

Emerging thinking

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28 April 2006

Introduction

1. This document sets out our emerging thinking on competition in the market for personal current account (PCA) banking services in Northern Ireland on the basis of the evidence that we have examined to date. It also identifies those issues on which we expect to concentrate our attention in the next few months prior to the publication of our provisional findings report. We have not reached any conclusions on these issues and part of the purpose of this document is to elicit further evidence on them.

Background

2. On 26 May 2005 the Office of Fair Trading (OFT) referred the supply of PCA banking services in Northern Ireland to the Competition Commission (CC) for investigation under section 131 of the Enterprise Act 2002 (the Act). The reference followed an initial OFT study into PCA banking services in Northern Ireland, undertaken in response to a supercomplaint from *Which?* and the General Consumer Council for Northern Ireland (GCCNI). Our terms of reference are set out in Appendix A.
3. A PCA is defined in our terms of reference as:

...an account, marketed to individuals not businesses, which provides the facility to hold deposits, receive and make payments (cheque and credit cards), use automated teller machine (ATM) facilities and make regular payments (direct debits and standing orders).
4. Our inquiry into PCA banking services in Northern Ireland is a market investigation under part 4 of the Act. Section 134(1) of the Act requires us to determine whether any feature or combination of features of the relevant market or markets prevents, restricts, or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK. Features of the market mean:
 - (a) the structure of the market concerned or any aspect of that structure;
 - (b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or
 - (c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.
5. If the CC decides that there is an adverse effect on competition, it is required under Section 134(4) of the Act to decide whether action should be taken by it, or whether it should recommend the taking of action by others, for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers¹ so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and, if so, what action should be taken.
6. On 28 October 2005, in the statement of issues (Issues Statement), we set out what we considered to be the most important issues relating to competition in the market for PCA banking services in Northern Ireland.² This document, together with the

¹A detrimental effect on customers is defined in section 134(5) of the Act as one taking the form of:

(a) higher prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or

(b) less innovation in relation to such goods or services.

²In this document we refer to the market for PCA banking services in Northern Ireland as the PCA market.

appendices, sets out our emerging thinking on these issues on the basis of the evidence so far presented, gathered, and analysed. We have also published on our website the results of our qualitative (Millward Brown) and quantitative (ORC) surveys of customers, submissions from PCA providers and third parties, summaries of key arguments and views, and various working papers.³

7. PCA banking services are provided by many different organizations in Northern Ireland. For the purposes of this inquiry we discuss separately, where relevant, the Northern Irish clearing banks (the clearers)—Governor & Company of the Bank of Ireland (BoI), AIB Group (UK) plc (First Trust), Northern Bank Limited (Northern) and Ulster Bank Limited (Ulster)—and those that are not clearers (the non-clearers) such as Abbey National plc (Abbey), Alliance & Leicester plc (A&L), Halifax plc (Halifax), Nationwide Building Society (Nationwide) and Barclays Bank plc trading as 'The Woolwich' (Woolwich). The non-clearers also include several remote providers such as cahoot (a division of Abbey), first direct (a division of HSBC Bank plc (HSBC)), Intelligent Finance (a division of Halifax) and smile (a division of Co-operative Financial Services). We refer to the clearers and non-clearers collectively as the banks.⁴
8. In our Issues Statement we noted several recent developments which may indicate a change in the competitive environment for the PCA market. These included the removal of standing order and direct debit set-up charges by Northern and the launch of Northern's new 'fee-free' PCA, Current Account Plus in February 2005;⁵ the purchase of Northern by Danske Bank in March 2005; and the announcement of Ulster's new charging structure in October 2005. Since publishing our Issues Statement, Ulster launched its new PCA charging structure and Northern launched a new range of products with a new charging structure in April 2006.
9. Given these developments, which have taken place since the supercomplaint was made to the OFT in November 2004, we attempt to distinguish between the market conditions up to the time of the supercomplaint, current market conditions (up to spring 2006), and, as far as possible, the changes that we might reasonably expect to occur in the foreseeable future.⁶
10. The economic circumstances in Northern Ireland over the past 20 years or so are important in setting the context of our inquiry. Details are set out in Appendix B. The key elements that we have taken into account in our assessment of the market include:
 - (a) the population of Northern Ireland is around 1.7 million (less than 3 per cent of the UK population), with a higher proportion of young people and lower average earnings than most of the rest of the UK;
 - (b) the Northern Irish economy is heavily dependent on the public sector. Over one-third of those in work are employed in the public sector compared with 25 per cent across the UK as a whole;

³These include working papers on banking regulation, payment systems, the Banking Code, switching, market definition, local competition, and entry and expansion.

⁴This is not intended to be a comprehensive list of all banks and building societies which offer PCAs in Northern Ireland, although it lists all four clearers. We also note that, although we refer to them collectively as 'banks', certain organizations, including Nationwide, are building societies with mutual status. References to the banks refer to all clearers and non-clearers, whether or not they are named. Further details of the banks' parent companies are set out in the glossary.

⁵Current Account Plus was available between February 2005 and April 2006 to new customers and to existing customers who applied to change their account.

⁶In our provisional findings report, the current market conditions will be extended to include the period between publication of this Emerging Thinking document and publication of provisional findings, taking account of any changes by any of the banks during that time.

- (c) after a long period of economic stagnation, there have been improvements following the Good Friday Agreement in 1998; and
 - (d) the increase in the proportion of the population who are economically active, together with a move towards electronic payment of state benefits, which has led to an increased penetration of PCAs.
11. Paragraphs 12 to 20 summarize our current thinking, which has emerged from the evidence that we have examined to date. The subsequent paragraphs set out our emerging thinking on these points in more detail. Other matters raised in the Issues Statement but not discussed in this document are currently of less concern, although they may still be subject to further consideration.

Summary of current thinking

12. In summary, based on the evidence to date, our current thinking is that, despite changes by some, but not all, of the banks in their products and associated prices, competition in the provision of PCAs in Northern Ireland appears not to be fully effective. It appears that charges are higher and may be applied in a wider range of circumstances, and credit interest rates may be lower, than we might expect in a competitive market.

Market definition

13. We consider that the provision of PCAs in Northern Ireland is an appropriate market framework for our assessment of competition for PCAs. Our current thinking is that the product market should not be drawn more widely to include basic bank accounts (including the Post Office Card Account),⁷ instant access savings accounts⁸ or Credit Union accounts;⁹ and that PCAs in the rest of the UK do not provide a sufficient constraint to justify a broader geographic market definition.

Market structure

14. We will focus our attention in the next few months on the key market characteristics that we currently believe to be most relevant in our assessment of competition:
- (a) clearers and non-clearers operate business models that differ in a number of significant respects. While both offer PCAs as part of a wider portfolio of banking services, there are important distinctions in their corporate or organizational structures, product mix and priorities. Irrespective of ownership, the clearers operate as Northern-Irish-focused businesses with products branded and priced specifically for the Northern Irish market, as part of a broad range of personal and business banking services. In contrast, the non-clearers operate as part of integrated UK-wide businesses offering the same products on the same terms and conditions throughout the UK, with a particular focus on personal banking services including mortgages and savings products. We are investigating whether, and if so how and to what extent, such differences in strategic

⁷A basic bank account allows money to be paid, standing orders and direct debits to be set up and money to be taken out using a cash card. It cannot go overdrawn.

⁸An instant access savings account allows immediate withdrawals without incurring a penalty. Some accounts also offer full banking facilities such as cheque books, cheque guarantee cards and credit cards.

⁹Credit Unions are cooperative financial organizations owned and run by their members for their members. Members save with their respective Credit Union and can borrow from it.

positioning between the clearers and non-clearers impact on competition in the market for PCAs;

- (b) the aggregate market share of the clearers measured by volume has decreased significantly over the last five years, although not all the clearers have lost share. When measured by value, the decrease in the clearers' share is much less significant. We are investigating the relationship between market share and market power;
- (c) there may be significant barriers to entry and expansion, relating in particular to the need for branches in order to achieve significant sales of PCAs. However, the low levels of switching in the market and the fact that sales of other personal financial products are not as dependent on branch density mean the payback on any such investment is likely to be slow when viewed solely in the context of PCAs. We think that branches will continue to be important in the foreseeable future despite an increasing percentage of customers being comfortable with using multiple channels to access their PCAs. This is because of the role of the branch in marketing and opening PCAs, and because, once opened, switching is infrequent. We are considering the reasons for, and the competitive impact of, the size of different banks' branch networks.

Conduct of customers

- 15. Levels of switching in the PCA market are low relative to other industries such as utilities and other financial services. Customers are reluctant to switch bank for a variety of reasons, including:
 - (a) customer indifference, arising from factors such as a low interest in PCAs, a perceived small financial benefit from switching, both in absolute terms and relative to the perceived difficulties, costs and risks, and a perceived lack of differentiation between the banks;
 - (b) a high perception of barriers to switching, including fear of cost, hassle, errors and delay, the perception that longer-term banking relationships might be damaged by switching, and strong bank loyalties; and
 - (c) the difficulties of comparing PCAs, given the complexity and lack of transparency of the banks' products and charges.

Conduct of banks

- 16. We examined pricing behaviour and found similarities in pricing among some of the clearers' PCAs. In many cases, when one clearer increased prices, others tended to follow and prices converged on similar levels. We believe such outcomes are unlikely to be explained by common costs and may be indicative of a lack of effective competition in the market.
- 17. We considered whether pricing behaviour reflects market power. We found that:
 - (a) both clearers and non-clearers may individually have market power over their customers (unilateral market power). Given the low customer propensity to switch, this may allow the banks to charge higher prices than would otherwise be the case. In addition, in the case of the clearers, there are other factors which may increase their possible unilateral market power, including their ability to

recruit new-to-banking customers (those customers opening their first account) as a consequence of their denser branch networks.

- (b) conditions that existed and may still persist may allow the clearers to coordinate pricing on some PCAs. Pressure from non-clearers seems to have been weak in the past. We are considering whether there are incentives for the clearers to coordinate, in particular given the low propensity of customers to switch, and why there appears to have been price-following on some but not all charges and products.
18. However, there have been recent changes in both the competitive conditions in the market, particularly the increasing market penetration by the non-clearers, and in the charges and products offered by some of the clearers. We are considering whether these changes may have resulted from an increase in the competitive threat posed by non-clearers, perhaps resulting from increasing willingness to switch among customers, increasing price-sensitivity of new-to-banking customers, or reduced dependence on branch networks. We are also considering whether there has been a reduction or elimination of unilateral market power, and whether coordination (if any) is no longer sustainable, or alternatively whether the changed behaviour of some banks is temporary, and conditions allowing market power to be exercised remain.
19. There may be local markets for PCAs depending on the catchment areas around branches. However, these catchment areas are likely to overlap extensively in the main areas of population. We found no evidence that the clearers locate their branches so as to avoid serving the same areas. Many of the clearers' branches are located in the same areas as non-clearing bank branches, which are accessible to the majority of consumers. There is no evidence of market segmentation on religious lines. For these reasons, and because the banks all offer national pricing, we do not think that there are likely to be local competition concerns.

Financial performance

20. Banks evaluate the financial performance of PCAs in different ways. However, in almost every case the clearers focus on the revenue contribution from PCAs in conjunction with a number of other products. The non-clearers look at the provision of PCAs across the UK as a whole. We recognize that it is difficult to analyse the financial performance of PCAs, and PCAs in any one region in particular, as if they were a stand-alone product. Our focus to date has been on seeking to understand the revenue generated by each bank from its PCA portfolio. Certain costs must be shared between PCAs and other products and we are considering how best to allocate these common costs to PCAs. Notwithstanding the significant conceptual and practical difficulties in such cost allocation, we are analysing the costs and resultant profits allocated to the PCA business for each bank. We recognize, however, that it is likely to be difficult to draw any firm conclusions based on our analysis of profitability. More generally, in our competitive assessment of the market, we are considering how best to use the results of our analysis of the financial performance of the banks across a number of dimensions. Appropriate financial measures are likely to include revenue, operating costs and contribution per PCA or per branch.

Analysis and assessment

Market definition

21. We took the terms of reference set out by the OFT as our starting point for market definition. A PCA must have all the characteristics listed in our terms of reference. Therefore PCAs are accounts that are marketed to individuals¹⁰ not businesses that perform a variety of functions including the facility to:

- (a) hold deposits;
- (b) receive and make payments (cheques and debit cards);
- (c) use ATMs; and
- (d) make regular payments (direct debits and standing orders).

An account which has additional characteristics (such as a facility for short-term borrowing through overdrafts) will also be taken to be a PCA.

22. We looked at several potential substitute products. We found that basic bank accounts, instant access savings accounts and Credit Union accounts are incomplete substitutes for PCAs. Although a small minority of customers with simple financial needs might regard these as substitutable for a PCA, there is no evidence to suggest that there are enough such customers to constrain PCA offers. On the other hand, we found that packaged accounts¹¹ are full substitutes both from a demand- and a supply-side perspective.¹²

23. From a supply-side perspective, we believe that another provider of financial products which does not currently provide PCAs would be unlikely to move into the provision of PCAs quickly, easily and profitably, without significant investment, within the short term (around one year).

24. We looked at whether the market was segmented. We saw no evidence of a substantial and distinct segment of customers that favour remote banking through the Internet or over the telephone—rather, customers expect choices in the operation of their bank account, with access through branches, ATMs, through the Post Office, over the Internet, and by telephone. We found evidence of market segments for students, graduates, and high net-worth individuals, but we do not think that these are separate markets given the ease of supply-side substitution.

25. We also considered whether Northern Ireland is a separate geographic market from Great Britain.¹³ From a demand-side perspective, we did not find that significant numbers of Northern Irish customers operated PCAs through British bank branches. There is no evidence that they would consider doing so, nor that Northern Irish customers would be likely to switch to remote British-based providers of banking

¹⁰This definition will include sole traders as well as personal customers.

¹¹A packaged account is a PCA that provides additional financial and non-financial benefits, for example discounts on loans or travel insurance, for which a monthly or annual fee may be chargeable.

¹²We do not reach a conclusion as to whether offset mortgage accounts or current account mortgages are substitutable for PCAs from either a demand- or a supply-side perspective. The purpose of these accounts is to use positive balances in the current account to reduce the sum owed on the mortgage. The number of offset mortgage accounts and current account mortgages in Northern Ireland is very low, constituting less than 0.05 per cent of the total number of PCAs.

¹³The Republic of Ireland has a different currency and different regulatory requirements to Northern Ireland. We therefore consider that the potential for demand- or supply-side substitution for the Republic of Ireland is less than for Great Britain, and we concentrate our analysis on whether Northern Ireland is a separate geographic market from Great Britain.

services. Nor do we believe that short-run, supply-side substitution by British providers of banking services would be likely, despite the possibilities for entry in the longer term.

26. We considered whether the non-clearers were constrained by the actions of the British clearing banks, and whether the clearers in Northern Ireland responded to changes in PCA offers introduced by the non-clearers that were, in general, making a UK-wide offer. This might, in theory, suggest that there was a chain of substitution from Great Britain to Northern Ireland. However, we saw no evidence either that the clearers in Northern Ireland changed their pricing directly and rapidly in response to pricing changes by non-clearers, or that the non-clearers changed their offers in response to changes by British clearing banks. It seems to us that, in so far as the clearers adjust their pricing and offers in response to competitive pressures from the non-clearers, they are responding to offers in Northern Ireland, rather than to offers in Great Britain.
27. We found that local markets are unlikely to be relevant to our assessment of competition (see paragraphs 182 to 188).
28. In summary, our current thinking on market definition is that the product market for PCAs includes packaged accounts, but does not include basic bank accounts, instant access savings accounts, and Credit Union accounts. We also currently believe the geographic market to be Northern Ireland.
29. Further details of our current thinking on market definition are set out in our working paper on the CC website.

Market structure

Overview

30. We set out below our current thinking on those elements of the structure of the market most relevant to our assessment of competition in the market:
 - (a) regulation, payment systems, provision of bank notes and the Banking Code (the Code);
 - (b) business models and charging structures of banks;
 - (c) market shares and concentrations;
 - (d) branch networks; and
 - (e) barriers to entry and expansion.

Further details of several of these aspects are set out in our working papers on the CC website or as appendices to this document.

31. From time to time we have made comparisons between certain characteristics or metrics in Northern Ireland with elsewhere in the UK or, in some cases, the Republic of Ireland. However, we only sought information on the British clearing banks' products where it is relevant to our competitive assessment of the Northern Irish PCA market. Since the non-clearers' offers are UK-wide, they automatically provide an element of comparison with Great Britain. We have not, however, sought evidence on the PCA market as a whole in either Great Britain or the Republic of Ireland, and have not undertaken a competitive assessment of the PCA market or the banking

markets more generally in either territory. We made no assumptions, nor have any view, as to whether Great Britain provides a competitive benchmark. We believe that the Republic of Ireland is less relevant as a comparator, largely because of its different regulatory regime.

Regulation, payment systems, provision of bank notes and the Code

Regulation

32. Banking is a heavily regulated activity. Regulation has an ongoing impact on all banks' costs and ways of working. The Financial Services and Markets Act 2000 (FSMA) provides the regulatory framework for the financial services sector in the UK, including banking. The regulatory arrangements for the banks operating in Northern Ireland differ according to the home country of the group concerned and their corporate structure. With the exception of BoI, which is regulated by the Irish Financial Services Regulatory Authority (IFSRA), all the banks are regulated by the Financial Services Authority (FSA).¹⁴ Our working paper on banking regulation, published on the CC website, sets out further details relevant to this inquiry.

Payment systems

33. Payment systems are central to the operation of the overall banking system.¹⁵ In general the banks participate in the UK-wide payment systems. The exception is cheque and paper credit clearing, for which Northern Ireland has a different system.
34. In 2000, the Cruickshank Report concluded that there were profound competition problems and inefficiencies associated with UK payment systems. In May 2005 the OFT's Payment Systems Task Force (the Task Force) recommended the introduction of a faster payments service for telephone banking and Internet banking payments with the ability to accept standing order payments. Implementation plans are now being drawn up covering the UK as a whole. The Task Force is examining issues relating to cheques, including possible changes to cheque clearing, the governance of the British and Northern Irish cheque clearing systems and arrangements for access to them; a report is expected in the summer of 2006. Further details of payment systems are set out in the relevant working paper, published on the CC website.

Provision of bank notes

35. The clearers issue their own notes which must be covered by coins or Bank of England notes.¹⁶ HM Treasury (HMT) is currently consulting on possible changes to the arrangements under which the clearers and the note-issuing banks in Scotland issue their notes.¹⁷ At present, the calculation of note cover is based on the average value of notes in circulation and the average value of note covering assets at the close of business each Saturday. HMT is proposing that all note-issuing banks

¹⁴The FSA sets the prudential requirements for banks, which derive from the Basel Capital Accord (Basel Accord). The minimum level of capital that a bank is required to hold at all times is determined by applying a capital adequacy risk-weighting framework, set under the Basel Accord, to each bank's balance-sheet exposures. A revised Basel Accord (Basel 2) is in the process of being adopted by the EU and national regulatory authorities and is expected to come into operation in the UK during 2006. As a result, it is expected that banks will need to hold less capital to support their PCA business.

¹⁵A payment system consists of a set of instruments, banking procedures and, typically, interbank funds transfer systems which facilitate the circulation of money.

¹⁶In terms of cover, the clearers must hold the equivalent of the value of their assets in coins or Bank of England notes.

¹⁷HMT, Banknote issue arrangements in Scotland and Northern Ireland, July 2005.

should be required to hold note-covering assets at all times, rather than only once a week.

36. Based on HMT figures, we estimate that the clearers as a whole receive a £24 million financial advantage each year as a result of holding their own bank notes.¹⁸ The financial advantage accrues to the clearers because they do not have to meet the cost of holding note-covering assets for six days a week. Some clearers told us that this gave them an incentive to offer a more extensive ATM network than they might otherwise do. Some clearers also benefit from providing the non-clearers with notes for their ATMs and tills.

The Code

37. The Code is a voluntary code of practice adopted by all major UK banks and building societies, including those in Northern Ireland.¹⁹ It was established in 1991 and is now in its seventh edition (March 2005). It is monitored and enforced by the independent Banking Code Standards Board (BCSB).
38. The Code sets minimum standards for banks' treatment of their customers²⁰ and for the information that they should provide to them. It covers a wide range of subjects including: changes to interest rates and charges; terms and conditions; guidance on lending; how customers should be informed about changes to their accounts; and arrangements for switching accounts. It covers a range of personal financial products including PCAs.
39. In 2001, in response to the Cruickshank Inquiry, there was a review of the Code in the UK (the Julius Review) which found considerable concern among customers about switching between banks. These centred on the 'hassle factor' of changing payment instructions and the fear that things would go wrong. There was also evidence that customers had inadequate information about the Code, and that information on their accounts was not presented clearly enough to facilitate comparisons with alternative products.
40. The Julius Review recommended various improvements including the following:
 - (a) making account switching easier by introducing portable credit histories and a '5-day start—5-week finish' standard for switching accounts;
 - (b) providing each customer with a consolidated annual summary statement (CASS) showing the total charges paid and interest paid on their accounts for each tax year;
 - (c) providing more information on compliance with the Code; and
 - (d) requiring all providers of banking services to sign up to the relevant codes.²¹
41. Of these recommendations, (a) and (c) have both been implemented, and all banks in Northern Ireland have signed up to the relevant codes under recommendation (d). Following the Julius Review, the proposal to provide each customer with a CASS

¹⁸HMT estimated the financial benefit to the clearers and the note issuing banks in Scotland to be £70 million a year. The CC estimate of the financial benefit to the clearers is based on the notes in circulation issued by the clearers as a percentage of the total notes in circulation issued by the clearers and the note issuing banks in Scotland.

¹⁹The Code is sponsored by the British Bankers' Association, the Building Societies Association and APACS. The Government and consumer bodies also have a role in its determination.

²⁰The Business Banking Code sets the standards for banks' treatment of their business customers.

²¹The relevant codes are the Code and the Business Banking Code.

(recommendation (b)) was initially rejected by Professor Kempson in her review of the Code in 2002. However, she recommended that the banks should commission research to identify, for each main type of account, what information customers lacked and would use if it were provided on a regular statement. The results led Professor Kempson to reject the proposal to provide each customer with a CASS in her latest review of the Code in 2004.²²

42. We are considering the relevance of these structural characteristics to our assessment of competition in the market. Currently we think it unlikely that the existence of distinct payment systems in Northern Ireland affects competition in the market. We are also considering how note issuance by the clearers affects the PCA market, and whether, and if so how, HMT's proposed changes might affect the PCA market in the future. We are also looking at the impact of the Code, particularly on switching.

Business models and charging structures of banks

Business models

43. The banks' business models are not designed specifically for the provision of PCAs. We therefore looked more broadly at the business models of the clearers and the non-clearers across a range of products and/or geographies to inform our thinking about the competitive dynamics in the market.
44. There are two primary business models operating in the PCA market: the clearers' and the non-clearers' models. We describe each of these in turn.
45. The clearers' business model is based on the requirements of both personal and business banking. The clearers have an extensive branch network, ranging from 46 branches for Bol to 101 for Northern,²³ maintain relatively highly-staffed branches, and offer a wide range of products.
46. PCAs have always been a core product of the clearers. In some cases PCAs have been seen as a 'gateway' to other personal financial products, such as savings or loans. They are also a significant net provider of funds for the banks. The clearers told us that they did not measure the financial performance of PCAs as stand-alone products, and normally monitored their performance by assessing volume information (such as total balances or number of accounts) and revenues (net interest income (NII)²⁴ and charges).
47. The non-clearers can be divided into three sub-groups: current and former building societies (including Abbey, A&L, Halifax, Nationwide and Woolwich); British banks that have launched PCAs in Northern Ireland in the past ten years or so (Co-operative Bank plc (Co-operative Bank) and HSBC); and banks that provide a remote service by Internet or telephone (the remote providers such as cahoot, first direct, Intelligent Finance and smile).
48. The majority of the non-clearers' market share is held by the first sub-group, and we therefore focus on their business model. Many of these non-clearers were originally

²²Professor Kempson of Bristol University's Personal Finance Research Centre carried out two independent reviews of the Code in 2002 and 2004.

²³Includes one sub-branch for Bol and six for Northern.

²⁴NII is earned from credit and debit balances. NII on credit balances is the income from use of funds elsewhere in the bank less interest paid to customer. NII on debit (overdraft) balances is the interest received from the customer less income forgone by providing funds.

building societies, offering mortgages, savings accounts and loans. They started to offer PCAs 15 to 20 years ago.²⁵ They do not, in general, offer business banking services. They have fewer branches in Northern Ireland than the clearers, with fewer staff on average per branch and PCA products that are standardized across the UK. None of the non-clearers focus on Northern Ireland or any other regional market in particular. In many cases, the non-clearers have acquired PCA business through cross-selling from their more traditional products, particularly on the back of the growth in the housing market.

49. The clearers and many of the non-clearers offer multi-channel banking via the branch, ATMs, the Internet, or by telephone, although the clearers have, in general, been slower to develop their remote channels.
50. We are considering the relevance of these two different business models to competition in the market.

Charging structures

51. There are two basic PCA charging structures: the historic charging structure (the 'traditional' PCA) and the fee-free PCA. In most cases, customers are not charged for operating a PCA when it is in credit. Customers usually have to pay interest on authorized overdrafts. They may have to pay a variety of charges which can be categorized as follows: transaction charges, account maintenance charges, ancillary charges and additional charges for operating an unauthorized overdraft.²⁶ All PCAs incur ancillary charges for occasional activities such as special transactions, including CHAPS²⁷ payments or bank drafts, or for additional administration such as stopping a payment or providing a replacement bank statement, whether or not the account is in credit.
52. In addition to these two common charging structures, there are a number of other charging structures. First Trust and Ulster offer packaged accounts, where customers typically pay a monthly or quarterly fixed charge regardless of whether the account is in credit or overdrawn, but do not pay any transaction charges. They are also likely to receive preferential terms on the account (for example, on credit interest rates or approved overdraft rates), may be exempt from some ancillary charges, and often receive other bundled benefits such as free travel insurance or discounts on some purchases. Some accounts (eg Northern's ChequeMaster) levy a fixed monthly fee for authorized overdrafts but there are no transaction charges. Other accounts (eg Northern Re:pay and Woolwich's Openplan) link the PCA with mortgage and savings accounts.
53. The characteristics of each of the PCAs offered by the nine largest banks in Northern Ireland are listed in Appendix D, including levels of interest and charges on specific PCAs. These are grouped by charging structure. We have concentrated in the following analysis on traditional and fee-free accounts as these represent the great majority of PCAs. We describe the traditional PCA in paragraphs 54 and 55 and the fee-free PCA in paragraphs 56 and 57. We estimate that around half of the clearers'

²⁵The Building Societies Act 1986 allowed building societies to move into the provision of services previously offered only by banks such as personal loans and current accounts.

²⁶Drawings on the PCA beyond the authorized limit are referred to as being unauthorized.

²⁷Clearing House Automated Payment Scheme.

PCA customers have traditional PCAs.²⁸ None of the non-clearers offer traditional PCAs.

Traditional PCAs

54. Transaction charges are levied on traditional PCAs on a per-transaction basis. They apply to a variety of regular transactions such as cheques, ATM withdrawals, debit card payments, standing order or direct debit payments. Account maintenance charges are generally levied on a quarterly basis. Both transaction and account maintenance charges are levied during a quarter if the account is overdrawn at any point during that quarter whether or not the overdraft has been authorized.
55. The traditional PCA incurs charges for setting up, amending, or cancelling standing orders or direct debits. Additional charges are levied when operating in unauthorized overdraft mode. These unauthorized overdraft charges may include, for example: charges for notifying the customer of their unauthorized overdraft position; unauthorized transaction charges; and referral charges for declining unauthorized transactions. Credit interest rates on traditional PCAs are typically very low (0.1 per cent) or zero. Overdraft limits and rates may be subject to negotiation.

Fee-free PCAs

56. The second basic charging structure is that of the fee-free PCA. It is described as 'fee-free' because transaction and account maintenance charges are not levied when the account is operated in either authorized or unauthorized overdraft mode. However, fee-free PCAs are subject to a range of ancillary charges other than charges for setting up, amending, or cancelling standing orders or direct debits. Fee-free PCAs are also subject to unauthorized overdraft charges. They also typically offer more attractive credit interest rates. If certain conditions are met, these can be as high as 6 per cent, although credit interest rates are often much lower on PCAs which do not meet such conditions (see paragraph 120).
57. All the non-clearers offer fee-free PCAs. As outlined in paragraph 8, there have been various changes to PCA offers after the supercomplaint, particularly those offered by the clearers.²⁹ As at March 2006, two of the four clearers offered fee-free PCAs: Northern's Current Account Plus, and Ulster's new PCA charging structure.³⁰ Current Account Plus was available between February 2005 and April 2006 to new customers and to existing customers who applied to change their account; existing customers were not automatically transferred to Current Account Plus. Northern launched a new PCA product portfolio in April 2006.³¹ Northern also removed ancillary charges for setting up, amending or cancelling standing orders and direct debits from its traditional PCAs. Ulster's PCAs, which do not incur transaction charges or ancillary charges for setting up, amending or cancelling standing orders and direct debits, apply to all PCA customers. We discuss these offers in more detail in paragraphs 170 to 174.

²⁸Those not on a traditional PCA include all customers of Ulster, and those with student accounts, packaged accounts, and accounts (such as Northern's ChequeMaster account) which charge fixed quarterly or annual fees but no transaction charges.

²⁹During this period there have been no significant new offers by the non-clearers, and those new offers that have been introduced apply across the UK.

³⁰We note, in addition, that First Trust's packaged account has a fixed charge rather than transaction charging, and Bol's Clear account is fee-free for the first year.

³¹Shortly before publication of our Emerging Thinking, Northern announced details of its new PCA portfolio. This has not been taken into account at this stage.

58. Our preliminary review of the financial performance of the banks, over the period 2002 to 2004, illustrates the financial impact of differences in charges and credit interest rates between the two charging models.³² It suggests that the non-clearers earn significantly lower charges per account than the clearers, and pay higher average credit interest per account (see Table 1).

TABLE 1 **Average credit balances, credit interest rates, NII and charges per account (by clearers and non-clearers), 2004**

| | Clearers | Non-clearers* | Average† |
|---|----------|---------------|----------|
| Average credit balance per active account (£)‡ | 1,900 | 1,500 | 1,800 |
| Average interest rate paid on credit balances (%) | 0.10 | 1.25 | 0.30 |
| Average NII per active account (£) | 95 | 55 | 86 |
| Average charges per active account (£) | 65 | 43 | 60 |

Source: CC analysis of financial information provided by the banks.

*The non-clearers included in this table are Halifax, Abbey, A&L and Nationwide. Our financial analysis included only the clearers and the largest four non-clearers, covering over 95 per cent of the market.

†All averages are weighted by the number of active PCAs.

‡Average credit balances are calculated on a daily basis.

Market shares and concentrations

59. Market shares and concentrations can be indicators of the competitiveness of the market. We looked at a range of bases for calculating market shares and concentrations, including shares based on volume (number of accounts (total or active³³ only); number of new account openings) and value (total credit balances or PCA revenues). We first consider market shares based on volume data from the MORI MFS (MORI) survey,³⁴ since this is the information that is widely available and used by the banks. However, we believe that this may not be an accurate indicator of possible market power.

Volume-based market shares and concentrations

60. Relative market shares in different personal banking products largely reflect the historic focus of different providers (see Table 1 in Appendix C, based on the MORI survey). The clearers have the highest market shares in PCAs and savings accounts, whilst the non-clearers tend to have higher market shares in mortgages.
61. Figure 1 shows the trend in market share based on the numbers of accounts from the MORI survey.³⁵ We note that these data are based on the bank where an individual's 'main account' is held,³⁶ and include basic bank accounts (in particular the Post Office Card Account).
62. On this basis, the clearers have retained the largest market shares throughout the period 2000 to 2005. However, their total share has declined, from 82.4 per cent in

³²During the period covered by our financial analysis the vast majority of the clearers' PCAs were traditional PCAs.

³³We define active accounts as ones where the customer initiates a transaction at least every six weeks.

³⁴The clearers all subscribe to the MORI survey. This is their primary source of information on market shares based on numbers of accounts and share of new account openings. The survey reports rolling annual averages of four quarterly financial surveys of 1,500 Northern Irish respondents.

³⁵MORI's figures included instant access savings accounts until 2000; caution should be exercised in reading trends across the period 1999 to 2000. Figure 1 includes all banks with markets shares greater than 0.1 per cent in Northern Ireland.

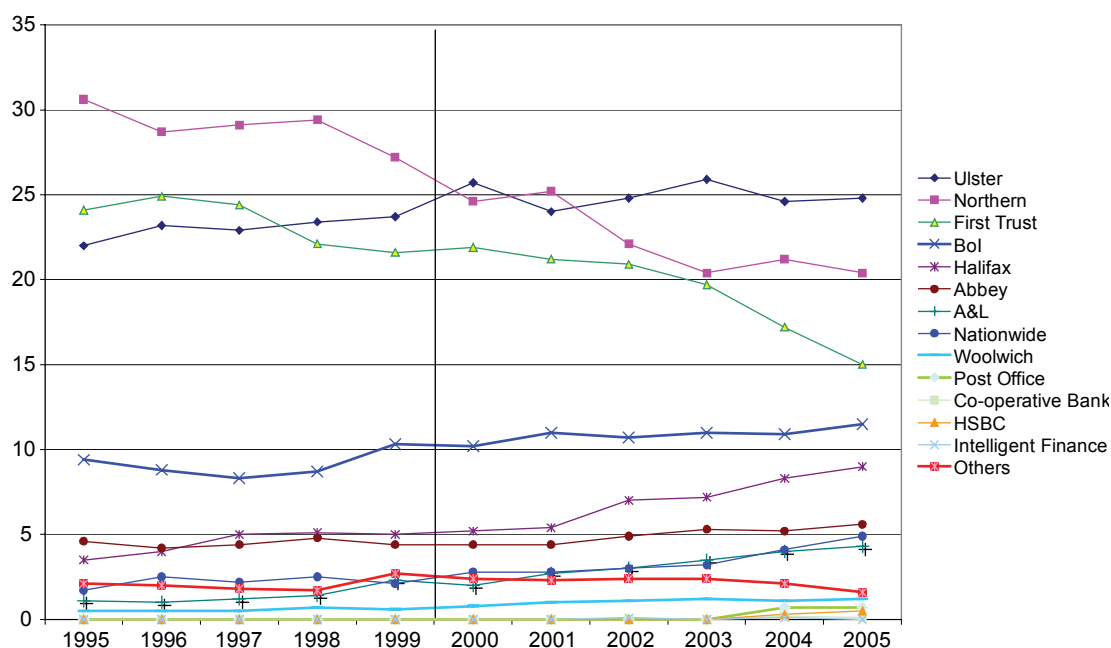
³⁶The ORC survey suggests that around 25 per cent of PCA holders have a second PCA with a different bank, and about 20 per cent of PCA holders had at least one extra PCA with the bank that supplied their main PCA.

2000 to 71.7 per cent in 2005. Within this, Ulster's share has remained fairly stable, and Bol's has increased slightly. On the other hand, since 2000, First Trust and Northern have lost nearly 6 percentage points and over 4 percentage points respectively.

63. The total market share of the five largest non-clearers (Abbey, A&L, Halifax, Nationwide, and Woolwich) has increased by nearly 10 percentage points between 2000 and 2005, with each of them showing gains. A&L, Halifax and Nationwide in particular have increased their market share by over 70 per cent. New entrants to the market include the Co-operative Bank, HSBC, Intelligent Finance and the Post Office.

FIGURE 1

Market shares of stock of PCAs, 1995 to 2005, per cent



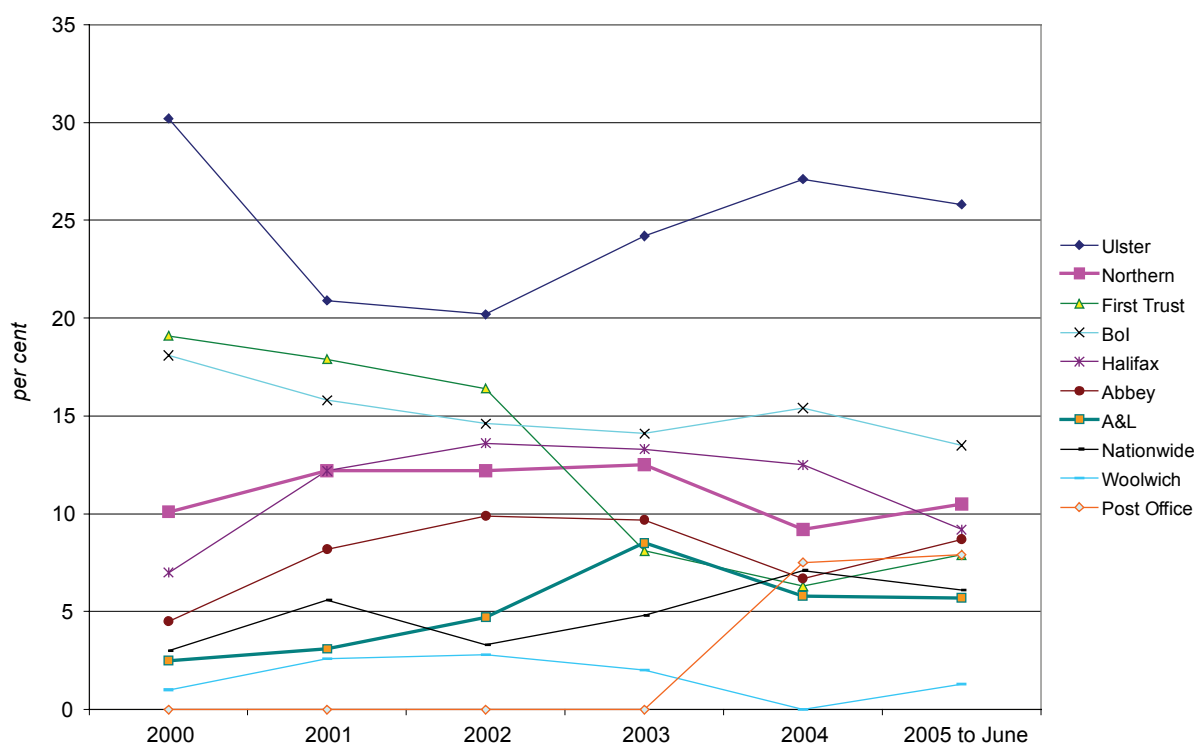
Source: MORI data.

64. Based on the MORI data on share of current account stock shown in Figure 1, the market was highly concentrated in 1995 (Herfindahl-Hirschman Index (HHI) of 2,127). However, by 2005 it had become only moderately concentrated (HHI of 1,546).
65. We have also looked at the share of new account openings achieved by each bank (see Figure 2).³⁷ This shows greater volatility than the stock of accounts. Between 2000 and 2005 the clearers' share of account openings fell from 78 per cent to 58 per cent (63 per cent in 2005 excluding Post Office accounts). We note that, since 1999, the level of penetration of PCAs (by proportion of households) in Northern Ireland has increased by at least 10 percentage points (see paragraph 95).

³⁷The share of new account openings has also been affected by the inclusion of the Post Office Card Account, which accounted for nearly 8 per cent of openings in 2005.

FIGURE 2

Share of new account openings



Source: MORI data.

66. Figure 2 shows the share of the customer base represented by new accounts opened with a particular provider in any year by customers who are either new-to-banking or switching provider. We estimated that, in 2002 to 2004, new accounts (flow), as a percentage of total PCAs (stock) each year ranged between 12 and 15 per cent overall (11 to 14 per cent for the clearers and 17 to 20 per cent for the non-clearers). Hence, changes in shares of flow will feed relatively slowly into changes in the stock of PCAs. Although the rate at which banks attract new account holders is a major influence on market share over time, market share will also be influenced by other factors such as the rate of account closure and multiple account use.
67. We also collected details of PCA volumes from the eight banks with the highest volume of PCAs between 2002 and 2004. We looked at both the number of PCAs in total and the number of those that were active. These estimates could differ from the MORI data because they refer to different time periods (the account data from the banks is based on financial year-end positions whereas the MORI data is based on quarterly survey data); they reflect the fact that customers may use more than one PCA; active and dormant accounts might be defined differently; or different methods of data collection and analysis might be used. Table 2 shows that, using MORI data, the market share in December 2004 of the top eight banks based upon total numbers of PCAs and active PCAs was 95.5 per cent.^{38,39}

³⁸Account numbers supplied by the smaller banks indicate that they collectively have a share of around 4.2 per cent of all open PCAs.

³⁹The noticeable differences between MORI data and Table 2 are Ulster and Halifax.

TABLE 2 Share of number of PCAs, and active PCAs, for the eight largest banks in Northern Ireland in 2004

| | <i>per cent</i> | |
|-----------------------|---|--|
| | <i>Share of number of accounts (year end)</i> | <i>Share of number of active accounts (year end)</i> |
| Ulster | (| ✂ |
| Northern | | |
| First Trust | | |
| Bol | | |
| Subtotal clearers | 72.8 | 73.4 |
| Halifax | (| ✂ |
| Abbey | | |
| A&L | | |
| Nationwide | | |
| Subtotal non-clearers | 22.7 | 22.1 |
| | <u>95.5*</u> | <u>95.5*</u> |

Source: CC analysis of financial information provided by the banks.

*We obtained detailed financial data from the eight largest banks. We used the MORI estimate of market share for those banks for which we did not have detailed financial data (4.5 per cent) to calculate shares of the total market based on the number of PCAs for the eight largest banks.

68. The market shares derived from the total and active number of PCAs both suggest that the clearers' market share is higher than indicated by the MORI survey results. There are also some significant differences between these results and those of the MORI survey for particular banks; furthermore the proportion of active accounts varies between banks. We are looking into these differences in more detail, but believe that, in coming to our view about competition in the market, we should take account of all measures of volume-based market shares.

Value-based market shares and concentrations

69. The financial benefit of an individual PCA to a bank depends on the way in which the customer uses it. It depends, for example, on average credit balances (on which the bank can earn interest) and the level of chargeable behaviour. In addition, the bank may take into account the extent to which the account holder has, or might have in the future, other (potentially more profitable) products.
70. We looked at the banks' PCA credit balances and revenues. Credit balances provide funds that can be used elsewhere in the bank to earn income. On average we found that the banks earn more than half their total income from net interest on credit balances, over 40 per cent from charges and 5 per cent from NII on debit balances.
71. The average credit balance of the clearers is substantially higher than that of the non-clearers. In 2004, for example, the average credit balance per active account was £1,900 for the clearers compared with £1,500 for the non-clearers, a difference of over 25 per cent. We estimated that the clearers held over 77 per cent of the total credit balances for PCAs in Northern Ireland (see Table 3). We also estimated that the clearers earned more than 82 per cent of the total income earned on PCAs in Northern Ireland.

TABLE 3 Share of PCA credit balances for the eight largest banks in Northern Ireland

| | <i>per cent</i> | |
|-----------------------|---|---|
| | <i>Total average credit balance (2002 year end)</i> | <i>Total average credit balance (2004 year end)</i> |
| Ulster | (78.9) | (77.6) |
| Northern | | |
| First Trust | | |
| Bol | | |
| Subtotal clearers | 78.9 | 77.6 |
| Halifax | (16.9) | (18.6) |
| Abbey | | |
| A&L | | |
| Nationwide | | |
| Subtotal non-clearers | 16.9 | 18.6 |
| | <u>95.8*</u> | <u>96.2*</u> |

Source: CC analysis of financial information provided by the banks.

*We obtained detailed financial data from the eight largest banks. We assumed that the average credit balances per active account for those banks for which we did not have detailed financial data was the same as the average for the four non-clearers shown in Table 3, and that the market share of the smaller banks was 4.5 per cent.

72. The market is more concentrated based on number of active accounts or value of credit balances than suggested by the MORI market shares based on number of main accounts. Table 4 shows the HHIs for various measures of market share, based on the eight largest providers.⁴⁰ By any of these measures, the market is likely to be rated as moderately concentrated.

TABLE 4 HHI values for the eight largest banks in Northern Ireland based on different measures (2005)*

| | |
|-------------------------------|-------|
| Share of main accounts (MORI) | 1,692 |
| Number of accounts | 1,675 |
| Number of active accounts | 1,734 |
| Share of PCA credit balances | 1,839 |

Source: CC calculations.

*These HHIs are all higher than the HHI of 1,546 in paragraph 64, since those in Table 4 are calculated using only the eight largest banks.

73. In general, market shares based on a measure of value rather than volume give a higher market share to the clearers. There are also significant differences between the individual clearers based on the two different measures. In particular, it appears that Northern and First Trust have preserved a significantly higher share of the market than would appear to be the case based on volume-driven market shares. Several parties have told us that, although Northern and First Trust had lost customers, this might at least in part have been a conscious effort to retain the higher-value customer.

74. Based on either PCA credit balances or revenues, the market shares of the clearers have fallen only slightly—by around 1 or 2 percentage points—between 2002 and 2004.⁴¹ This suggests that the clearers that have experienced a reduction in market share by volume might have partially mitigated this by increasing their average credit balance and average revenue per account at a faster rate than the non-clearers.

⁴⁰The HHI values for the overall market will be slightly lower as the smaller providers account for 4 to 5 per cent of the market.

⁴¹The clearers' market shares based on credit balances has reduced from 78.9 per cent to 77.6 per cent, and from 83.5 per cent to 82.1 per cent based on revenues between 2002 and 2004.

75. We are continuing to consider how best to interpret the market share and concentration information. We believe that it is relevant to look not only at the MORI volume-based market share information, but also at the other measures of volume-based market shares as well as the information on value-based market shares.

Branch networks

76. As set out in paragraph 45, the clearers all have substantial branch networks spread across Northern Ireland. In contrast, the non-clearers have many fewer branches, located primarily in the main centres of population, although they have significant UK-wide networks of branches. Table 5 sets out the number of branches and agencies in Northern Ireland for each bank.

TABLE 5 Number of branches and agencies in Northern Ireland in 2005

| | Full branches | Sub-branches or part-time branches* | Agencies |
|-------------------|---------------|-------------------------------------|----------|
| Bol | 45 | 1 | 0 |
| First Trust | 57 | 0 | 0 |
| Northern | 95 | 6 | 0 |
| Ulster | 87 | 4 | 0 |
| Halifax | 15 | 0 | 25† |
| Abbey | 21 | 0 | 0 |
| A&L | 14 | 0 | 0 |
| Nationwide | 14 | 0 | 12 |
| Woolwich | 9 | 0 | 0 |
| HSBC | 4 | 1 | 0 |
| Co-operative Bank | 1 | 0 | 0 |

Source: CC from market questionnaire responses (2005).

*Sub-branches or part-time branches may, for example, have limited opening hours.

†This includes 18 independent agents and seven Halifax estate agents which offer counter services.

77. Some of the non-clearers (in particular Halifax and Nationwide) supplement their full- or part-time branches with agencies.⁴² Several banks (primarily the non-clearers) also have an agreement with the Post Office to provide counter services for PCAs including cash withdrawal, balance enquiries, and paying in cash and cheques.⁴³ Bol is the only clearer to have such an arrangement.
78. Although the clearers have reduced their numbers of branches from 345 in 1996 to 294 in 2005, the bulk of these closures took place in the late 1990s. Recent closures have generally been due to merging two neighbouring branches. Some non-clearers have also reduced their number of branches; A&L reduced its branches from 17 in 1996 to 14 in 2005, and, although Halifax has opened four new branches, it is now present in fewer locations having reduced its number of agencies.
79. The ORC survey showed that a branch is very important to customers when opening an account. Although many customers transact much of their day-to-day business away from the branch (for example, almost two-thirds of customers transact most of their business via an ATM),⁴⁴ many customers, particularly those in socio-economic groups D and E, still visit the branch fairly frequently. We also understand from our

⁴²Entities other than the bank which provide branch type services to personal customers on behalf of the bank. These services are often provided by businesses such as estate agents, solicitors and insurance brokers, although some are stand-alone agencies.

⁴³This includes A&L, Bol, Co-operative Bank, Nationwide and smile. cahoot customers can cash cheques free of charge. The Post Office provides counter services for many more suppliers of basic bank accounts (which are not PCAs).

⁴⁴64 per cent according to the MORI survey.

qualitative survey that customers regard it as important to have the option of visiting a branch to resolve any difficulties that might arise as required.

80. In addition, the banks consider the branches to be important marketing tools, raising customers' brand awareness and providing an opportunity for cross-sales. However, the clearers have many branches in rural locations or small towns with a relatively limited catchment population. Although it is possible that not all of these branches are profitable on a stand-alone basis, branch closures are considered to be sensitive and difficult to achieve without significantly damaging the bank's overall reputation and hence its business.
81. All banks now offer remote banking as an additional channel. Whilst few customers choose to use remote banking as the only mode of accessing their PCA we were told that they expected to be able to access their accounts from a variety of channels including branches, the Internet, and by telephone.

Barriers to entry and expansion

82. Barriers to entry may reduce the likelihood of a bank entering the PCA market. Similarly, barriers to expansion may inhibit a bank with an existing but smaller presence in the market from expanding its activities. Sunk costs incurred by the incumbents in developing the branch network, for example, will reduce the attractiveness of entry by reducing anticipated returns or increasing risk to the potential competitor. This may reduce the likelihood of entry, or reduce the likely scale of any such entry.

Entry

83. Based on the ORC and MORI survey evidence, which suggests low levels of take up of Internet or telephone-only PCAs, we believe that successful large-scale entry would need to include access to a branch network. Our current thinking is that there may be significant barriers to entry to the PCA market, including the need to develop a branch network, the need for marketing to raise awareness of a new bank and its PCA offer, and the need to overcome customer indifference.
84. We discussed some of the issues associated with a branch network in paragraphs 76 to 80. The disadvantage of operating with a small branch network may be declining as customers become more comfortable with remote channels, or are more able to access the non-clearers' branches located in the major conurbations. In addition, we believe that the sunk costs involved in developing a small number of branches are unlikely to be high, since premises and appropriately trained staff can be obtained fairly easily, and leases can often be reassigned if necessary. However, as shown in paragraph 80, closing branches may be difficult due to the sensitivities and adverse publicity surrounding closures; this barrier to exit may make a bank less willing to open large numbers of branches. Alternatively, as set out in paragraph 77, new entrants can enter into agency arrangements or can use the Post Office to supplement their branch networks (although we note that PCAs cannot be opened in a Post Office branch, nor are Post Office staff in a position to offer financial advice to customers).
85. Customers' reluctance to switch is discussed in paragraphs 97 to 109. This may impose a constraint on the ability of a new entrant to attract customers, leading to a relatively slow payback on any investment.

86. An entrant would also need to market itself actively to ensure that customers were aware of its offer, and to overcome any lack of trust associated with an unknown provider.
87. On the other hand, we think it unlikely that the need to gain access to clearing systems represents a barrier to entry (see working paper on clearing systems on the CC website). Nor do we believe that there is any difficulty obtaining information on credit risks. The need to obtain regulatory authorization could be a potentially significant barrier to entry, but there are many possible entrants that would not need to seek further authorization to operate in Northern Ireland (either those already authorized in Great Britain, or banks from other EU member states).
88. The likelihood of entry will depend not only on the extent of entry barriers, but also on the anticipated profitability of offering PCAs within the context of the potential competitor's business model. This is likely to be a multi-product offering in more than one region or country, and as such it is unlikely that a potential competitor will make a decision about possible entry into the PCA market on a stand-alone basis. We were told that sales of other personal financial products were less dependent on the density of the branch network than PCAs.
89. The former building societies have been offering PCAs in Northern Ireland since the mid-1980s. There has been a number of entrants to the PCA market over the last ten years. HSBC and the Co-operative Bank have offered PCAs in Great Britain for many years but only recently entered Northern Ireland. cahoot, Intelligent Finance and smile launched a remote service across the UK (including Northern Ireland) around the end of the 1990s. None of these recent entrants has achieved a market share of more than 0.5 per cent. The recent experience of entry suggests that it is difficult for new entrants to build a significant market share quickly, in part due to the low levels of switching in the market; and that entrants that offer a physical branch network tend to achieve higher market shares than those offering a remote-only PCA.

Expansion

90. The major barriers to expansion are similar to those outlined in paragraph 83 in relation to entry. In particular, although some of the non-clearers have expanded fairly rapidly over the past few years, we believe that their future growth may be constrained by the present size of their branch networks. The non-clearers told us that opening further branches would allow them to increase their sales of PCAs, but none of them indicated that they intended to increase their branch network. It appears that none of the non-clearers currently regards building PCA market share in Northern Ireland as a priority. They told us that Northern Ireland represented a small proportion of their PCA business (around 2 to 3 per cent), and they had other priorities with more growth potential in other regions.⁴⁵
91. We think that the sunk costs of opening new branches are unlikely to be prohibitive for most existing non-clearers, although they may still be a sizeable investment. However, we believe it unlikely that existing non-clearers would seek to expand through investing substantially in new branches, given:
 - (a) the evidence set out in paragraph 90;

⁴⁵For example, Halifax's press release of 1 March 2006 announced that Halifax would open 100 new branches over the next five years in the South of England.

- (b) that PCAs are only one part of non-clearers' business and customers of other products appear to place less importance on access to a branch;
- (c) that the non-clearers do not generally have extensive business banking activities; and
- (d) that there is a low rate of switching.

They would be more likely to seek increased sales from their existing branch network.

- 92. We are looking further at the significance of the branch network in particular as a possible barrier to entry or expansion in the market.
- 93. Further details on barriers to entry and expansion are set out in the relevant working paper published on the CC website.

Conduct of customers

Overview

- 94. We next look at the behaviour of PCA customers, taking into account the market structure that we outlined in paragraphs 30 to 93. We looked first at some of the characteristics of PCA customers, and then focused in particular on levels of switching and reasons for the low rates of switching observed.
- 95. The current account is the most widely held personal banking product in Northern Ireland. About 80 per cent of households have access to a current account compared with almost 90 per cent in the UK as a whole.⁴⁶ First Trust told us that penetration rates had increased from about 68 per cent in 1999. Penetration rates of PCAs in Northern Ireland are lowest for young people, pensioners, and lower socio-economic groups.
- 96. We looked at reasons for the choice of bank. In general, when customers first choose their bank, they are particularly influenced by branch location, whether this be close to their home, place of work, or other frequently visited location. They are also more likely to choose a particular bank if other family members already bank there, charges are low, and, to some extent, if credit interest rates are high. As discussed in paragraphs 79 and 80, only around one-third of customers transact the majority of their business in a branch. We found that relatively fewer younger people said that branch location was important to them in their choice of bank, perhaps reflecting a move towards a greater use of remote banking.

Switching

- 97. If there are barriers to switching or a reluctance to switch, banks might have some market power against their existing customers, allowing them to raise prices above competitive levels (or to allow service standards to fall below competitive levels) without competitors succeeding in attracting customers away. We therefore looked at levels of switching and barriers to switching in some detail. We note that switching rates by type of customer might be relevant, given an individual customer's varying

⁴⁶The Northern Ireland Statistics and Research Agency (NISRA) Family Resources Survey found that 81 per cent of all Northern Irish households had access to a current account compared with 89 per cent in the UK as a whole.

profitability to the bank. Further details are set out in our working paper on switching on the CC website.

98. Switching rates for PCAs are low compared with the rates of switching seen in other industries across the UK (eg utilities, mobile phones, mortgages etc). PCA customers normally stay with their chosen bank for a long time. The ORC survey showed that more than half of all PCA customers had been with their main PCA providers for more than five years, and the median time since opening a main PCA for all customers was much longer at 13 years. The clearers, in particular, have a customer base largely made up of customers who have been with them for a long time: [X] per cent of Ulster's customers, [X] per cent of Northern's customers, [X] per cent of Bol's customers, and [X] per cent of First Trust's customers have been with that provider for more than five years.⁴⁷ We explore the reasons for this in paragraphs 102 to 110.
99. The total proportion of PCA customers who have switched suppliers is estimated to be 11 per cent over five years by ORC, equating to between 2 and 2.5 per cent each year. The MORI survey showed 22 per cent of the total Northern Irish population had switched PCA provider at some time in the past. The clearers told us that the surveys underestimated the extent of switching.⁴⁸ In addition to switching occurring through the banks' switching services, the banks also said that there were high levels of 'hidden switching'. This is used to describe a situation where customers open a PCA elsewhere and switch their main account themselves without informing the original provider, and without necessarily closing down their initial PCA. The banks experience a high number of accounts becoming dormant, which they attribute to hidden switching. Ulster reported total switching rates of over [X] per cent a year after allowing for hidden switching, excluding customers whose accounts became dormant for other reasons (eg switched accounts within the same banking group: RBS, or where the customer died). A non-clearer ([X]) told us that around 25 per cent of their PCAs were opened as second accounts, with the customer's first PCA remaining open. However, none of the market surveys in Great Britain or Northern Ireland that we identified detected high rates of hidden switching.
100. Data from switching services⁴⁹ show that switchers from clearers' PCAs are currently moving primarily to non-clearers. All the clearers have a lower share of switchers than their market share would suggest.⁵⁰ However, 55 per cent of those who switched PCA provider at some point switched to one of the clearers. MORI data show that since the start of 2003 the clearers have picked up 45 to 50 per cent of all customers who switched their main accounts.⁵¹ This is considerably below their share of the stock of PCAs, and indicates that switching may be a significant factor in the decline of the clearers' aggregate market share by volume.⁵²
101. There is mixed evidence on switching rates for PCA customers in Northern Ireland compared with those in Great Britain. It seems that current switching rates may currently be higher in Northern Ireland than in Great Britain. This view was supported by the majority of the non-clearers. Rates of PCA switching have fallen recently in Great Britain, possibly as public interest in, and media attention to, PCAs has

⁴⁷Source: clearers' responses to the market questionnaire.

⁴⁸The proportion of switchers identified in the surveys appears low relative to the proportion of new accounts opened shown in paragraph 66. However, paragraph 66 includes new-to-banking customers and secondary PCAs.

⁴⁹Services provided by banks to customers to facilitate switching accounts to another financial institution.

⁵⁰With the exception of [X] whose share of switchers in Q2 2005 as a rolling average was [X] per cent compared with an overall market share of [X] per cent.

⁵¹This compares with 55 to 60 per cent of all account openings, since the clearers have a higher share of first-time accounts.

⁵²A clearer [X] indicated that of switchers out between January and September 2005, a high proportion ([X] per cent) went to the non-clearers. Another clearer [X] told us that from January to October 2005, a high proportion ([X] per cent) of switchers said that they were moving to one of the non-clearers.

declined. This alone does not necessarily indicate, however, a competitive market in Northern Ireland since, as set out in paragraph 31, we have not carried out an investigation of the Great Britain market and have made no assumptions nor have any view as to whether Great Britain provides a competitive benchmark.

102. The decision to switch may be taken either because a better offer is seen elsewhere (a 'pull' factor) or because of dissatisfaction with the existing provider (such as poor service or because the customer feels charges are unfair or rates are uncompetitive; a 'push' factor). In the latter case a separate and subsequent decision is made as to the preferred alternative PCA provider.
103. We found that switching is primarily influenced by push factors. Recommendations, levels of charges, and interest rates play a greater role in the choice of alternative PCA provider once an individual has decided to move, although the single most significant factor appears to be access to a branch.
104. A clearer ([X]) submitted an analysis of MORI data which attempted to demonstrate that market share was responsive to respondents' average level of satisfaction with their bank's charges (a push factor, if satisfaction is falling), and the average satisfaction score for all other banks' charges (a pull factor, if the satisfaction with other banks' charges is seen to be increasing). Such a relationship was detected for the clearers but not for the non-clearers. However, we believe that the results show that market shares are influenced by a number of factors, and the effect of changes in satisfaction with charges on customer behaviour is, in fact, small. Declines in customer satisfaction can, through this model, only explain a small proportion of First Trust's and Northern's loss of customers over time, while market shares over the last five years have increased for BoI and Ulster despite falling satisfaction ratings. We therefore do not believe that relative charges are a major driver of the original decision to switch.
105. We believe that one of the main reasons for low PCA switching rates is customer indifference. This may be due to a lack of transparency in the market, a low interest in PCAs, or a belief that there was little differentiation between different PCAs. We found that the financial incentives to switch were fairly low, and the perceived risks relatively high. Given the wide variation in charges paid by customers of different banks, we estimate that the benefit for a customer switching banks might be up to £80 a year.⁵³
106. Survey evidence shows that customers perceive switching to be problematic. Concerns include anticipation of hassle and delay in switching. The ORC survey found around 40 to 50 per cent of respondents who had not switched anticipated likely problems in terms of the amount of paperwork; time taken to switch; moving direct debits and standing orders; moving salary or benefit payments; and charges for switching. The perception seemed far more negative than the experience of those who had switched. This suggests measures such as the Code are working to ease the switching process, but that customers either are not aware of this prior to switching, or are unwilling to rely on its working smoothly in their own case.
107. Customers also perceive risks and costs in switching (such as if there should be an error in transferring direct debits and payments are missed). Although switching is free under the Code, self-switchers may be subject to charges when switching from

⁵³Source: CC analysis of financial information provided by the banks (calculated as the fees and interest paid less the interest received). This was based on our analysis which showed that, after normalizing for differences in average credit and debit balances between banks, the average customer of one bank paid up to £80 more than the average customer of another bank in 2004 (2003: £83 and 2002: £59).

or to traditional accounts as charges may be levied for cancelling or establishing standing orders and direct debits where the bank does not know that the customer is switching.

108. Customers also believe that switching PCA provider may damage their longer-term banking relationship, jeopardizing in particular future availability of credit. Customers tend to be distrustful of new providers, particularly in connection with their financial affairs.⁵⁴
109. Finally, there may be problems with the way in which information is provided. All the banks publish terms and conditions including rates and charges. These are usually available in pricing leaflets in the branch and on the banks' websites, and, under the requirements of the Code, will be provided to customers when they open accounts. Customers must be notified when charges and charging structures change. However, we found that the number of different charges, the variety of names or terms used to denote such charges by different banks, and the lack of clarity of certain charges is likely to make it difficult to understand and compare accounts between different providers, despite some independent comparisons being available (eg from *Which?* and through price comparison websites).
110. There is often a particular lack of clarity relating to charges for authorized and unauthorized overdrafts. Charges can be levied in various ways such as through overdraft arrangement charges, account maintenance charges, referral charges, unpaid item charges, misuse charges, transaction charges, notification of unauthorized borrowing or unarranged borrowing charges and so on. The circumstances under which different charges might be levied, and the extent to which multiple categories of charges might be incurred, are often not explained.
111. Further, some charges are subject to the bank's discretion. Thus a bank might have the option of making a payment where the customer has insufficient funds and different charges might be invoked as a result. Arguably, it might be in the bank's interest to do this.
112. We believe that as a consequence, it can be very difficult for customers to know in advance what fees and charges may arise from incurring authorized and particularly unauthorized overdrafts, and it can be very difficult for a customer to compare these charges between banks. To help us understand the impact of these charging structures, we are looking further at the charges associated with different customer scenarios.⁵⁵ The initial work that we carried out with the banks demonstrated the difficulty in obtaining a clear and reliable estimate of the charges associated with the operation of a particular PCA under different scenarios. This reinforces the difficulty that an individual might have in making meaningful comparisons between different PCAs.
113. We considered whether the difficulties in obtaining and comparing information might be a cause of low switching rates. There was mixed evidence from surveys on whether information availability was a problem. Our qualitative survey found that customers had very low awareness of alternative offers, while over 50 per cent of respondents to the ORC survey considered themselves uninformed about charges on other PCAs. Although lack of information was not cited as a major reason for not

⁵⁴*Switching Suppliers*, a research study commissioned by the Consumer Affairs Directorate DTI, November 2000.

⁵⁵We created four hypothetical scenarios where, over the course of three months, and using an illustrative pattern of credits and transactions, a PCA runs into authorized or unauthorized overdrafts, either once, or several times, over the quarter. We asked the banks to describe and quantify the charges that would be incurred on this pattern of transactions and to explain how discretion on charging and honouring payments would be applied. The hypothetical scenarios are not based on average patterns of account use.

switching by respondents to the ORC survey, this might be because customers do not realize that they need more information. There is some evidence that customers are not interested in switching for other reasons (see paragraph 105). There are also perceived to be risks and costs in switching. We are considering whether improved availability of information might need to be associated with a stimulus for customers to take action in order to be effective.

114. We recognize that an alternative explanation for the relatively low switching rates in Northern Ireland is that customers are satisfied with the service that the banks provide, and therefore few customers experience the push factors that are most likely to cause switching. The MORI survey shows high levels of satisfaction with PCAs. Our qualitative survey, however, did not support this evidence, and given the other evidence that we have on levels of charges and customer behaviour, we are not currently inclined to believe that the low switching rates are caused by high levels of satisfaction. Nevertheless, we are continuing to explore the evidence for this.
115. Our current thinking is that cumulatively these obstacles to switching are perceived to be significant for many customers. We believe that this contributes to a high level of customer indifference resulting in low switching rates, which is likely to be a contributory factor to the relative lack of competition in the market.

Conduct of banks

116. Following our assessment of market structure and the conduct of customers, we looked at the conduct of the banks and whether they might benefit from any market power that they might have. We analysed PCA pricing behaviour. We then considered whether the observed pricing behaviour could be explained by unilateral market power, and also whether there was any potential for tacit coordination to occur.⁵⁶ We also considered whether there were any indications of actual pricing coordination. We looked first at the conditions in the market prior to the supercomplaint being made. We then considered the current conditions in the Northern Irish PCA market and examined whether the situation has now changed, in particular whether any potential for unilateral or coordinated market power could have been eliminated in the long term.
117. In this analysis we distinguish between clearers and non-clearers. There are strong similarities in the charging structures and prices over time for the clearers' traditional PCAs and these in turn have been significantly different from the charging structures and prices set by the non-clearers. In addition, there is a significant difference in average net cost per customer between the clearers and non-clearers implying a different level of pricing (see Table 6).

⁵⁶Tacit coordination does not require any type of collusion in the usual sense of the word. Any parallelism of price does not have to be 'conscious' in the form of explicit or documented analysis of interdependent pricing strategies. Instead the behaviour can arise purely from firms' perception of interdependence, with benefits accruing to all coordinating firms. Further information on this point can be found in the CC's *Market Investigation References: Competition Commission Guidelines (CC3)* in paragraphs 3.58 to 3.61.

TABLE 6 Annual net cost to customer (per active PCA), 2004

| | Clearers | Non-clearers* | Weighted average |
|---------------------------------------|----------|---------------|------------------|
| £ | | | |
| Charges paid by customers | 66 | 43 | 60 |
| Debit interest paid by customers | 13 | 12 | 13 |
| Credit interest received by customers | -2 | -23 | -5 |
| Net cost | 77 | 32 | 68 |

Source: CC calculations from financial information provided by the banks and normalizing for differences in average credit and debit balances between banks.

*The non-clearers included in this table are Halifax, Abbey, A&L and Nationwide. Our financial analysis included only the clearers and the largest four non-clearers, covering over 95 per cent of the market.

Competitive conduct

Pricing analysis

118. In this section we compare credit interest rates and certain transaction and ancillary charges offered by the clearers and three of the largest non-clearers between June 2001 and October 2005. Further details are set out in Appendix E. Our analysis is based on information provided by the banks in their responses to our financial questionnaires and also on the clearers' internal pricing papers.
119. Paragraphs 51 to 59 set out the banks' charging structures. The following analysis primarily considers traditional PCAs, as these were the most significant category of accounts offered by the clearers in the period under consideration. We also considered some recently introduced accounts with alternative charging structures, particularly packaged accounts that have been introduced by two clearers in recent years.⁵⁷
120. Table 1 in Appendix E lists the credit interest rates offered by the clearers on their traditional PCAs. We found that most such PCAs offered by either the clearers or the non-clearers pay very low rates of interest (0.1 per cent) or zero interest. Some of the non-clearers offered better credit interest rates, although in these cases there may be conditions attached, such as minimum levels of monthly funding, use of remote banking channels, or time limits.⁵⁸
121. Ulster and First Trust were the only two clearers to offer packaged accounts. The pattern of credit interest rates on their packaged accounts (see Figure 10 of Appendix E) suggests competitive interaction between these products. The introduction of First Trust's account coincided with Ulster raising the interest rate on U-First. First Trust then appeared to respond with an improved credit interest rate with Ulster subsequently improving its offer, again resulting in a response from First Trust.
122. We looked at three different types of transaction charges: automated transaction charges (eg on debit card transactions and ATM withdrawals), manual transaction charges (eg for cheques), and account maintenance charges. We also looked at three different types of ancillary charges: direct debit set up charges, standing order

⁵⁷These amount to some 5 per cent of all PCAs (by volume).

⁵⁸Abbey, for example, offers 6 per cent interest on the first £1,000 if the account is credited with at least £1,000 a month. The A&L Premier Direct account only offers 4.89 per cent interest for an introductory period, after which the interest rate reverts to the Bank of England base rate minus 1 per cent.

set up charges, and card replacement charges. In all cases, the non-clearers did not charge for these transactions. The details of our comparisons are set out in Figures 1 to 7 in Appendix E.

123. We found a significant degree of similarity in both the levels of clearers' transaction and ancillary charges, and the timing of any changes to them. When one clearer increased prices, the others tended to follow within a short period. Northern appears in most cases to have initiated price increases on automated transactions and direct debit and standing order set-up charges.⁵⁹ First Trust was generally the first to increase prices of manual transactions; prices were not quite as closely aligned as they were on automated transactions but each of the clearers raised prices to a new band shortly after First Trust increased its charges. Such behaviour did not always apply: for example, on card replacement charges the clearers at times charged identical charges but at other times had very different prices. There was no evidence of parallel pricing on transaction or ancillary charges on packaged accounts, where these charges have been set at different levels or removed altogether.
124. As set out in paragraph 8 and 57, and discussed further in paragraphs 170 to 172, both Northern and Ulster have launched fee-free PCAs. Until the adoption of fee-free accounts, prices of automated and manual transaction charges and account maintenance charges tended to converge on very similar levels.⁶⁰ We did not observe suppliers reducing transaction charges on their traditional PCAs until fee-free accounts were introduced. Ancillary charges also converged to a large extent, although in some cases they have been removed altogether. Ulster dropped card replacement charges in July 2004 and Northern removed standing order and direct debit set-up charges in January 2005.
125. It was put to us that any similarities in pricing behaviour between the clearers were unsurprising. It was argued that prices would converge on similar levels due to effective competition between the banks. In any event, during this period the banks experienced increasing costs for similar reasons (for example, from increased regulatory requirements) and so all reflected similar increases in their costs.
126. However, we think it unlikely that cost changes could account for the similarity of pricing behaviour, since in most cases the banks do not know the costs of providing particular services, and they have stated that many costs are not allocated to particular products. We therefore believe it unlikely that each of the clearers would assign cost increases to particular charges in the same way to reach the same price levels.
127. If there were strong competition on charges, prices would be likely to converge. However, we do not think that the banks compete for customers primarily on the basis of their charges. We have not seen these charges heavily advertised. Nor do we believe that customers are particularly aware of, or sensitive to, differences in charges between banks (see working paper on switching).
128. In addition, the clearers told us that the main competitive threat—which has forced them in recent months to review their products and associated pricing—has come from the non-clearers. However, evidence that we received from the clearers' internal pricing papers over a longer time period suggests that they have monitored and set charges to be in line with the other clearers rather than the non-clearers.

⁵⁹Northern removed standing order and direct debit set-up charges in February 2005.

⁶⁰These charges are shown from 2001 to 2005 in Figures 1 to 4 of Appendix E. At times prices have diverged by 5 to 10 per cent, but these divergences have not been sustained. Price converged on very similar levels for all the clearers for each of these fees by October 2004.

129. In summary, we found similarities in pricing among the clearers' traditional PCAs that we do not think can be explained by common costs or by high levels of competition in the market.

Non-price competition

130. The clearers pointed to investment in customer service as evidence of non-price competition. Northern launched a customer experience programme in 2002, consisting of enhanced customer service training for staff and redesigning Northern's branches. Ulster reviewed its service delivery as part of its development programme from 2000 to 2002, and made significant changes including introducing more customer advisers, investing in staff training, and introducing customer service reviews. First Trust has also introduced customer service reviews.
131. Product innovation on traditional PCAs appears limited. Some banks argued that their traditional PCAs were substantially differentiated from others (for example, through provision of a fee-free period after opening an account, or a fee-free overdraft buffer). However, we regard the products as fundamentally similar in that they all have the same core functionality.
132. There have been some PCAs introduced with alternative charging structures:
- (a) Ulster launched the first packaged account in Northern Ireland in 2001;
 - (b) First Trust launched its packaged account in 2003;
 - (c) Ulster launched a second packaged account (U First Gold) in 2004;
 - (d) Northern launched a fee-free PCA, Current Account Plus, in February 2005 (superseded by its new PCA portfolio launched in April 2006), and removed standing order and direct debit charges for all its PCAs;
 - (e) Ulster removed transaction charges, and standing order and direct debit charges for all its PCAs in November 2005.
133. We have been told that PCAs in Northern Ireland have not been heavily advertised, and our ORC survey showed that there was low customer awareness of PCA advertising. The non-clearers, on the other hand, benefited from UK-wide advertising.
134. Overall, we have not seen evidence of vigorous competition on non-price aspects.

Competition analysis

135. Given the conduct of customers described in paragraphs 94 to 115, in particular the low rates of switching, and taking into account the observed pricing behaviour in the previous section, we considered two possible manifestations of market power: unilateral market power, and coordinated market power.
136. We think it helpful in this discussion to distinguish between the period up to the supercomplaint, including most of the period covered by our pricing analysis (2001 to 2005), and the current situation. There have been some recent changes in the market such as the growth in the (volume-based) market share of the non-clearers, and changes in the products offered and pricing by the clearers. We therefore considered whether current conditions in the market may be different from the conditions which applied up to the supercomplaint, and if so, whether the competitive

conditions in the market have changed sufficiently to indicate that there had been a change in, or an elimination of, the potential for clearers to exercise market power.

Conditions up to the supercomplaint

Unilateral market power

137. We considered whether conditions of competition in the market might have given individual banks market power, which might have resulted in, or contributed to, higher prices, or lower service quality and/or innovation, than might otherwise have been the case. If customers are unwilling to switch to other providers, banks may be able profitably to maintain prices at higher levels than would otherwise apply.
138. Unless they are able to discriminate between customers, banks must strike a balance between pricing low in order to attract new customers and pricing high to gain profits from existing customers. If discrimination is possible, there is more potential to increase prices to existing customers.
139. We believe that the incentives to price low for new customers were unlikely to override the incentives to raise prices to existing customers since:
 - (a) the number of new-to-banking customers coming into the market is low relative to the stock of existing PCAs (around 11 to 14 per cent of the stock of existing customers for the clearers each year—see paragraph 66);
 - (b) banks might attract new-to-banking customers primarily in proportion to the number of well-located branches, or for other reasons such as personal recommendation, rather than according to the competitiveness of their products. This might work to the advantage of banks with denser branch networks; and
 - (c) banks discriminate in favour of some new-to-banking customers, and sometimes switchers, and can therefore avoid having to make the trade off outlined above.
140. In principle, given customers' reluctance to switch, both clearers and non-clearers might enjoy some degree of unilateral market power. We believe that the scope for exercising unilateral market power might be greater for clearers than for non-clearers because of the higher observed average net costs charged to customers of the clearers compared with the non-clearers (see Table 6), and because of the similar patterns of pricing behaviour among the clearers observed in our pricing analysis.
141. Similarities in pricing behaviour could arise under conditions of effective competition. They could also arise as a result of tacit coordination (see paragraph 116) or through price leadership, where one bank sets a price and others follow the signal if they believe customers would be likely to tolerate that price. In this way a new market price is established. These considerations seem to be reflected in the clearers' internal pricing papers we have seen (see paragraph 128).
142. Although the clearers might have greater scope to exercise unilateral market power, we also considered whether unilateral market power could be exercised by the non-clearers. We saw no evidence to suggest that customers are more willing to switch away from non-clearers than clearers. We also note that the non-clearers may be in a position to exercise unilateral market power on different charges (see paragraphs 180 to 181). We therefore believe it possible that unilateral market power could apply to all banks (clearers and non-clearers), although we are continuing to consider whether all or some of the banks choose to exercise any unilateral market power that

they might have. The remainder of the discussion in this Emerging Thinking document focuses on the market power of the clearers.

143. The clearers appear to compete in particular for students and graduates, presumably in the expectation that once they have opened a PCA with them, given the relatively low switching rates, they will be likely to stay and, given the likely higher average earning potential of students and graduates, such PCAs will be profitable in the longer term.
144. The clearers argued that overall market share would be significantly impacted by a failure to recruit either new-to-banking customers or switchers, and pointed to the reduction in market share (by number of main accounts) suffered by some of the clearers in the last five years as evidence that they could not exploit unilateral market power in this manner. In addition, they argued that those customers that held multiple PCAs could easily switch their credit balances and transactions between providers without opening and closing their accounts. The clearers also argued that the non-clearers had attracted a much higher proportion of new accounts than suggested by their stock of PCAs.
145. However, as set out in paragraphs 97 to 109, we consider levels of switching to be low, and customers are reluctant to switch bank, even if better terms and conditions might be available. This is because customers are not very interested in their PCA provided it functions effectively, and for many customers, particularly those who do not incur overdraft-related charges (or who do not believe that they are going to incur such charges), the financial gains from switching are, or are perceived to be, low. (This particularly applies to the many customers who do not incur charges on traditional PCAs as they never overdraw their account.) Switching is also seen as difficult, risky, and potentially harmful to the customer's relationship with the bank. Further, the non-clearers have a lower density of branches than the clearers, and customer awareness and trust of their offers has been lower than for the longer established clearers. For these reasons we believe that customers have been unlikely to switch, and the constraint on the clearers from the non-clearers has been relatively low, allowing the clearers to maintain the charging structures on traditional PCAs, at least until recently. The clearers have also been able to attract the majority of new-to-banking customers, (based on the MORI survey they recruited 65 to 70 per cent of new-to-banking customers in 2004 and 2005), partly because of their greater branch density and the active targeting of student accounts.
146. Overall, it appears that the conditions in the market were such as to support unilateral market power for both the clearers and the non-clearers. The documentary evidence from the clearers in particular did not suggest that pricing was subject to tight competitive constraints. Pricing similarities might then have arisen as a result of clearers setting prices in line with the market. While we were told that overall costs increased during this period, we saw no indication that decisions on specific pricing levels were driven by changes in costs as the banks did not have information in sufficient detail to allow that to occur.

Coordinated effects

147. In addition, we considered whether the conditions that have existed and may continue to exist in the market facilitate tacit coordination between the clearers. Through mutual self-awareness of interdependence, the clearers might find that if each of them adopts a less competitive strategy, they will all enjoy higher prices or lower costs (eg because of a reduction in innovation, marketing spend or service quality). This would lead to higher profits than would otherwise have been the case, or, alternatively, greater scope to sustain inefficient operating practices.

148. We looked at the three conditions necessary for coordination as set out in our guidelines.⁶¹ Given the different business models and incentives of the non-clearers, and for the same reasons as given in paragraph 117, we assumed the coordinating group to be the clearers. We also noted that while the clearers told us the main competitive pressures came from the non-clearers, the pricing papers we saw indicated that the clearers monitored and set prices to be in line with the other clearers.
149. The first condition requires the market to be sufficiently concentrated and transparent for the clearers to be aware of the high interdependence of their strategies and be able to monitor each other's behaviour. This is likely to depend on certain structural features of the market (see paragraphs 30 to 93).
150. The second condition requires the clearers to have sufficient incentive to coordinate and to sustain coordination over time. We considered whether the clearers' incentives were aligned, and the possible costs of deviation.
151. The third condition requires there to be relatively weak competitive constraints from outside the coordinating group such that coordination is sustainable. In this market, we believe that the primary competitive constraint is likely to be exercised by the expansion of the non-clearers.
152. We first considered whether there may have been coordination among the clearers on pricing of traditional PCAs before the supercomplaint. We looked at whether the necessary conditions for coordination were met and whether there was evidence of coordination having occurred.

Assessment of coordination before the supercomplaint

153. We found that, although the degree of concentration had fallen over the last five years, the market remained moderately concentrated (see paragraph 64). This was particularly true when market share was measured in terms of value rather than volume. In particular, each of the clearers could easily observe the others' pricing and terms and conditions, since these are published on websites or in leaflets.⁶² We also found that the banks monitor each other's PCAs, and in addition, price adjustments traditionally took place on a predictable, annual, basis. It was argued to us that PCAs were differentiated products, and that competition could occur over many different dimensions, such as innovation, service quality and branch provision. We considered that the traditional PCAs offered by the clearers were sufficiently similar in their important characteristics to make coordination plausible, and that competition on other aspects of these PCAs was not notably stronger than competition on pricing aspects. We therefore think it likely that the first condition for coordination was satisfied.
154. In order to assess whether the clearers' incentives were aligned as required by the second condition for coordination, we looked at their market shares, products, cost structures, and financial situation. The clearers had higher market shares than the non-clearers, regardless of the basis of measurement, and despite changes in market share still retain the top four positions in the market. Although individual experiences differ—Northern and First Trust lost market share by volume in recent years whilst Bol and Ulster's market share was stable or increasing—their behaviour was similar. Thus they all have a similar business model, have been present in the

⁶¹ *Competition Commission Guidelines on Market Investigations References (CC3)*, June 2003, paragraphs 3.62 to 3.64.

⁶² The only exception to this is with respect to overdraft rates or limits which may be subject to individual negotiation.

Northern Ireland market for a long time, and have a substantial branch network. All have multiple products to offer personal customers and have, in the past, offered similar traditional PCAs.

155. The clearers did not agree that their incentives were aligned. For example, BoI argued that its relatively smaller size gave it an increased incentive to grow its customer base. We were also told that the nature of the clearers' customers differed—for example, one clearer ([redacted]) had a significantly higher proportion of older customers and those from socio-economic groups A and B than the other banks, and another clearer ([redacted]) had more younger customers from socio-economic groups D and E and with a lower average income. We are looking more closely at the clearers' relative financial positions and possible levels of efficiency, and considering the significance of differences in customer demographics between them, but our current thinking is that they are unlikely to have had markedly different incentives to one another.
156. In terms of the costs of deviating from coordinated behaviour, we found that the extra costs incurred by a deviating clearer to improve its offer to attract new customers were likely to be low since they have high fixed costs and low variable costs. However, the benefits of deviating are also likely to be low because of the low willingness of customers to switch in the market.
157. On the other hand, the low levels of switching in the market mean that competitors may not consider it profitable to respond to deviating behaviour by matching any price change if they do not expect their own customers to switch. This will also depend on the importance of attracting new customers, the extent to which new customers are responsive to relative prices, and the timescales under consideration. If competitors would not respond to pricing changes then the original behaviour should not be characterized as coordination.
158. It was put to us that coordination could not apply because the two clearers who had lost substantial market share in this period would have had a particular incentive to deviate from the coordinating behaviour (breaching condition two).⁶³ We were told that there was variability in the profitability of particular PCA customers, and many may be loss-making for the clearers. Those clearers that lost market share may have had deliberate policies in place to concentrate on particular types of customer, which could have accounted for loss of market share. It is also possible that losses in market share could have arisen due to factors specific to the individual bank that were not the result of general market pressures. Coordinating behaviour may have remained the optimal strategy in such circumstances.
159. We recognize that low switching rates may mean that competitive pressures between the clearers are so low that clearers can choose their optimal strategy without much regard to what the other clearers are doing. If this were the case, the second condition for coordination would not hold. We are continuing to consider the validity of this argument.
160. With regard to the third condition for coordination, the clearers argued that switching had become easier following the introduction of the switching provision in the Code, switching rates had increased, and the non-clearers were picking up new customers as shown by their increasing share of the market. However, as set out in paragraph 83, we thought that there were some substantial barriers to expansion of the non-clearers. These include, in particular, customers' reluctance to switch, marketing

⁶³A clearer [redacted] put it to us that because the banks faced high fixed costs, they were sensitive to loss of market share.

costs and the need for a branch network to be attractive to switchers, whereas the business model of most of the non-clearers is based on the sale of a range of products that are not as responsive to branch density as PCAs. Many of the non-clearers have been offering PCAs in Northern Ireland for over 15 years and their growth has not been particularly rapid. We note that the clearers only began to revise their traditional PCA charging structure in the past year. This suggests that the past competitive pressure from the non-clearers was not an effective constraint on the clearers' actions. We therefore think it likely that the competitive constraint was insufficient to prevent the third condition from having been met.

161. It therefore appears that two of the conditions required for coordination to be possible are likely to have applied prior to the supercomplaint; we are considering whether the second condition on alignment of incentives and the possible costs of deviation also applied.
162. We considered whether there were other indicators of coordinated behaviour (see paragraphs 118 to 129). Our pricing analysis found a significant degree of similarity in the clearers' transaction and ancillary charges on traditional PCAs, demonstrated by parallel pricing behaviour, the convergence of prices on similar levels, and a general absence of price reductions. We also found documentary evidence of an awareness of the need for price alignment with the other clearers and conscious price-following behaviour. Prices were not set with similar regard to the non-clearers, even though we have been told that these banks posed a major competitive constraint.
163. However, we note that similar behaviour was not evident on some alternative products, such as packaged PCAs, and there was no consistent price leader over all charges examined. While clearers seem to have followed price increases on transaction charges quite closely, the clearers have not always followed price increases on other charges for a substantial period of time, and the originator of the price increase did not respond by reversing the increase (for example, First Trust's increase in account maintenance charges in 2001, and Northern's increase of direct debit and standing order set-up charges in 2001). It may be that coordination only occurred on certain charges, but it is not apparent why the patterns of parallel pricing behaviour were more evident on some charges than on others. The financial information provided by the banks was not sufficiently detailed to enable us to assess whether price following was more evident on those charges of greater financial significance to the banks.

Current conditions

164. As noted in paragraph 8, there have been some changes in the market since the supercomplaint and it was put to us that competitive conditions had changed. This section addresses the possible impact of those changes on the exercise of any market power by the clearers.
165. We looked to see if the competitive conditions in the market appeared to have changed sufficiently to suggest that the clearers could no longer exercise market power. We looked in particular at the following:
 - (a) changes in competitive conditions: growing awareness of the option to switch coupled with reduced dependence on branches; increased awareness of the Code's provisions on switching and switching services offered by the banks; increased publicity about PCAs and the clearers; increased marketing by the non-clearers; entry of new providers and the expansion of non-clearers; and the changes in ownership of two of the four clearers; and

- (b) changes relating to products and associated pricing: the introduction of packaged accounts; the removal of charges relating to the setting-up of standing orders and direct debits by Northern; the introduction of the fee-free Current Account Plus by Northern; and the launch of Ulster's new charging structure in November 2005.

Changes in competitive conditions

166. Despite the evidence of increased publicity around switching and the experience of most switchers that it was a pain-free process, we found that switching was still widely perceived by those who had not yet switched to be risky and costly, and switching rates, although increasing, were still low (see paragraphs 97 to 109). In terms of publicity, the evidence from the ORC survey suggested that, while customers in Northern Ireland are aware that there is an issue around PCAs, they do not make a clear distinction between clearers and non-clearers. The clearers still win 65 to 70 per cent of all new-to-banking accounts. We also found from our qualitative survey that there were low levels of advertising awareness of PCAs.
167. Historically Ulster and Northern have been operated as locally distinct banks with locally determined pricing and products. We thought that, under the ownership of RBS and Danske Bank respectively, there would still be incentives for these banks to determine their pricing and products locally, although we recognize that the changes in ownership may lead to a change in competitive tactics and positioning. Danske Bank has only recently acquired Northern, and launched a new range of PCAs in April 2006. We are continuing to monitor in particular the impact of Danske Bank's acquisition of Northern on the market.
168. We thought that the growth in market share of the non-clearers might be more significant as an indicator of changed market conditions, suggesting increasing external constraints on the clearers' market power. We are considering whether the non-clearers might have passed some threshold of market presence and awareness which might support the clearers' claims that the non-clearers are now an effective alternative, decreasing the power of the clearers profitably to maintain a pricing margin over the non-clearers, and making any coordination among the clearers unsustainable. The clearers argued that these constraints had already applied for many years.

Changes in products and associated pricing

169. The pattern of parallel pricing of transaction and certain ancillary charges on traditional PCAs changed when Ulster and Northern (on one type of PCA) moved away from the traditional pricing model to fee-free accounts. Fee free accounts generally do not attract charges for maintenance, transactions or routine services if the customer is within their overdraft limit. Some existing PCAs had already adopted different pricing structures, such as Ulster's and First Trust's packaged accounts and Northern's ChequeMaster account, but the great majority of the clearers' PCA customers before 2005 had traditional accounts.
170. In February 2005 Northern introduced Current Account Plus, which does not charge transaction or maintenance charges on overdrafts. Existing customers were offered the opportunity to switch to the new account, but terms on existing accounts remained unchanged. Northern also removed set-up, amendment and cancellation

charges for standing orders and direct debits for all customers.⁶⁴ It told us that it had decided to do this in response to customer dissatisfaction with the charges and loss of customers to the non-clearers.

171. The decision by Northern to remove its charges for setting-up and amending standing orders and direct debits appears to have been a competitive tactic designed to reduce the loss of customers to the non-clearers. Current Account Plus was introduced by Northern's former owners, National Australia Bank, as part of a UK-wide policy. Northern argued that its introduction in Northern Ireland was a response to competitive pressures from the non-clearers and that its introduction at Yorkshire and Clydesdale banks was a response to competitive pressures in Great Britain.
172. In November 2005, Ulster removed all transaction and maintenance charges on its existing PCAs, and removed direct debit and standing order charges. The introduction of Ulster's new pricing structure was, we were told, prompted by the view that otherwise customers might be lost to the non-clearers.
173. BoI told us that its Clear PCAs were designed in part as a response to competitive pressures from the non-clearers. Despite being traditional PCAs, BoI pointed out that it increased its market share with its Clear PCAs. [✂]
174. Packaged accounts, first introduced in 2001, have an alternative charging structure and as discussed in Appendix E, there are indications of competition in credit interest rates on packaged accounts. The monthly charges do not show the same level of competitive interaction.
175. We are considering the effect of the new pricing structures. We note that many of the changes (with the notable exception of the introduction of Northern's Current Account Plus) have been made since the start of our market inquiry. It is therefore possible that these are responses to the inquiry itself, or to greater customer awareness associated with it, rather than a response to more permanent changes in market conditions. Nevertheless, now that certain charges have been removed, it is likely that the banks would face significant customer resistance if they tried to re-impose charges on existing customers.
176. The evidence that we have seen so far suggests that some of the changes to pricing might in part be a rebalancing exercise, removing certain charges from a larger number of customers and replacing them with higher charges focused on those customers who run an unauthorized overdraft. We are considering whether such customers are less price-sensitive than others. Our preliminary analysis suggests that some of the changes might be revenue neutral overall, while others may be loss-making unless they lead to significant levels of new business.

Current thinking on the effects of recent changes in the market

177. In summary, it appears to us that there have been recent changes in behaviour by the clearers that represent a shift in competitive positioning. We are investigating the possible causes and consequences of this, and whether these changes are likely to represent a long-term shift in the incentives to exercise market power.
178. We are unclear as to whether the shift to some form of fee-free banking by two of the four clearers is a reaction to a loss of unilateral market power, in particular because

⁶⁴Shortly before publication of our Emerging Thinking, Northern announced details of its new PCA portfolio. This has not been taken into account at this stage.

these changes are seen, at least to some extent, to be revenue neutral. The new pricing model may still be consistent with the presence of unilateral market power. Our surveys show that there are still perceived to be barriers to switching (despite the switching process having become easier), branches are still seen to be necessary by the great majority of customers, and banks can discriminate in favour of new-to-banking customers. As at April 2006, two of the four clearers had revised their pricing structures; this may be because such changes take considerable time to plan and implement, but it may also be indicative that the competitive pressures on the banks are limited. Overall, we are therefore inclined to believe at this stage that the clearers still have the ability to exercise unilateral market power and that recent changes in the market do not demonstrate that this power has been eliminated.

179. With regard to coordination, we do not find evidence of any significant change to the first condition for coordination. If the conditions for coordination have changed, it is most likely to be in relation to the costs of deviating, if customers are becoming more price-sensitive over time, or to the degree of competitive constraint exercised by the non-clearers, ie whether customers are more willing to switch, and whether new-to-banking customers are less influenced than hitherto by branch location and network density in their choice of PCA provider. This would increase the returns from deviating from coordinated behaviour, while for similar reasons the profitability of coordination may be undermined by the loss of existing and potential customers to non-clearers. To understand if this is the case, we are seeking to establish the extent and motivations for customers switching, and the reasons for choice of provider for new-to-banking customers, to see how this may have changed incentives for coordination.

Levels of charges

180. We are considering how charges are set, and whether charges are subject to effective competition. In particular we are considering whether:
- (a) customers actively consider and compare charges before opening an account;
 - (b) full information on the level of charges and when and how they are applied is available, and whether it is presented in a way that allows customers to understand and compare charges;
 - (c) there is any element of discretion in the application of charges and whether they may be waived, and whether this complicates comparison;
 - (d) the way in which charges are described complicates comparisons; and
 - (e) customers are less sensitive to unauthorized overdraft charges because they are unwilling to recognize that they may incur such charges, they find it difficult to assess and compare such charges, or because customers are more tolerant of charges where they believe they are in breach of contract.
181. The OFT published its findings on credit card default charges on 5 April 2006.⁶⁵ This concluded that credit card default charges had generally been set at a significantly higher level than it considered legally fair.⁶⁶ It stated that default charges should only

⁶⁵OFT press release 68/06.

⁶⁶The OFT findings are based on its view of the law, which is in essence that default charge provisions are open to challenge on grounds of unfairness if they have the object of raising more in revenue than is reasonably expected to be necessary to recover certain limited administrative costs incurred by the credit card issuer. The OFT acknowledged that only a court could

be used to recover certain limited administrative costs; these may include postage and stationery costs and staff costs and also a proportionate share of the costs of maintaining premises and IT systems. The OFT said that these broad principles were likely to be relevant to other default charges in standard agreements with consumers such as those for bank accounts. While the findings relate to fairness rather than competition issues, they may have implications for this inquiry, in particular, for unauthorized overdraft charges. In addition, the European Commission has launched a sector inquiry into retail banking. It is conducting this inquiry in two phases: the first to consider issues in relation to payment cards, and the second to consider other retail banking products and services. We shall be considering the implications of these inquiries for our market investigation.

Local competition

182. We considered whether the clearers are mostly in local competition with each other through their branches or whether branches are located so as to limit head-to-head competition. We also considered whether the clearers are located close to non-clearers.
183. Given that Ulster and Northern have a denser branch network, they have a considerable number of branches without local competitors. However, we did not find any evidence to suggest that the clearers choose to locate their branches to avoid head-to-head competition.
184. We also found that many of the clearers' branches are located close to those of non-clearers. BoI and First Trust branches usually face a Halifax in the same location, and often a Nationwide branch. Nearly half their branches face an Abbey branch as well. Proportionate exposure to a specific non-clearer is lower for Ulster and Northern as a result of their greater number of branches.
185. The market shares of the five largest non-clearers varied from 30 per cent in Greater Belfast to 16 per cent in Londonderry/Derry (based on MORI data), with an average of 24 per cent in urban areas and 19 per cent in rural areas. We received evidence to suggest that most Northern Irish customers can reach one of the five largest non-clearers within a 10 to 15 minute drive time. In addition, as set out in paragraph 77, some PCAs can be accessed through Post Offices. In May 2004 there were 568 Post Office branches in Northern Ireland.
186. In addition, the banks' offers and strategy are set primarily on a national basis. Although there is some local flexibility, particularly with regard to setting overdraft limits and rates and possible waiving of certain charges, we saw no evidence to suggest that banks alter their behaviour on a local basis according to the nature of local competition.
187. We also considered whether the market may be segmented along religious lines. However, the extent to which the different banks are in head-to-head competition does not appear to depend on any potential religious associations. We considered whether branch location correlated with the population distribution by religious grouping. We found no evidence to support this idea. Our analysis suggests that in most cases there are likely to be few instances of religious divisions strongly separating local markets and impacting on local market boundaries. The ORC survey

finally decide whether a charge was unfair or not, and reported that its views had not generally been accepted by most of the eight credit card issuers consulted.

suggests religious associations are unlikely to influence customers' choice of PCA provider.

188. In summary our current thinking is that any competition concerns are unlikely to have a local focus.

Financial exclusion

189. The purpose of our inquiry is to investigate competition concerns. It has been put to us that we should consider the impact of the structure and operation of the market on financial exclusion. However, we consider that financial exclusion is more likely to be an outcome rather than a cause of any competition concerns.

Financial performance

190. The clearers are all full service providers, supplying a variety of products and services to personal, small and medium-sized enterprises, and corporate customers. The non-clearers provide a variety of products to personal customers. Personal products include mortgages, current accounts, loans, investment products, deposit accounts and foreign exchange, as well as credit cards, and are provided to customers through the banks' branch network, service centres and call centres. A significant proportion of each banks' operating processes, including the operation of its branch network and manufacturing operations, is shared across its businesses and products.
191. The banks earn income from providing PCAs in three forms; net interest income on credit balances, net interest income on debit (overdraft) balances, and charges. On average the banks earn more than half their total income from net interest on credit balances, over 40 per cent from charges and 5 per cent from net interest income on debit balances.
192. Credit balances provide a bank with funds that it uses elsewhere in the bank to earn income. To calculate the total revenue earned by providing PCAs the revenue earned by using the funds elsewhere in the bank needs to be allocated to PCAs. The profitability of PCAs is in part dependent on the way in which gross interest income on credit balances is calculated and allocated to PCAs.
193. The clearers do not routinely assess the profitability of their PCA business. The non-clearers assess the profitability of their PCAs for the UK overall. All banks were asked to allocate shared costs to their PCA businesses in Northern Ireland. We recognize that there are significant conceptual and practical difficulties in establishing an appropriate basis for allocating the many shared costs that may be attributable to the banks' PCA business in Northern Ireland. The allocation and apportionment of costs is subjective and dependent on the assumptions made. Notwithstanding these conceptual and practical difficulties we are examining the cost, and the resultant profits, allocated to the Northern Irish PCA business. Furthermore, we are considering the performance of each bank's PCA business in Northern Ireland relative to other personal retail banking products and/or businesses in other parts of the UK.