

Unauthorized overdraft charges

Introduction

1. This appendix considers the application of unauthorized overdraft charges,¹ and evaluates evidence relating to the extent of competition on unauthorized overdraft charges.
2. We first briefly outline the background to charges. We then consider evidence relevant to the assessment of whether there is effective competition on unauthorized overdraft charges, looking at complexity around these charges, customer behaviour and market outcomes. Annex 1 to the appendix summarizes evidence presented by the banks on the practices with regard to unauthorized overdrafts and charges, including an analysis of pricing behaviours and internal pricing papers.

Background to charges

3. Unauthorized overdraft charges are described in paragraphs 4.114 to 4.118.
4. The available evidence on the incidence of these charges is presented in Annex 1, paragraphs 26 to 37. Not all the banks were able to provide data. [X] and [X] results suggest around 5 per cent of customers were paying referral charges in a month, and 18 per cent in the last year. [X] said that 7 per cent of its Northern Ireland customers had paid such charges in the last month, and 23 per cent in the last year. This suggests many bank customers are incurring these charges in several months each year. [X] believed that 3 per cent of its customers incurred charges in

¹In discussing unauthorized overdraft charges, we are referring to charges arising solely because an account is in unauthorized overdraft, that would not be charged if the account were in authorized overdraft.

a typical month, and estimated that around 10 per cent of customers would pay charges in any year, but it had been unable to verify that figure.

5. A&L reported that fewer than [redacted] per cent of UK customers who had paid the unauthorized overdraft charge this year had also paid it in 2004/05. BoI found that [redacted] per cent of customers who paid a referral charge in 2005/06 had also paid the same charge in the previous year; the proportion was just under [redacted] per cent for unpaid charges. [redacted] told us that 90 per cent of the value of charges in May 2006 were incurred by customers who also incurred a charge in the preceding 12 months.
6. Ulster said that following the introduction of fee-free accounts in 2005, [redacted].
7. We note from these results that there are differences between banks in the proportion of customers paying unauthorized overdraft charges, and in the proportions who pay charges repeatedly. While it is not possible from the information available to determine the exact spread of incidence, the fact that the annual incidence of charges is typically three to four times the monthly incidence suggests that many of the customers who pay these charges, are doing so several times a year. Similarly the fact that the banks identify many customers paying charges as having already paid charges in the preceding year, suggests a significant number of customers are repeatedly incurring these charges. The exact mix between customers who incur charges as a one-off, occasional repeaters and regular repeaters is unclear, but it also shows at least some customers who have incurred charges neither modify their behaviour to avoid charges, nor switch bank.

Areas of evidence

8. This appendix is intended to present relevant evidence in the following three sections covering:

- (a) whether customers may find it difficult to consider and evaluate unauthorized overdraft charges and build their assessment into making efficient choices of PCA. Thus search costs may be particularly high in this case;²
- (b) evidence on customer behaviour, to see whether customer actions suggest they are responding to competitive incentives, and whether they are acting in a way which would incentivize banks to compete effectively; and
- (c) lastly we consider evidence of market outcomes showing a lack of competitive constraints.

Evidence for undue complexity

9. We discuss complexity of charging structures and practices, and the clarity of information provided, in paragraphs 4.120 to 4.134. Tables 1 and 2 of Annex 1 show that different banks have different descriptions for similar charges. There are also several charges to be considered simultaneously which depending on the bank may have a different impact on the customer.
10. We also note that when Ulster restructured its unauthorized overdraft charges when it moved to a fee-free charging structure, it changed some of the charges. This may have obscured changes in unauthorized overdraft charges. For example, the notification of unauthorized borrowing (£13) was removed but an unarranged borrowing fee (£30) was introduced.
11. Many banks challenged the suggestion that comparison of unauthorized overdraft fees was difficult.³ All said that they provided the customer with the applicable charges leaflet on account opening, and some said that staff would talk the customer

²Factors that impact on search costs can be very significant because search costs are sunk for the customer without any knowledge of whether they will actually find any benefit as a result, whereas switching costs can be evaluated relative to the anticipated benefits of switching.

³While most price comparison websites do not list any unauthorized overdraft charges, some do list some or all of these on the separate pages detailing particular accounts (but there is no facility to pick best-buys on the basis of these charges).

through it. Customers could always contact branches or call centres for clarification. Some banks sent customers reminders of the schedule of charges if the customer breached the overdraft limit, and all would advise the customer if there were any changes to charges. Banks made charging details available on their websites and in branch, and A&L said that it printed a description of charges on every PCA statement. Northern said that it had simplified its charges, removing the letter fee and card misuse fee to leave just the unpaid and referral charges.

12. Our own work to gather information on charges has proved time-consuming and difficult to understand properly all the charges. In order to understand them we required explanations from the banks which would not normally be available to the public. Customers have the option of asking for an explanation of charges from branch or call-centre staff, although they will not know or may not be able to reveal the full details of charging policy (eg on buffers).
13. One non-clearer ([redacted]) said that there was a lack of financial capability in the country and a level of complexity about charges which made it difficult for people to work out what they might pay in certain situations.

Evidence for customer behaviour

14. There is some evidence that banks believe customers either do not consider unauthorized overdraft charges before they suffer them, or else are not responsive to them when they have suffer them.
 - [redacted] says 'the vast majority of fees reviewed in this paper are believed to be unshopped at point of sale, and relatively inelastic in comparison to interest rate'.
 - [redacted]

- A [REDACTED] internal pricing paper [REDACTED] indicated that charges are not particularly visible to customers and new sales are not focused on the level of default charges: [REDACTED].
 - [REDACTED] 'Anecdotally, when we get complaints in from customers it would suggest that they pay very little attention to what will happen if they have to then find themselves in an overdrawn position and charges be put through on the account.'
15. However, other banks said that customers who had had unauthorized overdraft fees in the past and those who were at risk of incurring these fees would be much more likely to be aware of them.
16. Ulster commissioned some qualitative survey work to consider, among other things, attitudes to moving to a fee-free model (*Ulster Bank free-banking proposition research*, February 2005, Management Solutions). The report categorizes one group of PCA users as [REDACTED], ie ones who were not in control of their finances and would often run into unauthorized overdrafts. The report states that [REDACTED] like the sound of free banking, but are rapidly put off when they understand that as a consequence they will be paying through higher unauthorized charges. The report therefore says that the free-banking proposition will not attract new customers from this group, although it believed inertia will prevent most existing [REDACTED] from leaving Ulster. The report also notes that there is a lack of accurate knowledge about current account charges.
17. We examined the ORC results regarding the reasons respondents gave for their choice of bank. One possible response was that fees and charges were lower. On a prompted basis 44 per cent of respondents gave this answer, there was no significant variation with the frequency with which customers went into overdraft.

However, only 34 per cent of those on incomes over £750 a week agreed that this was a reason for their choice of bank. For those customers who have never been into unauthorized overdraft and never intend to do so, these charges are likely to be irrelevant to them. On an unprompted basis, those who had incurred overdrafts in the last year were more likely to refer to charges (4 to 7 per cent) than those who had not (1 per cent) but the numbers of such respondents were very low.

18. It was put to us that bank charges are a significant source of customer discontent and complaints, and are a cause of switching. Therefore the banks argued that they needed to compete on charges. For example, one of [REDACTED] internal pricing papers [REDACTED] said that fees accounted for 19 per cent of customer complaints, and of these the majority of complaints (43 per cent—*sic*) related to unauthorized borrowing, primarily the referral fee. The information is not available to identify the number of accounts closed due to the referral fee. [REDACTED] said that the majority of complaints it received were about fees and this had led it to introduce an unpublicized buffer zone for referral fees. Internal pricing papers [REDACTED] show its experience was that complaints increase when higher charges are implemented, but that this effect is short-lived.

19. The ORC survey asked customers who had switched their main account the reason why they had switched. 29 per cent of respondents said, unprompted, that the main causes of switching were charges being too high, or charges were cheaper elsewhere. There was no clear correlation with the extent to which they had been overdrawn in the last year. When prompted as to whether charges had been a contributing factor to the decision to switch, 59 per cent agreed (the proportion agreeing increased the longer the time in the previous 12 months they had spent overdrawn). From the MORI survey, 15.3 per cent of customers who had closed their account cited high charges, a proportion that had increased from 7.5 per cent in 1999. Both these surveys include authorized as well as unauthorized overdraft

charges as reasons for switching, but the banks argued that this indicated a significant proportion of customers were responsive to charge levels.

20. Customers who had switched bank in the previous five years were no more or less likely on average to have experienced charges than those who had not switched, indicating that charges may not be a major cause of switching, but also suggesting that having experienced unauthorized overdraft charges did not create a barrier to switching. We found no evidence that customers who had switched bank in the previous five years considered themselves to be more or less informed than non-switchers about the charges and fees associated with PCAs offered by banks other than their own, suggesting charging did not stimulate customers into researching offers in the market.
21. It is notable that charges are cited as a reason for switching by a greater proportion of respondents who left the clearers than the non-clearers (see Figure 9 of the switching working paper published with Emerging Thinking). This reason was given by around [redacted] per cent of former Ulster and First Trust customers, [redacted] per cent of Bol's and [redacted] per cent of Northern's former customers. For the non-clearers the numbers were [redacted] to [redacted] per cent. This suggests that a lot of the charges being identified by respondents were authorized overdraft charges rather than unauthorized overdraft charges, as unauthorized overdraft charges have been, in most cases, higher for the non-clearers than the clearers' traditional accounts (see Appendix 4.7). Similarly, in the ORC survey, whereas 0.3 per cent of the clearers' customers said that the main reason for their choice of bank was no cost, fees or free banking. 8.9 per cent of the non-clearers' customers gave these as their reason. This again suggests that authorized overdraft charges are the main effect being picked up in the ORC and MORI surveys.

22. Surveys in Great Britain found that charges were much less significant as a cause of switching than suggested by the ORC and MORI results, which may be because these survey results reflect the existence of authorized overdraft charges on traditional accounts in Northern Ireland but not in Great Britain. A UK-wide survey of reasons for switching was conducted for the Mintel Report Current Accounts, Finance Intelligence (June 2005). Respondents were given a list of 12 reasons and asked for the top three that might convince them to switch supplier (ie this was a hypothetical question rather than asking switchers about actual behaviour). Overdraft charges were the third most important reason given (11 per cent) compared with dissatisfaction with level of service (33 per cent), and higher interest rates on credit balance (18 per cent). Another report by Datamonitor, *UK current accounts—service not included?* (June 2004) explored the reasons for switching among UK respondents to a MORI survey who had switched. Lower charges were the tenth most important reason with just 5 per cent of responses.
23. We also note that even though account charges are found to be one of the main push factors in persuading those who switch to decide to switch, according to the ORC and MORI surveys, comparative charges are only a very small factor in the reasons switchers give for their choice of new provider. 8 per cent of respondents gave lower or no charges as their reason for choice of new bank in the MORI survey for the year to 2005Q2 (see Figure 6 of Appendix 4.3).
24. [REDACTED]
25. A [REDACTED] pricing paper [REDACTED] also indicates that although charges may impact on switching, levels of charges may not be the issue. It says: 'Fees are often cited as reasons for customer complaint and attrition, although previous research indicates

that application of a fee is often the trigger for change rather than the underlying cause, with service and promotion of competitors key drivers’.

26. Comments on customer behaviour made by the banks reveal some evidence or beliefs that comparative charges are not influential in deciding where a customer opens an account or where they move their account to when they switch:

- [X] told us that it had not seen any evidence that the level of these charges plays any part in the decision as to where someone is going to move their account, and it said ‘I think that most people open an account and they do not think that they will actually incur a charge’;
- [X] said that ‘I don't think a consumer thinks, “Hey, I am going to be going into unauthorized overdraft on a regular base, therefore ...” I think it is a consequence of other things that happen to them. So I am not sure the consumer gets out of bed in the morning and says, “Hey, I have got a problem continually going into unauthorized overdraft. I have got to find somewhere where it is cheap to do that”.’
- [X] suggested that past use of unauthorized overdraft might act to reduce the likelihood of switching. It said in a hearing that ‘I think customers who typically regularly use their overdrafts will just naturally be more nervous about switching and see less in it for them’.
- [X] told us that: ‘If they find themselves overdrawn by £100 or £1,000 it is embarrassing. It has to be dealt with. It may have consequences if they want to go to the wider market.’

27. The banks have not been able to provide us with any estimates of the proportion of customers who incur charges who switch, or show whether those who pay charges are more or less likely than average to switch. The fact that they have not researched this may partly result from inadequate IT systems but seems at odds with arguments

that switching is an important constraint. The extent of repeat charging of these charges (see paragraph 36) suggests many customers neither switch away nor change their patterns of account use following the imposition of charges.

28. The banks told us there was nothing in their policies that prevented customers who had had unauthorized overdrafts from switching. The banks were very clear that a history of unauthorized overdrafts would not prevent a customer from switching bank; [REDACTED] said that it would welcome overdrawn customers because it was in the business of lending money, and [REDACTED] said that an overdrawn customer would be attractive so long as they had other assets. Unauthorized overdrafts are not recorded in the black data shared through credit reference agencies. Therefore a history of unauthorized overdrafts should not be a barrier to switching, unless customer perceptions are erroneous in that: they wrongly anticipate that their history would debar them from acceptance by a new bank; and/or they anticipate their history would lead to them being offered worse terms and conditions; and/or their application would require additional credit checks or other assessments. The customer may be embarrassed about asking for a PCA to be opened when they have a history of unauthorized overdraft.

29. Survey work indicates that many customers have a belief that there are advantages in staying with one bank (eg see the ORC survey results on reasons for not switching). There are some instances where an established relationship is relevant where banks exercise discretion associated with unauthorized overdrafts, eg on whether to authorize a payment, whether to refund charges, and whether to extend an overdraft facility. The lack of established relationship and cross-sales of other products might disadvantage a new customer. Ulster argued that there were no barriers to switching created by having an unauthorized overdraft—see paragraph 20. It noted that the MORI survey results suggested customers who had switched

account were more likely than others to incur these charges, and that customers who paid charges tended to be from higher income groups who might be expected to be more financially sophisticated and therefore capable of switching.

30. Several of the banks told us that they did not seek to use unauthorized overdraft charges as a source of profits, because this would alienate customers and reduce potential to build a long-term profitable relationship with a customer, including cross-sales. For example, [REDACTED] said that: 'If we simply end up charging those 10 per cent of customers who do not enjoy fee free banking in any quarter with excessive delinquency charges, on a reputational basis, that takes you nowhere ultimately.' Thus several of the banks said that they would contact customers and seek to educate their behaviour to reduce the likelihood of them going into unauthorized overdraft again;⁴ this may take the form of explaining charging structures, giving advise on budgeting, and suggesting more suitable financial products such as loans.

31. Ulster told us that following Project Hanover, the proportion of customers going into unauthorized overdraft was higher [REDACTED] than the [REDACTED] it anticipated. While this generated income, Ulster said that it specifically targeted customers who were paying charges and sought to reduce the number. Each month it sent out flyers to all those who incurred unauthorized borrowing fees with tips about managing their finances and suggestions about how to manage their finances so as to avoid paying fees. They were also invited in for a customer service review, and this offer had been repeated for those who had incurred the fee for three consecutive months. Ulster said that there had already been success in reducing the incidence of charges; therefore it said there were behavioural aspects leading to people going into unauthorized overdraft which could be corrected through education.

⁴Northern told us that it contacted and worked with customers who had incurred unauthorized overdraft charges to help avoid the situation arising again. Similarly [REDACTED].

Evidence from outcomes

32. We now consider how unauthorized overdraft charges are set and implemented.
33. The clearers' internal pricing papers are reviewed in Annex 1. These shed some light on how the banks perceive the market and how they anticipate customers would respond to increases in charges. In many cases the banks either did not anticipate, or did not model any quantitative response when they increased unauthorized overdraft charges (three exceptions are described below). The pricing decisions often take note of the charges set by competitors;⁵ however, there does not seem to have been any discussion around whether increasing charges to those of the highest competitor, or exceeding these, would not be viable because charges are constrained by the threat of customers consequently switching to competitors. It could be that the clearers would find it very difficult to make any accurate estimates of the effects on customer behaviour and switching arising from changing these fees (for example, it was put to us that the lack of modelling merely reflected the difficulty of the task), but the fact that in many cases no customer response was built into the assessment of price changes suggests that banks may believe customers are not significantly responsive to them. However, we did see some examples of consideration of customer reaction. One of [redacted] pricing papers (see paragraph 24) does include an assumed response from customers leaving ([redacted] per cent) because of an increase in charges, but judges the increase to be profitable, while Ulster's assessment of Hanover included some sensitivity analysis depending on the rate of out-of-order accounts being incurred following implementation of new charges. [redacted] said that [redacted] buffer zone was introduced to reduce the costs and incidence of overdraft charges following scenario analysis. Some banks have substantially increased charges despite their awareness of competitor levels.

⁵The papers refer to the headline charges imposed by other banks, and so will compare levels of referral fees, levels of unpaid charges etc. None of them look at the total cost of all charges together, and none appear to consider or measure the incidence of charges making allowance for application of the different policies on charging and exemptions, such as buffer zones. Banks are unlikely to be aware of their competitors' precise policies in this respect.

34. We also note the extent of rebalancing of charge income that has occurred when Ulster revised its charging structure, and that was envisaged in BoI proposals for new fee structures, although Northern argued that it recently removed its card misuse charge and cut its unpaid charge without any counterbalancing increases. This is discussed in Appendix 4.8. As noted above, refocusing charges on to unauthorized overdraft charges would not help retain and attract customers if they were sensitive to these charges.
35. Referral and unpaid charges are illustrated in Figures 3 and 4. We have seen two instances of banks reducing charges: in November 2005 and July 2006, Ulster and Northern respectively reduced their unpaid fees. BoI suggested that there had been no reduction in referral fees due to the low level of incidence of such fees in the Northern Ireland PCA market and the subsequent lack of customer price sensitivity to changes on or to the introduction of fees that they would not anticipate paying.
36. The argument that imposing charges will lead customers to switch away is explored in paragraphs 18 to 31. However, the incidence data that we have show that many customers will be hit by more than one set of monthly charges in a year, and that 40 to 90 per cent of customers who paid charges had paid charges in the previous year. This shows that many customers who suffer charges do not consequently switch. Some may do but the banks were unable to provide any estimates of the switching rates arising. There has been virtually no advertising of unauthorized overdraft charges and rates. Recently, Northern has used some advertising which includes a comparison of unauthorized debit rates and monthly or standard charges for unauthorized borrowing (but not referral and unpaid charges).

Background to unauthorized overdraft charges

1. This annex presents a description of what unauthorized overdraft charges are, their levels, under what circumstances they are applied, when they are debited to the customer's account, and the banks' explanations of how they set such charges. We look at the banks' internal pricing papers to consider whether these provide evidence of how charges are actually set and what factors constrain them. We also consider the banks' policies on honouring or refusing payments where these create or extend an unauthorized overdraft, and their policies on refunding charges where customers complain. The analysis of charges is considered elsewhere: in Appendix 4.7 we look at the total cost of charges and interest under various scenarios of account use. In Appendix 4.4 we look at how charges have developed over time for various banks.

Structure of unauthorized overdraft charges

2. There are a number of different charges that may be applied to unauthorized overdrafts. These are listed in Table 1, but banks differ in which charges are applied, how they are described, under what circumstances they are applied, and whether total charges may be subject to limits.

TABLE 1 Categories of unauthorized overdraft charges

<i>Type of charge</i>	<i>Description</i>	<i>Name of charge used by different banks</i>
Referral charge	Charge levelled when the bank makes a payment which creates or extends an unauthorized overdraft. Other than for guaranteed cheques, these payments are made at the bank's discretion. Charges may apply per item, or per day even if several items are presented. Usually applied at the time the transaction is made.	Paid item charge, paid referral, referral, charge for cheques guaranteed.
Unpaid charge	The bank may choose to return (unguaranteed) cheques unpaid, or decline to pay a standing order or direct debit that creates or extends an unauthorized overdraft. This charge is usually applied at the time the transaction is returned unpaid	Unpaid item fee, unpaid outward fee, failed item, failed transaction due to insufficient funds, charge for transaction unpaid.
Card misuse fee	The bank may charge when a bank or cheque card is used when there are insufficient funds in the account. This charge is applied the day after the transaction is paid.	Card misuse fee.
Unauthorized overdraft letter	Letter informing customer that account is in unauthorized overdraft.	Letters re unauthorized borrowings/account conduct.
Fixed charge	A fixed charge, one-off or monthly, charged when the customer goes into or persists with an unauthorized overdraft. Usually debited two to three weeks after customer has been advised it will be charged.	Monthly unauthorized overdraft charge; unauthorized overdraft fee; unarranged borrowing fee.
Interest	Banks will charge a higher rate of interest on unauthorized overdrafts than are charged on authorized overdrafts. The higher rates may be charged on the entire overdrawn amount.	Unauthorized overdraft rate.

Source: CC.

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3. Table 2 shows the unauthorized overdraft charges levied by the different banks, with applicable limits to the total charges. Charges have been grouped into four categories: referral charges, unpaid charges, maintenance charges, and card misuse charges. Maintenance charges include fixed charges relating to incurring an unauthorized overdraft, be they charged as a one-off item, or repeated on a monthly basis, for example the unauthorized overdraft letter charges and fixed charges described in Table 1. The other three categories are examples of transaction charges. Card misuse charges are a specific example of a charge applied for a payment, where the bank may not have the option to exercise discretion as in a normal referral. These charges have been grouped with referral charge in paragraph 4.114. Debit interest payable is not shown, as this often varies by account. In general, banks apply common unauthorized overdraft charges across all their

accounts, although there are some exceptions, for example for some banks student accounts may not be subject to referral and unpaid fees.

TABLE 2 **Unauthorized overdraft charges by bank**

<i>Bank</i>	<i>Referral charges</i>	<i>Unpaid charges</i>	<i>Maintenance charges</i>	<i>Card misuse charges</i>
A&L	Paid item £25 per item, capped at 3/day, 4/month	Failed transaction because of insufficient funds £34 per item	Unauthorized overdraft fee £25 if account overdrawn for 1 day in a month, with a further £25 if overdrawn for a further 4 days in that month. Limited to £50 in one month.	
Bol	Referral item, £14.50 per item, maximum 5 per day	Unpaid item charge £38	Non-conforming overdraft charge (annual charge where average debit balance over 12 months does not revert to credit for 30 days over the 12 month period)	
FT	Referral fee £14 per excess (ie. only once per day)	Unpaid item £38 per transaction	Letters re account conduct £13 as and when letter is sent	
Nationwide		Unpaid items £30 per transaction	Unauthorized overdraft charge, £20 once per month	Card misuse, where a guarantee card has been used to back a cheque with insufficient funds £21.50 per item (other paid items do not incur a charge)
Northern	Referral fee £25 per excess	Unpaid out fee £28 per item (reduced from £38 on 3 rd July)		
Abbey	Paid fee £30 per item	Unpaid fee £35 per item	£20 monthly un-authorized overdraft fee	
Halifax	Paid item fee £30, capped at 3/day	Failed item £39, capped at 3/day	£28 unauthorized overdraft charge issued monthly	
Ulster	Paid referral £30, maximum £90/month, not applied if customer pays an unpaid charge or card misuse charge that day	Unpaid £30	Unarranged borrowing fee £30 applied monthly	Card misuse for using bank service card or cheque guarantee card without sufficient funds £30
Woolwich		Unpaid fee £35	£3 per day (7 days a week)	Paid referral fee £30 applied only where payment is guaranteed, ie similar to card misuse fee

Source: CC analysis of published information.

- An additional charge is made by most banks (Northern and Ulster make no charge) to a customer where a cheque is paid into that customer's account, and the cheque then bounces. This is applied even though the event is outside the customer's

control, and may have occurred without their knowledge. We do not consider these unpaid inwards charges further here as they will be applied whether or not the customer is in unauthorized overdraft.

Exemptions

5. Many of the banks apply buffer limits, and cap referral item charges. It appears that customers are not normally informed about the existence of buffer limits. Bol notifies Clear 1 customers that a £200 buffer is available, and First Trust notifies customers that there is a £100 buffer is available on its packaged account.
6. Caps to the number of charges applied, or their total value, are not normally communicated to customers.
7. The banks argue that buffers and caps are designed to treat customers fairly and give them time to redress balance problems. As these are not normally communicated to customers, it does not appear that they are designed as a competitive tool, as customers cannot respond to factors they do not know about. Rather, these limits appear to be designed so as to limit customer displeasure.⁶ The nature of unauthorized overdraft charges mean that customers can rapidly build up substantial fees despite being only slightly over their overdraft limit or only for a very brief period; in such cases customers may consider charges to be unjustified or disproportionate. Buffers remove many such cases. Total charges could also mount up rapidly if an unauthorized overdraft were maintained and a total cap limits charges where high charge levels may be unacceptable to customers and attract adverse publicity.
 - Bol Clear 1 has a £200 disclosed overdraft buffer before any charges are applied. [✂]

⁶Ulster argued that because buffers act to reduce customer discontent, they work in the same way as any other aspect of customer service, in that the outcome impacts on customers even if the policy and practice is not listed in the same way as charges. Therefore these can be regarded as equivalent to competing actively on non-price competitive characteristics.

- First Trust applies a £100 buffer on its packaged account
- [✂]
- A&L has a disclosed buffer on unauthorized overdraft fee of £20 on Premier, Premier Direct and Young Worker accounts, £10 on current accounts.
- [✂]
- Halifax's referral and unpaid fees are capped at three per day.
- Ulster [✂]. Its packaged accounts have a published £250 buffer facility.

Policies on setting unauthorized overdraft charges

8. We asked the banks to describe their policies for setting charging structures and charge levels; we also asked them what factors they take into account when setting unauthorized overdraft charges.
9. The answers were consistent across all the banks that responded, that unauthorized overdraft charges were set in the same way as other fees and charges. Thus banks tended to look across all their products and all their charges and sought to ensure their products were competitive with their rivals. This would be assessed through price comparisons, and also by monitoring account recruitment and retention. In the main, the clearers paid particular attention to the other clearers. The non-clearers set their pricing UK-wide and so particularly monitored the UK wide banks and the banks based in Great Britain. However, that said, there were clear examples of banks concluding that it would be profitable to raise charges above competitors (eg see paragraphs 20 and 22 in Annex 1).
10. Ulster recently restructured its charges. It told us, 'Clearly, we had to understand what the charges would be for things like unpaids and referral fees, et cetera, so we had regard to the local market and we assessed what was competitive and I believe we came up with something that was competitive'.

11. The banks did not declare that they were seeking necessarily to price match their rivals on these charges, although there were some references to this. A&L increased its failed item charge from £30 to £34 in April 2004, in line with its competitors, because it said charges that went out of line with the industry would attract adverse publicity, [REDACTED].
12. Most of the banks made reference to monitoring of their costs, and sought to recover cost increases through their charges. However, as such costs tended to arise across a range of bank activities there was no direct feed through from particular cost increases to particular charges, but would be spread across the charging structure with regard to competition on these charges.
13. None of the banks told us that their charges were determined mainly by estimates of costs. There is a wide range of potential discretion in calculating relevant costs, because of the difficulties in cost allocation. Therefore even if it were argued that unauthorized overdraft charges were determined by costs then they would still not necessarily be constrained to a particular level, as there would discretion as to how to include costs in charge calculations.
14. We were also provided with some of the clearers' internal pricing papers from the last five years.

Internal pricing papers

15. [REDACTED] pricing papers show that it priced with regard to the other clearing banks. [REDACTED] the papers stated under the heading 'competitors', '[REDACTED] traditionally lead the price changes and I would recommend that as in the past we follow their lead'. [REDACTED]

16. [REDACTED] The increased revenue calculations make no allowance for any changes in customer behaviour, ie they assume the price elasticity of demand for referral fees is zero. It says in the context of discussing how to achieve income targets, 'In the past we have relied on increases in the unpaid and referral item charge, this year there is a need to rely on changes in the referral item charge [REDACTED].
17. [REDACTED] states 'as is always the case the biggest impact in terms of service income price increases lies in penal charges such as unpaids and referral items, and I have had little option but to concentrate on these in an attempt to achieve the [REDACTED] targeted increase in income'. [REDACTED]
18. [REDACTED]
19. One of [REDACTED] pricing papers [REDACTED] noted there had been increased media focus throughout the last year on the uncompetitive position of the 'big 4' (ie the clearers) for PCAs. It therefore proposed that the increase in personal tariffs would be restricted to referral fees. [REDACTED]
20. [REDACTED] The paper says, 'the vast majority of fees reviewed in this paper are believed to be unshopped at point of sale, and relatively inelastic in comparison to interest rate.' ... 'Fees are often cited as reasons for customer complaint and attrition, although previous research indicates that application of a fee is often the trigger for change rather than the underlying cause, with service and promotion of competitors as key drivers.'
21. [REDACTED]

22. [REDACTED] also provided us with several internal pricing papers which are referred to in the main section of the paper above. Through the papers [REDACTED] is concerned about the PR implications of the changes, particularly if customers are seen to be hit with very high fees. There is reference to increases in charges pushing up complaints (which will push up reversals, believed to mean refunds) but only on a temporary basis. [REDACTED] A number of changes such as providing clearer information and offering unauthorized overdraft buffers were also introduced, but it is interesting that the motivation for this was to reduce pressure on bank staff in dealing with complaints.
23. [REDACTED]
24. Some inference on unauthorized overdraft charges can be seen in the banks' moves to fee-free accounts, as analysed in Appendix 4.8. As covered previously, Ulster's proposals for fee-free banking rebalanced to an extent the loss of fee-income from transactions with an increase in unauthorized overdraft charges. BoI had developed proposals for a similar fee-free account where income loss would be approximately offset by increased unauthorized overdraft charges.
25. Charges are a significant source of revenue for the banks on PCAs. [REDACTED] said that increased unauthorized overdraft fees were part of the strategic imperative to turn the PCA into a profitable business over time. The charges were significantly less than a number of its competitors.

Incidence of charges

26. We asked the banks to provide details of the incidence and distribution of unauthorized overdraft charges, so we could understand how many customers pay these charges, whether the same customers repeatedly pay them, and the distribution of amounts charged. Many of the banks had difficulty in supplying this

information; their records did not allow them to identify the number and type of customers affected by unauthorized overdraft charges, and how such customers were affected.

27. Ulster said that following Project Hanover, [redacted] of all customers were in unauthorized overdraft. This number fell to [redacted] by May 2006 and Ulster said it expected the proportion of customers in unauthorized overdraft to fall to the [redacted] assumption in the Hanover business plan, and possibly lower.
28. [redacted] said that the proportion of its customers who incurred charges in any one month is around 3 per cent. It was not able to calculate what proportion of its customers incurred charges in a year.
29. [redacted] said that 7 per cent and 23 per cent of its NI customers had incurred a fee in the last month and in a 12-month period respectively. 90 per cent of the value of fees in May 2006 were incurred by customers who also incurred a fee in the period May 2005 to April 2006.
30. [redacted] gave details of unauthorized overdraft charges, [redacted]—see Table 3. [redacted]we report unauthorized overdraft charges in Table 3.

TABLE 3 **Incidence of [redacted] unauthorized overdraft charge**

	%
Proportion of customers charged in a month (May 2006) –	4.90
Proportion of customers charged in a quarter (March - May 2006)	8.98
Proportion of customers charged in the last year (June 2005 – May 2006)	18.20
Proportion of customers charged in the previous year (June 2004 – May 2005)	13.46

Source: [redacted].

31. The proportion of customers paying unauthorized overdraft charges was just under 5 per cent in a month, and just over 18 per cent in the most recent full year.

32. It appeared that slightly less than half (45.1 per cent) of customers who paid the unauthorized overdraft charge in May 2006 had also paid the same charge previously in the year June 2004 to May 2005. The proportion of payers in May 2006 who had paid the same fee in 2004/05 was 37.2 per cent for the referral charge, and 45.3 per cent for the unpaid item charge.

33. [redacted] of the proportion of PCA customers paying referral and unpaid item charges. The proportion paying referral charges in any month varied between 4.24 and 5.41 per cent between April 2004 and March 2006. There is no obvious trend in the data. The proportion of customers paying unpaid charges varied from 1.33 to 1.94 per cent over the same period. The proportion of [redacted] customers who incurred any referral item charges was 18.87 per cent in 2004/05, and 18.56 per cent in 2005/06. The proportion of customers who incurred any unpaid item charges was 8.55 per cent in 2004/05, and 8.87 per cent in 2005/06. 60.35 per cent of the [redacted] customers who received a referral item charge in 2005/06 had also received a referral charge in 2004/05. The proportion of customers who had unpaid item charges in 2005/06 who had also had unpaid item charges in 2004/05 was lower at [redacted] per cent.

34. The distribution of [redacted] charges in May 2006 is shown in Table 4.

TABLE 4 Distribution of charges by customer, May 2006, as percentages of the total number of accounts

May 06	Unauthorized overdraft fee	Referral charge	Unpaid item charge
[redacted]	[redacted]	[redacted]	[redacted]

Source: [redacted].

35. [redacted] gave details of the distribution of charges in a sample month for the [redacted] per cent of customers who paid charges. This was estimated as shown in Table 5.

TABLE 5 [redacted]: typical monthly distribution of charges among customers who pay charges

<£20	[redacted]
£20<£60	
£60<£100	
£100<£180	
£180<£280	
£280<£400	
£400+	

Source: [redacted].

36. The distribution of [redacted] referral and unpaid item charges for the year 2005/06 is shown in Table 6, listed for each PCA type.

TABLE 6 Distribution of charges for [redacted] customers, 2005/06 (as percentages of the total number of accounts of the specified type)

[redacted]

Source: [redacted].

37. [redacted] also supplied data for its NI business on the distribution of charges paid for its main accounts, showing the proportion of customers paying charges—see Table 7.

[redacted]

TABLE 7 Distribution of charges for [redacted] customers, May 2006 and year 2005/06 (as percentages of the total number of accounts of the specified type)

	<i>per cent</i>					
	May'06	May'05–Apr'06	[redacted] May'06	May'05–Apr'06	May'06	May'05–Apr'06
No fees	[redacted]					
Under £50						
Over £50						

Source: [redacted].

38. Overall, the great majority of customers pay no charges in any month; of those who do, many may pay an unauthorized overdraft charge and referral and/or unpaid item charge. [X] data for annual charges show over [X] per cent of customers paying more than £[X] in referral charges, those customers may also have substantial unpaid charges as well, and will also be paying transaction charges throughout quarters where they have been overdrawn.

Policy on making or refusing payments

39. Under the terms of most PCAs, banks have the option of deciding whether or not to make a payment when the payment instruction would create or extend an unauthorized overdraft. This depends on the bank's discretion, unless a cheque has been guaranteed with a guarantee card, or authority for a debit card transaction has not been sought. Retailers can agree an 'authorization limit' with their card services provider below which online authorization for a transaction is not sought. The purpose of this is to reduce waiting times at tills for low-value transactions. Where authorization is sought the bank may agree to or reject the payment, but only those with fully automated approval systems would be able to make a discretionary assessment in the time available.
40. Normally, ATM withdrawals require online authorization from the card-holders bank, and this is not normally provided when it creates or extends an unauthorized overdraft.
41. It is possible that systems failures may mean online authorization is not possible and so transactions may go through where normally the bank would not have allowed them. Where banks do not authorize ATM withdrawals or debit card transactions, no transaction has taken place and so no charge is levied.

42. Some banks, eg Halifax and Nationwide have fully automated systems which decide whether or not to make payments. Others have systems which are mainly automated but refer cases for manual assessment when they fall outside normal parameters (eg HSBC, A&L, Co-operative Bank). Some banks calculate in advance an allowable amount, where payments will be allowed without further assessment. For example, one clearer ([REDACTED]) may calculate a tolerance limit on some accounts which have been open for more than six months, depending on whether customers appear to have the potential and capacity to repay the account excess and whether they have done so in the past. HSBC has a similar 'expansion amount', and Nationwide an authorization limit.
43. The banks each look at a variety of factors in deciding whether to make a payment: as indicated above, in some cases this is done through rules applied automatically to past account behaviour, and sometimes through human discretion.
44. Automated systems may utilize behavioural scoring data based on account data (particularly ability to repay, based on level and timing of credits, overdraft and other credit commitments etc), credit reference data and performance on any other accounts held, as well as possible consideration of cross-holding product mix and quantity, customer's time with the bank, and an assessment of the likelihood of default. [REDACTED]
45. Other banks refer most or all such requests for manual assessment. Factors which the banks say they would take into account when considering whether or not to make the payment include the performance of the PCA, consideration of the general customer relationship including other products held, and the ability to repay the overdraft. For example they may look at any of:
- track record on credit history;

- knowledge of customer;
- length of time with the bank;
- financial commitments;
- income;
- account turnover;
- operation of associated accounts;
- operation of accounts previously held;
- previous communications with customer regarding unauthorized overdrafts;
- will expected credits, eg salary, restore account to order;
- are other payments due into the account;
- value of item presented for payment;
- whether similar items of similar value have been paid in the past; and
- whether the item is an insurance payment, eg the bank may choose to honour car, home or life cover where otherwise there would be a particular detriment to the customer.

Policy on refunding charges

46. The banks told us that where charges had been made in error, these would be refunded in full. The banks had different policies and practices when it came to goodwill refunds (ie where charges have been made in accordance with the terms and conditions of the account but the customer complains).

47. [✂]

48. [✂]

49. [✂]

50. [REDACTED] said that it refunded around [REDACTED] per cent of gross fee income, and [REDACTED] said that it refunded around 7 per cent of gross fee income. [REDACTED] refunded [REDACTED] per cent of referral item charges, and [REDACTED] per cent of unpaid item charges, in the year to March 2006.