Second Data Room Report Prepared by Brattle on Behalf of Barclays

1 Executive Summary

1 The purpose of this report is to evaluate the CMA's analysis and interpretation of the PCA market data made available in the second data room as part of the CMA's Retail Banking Market Investigation (RMBI). We have reviewed the CMA's Revised Pricing Analysis and noted changes in data and methodology which have resulted in a significant increase in the CMA's estimated gains from switching. Although we are pleased to see that the CMA has used the most up to date market prices in its revised pricing analysis, we are concerned that the switching gains have been overstated. Brattle analysis shows that the switching gains are highly sensitive to the inclusion of an outlier product provided by a small niche bank that is targeting customers with large credit balances. Removal of the outlier results in the average gains from switching falling by half. The sensitivity of the CMA's estimated switching gains to one outlier observation, that is some distance from the other prices in the market, suggests that the results are not statistically robust.

2 We are pleased that the CMA has taken on board our suggestion to directly link the relationship between price and quality by using both sets of information from the same GfK survey. However, it is disappointing that the CMA has retained the results of previous analysis, based on the *Which*? survey which was not statistically robust, and the FRS survey which used a completely different sample set and size. Brattle's review of the CMA's revised pricing analysis suggests that the price quality relationship is of limited relevance as it is at a highly aggregated level using data that shows little statistical variation. As 90% of customers are either satisfied or very satisfied with their bank, it is difficult to draw strong conclusions between prices and quality, as the CMA has done. We also note that customers select banks on the basis of quality along different dimensions of service. It would therefore be more meaningful for the CMA to analyse quality at a more disaggregated level.

3 We note significant new information on the use and costs of arranged and unarranged overdrafts which is helpful for shedding greater light on the use and costs of overdrafts. We consider, however, that it would have been helpful for the CMA to have conducted a more detailed behavioural analysis of overdraft use which would have obtained more information on the way in which consumers use arranged and unarranged overdrafts

and the factors that affect the frequency, level and duration of overdraft use. Such analysis would have been helpful in informing the development of remedies, to help ensure they were well targeted, effective and proportionate. We provide more detailed comments in the sections that follow.

a. Estimated gains from switching

4 We are pleased that the CMA has revised its pricing analysis, taking on board Barclays' comments regarding the importance of including the most recent data available. The CMA's revised pricing analysis shows a significant increase in the CMA's estimated gains from switching. We note that the estimated gains increase from the CMA's previous analysis (based on 2014 prices) of a monthly average of £6.21 or around £75 a year to £9.69 a month, or around £116 a year, an over 50% increase in the estimated gain from switching. The CMA estimates that if all customers switched to the five cheapest accounts, there would be an aggregate benefit of £5.7bln in GB on Standard and Reward current accounts alone. Brattle analysis shows that the CMA's gains from switching result is not statistically robust as it is driven by an outlier product which, when removed, results in gains from switching falling by half, from around £116/year to £67/year. We also consider it misleading for the CMA to report aggregate gains from switching of £5.7bln as the CMA has done in Table 10 of the its update on personal current account pricing Working Paper.[1] The CMA's approach is to calculate aggregate benefits on the unrealistic assumption that 100 percent of 65 million active PCAs would switch.

5 The CMA's estimated switching gain is based on the assumption that all customers could switch to any product in the market offered by any provider. Whilst this might be hypothetically feasible, in reality some products would not be viable for provision to significant market shares. The CMA does not consider whether the smaller banks, that have the cheapest prices, could sustain such prices if there was a sudden and dramatic increase in switching to the very low price accounts. Indeed, the low price accounts effectively pay customers to bank with the provider. Such a pricing strategy is not sustainable for a large and more diverse set of customers that do not have large credit balances. The CMA acknowledges that their analysis does not consider the dynamic effects of switching on prices. But the CMA does not appear to have considered if the

[1] Retail Banking Market Investigation: Update on personal current account pricing, Table 10, pp 29.

lower prices offered by some banks would be sustainable if large numbers of customers were to suddenly switch to the lowest price accounts.

b. Arranged and unarranged overdrafts

6 We note that the CMA's revised pricing analysis also includes more detailed information on the cost of arranged and unarranged overdrafts. As bank charges are driven by overdraft use, it is important to understand the way in which consumers use overdrafts and the charges they face. Unfortunately, the CMA has not conducted any analysis of the behavioural aspects of overdraft use which would help inform the CMA's proposed remedy for prompts for overdraft users and for banks to introduce voluntary monthly maximum charges (MMC) for unarranged overdrafts. In the absence of behavioural analysis of why and how customers use overdrafts, it is difficult to know how best to design and target behavioural and price remedies and to determine what costs the MMC would comprise. We also note that Barclays does not have an unarranged overdraft facility which has led to the CMA treating the emergency borrowing facility as an unarranged overdraft. We note that Barclays does not agree with this treatment of its emergency borrowing facility and refer the CMA to Barclays' submission in response to the Provisional Decision on Remedies.

7 Considering the proposed remedy of introducing monthly maximum charges for overdrafts, we provide some information on the distribution of overdraft fees and interest charges to better understand what reasonable maximums might be.

c. Price Quality Relationship

8 We appreciate the CMA's effort to analyse the relationship between price and quality by directly linking data from the same survey of customers so that the analysis can be undertaken on an individual customer basis. The CMA has now directly linked customers' views on quality with how much they pay for banking services, obtained from the GfK survey. Based on a survey of around 3,700 customers, the CMA's analysis shows that over 90% of customers surveyed are either very satisfied or satisfied with the quality of their banking services. The CMA found a direct inverse relationship between price and quality such that those that pay the most for their banking are also the least satisfied. However, the CMA continues to focus on overall satisfaction, which has very little variation, rather than customer satisfaction with particular service offerings of their bank.

9 The CMA also does not consider that the smaller banks, who are likely to be targeting more profitable market segments, and who may not offer a flexible overdraft service, are able to sustain low prices because their risk characteristics are different to the larger banks that have a much more diverse customer base. The price-quality relationship investigated by the CMA has been at a very broad level, assuming that all banks have the same pricing strategy and target the same group of customers. A more disaggregated analysis of price and quality would likely show up a more differentiated level of service between banks and therefore call into question whether it would be feasible for substantial numbers of customers to switch to the bank accounts with the lowest prices in the market. We consider, therefore, that although the CMA's revised pricing analysis incorporates methodological improvements, a more disaggregated analysis of prices and quality would have obtained greater insight and understanding of how the retail banking market works, how customers respond to pricing signals, particularly in the provision of overdrafts, and the basis on which banks are competing with each other.

2 Gains from Switching

10 The CMA's estimated gains from switching have increased significantly since the previous pricing analysis based on 2014 pricing data. Table 1 shows the detailed distribution of gains from switching. The average gains from switching increased by over 50% since previous analysis, from an average of £6.21/month in the five year scenario to £9.69/month in the new analysis. We note that there is still significant skewing in the distribution, as the median gains of £7.07/month are again well below the mean gains. This means that the relatively few overdraft users with significant gains from switching have the effect of skewing upwards the sample mean.

Table 1: Distribution of Y5 Average Gains from Switching to Five Cheapest Products

5%	10%	25%	50%	75%	90%	95%	Mean
2.15	2.70	5.73	7.07	11.39	17.35	22.55	9.69

11 The main reasons for changes are:

a. Updated account information: since 2014, some high-switching incentive accounts from new entrant banks have been discontinued, while larger incumbent banks improved their account offerings.

b. The inclusion of benefits that were previously not valued, particularly for [ ] one of the cheapest providers for nearly all observations.

c. A methodological change concerning negative gains from switching: the CMA now considers that negative gains from switching (i.e. the gains from switching to an account with higher charges than the observation's incumbent account) should be included as zero in the averages reported, rather than the actual negative value.

12 We consider the methodological change reasonable, as the CMA intends to report on the average foregone gains from switching, not the average price change if every customer switched accounts. However, the CMA should not understate the significance of the large number of customers, particularly amongst those who do not use overdrafts, who could not gain significantly from switching.

13 Table 2 illustrates the impact of the changes discussed above. Panel 1 is the base case reported by the CMA in the updated current account pricing analysis working paper. Panel 2 rolls back the methodological change concerning negative gains from switching, and shows that including negative gains from switching, as in the previous CMA analysis, has an effect of only about 7%. That is, around 7% of the increased gain from switching is due to the fact that the CMA has treated customers who would make negative gains (i.e. losses) as if they were zero values – i.e. had no gain or loss from switching.

Table 2: Changes to CMA analysis due to negative gains methodology

	CMA base case			Including switching losses			Difference		
	Excluding switching incentives	12 months (including switching incentives)	5 years (including switching incentives)	Excluding switching incentives	12 months (including switching incentives)	5 years (including switching incentives)	Excluding switching incentives	12 months (including switching incentives)	5 years (including switching incentives)
Cheapest product	16.91	24.12	17.72	16.91	24.11	17.72	0%	0%	0%
2nd cheapest	9.69	15.83	9.88	9.14	15.40	9.35	6%	3%	5%
3rd cheapest	7.84	13.62	8.30	7.07	13.07	7.59	10%	4%	8%
4th cheapest	6.59	12.44	6.73	5.64	11.69	5.83	14%	6%	13%
5th cheapest	5.51	10.49	5.80	4.36	9.73	4.73	21%	7%	19%
Average of 3 cheapest	11.48	17.86	11.97	11.04	17.53	11.55	4%	2%	3%
Average of 5 cheapest	9.31	15.30	9.69	8.62	14.80	9.04	7%	3%	7%

14 Table 9 in the CMA's working paper shows that the gain from switching to the cheapest product at £17.72 a month is twice as high as the gain from switching to the second cheapest which is £9.88 a month. Looking at Table 11, we see that this roughly corresponds to the switching gain for the heaviest overdraft users who are on average 8-14 days in overdraft in any given month. This would cover roughly 5% of the market.

15 We note that a major change to the pricing is the inclusion of very cheap products which were not included in the CMA's previous analysis. The inclusion of the products

overwhelms the other recent changes in the market that have worked to lower gains from switching.

16 The CMA does not consider whether the cheaper products are sustainable and scalable to the population of PCA customers. Neither has the CMA considered the sensitivity of its switching results to the inclusion of outliers. In Table 1 of the CMA's revised pricing analysis, which we have reproduced as a scatter diagram in Figure 1 below, the CMA reports the current market prices used in its switching analysis.

Figure 1: Chart based on CMA Table 1: Estimated product prices for non-overdraft users

[ ]

17 If we re-run the CMA's switching analysis, excluding the outlier products which are at a considerable distance from the sample mean, then the average gain from switching to the next five cheapest products is only [ ], a reduction from £9.69/month and even lower than the CMA's initial estimate of £6.21 from the previous working paper, even before accounting for the methodological change concerning negative values. Hence the CMA's calculation of gains from switching based on the five cheapest products is highly sensitive to the inclusion of the cheap and possibly unsustainable products. The exclusion of these products results in average gains from switching declining from £116/year to £67/year, a reduction of almost 50%. Crucially, the switching gain is now significantly less than the £100 a year that customers say they would need to be willing to switch.

18 Table 3 shows the gains from switching calculated by the CMA for Standard and Reward accounts in GB compared to the same calculations if the[ ] accounts were excluded from the market, and replaced by the next cheapest accounts. The difference is significant across all scenarios, and all scenarios are lower than the CMA's original estimates from the previous working paper (shown above in Table 2).

Table 3: Gains from Switching Excluding[ ] Bank Accounts

[ ]

19 The CMA has not considered whether providers such as [ ] would have the capacity to offer such low prices to a significant share of the market. If we assume, hypothetically that 2% of the market switched tomorrow to the [ ] current account – that would

result in approximately 1m customers that [ ] would effectively be paying [£ /year to bank with] for the first year.

3 Costs of Overdrafts

20 We note that the CMA's gains from switching analysis is based on an assumed level of average arranged and £100/month unarranged overdraft. The CMA notes that the assumed level of unarranged overdrafts does not significantly affect their results. This is because most unarranged overdraft costs relate to flat fees rather than balance-based interest charges. There is a significant range in overdraft charges between providers. Overdraft charges vary significantly with the level and duration of overdraft use. However, the majority of overdraft users pay between £5-15 a month for their arranged and unarranged overdrafts. Around half of arranged overdraft users pay £3/month or less and 80% pay £11/month or less for their arranged overdraft. For unarranged overdraft customers, around half pay £4 or less a month and around 90% pay £21 or less a month.

21 [ ]

Table 4: Overdraft Customers

[ ]

22 The average cost of arranged overdrafts vary widely among banks, from less than £1 per month to nearly £10 per month. The breakdown of fees and interest also varies among banks. On the other hand, the charges for unarranged overdraft are mostly fixed. The average charge of unarranged overdraft could be as low as less than £1 per month or as high as £15 per month. This range suggests that banks are targeting different customer categories and it would be difficult, or even desirable, to achieve a uniform MMC for unarranged overdrafts across banks.

Figure 2: Average Charge, Arranged Overdraft

[ ]

Figure 3: Average Charge, Unarranged Overdraft

[ ]

23 The overdraft charge, which depends on actual days of usage, also varies significantly within each bank. Taking [ ] for example, the overdraft charge incurred on average is £[ ] per month. This figure includes charges on both arranged and unarranged overdrafts.

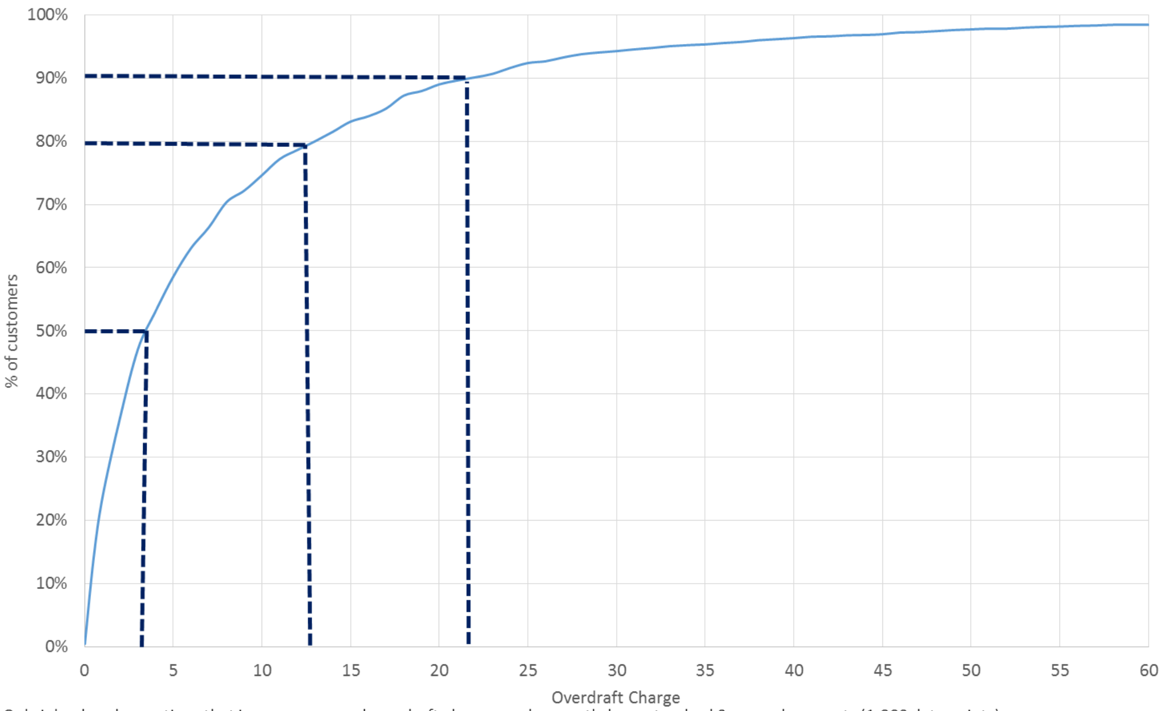
For 1% of customers, the charge is over £100 /month. For the lowest 1%, the charge is less than £1 per month.

Table 5: Overdraft Charge, £/month

[ ]

24 Looking at the overall distribution of unarranged overdraft charges, 50% of customers who use overdraft incurred £4 or less each month, and 90% incurred £22 or less each month.

Figure 4: Unarranged Overdraft Charge, Cumulative Distribution



Only inlcudes observations that incur unarranged overdraft charges and currently have standard & reward accounts (1,802 data points).

4 Price-Quality Relationship

25 The CMA have updated their analysis of the relationship between price and quality by using customer-level data. This is a significant improvement in methodology from the previous analysis by the CMA which bolted together separate surveys of quality and prices. This time, the CMA uses the same survey to compare, for a given set of customers, the relationship between the price that customers are paying and the quality they report. The CMA use a sample of around 3,700 customers that were surveyed in the GfK PCA survey.

26 In Table 8 of the Update on PCA pricing Working paper, the CMA report summary statistics on reported levels of satisfaction and average prices. The analysis shows that the average price per month steadily increases as the level of satisfaction decreases. The

CMA concludes that the most satisfied customers on average paid much lower prices than the most dissatisfied customers: the difference in prices between those 'very satisfied' and 'very dissatisfied' is statistically significant at the 1% level, as is the difference in price between those 'fairly satisfied' and those that were 'fairly dissatisfied'.

27 We have previously commented that an aggregate quality score is not particularly informative, as banking is becoming increasingly differentiated in terms of services, with some banks focussing on attracting high credit customers, others focussed on attracting young, tech-savvy customers with online services and applications. We note that the CMA refers to Ofwat using aggregate satisfaction scores. However, water is a commodity with little scope for service differentiation compared with banking.

28 An important reason for differentiating between types of service quality is that in the GfK survey customers said that quality rather than price is the key factor in determining where they bank. In an industry where quality is regarded as being highly important, it would be useful to understand and compare banks across different elements of service quality.[2]

[2] CMA's Update on personal current account pricing, p.20, fn.29.