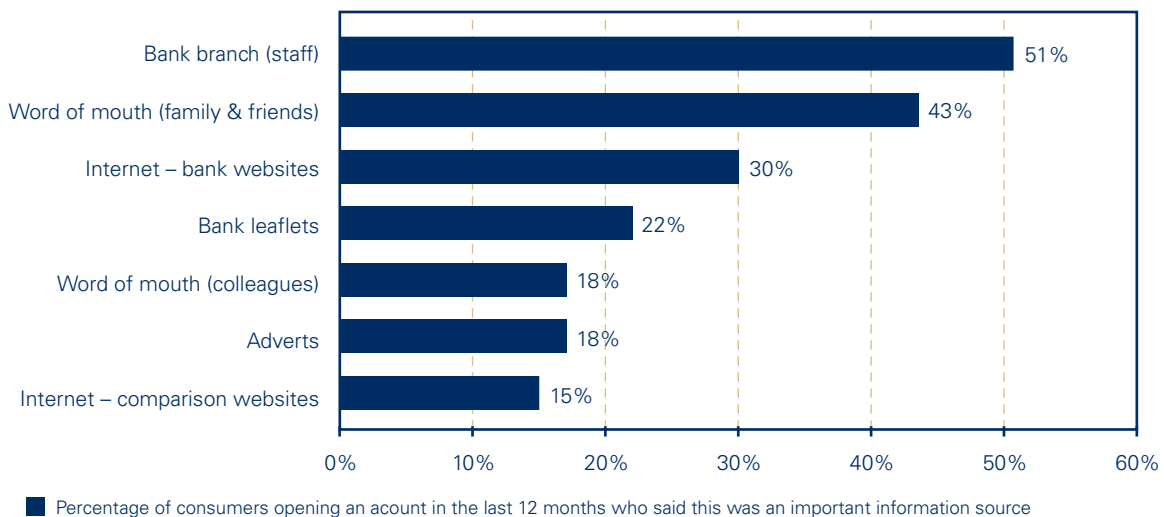
193 Page 100, paragraph 4.221.

- 5.32 Moreover, we note that since January 2007 most of the main UK banks have been sharing positive as well as negative credit data through credit bureaux. This reduces the difference in the information held about the consumer by the current and potential future banks. One of the major banks told us that this might increase the level of credit that the new bank would be willing to offer if the consumer were creditworthy.
- 5.33 Despite these changes in the ways that banks share information, it remains the case that when consumers have built up a relationship with a bank that they trust they may be reluctant to lose it, and this reduces their incentive to switch.

Sources of information that consumers use

- 5.34 If consumers find comparing interest rates and charges difficult, they may turn to other criteria when comparing current accounts. The criteria that consumers use could have an impact on the incentives for banks to offer competitive products. In our survey we asked people who had opened an account in the previous 12 months what information sources they found most useful (see Chart 5.4). The most frequent answer was bank branch staff (51 per cent) followed by recommendations from family and friends (43 per cent). The latter source was particularly important for the young and those opening their first current account.¹⁹⁴

Chart 5.4: Most common important sources of information for those who opened an account in the previous 12 months



Base: 259

Source: Ipsos/MORI Consumer Survey carried out for the OFT

194 Sixty four per cent of 16-24 year olds, 56 per cent of those opening their first ever account in the last 12 months.

- 5.35 In our qualitative survey, one consumer told us that they had chosen a bank recommended by their parents who felt they had been treated fairly by it. Another said 'my son recommended them and he has never had any problems'. One consumer said that 'I was tempted in the past by some of the online accounts, Egg and things like that, because friends were saying that they were brilliant and you can trust them and there are no charges'.
- 5.36 A similar picture to our survey is provided by other sources. For example, an internal research document provided to us by a major bank also found that recommendations from family and friends, followed by suggestions from branch staff, were the most important sources of information when choosing a new current account.
- 5.37 Price comparison sites offer a free online service to consumers enabling them to search for and compare a wide range of products across a substantial number of banks in once place, as outlined in Box 5.5.
- 5.38 There has been a fairly low take-up of the services offered by such price comparison sites, with just 21 per cent of those who had switched banks in the last year having used one, although this appears to be growing as only 10 per cent of those that switched at some point between two and five years ago said they had used them.

Box 5.5: Price comparison sites

There are a number of price comparison sites to help consumers compare personal current accounts without having to go to several different websites. An OFT review of some price comparison sites revealed the following characteristics:

- the main sites are interactive and allow consumers to tailor their search for their specific needs
- they all include credit interest rates, comparisons usually include arranged overdraft interest rates and some also compare unarranged overdraft interest rates
- most sites offer best buys or best seller information about accounts
- some of the sites can provide prominent information on charges, two of the four we considered showed a comprehensive list of all the possible charges that could apply to an account. Typically a link is provided that gives full details of all charges and interest rates relating to a particular account. Information is both easier to find and clearer than that provided on bank websites
- switching details are more prominent on price comparison sites than on bank websites. There is more emphasis on switching and links for each account are provided, together with an explanation of how the switching process works
- some sites allow the consumers to apply for an account directly via a link. These tend to be the products of those banks who have a commercial relationship with the site, and
- some banks pay to be listed and they appear higher on the lists of the main sites. However, best practice price comparison sites are open and transparent about the commercial relationship they have with any banks.

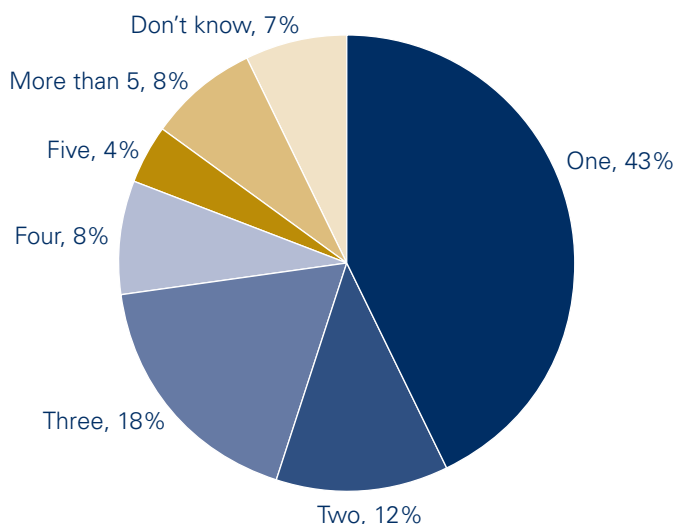
Price comparison sites can be a useful tool to help consumers choose an account with more readily available and better information on interest rates, charges and switching than individual bank websites. Not all sites cover the whole range of products on offer, however, and this is an important point that consumers need to know.

More details are contained in Annexe B.

The number of banks that consumers compare

5.39 The number of banks consumers consider before switching indicates both their level of engagement in the market and the degree to which their purchasing decisions are informed. The number of banks compared by those switching is low:¹⁹⁵ 43 per cent of consumers in our survey who had switched in the past five years had looked at no other bank than the one to which they switched, and only 20 per cent considered more than three banks (see Chart 5.6).¹⁹⁶ A National Consumer Council survey found that a third of consumers that had switched banks spent just a few minutes comparing banks before switching and one in five spent one hour.¹⁹⁷

Chart 5.6: Number of banks considered before switching by recent switchers¹⁹⁸



Source: Ipsos/MORI Consumer Survey carried out for the OFT

The switching process

Practicalities of the switching process

5.40 When changing banks, consumers can either handle all the arrangements themselves (for example, by changing direct debits and standing orders), or they can use the switching service of their new bank, which includes an automated process for transferring direct debits and standing orders known as ToDDaSO (Transfer of Direct Debits and Standing Orders).

¹⁹⁵ This refers to switchers only and does not include those new to banking.

¹⁹⁶ This suggests that there may have been some improvement since the Cruickshank Report, which found that over 60 per cent of consumers looked at just one alternative bank and that less than five per cent looked at more than four alternative banks (page 108). However, when we compared consumers in our survey who had switched recently (up to a year ago), fairly recently (one to two years ago), and less recently (two to five years ago), there were no statistically significant differences in the number of banks considered.

¹⁹⁷ 'Switched on to switching: A survey of consumer behaviour and attitudes, 2000-2005', National Consumer Council, November 2005, page 10.

¹⁹⁸ Respondents to the survey that had switched banks within the last five years.

5.41 Table 5.7 shows the actions required by the consumer depending on which method they choose.

Table 5.7: What consumers need to do to switch

Task	Consumer switches on their own	Consumer uses bank switching service
Proof of ID required for money laundering regulations	Consumer has to do	Consumer has to do
Speak to an advisor over the phone or in a branch	Consumer has to do	Consumer has to do
Arrange for balance transfer	Consumer has to do	<i>Done by bank</i>
Switch direct debits	Consumer has to do	<i>Done by bank</i>
Switch standing orders	Consumer has to do	<i>Done by bank</i>
Redirect salary and any income (e.g. a pension or child benefit)	Consumer has to do	Consumer has to do
Ensure any outstanding payments to old account have been made	Consumer has to do	Consumer has to do
Close old account	Consumer has to do	<i>Done by bank</i>

5.42 As can be seen from Table 5.7, the use of a bank's switching service reduces the number of tasks that the consumer needs to complete, and in particular avoids the need for the consumer to change over direct debits and standing orders and to arrange balance transfers, which are potentially the most time consuming. It therefore has the potential to offer significant savings in terms of time and effort involved.

5.43 Switching services and, to a lesser extent, consumers making their own arrangements are backed up by commitments in the Banking Code, a voluntary code of practice, as outlined in Box 5.8.¹⁹⁹

¹⁹⁹ See Chapter 3 for more details about the Banking Code.

Box 5.8: The switching commitments of the Banking Code

Consumer switches for themselves

- consumer to be provided with information on standing orders and direct debits within three working days of requesting them, and
- account to be closed or moved without charge.

Consumer transfers to new bank using its switching service

Consumer is told:

- how the switching process will work
- who is responsible for each step of the process
- what information the old bank will pass to the new bank
- what features will be offered with the new account so that comparisons can be made, and
- how long the process is likely to take.

There are also the following commitments

- consumers will be given what they need to operate the account within ten working days of the application being approved, and
- any unnecessary charges on the part of the bank or those resulting from a mistake will be refunded when consumers transfer accounts to or from them.²⁰⁰

- 5.44 As seen in Box 5.8, the protection offered by the Banking Code is greater if consumers use a bank's switching service rather than making their own arrangements because any unnecessary charges on the part of the bank or those resulting from a mistake will be refunded. Consumers still need to fill in an application form and provide identification, however, and may need to redirect salaries and benefits. They also need to ensure that any outstanding payments on the old account have been made.

²⁰⁰ One major High Street bank also told us that in addition to the protections of the Banking Code it offers a £10 guarantee payment to customers if there is a delay or a problem in switching accounts to it.

Table 5.9: Awareness of bank switching services

Awareness	Per cent
Know a lot about switching services	9
Know a little about switching services	33
Have heard of switching services but don't know about them	42
Have never heard of switching services offered by banks	16

Base: 2,074

Source: Ipsos/MORI Consumer Survey carried out for the OFT

Note: This question was asked only of respondents that had switched in the last five years

5.45 Table 5.9 shows that awareness of switching services is relatively limited. Not surprisingly there was a marked difference between those who had switched in recent years and others. In our survey, 60 per cent of recent switchers knew a little or a lot about switching services, compared with just 41 per cent of others.²⁰¹ For those that do switch there is a broadly even split between consumers using a switching service and those making their own arrangements – 53 per cent of those switching in the past five years said they used a switching service. In a recent survey carried out by Bacs, slightly more than half of those that switched in the last 12 months used a switching service.²⁰²

Confidence in the switching process

Fears about things going wrong

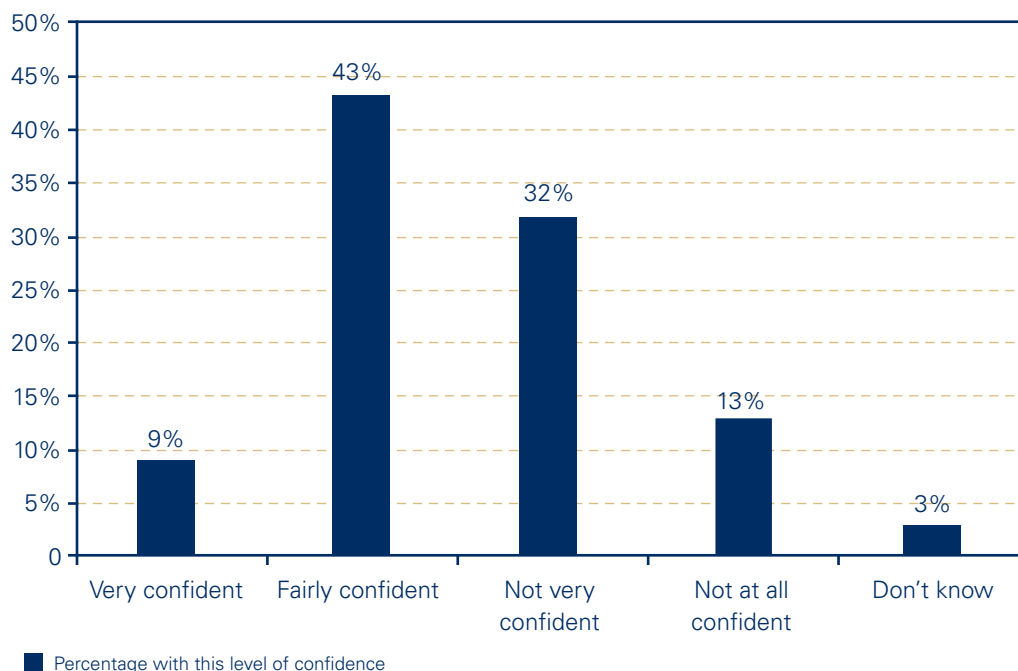
5.46 Even if actual switching costs are low, consumers may be reluctant to switch if they perceive them to be higher than the perceived benefits. In particular consumers may have a fear that the process may go wrong.

5.47 A significant proportion of consumers who have not switched think that things may go wrong when switching. In our survey people who had never switched were asked how smooth they thought the process would be if they did. As Chart 5.10 shows, 45 per cent were 'not very' or 'not at all' confident that if they switched it would go smoothly. Our qualitative survey also suggested that consumers have concerns about the switching process going wrong. For example, when we asked consumers about any particular concerns, one consumer said 'maybe about a standing order or a direct debit not being paid or something like that. I'm not convinced by the publicity of how easy it is', and another said 'anything not being paid would be my biggest fear'.

201 Also, having more knowledge of switching services is related to whether consumers use them. Just 44 per cent of consumers who had never used a switching service claimed to know a little or a lot about them, compared with 84 per cent of those who had used the service.

202 'Review of Account Switching Process Final Report', Bacs, April 2008.

Chart 5.10: Non-switchers' confidence in the switching process being smooth



Base: 1,326

Source: Ipsos/MORI Consumer Survey carried out for the OFT

- 5.48 Our report on the psychology of account usage suggested that while consumers feel in control of the decision over whether to switch, they are concerned about missed payments leading to charges being levied by third parties, or having to correct missed payments. Actual switchers showed less concern about potential losses than non-switchers.²⁰³
- 5.49 Similar results were found by the Competition Commission's study in Northern Ireland: 54 per cent of non-switchers feared fees charged for switching,²⁰⁴ 39 per cent feared problems with moving salary and 49 per cent problems with direct debits/standing orders. As will be seen in Chart 5.12, 19 per cent of those that had switched in the last five years in our survey reported problems with direct debits, so some of this fear seems justified given the number of direct debits that many people have.
- 5.50 A missed payment arising from switching problems will usually automatically show up on a consumer's credit record. In order for this record to be removed the consumer will need to realise that there has been a problem and then contact the third party involved. They may also need to get a letter from their bank explaining that the consumer was not at fault. It is then up to the third party who did not get the payment to decide whether or not the missed payment is removed from the consumer's credit record. If they refuse the consumer has the option of putting a note of explanation on the file, but there will still be a mark against their name. Such a situation clearly imposes costs on the consumer.²⁰⁵

203 This may be because lower concerns about losses make them more likely to switch, or because a positive experience when switching reduces their concern about losses.

204 Northern Ireland Personal Banking Inquiry Consumer Survey Results, ORC International, January 2006, page 20. It should be noted that in Great Britain there is a commitment in the Banking Code not to charge for switching.

205 These findings come from a discussion with a major credit bureau.

Perceptions about the time and effort required

- 5.51 When we asked consumers in our survey who had not switched banks, but had considered switching, to give reasons why they had decided not to (without giving them any prompting), the most common answer was that it was too complicated (23 per cent).
- 5.52 For all consumers who had never switched, the time involved in doing so was not a significant reason for not switching – just seven per cent said that it was too time consuming, five per cent that they didn't have the time, and three per cent that they were too lazy. However, this may give a misleading picture of views on the time and effort it takes to switch because the most frequent reasons given for not switching were that consumers were happy with their current bank (48 per cent), had never wanted to switch (24 per cent), and had never thought about it (14 per cent). For consumers in these categories the question of the time and effort required to switch may never have arisen previously.
- 5.53 We therefore asked consumers specifically for their views on the time and effort required to switch. Seventy six per cent agreed that shopping around for an alternative account was too much hassle, and 63 per cent that they didn't have the time to research the differences between banks.
- 5.54 Similar findings have been made by other studies:
- the National Consumer Council study found that consumers see switching procedures as lengthy and cumbersome and that they were a significant barrier to switching,²⁰⁶ and
 - 'hassle' was also the most important reason for not switching in the Competition Commission's Northern Ireland banking study.²⁰⁷
- 5.55 The concerns that consumers have about the cost of switching are highlighted when comparisons are made with other EU countries. The percentage of consumers who think that it is easy to change banks in the UK (58 per cent) is below the EU-25 average (69 per cent), and of the countries considered in the Eurobarometer 2005 survey, Ireland was the only country where it was lower.²⁰⁸

206 'Switched on to switching: A survey of consumer behaviour and attitudes, 2000-2005', National Consumer Council, November 2005, page 2.

207 Northern Ireland Personal Banking Inquiry Research Project, BMRB Social Research, December 2006, page 30.

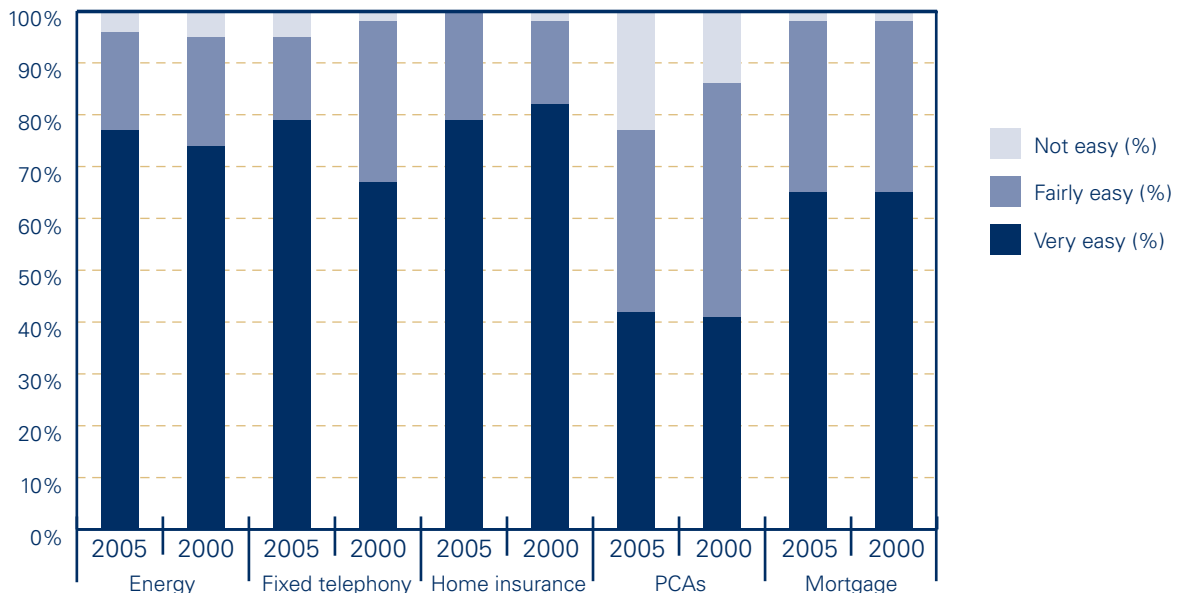
208 Eurobarometer survey 2005; Note that this was just before the introduction of the switching code in Ireland in February 2005. Average data of EU25, not EU15.

The actual switching experience

Ease of switching in practice

5.56 Despite the concerns that consumers have about switching, many of those who do switch find it relatively easy and trouble free, and feel positive about it. Eighty two per cent of recent switchers in our survey said that they found it 'easy'. Similarly, the National Consumer Council survey found that 77 per cent of switchers found it 'very easy' or 'fairly easy'.²⁰⁹ A survey carried out by Bacs in October 2007 also found that consumers rated satisfaction with the switching process at seven out of 10 in Great Britain and eight out of 10 in Northern Ireland.²¹⁰ However, there is evidence that some consumers who have switched may still have concerns and a lack of confidence in the switching process, even if it was straightforward for them. A third (33 per cent) of recent switchers in our survey said that they were 'fairly unlikely' or 'very unlikely' to recommend switching to others and in the Bacs survey 24 per cent of those that had switched in the last year in Great Britain and eight per cent of those in Northern Ireland said that they would not attempt to switch again. Furthermore, as shown in Chart 5.11, the National Consumer Council Survey showed that consumers find it considerably easier to switch in various other markets. It is also notable that the percentage of respondents that said it was not easy to switch PCA went up from 14 per cent in 2000 to 23 per cent in 2005.

Chart 5.11: Easy of Switching in various markets



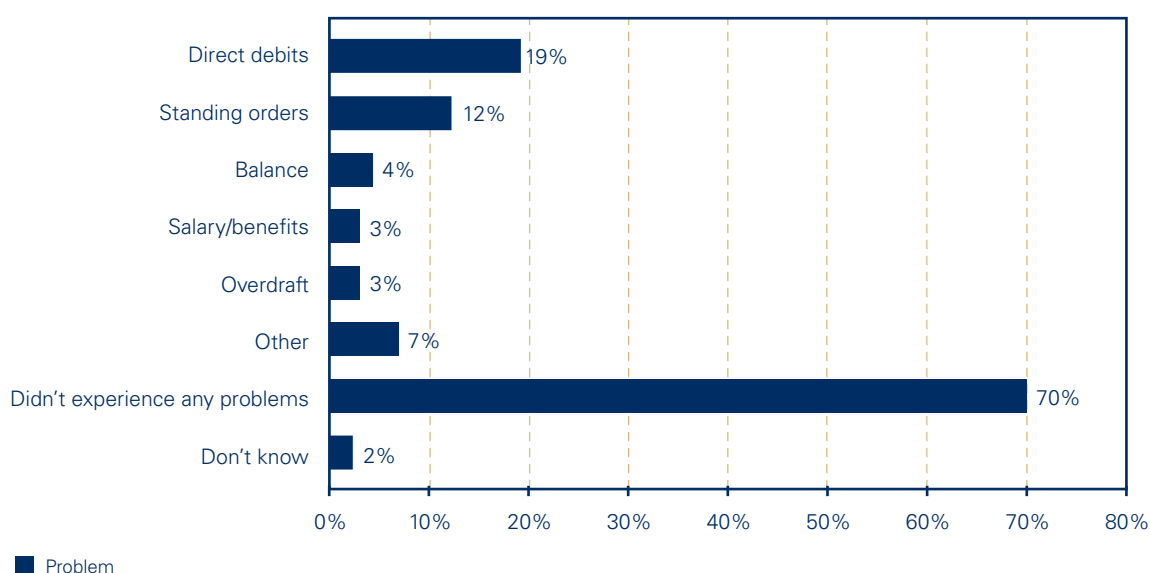
Source: 'Switched on to switching: A survey of consumer behaviour and attitudes, 2000-2005', National Consumer Council, November 2005, p5.

209 Page 5.

210 'Review of Account Switching Process Final Report', Bacs, April 2008.

- 5.57 Seven out of 10 recent switchers did not encounter any problems when switching, although this leaves a significant minority of 28 per cent²¹¹ that did have problems. Of those that did have problems, more than two thirds (69 per cent) said they had all been resolved satisfactorily. The Bacs survey also found that around one in three of those that had switched in the last 12 months experienced problems, mainly concerning direct debits, or the amount of time that the process took.
- 5.58 When we asked consumers about what problems had occurred the most common answers were that they concerned direct debits (19 per cent of recent switchers), standing orders (12 per cent), balances (four per cent), salaries or benefits (three per cent) and overdrafts (three per cent).

Chart 5.12: Problems experienced when switching banks.



Source: Ipsos/MORI Consumer Survey carried out for the OFT

- 5.59 As shown in Table 5.13, consumers who used bank switching services were significantly more likely to report experiencing problems, usually with direct debits or standing orders. In addition, those who used a switching service provided by the bank were significantly less likely to have said that the switching process took no more than 10 working days (48 per cent of people using the switching service and 67 per cent who made their own arrangements said it was all done in less than ten working days). In the Bacs survey, of those that had switched in the last 12 months, 17 per cent in Great Britain and 11 per cent in Northern Ireland said that they would not ask their bank to organise things if they switched again.²¹²

211 Ignoring the don't knows, as shown in Chart 5.12.

212 *Review of Account Switching Process Final Report*, Bacs, April 2008.

5.60 In its report, Bacs concludes that whilst ToDDasO is largely working well, there is room for service enhancement and improved efficiency, and there needs to be some re-education of users and re-enforcement of the rules. It suggests that some areas of the switching process would benefit from standardisation, in particular regarding the transfer of balances, account closure and the transfer of regular Bacs direct credits such as salary payments.²¹³ A recent bulletin by the Banking Code Standards Board has stated that in the light of public interest and complaints it has received, it will be doing a follow-up to previous satisfaction reviews to ensure that account opening timelines are being met, customers are provided with the required information and that, where errors have occurred, appropriate refunds are offered.²¹⁴ The European Commission has prepared draft regulations on bank account switching and is expected to begin negotiations with member states in Autumn 2008.

Table 5.13: Problems with switching reported by consumers who used bank switching and those who made their own arrangements²¹⁵

	Percentage who used a bank switching service (Base = 142)	Percentage who made their own arrangements (Base = 121)
Had some kind of problem	37	19
Had a problem with direct debits	28	10
Had a problem with standing orders	18	5

Source: Ipsos/MORI Consumer Survey carried out for the OFT

The actual gains from switching

5.61 The financial benefits of switching are likely to vary considerably depending on how an individual uses his or her current account, and the type of account that he or she is currently using. In our study we looked at the potential savings from switching by developing different consumer profiles based on various credit and debit scenarios. Full details can be found in Annexe C.

5.62 The potential financial gains from switching are shown in Table 5.14, based on consumers in each 'profile' switching from the median account to the best account, and the worst account to the best account. Given that the mean time accounts were held in our survey was over 10 years and few consumers switch their account in less time than this, potential savings over 10 years gives an indication of the savings an average consumer could make over this period by having switched.

213 Bacs, April 2008.

214 Banking Code Standards Board Bulletin, 28 March 2008.

215 Based on those who had switched in the last five years.

Table 5.14: Potential savings from switching for various consumer profiles²¹⁶

Profile	Switch from average to best account		Switch from worst to best account	
	1 year	10 years	1 year	10 years
Typical credit without unarranged overdraft	£56	£562	£63	£632
Typical credit with unarranged overdraft	£51	£511	£69	£688
Typical debit without unarranged overdraft	£39	£388	£50	£505
High credit	£102	£1016	£114	£1143
High debit with unarranged overdraft	£76	£764	£112	£1122
Marginal credit	£27	£271	£30	£305

Source: see Annexe C

- 5.63 A Financial Services Authority study found that for a typical consumer remaining in credit, annual savings when moving from the worst to the best deal would be £37, while for those using the account as a borrowing facility it was £231.²¹⁷ In its recent study, the Bank of England concluded that the monetary loss from not choosing the cheapest bank was relatively small.²¹⁸
- 5.64 In its study of banking in Northern Ireland the Competition Commission looked at the potential benefits of switching by formulating four scenarios.²¹⁹ They asked the banks to calculate what charges would be applied to each in a quarter. They then took the difference between the most and least expensive account in the quarter and multiplied it by four to give an indication of how much might be saved by switching in a year.²²⁰ Results are shown in Table 5.15.

216 Results have been rounded to the nearest pound.

217 'Losing interest: How much can consumers save by shopping around for financial products?', Financial Services Authority, October 2002, page 15, Table 2.

218 'Switching Costs in the market for personal current accounts: some evidence for the United Kingdom', Working Paper no 292, Bank of England, March 2006, page 9.

219 Price models in Northern Ireland are somewhat different from those in Great Britain, thus making direct comparisons difficult.

220 Annexe 4.7, page A4(7)-10.

Table 5.15: Potential annual savings on charges from switching in Northern Ireland²²¹

Scenario	Potential annual saving if switching from most to least expensive account
Balance in overdraft once per quarter	£133
Balance in overdraft once per month	£141
Balance in unarranged overdraft once per quarter	£286
Balance in unarranged overdraft once per month	£894

Source: 'Personal current account banking services in Northern Ireland market investigation', Competition Commission, May 2007

5.65 It is clear from the above findings that the amount that might be saved by switching varies considerably depending on how a consumer uses his or her account, in particular the credit and debit profile of the consumer in question. Under the current pricing model, the savings for consumers that manage their account well, maintaining low credit balances and not going into unarranged overdraft, will be modest. However, those with high balances or who pay charges stand to gain somewhat more, so it is perhaps surprising that switching rates are not higher, at least for such consumers.

Vulnerable consumers

5.66 In line with current account holders generally, 66 per cent of basic bank account holders have never switched (compared with 64 per cent for all respondents), and 24 per cent²²² have switched only once. Furthermore, 80 per cent of those on low income (76 per cent of basic bank account holders) who had never switched had never even considered switching (compared with 74 per cent for all respondents). This means that 55 per cent of consumers on low income have never considered switching their accounts.

5.67 Results from our consumer survey show that, when switching did occur vulnerable consumers generally consider the same things important as when they are looking to open an account for the first time. There are, however, some differences. Among those consumers with low savings, those who were switching account providers were significantly more likely to take into account the products and services on offer than those looking to open an account for the first time (20 per cent compared with eight per cent). Furthermore, among consumers on low income, those who were switching banks were more likely to take into account lower charges or a free/low charged overdraft than those opening an account for the first time (eight per cent compared with two per cent).

5.68 A majority of low income consumers from our consumer survey (69 per cent) considered that they lacked the required knowledge to choose between current account providers. Only one of the price comparison websites we looked at currently offers consumers the option of comparing basic bank accounts.

²²¹ Results have been rounded to the nearest pound.

²²² Of those respondents that have switched provider in the last five years, 39 per cent considered only one provider and 19 per cent considered two (effectively the one they eventually chose and one other).

Conclusions

- 5.69 High levels of switching can generate costs and inefficiencies in a market and low levels of switching can be a sign of happy customers. However, for a market to gain the benefits of competition, companies have to believe there is a credible threat of switching by their customers. Economic theory predicts that where there is not a credible threat, markets may exhibit relatively high prices.
- 5.70 In our survey nearly half of all consumers (47 per cent) had not even considered switching their current account, and only a small minority of those that had considered it actually went on to switch in any one year – only six per cent had switched in the last twelve months. Consumers tend not to keep an eye on the market. This is despite a general awareness that there may be better alternatives to their existing account.
- 5.71 The main motivators of switching are ‘push’ factors, when consumers feel that their current bank has let them down in some way, or something has gone wrong rather than ‘price’ factors, when a better offer is seen to be available.
- 5.72 When consumers do decide to compare accounts, the lack of transparency of the cost of the current account, in particular in relation to interest forgone and the application of charges, make such comparisons inherently difficult. Quality of service is also not easily observed before selecting a bank. Consumers tend to rely on information from bank branch staff and recommendations from family and friends.
- 5.73 Consumer perceptions about both the potential financial benefits of switching and any resulting change in service levels are mixed, but many consumers say that they are happy with their current bank. Trust is also very important, and many consumers are concerned about losing a relationship with a trusted bank that they know. When consumers do search, information sources and number of banks considered is limited, given the number of current accounts available.
- 5.74 Concerns about the switching process going wrong, and the time and effort required to switch act as a further barrier to consumers actually switching. There are particular concerns about missed payments and having to rectify any problems. While the majority of those that do switch find it to be relatively easy and trouble free, such concerns are at least partly justified given that in our survey 28 per cent of those that had switched reported some kind of problem. This was significantly more likely to be the case for those that used a bank switching service rather than making their own arrangements. It is of particular concern that 33 per cent of switchers would be ‘unlikely’ or ‘very unlikely’ to recommend switching.²²³
- 5.75 This raises questions of whether there is a fair allocation of the risk of switching. Consumers that switch have little control over the process relative to the banks. However they appear to face a significant proportion of the consequences, and hence risk, of the process going wrong. For example, problems with third party payments may show up on a consumer’s credit record, which will take time and effort to rectify. Third parties may also levy charges for defaulting that the bank may not be prepared to refund. This unequal allocation of the risk is consistent with the evidence that consumers find it considerably easier to switch in various other markets, and it may be driving the finding that nearly half of the consumers surveyed fear the switching process.

²²³ Results quoted in this paragraph refer to people that had switched within the last five years.

- 5.76 Results from our analysis and from previous studies suggest that under the current pricing model the potential gains from switching are relatively modest for many consumers, but could be significant for those that maintain high credit balances and/or pay insufficient funds charges. It is therefore surprising that switching levels are not higher.
- 5.77 Vulnerable customers face very similar issues to those faced by non-vulnerable ones when it comes to switching accounts. The two groups also show very similar behaviour in terms of low levels of switching and little interest in doing so.
- 5.78 The overall picture is one of consumers who are for the most part relatively unengaged in the market for current accounts and uninterested in switching. Generally their decisions are not well informed. As a result, consumers are driving competition only to a limited extent.

6 CONCLUSION

- 6.1 The PCA market has several positive features. In particular there is evidence of competition, high consumer satisfaction and low fees for many of the visible elements to consumers' accounts. Despite this we are concerned that there are features of the market that are not working well for consumers – specifically the limited degree of transparency, complexity in the way some charges are implemented, the lack of control that consumers have in incurring charges, and the real and perceived barriers to switching.
- 6.2 In particular our positive findings include:
- there are a number of providers in the market and there is evidence of some competitive pressure on the four 'established' banks by 'challengers'
 - consumers receive many day-to-day services without incurring a charge
 - high levels of consumer satisfaction overall, and
 - internet and telephone banking makes it easier for consumers to manage their account.
- 6.3 The significant areas of concern are:
- low levels of transparency on fees that make up a substantial proportion of the effective payment that consumers make for current account services, meaning that consumers lack the fundamental information needed to compare competing products
 - complexity in the way that these fees, particularly insufficient funds charges, are implemented that makes it hard for consumers to predict when they will be incurred
 - the lack of simple mechanisms for consumers to control, or opt out of, whether they use the service(s) for which they pay, and
 - a general and valid perception amongst a significant proportion of consumers that switching is both complex and risky, and that unless they manually switch, they have little control over these risks.
- 6.4 The OFT believes that, collectively, these concerns constrain the market's ability to deliver value to a significant proportion of consumers, and constrain banks' incentives to provide new and innovate PCA solutions. This is because the lack of transparency and control on key elements of their accounts means a significant number of consumers do not know what they will effectively pay or what they have paid afterwards. For example, 21 per cent of consumers who received an insufficient funds charge didn't know such charges existed before they were incurred. Many consumers were unaware of the level of their bank's insufficient funds charges (67 per cent of all consumers), even when they had incurred these charges recently (25 per cent), showing that some do not learn from their past experiences. Furthermore, few consumers, if any, are likely to be able to calculate forgone interest with any precision.
- 6.5 Consumers' limited understanding of these key account elements provides banks with little incentive to compete on them. This may lead to relatively high charges for those elements, and thus harm consumers who are unaware of, or cannot avoid, incurring them.²²⁴ While many markets have some element of cross-subsidisation, it is a concern in the PCA market for several reasons.

²²⁴ These issues and their resulting distortions have been increasingly studied within economic literature. See for example, Xavier Gabaix and David Laibson, 2006. 'Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets,' *The Quarterly Journal of Economics*, MIT Press, vol. 121(2), pages 505-540, May. See also Stefano Della Vigna & Ulrike Malmendier, 2004. 'Contract Design and Self-control: Theory and Evidence,' *The Quarterly Journal of Economics*, MIT Press, vol. 119(2), pages 353-402, May.

- 6.6 First, there seems to be a significant cross subsidisation from those consumers who incur insufficient funds charges to those who do not; and to a considerable extent this is from socially vulnerable, low income and low saving consumers to higher income, higher saving ones.²²⁵
- 6.7 Secondly, the magnitude of these cross subsidies suggests that there may also be significant distortions within the market. We found that the banks earned over thirty percent of all their revenues from insufficient funds charges in 2006. Misalignment of costs and prices may lead to allocative efficiency distortions through the under or over consumption of services by consumers.
- 6.8 Thirdly, it is a concern because the absence of competition on a significant proportion of revenues reduces banks incentives to provide new products and services within these areas. Increased transparency and hence consumer awareness in previously non-visible areas would generate greater consumer sensitivity to differences in price and quality on these services. More active consumer engagement would provide greater incentives for all banks to provide new and innovatory services in these areas. The OFT believes this would benefit the more efficient banks the most, as they would be able to win more consumers by having the best offers. This in turn would put competitive pressures on less efficient banks to improve, driving a virtuous circle of better products and services for consumers.
- 6.9 All three concerns exist independently of the level of competition on more visible elements of the banks' offerings. However there may be an additional concern where there are constraints on their ability to compete on these visible elements. In highly competitive markets any profits made on non-visible fees should be competed away through competition for consumers on visible fees. This does not appear to be the case here, however. Internal documents supplied by some of the banks show that they can raise the level of the less visible fees (and indeed have done over time) without reducing their overall competitive position. In addition chapter 5 showed that competition in the visible elements is limited by both real and perceived problems in the switching process. For these reasons we are not persuaded that profits earned from less visible fees are fully competed away in other areas. This raises the possibility of the additional concern that a significant proportion of the profits made on less visible elements such as insufficient funds charges are kept by the banks rather than passed back to consumers through more intensive competition.
- 6.10 In conclusion the OFT believes that for many consumers, the current market does not work well. Consumers are losing in two ways. A minority of consumers are losing out significantly in financial terms, but ultimately everyone suffers if the banks have little incentive to provide better offers on fees and interest, or information that would better facilitate switching.

²²⁵ Consumers on low incomes or with less than £1,000 in household savings were significantly more likely to have been charged in the past 12 months for a refused payment. Furthermore, those with less than £1,000 in household savings were significantly more likely to have been charged in the past 12 months for going into their unarranged overdraft.

NEXT STEPS

- 6.11 There are three areas of the market where we believe improvements may deliver significant benefits to consumers and the wider economy. The first is increased transparency, with banks informing consumers in a way that greatly reduces the need for high levels of regulatory intervention. The second is an increase in the number of active and informed consumers so as to enhance the current competition between banks, delivering efficiency in supply and value for consumers. The third is to improve the switching process, by minimising barriers to switching and improving consumers' perception of the process.
- 6.12 Regulatory intervention can create uncertainty for industry, stock markets and consumers. The OFT is therefore committed to applying the Government's principles of better regulation – transparency, accountability, proportionality, consistency and targeted intervention. The OFT's overall approach – including, for example, rigorous prioritisation and evaluation of its market interventions – is closely aligned with these better regulation principles. Competition is the preferred option, but where this does not function well, effective self-regulation of markets is preferred over explicit regulation. However self-regulation has the potential to generate a single industry solution, which may stifle innovation and the diversity of products available. In these instances there may be a rationale for consumer-focused and light touch regulatory intervention and, where necessary, enforcement action. It is the OFT's provisional view that in this market some form of intervention is necessary.
- 6.13 Following publication of this study, the OFT will be engaging with the banking industry, consumer groups and interested parties on appropriate next steps. As part of this exercise we have published a separate consultation paper which seeks views both on the findings in this report and on potential remedies. This can be found at www.of.gov.uk

GLOSSARY

Active accounts	A current account which has had at least one transaction during the previous three months.
Ancillary charges	Charges or fees for transactions carried out abroad, issuing replacement statements, making payments overseas, bankers drafts and other special money transfers, and arrangement fees.
Arranged overdraft	A pre-arranged overdraft facility which sets a limit agreed by a consumer and their bank.
Arranged overdraft interest rate	The annual interest rate that banks charge on arranged overdraft balances.
Average daily credit balance over the year	The sum of daily credit balances divided by the number of days in the year. This definition can be applied to a consumer, a bank or a number of banks depending on the level of aggregation.
Average daily credit balance when in credit	The sum of credit balances on all days when in credit, divided by the number of days when in credit. This gives an indication of a consumer's balance when in credit.
Average daily debit balance over the year	The sum of daily debit balances divided by the number of days in the year. This definition can be applied to a consumer, a bank or a number of banks.
Average daily debit balance when in debit	The sum of daily debit balances divided by the number of days when in debit. This gives an indication of a consumer balance when in debit.
Basic bank account	An account that allows consumers to pay income, benefits, cheques or cash directly into the account and withdraw cash at ATMs. Basic bank accounts can also be used to pay bills by either direct debit, by transferring money to another account or by payment to a linked account. Basic bank accounts do not offer an overdraft.
BERR	The Department for Business, Enterprise and Regulatory Reform (formally the Department of Trade and Industry).
Challenger banks	Banks which are not one of the traditional established four banks of Lloyds, RBSG, Barclays and HSBC Group.
Consumer categorisation	A method of classifying and describing social classes, used for market research purposes. The consumer categories include A, B, C, D and E classifications.
Consumer category D	Semi and unskilled manual workers. ²²⁶

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Consumer category E	State pensioners or widows (no other earner), casual or lowest grade workers.
Credit interest rate (CIR)	The interest rate banks pay on credit balances (either monthly or annually).
Cross-subsidisation	Funding the loss or low return from one line of goods or services from another more profitable activity. For example a bank or other lending institution might charge a lower-than-cost rate on certain loans or services and compensate by charging a more-than-economic rate on other loans or services.
Debit interest rate	The interest rate banks charge on balances in debit (either monthly or annually).
Dormant/non active accounts	An account which has not had at least one transaction during the previous three months.
Equivalent annual rate (EAR)	A notional rate which illustrates the annual interest rate, taking into account how often interest is charged to the account, and does not include any fees or charges.
Economies of scale	Economies of scale exist when long run average costs of each unit of output falls as output rises. This allows the firm to produce proportionately more for the same amount of inputs as volume increases.
Economies of scope	Economies of scope exist when average costs fall as the range of products provided increases. This allows the firm to produce proportionately more for the same amount of inputs, as its product range increases. This is often due to common costs.
Faster payments	A new payment service, introduced in May 2008, designed to speed up internet and telephone initiated payments and standing order payments.
Financially constrained	Indicates consumers with low income and low savings.
Fixed costs	Costs that do not change with the volume of activity of a business.
Free-if-in-credit model	The 'free-if-in-credit' model imposes no charges on consumers for day to day money transmission services, or for access via ATMs, branches, telephone or internet.
Ipsos MORI	Market & Opinion Research International Ltd/MORI Financial Services, a market research company.
Insufficient funds charges	Charges levied as a result of consumers requesting or instructing their bank to make payments for which there are insufficient funds available in their current account.

Interest forgone	The difference between the amount a consumer could earn in credit interest from his or her current account the amount he or she could earn using an account that pays a higher interest rate or a savings account. It is in effect the opportunity cost of holding credit in a current account with a low credit interest rate.
Interest rate	The amount paid (received) in interest divided by the amount borrowed (deposited).
Internal funding price	The cost/benefit of lending/storing consumers' funds to the bank. It is set by the treasury of the bank and is used to determine the net interest income from credit and debit balances.
Established four banks	Lloyds, RBSG, Barclays and HSBC Group.
LINK	Link Interchange Network Ltd, a company jointly owned by banks and building societies which was set up to share the costs of building and operating an ATM network. At peak, the LINK switch processes almost one million transactions per hour.
Maintenance charges	Monthly and/or daily overdraft excess charges levied for each relevant period the balance remains in unarranged overdraft. The period may be a month or may be a day depending on the bank.
Money transmission services	'Money transmission' includes services that transfer funds and make payments to and from a current account.
Net interest income from debit balances	The difference between the interest charged to borrowers on debit balances (such as arranged and unarranged overdrafts) and the cost to the lender of funding this lending.
Net interest income from credit balances	The difference between interest earned by banks from credit balances held by their customers, less the cost to them of borrowing this money.
OFT	The Office of Fair Trading.
Overdraft	An overdraft is a negative balance in a current account.
Overdraft excess charge	Unarranged overdraft charge that is incurred when a current account is in unarranged overdraft at any stage in a given period, usually a month.
Overdraft facility	An overdraft facility is where the bank has agreed in advance that a customer has a right to draw on his account to create an overdraft up to an agreed level if they wish to do so.

Packaged account	A current account where customers typically pay a monthly or quarterly fixed charge regardless of whether the account is in credit or debit. Customers are also likely to receive preferential terms on other characteristics of the account (for example, on credit interest rates or approved overdraft rates), may be exempt from some ancillary charges, and often receive other bundled benefits such as free travel insurance or discounts on some purchases.
Paid Item charge	Unarranged overdraft charges that are levied when a bank authorises a payment that creates or extends an unarranged overdraft.
Personal Current Account	An account, for individuals not businesses, which provides the facility to hold deposits, receive and make payments (cheque and debit cards), use ATM facilities and make regular payments (direct debits and standing orders).
Personal banking	Banking aimed at individuals. This may include products such as PCAs, mortgages, loans, credit cards or savings accounts.
Post Office Card Account	Account offered by Citibank International Plc through the Post Office Limited which can be used only to receive state benefits (such as pensions, income support and tax credits).
Retail banking	Banking aimed at consumers, rather than corporations or other banks.
Revenue	Income that a company receives from its normal business activities, usually from the sale of goods and services to customers.
SMEs	Small and medium sized enterprises.
Snowballing of charges	A snowball effect is said to occur where a consumer enters unarranged overdraft and incurs multiple charges.
Standard current account	A current account which, in addition to providing basic banking services, may offer additional services such as an overdraft facility.
Standing order	Regular transfer of funds automatically from one account to another on a pre-agreed basis as to amount, regularity and date of transfer.
Statement	A communication from a bank to a customer setting out the transactions that occurred on that customer's account in a given period.

Sweep accounts	Accounts under which cash can be moved between accounts automatically. They could be used to sweep excess cash from a current account to a savings account to minimise interest forgone or sweep in cash from a savings account to avoid an unarranged overdraft.
Switching services	Services provided by banks to customers, whereby a new bank facilitates switching accounts from another bank.
Transaction charges	Charges that may apply for common transactions such as cheques, ATM withdrawals and debit card payments. These are usually levied on standard accounts only when they are in arranged overdraft, and any account when it is in unarranged overdraft. Transaction charges in unarranged overdraft may be called paid item charges, referral charges or card misuse charges where the transaction is made, and unpaid item charges if the transaction is declined.
Unarranged overdraft	Overdrafts are said to be unarranged when the debit balance exceeds a limit agreed between the customer and the bank or if no such limit had been agreed.
Unarranged overdraft charges	Transaction and maintenance charges incurred when a customer goes into, or is in, an unarranged overdraft.
Unarranged overdraft interest rate	The annual interest rate that banks charge on unarranged overdraft balances.
Unpaid item charges	Unpaid item charges are insufficient funds charges that are levied on any unpaid payment that, if paid, would create or extend an unarranged overdraft.
UTCCR	Unfair Terms in Consumer Contracts Regulations 1999.
Variable costs	Costs that change with the volume of activity of a business.

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