

Consumer credit insights

Overdrafts

Understanding consumer credit

We have carried out intensive research to understand the consumer credit market and the people that use it. Find out more about this research, our findings and what we plan to do next.

Overdrafts allow an account holder to take money from their account when there is no money in it. This can be up to an agreed limit (for an authorised overdraft) or beyond the agreed limit at the bank's discretion (for an unauthorised overdraft).

A few authorised overdrafts are free up to a limit. Otherwise consumers pay for overdrafts through interest, maintenance or usage fees, paid and unpaid item charges, and unauthorised overdraft fees if payments exceed the balance.

Authorised overdrafts can provide a convenient way to help consumers manage day-to-day finances. Unauthorised overdrafts are intended primarily for 'emergency' use and are much more expensive.

Key findings

We found that consumers:

- pay little attention to overdrafts when choosing a bank account

- often do not see overdrafts as debt and quickly become accustomed to using them
- do not know how much overdrafts cost and are confused by unauthorised overdrafts
- do not actively repay overdrafts, repayments are driven by funds coming in

Our research also shows that overdraft providers:

- can earn revenue from consumers' lack of understanding, confusion and limited attention
- have incentives to raise revenue by increasing overdraft limits
- have historically had very high, complex and opaque charges for unauthorised overdrafts and this appears to still be the case

Overall, we think the voluntary measures agreed between Government, the Office of Fair Trading (OFT) and industry have helped reduce overdraft costs, but we think a significant number of overdraft users are still potentially paying too much.

You can see more detail in our full consumer research report by Jigsaw at www.fca.org.uk/consumer-credit

“My overdraft’s £1,300 and I never get paid that. So my overdraft is my money now”

What we plan to do and why

To further reduce costs, building on the progress already made through voluntary measures agreed with the industry, we will investigate how providers set and monitor overdraft limits and their governance and strategies for doing so by autumn 2014.

We will also start to consider making some voluntary measures mandatory in autumn 2014.

To avoid unwanted wider impacts on the current account market, we will work alongside the Competition and Markets Authority to make sure our actions complement (and do not duplicate) its work updating the OFT’s 2013 review of the personal current account market.

Recent regulatory steps on overdrafts¹

The Office of Fair Trading’s (OFT) July 2008 study of personal current accounts found unauthorised overdraft charges were complex and not transparent, and consumers lacked control and experienced problems switching accounts.

Since then, voluntary measures on overdrafts have been agreed between industry, OFT and Government. These include providing consumers with annual summaries of charges and illustrative scenarios of cost, giving consumers the ability to opt-out from unarranged overdrafts for free, making charges more transparent, introducing texts alerting the account holder that an overdraft may be used, and introducing grace periods and buffer zones before charges are incurred.

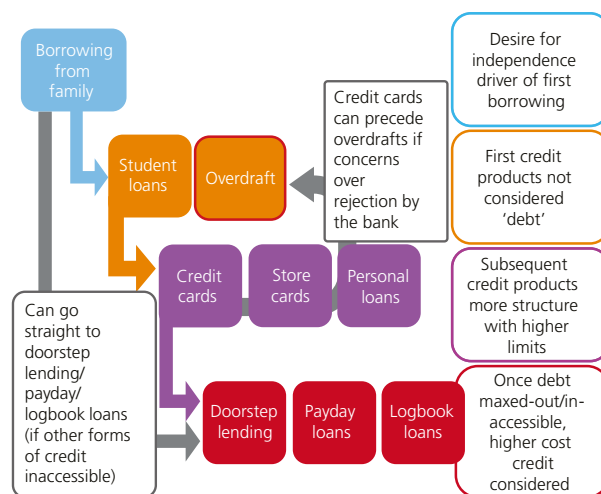
In its January 2013 review of the current account market the OFT found improvements had been made, but these were due to regulatory and Government actions rather than improvements in competition.

We have now taken over the regulation of consumer credit from the OFT.

Key findings

Consumer behaviour

Looking at how consumers use credit throughout their lives, we found that as consumers become more independent, they move from borrowing from friends and family to more mainstream credit products, such as overdrafts (e.g. in student accounts).



We found that most consumers do not shop around or switch accounts based on overdrafts, so there is little pressure on providers to compete.

Users typically do not actively decide to go into their overdraft, do not consider it debt, and are unaware of the costs. Typically, they will also only consider alternatives to overdrafts once they have reached their overdraft limit.

We have also found that for some consumers overdrafts may ultimately lead to more debt, as once an overdraft has been exhausted, they can be pushed towards using other high-cost forms of credit.

¹ See the OFT’s July 2008 and January 2013 reports: <http://www.offt.gov.uk/OFTwork/markets-work/personal/>

“I prefer not to think about it because there isn’t much I can do about it”

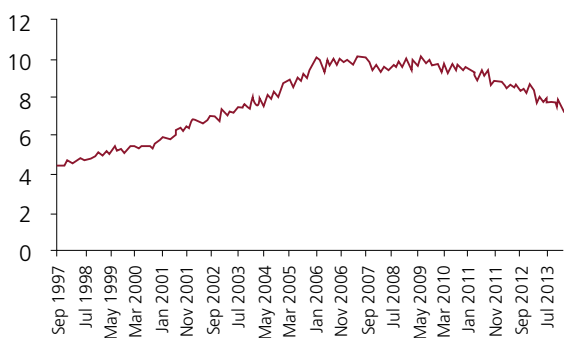
About 15% of consumers with an overdraft are permanently or usually overdrawn and providers still earn very high revenue from them.²

Based on the research we are concerned that a significant minority of current account customers regularly experience high charges and interest payments from their overdraft usage.

Market size

Overdrafts are widely available. We estimate that out of 61 million active personal current accounts,³ 32-40 million of them have overdraft facilities.⁴

Overdraft debt for high street banks (£bn) from BBA



According to the British Bankers Association, there was £8bn outstanding on overdrafts in high-street banks as of July 2013.⁵ Of this overdraft debt, we expect over 90% is authorised.⁶

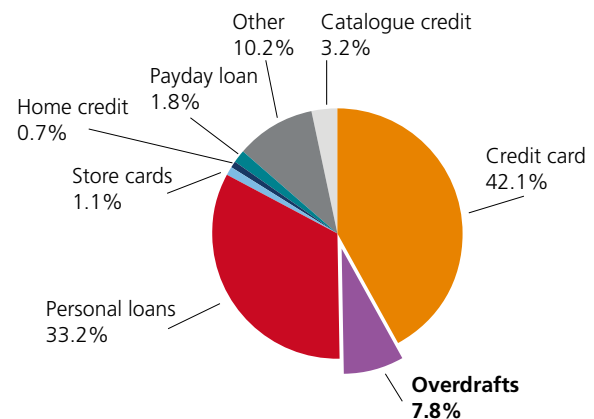
2 From the OFT statistics presented below i.e. 10% of current account holders are permanently or usually overdrawn, 65% have an overdraft facility. This implies 15% of those with an overdraft facility are permanently or usually overdrawn.
 3 Para 9.10, OFT's January 2013 Review of the personal current account market: http://www.offt.gov.uk/shared_offt/reports/financial_products/OFT1005rev
 4 OFT 2013 Annex C, p.147, 65% of consumers with PCAs surveyed in November 2012 had an arranged overdraft. See: http://www.offt.gov.uk/shared_offt/reports/financial_products/annex-c.pdf. GfK FRS survey for the FSA December 2012 reports 52.4% of PCAs have an arranged overdraft. Applying the 52.4%-65% range to 61m active PCAs yields a range of 32-40m active accounts with overdraft facilities.
 5 See https://www.bba.org.uk/wp-content/uploads/2014/03/BBA01-303701-v87-MSR_-_Monthly_Statistics_Release_Tables.xls. It does not include building societies.
 6 From the OFT's 2008 market study which reports £680bn average daily unarranged overdraft balances vs. £8.4bn average daily arranged balances in 2006. This equates to 92% of balances being arranged. See http://www.offt.gov.uk/shared_offt/reports/financial_products/OFT1005.pdf

A step to further debt

Some consumers may be struggling to pay off their overdraft and other debt. Research by the debt advice charity StepChange shows that overdraft debt is common among consumers seeking their help.

Most (67%) have overdraft debt, and overdrafts account for 7.8% of their clients' debt by volume.⁷ With the findings that some consumers move to high-cost credit as overdraft limits are reached, overdrafts may be a step to further debt for some.

StepChange clients 2012, debt by volume



Market trends

Overdraft debt doubled between 1997 and 2007, was stable until 2010, and since then has been falling.

This is consistent with more lenient credit conditions pre-crisis, followed by lenders tightening their belts and consumers paying debt off during and after the crisis.

Use of overdrafts

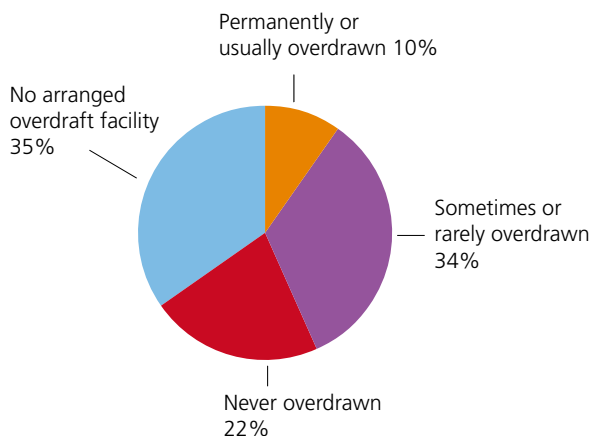
Research by the Office of Fair Trading indicates that 10% of current account holders are permanently or usually overdrawn, 34% are sometimes or rarely overdrawn and 21% are never overdrawn (and have an overdraft facility).⁸

7 See their 2012 Statistical yearbook: http://www.stepchange.org/Portals/0/Documents/media/reports/statisticsyearbooks/Statistical_Yearbook_2012.pdf
 8 Calculated from the OFT's November 2012 survey. See OFT Review of Personal current account, Annex C (2013), p.147-8. Available from: http://www.offt.gov.uk/shared_offt/reports/financial_products/annex-c.pdf.

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It also found that overdrafts are used in a similar way across income bands, but are much less common among people over 45.

OFT consumer survey of current account holders 2012 – overdraft use



How overdrafts are managed

Consumer behaviour

Our research looked at consumers who regularly use overdrafts and found:

- virtually no evidence of shopping around on overdraft features or charges
- little evidence of account switching
- a common belief that other providers will not take on consumers with overdraft debt
- authorised overdrafts are seen as an extension of money rather than debt, and some providers encourage this by presenting overdraft limits as 'funds available'
- using an authorised overdraft quickly becomes a habit and limits tend to be raised (with about half of the limits unsolicited in the sample)
- over time, consumers aim to stay within an authorised overdraft limit rather than pay it off – they feel things are 'under control' as long as they are inside the limit
- usage is driven by general pressure on finances, with no stigma in going overdrawn
- for more affluent consumers, an unauthorised overdraft is more likely to be a mistake and they are more likely to challenge charges

- for the less affluent, usage is more intentional, less avoidable and they are resigned to incurring charges
- there is widespread confusion and a lack of understanding about overdrafts – for example, many wrongly thought that overdrafts were simple or free and were generally confused about what happened when going into an unauthorised overdraft

Consumers do not pressure firms to offer good value overdrafts

Consumers do not tend to shop around or switch accounts on the basis of an overdraft. They also typically do not consider alternative credit products when drawing on an overdraft, because they do not actively choose to draw on it, do not consider authorised overdrafts as debt and are often unaware of costs.

As a result, consumers aren't very responsive to overdraft costs, so there is little pressure on banks and building societies to provide good value overdrafts. It also means banks and building societies can earn greater revenue from overdraft users.

Some firms have argued that overdrafts effectively subsidise 'free if in credit' banking. We think subsidies are more complex. As part of our ongoing market study into cash savings, for example, we have seen evidence that suggests that for some providers, a significant proportion of their instant access savings account holders also hold personal current accounts. This is consistent with these accounts being a gateway product for selling other products, as noted by the OFT in its 2008 market study.⁹

These complexities show that any regulatory interventions will need to consider overall issues in the retail banking market.

Costs of overdrafts

We have seen evidence of banks charging high fees for unauthorised overdrafts.

⁹ See OFT (2008) Personal current accounts in the UK An OFT market study, http://www.of.gov.uk/shared_of/reports/financial_products/OFT1005.pdf

“Being in my overdraft is not a problem as long as I replenish it every month”

The OFT compared the cost of borrowing £100 over a month for different forms of high-cost credit in 2010. Unauthorised overdrafts were the second most expensive, with an average total cost of £37.¹⁰

Authorised overdraft charges have evolved recently, with many providers moving away from interest charges to daily charges with caps on charges per month. In 2013 Which? found that authorised overdrafts were cheaper than unauthorised overdrafts, with costs of borrowing £100 over a month ranging from £0 to £30.¹¹

Still significant revenue from overdrafts

Revenues from overdrafts have fallen overall in recent years. However, they remain significant.

In 2011, 34% of revenue from personal current accounts was from overdrafts – down from 36% in 2007. This was largely driven by a reduction in unauthorised overdraft revenue from charges, down from £2.4bn in 2007 to £1.7bn in 2011. However, revenue from authorised overdraft charges increased by £0.4bn over the same period.¹²

The recent changes to authorised overdraft charges structures, away from interest to daily charges, may be a mechanism by which providers are increasing revenue from authorised overdrafts.

How firms structure overdrafts

Our internal research with providers found that:

- most providers include an overdraft as standard with a personal current account
- opt-outs from unauthorised overdrafts are typically offered, but usually for a fee
- most providers plan to move toward daily fees on unauthorised overdrafts, but charging structures still remain complex
- detailed information on overdrafts is available and actively disclosed to consumers (for example, in monthly statements and annual summaries)
- most providers offer a text alert option to consumers approaching their overdraft limit
- providers offer different grace periods for charges, but disclosure about these varies
- most providers offer a small buffer (£10 to £20) before breached authorised limits triggered charges

Overdraft providers appear to have made improvements, particularly around disclosure. We think these have been driven by regulatory pressures, such as the OFT’s and Government recent actions, rather than from improvements in competition in the current account market. For example a number of major banks have recently lowered the level at which charges start on authorised overdrafts to very similar levels, suggesting some degree of ‘following’ behaviour in the market.

All the same, the ongoing high revenue from unauthorised overdrafts and the increase in revenue from authorised overdrafts suggest that providers can still potentially profit from consumers’ lack of understanding, confusion and limited attention.

10 OFT (2010) High Cost Credit Review, Annexe D: http://www.of.gov.uk/shared_of/reports/consumer_credit/High-cost-credit-review/OFT1232d.pdf.

11 See <http://press.which.co.uk/whichpressreleases/which-says-it-time-to-clean-up-credit/>.

12 From p.33, Mintel (July 2013), Packaged and Current Accounts – UK, itself based on data from the OFT’s January (2013) Review of the personal current account markets.