

Personal current accounts in the UK

An OFT market study



Executive summary

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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.

The full report, *Personal current accounts in the UK: An OFT market study* (OFT1005), annexes and accompanying consultation document can be found at www.offt.gov.uk/pca

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