

## HIGH-COST CREDIT REVIEW: OVERDRAFTS

### FCA CONSULTATION PAPER CP18/13

#### SUBMISSION BY THE FINANCIAL INCLUSION CENTRE

### INTRODUCTION

The Financial Inclusion Centre is pleased to submit a response to this important consultation/discussion paper. Before responding to the specific questions, we would like to summarise our position on the current account market.

### SUMMARY OF OUR POSITION

As with the accompanying work on RTO, home credit, catalogue credit, and store cards, we commend the additional research and analysis the FCA has undertaken to help us understand the scale and nature of the detriment experienced by vulnerable people who have to use unarranged overdrafts.

We also support many of the proposals in CP18/13. No doubt, *some* consumers will benefit from these measures and act more effectively in the market. Moreover, the supply side measures proposed should have *some* effect on making current account providers behave more responsibly.

But, considering the overall package we are not convinced that these measures go far enough. We are, of course, interested in making the current account market work for all consumers. However, our focus is on the detriment experienced by the most vulnerable households – in particular, the harm experienced by groups of households with protected characteristics which the FCA's excellent analysis has highlighted.

#### The extent of financial harm

The FCA's analysis has found that borrowers in more deprived areas are less likely to have an arranged overdraft in place and, when they do, they have a lower overdraft limit. Linked to this, households in more deprived areas of the country are much more likely to have to use unarranged overdraft than other consumers. These borrowers tend to:

- have lower incomes;
- be from Black, Asian and minority ethnic (BAME) communities; and
- have a higher probability of being vulnerable due to poor health or a disability.

The fact that these households are more likely to be harmed by high unarranged charges is perhaps not surprising. After all, we know these households are disproportionately likely to be poor and have low levels of financial resilience. But the extent of the harm revealed by the FCA's analysis is shocking. To summarise:

- People living in more deprived areas are 70% more likely to use an unarranged overdraft than those living in the least deprived areas. They also tend to use the unarranged facility more frequently (para 4.22). This suggests a high level of financial vulnerability – that is, it suggests their incomes are so low that they regularly run out of money.
- They are paying twice as much in charges and fees as those living in less deprived areas (para 4.23).
- Banks are making over 10 times as much (per £ lent) from unarranged overdrafts as from arranged overdrafts (see para 4.13).
- Unarranged overdrafts account for, on average, around 30% of all overdraft revenues (para 4.14). The FCA has identified a clear link between unarranged overdraft use and vulnerability and, tellingly, it sees firms **using unarranged overdraft fees as a source of revenues to fund other parts of the current account offering** (para 4.24). In other words, the most vulnerable borrowers including those with protected characteristics are cross-subsidising better off households. This is a significant recognition by the FCA.
- The majority of fees levied are concentrated on only 1.5% of customers who pay on average £450 a year in unarranged overdraft charges (para 4.9). To put this into context, third decile gross household incomes in the UK are around £340 a week<sup>1</sup>. So, lower income households could be losing more than a week's income in overdraft charges.
- Charging structures are asymmetric and cause significant harm to vulnerable borrowers. Fixed fees mean that a small amount of additional borrowing on an overdraft can lead to significant additional charges (para 4.19).
- People living in the most deprived areas are also more likely to be hit by refused payment fees. On average, they pay 3.5 times as much each year in refused payment fees as those in less deprived areas. These refused payment fees are also highly concentrated with 10% charged for declined transactions – the majority of charges paid by 1.2% of consumers.
- What is also interesting is that FCA basically says that because of technology there is no longer any justification for banks to have such different fees and charges on arranged and unarranged overdrafts (para 4.12).

The level of detriment evident in this market warrants a much tougher approach from the FCA. Better off, 'lower risk' consumers can switch away to better deals. That option is just not open to the most vulnerable households. Moreover, they are more likely to be hit by unforeseen events out of their control which push them into debt. They are already struggling to make ends meet with little room to reduce spending any further, or do not have savings to fall back on. Therefore, the welcome proposals such as mandatory unarranged overdraft alerts (which will help some consumers) will be of little benefit for the most vulnerable households.

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<sup>1</sup> See, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/adhoc/006770grosshouseholdincomebyincomedecilegroupukfinancialyearending2016>

## **Institutionalised detriment**

In effect, these consumers are a captive market and are being exploited by the use of indefensible charging practices. We are always wary of using phrases such as ‘institutionalised detriment’ as this level of criticism should be reserved for the most egregious practices.

But, it is hard to escape the conclusion that this is indeed what is happening to many of the most vulnerable households. To be clear, we do not have the evidence to prove banks are deliberately targeting households with protected characteristics. However, deliberate targeting isn’t a necessary condition for institutionalised detriment. The conditions for institutionalised detriment are:

- i. The use of exploitative market practices that could cause significant harm to groups with certain vulnerabilities – in this case, charging levels and structures
- ii. Existence of vulnerable groups who are at greater risk of being harmed by those practices
- iii. Evidence of vulnerable groups actually being harmed by those practices
- iv. Failure to act to stop those market practices known to cause harm (or at least limit their impact)
- v. Failure to ensure groups affected by harmful practices obtain redress

The harm caused to many consumers with protected characteristics meets those conditions.

## **What can be done to protect vulnerable consumers?**

The question is: what should be done to protect these vulnerable consumers? We have become concerned that recently the FCA increasingly sees its primary objective as raising consumer awareness or increasing consumer engagement to stimulate competition.

But, stopping detriment should always be the primary objective for regulators – using the most effective means possible. Regulators are best placed to make markets work – not consumers.

If in doing so, regulators manage to also increase engagement or raise awareness, then so much the better. But, raising awareness/ improving engagement should be the secondary objective.

The evidence of history suggests that, certainly in the banking market, information remedies<sup>2</sup> have not been particularly effective amongst the **general** consumer population at:

- helping consumers avoid harm; or
- improving markets by promoting effective competition.

Information based remedies provide even less protection to vulnerable groups. While many households on low incomes are very good at managing money (they have no choice but to make ends meet), evidence suggests that, overall, they have lower levels of financial capability than higher income households (as measured by planning ahead, staying informed, and choosing products)<sup>3</sup>.

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<sup>2</sup> <sup>2</sup> ‘Information asymmetry’ really is of little value in tackling the root causes of market failure in financial services. For any theory to have real value, it has to be helpful in *explaining* market failure and, most importantly, it should be possible to *act effectively* on the insights provided by the theory. Information asymmetry theory may have some academic value for economists. In the ideal world of competition theory, we would have a group of informed consumers dealing with suppliers/ intermediaries on a level playing field. But, in the real world, regulatory interventions designed to address information asymmetries have not been, and are unlikely to ever be, effective at protecting consumers, constraining supplier/ intermediary behaviours, and improving efficiency. The focus of regulatory interventions needs to be on where these have been shown to be effective – that is, constraining supply side behaviours.

<sup>3</sup> See, for example, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/financialcapabilityingreatbritain/2015-06-24#levels-of-financial-capability-by-socio-economic-characteristics>

But, most importantly, as mentioned above, information remedies are of little use to these particular vulnerable groups as they are, in effect, a captive market and/ or cannot act on the information provided.

We very much support proposals such as alerts to warn consumers when they might be entering an unarranged overdraft. However, more direct interventions are needed urgently to protect vulnerable borrowers by stopping these unfair, indefensible practices.

Direct interventions produce a greater return on intervention<sup>4</sup> than demand side interventions which aim to improve consumer engagement/ awareness in the hope that they will, in turn, drive improvements in market behaviours. Therefore, we make a number of calls on the FCA:

- **Price caps:** we very much support the proposals to simplify prices into a single interest rate. The proposals to align arranged and unarranged overdraft prices might also produce some benefits. But, compared to an absolute price cap, this is an indirect and, therefore, inefficient way of achieving the desired outcomes. Moreover, it still provides current account providers too much leeway and as the FCA accepts (para 4.54) falls short of an absolute price cap. Therefore, we call on the FCA to undertake to cap interest rates and other charges (such as refused payment fees) on overdrafts. We suggest a daily interest cap with a backstop cost ceiling is the most appropriate method.
- **Interim consumer protection measures:** the fact that banks impose such high costs on vulnerable borrowers (who are by definition already in financial difficulty) is surely in contravention of the principle of acting in the interests of customers and treating customers fairly. Indeed, these charges exacerbate the financial difficulty borrowers face. Until a cap on interest rates and fees is introduced, the FCA should target its supervisory activities to ensure that banks are treating vulnerable borrowers fairly. In practice, that means using supervisory powers to stop the use of these charging practices now. This would be a particularly good opportunity for the FCA to use its temporary product intervention powers.
- **Greater transparency:** we have long argued for the introduction of financial inclusion legislation similar to the US Community Reinvestment Act (CRA) and Homeowners Mortgage Disclosure Act (HMDA). We advocate greater transparency on how well individual financial institutions perform against financial inclusion metrics. Our understanding is that due to legal constraints contained in FSA 2012/ FSMA 2000, we would need new legislation to force publication at the level of individual financial institution. We would urge the FCA to communicate to HMT the benefits of greater transparency. In the meantime, we would urge the FCA to build on its important Financial Lives initiative and publish more granular data on which communities are facing high levels of financial exclusion and discrimination.

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<sup>4</sup> That is, these produce a greater gain for consumers with less effort on the part of consumers or regulator

## RESPONSE TO SPECIFIC QUESTIONS

### CONSULTATION QUESTIONS

**Q1: Do you agree that the threshold for application of the overdraft eligibility and overdraft alerts rules should be set at bank and building society brands (excluding private banks) with 70,000 or more PCAs?**

No. It seems like an arbitrary threshold. Moreover, if the FCA really believes this would be disproportionate due to the costs involved, surely this would act as a constraint on smaller providers growing market share.

**Q2: Do you agree that firms should be given 12 months to comply with the proposed rules?**

Yes, with regards to the measures proposed by the FCA. But, there are other interim measures which should be implemented more quickly to protect the most vulnerable borrowers with unarranged overdrafts. For example, see above our proposals on the use of temporary product intervention powers.

**Q3: Do you agree with our draft rules to require firms to offer an online overdraft eligibility tool which indicates the likelihood of a consumer being eligible for an overdraft facility?**

Yes, this could be a helpful tool for some consumers. If this is to be effective, the tool should be standardised and not be left to individual institutions to determine the appropriate information to be included.

But, to reiterate, we doubt very much if this will drive the types of behaviours and deliver the outcomes expected by the FCA. The amount of behavioural change required on the part of consumers to cause current account providers to change *their* behaviours is considerable. However, we also know from experience that information remedies have had little effect on consumer behaviours. These have been tried so often. So, the chances that information remedies will have enough impact on consumer behaviours to then improve provider behaviours really are quite small.

It is obvious that the desired outcomes could be achieved much more effectively using direct interventions such as caps on interest rates and fees. In other words, direct interventions have a much greater *return on intervention* than information remedies.

**Q4: Should we require firms to design tools in a way that could be provided through APIs to third-party providers so that the same comparison can be run for a consumer across different banks?**

Yes. If the FCA wants to use this tool to promote competition, then it has to be as easy as possible for consumers to compare different offers.

**Q5: Do you agree with our draft rules to require firms to provide clear, easy-to-read, prominent information about overdrafts to their customers before they apply for an overdraft?**

Yes. But, to reiterate, low engagement is the secondary problem in this market. The primary problem is the actual structure and level of overdraft charges. We see no evidence to suggest that - even if it is possible to improve levels of consumer engagement – this will have much meaningful impact on provider behaviour.

**Q6: Do you agree with our draft rules that online calculators should be made available to show consumers how much they will be charged for their overdraft and allow consumers to calculate their costs?**

Yes. But the 70,000 PCA number seems arbitrary.

**Q7: Do you agree that rules requiring consumers to be automatically enrolled into unarranged overdraft and refused payment alerts should be included in the FCA Handbook?**

Yes.

**Q8: Do you agree with our draft rules to require firms to automatically enrol their customers into arranged overdraft, unarranged and refused payment alerts?**

It would be preferable if consumers had low-balance or near-limit alerts. The intention of these information remedies is to prevent consumer detriment from occurring. Surely the point is to prevent the conditions (ie. the opportunity for current account providers to levy high charges) that cause detriment from occurring in the first place.

The FCA's proposals would still allow current account providers to generate revenue from overdraft charges – unarranged overdraft charges are a particular concern.

**Q9: Do you agree with our draft rules regarding alert channel, content, scheduling and grace periods?**

No. We do not understand the thinking behind the FCA's proposals on grace periods. The detriment caused in this market is due to overdraft charges. Yet in para 3.76 the FCA says that it would not be proportionate to require firms to offer a grace period to avoid overdraft charges.

As is the case throughout this CP (and in other recent CPs and DPs), the FCA seems to see its primary objective as raising awareness or increasing engagement rather than actually stopping the detriment from occurring.

Stopping detriment should always be the primary objective for regulators – using the most effective means possible. If in doing so, regulators manage to also increase engagement or raise awareness, then so much the better. But, raising awareness/ improving engagement should be the secondary objective.

**Q10: Do you agree with our draft rules to require that if a firm refers to ‘balance’, ‘available funds’, or ‘available balance’, this must exclude any arranged overdraft available to the customer?**

Yes.

## DISCUSSION QUESTIONS

**Q11: Do you agree with our approach to harm in this chapter? Do you have any comments, observations or evidence which would be relevant to this part of our analysis?**

We make a number of comments on this.

What matters are the outcomes experienced by consumers. We would reiterate that the major harm in this market is the financial loss caused by the level and structure of overdraft charges – particularly the indefensible level of charges applied to unarranged overdrafts.

This harm, as the FCA’s very helpful research shows, is disproportionately borne by many of the most vulnerable households including those with protected characteristics.

The harm is **not** lack of engagement, awareness, understanding, or switching. Those are inputs, and if they are to be considered as ‘harms’ they should be secondary harms. We expect markets to deliver good outcomes regardless of whether or not consumers engage, switch, or even understand a market.

This continued focus by the FCA, and previously the CMA, on trying to get consumers to move the market, rather than regulators intervening directly to **make** the market work has held back efforts to protect consumers and improve their experiences. The continued reliance on information remedies - designed to address these secondary harms in the hope that this will promote competition - is not constructive.

We do support, however, the FCA’s view that the harm caused by diversity of pricing structures outweighs the benefits.

**Q12: Do you have any comments, observations or evidence about the range of potential remedies we have discussed?**

**Q13: Are there other remedies we could consider to address the high level of fees or complexity of price structures? Please explain what the impact might be, why such remedies would be appropriate, and any evidence you have to support your views.**

We support the idea of price simplification. The proposals to align arranged and unarranged overdraft prices might also produce some benefits. But, as the FCA accepts (para 4.54) this falls short of an absolute price cap. Compared to an absolute price cap, this is an indirect and, therefore, inefficient way of achieving the desired outcomes. Moreover, it still provides current account providers too much leeway. Similarly, the MMC allows current account providers too much leeway

to set their own backstop. Therefore, we reiterate our call on the FCA to undertake now to cap interest rates and other charges (such as refused payment fees) on overdrafts.

We would suggest that a daily interest cap with a backstop would be the most appropriate structure. This cap would be the most direct way of protecting the most vulnerable borrowers.

Moreover, as outlined above, interim measures are needed to protect vulnerable borrowers. We urge the FCA to use its temporary product intervention powers to ban exploitative fees until permanent measures capping the total costs paid can be introduced. As the FCA points out in para 4.18, fixed fees mean that a small amount of additional borrowing on an overdraft can lead to significant additional charges. These asymmetric charging structures are causing significant harm to the most vulnerable borrowers.

**Q14: Do you agree that repeat overdraft use is a harm that we should address? Please explain what pattern(s) of repeat use that you would consider problematic, and provide any evidence that you may have to support your views?**

Yes. We agree that repeat overdraft use is harmful. In terms of harmful patterns, the more times the behaviour is repeated, the greater the number of days in overdraft, the longer the behaviour goes on, and the amount of charges incurred, then the more harm is caused.

And as the FCA's excellent analysis demonstrates (see Figure 8/ para 5.10), this repeat use doesn't just cause harm in relation to overdrafts, it has knock on effects on credit card balances.

**Q15: Do you have any comments, observations or evidence about the range of potential remedies we have discussed, or when we should intervene?**

We agree with the proposal that firms should be explicitly obliged to have adequate systems and policies in place to assess whether consumers are in, or at risk of, financial difficulty and take appropriate action.

We are attracted by the idea of a repayment plan to help consumers restore their financial position. To enhance the effectiveness of this, part of the treating customers fairly should include a requirement to refer borrowers to debt advice charities. The fact that there is repeat borrowing is *prima facie* evidence that these consumers are experiencing regular financial difficulties and are likely to need support to restore their finances to an even keel.

We do not think that voluntary industry agreements are appropriate given the nature of the harm experienced. Existing FCA rules should be improved by the issuance of formal guidance on what treating overdraft borrowers fairly means in practice.

**Q16: Are there other remedies we could consider? Please explain what the impact might be, why such remedies would be appropriate, and any evidence you have to support your views.**

As mentioned, we call for an explicit cap on interest charges (on the basis of the proposed simplified pricing structure) and refused payment charges. Clearly, given the nature of overdrafts there is a risk

that a large balance could accrue quickly which means that even with an interest rate cap the £ amount of interest paid could be large.

Therefore, in addition to the interest rate cap there may be merit in capping the level of the outstanding balance on which interest can be charged. Unfortunately, we do not have the data or resources to model what level that balance should be.

**Q17: Do you have any comments on our cost benefit analysis?**

We think the FCA should be highly commended for the data analysis contained in the condoc. It has illuminated the debate and helped us understand much more clearly the nature and scale of detriment experienced by vulnerable consumers. The analysis of the charges paid by households in areas of greater deprivation is especially powerful.

We continue to campaign to persuade HMT to introduce transparency measures similar to those contained in the US Community Reinvestment Act (CRA) and Home Owners Mortgage Disclosure Act (HMDA). In the meantime, we would urge the FCA to take forward the analysis in this condoc and build on its important Financial Lives initiative by publishing more granular data on which communities are facing high levels of financial exclusion and discrimination.

Unfortunately, the FCA did not include an assessment of how much the most vulnerable households would save if absolute price caps were introduced.

We do not agree with the FCA's categories of market failure (p62). The issues mentioned – asymmetrical information, complexity, behavioural distortions, and lack of competition – are secondary input measures, they are not market failures.

Markets should be judged according to whether they deliver the right consumer outcomes. In this case, good value, good service, fair treatment, and financial inclusion are the most important outcomes. As the FCA's powerful evidence shows, this market is failing to deliver those outcomes for many of the most vulnerable households.

The issues the FCA mentions such as information asymmetries might be contributory factors to market failure. But, the biggest contributory factors are the most obvious ones:

- **Corporate cultures:** current account providers are choosing to levy indefensible charges on vulnerable consumers who, in effect, constitute a captive market. Information remedies or encouraging people to switch will be of little help to these consumers.
- **Regulatory failure:** regulators are best placed to make markets work. The fact that these unfair and exploitative behaviours and practices have been allowed to continue is a failure of regulation. The FCA could achieve much more, and achieve it much more quickly, by directly intervening to constrain these unfair practices than deploying demand side remedies.

**Q18: Do you have any views on the outcome of our EIA or the equality and diversity implications of the issues set out in this paper?**

Yes. The FCA should be commended in the data produced for this report. It shows, at an aggregate level, the harm caused by these unfair practices. In particular, it shows how much harm is experienced by many people from groups with protected characteristics.

In effect, these consumers are a captive market and are being exploited by the use of indefensible charging practices. We are always wary of using phrases such as ‘institutionalised detriment’ as this level of criticism should be reserved for the most egregious practices. But, it is hard to escape the conclusion that this is indeed what is happening to many of the most vulnerable households.

To be clear, we do not have evidence to prove that banks are deliberately targeting households with protected characteristics. However, deliberate targeting isn’t a necessary condition for institutionalised detriment. The conditions for institutionalised detriment are:

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- v. Failure to ensure groups affected by harmful practices obtain redress

The harm caused to many households with protected characteristics by unfair and exploitative charges meets those conditions. While current account providers may not be intentionally discriminating against vulnerable groups, there is no doubt that these unfair practices have the effect of disproportionately harming these groups. Failure to use all means possible to stop these practices harming groups on this scale leaves these groups exposed to institutionalised detriment.

**This marks the end of the submission by the Financial Inclusion Centre**

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