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Creditworthy? The OFT Review of Personal Current Accounts

On 25 January 2013 the OFT issued a Review of the UK personal current account (PCA) market.[1] The Review concluded that "longstanding competition concerns" remain in the PCA market, but opted to defer the threat of a full market investigation for two years. This Brief examines the economic rationale for the UK regulators' continued preoccupation with intervention in the PCA sector.

What's wrong with PCA competition?

UK regulators have consistently criticised the PCA market ever since the Cruickshank report in 2000 concluded that there was a lack of effective competition in UK banking.[2] However, the OFT Review offers little concrete evidence on how these perceived competition problems cause consumer harm.

One indicator of ineffective competition might be high prices or margins, but most PCA services are provided to consumers free of charge under the "free-if-in-credit" ("FIIC") model.[3] The OFT finds that the typical active PCA nevertheless generates revenue of around £140 per year to the bank, 40% of which is derived from the imputed revenues that the banks earn from not paying interest on the positive credit balances of account holders, and around 25% from the charges banks levy on accounts that go overdrawn without permission.[4] However, the OFT provides no basis to establish that £140 per active account is an excessively high remuneration for the services provided. Since the PCA is just one of several products that share the common costs of the typical bank branch retail network, it would also be challenging to provide any meaningful analysis of supra-competitive PCA profitability on a stand-alone basis, and indeed the OFT Review avoids any assessment of profitability.[5]

PCA market concentration has increased in recent years following the crisis merger of Lloyds and HBOS in 2008, and the Review expresses concern with market concentration. However, the HHI remains just below 1800 and by the standards normally applied in competition analysis a market structure that has six or more significant suppliers in total, and in which the main four suppliers account for less than 75% does not appear problematic.[6]

One very clear feature of the market is the persistently low rate of PCA account switching – just over 3% of consumers switched provider in the last 12 months. But low switching can be consistent with consumers being satisfied with their existing providers, or simple indifference, and the OFT Review does not establish that it represents a failure of competition. Indeed, when the OFT asked consumers to explain why they had never switched PCAs, very few indicated any significant frustration with being locked in to their existing provider.[7] It is notable that despite conducting an extensive consumer attitudes survey the OFT Review did not collect direct evidence on consumer satisfaction with PCAs, and previous surveys have revealed high levels of consumer satisfaction.[8]

1. "Review of the personal current account market", OFT, January 2013.

2. "Competition in UK Banking: a report to the Chancellor of the Exchequer", Don Cruickshank, March 2000

3. In many other European countries, banks levy annual fees on standard PCAs, and/or levy direct charges for services such as the provision of debit cards.

4. See Figure 3.1 of the OFT Review. A little over 10% of revenues derive from monthly fee charges on some PCAs, with a slightly smaller amount coming from interchange fees and net debit interest. Arranged overdraft fees comprise around 5% of total revenues.

5. See OFT Review, footnote 31. In 2002, a UK Competition Commission investigation into SME banking relied on a profitability assessment to justify intervention into that segment of the retail banking sector, but those findings were strongly contested.

6. See Figure 4.1 of the Review.

7. 58% stated they were happy with their current provider and a high proportion also gave responses that implied an absence of concern with their current PCA provider (e.g. "have never wanted to", "can't be bothered", "no significant benefit" in switching).

8. The UK CC's 2007 review of banking services in Northern Ireland, for example, found that 90% of consumers were satisfied with their PCA provider, but the CC dismissed this evidence on the grounds that such results simply reflected "an absence of informed consumers". See RBB Brief 24, November 2007.

Ultimately, the OFT relies on a peculiar analysis of bank responses to consumer complaints for its conclusion that there is lack of competition in PCA provision. Across eight different PCA providers, it finds that the proportion of complaints upheld by the various banks varied between 35% and 60%. It concludes that this observed inter-bank variation "might not be expected" if the market was working properly and that therefore "competition is not particularly intense".[9] In terms of both logic and statistical methodology, however, this inference is wholly unconvincing and does not even begin to establish a robust finding on the degree of competition in the PCA market.

Distortions arising from the free-if-in-credit ("FIIC") model

Under the FIIC model, banks loss lead in providing the most visible (and costly) elements of the PCA service including the provision of ATM cards, cheque payment services, and electronic bill paying free of charge, but then earn revenues on less visible elements, notably in taking commercial advantage of positive PCA cash balances and from penalty fees on unauthorised overdrafts. The OFT claims that it "does not have a preference for one model or type of account over another", but in reality it does seem to disapprove of the FIIC model.[10] Ever since it lost a test case legal challenge under the UK unfair contract terms legislation against high overdraft penalties, the OFT has sought to persuade the banks to reduce these fees, and the Review claims that these efforts have been instrumental in achieving consumer savings of between £388m and £928m since 2008.[11]

The FIIC pricing model does not conform to textbook notions of perfect competition in which each and every service element is offered at a price reflecting its cost, and it is also arguable that such pricing leads to odd distributional consequences and distorted consumer choices. Nevertheless, the FIIC model does appear to be the outcome of competitive rivalry between the banks and their attempts to give consumers what they want. In particular, it seems plausible that the pursuit of competitive advantage has led banks to bid prices down for the elements of the product that are most visible to consumers, whilst seeking to recoup the losses on the less visible elements.

The result might not look pretty, but it is not dissimilar to the pricing patterns observed in many other markets from razor blades to mobile phone contracts, and it is entirely in line with the kind of rivalrous behaviour that competition policy generally seeks to encourage. The presence of high margins and prices in the parts of these markets that provide the pay-off for loss-leading could create distortions, but it cannot be assumed to represent a failure of the competitive process.

The OFT Review suggests its future work on PCA pricing will explore how it can derive greater insights from behavioural economics.[12] In doing so, it will need to assess whether it is reasonable to blame the banks for adapting their conduct to the way they find consumers, or whether suppliers have an obligation to educate consumers away from the apparent departures from rational decision-making that are identified in the behavioural economics literature. If phenomena such as loss aversion or endowment effects cause consumers to over-emphasise the risks associated with PCA switching, for example, it is not clear why banks should have to bear the costs of subsidising such activity to compensate for this inherent consumer bias.[13]

9. See OFT Review, para 4.23. The OFT also notes that there has been an increase in the number of consumer complaints against banks in recent years, but recognises that this can be attributed to external factors such as the financial crisis.

10. See Review para 3.13: In a speech given in June 2012, however, OFT Chief Executive Clive Maxwell pointedly said: "banks should look across their revenue streams and consider whether they are earning their revenues in the right way."

11. See Review Executive Summary, page 5.

12. See para 1.11 of the Review. See also "What does Behavioural Economics mean for Competition Policy? ", OFT 1224, March 2010 for a discussion of the role that behavioural economics might play in competition policy enforcement.

13. Loss aversion and endowment effects explain why consumers might forego apparently attractive opportunities to switch because they place a stronger preference on what they own over the benefits they might gain from trading those endowments for an alternative option.

Available remedies

Even if one were to accept the proposition that regulatory intervention into the PCA market is justified, devising appropriate remedies presents major challenges.

As regards the pricing distortions inherent in the FIIC model, one way to reduce the incentive for loss-leading in the up-front (visible) elements is to impose price control on the high margin elements that recoup the up-front losses. Indeed, as noted above, by constantly threatening the banking sector with dire regulatory consequences the OFT has *de facto* applied regulation of this form since 2008, succeeding in reducing penalty charges for unauthorised overdrafts and rebalancing PCA revenue streams.[14] However, nothing in the OFT Review suggests any inclination to impose formal price controls.

A more likely (and less intrusive) approach to remedies would be the provision of clearer information and education to consumers. The OFT has made systematic attempts to bring the hidden cost elements to consumers' attention in the hope that banks will then respond to consumer pressure to shift competition towards cost-based PCA pricing. Several further information-based remedies are in the pipeline, including efforts to encourage consumers to pay more attention to the interest foregone when leaving positive cash balances in their PCAs. However, the idea that such changes will simplify PCAs seems misconceived – a PCA model in which each individual PCA element was separately identified and priced would result in a far more complex product than we see in the FIIC model.

There is also a substantial OFT and bank initiative to facilitate greater PCA switching.[15] On current evidence, however, it remains unclear whether it is switching costs or the sheer lack of motive to switch that explains low switching rates. Significantly, 70% of consumers who had actually switched PCA accounts said they would place a zero value on the ability to change their PCA provider with no hassle, and the valuations of the other 30% were very low.[16] These results are consistent with the other survey evidence that suggests the low rates of PCA account switching reflect an absence of consumer discontent with their current provider. If there is no suppressed appetite for switching, there can be no assurance that imposing costly regulatory intervention to ease switching through measures such as PCA account number portability will change behaviour or improve consumer welfare.

The OFT's highest profile remedy, however, is the threat to change the PCA market structure by enforced divestments of bank branches and PCA customers. But whilst the threat of structural remedies is no doubt a powerful weapon for extracting concessions from the banks, it seems ill-suited as a prescription for increasing competition in the PCA market. If interventions such as the provision of information and increasing the ease of switching do work, the existing PCA market structure has more than enough providers to ensure a competitive response. And if those initiatives fail, it is very hard to see how any forced change in market structure will fix the problem.

The received wisdom of the UK regulatory authorities is that banks with a PCA share below 6% are too small to exert competitive influence because they fall short of minimum efficient scale. Meanwhile, incumbent banks that enjoy a PCA share above 12% are assumed to be unable to differentiate between the terms they offer to new and existing account holders.[17] Consequently, it is argued that the cost of extending attractive terms to their stock of existing customers gives them no incentive to compete hard for new consumers. They are assumed to be so preoccupied with protecting what they have that they cease to compete.[18]

14. Overdraft penalty fees now account for 20% of PCA revenues, compared to 30% in 2007. The OFT accepts that such changes have arisen from regulatory pressure, and not from competitive rivalry.

15. The UK banks, through the Payments Council, have committed to implement a new PCA switching service by September 2013.

16. See Annexe C to the OFT Review, pages 520-521.

17. This result is one of the conclusions reached by the Independent Commission on Banking in 2011 – see the Competition Recommendations at Section 8, and page 211 in particular.

18. Paradoxically, in its investigation of SME banking in 2002, the UK CC specifically criticised the banks for the fact that they did offer better terms such as free banking to new customers, arguing (at para 2.112 of the CC report) that this practice tended to "prevent the benefits of price competition diffusing through to the majority of customers."

Under this stylised view of how competition operates it is therefore argued that it is only PCA providers who have achieved a market share between 6 and 12% – so-called "challenger banks" – that are capable of injecting competition into the market.[19] This in turn gives rise to a belief that some form of structural change is required to create a healthier market structure. But the evidence to support this curious diagnosis is thin, and it must be evident that industrial engineering aimed at this "incumbent/challenger" problem would provide at best a temporary impetus to competition. Even if taken at face value, the predicted success of challenger banks in growing their PCA market share would soon place them in the same uncompetitive category as the other incumbents.

Such a speculative analysis scarcely justifies the upheaval and cost of imposing structural change. Nevertheless, the OFT Review places strong emphasis on the impact that might arise from the creation of new "challenger" banks as a result of the obligations on RBS and Lloyds Banking Group to divest substantial numbers of operational bank branches as part of their state aid commitments.[20] But even the larger of these divestments – the requirement on Lloyds to divest 600 branches and the associated PCA accounts – seems unlikely to meet the Review's objectives, since the divested business amounts to a PCA market share of less than 5%. Lloyds' plans to sell these branches to Co-Op Bank have recently fallen through and an IPO is now the most likely outcome, thus further reducing the likelihood that the product of this divestment will create a new player that satisfies the "challenger" criteria.[21] The OFT nevertheless continues to hint at the threat of further enforced structural remedies should the PCA market be referred for an in-depth market investigation in 2015.[22]

19. Currently there are two UK PCA providers, Santander and Nationwide, who appear to fall within this "challenger bank" definition.

20. See Review, para 9.12. As a condition of the grant of state aid, both Lloyds Banking Group and RBS are in the process of divesting branches and active customers to new entrants or smaller players.

21. See 24 April announcement from Lloyds Banking Group, at: http://www.lloydsbankinggroup.com/media1/press_releases/2013_press_releases/lbg/2404_LBG_Verde.asp

22. In today's UK regime, that further inquiry would be conducted by the CC, but after 2014 the new combined UK enforcement entity (CMA) will have this role.

Conclusions

The banking sector lies at the heart of some far-reaching regulatory problems and key public policy dilemmas, but the OFT Review does not provided a convincing case for making PCAs a priority for regulatory attention. Even the OFT's basic assertion that banks are failing to respond to consumer preferences in the PCA sector is not convincing.

If a price distortion problem does arise from the FIIC model, there are strong indications that these distortions reflect the fact that rivalrous behaviour between the banks has responded to consumer preferences all too well. Any anomalies and imperfections that arise from this model of PCA provision come more from information imperfections than conventional market power problems, and hence it is extremely unlikely that the standard toolkit of competition law remedies provides good solutions. In order to justify imposing an obligation on the banks to save consumers from their own behavioural biases, the OFT would need to provide a more convincing account of the problem, and a clearer analysis of how its proposed interventions would contribute to the solution.

Similarly, in order to justify the threat of enforced structural change in the PCA industry the OFT would need to take a fresh and critical look at the incumbent/challenger story that provides the pretext for such intervention. The analysis contained in the Review does not establish a credit-worthy case that such draconian action would resolve a competition issue or increase consumer welfare.