

The FCA's response to the CMA's consultation on its provisional decision to refer personal current accounts and SME banking

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1.

Executive summary

In this document, we (the Financial Conduct Authority – the FCA) respond to the Competition and Markets Authority's (CMA) consultation on its provisional decision to refer the markets for personal current accounts and SME banking.

We have an operational objective to promote effective competition in the interests of consumers. We also have a duty to promote effective competition when using our general functions to advance our consumer protection and market integrity objectives. This gives us a strong mandate to help achieve our strategic objective of making markets for financial services work well. We are also expected to receive concurrent competition powers from April 2015, under the Financial Services (Banking Reform) Act 2013.

In this response we:

- make some general comments and observations on the CMA's provisional decision to refer personal current accounts and SME banking markets for an in-depth review
- and set out aspects of our work programme in retail banking that are most relevant to the issues the CMA is considering, to ensure that the CMA has the full picture in making its final decision

We welcome the CMA's provisional decision to refer the SME Banking market for in-depth investigation. The SME banking market study was the result of work undertaken jointly by the FCA and the CMA. This was our first collaborative project; we pooled resources and expertise and have come up with these findings together.

There have been some important improvements in recent years, including changes to the authorisation regime to make it easier and more cost-effective for new banks. But we share the CMA's concerns that competition is still not working well enough to deliver good outcomes for small business banking customers, particularly in relation to the service they obtain from their banks.

A number of features of the SME banking market combine to distort competition (e.g. a concentrated market with high barriers to entry and expansion, combined with SME inertia, difficulty in understanding pricing structures and a perceived lack of differentiation between providers). Given the complex dynamics of the SME banking sector we share the CMA's view that an in-depth inquiry will provide a better forum for testing the design and proportionality of potential remedies to ensure they are effective in providing solutions to the identified concerns.

We also welcome the CMA's efforts to identify and address continued competition concerns in the personal current account market. We note that, although not a collaboration in the same way as SME banking, we did provide input into the CMA's update on personal current accounts.

Whether or not a final reference decision is made, we hope and expect that the FCA and the CMA will continue to cooperate and coordinate with a view to making these markets work well for customers.

2. The FCA's work programme in retail banking

In addition to our routine work in retail banking, we do a lot of work to help us understand the competitive dynamics of the sector. For example:

- We carried out consumer credit research to develop our understanding of the diverse consumer credit markets before we began regulating consumer credit in April 2014.
- We are doing a market study into cash savings, the interim findings of which we published in July. As part of this review, we have been examining the extent to which consumers' choice of savings provider is influenced by where they hold their personal current account.
- We have several ongoing projects on overdrafts, including:
 - i. as part of our supervisory work looking at a number of trends that have a bearing on overdraft charges and
 - ii. conducting a review of the impact on consumers of regulatory and commercial initiatives – including annual statements, mobile banking and SMS alert – aimed at increasing the transparency of the personal current account market

Our initial findings have been shared with the CMA.

- Our market study into credit cards will be launched before the end of the year.
- A review of the effectiveness of the Current Account Switching Service (CASS) will be launched later this month.
- Our work to implement the recently adopted Payment Accounts Directive. This will bring about some standardisation of personal current account related terminology and mandate firms' provision of cost information through standard templates.
- We are looking at whether consumers that are charged for unauthorised transactions are getting fair outcomes.
- Our review of how banks have implemented the packaged bank account rules that we introduced in March 2013 and how they are dealing with past complaints.
- We are considering the impact of certain cost-cutting initiatives by firms (such as the withdrawal of paper statements) on certain customer groups.
- We launched Project Innovate, an initiative to encourage start-ups and established firms to bring innovative ideas to financial services markets, including fostering genuine innovation in retail banking.

- Our thematic review on Mobile Banking and Payments, published in September, looks at how firms are achieving good outcomes for consumers when delivering mobile banking products.

We give further detail on these projects and associated timetables in the **Sections I-IV** of this response. Although each of these projects will continue according to its own timetable, we will work collaboratively with the CMA and, as far as possible, share relevant findings at the earliest opportunity.

We also note that the CMA's provisional reference decision concerns the 'supply of retail banking services' (as defined in the draft terms of reference) to personal current account customers and to SMEs. In the interest of clarity, however, we note that 'retail banking' (as used in ordinary parlance) captures a far wider set of products and services. Our comments on the scope of the reference are attached in **Section V** (on page 12) of this response.

Section I: Consumer credit research

We began regulating consumer credit in April 2014. We were aware of the need to develop our understanding of the diverse consumer credit markets. In 2013/2014 we reviewed existing information sources, as well as new research on several sectors including overdrafts and credit cards (**Annex A**). Here, we summarise the results of this research.

Overdrafts

It is not clear that competition in the PCA market is effective at providing consumers with good-value overdrafts.

Overdrafts are a credit facility offered by banks and building societies as part of a personal current account (PCA), allowing money to be withdrawn once the balance reaches zero for arranged overdrafts, or beyond the arranged overdraft limit for unarranged overdrafts. Over 30 million PCAs have overdraft facilities, with £8bn in overdraft lending outstanding as of July 2013.

Our research and other evidence indicate consumers pay little attention to and don't shop around on overdrafts when choosing a PCA. Consumers don't know how much overdrafts cost them and are confused when they go into an unarranged overdraft. Many don't see arranged overdrafts as borrowing, but as an extension of their money. So arranged overdrafts can quickly become habitual with little consideration of cost. Overdraft repayment appears driven by income coming in.

Providers appear to exploit consumers' lack of understanding, confusion and limited attention. They have incentives to raise revenue by increasing overdraft limits. Unarranged overdraft charges have also historically been very high, complex and opaque. Recent OFT actions (pressure on charges, grace periods, text alerts, opt-outs) have helped to significantly reduce revenue from these. Nonetheless, unarranged overdraft revenue remains high (£1.7bn in 2011) and a significant proportion of PCA revenue (21%). Providers appear to have effectively recouped a significant amount of lost revenue from unarranged overdrafts by changing the structure of arranged overdrafts.

As a result, consumers are still harmed by high charges. In some cases, this may contribute to over-indebtedness, directly by increasing debt, and indirectly by pushing consumers to higher-cost forms of credit as overdraft limits are reached.

Credit cards

Our initial research indicates that the market may not be working well for certain groups of consumers.

Credit cards are a key consumer credit product. Most UK adults own a credit card. About 30 million cardholders borrowed £150bn in 2013 and currently owe £56.9bn. 40% of this debt incurs no interest, from 'transactors' who pay off balances monthly (60% of consumers) and from 0% balance transfer and purchase deals.

While credit cards provide a free service for many, our consumer research and other studies indicate consumers lack understanding of credit cards and are prone to behavioural biases. Many are susceptible to marketing (direct mail, in-branch) and do little shopping around; those who do shop around focus on one or two salient features (such as 0% balance transfer deals, reward schemes, APR) but don't form a rounded view of cards' value. Many cards have complex features. Biases also contribute to some consumers' tendency to use up credit limits, repeatedly make minimum payments and over optimistic assumptions on how they will repay their credit card debt.

Superficially, the credit card market appears healthy, there are a range of providers, and some consumers do shop around and switch actively, particularly those seeking 0% balance transfers. However, competition is focused on particular card features that may not represent long-term value or sustainability. Consumers paying interest on balances may be paying more than they realise or originally expected. They may also be subsidising users for whom card usage is free.

As a result, some consumers are likely to be paying more than they realise. A small proportion of consumers also appear to be using cards unsustainably (to the benefit of card issuers) and are likely to experience detriment as a result. The proportion affected in this way appears small, but represents a large number of consumers who could experience detriment. We are examining some of these concerns in our credit card market study referred to in Section IV below.

Section II: Cash savings market study

Our interim findings in this market study found that consumers' existing relationships, especially with their PCA provider, have a significant influence on where they choose to open new savings accounts, and on their switching behaviour.

In October 2013, we launched this market study under our competition objective focused on the cash savings market. We wanted to assess whether competition in the market for cash savings products is working well for consumers. As part of the study we are considering the extent to which consumers' choice of savings provider is influenced by their choice of PCA provider. Our analysis so far has been focused on easy access savings accounts and no-term Cash ISA accounts, which we estimate account for around two thirds of total cash savings balances held by firms in our sample.

In July 2014, we published an interim report which set out our initial observations on the nature of competition in the cash savings market (**Annex B**). The report highlighted our emerging findings and the issues we have observed so far, but did not reach firm views on the nature of any competition concerns or on market interventions that should be made. The interim findings in relation to the extent to which consumers' choice of savings provider is influenced by their choice of PCA provider are summarised below.

A significant proportion of consumers are not necessarily considering a broad range of providers when opening a new account or considering switching. For example, a GfK survey found that:

- 82% of savings accounts opened in 2013 were opened with a provider with whom the customer had an existing relationship
- 57% of accounts were opened with the customer's PCA provider and 30% with a provider with whom the customer already held a savings account¹

One of the most important drivers behind these choices is likely to be convenience, as it is easier to manage several retail banking products through a single branch or online banking facility than across different providers.

Our data from the sample of firms we surveyed shows that for the largest PCA providers, over 80% of their total balances in easy access savings accounts are held by consumers who also hold a PCA with the same provider. For Cash ISAs the corresponding proportion of balances held by PCA customers was on average lower, although still above 80% for some providers.

These trends are consistent with the strategy documents of providers, which highlight the importance of encouraging PCA customers to open saving accounts. This strategy is considered an effective means of establishing deeper relationships with their customers.

We found that the providers with the largest share of the PCA market are able to retain in aggregate a significant share of the easy access market despite, on average, paying interest rates that are materially lower than those offered by the smaller PCA providers. For example our analysis of data submitted by the firms in our sample suggests that the average interest rate offered by the leading PCA providers on easy access saving accounts opened in the last two years is around 0.5%, but the equivalent rate offered by other providers is 1.2%. This suggests that the larger PCA providers may be protected from vigorous competition in the supply of easy access products.

In relation to no-term Cash ISAs, the aggregate data suggests that to retain (in aggregate) a significant market share, the largest PCA providers are required to offer interest rates that are comparable with or higher than those offered by other providers. This may be because consumers are more likely to shop around for Cash ISA products that will on average hold higher balances than easy access accounts, such that the larger PCA providers are required to offer more competitive rates for Cash ISA products.

The low levels of switching by consumers, and the high proportion of savings balances held by PCA providers, mean that challenger banks face difficulties in developing substantial market shares in the cash savings market at a similar cost to the larger providers. Challenger banks must offer comparatively higher interest rates to attract and retain their customers and so customer deposits are a relatively more expensive source of funding for challengers than for the larger providers.

We are currently investigating these issues further and will publish our final report around late 2014.

¹ © GfK NOP Ltd, Financial Research Survey (FRS), six months ending December 2013; 6,826 adults interviewed.

Section III: Ongoing FCA work on overdrafts

A. Supervisory evidence and analysis on overdrafts trends, policies and procedures

As part of the FCA's supervisory work, we carry out business model and strategy analysis (BMSA) of firms to better understand the drivers of conduct risks. As part of the BMSA work on four large PCA providers that together account for a large proportion of the PCA market, we gathered additional information on overdrafts.

We have observed a number of trends since 2010 that have a bearing on overdraft charges. These are consistent with findings in the OFT's 2013 Review of the PCA market:

- new policies, such as buffer zones aimed at reducing charges for unauthorised overdrafts for some customers, have led to a significant fall in fee income generated by unauthorised overdrafts
- there has been a shift in the balance of overdraft income away from unauthorised overdrafts towards authorised overdrafts, which we expect to continue
- there has been a move by some firms away from charging interest on authorised overdrafts towards daily fees, which has generally been accompanied by an increase in income or projected income

Overall overdraft (interest and non-interest) income is a significant proportion of PCA income (close to half of total PCA income in the providers we looked at). Given the large contribution of overdrafts to total PCA income, a large reduction in revenue generation in one area (e.g. paid items for customers in an unauthorised overdraft) is likely to be made up by an increase in another area(s) (e.g. authorised overdraft interest or charges). We have observed some instances of this in our business model analyses conducted over the last two years.

We have also considered who pays for overdrafts. Distributional effects vary significantly between firms but, for all the firms we considered, a relatively small number of customers were responsible for a disproportionate amount of the income generated by firms from overdrafts, as a result of heavy usage. At the extreme, 1% of customers generate over a quarter of total overdraft income. Most firms had done some form of customer segmentation analysis and knew the distributional effects within those segments. Most firms also monitor heavy users of overdrafts, although the definitions of heavy user vary.

Initial decisions about authorised overdraft limits at the level of individual customers appear to be made using the normal credit scoring arrangements combined with discussions with the customer about their needs. We did not establish whether authorised overdraft limits for individuals were set at levels most likely to incur debt, as some have alleged. However, we did note that the policies allowing firms to unilaterally increase limits varied significantly.

All the firms we considered allocated resources and had capability to identify and intervene with customers identified as likely to be in financial difficulty, even if, in several cases the ability of the firm to intervene proactively – that is, before debt became a significant problem for the customer – was limited.

B. Assessing consumer behaviour and the impact of regulatory and commercial innovation in the PCA market: evidence from a large bank

Overview

We are conducting a review of the impact on consumers of regulatory and commercial initiatives aimed at increasing the transparency of the personal current account (PCA) market and to facilitate account management, including switching. This review focuses in particular on the introduction of annual statements, the mobile banking app for smart phones and SMS alerts.

So far, we have analysed a representative sample of 500,000 customers (observed monthly over more than two years²) from a single large UK bank and evaluated consumer³ reactions to the initiatives with respect to:

- arranged and unarranged overdraft charges (as defined by the OFT⁴)
- balance levels and interest foregone
- switching activity⁵

Our research also describes consumer behaviour, focusing on which consumer sub-groups incur the highest overdraft charges.

Given the nature of change in this market, we note that our analysis is based on historical data and does not assess the impact of any changes to pricing structures after our sample time period. We expect these market-wide changes to have a positive impact and to improve some of our findings below – in particular, the distribution of overdraft charges. We also plan to incorporate analysis from a second large UK bank to understand whether our results are bank specific.

Our preliminary findings

The distribution of overdraft charges was skewed towards a small group of consumers who accounted for a significant proportion of total charges, with the most heavily charged users of overdrafts accounting for a very large share. Consumers that appeared to be most affected by overdraft charges were middle-aged and those with higher incomes⁶ (40-49 year olds, and income of £2,500 a month or more) and were characterised by having low savings, low average balances and were the most likely group to have ongoing loan repayments.

Younger consumers tended to have higher switching rates than older consumers. The average annual full switching rate for the 18-29 age band was 2.5% whereas the full switching rate for the 60-69 age band was 1.35%. However, if we expand our definition of switching, these rates would be higher.

2 We observed general information on the individuals account, monthly balances, cross-product holdings and the month a customer signed up to a specific initiative.

3 We investigated the effects of these initiatives on various consumer sub-groups including by age, income and overdraft usage.

4 The Office of Fair Trading, Review of the Personal Current Account Market (January, 2013), page.26

5 There are different ways of measuring switching activity in the PCA market such as: full switching, which refers to instances where old PCAs are closed during the switching process; partial switching, which refers to customers who manually move their banking to their new PCA over time; multi-banking, where customers hold a number of different PCAs with different PCA providers; churn, the total number of new PCAs opened in a year over the total number of PCAs; and internal switching, which is a switch to a PCA with the same provider.

6 We use average monthly credit turnover to proxy income.

The sign up rate for SMS alerts and mobile banking is also highly dependent on age. For SMS alerts we observed 30% for 18-29 year olds and 16% for 40-49 year olds, whereas these numbers were 44% and 20% for mobile banking at the end of the sample period. Sign up rates for SMS alerts were low before the introduction of mobile banking – below 5% for all age groups.

During our sample period, the bank rolled out two major initiatives:

- a regulatory initiative to provide annual statements that include a summary of the total cost of each account
- a commercial initiative to introduce a mobile banking application

Customers could also sign up for previous initiatives, including online banking and a wide range of SMS alerts. We carried out econometric analysis, which allowed us to isolate causal impact to determine the effects of these initiatives, focusing for now on annual statements and mobile banking.

Our key preliminary findings are:

- The introduction of annual statements had no effect on overdraft charges (arranged or unarranged) or the number of days that consumers remained in their overdraft. This result is consistent across age groups, as well as both arranged and unarranged overdraft charges. We can say with certainty that there was no effect.
- The introduction of the mobile banking application decreased average overdraft charges by 12% to 28% depending on the consumer sub-group. The effect was driven by a reduction in unarranged fees.⁷
- The introduction of annual statements had no significant impact on full switching rates.⁸ However, we have yet to assess the impact on other forms of switching, including multi-banking, internal-switching, partial switching and churn.
- The introduction of annual statements had no economically significant impact on interest foregone.⁹

Next steps

We will carry out more research on how the current account switching service has affected consumer behaviour. We will also analyse the impact of mobile banking and SMS alerts on overdraft charges, switching propensity and interest foregone.

We have received very useful input from the subject bank, which has helped us uncover opportunities for extensions to our work and will make our conclusions more robust. For example, annual statements may have had an important impact on consumers holding packaged bank accounts. We will provide a copy of this report to the CMA and we aim to publish our full analysis early next year.

⁷ This result is subject to further development and refinement of the model.

⁸ This result is subject to further robustness tests.

⁹ This result is subject to further robustness tests

Section IV: The FCA's additional planned and ongoing work in retail banking

1. Credit card market study

We are launching a market study into the credit card sector to determine whether competition is working in the best interests of consumers. We will be publishing a launch document before the end of the year, which will set out in more detail the focus of the market study.

2. Review of CASS and account number portability

A review of the effectiveness of the Current Account Switching Service (CASS) will be launched later this month. We expect to include an analysis of switching data, a customer survey and a review of the banks' recent and planned product development. Alongside this review, we also plan to consider the potential benefits of other measures to facilitate switching, such as account number portability, as a means of increasing competition in retail banking.

3. Implementation of the Payment Accounts Directive

We will work with the Treasury to implement the recently adopted Payment Accounts Directive. Under the Directive certain PCA-related terminology will have to be standardised in rules at UK and EU level, and mandated templates will be produced for industry to use, such as for annual statements of fees.

Likewise, we continue to work with the Treasury on the revision of the Payment Services Directive, which could also alter the way in which payment services can be conducted and what types of firms can participate in the market. This is part of the European Commission's payments legislation package which includes proposals for a Regulation on multilateral interchange fees.

4. Unauthorised transactions

The Payment Services Regulations set out how banks should deal with unauthorised transactions from customers' accounts and previous FCA work has set out our expectations of banks in this space. We will be looking at whether banks are complying with both the Payment Services Regulations and our expectations. The work combines analysis of information provided by banks with survey information from customers who have been subject to unauthorised transactions. We will ensure that firms are not placing unreasonable obstacles or responsibilities on their customers, or unfairly rejecting claims.

5. Packaged bank accounts

We will review how banks have implemented the packaged bank account rules that we introduced in March 2013 and how they are dealing with past complaints. These rules require firms to ensure that the product is appropriate for the customer, that the customer knows if they are eligible to claim, and that they are provided with an annual insurance eligibility statement.

6. The impact of cost-cutting initiatives on different consumer groups

Earlier this year, we started to examine what firms are doing on providing current account statements, particularly paper statements. We are aware that some banks are considering withdrawing or reducing the frequency of paper statements, requiring, amongst other things, customers to opt-in for paper statements.

We want to understand if these banks have thought about the impact their cost cutting initiatives will have on customers, for example what alternatives are available for customers without internet access who rely on paper statements. We will also be looking at whether banks are acting in compliance with the Payment Services Regulations, insofar as they relate to the provision of account information to customers. We expect this review to conclude in mid-2015.

7. Encouraging innovation in financial services

In addition to the changes we have made to our authorisations regime to make it easier and simpler for new banks (**Annex C**) we are also looking to do more to support and encourage innovation in financial services.

We have launched an initiative, Project Innovate (**Annex D**), which will help both start-ups and established businesses to bring innovative ideas into financial services markets. The objective is to foster innovation that can genuinely improve the lives of consumers.

We aim to help innovative financial businesses through our authorisations process and provide a dedicated contact to talk to existing regulated and unregulated firms with innovative ideas. We launched a call for inputs in July 2014 and will publish our final proposals by the end of the year.

8. Thematic review on mobile banking and payments

We conducted a thematic review to determine how firms are achieving good outcomes for consumers when delivering mobile banking products. In September 2014 we published our findings (**Annex E**). In the report we recognise that new technology is changing the way people access financial services and that innovation can be a powerful driver of effective competition that benefits consumers.

Our thematic review has not found evidence that people using mobile banking are currently suffering any harm and existing protections already ensure that customers get a refund if they are a victim of fraud. However we do need to ensure that firms' risk management practices continue to keep pace as they expand the range of products and services they offer through mobile in what is a fast moving market. Our review has identified several areas that firms should continue to focus on and we will be engaging with the industry to discuss these further.

Section V: Scope of the reference

We are content with the scope of the terms of reference in respect of SME banking. Given the close linkages between business current accounts and the various other forms of finance available to SMEs, we agree with the CMA that an unduly narrow terms of reference in respect of SME banking, would be inappropriate.

We observe, however, that the terms of reference in respect of personal current accounts may be cast in such a way as to exclude other types of payment account such as:

- Accounts which have a similar functionality to personal current accounts but are provided by credit unions or non-deposit takers (such as e-money firms) rather than banks or building societies

- Payment accounts offered by firms that do not have ATMs but nevertheless provide a facility (e.g. access to the Link network) that enables customers to receive and make payments.

While the impact of these firms on the mainstream current account business is limited at the moment, we expect technological change will increase the importance of payment firms over time. For example, the increase in digitisation which is currently driven by banks may erode consumer demand for firms with an extensive branch network and make payments services firms more viable alternatives to banks as payment institutions.

We note also that the definition of a personal current account as the 'provision of an account marketed to individuals rather than businesses' does not capture charities and micro-enterprises below £1million turnover a year, which often use personal current accounts for business needs. In general our view is that these customers, to a large extent, demonstrate similar characteristics to individual customers when purchasing financial services products.

Annexes

Annex 1: Consumer credit research

Available to download at:
www.fca.org.uk/firms/firm-types/consumer-credit/consumer-credit-research

In particular, we draw your attention to:

- Consumer credit insights into overdrafts
- Consumer credit insights into credit cards
- Consumer credit qualitative research: credit cards & unauthorised overdrafts (Jigsaw Research)
- Consumer credit: low income, qualitative research (Optimisa Research)

Annex 2: MS14/2 Cash Savings market study, interim report

Available to download at:
www.fca.org.uk/your-fca/documents/market-studies/ms14-02-interim-report

Annex 3: Barriers to Entry

Available to download at: www.fca.org.uk/news/barriers-to-entry-one-year-on

In particular, we draw your attention to:

- Barriers to entry review one year on
- Barriers to entry third party technology considerations

Annex 4: Project Innovate – call for input

Available to download at: www.fca.org.uk/your-fca/documents/project-innovate-call-for-input

Annex 5: TR14/15 Thematic review on mobile banking and payments

Available to download at: www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-15

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