Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: PS19/16: High Cost Credit Review: Overdrafts (Pricing and Repeat Use Interventions)

Lead regulator: FCA

Date of assessment: 6 June 2019

Commencement date: 18 December 2019 and 6 April 2020

Origin: Domestic

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? All regions

Brief outline of proposed new or amended regulatory activity

There are three aspects to our proposals:

First, our new rules **simplify overdraft pricing structures** for personal current accounts (PCAs). The rules:

- require firms to charge a single annual interest rate for each of arranged and unarranged overdrafts
- require the rate for unarranged overdrafts to be no higher than that for arranged overdrafts
- standardise how prices are represented, through requiring a representative annual percentage rate (APR) in certain advertising for arranged overdrafts

These rules come into effect on 6 April 2020.

The changes made do not affect business users of overdrafts as the rules only apply to personal current accounts. There were therefore no impacts to consider for these types of consumers.

Second, our **early intervention rules** seek to prevent the harm caused by repeated use of overdrafts. Our rules require firms to:

- develop a strategy for reducing repeat use; we have defined "repeat use" in the rules as "a pattern of overdraft use" where the frequency and depth of use may result in high cumulative charges that are harmful to the customer or indicate that the customer is experiencing or at risk of financial difficulties".

- Incorporate, within their strategy policies, procedures and systems to monitor customers' overdraft use, identify repeat users, and sub-divide the latter into two categories based on indicators of actual or potential financial difficulties:

    a) Those in respect of whom there are signs of actual or potential financial difficulties, and

    b) all other repeat users

- Incorporate, within their strategy interventions for the firm to take, dependent on whether a customer is in category (a) or (b):

    - If the customer is in category (a) (financial difficulties), the firm must seek dialogue with the customer, and present options for reducing use (the guidance to the rules gives examples of options.

    - If the customer is in category (b), the firm must communicate with the customer, highlighting the customer's pattern of use and indicating that this may be resulting in high avoidable costs; the firm must continue to monitor the customer, and if the pattern of use continues, the firm must send a similar communication after a reasonable period, and then at least annually.

Firms will implement their strategy from when the rules start to apply, and then monitor the effectiveness of their strategy, and update or adjust it as appropriate.

These rules came into effect on 18 December 2019.

Third, we are also **issuing guidance to help firms comply with existing requirements** set out in the Payment Services Regulations that refused payment fees should reasonably correspond to the costs of refusing payments. This revised guidance applies to refused payment fees for micro-enterprises as well as personal customers.

This guidance took effect on 7 June 2019.

We will evaluate the impact of our proposals.

As outcomes will take time to develop, we would not expect to start the evaluation until at least 12 months after implementation of the full package of remedies. We have been engaging with firms to discuss the changes they will be making, how they will implement those changes and what data they will need to record to enable an evaluation of the changes.

To evaluate the impact of the early intervention rules, we require firms to provide the FCA with their strategy when the rules start to apply, and after any substantial changes. Firms are also required to report on the outcome of their monitoring after 6 and 12 months, including details of any change to the total number of repeat users, the total size of their overdraft balances and any other relevant background information.

Which type of business will be affected? How many are estimated to be affected?

There are 32 banks and building societies currently offering personal current accounts that will be affected.

Price base year	**Implementation date**	**Duration of policy (years)**	**Business Net Present Value**	**Net cost to business (EANDCB)**	**BIT score**
2018	2019	10	-218.0	25.3	126.5

Please set out the impact to business clearly with a breakdown of costs and benefits

In August 2018, we sent a questionnaire to 17 firms seeking their feedback on the incremental one-off and on-going compliance costs associated with our pricing proposals. We received responses from 15 firms.

We use a stratified sampling approach (i.e. we group firms into different size categories) to estimate costs to firms. We use this approach because the cost per firm varies significantly by firms' size and business model. Stratifying our sample helps us to more accurately extrapolate costs outside our sample of firms.

PCA provider category	Number of PCA providers responding to survey	Total number of PCA providers	Percentage of population that responded
Large PCA providers	6	6	100%
Smaller retail banks	5	21	24%
Smaller building societies	2	2	100%
New challenger PCA providers	2	3	67%
Total	15	32	47%

The large providers, which hold most of Personal Current Accounts in the market, all responded to our survey. We note the slightly lower coverage of smaller retail banks in our survey of firms. This is partly due to the larger number of firms in this category and hence we did not need to survey as large a proportion of firms to gather information on the likely cost to these firms. In our consultation, none of the 21 firms challenged our cost estimates.

While both small building societies affected by our change did respond to our questionnaire, they only provided qualitative responses about the likely costs. We do not think that cost estimates for these firms would materially affect the overall estimates as there are only two of them in total and any costs are likely to be small compared with the other cost data we have gathered.

Familiarisation costs and legal review costs of both proposals are estimated jointly using standard FCA assumptions. Other compliance costs due to our proposals are estimated based on the responses to the firm cost survey described above.

Familiarisation costs

We expect firms affected by our intervention will read relevant changes put forward as part of the proposals in the consultation paper and will familiarise themselves with the detailed requirements of the new rules and guidance.

We have estimated the costs of this to firms using assumptions on the time taken to read the document, which is around 70 pages long. We assume that there are 300 words per page and reading speed is 100 words per minute. This means that the document would take 3.5 hours to read. We convert this into a monetary value by applying an estimate of the cost of time to firms, as set out in the table. We assume that more staff at larger firms familiarise themselves with the rule changes.

The estimates of salaries of staff reading the document are based on the salaries of compliance staff from Willis Towers Watson 2016 UK Financial Services Report. The number of staff reviewing the document is based on a FCA commissioned compliance cost research.

PCA provider category	Total familiarisation cost (£)[1]
Large PCA providers	£24,000
Smaller retail banks	£38,000
Smaller building societies	£5,000
New challenger PCA providers	£2,000
Total	£68,000

Source: FCA commissioned compliance cost research project, 2016 Willis Towers Watson UK Financial Services Report

In total, we estimate that the one-off industry cost of familiarisation would be around £68,000.

Legal review costs

Following familiarisation with the proposals, we expect firms to conduct a legal review of the proposals and an accompanying gap analysis to check their current practices against expectations.

We have estimated the cost to firms of reading around 25 pages of legal text. The table below sets out the main assumptions used to estimate these costs based on firm size. Again, we assume that more staff at larger firms familiarise themselves with the rule changes. We also assume that legal staff at larger firms spend more time reviewing the rules.

Again, the salaries of legal staff reviewing the document are based on the salaries of compliance staff from Willis Towers Watson 2016 UK Financial Services Report. The number of staff reviewing the document is based on a FCA commissioned compliance cost research.

PCA provider category	Total legal review cost (£)[2]
Large PCA providers	£22,000
Smaller retail banks	£38,000
Smaller building societies	£5,000
New challenger PCA providers	£2,000
Total	£67,000

Source: FCA commissioned compliance cost research project, 2016 Willis Towers Watson UK Financial Services Report

[1] The familiarisation costs are calculated using the following formula – number of staff x hourly cost x number of hours x number of firms.

[2] The legal review costs are calculated using the following formula – number of staff x hourly cost x number of firms x number of pages to review x number of hours to review a page.

In total, the one-off industry cost of legal review is estimated to be £67,000.

Costs of the pricing intervention

This section sets out the costs of simplifying the overdraft pricing structures, the first intervention set out in the introduction.

One-off costs

In total, we estimate that the one-off industry cost of our pricing intervention would be approximately £105.7m (note that this cost does not include the familiarisation and legal review costs above, which relate to all three interventions). We consider that the direct one-off costs to firms from our pricing intervention would come from, primarily, changes to:

- IT systems (28% of one-off costs)

- communication costs associated with notifying consumers of the changes being made (49% of one-off costs)

These costs are likely to be more significant for those firms with legacy IT systems. These firms may require more substantial IT systems changes and are likely to have a larger consumer base to communicate these changes to.

We also anticipate that firms would incur training costs in ensuring that staff are aware of the changes made to PCA pricing practices. The remaining costs cover a wide variety of categories.

Some firms indicated they may incur relatively minor governance costs, which might come from: gaining internal sign-off on changes to pricing structures and price; and putting in place new governance structures for other, more substantial changes.

Ongoing costs

In total, we estimate that the ongoing industry cost would be approximately £6.2m per annum. This is predominantly driven by the costs reported by one large firm.

97% of ongoing costs arise from inbound consumer engagement as a result of the pricing intervention. Most of these ongoing costs fall exclusively on one of the largest PCA providers. This firm has a specific business model which differs from others in the group who reported minimal ongoing costs from the proposals and may explain the higher level of costs.

Many firms reported zero or minimal ongoing costs of implementing the proposed pricing interventions. Firms considered that the majority of activity after the initial implementation would be captured in their 'business as usual' costs.

Impact on firms' revenue

Our proposals could lead to firms losing revenue either directly as a result of the interventions or indirectly as consumers change how they use overdrafts.

In response to our interventions we expect that firms will adjust their pricing structures to recover any potential loss in revenue. As we explain below, our expectation based on the evidence before us was that firms would rebalance their overdraft pricing to recoup revenue and be revenue neutral in impact; we saw no evidence to suggest that pricing of other products or services would be altered to recoup the revenue. We conducted both qualitative and quantitative analysis to support this.

Qualitative analysis:

We reviewed internal documents describing past and planned changes to overdraft pricing structures and had a series of discussions with banks to complement our understanding. We concluded that firms would generally seek to recover as much revenue as possible from within their overdraft offering, rather than other components of the PCA or their wider retail banking business.

Quantitative analysis:

We looked at historical trends in revenues to identify patterns that could inform our understanding of the firms' potential pricing response to our proposals. We acknowledge that market dynamics may make these trends less relevant in the future but these patterns provide a basis for forming our estimate of the likely effects of the intervention. We explicitly considered the most likely forms for recovering any lost revenue – changes in refused payment fees and changes in pricing of personal current accounts.

First, we looked at the relationship between refused payment fees and changes in overdraft revenues, and the likelihood that refused payment fees would be adjusted. We reviewed the 2013-17 period and found no indication of adjustment of refused payment fees in response to changes in overdraft revenues (see Technical Annex to the Overdraft Consultation paper). The inclusion of the refused payment fees in the Competition and Market Authority's Monthly Maximum Charge places limits on increases in refused payment fees due to price competition. More importantly, the requirements from the Payment Services Regulations on cost-reflectivity would prevent refused payment fees from being increased as a result of waterbed effects. Consequently, we see a limited probability that refused payment fees will be used to offset a fall in overdraft revenue.

Second, we reviewed historical pricing trends of personal current account and overdraft revenues to detect any occurrence of a rebalancing in pricing at the personal current account level. We saw no such indication based on the revenues analysis conducted by the Competition and Market Authority in its Retail Banking Market Investigation (Final Report). Overall PCA revenues per main current account decreased at a faster rate (-10% annualised rate over 2011-14) than overdraft revenues per main current account (-6% annualised rate over 2011-14). The data collected as part of the Strategic Review of Retail Banking showed a fairly similar pattern over 2015-17. Based on approximately 90% of the market, net revenues from overdrafts remained flat over this period (0% annualised rate over 2015-17) when PCA fees excluding overdrafts decreased slightly (-2.8% annualised rate over 2015-17).

Although it is difficult to predict exactly what the new pricing structures will be, we anticipate that firms will seek to realign pricing from within their overdraft offering, for instance by increasing arranged overdraft prices, such that there are no large transfers from firms to consumers in aggregate ie when looking across all consumers there is a net neutral impact on total overdraft revenue.

In the CBA in our consultation paper we considered some other possible scenarios largely to have a discussion with firms around the possible impacts. Our central scenario was a revenue neutral impact as described above and in the CBA. No respondents to the consultation supported those alternative scenarios and the central expectation of revenue neutrality was not challenged by firms when we consulted upon our rules and published the CBA. This reinforced our view that the revenue effects on firms would be managed within overdrafts by a rebalancing of arranged and unarranged overdraft pricing and not from changing the pricing of other products. There were not therefore additional direct or indirect costs that we had not accounted for.

Costs of repeat use intervention

Costs in this section relate to the repeat-use intervention only.

We have split costs into two types. These are 'fixed' costs and 'variable' costs. Variable costs in the context of these proposals are those costs which vary depending on the number of customers for which banks need to make interventions and for which there is a non-negligible marginal cost for dealing with that consumer eg the cost of phoning a consumer to prompt them regarding overdraft usage. Fixed costs, on the other hand, do not directly vary by the number of consumers which require interventions (eg the incremental cost associated with updating or maintaining updated IT systems).

One-off fixed costs

We expect that the one-off fixed costs of our repeat use intervention would cover a range of different types of costs. We anticipate a large proportion of the one-off costs to come from:

- IT development costs (63% of fixed one-off costs)
- communication costs (23% of fixed one-off costs)

Training and governance also appeared to be areas where firms anticipated incurring costs, though these are proportionately smaller types of costs.

Firms across all categories also reported notable 'other' costs due to this intervention. Typically, these costs include business transformation activities and set-up costs. For the larger PCA providers, 'other' costs can account for up to a quarter of their total estimated costs.

In total, we estimate the fixed one-off costs for the repeat use rules to be £22.5m.

Ongoing fixed costs

These costs appear to fall almost exclusively on one of the largest PCA providers. This firm may have a specific business model which differs from others in the group who reported minimal ongoing costs from the proposals and may explain the higher level of costs.

Smaller firms and challenger PCA providers reported no ongoing fixed costs. This is due to the low number of repeat users at new challenger PCA providers (as above for one-off fixed costs). Smaller firms indicated that the ongoing costs of the intervention would be absorbed into business as usual activity following the one-off systems changes.

The large PCA providers expect to incur costs from ongoing IT development, changes to governance (eg increased monitoring and reporting for individuals in danger of repeat-use), and additional staff and communication costs (eg expected increased contact with PCA users). These costs vary from firm-to-firm, and are, typically, a function of the specific internal structure and business model of the large PCA providers.

In total, we estimate the fixed ongoing costs for the repeat use rules to be £1.5m per year.

Variable intervention costs

As a result of the repeat use interventions firms will incur costs related to taking proportionate action for consumers flagged as repeat users. This may include communicating a warning or prompt to the consumer or contacting the consumers to discuss strategies for dealing with their debt and how to reduce their balance. These contacts may generate further inbound consumer contact. These costs will vary depending on the total number of flagged consumers a firm has.

The number of consumers flagged for intervention are likely to fall into two categories which we define as the 'stock' and the 'flow'. PCA providers may currently have a group of consumers for which intervention is already required. As a result, in the first year of the intervention coming into effect there will be a higher than usual number of consumers requiring intervention (the 'stock'). In subsequent years, particularly given more active early intervention, firms will have a lower number of consumers which will require an intervention each year (the 'flow'). To account for this we have estimated one-off and ongoing variable cost figures for the difference in size between these groups.

Since the size of the costs would depend on the nature of the interventions, our cost survey to firms provided them with an indicative 4 stage process to help them estimate the costs. The types of interventions required at each stage are:

1. Firms could send an initial message to communicate with a consumer.
2. Firms could send a repeat message.
3. Firms should contact the consumer directly to offer a plan to the consumer that enables the consumer to bring down their overdraft use. Firms will determine what they consider appropriate strategies to be in discussion with the consumer, provided these are consistent with the principle that it is not generally appropriate for consumers to use overdrafts repetitively without time limitations.
4. The firm should provide debt advice agency details, and reassess whether the overdraft facility should continue to be offered.

Firm responses to our cost survey estimated the number of repeat users identified and the costs of undertaking any interventions. However, our final repeat use rules require firms to identify consumers who show patterns of repeat use. Firms are then required to separate these consumers into two groups:

• consumers in respect of whom there are signs of actual or potential financial difficulties

• all other consumers who show a pattern of repeat use

For each group of consumers firms will initiate a communication with the consumer and take appropriate action in the form of interventions. The intensity of these interventions depends on the group which the consumer falls into, with the first group likely to receive more intensive interventions.

For the purposes of the CBA we have interpreted responses from the cost survey as follows:

• consumers in the first group who show signs of actual or potential financial difficulties may receive a combination of intervention types depending on their pattern of usage or other related factors. For those most at risk of or in actual financial difficulty they are likely to receive a type 3 or type 4 intervention

• consumers in the second group are likely to receive a type 1 or type 2 intervention only

All interventions involve consumer communication, with the amount of input from firms rising depending on the consumer's degree of financial difficulty and the corresponding intensity of the intervention.

Similar to fixed costs, ongoing variable cost estimates varied based on whether PCA providers already have pre-existing processes in place. Apart from the large PCA providers, only one firm (a smaller retail bank) provided quantitative estimates of ongoing variable costs. The cost of inbound consumer engagement was the most significant area of ongoing variable cost.

The costs of less intensive interventions were generally lower than for more intensive interventions. This is likely due to the greater employee time firms would be required to spend in order to engage with consumers requiring such an intervention. Some firms noted that no accounts would be affected for the stock (one-off) costs by a more intensive intervention.

In total, we estimate that the one-off variable cost would be approximately £12.4m and the ongoing variable industry would be approximately £4.2m per annum.

Impact on firms' revenue

Using firm survey submissions and calculations to extrapolate these results to the full market, we estimate that 4.0m consumers will be impacted in the first year. This is equivalent to 60% of consumers using an arranged overdraft each month of the year in 2016. This falls to 1.3m in subsequent years.

We do not believe it is reasonably practicable to provide a monetary estimate of the impact of our repeat use interventions. The principles based approach to the intervention means that each firm will take a different approach. As such it is unclear what impact the improved monitoring and intervention will have and over what time period. To ensure that firms are making appropriate efforts to reduce the number of repeat users and the level of their balances in a way that does not adversely affect consumers' financial situations we will be reviewing firm strategies and the monitoring work they undertake to ensure the intervention is having the desired impact.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

CP18/42: High-Cost Credit Review: Overdrafts consultation paper and policy statement

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