CONTENTS

Introduction ........................................................................................................................................... 4

Section 1: Allocation of payments ................................................................................................. 17

Section 2: Minimum payments ....................................................................................................... 30

Section 3: Unsolicited limit increases .......................................................................................... 45

Section 4: Re-pricing of existing debt ............................................................................................. 59

Annex 1: Sources of revenue for credit & store card providers ....................................................... 73

Annex 2: Credit and store cards – background .............................................................................. 80

Annex 3: Credit card regulation and usage – UK-US comparison .................................................. 90

Annex 4: Specific impact tests ......................................................................................................... 92
What is the problem under consideration? Why is government intervention necessary?
Concerns have previously been raised in relation to card lending – by Government, Parliament and consumers. These have been partially addressed by regulatory reforms and market adjustments. However, recent evidence – rising credit & store card complaints, debt advice demand for credit and store cards issues, increasing credit card arrears – have led to renewed concerns about whether such reforms have gone far enough. Evidence indicates the presence of incomplete information in relation to credit and store card provision, combined with difficulties for consumers in processing large amounts of information, which could be exacerbated by the existence of search costs and certain psychological biases that may operate to disadvantage consumers.

What are the policy objectives and the intended effects?
The overarching objective of this review is to secure a better deal for consumers, giving them improved control of their credit and store card borrowing whilst also ensuring that regulation is proportionate and targeted.
As a result of this, it is intended that: Consumers make better decisions about credit and store card borrowing; Levels of unsustainable credit and store card debt are reduced; Credit and store card borrowing remains accessible to vulnerable consumers; Credit and store card borrowing is based on a fair and transparent relationship between borrower and lender, and card lending remains an innovative, viable and profitable sector.

What policy options have been considered? Please justify any preferred option.
Four policy areas that have been considered for potential further action:
- Allocation of payments; minimum payments; unsolicited credit limit increases, and re-pricing of existing debt
A number of potential solutions have been considered under each of these areas. These are compared against a 'do nothing' option. As these policy areas are the focus of a review, there are no preferred options at this stage.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?
If further action is necessary, a post-implementation review would be undertaken after 3 or 5 years.

Ministerial Sign-off For consultation stage Impact Assessments:
I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.
Signed by the responsible Minister:
### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: N/A</th>
<th>Description: Proposals for changes to regulation of credit cards and store cards</th>
</tr>
</thead>
</table>

#### ANNUAL COSTS

| Description and scale of key monetised costs by 'main affected groups' |
|---|---|
| One-off (Transition) Yrs | £ TBC |
| Average Annual Cost (excluding one-off) | £ TBC |
| **Total Cost (PV)** | £ TBC |

Other key non-monetised costs by 'main affected groups'

Industry – implementation costs from potentially significant system changes, staff training and customer service resource; reduction in interest income from lower credit and store card balances (transfer to cardholders)

#### ANNUAL BENEFITS

| Description and scale of key monetised benefits by 'main affected groups' |
|---|---|
| One-off | £ TBC |
| Average Annual Benefit (excluding one-off) | £ TBC |
| **Total Benefit (PV)** | £ TBC |

Other key non-monetised benefits by 'main affected groups'

Customers – potential reduction in credit and store card balances, which would reduce interest cost of borrowing (transfer from card providers); also, potential reduction in problems associated with over-indebtedness

### Key Assumptions/Sensitivities/Risks

Whether information provision leads to changes in customer behaviour; reduction in profitability for lenders from potential reform could lead to exit from industry; reduction in availability of credit (especially to high-risk borrowers/vulnerable consumers) or increases in interest rates/fees/charges

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

What is the geographic coverage of the policy/option? UK

On what date will the policy be implemented? 2010

Which organisation(s) will enforce the policy? TBD

What is the total annual cost of enforcement for these organisations? £ TBC

Does enforcement comply with Hampton principles? Yes

Will implementation go beyond minimum EU requirements? No

What is the value of the proposed offsetting measure per year? £ 0

What is the value of changes in greenhouse gas emissions? £ 0

Will the proposal have a significant impact on competition? Yes

Annual cost (£-£) per organisation (excluding one-off) Micro Small Medium Large

Are any of these organisations exempt? No No No No

### Impact on Admin Burdens Baseline (2005 Prices)

(Increase - Decrease)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>£ TBC</th>
<th>Decrease of</th>
<th>£ TBC</th>
<th>Net Impact</th>
<th>£ TBC</th>
</tr>
</thead>
</table>

**Key:**

Annual costs and benefits: Constant Prices

(Net) Present Value
Introduction

1. Credit cards serve an important purpose in the economy, allowing consumers to borrow flexibly against future income, paying off credit at their convenience and making use of their card as a widely accepted payment instrument. Many consumers value the flexibility that credit cards afford them and their use has grown steadily over the last 10-15 years, leading to them being the most popular unsecured credit product.

2. Concerns have previously been raised in relation to card lending – by Government, Parliament and consumers. These have been partially addressed by regulatory reforms and market adjustments. However, recent evidence (e.g. rising credit and store card complaints, debt advice demand in relation to credit and store cards, increased credit and store card arrears) has led to renewed concerns about whether such reforms have gone far enough and whether more needs to be done to promote responsible lending and fairness, including whether certain product features rely on behavioural factors that operate to cardholders’ disadvantage. This has coincided with the introduction of regulatory reforms in the US concerning credit cards, recently signed into legislation under the CARD Act.  

3. Credit and store card providers undoubtedly face tough operating conditions, separate to but exacerbated by the economic downturn. Margins have come under pressure from rising bad debts, declining transaction-based revenue (due to falling interchange fees) and recent action regarding credit card default fees. Some providers feel that their participation in the market may be threatened by recent intervention in relation to Payment Protection Insurance (PPI), which has also reduced profitability.

4. In addition, credit and store cards have already been subject to a substantial amount of regulatory intervention (such as HM Treasury Select Committee investigations, OFT’s intervention on default fees, the Competition Commission’s investigation into store cards and payment protection insurance, the Consumer Credit Act 2006), with more to come (such as OFT’s forthcoming irresponsible lending guidance and implementation of the Consumer Credit Directive). These issues have to be taken into consideration when contemplating further action in this area.

5. This first section of the impact assessment sets in context the state of the credit and store card market and its evolution over time, before discussing some of the emerging problems and the rational for Government intervention. Each of the four policy areas identified for further investigation, as set out in the recent White Paper, are then dealt with in greater detail: allocation of payments, minimum payments, unsolicited credit limit increases and re-pricing of existing debt.

Background

6. The possibility to borrow against future income (i.e. make use of credit) is an important facility, allowing consumers to match spending to need and opportunity, spread the cost of significant purchases and smooth fluctuations in income. In the UK, consumers have expanded their use of credit significantly over the last 20 years or so. Current outstanding total borrowing by individuals stands at around £1.4 trillion, the vast majority of which (£1.2 trillion, over 85%) is accounted for by ‘secured’ credit (i.e. borrowing for mortgages on houses). The remaining £230 billion is accounted for by unsecured credit.

7. In 1993, credit card lending accounted for less than 19% of all outstanding consumer credit; the latest figures show that this share is now almost 23%. In terms of levels, credit card lending increased from less than £15 billion in 1993 to a peak of almost £64 billion (28% of

---

1 Credit card Accountability, Responsibility and Disclosure Act
unsecured credit) by the end of 2005, falling to around £54 billion in July 2009.\(^3\) In contrast, the store card market is much smaller, with approximately £1.9 billion in outstanding balances as of December 2008.\(^4\)

![Outstanding credit card borrowing, 1987-2009](image)

**Source:** Bank of England

8. Credit cards are an increasingly important element of consumer borrowing. Consumers value the flexibility of credit cards – there are now 63 million credit cards in circulation in the UK, covering nearly 170 million transactions a month, up from 25 million cards and 80 million transactions per month at the end of 1994.\(^5\) In contrast, there were approximately 15.6 million store cards in issue in 2007, resulting in nearly 57 million annual transactions.

9. Given this disparity, most of the available data relates to credit card borrowing; however, store cards and credit cards are relatively similar products, which means that arguments related to product features are just as likely to apply to store cards as credit cards in the discussion that follows.

10. There are a number of potential sources of revenue for card lenders: income earned from interest charged on outstanding balances; fees charged on a per-transaction basis (interchange fees); penalty or default fees charged to consumers and card-related insurance income (e.g. payment protection insurance). Interest income is typically the most important of these, accounting for up to 80% of UK credit card issuer profits, and around two-thirds of revenue for store card providers.

11. However, given that around 60% of credit and store card holders regularly pay off their balance in full, this would imply that around 40% of credit and store card customers are providing the majority of this revenue – through interest charges and default or penalty fees. This income can then be used to fund some of the features of credit and store cards that certain consumers have come to particularly value, such as cashback, airline travel, retail discounts and other special offers.

12. Research suggests that it may be rational for a profit-maximising card provider to increase the level of risk of its customer base in order to generate additional customers.\(^6\) This will be profitable, provided that the long-term increase in the rate of defaults is consistent with enhanced profitability from the average non-defaulting customer. This implies that an

---

\(^3\) In 2009 prices, deflated using Retail Prices Index

\(^4\) Store cards share many of the same features as credit cards, in that they offer the customer the ability to take out short- or long-term credit with the card issuer. However, unlike credit cards, their use is typically limited to purchases with a small group of retailers and offer retailer-specific benefits. Few retailers finance and operate their store card programme in-house; most contract with store card credit providers to finance and administer the card on their behalf (e.g. GE Finance, HSBC).

\(^5\) Latest figures from July 2009, 1994 are earliest figures available (Source: BBA)

increase in the profitability of issuing credit cards could lead to an increase in defaults and bankruptcies. Moreover, if alternative devices for attracting new customers become less effective, card issuers may be increasingly drawn to reducing their criteria for judging creditworthiness.

13. However, there are adverse consequences of offering credit, especially at higher interest rates, to less creditworthy consumers. For example, increased credit or store card borrowing among lower-income or young consumers, who do not have the financial means to sustain such debt, could result in a significant worsening of their financial situation, which could lead to default and, in a worst case scenario, insolvency.

14. Provisions for bad debt and default are important determinants of profitability for card lenders. Credit and store card loans are unsecured, available to large and heterogeneous populations, and repayable on flexible terms at the cardholders' convenience. For other types of fixed-term lending, collateral and fixed repayment terms reduce the risk of loss to the lender, enabling them to charge lower interest rates on such loans. It can therefore be argued that the higher interest rates charged for credit and store card lending is recognition of the greater risk of default associated with unsecured lending.

15. Given their unsecured nature, borrowers may potentially be more likely to cease making payments on their credit cards if they become financially distressed than they would on other loans that are secured by an asset they could lose. This would explain why default rates on unsecured loans appear to be higher than for secured loans.

16. However, even within unsecured lending, credit card default rates are high. As can be seen in the chart below, write-off rates for credit cards have more than tripled since 2000 and remained well above the write-off rate for other types of unsecured debt since 2006. This may suggest practices by lenders or borrowers that are specific to credit cards that make it more likely that borrowing results in default.

17. Recent reports suggest that the losses on unsecured consumer debt are likely to worsen – a recent IMF report indicates that write-offs could amount to 7% of total European consumer debt ($173 billion), much of which they would expect to fall on the UK. Recent credit card indices from Moody’s show that annualised charge-off rates have risen from 6.4% in May 2008 to 9.37% in May 2009. Historic norms from previous recessions suggest that the default rate for credit card loans is typically around 7-9%, but it is reported that this figure could rise above 10%.

18. A recent paper by the Joint Economic Committee suggested that credit card interest rates are increasing as a result of increased write-offs and falls in the supply of credit. This has

---

7 ‘Vicious Cycle: How unfair credit card practices are squeezing consumers and undermining the recovery’
forced credit card companies to make up for the growing deficits by raising interest rates for all borrowers.

19. High levels of interest rates have previously been the subject of an investigation by the Competition Commission in relation to UK store cards, which found that competitive pressures exerted by retailers and customers were not particularly strong. Due to this, it was estimated that the detriment associated with excess prices paid by consumers amounted to at least £55 million per year, and possibly significantly more. As a result, a warning about costs of borrowing was brought in for store cards whose APRs exceeded 25%.

20. Concerns have been raised that, despite falls in the base rate to a record low of 0.5%, UK interest rates on credit cards have remained relatively unchanged, even slightly higher than a year ago, as shown in the chart below. This has also coincided with a fall in the cost of funds for credit card issuers, as interbank lending rates (such as LIBOR) have also declined significantly.

21. As can be seen from the chart below, between 1999 and 2004 the ‘quoted’ credit card interest rate\(^8\) has broadly fallen in line with the ‘effective’ interest rate\(^9\), which might imply that many consumers were regularly renewing their balance through balance transfers, to take advantage of lower promotional rates. Since 2004, the average ‘quoted’ credit card interest rate has stayed roughly the same, and has fallen below the ‘effective’ rate. This may imply that, as the availability of balance transfers and promotional deals with low interest rates to consumers has declined, there has been an increase in the amount of interest income being paid to issuers.

\[
\text{Interest rate comparison, 1995-2009}
\]

\[
\begin{align*}
\text{Percent} & \quad 0 \quad 5 \quad 10 \quad 15 \quad 20 \quad 25 \\
\text{Year} & \quad 1995 \quad 1996 \quad 1997 \quad 1998 \quad 1999 \quad 2000 \quad 2001 \quad 2002 \quad 2003 \quad 2004 \quad 2005 \quad 2006 \quad 2007 \quad 2008 \quad 2009
\end{align*}
\]

\[
\begin{align*}
\text{Credit cards - quoted interest rate} & \\
\text{Credit cards - effective interest rate} & \\
\text{Credit cards - effective interest rate (interest-bearing balances only)} & \\
\text{Base rate} & \\
\text{3-month interbank lending rate} & 
\end{align*}
\]

\*Source: Bank of England

22. It is difficult to be certain about the extent to which these problems can be attributed to the specific economic circumstances being experienced by both lenders and consumers, in which case we would expect to see a deterioration in repayment behaviour, resulting in increasing write-offs and defaults. It is possible that the foundations for the current problems were laid well before the onset of the current financial crisis, in terms of the overall household borrowing situation.

23. Since 1987, there has been a significant increase in the household debt-to-income ratio – from around 80% to over 150%. Although the majority of this increase is accounted for by

\[\text{\footnote{8 This rate is based on a sample of interest rates offered to new customers, collected by the Bank of England and then weighted according to market share of lenders. Where there are multiple rates, the lowest rate is taken.}}\]

\[\text{\footnote{9 This rate is based on the interest income received by issuers, divided by outstanding balances and then weighted according to the market share of lenders.}}\]
the growth of secured debt, this general increase in household indebtedness has increased
the vulnerability of households to sudden changes in interest rates and debt servicing costs.

![Household debt-to-income ratio, 1987-2009](image)

Source: ONS

24. This growth in indebtedness has coincided with the rise in credit card lending identified
previously, which means that credit card usage was significantly higher at the beginning of
this current recession (despite a peak around 2005) compared to the previous recession of
the early 1990s.

25. Industry analysis suggests that consumers may make increasing use of ‘revolving’ credit-
style products in the future, such as credit cards, possibly linked to the declining availability
of fixed-term unsecured lending. This would seem to be supported by the latest available
evidence – although net unsecured lending fell by £309 million in August 2009 (a bigger
decrease compared to the previous month, which was £259 million), credit card lending
increased by £196 million, which was a bigger increase than the previous month (£97
million).  

26. This increase in credit card lending follows a trend which has emerged since 2008, as
growth of credit card lending has exceeded that for other types of unsecured lending (see
below). Industry intelligence suggests that consumers are increasingly making use of their
credit cards, suggesting that declining approval rates for personal loans have coincided with
reactivation of dormant credit card accounts and an overall increase in credit card balances.

![3-month growth rate of net unsecured lending, 1993-2008](image)

Source: Bank of England

---

Source: Bank of England
27. In addition, it is recognised that small businesses can also be significant users of credit cards, as a means of managing cashflow and a convenient payment mechanism. Organisations representing small firms and debt advice charities have expressed concerns that some business owners may be using credit cards taken out in a personal capacity to support their businesses through the downturn, incurring significant debts as a result.

28. In contrast, activity on store cards seems to be declining, with latest figures (July 2009) from the Finance and Leasing Association (FLA) indicating that monthly new business was down by 27% compared to the previous month; quarterly growth down by 17% and annual growth down by 12%.

29. Survey data shows that there is a significant minority of consumers that owe large sums on their credit and store cards, though credit card balances are typically a lot higher than for store cards. For example, almost 60% of store card holders have less than £500 outstanding, compared to only 30% of credit card holders. In the extreme, 6% of credit cardholders have balances in excess of £9,500, with 1% of those having a balance exceeding £25,000.

30. Survey data also shows that there is a concentration of arrears in credit cards and store cards – 16% of cardholders are in at least 1 month’s arrears on their store or credit card payments, with just under 10% in at least 3 months’ arrears.

31. Credit card holding is lower among low socio-economic groups (32% of adults in group E had a credit card in 2008, compared to 82% of adults in socio-economic groups A and B) and is also lower among low-income groups (38% of those with an annual income below £13,500 have a credit card, compared to 50% for those with an annual income above £25,000).

32. According to survey data, a credit card was the most popular unsecured credit product applied for in the last 6 months, with 10% of respondents applying. Of these, around three-quarters were successful and approximately one-fifth were declined. In comparison, only 2% of respondents applied for a store card, but the proportion of applicants that were successful and unsuccessful were very similar to those applying for a credit card.

33. Survey data about actions undertaken in order to help make ends meet indicates that 11% of respondents had borrowed more on their credit card. However, among low-income households (those with an annual income below £13,500), the proportion that had borrowed on a credit card was higher (15%). Survey data also suggests that around 15% of credit cards are used for debt consolidation purposes; this rises to 20% for low-income households (those with income below £13,500).  

34. This data suggests that credit cards may be being used by households in ways that are potentially unsuitable and/or unsustainable, which may then result in a worsening of their financial position.

35. Evidence available from advice agencies shows that consumers’ need for debt advice mainly relates to credit and store cards. For CCCS (Consumer Credit Counselling Service), the most frequent category of problem debt was credit and store cards, accounting for just over half of all enquiries. Credit, store and charge cards also account for around 20% of all debt enquiries to Citizens Advice – the most frequent enquiry.

36. The Financial Services Authority collects data about the number of complaints to firms that it regulates. These show that complaints about credit cards have more than doubled between 2006 and 2008 – from 73,500 in the first half of 2006 to over 150,000 in the second half of 2008.

37. Complaints about credit cards to the Financial Ombudsman Service have also increased significantly over recent years – from about 1,500 in 2003/4 to over 18,000 in 2008/9.

---

Complaints about store cards have also risen, albeit from a low base (372 in 2008/9, up from 110 the previous year). Credit cards are now the most complained-about product in the ‘banking and credit’ category, accounting for 34% of all complaints received last year. The fact that three-quarters of credit card complaints were upheld by the Financial Ombudsman Service suggests that such complaints are not without merit.

38. As characterised by one study, credit cards have generated concerns in two areas:

- whether consumers fully understand the costs and implications of using credit cards, and
- whether credit cards have encouraged widespread over-indebtedness, particularly among those least able to pay.  

39. One potential explanation for this level of (seemingly well-founded) complaints is that credit card users do not adequately understand some aspects of the terms and conditions associated with the use of their card.

Rationale

40. The rationale behind Government intervention in this area is a market failure brought about by imperfect information. As the evidence below suggests, consumers find credit card products confusing, which could be exacerbated by evidence showing low levels of financial capability among certain parts of the UK population. This, coupled with psychological biases in behaviour, might make credit card products even more difficult to understand and use. This could, in turn, lead to some consumers taking on unaffordable amounts of debt.

41. Provided that certain conditions are met, markets can provide an efficient allocation of resources. However, one of these conditions is that consumers have ‘perfect’ information, which allows them to make a fully-informed choice about what purchases (and in what quantities) will give them the most satisfaction or be in their best interests. Where consumers are unable to access the information relevant to their purchase, then having a number of suppliers to choose from will be ineffective in promoting efficient outcomes.

42. Imperfect information occurs when suppliers or consumers have information that is hidden from the other party to the transaction. In practice, suppliers often have more information about a good or service (e.g. its quality, or features) than consumers. This can lead to an inefficient allocation of resources, as consumers make ‘poor’ choices – i.e. ones that do not accurately reflect their preferences.

43. Varian suggests that firms are aware that consumers will often make uninformed decisions and will sometimes trade off offering a low price that will attract informed customers, and setting high prices to exploit vulnerable consumers, who do not take all information into account. As more people become informed, firms will reduce the average price, thus suggesting that consumer policy that increases transparency can lead to an overall improvement in welfare.

44. Some features of credit cards can make the product difficult to understand for consumers and might lead some of them into financial difficulty. This difficulty is compounded by low levels of financial capability in some cases, which can make it even harder for certain consumers to choose products that best suit their needs.

45. For example, in 2006 the FSA identified low levels of financial capability amongst a significant part of the UK population, particularly young people; whilst the OFT found that in 2004, over three-quarters of credit card holders did not know what APR applied to their

---

12 Durkin, T. A. (2000) 'Credit cards: Use and consumer attitudes'. The two issues are related, as over-indebtedness may result from a lack of understanding
14 http://www.fsa.gov.uk/pubs/other/fincap_baseline.pdf
It also indicated that most people are poor at choosing financial products and often do not seek independent advice.

The nature of financial products, notably the number of different providers and the complexity of the information, tends to make searching for them more difficult and/or more costly than for other goods. A more recent report by OFT on credit card comparisons found that the complex nature of credit cards and financial products in general adds to the difficulties that consumers face when attempting to choose a credit card that best suits their needs.

Financial products are generally not purchased or obtained frequently so there is less opportunity for consumers to learn about how these markets operate. The complexity of financial products can also mean that it is difficult for consumers to understand the available information. A survey by the OFT in 2004 found that understanding of credit cards among cardholders was quite low, with only 17% claiming to have a ‘very good understanding’ of credit cards. Almost one-third (30%) have ‘limited understanding’ and a further 10% are ‘not really interested’ in understanding how they work.

In terms of cardholder characteristics associated with levels of understanding, those in higher socio-economic groups, heavy users (those with 3 or more credit cards) and those on a low rate of interest are more likely to say they have a ‘very good understanding’ of credit cards. Those in lower socio-economic groups are more likely to say they have a ‘limited understanding’.

The FSA reports that the opaque pricing of many financial products, combined with many consumers’ inability to assess financial information, can make it relatively expensive to shop around. Providers, knowing that consumers cannot process complex information, can add to the problem by increasing the quantity and complexity of information, which makes it more difficult for consumers to see the real price.

When asked to choose between three alternative credit card offers, the OFT survey found that a significant proportion – but less than half of respondents (43%) – could correctly identify the (objectively) ‘best’ deal. However, the confidence with which they expressed this opinion varied, particularly among socio-economic groups. Almost half of those in group AB (49%) were ‘very confident’ in their opinion, compared to only one-quarter (25%) of those in group C2 and under one-third (30%) of those in group DE.

The OFT survey further found that cardholder understanding was particularly poor in relation to repayments. Across the three different offers, the majority (between 60% and 62%) were unable to respond.

When asked to identify three features from a sample credit card agreement (APR, monthly repayment, minimum repayment), only one-quarter of respondents (26%) were able to identify all three correctly. Older respondents (55+) and those in socio-economic group DE found this particularly difficult, with only 18% and 22% of respondents respectively providing 3 correct answers. In total, almost one-third (29%) did not answer any of the three correctly, with new cardholders performing particularly poorly (34% not answering any correctly).

Overall, only one-quarter of credit cardholders (26%) found the information easy to understand, which was low for older respondents (20%), those in lower socio-economic groups (23% for DE) and new cardholders (23%). The most popular reasons for this lack of understanding were ‘too much information’ (23%), ‘jargon’ (17%), ‘looks complicated’ (11%), ‘confusing’ (9%) and ‘figures need explaining’ (7%).

As a result, consumers do not shop around when the perceived costs (for example perceived difficulties due to lack of transparency and time costs) of doing so are greater.

---

than the perceived benefits. For example, recent research by the OFT found that nearly 70% of consumers had not shopped around at all when choosing their most recent credit card, basing their choice mainly on a recommendation by their bank.¹⁹

55. Search costs associated with understanding different products offered by a supplier may make it too costly for some consumers to consider switching. Historically, levels of switching amongst consumers for financial products have been low, which is partly explained by perceived riskiness or complexity in the switching process.

56. Steps have been taken to try and reduce search costs in relation to credit products through the provision of information. However, care is needed here as informing consumers can sometimes be ineffective when, for example, consumers feel they are faced with too much choice or information.²⁰ Recent research has shown that a good deal of the regulated information provided on credit contracts does not reach its target audience, often because there is too much information, or the way that it is provided tends to dissuade consumers from reading it.²¹

57. Some aspects of these problems may since have been addressed through reforms to information included on credit agreements, following regulatory interventions (such as the Consumer Credit Act 2006) and voluntary initiatives (such as the summary box introduced by APACS). However, more recent evidence on consumer understanding suggests that some of these difficulties have not been addressed – survey evidence indicates that 40% of respondents agree with the statement ‘financial services are complicated and confusing to me’, with nearly 30% disagreeing.

58. Insights from behavioural economics suggest that the context in which information is provided can be particularly important, and how consumers use and process that information is also critical to the outcome. Although traditional economic theory assumes that individuals are ‘rational’ in their decision-making processes, that rationality could be constrained by limited resources (e.g. information available, time, cognitive ability).²² This ‘bounded rationality’ can lead to consumers making decisions where not all relevant information is taken into account and may instead use heuristic judgements (“rules of thumb”), which can result in systematic ‘errors’ and sub-optimal decisions being taken.

59. Empirical research indicates the existence of a particularly relevant behavioural bias known as ‘framing’, which suggests that the manner in which a choice is presented can affect its outcome.²³ Other important examples include ‘anchoring’²⁴ (where consumers rely heavily on a particular feature or characteristic in making their decision), ‘loss aversion’ (where consumers attach more importance to "losses" than equivalent "gains", which has been put forward as a potential explanation for the 'endowment effect'²⁵, where consumers value a particular item more if they own it, compared to when they do not) and inertia/procrastination, leading to ‘status quo’ bias²⁶ (where consumers can tend towards the 'default' option).

60. This suggests the potential for firms to exploit these biases and influence the decisions of consumers, through the way in which information is presented. It could therefore potentially be argued that it is appropriate for governments to intervene and alter the way in which options/choices are presented. This could be particularly relevant in relation to credit cards – for example, in thinking about the way that information is presented on credit agreements

---

²⁰ The phenomenon of ‘choice overload’ has been documented by Schwartz (2005) and Iyengar et al (2003) test the ‘choice overload leads to inaction’ theory in a financial decision-making setting
²¹ ‘Warning! Too much information can harm’, Better Regulation Executive and National Consumer Council (2007)
²² Or at least, in the aggregate, that rationality provides a fair approximation for individuals’ collective preferences
²³ ‘The framing of decisions and the psychology of choice’; Tversky & Kahneman (1981)
²⁵ ‘Experimental tests of the endowment effect and the Coase theorem’; Kahneman, Knetsch & Thaler (1990)
²⁶ ‘Status quo bias in decision making’; Samuelson & Zeckhauser (1988)
or explained in letters to cardholders (e.g. changes in interest rates or credit limits), or on 
credit card statements (e.g. level of minimum repayments). It could also potentially justify 
interventions to restructure the choices available to consumers (e.g. a default for ‘opt-in’ to 
unsolicited credit limit increases).

61. There are also a number of related issues that affect decision-making from the perspective 
of how consumers use and process information that indicate that, if people have cognitive 
limitations on their ability to process information, providing more information can confuse 
consumers and lead to poorer decisions.

62. A recent FSA paper identified a set of cognitive biases related to information processing in 
the context of financial products – for example, consumers may draw incorrect inferences, 
focus on inappropriate or unimportant data, be distracted by too much information and 
choice, over-deliberate or otherwise misuse information. 27 Another problem that has been 
empirically identified is the ‘law of small numbers’, under which consumers draw strong 
inferences from only small amounts of data. 28 This raises the possibility that a consumer 
may not adequately understand the consequences of late payment or excessive borrowing.

63. This point is illustrated by research suggesting that consumers often chose cards on the 
basis of only a few criteria. Research suggested that a typical consumer selects a credit 
card product based on the brand, annual fee, interest-free period, affinity or rewards 
benefits, and the stated interest rate if the consumer expects to pay interest in the 
immediate future.29 This was confirmed by OFT research, which found that the key factors 
influencing choice of credit card for consumers were interest rates, brand name/reputation, 
length of promotional offer and the fact that their bank offered it to them. As these terms are 
often contained in the advertising materials (such as leaflets and mail shots), consumers 
may be unlikely to read the contract.30

64. Another behavioural bias that might be particularly relevant for credit card users is ‘bounded 
self-control’, which arises when a consumer is unable to defer satisfaction and makes 
impulse purchases. This could be particularly important for unanticipated changes to terms 
and conditions related to credit cards, such as an increase in a customer’s credit limit.

65. Empirical evidence suggests that individuals tend to over-estimate the likelihood of an 
exciting or frightening event occurring, but under-estimate the likelihood of events that 
happen relatively often; this is known in behavioural economics as ‘overconfidence’ and 
‘salience’. For example, consumers often underestimate their propensity to get into debt, 
and as a result it may be profitable for a credit card company to offer up-front inducements 
to use the card, combined with steep interest charges for late payments.

66. Academic research suggests that this bias may lead to an ‘adverse selection’ problem for 
credit card providers, if credit card providers lack information about different ‘types’ of credit 
card user.31 If many consumers systematically underestimate the extent of their current and 
future credit card borrowing, this may lead to sub-optimal decisions regarding the choice 
and usage of credit cards. In particular, consumers underestimate their credit card 
balances and, thus, underestimate the importance of credit card interest rates. This may 
then lead to an incentive for banks not to reduce credit card interest rates, as this could 
potentially attract a certain ‘type’ of customer, who is fundamentally a poor credit risk, but is 
responsive to changes in interest rates, as they plan to be paying substantial finance 
charges.

67. Overconfidence from consumers about their ability to repay a loan might lead consumers to 
borrow too much. Such behaviour may be caused by “hyperbolic discounting”, where many 
people have higher short-term, but lower long-term discount rates than those predicted by

28 ‘Belief in the law of small numbers’, Kahneman & Tversky (1971)
29 ‘Relationships Among Information Search Activities When Shopping for a Credit Card’; Lee & Hogarth (2000)
30 ‘Credit card survey’; OFT (2004)
traditional economic theory. This can cause some consumers to make sub-optimal decisions that are time inconsistent, such as borrowing on a credit card at a high interest rate. Empirical evidence provides support for this, indicating that more consumers would accept an introductory offer that has a lower interest rate, but a shorter duration, than a higher interest rate with a longer duration. Despite this, ex-post analysis of borrowing behaviour (such as continuing to borrow on their credit card) revealed that the longer-duration offer would have been a better choice for the consumer.

68. Consumers have been seriously affected by the past two years of turmoil in the financial markets. The unique flexibility offered by credit and store cards is at the heart of what makes them useful, but it can also allow consumers to quickly accumulate unsustainable debts. This is of particular concern at this time when people are facing financial pressures as a result of the downturn.

Objectives

69. The overarching objective of this review is to secure a better deal for consumers, giving them improved control of their credit and store card borrowing whilst also ensuring that any intervention is proportionate, transparent and targeted. Outcomes which flow from this overarching objective include:

- Consumers are better enabled to make decisions about credit and store card borrowing;
- Levels of unsustainable credit and store card debt are reduced;
- Sustainable credit and store card borrowing remains accessible to vulnerable consumers;
- Credit and store card lending is based on a fair and transparent relationship between borrower and lender, and
- Card lending remains an innovative, viable and profitable sector.

70. Where there are specific objectives for the relevant area, these will be included in the appropriate section.

Options

71. Forecasts by UK Cards Association of credit card usage indicates that credit cards will continue to provide a useful tool for short- to medium-term borrowing, once the economy begins to pick up and consumer confidence returns. It is therefore important that any potential problems in relation to credit card borrowing are addressed as soon as possible.

72. Any potential intervention and/or regulation needs to strike the right balance between maintaining access to credit for consumers and promoting responsible lending, while preserving a viable consumer credit industry. It must result in products that are simple for consumers to use and understand while allowing firms the freedom to innovate in response to changing customer needs in ways that stimulate beneficial competition.

73. The recent Consumer White Paper made a commitment to review the regulation of credit and store cards, considering, in particular, where indebted consumers may be most at risk of incurring increased costs as they try to repay their debts. Credit cards can be a useful and suitable product for consumers, as long as those who use them are aware of the associated costs and are given meaningful choices about the way they use them. However, evidence suggests that awareness among consumers is low, despite continuous action by

---

32 First introduced by Phelps and Pollak (1986); Huffman and Barenstein (2004) provide evidence that UK household expenditure patterns are consistent with hyperbolic discounting
34 http://www.berr.gov.uk/whatwedo/consumers/consumer-white-paper/index.html
the regulators and industry to provide more transparent information on the costs associated with their use.

74. Recent reforms in the US have seen the introduction of new measures relating to credit cards, including: a ban on unfair rate increases; prevention of unfair fee traps; plain sight and language disclosures; and additional protection for students and young people. These measures fall into three different categories:

- Those that address practices that US credit card companies have adopted that do not occur in the UK (e.g. ‘universal default’\(^\text{35}\), ‘double-cycle’ billing\(^\text{36}\), penalty interest rates\(^\text{37}\))
- Those that address practices that are already covered through regulatory or self-regulatory measures (e.g. OFT action on level of default charges, information requirements through Consumer Credit Act 2006, Banking Code requirements on 30-day notice periods for changes to terms and conditions and requirements on assessment of ‘ability to pay’)
- Those that are not already addressed through regulatory or self-regulatory measures and potentially warrant further investigation of their potential to deliver benefits in a UK context (e.g. retrospective interest rate changes, minimum repayments, allocation of payments)

75. There is significant crossover between some of these issues and some longstanding concerns that have been voiced by Government in relation to credit cards. For example, the second report of the Task Force on Tackling Over-Indebtedness identified decreases to the level of minimum payments on credit cards was associated with households in financial difficulties. Another such practice identified in that report was the automatic raising of credit limits on credit and store cards.

76. Therefore, as set out in the White Paper, four areas have been identified as meriting a review of existing practices and, if there are problems to be addressed in these areas, what the most appropriate solutions might be. These 4 areas are:

- Minimum repayment levels
- Allocation of payments
- Unsolicited credit limit increases
- Retrospective interest rate changes

77. It is acknowledged that it is difficult to analyse each of these areas in complete isolation, as there will be impacts of changes in one area on the others. In addition, there is a significant risk of unintended consequences when considering reform of a complex area such as consumer credit. Such intervention may address a key concern in one area, but may unintentionally adversely impact on consumers in other areas. For example, increasing the minimum repayment on outstanding balances could, if improperly implemented, make repayments too high for some consumers and worsen their financial situation. This may possibly push them into over-indebtedness. This risk could be mitigated through transitional measures to reduce the impact of any change on those most at risk.

78. Action to reverse the allocation of payments on a credit card (i.e. so that the most expensive debts are paid off first) might result in the withdrawal of some 0% balance transfer offers

\(^{35}\) Where default on one payment leads to all creditors classifying accounts with them as being in default, despite a customer not missing a payment
\(^{36}\) Where interest charges accrue not only on the current balance but also on the previous month’s
\(^{37}\) Where the interest rate charged on outstanding balances increases upon a customer entering default (i.e. missing a payment)
from the credit card market, of which many consumers currently take advantage and benefit from, and which has become a key vehicle for competition in the market.

79. Similarly, if the ability to retrospectively change interest rates on credit and store cards was removed, then this might conceivably lead to higher initial interest rates for all credit and store card users, as lenders would be unable to distinguish between those consumers with differing risk profiles. Lenders would also be unable to adjust prices over time to reflect changing risk costs associated with existing debt. The knock-on effect of these changes could then adversely impact on the access to credit for vulnerable consumers.

80. There have already been changes to card provision in the US – for example, many commentators have noted a general increase in interest rates, the introduction and increase in fees (annual fees, late payment fees, balance transfer fees) and the erosion of fee-free reward schemes. This is supported by evidence from the 2009 Consumer Action credit card survey in the US. Some of these practices have already begun to be introduced in the UK – for example, American Express has recently introduced a ‘dormancy’ fee, i.e. a charge for those who do not use their cards in a 12-month period. It is uncertain to what extent such changes have resulted from regulatory intervention rather than economic circumstances, but it would suggest that lenders are looking to recoup lost revenue through these means.

81. We are mindful of the difficult macroeconomic environment in which credit card providers are operating and take action to ensure that credit card lending remains a viable, innovative and profitable sector. However, we must also balance this need against the interests of consumers and ensure that the potential for borrowers to borrow unsustainable levels of debt is, insofar as possible, limited.

What is the problem under consideration? Why is government intervention necessary?

Typical industry practice is for the most expensive debts held on a credit or store card to be paid off last. Evidence suggests that consumers do not understand that this practice takes place. This practice, combined with promotional offers and a lack of consumer understanding about different interest rates being applied to different forms of borrowing, may result in outstanding credit and store card balances not being reduced in the way that consumers might expect, given their level of repayments. This may mean that cardholders are using their card in a way that might increase their indebtedness, without them being aware of this. Government intervention is required to correct this information asymmetry.

What are the policy objectives and the intended effects?

As set out above, the main objective of this review is to secure a better deal for consumers, giving them improved control of their credit and store card borrowing whilst also ensuring that regulation is proportionate and targeted.

In choosing the most appropriate policy option, we will be guided by their potential to contribute to achieving the outcomes outlined earlier.

What policy options have been considered? Please justify any preferred option.

Under this policy area, four options have been considered:

- Greater information transparency;
- Allocation of payments on a pro rata basis;
- Payments allocated to highest interest rate first; and
- Payments allocated to cash advance first

All of these are compared against a ‘do nothing’ option, with no preferred option at this stage.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

If further action is necessary, a post-implementation review would be undertaken after 3 or 5 years.
## Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Greater information transparency</th>
<th>Description: Proposals for changes to the allocation of repayments for credit cards and store cards</th>
</tr>
</thead>
</table>

### Costs

<table>
<thead>
<tr>
<th>ANNUAL COSTS</th>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off</td>
<td>£ TBC</td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

Other key non-monetised costs by 'main affected groups'

Industry – implementation costs of producing necessary information and integrating into customer communication

### Benefits

<table>
<thead>
<tr>
<th>ANNUAL BENEFITS</th>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off</td>
<td>£ TBC</td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

Other key non-monetised benefits by 'main affected groups'

Cardholders – if increased transparency leads to changes in consumer behaviour that could drive competitive changes in allocation of repayments, this could lead to benefits for consumers in terms of reduced time to pay off outstanding balances and reduced interest costs of borrowing

### Key Assumptions/Sensitivities/Risks

If greater information provision increases transparency and understanding, consumers need to change behaviour to incentivise providers to offer favourable allocation of payments; industry providers argue that changing the allocation of payments could lead to adverse impacts on availability of promotional rates and cash advance facilities

### Price Base Year

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>What is the geographic coverage of the policy/option?</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>Self-regulatory</td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ 0</td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>No</td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ 0</td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ 0</td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>No</td>
</tr>
<tr>
<td>Annual cost (£-£) per organisation (excluding one-off)</td>
<td>Micro</td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
</tr>
</tbody>
</table>

### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>£ TBC</th>
<th>Decrease of</th>
<th>£ TBC</th>
<th>Net Impact</th>
<th>£ TBC</th>
</tr>
</thead>
</table>

Key: Annual costs and benefits: Constant Prices | (Net) Present Value
## Summary: Analysis & Evidence

### Policy Option: Allocate payments in proportion to different interest rates

**Description:** Proposals for changes to the allocation of repayments for credit cards and store cards

### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off (Transition)</strong></td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong></td>
</tr>
</tbody>
</table>

**Other key non-monetised costs by 'main affected groups':**

Industry – implementation costs for system changes to calculate how payments are to be allocated, reduced interest income as balances are reduced and/or paid off sooner (transferred to cardholders); Consumers – potential for greater complexity, resulting in customer confusion.

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off</strong></td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
</tr>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
</tr>
</tbody>
</table>

**Other key non-monetised benefits by 'main affected groups':**

Cardholders – changes in allocation of repayments would lead to benefits for consumers in terms of reduced time to pay off outstanding balances and reduced interest costs of borrowing (transfer from card providers).

### Key Assumptions/Sensitivities/Risks

Changes to payment allocation may lead to customer confusion; industry providers argue that changing the allocation of payments could lead to adverse impacts on availability of promotional rates and cash advance facilities.

### Price Base

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV) £ TBC</th>
<th>NET BENEFIT (NPV Best estimate) £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>UK</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>TBD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ TBC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

<table>
<thead>
<tr>
<th>Increase of £ TBC</th>
<th>Decrease of £ TBC</th>
<th>Net Impact £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annual cost (£-£) per organisation (excluding one-off)</strong></td>
<td>Micro</td>
<td>Small</td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

**Key:**
- Annual costs and benefits: Constant Prices
- (Net) Present Value
### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Payments allocated to most expensive debt first</th>
<th>Description: Proposals for changes to the allocation of repayments for credit cards and store cards</th>
</tr>
</thead>
</table>

#### COSTS

**ANNUAL COSTS**

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition) Yrs</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
</tbody>
</table>

Other key non-monetised costs by 'main affected groups'

Industry – implementation costs for system changes to how payments are allocated, reduced interest income as balances are reduced and/or paid off sooner (transferred to cardholders)

#### BENEFITS

**ANNUAL BENEFITS**

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off Yrs</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
</tbody>
</table>

Other key non-monetised benefits by 'main affected groups'

Cardholders – changes in allocation of repayments would lead to benefits for consumers in terms of reduced time to pay off outstanding balances and reduced interest costs of borrowing (transfer from card providers); removes additional risk arising from lack of awareness

### Key Assumptions/Sensitivities/Risks

Industry providers argue that reversing the allocation of payments could lead to adverse impacts on availability of promotional rates and cash advance facilities

### Price Base

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV) £ TBC</th>
<th>NET BENEFIT (NPV Best estimate) £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>UK</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>TBD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ TBC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual cost (£-£) per organisation (excluding one-off)</td>
<td>Micro</td>
<td>Small</td>
<td>Medium</td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>£ TBC</th>
<th>Decrease of</th>
<th>£ TBC</th>
<th>Net Impact £ TBC</th>
</tr>
</thead>
</table>

Key: Annual costs and benefits: Constant Prices (Net) Present Value
### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Payments allocated to cash advance first</th>
<th>Description: Proposals for changes to the allocation of repayments for credit cards and store cards</th>
</tr>
</thead>
</table>

#### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COSTS</strong></td>
</tr>
<tr>
<td><strong>One-off (Transition)</strong> Yrs</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong> £ TBC</td>
</tr>
</tbody>
</table>

**Other key non-monetised costs by 'main affected groups'**

Industry – implementation costs for system changes to calculate how payments are to be allocated, reduced interest income as balances are reduced and/or paid off sooner (transferred to cardholders)

#### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BENEFITS</strong></td>
</tr>
<tr>
<td><strong>One-off</strong> Yrs</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Total Benefit (PV) £ TBC</strong></td>
</tr>
</tbody>
</table>

**Other key non-monetised benefits by 'main affected groups'**

Cardholders – changes in allocation of repayments would lead to benefits for consumers in terms of reduced time to pay off outstanding balances and reduced interest costs of borrowing (transfer from card providers)

### Key Assumptions/Sensitivities/Risks

Industry providers argue that altering the allocation of payments could lead to adverse impacts on availability of promotional interest rates and cash advance facilities

<table>
<thead>
<tr>
<th>Price Base</th>
<th>Time Period</th>
<th>Net Benefit Range (NPV) £ TBC</th>
<th>NET BENEFIT (NPV Best estimate) £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>Years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>UK</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>TBD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ TBC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual cost (£-£) per organisation (excluding one-off)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Micro</td>
<td>Small</td>
<td>Medium</td>
<td>Large</td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

**Impact on Admin Burdens Baseline (2005 Prices)**

<table>
<thead>
<tr>
<th>Increase of £ TBC</th>
<th>Decrease of £ TBC</th>
<th>Net Impact £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Increase - Decrease)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Key:**

- Annual costs and benefits: Constant Prices
- (Net) Present Value
Evidence Base (for summary sheets)

Overview

82. Generally, industry practice is for the most expensive debts held on a credit or store card to be paid off last. Evidence suggests that consumers are not aware that this practice takes place. This practice, combined with promotional offers and a lack of consumer understanding about different interest rates being applied to different forms of borrowing, may result in outstanding credit and store card balances not being reduced in the way that consumers might expect, given their level of repayments. This may mean that cardholders are using their card in a way that might increase their indebtedness, without them being aware of this. This is of particular concern to policymakers, especially where consumers are only making minimum payments, in which case it would take a long time to pay off a relatively small amount and at a high cost.

83. Further work needs to be undertaken to understand the impact of introducing regulation that would determine more clearly how payments should be allocated when there are multiple interest rates. A lot of recent competition in the credit card industry has focused on offering 0% balance transfers, and there are many customers who have benefited from such deals. Increased regulation could result in reduced competition and consumers could suffer as a result, but equally there are also a large number of customers who could have already suffered because of a lack of clarity around the allocation of payments.

Background

84. Almost every credit card charges different interest rates on different types of transaction – e.g. balance transfers, purchases and cash advances. The offer of 0% balance transfers is commonly used as a marketing tool to incentivise switching between card providers, and enable providers to acquire more customers, who will in turn make purchases with their new card. Even with a one-off fee (typically around 3%) generally charged for balance transfers held over 6 months, consumers are usually better off transferring their balance rather than holding it on another card, which charges a higher interest rate on purchase balances. A US study found that effective APRs paid by cardholders ranged between 5.3% and 5.67%, even though the APRs on non-promotional balances ranged from 14.8% to 16.2%.

85. However, balance transfers do not in themselves generate profit for lenders. This comes from balances created by new spending on the card and balances held beyond the promotional period. It is arguably logical for card issuers to allocate payment to the cheapest debt first, so that balances attracting interest accumulate while interest-free balances are reduced. Consumers benefit from 0% balance transfer deals because lenders can recoup costs from these interest-bearing balances.

86. This could have distributional implications, as those who take advantage of 0% balance transfers and use them effectively (i.e. do not incur any further debts and are able to take full advantage of a 0% interest rate) are effectively subsidised by those who do not either take out a balance transfer at all, or do not realise that they can incur debts that accrue interest while they are paying off their balance. Since those in the former group are more likely to have higher levels of financial capability, be from a higher socio-economic group and have a higher level of income, this could lead to growing inequalities, which may need to be addressed through intervention.

87. Cash advances are charged at the highest rates of interest to reflect the level of risk they present to the lender. Lenders submit that customers drawing multiple cash advances present a higher credit risk. In addition, cash advances carry a significant risk of fraud, which increases the cost to the lender of providing this facility.

39 http://files.ots.treas.gov/comments/bdc5cc5c-1e0b-8562-eb23-ff7159e49505.pdf
88. In the US, legislators are proposing to introduce rules around allocation of payments which reverse the typical UK practice. As an example, with the majority of UK providers, if a consumer had £1,000 balance at 0%, and had spent £500 on new purchases at a standard interest rate, any payment would go towards reducing the £1,000 balance, whilst the new balance would accrue interest until the £1,000 balance has been paid off. So if, over a year, a consumer paid off the original £1,000 balance, the new purchases would have accrued interest of £88 over the same period, assuming an interest rate of 17.6%.

89. Previous practice was for card providers to allocate repayments to debts incurred in a chronological order – i.e. those debts that were incurred most recently would be paid off last. Currently, credit card industry best practice guidelines state that the Summary Box (required on statements and pre-contractual materials) must contain information on the allocation of payments. Guidelines from the UK Cards Association requires that:

- Succinct description of the order in which payments will be allocated to the account, in numbered or bullet format. It is acceptable, in addition, to refer the consumer to a more detailed description in the full terms and conditions by means of a footnote.
- The order can be presented with the transaction attracting the lowest interest rate first, or from highest to lowest as long as this is specified. Consumers may also be referred to the terms and conditions.

90. Furthermore, Section 10.12 of the Banking Code states that a monthly credit card statement will include "...other useful information including the 'allocation of payments' (how we use your payment to reduce your balance)."  

91. However, research by the OFT into credit card information found that the terminology used by different providers varied considerably. Therefore, it is questionable whether this information is sufficient to enable consumers to understand how repayments are structured, and whether they are enabled to make rational decisions based on this information.

92. The OFT is currently consulting on draft Irresponsible Lending Guidance, which lists “Allocating payments to the least expensive debt first (or otherwise than to the oldest or most expensive debt first) under circumstances in which it was not explained to the borrower, clearly and fully, in plain and intelligible language, in advance of him entering into the credit agreement, that this would be the case” as an irresponsible lending practice that would call into consideration the fitness of the creditor to be licensed by the OFT.

93. Nationwide offer a credit card with a ‘positive’ allocation of payments – i.e. the debt being charged at the highest interest rate is paid off first. Based on data for current Nationwide credit card holders, they have estimated that switching to a card with a positive allocation could save a new customer around £224 per year, with Nationwide’s active cardholders saving a total of £5m each year.

94. It is unclear the extent to which consumers particularly value this aspect of the card, and whether or not it has played a significant part (if any) in the switching behaviour of credit card customers. Industry intelligence suggests that customers that have switched are more attracted to other features of the card (such as commission-free purchases abroad), rather than the allocation of payments feature.

95. There is no ‘universal’ policy on allocation of repayments, and there are other variants – for example, Home Retail Group offer terms and conditions on their store card under which repayments are allocated first to default charges.

---

41 http://www.bba.org.uk/content/1/c6/01/30/85/Banking_Code_2008.pdf
42 ‘Credit card survey’, OFT (2008)
Issue

96. If consumers are not aware that the allocation of repayments to pay off the cheapest debt first is common practice, they may therefore also not realise that their repayments do not prevent them potentially accruing interest at a higher interest rate. Nationwide estimate that the current allocation of payments structure increases industry credit card holder debts by £509m each year. However, given the likely profile of Nationwide cardholders compared to the portfolios of other lenders, this could overstate the true amount.

97. There are two groups who are particularly affected by the structuring of repayments in its current form. The first includes those customers taking advantage of balance transfer deals, often heavily-discounted promotions, who will find that, if they use their card for new purchases, they find the discounted balance paid back first. The concern these customers have is that they are unable to benefit from the discount as they would have liked or expected.

98. The current allocation of payments also limits the ability of consumers to assess accurately the costs of entering into a deal, particularly where competition between providers focused on 0% offers could mask the ‘true’ price to borrowers. Where a consumer has an interest-bearing balance and one subject to a promotional interest rate (especially for a short period), the allocation of payments to the lowest-cost lending can make the importance of the promotional rate illusory for consumers who cannot or do not repay more than the balance that is subject to the promotional rate.44

99. The second group affected by the current structuring of repayments are those that use the card to make cash withdrawals and find that this debt is repaid last. These cash advances attract the highest rates of interest, due to the higher risks associated with them. If there are substantial other outstanding debts, these can remain an element of balances for many years. This becomes a particularly serious concern if consumers are only making minimum payments, where it may take a significant length of time to pay off a relatively small balance, if there is a higher associated cost (as with cash advances).

100. We believe the problems associated with the allocation of payments are more acute for this second group of consumers. This group, while not necessarily a large proportion of credit card users, is likely to include a significant number of vulnerable consumers, who have limited choices of other borrowing vehicles. Given than these two different groups are affected in different ways, there may be a case for treating the allocation of cash advances differently from other payments. Research suggests that withdrawal of cash on a credit card could be associated with financial difficulties, particularly if this is done in order to make ends meet.45

101. For some store card issuers, the allocation of payments in cases of balances where there is a promotional interest rate is currently: fees, promotional balances and then non-promotional balances. We are advised that one store card issuer provides customers with the option of allocating payments to specific plans. While cash advance facilities within store cards are not as common as they are with credit cards, we understand that some store card issuers do allow cash withdrawals.

Rationale

102. OFT qualitative research in 2004 found that many consumers were unaware of how repayments on credit cards were allocated towards different debts, and many remained confused even after an explanation. When asked to choose from a prompted list about

44 In addition, introductory interest-free periods can expire on different dates – for example, one provider offers 0% for both balance transfers and purchases, but this introductory offer lasts for 15 months for balance transfers, but only 3 months on purchases, which then attract a rate of 15.9%.
features to include in a summary box on a credit card statement, 46% of respondents chose order of repayments.

103. A more recent research paper found that general awareness among US consumers around the allocation of credit card repayments was very low, with only 3% of consumers able to correctly answer 3 questions about payment allocation. Overall, only 17% answered a question about the payment allocation policy of their issuer correctly. In addition, awareness of payment allocation policies varied across different types of consumers – those least likely to answer correctly were those with lower levels of personal financial knowledge and those on lower incomes.

104. Preliminary evidence from the UK suggests that awareness among UK consumers could be slightly higher – Moneysupermarket recently asked consumers how they believed their credit card repayments would be allocated. Although we do not have more precise details about the repayment policies of their lender, the most likely situation in practice – according to industry intelligence – is that repayments are allocated to the cheapest debt first. Around 30% said that they believed their repayments would be allocated to the cheapest debt first, while a greater proportion (40%) said that they would expect their repayments to be allocated to the most expensive debt first. The remainder (around 30%) said that they did not know.

105. This lack of awareness on the part of consumers suggests the presence of asymmetric information. It could be argued that the presence of a credit card that has a ‘positive’ allocation of repayments (Nationwide) means that the market has provided a solution and consumers are free to switch to this card if they value this feature. If this was a feature that consumers demanded, there would then be a competitive advantage to other credit (and store) card providers also offering this feature and so practices would change. As anecdotal evidence would suggest that this has not occurred, it could be argued that consumers do not value this feature and it is rational for such a feature not to be offered.

106. However, the evidence showing low consumer awareness would suggest that not many cardholders are aware of their current repayment arrangements, let alone the features of a different card. Moreover, the benefits of switching could be difficult to compute for cardholders, given that reallocating credit or store card payments is not within their control and only forms part of a particular credit product, the price of which may be difficult to attribute across different components. This may suggest the potential for investigating whether it is necessary to intervene more directly in order to address this issue.

Options analysis

107. In order to address this information asymmetry, a successful policy intervention would mean that consumers understand the allocation of payments and are able to use their cards optimally as a result. This could then lead to a reduction in the overall cost of borrowing.

108. However, this does not take into account the fact that (especially vulnerable) consumers may not be able to understand the practice, even with increased information. Increasing information does not necessarily increase understanding among some consumers. There is a case for arguing that a successful policy intervention would alter the allocation of payments in the consumer’s favour, as has been introduced as part of recent reforms in the US.

---

46 ‘What’s draining your wallet? The real cost of credit card advances’, Frank (2008)
47 These were: awareness of different rates charged for different credit card activities; payment allocation policy of the issuer, and the impact on effective interest rate for the customer
48 It is possible that at least some of these respondents could have a credit card that does allocate payments to the most expensive debt first, though it is unlikely to cover all respondents
49 Saga also provide a credit card with an alternative repayment order: http://www.saga.co.uk/finance/spf/visa_card/
50 And this is not necessarily one of the key characteristics that consumers may focus on when choosing their card
109. As stated above, previous lender practice was to allocate repayments according to the chronological order in which the debts were incurred. This has not been considered as an option in this consultation, as although it may make some intuitive sense for consumers and may not present significant costs for lenders in terms of system changes and implementation costs (to simply revert to a system they previously operated), it could present severe difficulties for consumers to accurately assess their outstanding balance, and the associated interest rate. Such an option may also present significant challenges in terms of presenting these arrangements to customers.

110. This review proposes investigation of a number of potential policy options in this area:

1. Do nothing
2. Greater information transparency
3. Allocate repayments proportionately to debts attracting different interest rates
4. Allocate repayments to the most expensive debt first
5. Allow consumers to pay off cash advance first

Option 1: Do nothing

111. Under this option we would take no further action besides that which emerges as a result of the OFT’s consultation on irresponsible lending guidance and implementation of the Consumer Credit Directive, which includes an article on ‘adequate explanations’.

112. The information asymmetries described above would be reduced, but not removed, under this option. Subject to the results of the current consultation by the OFT on draft irresponsible lending guidance, it is unclear the extent to which the ‘adequate explanation’ of card features, including the payment allocation structure, by a card issuer – covered by the new requirement as part of the Consumer Credit Directive – could address the problems identified.

Option 2: Greater information transparency

113. This option would involve making it more explicit to consumers at the start of a credit card relationship and/or on monthly statements that debt attracting the lowest rate of interest would be paid off first, which may increase indebtedness over time. This would need to be consistent with the provisions of the Consumer Credit Directive, which restrict additional requirements for pre-contractual information, but allow considerable flexibility in terms of ‘adequate explanations’ and post-contractual information. Alternatively, an annual statement showing how payments have been allocated could be an effective illustration to consumers of the way in which repayment behaviour affects the costs of borrowing.

Costs

114. Under this option, there will be implementation costs for credit and store card providers. As the precise nature of the information requirements is unknown, it is difficult to assess the magnitude of these costs. However, costs associated with the notification of customers are likely to be minimal, as this would be achieved through regular contact with cardholders via their monthly statement.

Benefits

115. This option may address the problem of information asymmetry, but it is unclear whether increased information would sufficiently increase consumers’ understanding of the way payments are allocated, or significantly impact on their behaviour. This leads into the question of what, if any, action consumers might take if they fully understood how the allocation of payments was structured.

51 Though this may not necessarily be the case for recent entrants to the UK credit card market
116. As set out earlier, a better understanding of the consequences of paying off the cheapest
debt first might lead to more consumers choosing cards with a more favourable payment
structure, which could lead to more of these cards being offered by providers. However,
this needs to be set in the context of a general reluctance to switch among consumers for
financial products\textsuperscript{52}, including credit cards.\textsuperscript{53}

Option 3: Allocate repayments proportionately to debts attracting different interest rates

117. This option would see a monthly payment being divided up and used to reduce
outstanding debts on a pro-rata basis.\textsuperscript{54}

Costs

118. Given that both variations of this option could reduce the total amount of interest paid on a
given balance, this will result in a transfer from credit and store card providers (through lost
interest income) to consumers (in the form of debts being repaid earlier, so more money
being available to them).

119. Without more detailed information, it is difficult to assess the size of this transfer, though it
is likely that it would be significantly less than the Nationwide annual estimate of £509m.
Estimates that were made on the basis of US data suggest that the lost interest revenue
under such a system would amount to around $848m per year\textsuperscript{55} (roughly £530m).\textsuperscript{56}

120. In addition, there would be implementation costs for providers, as system changes would
be necessary to calculate how repayments should be allocated. For example, there would
need to be a complex calculation on the part of the card issuer to determine how a
repayment should be allocated, which would alter every month as the composition of the
balance changed.

121. Given these complexities involved with this option, this could lead to increased customer
confusion. In addition, card providers might be discouraged from offering low-rate
promotional balances, and would therefore have an impact on the availability of 0% balance
transfer deals.

Benefits

122. As set out above, there will be benefits to cardholders in terms of repayments being
allocated more favourably, which will reduce the time taken to repay outstanding balances
and the total associated interest cost.

Option 4: Allocate repayments to the most expensive debt first

123. This would follow the model set by the US CARD Act, which states that payments above
the minimum payment must be allocated to the highest-cost debt first, which would reverse
current UK practice. As mentioned above, Nationwide currently offers a credit card in the
UK with this payment structure, and claims that UK consumers could save a total of £509m
per year as a result.

\textsuperscript{52} Various sources indicate low levels of switching for financial products – OFT found switching in current accounts
to be low (6% of customers in the last 12 months); a recent European Commission survey also found switching for
current accounts to be low (9% of customers in the last 2 years). This is partially explained by the perceived
riskiness or complexity of the switching process.

\textsuperscript{53} Evidence for the Cruickshank Review in 2000 found that consumers had held their main credit card for 8.1 years,
on average, with nearly 40% having held theirs for more than 10 years

\textsuperscript{54} So if, for example, a balance comprised £300 balance transfer at 0% interest, £600 purchases at 15% interest,
and £300 cash advance at 20%, a payment of £120 would be allocated £30 to the balance transfer component,
£60 to the purchases component and £30 to the cash advance component.

\textsuperscript{55} Morrison Foerster (August 2008)

\textsuperscript{56} Based on an exchange rate of £1=$1.59507 (as of 1\textsuperscript{st} October 2009)
Costs

124. This would result in a complete transfer from credit and store card providers to consumers, for the full amount estimated by Nationwide (i.e. £509m). A paper looking at similar changes in the US estimated that the costs of this particular provision would lead to lost annual interest income of over $1 billion.\(^{57}\)

125. It is likely that there would be significant implementation costs associated with changes to providers’ IT systems. In addition, this option (like option 3) could also restrict the availability of 0% balance transfer deals, if profitability is significantly reduced. However, credit and store card providers may attempt to recoup this through increased prices in other areas (e.g. higher interest rates, charges or fees).

126. Under this option, the competitive advantage that Nationwide currently hold in relation to this allocation of payments would be eroded. Conversely, it could give Nationwide a potentially unfair advantage, in that such systems are already in place and so it would not incur any transitional or implementation costs in moving to such a system.

127. In addition, lenders have told us that if the cash facility is made more expensive to provide because of the way payments are allocated, costs to consumers who use this facility will rise, and some lenders may withdraw the cash advance facility altogether.

Benefits

128. While this option does not reduce complexity for consumers, it alters the allocation of repayments entirely in their favour. This will reduce the amount of time it takes to pay off their outstanding credit or store card balance and the total interest cost of borrowing.

Option 5: Allow consumers to pay off cash advance first

129. A more targeted option, which might address some of the concerns outlined in relation to option 4 – particularly regarding the availability of 0% transfer deals and wider impact on lenders – might be to allocate payments first to cash advances, with any excess allocated according to the preference of the lender.

130. As shown in the chart below, the proportion of total credit card transactions accounted for by cash withdrawals has been declining since 2005, in terms of value. The popularity of cash withdrawal remains strong, though the main source of growth has mainly been related to debit cards (on which the value of cash withdrawals has grown by a factor of 2.5).

![Cash acquisition as a proportion of credit card transactions, by value (1998-2008)](chart.png)

*Source: UK Cards Association*

\(^{57}\) Morrision Foerster (August 2008)
Costs

131. As cash advance users are a relatively small group, the reduction in lender revenue should not be as significant as a total reversal of the current pricing structure. However, this might lead to a reduction in the profitability of providing a cash facility, which could lead to a withdrawal of that facility, as described above.

Benefits

132. Cardholders would benefit from an allocation that reduces the highest-cost debt first, so that interest on any cash advances does not continue to accrue while other debts are paid off. This option would also have minimal impact on the allocation of payments for those cardholders that do not make use of the cash advance facility.

Risks

133. The relevant risks have been identified within the context of specific options above – e.g. a reduction in the availability of 0% balance transfer deals, the possibility of higher interest rates or fees or charges and the potential withdrawal of the cash advance facility.
What is the problem under consideration? Why is government intervention necessary?
The majority of card holders pay off their balance in full each month (around 60% for both credit and store cards), but the proportion of accounts on which the minimum payment is regularly made appears to have increased in the last couple of years. The Government is concerned that minimum payments are set at a level which means that a significant number of cardholders repay a debt over long periods of time, with high levels of interest, and that lenders have not done enough to explain to consumers the implications of consistently making only the minimum payment. These issues are compounded by recent declines in the levels of minimum payment, industry practice on the allocation of payments and evidence that low minimum payments indirectly affect all borrowers.

What are the policy objectives and the intended effects?
As set out above, the main objective of this review is to secure a better deal for consumers, giving them improved control of their credit and store card borrowing whilst also ensuring that regulation is proportionate and targeted.

In choosing the most appropriate policy option, we will be guided by their potential to contribute to achieving the outcomes outlined earlier.

What policy options have been considered? Please justify any preferred option.
Under this policy area, three options have been considered:

- Improve information transparency
- Set recommended repayment level
- Increase minimum repayment level

All of these are compared against a ‘do nothing’ option, with no preferred option at this stage.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?
If further action is necessary, a post-implementation review would be undertaken after 3 or 5 years.

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister:
## Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Improve information transparency</th>
<th>Description: Proposals for changes to minimum payments on credit cards and store cards</th>
</tr>
</thead>
</table>

### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
</table>

#### Costs

<table>
<thead>
<tr>
<th>One-off (Transition)</th>
<th>Yrs</th>
<th>£ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td>£ TBC</td>
<td>Total Cost (PV)</td>
</tr>
</tbody>
</table>

Other key non-monetised costs by 'main affected groups'  
Industry – implementation costs of producing necessary information and integrating into customer communication, loss of interest income if repayments increase and outstanding balances are reduced and/or cleared sooner (transfer to cardholders)

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
</table>

#### Benefits

<table>
<thead>
<tr>
<th>One-off</th>
<th>Yrs</th>
<th>£ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td>£ TBC</td>
<td>Total Benefit (PV)</td>
</tr>
</tbody>
</table>

Other key non-monetised benefits by 'main affected groups'  
Cardholders – if increased transparency increases repayment levels, benefits to consumers in terms of reduced time to pay off outstanding balances and reduced interest costs of borrowing

### Key Assumptions/Sensitivities/Risks

If increases in information provision improve transparency, but not consumer understanding, then this could have little or no impact on consumer behaviour.

### Price Base Year

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>Net Benefit (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ TBC</td>
<td>£ TBC</td>
<td></td>
</tr>
</tbody>
</table>

- **What is the geographic coverage of the policy/option?** UK  
- **On what date will the policy be implemented?** 2010  
- **Which organisation(s) will enforce the policy?** TBD  
- **What is the total annual cost of enforcement for these organisations?** £ TBC  
- **Does enforcement comply with Hampton principles?** Yes  
- **Will implementation go beyond minimum EU requirements?** No  
- **What is the value of the proposed offsetting measure per year?** £ 0  
- **What is the value of changes in greenhouse gas emissions?** £ 0  
- **Will the proposal have a significant impact on competition?** No  
- **Annual cost (£-£) per organisation (excluding one-off)**  
  - Micro  
  - Small  
  - Medium  
  - Large  
- **Are any of these organisations exempt?** No

### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>Decrease of</th>
<th>Net Impact</th>
<th>(£ TBC)</th>
</tr>
</thead>
</table>

**Key:** Annual costs and benefits: Constant Prices  
(Net) Present Value
### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Set recommended minimum payment</th>
<th>Description: Proposals for changes to minimum payments on credit cards and store cards</th>
</tr>
</thead>
</table>

#### ANNUAL COSTS

**Description and scale of key monetised costs by 'main affected groups'**

<table>
<thead>
<tr>
<th>One-off (Transition)</th>
<th>Yrs</th>
<th>£ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Cost (PV)</strong></td>
<td></td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Other key non-monetised costs by 'main affected groups'**

Industry – implementation costs due to system changes, ongoing costs associated with calculation and notification of repayment levels, reduced interest income as balances may be reduced and/or cleared sooner (transferred to cardholders)

<table>
<thead>
<tr>
<th>Average Annual Cost (excluding one-off)</th>
<th>£ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Other key non-monetised benefits by 'main affected groups'**

Consumers – those who are able to afford higher minimum repayment levels would be able to clear their outstanding balance sooner and at a lower overall cost of borrowing (transferred from card providers)

#### Key Assumptions/Sensitivities/Risks

Information notification necessary to give cardholders the option of setting their own repayment level might increase confusion and lead to no improvement in repayment levels; if repayment levels increase, profitability will be reduced – this might result in exit or further charges (as above)

#### Price Base Year

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Years</td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

- **What is the geographic coverage of the policy/option?** UK
- **On what date will the policy be implemented?** 2010
- **Which organisation(s) will enforce the policy?** TBD
- **What is the total annual cost of enforcement for these organisations?** £ TBC
- **Does enforcement comply with Hampton principles?** Yes
- **Will implementation go beyond minimum EU requirements?** No
- **What is the value of the proposed offsetting measure per year?** £ 0
- **What is the value of changes in greenhouse gas emissions?** £ 0
- **Will the proposal have a significant impact on competition?** Yes

#### Annual cost (£-£) per organisation (excluding one-off)

<table>
<thead>
<tr>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

#### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>£ TBC</th>
<th>Decrease of</th>
<th>£ TBC</th>
<th>Net Impact</th>
<th>£ TBC</th>
</tr>
</thead>
</table>

**Key:**

- **Annual costs and benefits: Constant Prices**
- **(Net) Present Value**
## Summary: Analysis & Evidence

### Policy Option:
**Increase minimum payment level**

### Description:
Proposals for changes to minimum payments on credit cards and store cards.

### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Costs</strong></td>
</tr>
<tr>
<td><strong>One-off (Transition) Yrs</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Total Cost (PV) £ TBC</strong></td>
</tr>
</tbody>
</table>

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Benefits</strong></td>
</tr>
<tr>
<td><strong>One-off Yrs</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Total Benefit (PV) £ TBC</strong></td>
</tr>
</tbody>
</table>

### Other key non-monetised costs by 'main affected groups'

- **Industry** – implementation costs due to system changes, reduced interest income as balances are reduced and/or cleared sooner (transferred to cardholders);
- **Consumers** – reduced utility/flexibility of the card, as higher minimum payments relative to income would limit the maximum balance.

### Other key non-monetised benefits by 'main affected groups'

- **Consumers** – those who are able to afford the higher minimum repayment level would be able to clear their outstanding balance sooner and at a lower overall cost of borrowing (transfer from card providers); potential reduction in over-indebtedness.

### Key Assumptions/Sensitivities/Risks

- Policy can be implemented without immediately imposing higher minimum payments on customers who cannot currently afford them;
- If profitability of card lending is reduced as a result, may result in exit from the market or offset by increases in interest rates or increases/introduction of fees/charges.

### Price Base Year

<table>
<thead>
<tr>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV) £ TBC</th>
<th>NET BENEFIT (NPV Best estimate) £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>2010</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

### What is the geographic coverage of the policy/option?
UK

### On what date will the policy be implemented?
2010

### Which organisation(s) will enforce the policy?
TBD

### What is the total annual cost of enforcement for these organisations?
£ TBC

### Does enforcement comply with Hampton principles?
Yes

### Will implementation go beyond minimum EU requirements?
No

### What is the value of the proposed offsetting measure per year?
£ 0

### What is the value of changes in greenhouse gas emissions?
£ 0

### Will the proposal have a significant impact on competition?
Yes

### Annual cost (£-£) per organisation
(excluding one-off)

<table>
<thead>
<tr>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

### Are any of these organisations exempt?
No

### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of £ TBC</th>
<th>Decrease of £ TBC</th>
<th>Net Impact £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Increase - Decrease)</td>
<td>(Net) Present Value</td>
<td></td>
</tr>
</tbody>
</table>

Key:
- **Annual costs and benefits: Constant Prices**
Overview

134. The minimum payment is the minimum amount that a cardholder must pay each month on their outstanding credit or store card balance. The level of minimum payments varies across providers, but Para 10.13 of the 2008 Banking Code states that: “We will make sure that your minimum repayment covers more than that month’s interest”. This means that the minimum repayment is set to ensure that the total outstanding balance does not increase over time (provided there is no further spending on your card). Currently, the average minimum payment is around 2-3% of the outstanding balance for credit cards and around 4% of the outstanding balance for store cards, subject to a minimum amount (usually £5 or £10).

135. Overall, evidence indicates that 60% of credit and store card holders pay off their balance in full every month, with a further 9% of credit cards holders doing so most months. In addition, the average ratio for credit card repayments to gross lending has remained above 95% since 2005. However, this aggregate data can vary considerably at the level of individual cardholders – the proportion of paying off their balance in full every month falls from 80% in socio-economic group AB to 56% in groups D and E. Data suggests that there has been an increase in the proportion of accounts on which the minimum payment has regularly been made in the last couple of years. Whilst this may be attributable to many factors, notably the deterioration in the financial position of many households, this represents a potentially worrying trend.

136. The Government is concerned that minimum payments are set at a level which means that a significant number of cardholders repay a debt over long periods of time, with high levels of interest, and that lenders have not done enough to explain to consumers the implications of consistently making only the minimum payment. Notwithstanding the warning set out in the Banking Code (see footnote below), consumers may not fully appreciate the significance of doing so, as there is no requirement to indicate how long it will take to repay the balance and how much this will cost overall. These issues are compounded by recent declines in the levels of minimum payment, industry practice on the allocation of payments and evidence that low minimum payments indirectly affect all borrowers.

137. In light of these concerns, the Government believes that further action is necessary in this area so that consumers not only have a clearer idea of the implications of regularly making only the minimum payment, but are also encouraged to make higher payments where they can so that credit and store card debts are repaid over a reasonable period.

Background

138. Regulatory authorities and the card industry have already put in place some mechanisms to alert cardholders to the impact of making only the minimum payment. For example, in 2005 the credit card industry agreed the text of a warning, which appears on all credit card statements. Credit card companies also agreed that additional information should be included within pre-or post-contract information to make clear that the minimum repayment amount does not constitute a repayment schedule.

139. Some issuers have chosen to go beyond the basic industry position, with several including a scenario showing the relative costs of only making the minimum repayment compared with making a small monthly payment (in excess of the minimum). In their report on minimum repayments, the Treasury Select Committee felt that the above warning set out

58 http://www.bba.org.uk/content/1/c6/01/30/85/Banking_Code_2008.pdf
59 This reads: “if you make only the minimum payment each month, it will take you longer and cost you more to clear your balance”.

34
above did not go far enough and supported the introduction of such scenarios showing the
cost of repeatedly making the minimum repayment.

140. These voluntary measures by industry were reinforced by regulations flowing from the
Consumer Credit Act 2006, which require that credit card statements state the
consequences of making only minimum payments. In addition, the Store Cards Market
Investigation Order, made by the Competition Commission in 2006 following its investigation,
requires store card lenders to provide a minimum payment warning (in the prescribed terms
set out in footnote 59) and to state the estimated interest the following month if only the
minimum payment is made.

141. In terms of further relevant regulatory intervention, the OFT is currently consulting on its
Irresponsible Lending Guidance, due to be published in January 2010. As currently drafted
(and therefore subject to change in light of responses to the consultation), the Guidance
states that:

- It would be an unsatisfactory business practice if credit card providers were to set
  "minimum repayments on a running account credit agreement at a level that would not
  repay capital, as well as interest, within a reasonable period" and;
- Pre-contract information should “enable the borrower to understand the impacts which
  the product may have on his own personal economic situation”.

142. However, it is not yet clear to what extent the final version of the guidance will change from
the current draft. It is possible that neither of the recommendations in the draft Guidance
that relate to repayment period and consumer understanding will appear in the final version.
In addition, the guidance does not currently define a reasonable period for the repayment of
the capital.

143. The Consumer Credit Directive – due to be implemented by June 2010 – requires EU
Member States to ensure that consumers receive adequate explanations before entering
into a credit agreement. These must be sufficient to enable consumers to assess whether
the proposed agreement is adapted to their needs and financial situation. Among other
matters, the draft regulations implementing the Directive require an explanation of “the cost
to the debtor of the credit to be provided under the agreement”.

Issue

144. Consumers that regularly make only the minimum payment are using what should be a
short-term product for longer term borrowing needs, where an alternative product (e.g. a
personal loan) could be cheaper. In addition, some consumers can lose control and take on
unsustainable debts, particularly if they have several cards or are refused more appropriate
forms of credit.

145. For those cardholders who regularly make only the minimum payment, this can leave them
paying off debt very slowly and paying significant interest over the life of the loan. This
problem has been compounded in two ways. Firstly, it is general industry practice for the
most expensive debt on credit and store cards to be paid off last. When making only the
minimum payment, cardholders will be paying off their loan at the lowest interest rate first
(see earlier section on the allocation of payments). Secondly, in recent years, the average
minimum payment on credit and store cards has reduced from around 5% to its current
average of 2-3%, as noted previously by the Task Force on Tackling Over-indebtedness,
the Treasury Select Committee and reported by Which?. In addition, earlier research

60 ‘Sneaky Tricks and Hidden Charges’, Which?, January 2005. Typical practice is to set minimum repayments at
around 2-2.5% of the outstanding balance, subject to a minimum amount (usually £5 or £10). However, Barclays
recently announced a minimum payment reduction to 1.5% for some of its customers.
found that reducing the minimum payments on credit cards was a lender practice associated with financial difficulties.\textsuperscript{61}

146. Such reductions could have a huge impact on the total amount of interest and the time it takes a consumer to repay the debt. For example, if a consumer had an average balance of £1,856 on his or her card and was paying a minimum of 2\% each month with interest of 17.6\%, the total interest would be £3,368 over 29 years and 3 months. If, however, the minimum payments were increased to 5\%, the debt would be paid off over 8 years and 1 month, with only £658 in interest.

147. Research by Oxera suggests that the population of those making minimum repayments is a fluctuating one, with very few cardholders remaining as a minimum payer for a significant period.\textsuperscript{62} It is difficult to ascertain precisely how many credit and store card holders regularly make the minimum repayment on their outstanding balance. Evidence from the UK Cards Association indicates that the minimum payment was regularly made for almost 14\% of all active credit card accounts in 2008, an increase on the 2006 figure of 12.5\%. A comparable figure for cardholders was that 12\% paid off the minimum balance on at least one of their cards.

148. Previous evidence suggests that the proportion of cardholders regularly making only minimum repayments on their credit cards could be much smaller – APACS (Association of Payment and Clearing Services, now known as UK Cards Association) estimated this figure to be 3\% of cardholders in 2004, but OFT research suggesting it could be as much as 8\%, with a further 12\% making the minimum payment every month, but paying more when they can.\textsuperscript{63}

149. Earlier research found the proportion of cardholders regularly making the minimum payment to be 7\%, but this proportion was much higher among those in financial difficulties (23\%) and those paying more than 25\% of their income on unsecured credit repayments (29\%).\textsuperscript{64} Those consumers in lower socio-economic groups are also less likely to pay off their credit card balance in full every or most months – only 56\% of those in groups D and E do so, compared to 80\% in group AB.

150. Evidence from the Competition Commission investigation on store cards shows that, among those cardholders who tend to ‘revolve’ their balance (i.e. pay more than the minimum but less than the full amount), the average balance for those making only the minimum payment (or less) was more than three times higher than those paying more than the minimum.\textsuperscript{65}

151. Further evidence from the inquiry found that the majority paid their store card bill in full each month (60\%), 13\% said they usually pay in full and 12\% said they usually make the minimum payment. This would seem to accord with FLA (Finance and Leasing Association) data, which shows that, as of June 2009, 53\% of store card accounts had no outstanding credit.

152. In considering options for action, we recognise that for some consumers who borrow on their cards, particularly those who only infrequently make a minimum payment or who benefit from a 0\% deal, paying small amounts may be a rational choice. The flexibility offered by the minimum payments regime on credit and store cards enables consumers to manage their finances as their personal circumstances change over a period of time.

153. Any policy intervention in this area will apply directly to the 14\% of cardholders who make the minimum payment, with the greatest impact on those who make minimum payments most frequently. However, research suggests that minimum repayment levels could also influence the payment behaviour of those cardholders who repay more than the minimum.

\textsuperscript{61} ‘Over-indebtedness in Britain’, Kempson (2002)
\textsuperscript{62} ‘Are Households Over-Indebted?’, Oxera (2004)
\textsuperscript{63} ‘Credit Card Survey’, OFT (2004)
\textsuperscript{64} ‘Over-indebtedness in Britain’, Kempson (2002)
\textsuperscript{65} Average balance of £800, compare to an average balance of £250
payment but less than the full outstanding balance each month, with the minimum payment acting as an “anchor” upon which they base their own levels of repayment.\textsuperscript{66} This suggests that if the minimum payment increased, the average amount they would pay above this would also increase.

**Rationale**

154. As discussed in the main rationale section earlier, there is evidence to suggest that the ability and awareness of consumers in identifying the correct repayment levels for a particular credit agreement is fairly low, with only 54\% of respondents able to identify the correct minimum repayment level on a sample credit card agreement.\textsuperscript{67} Such lack of awareness suggests the presence of imperfect information in relation to minimum repayments on credit cards.

155. The underlying reason behind this lack of awareness is uncertain. It could be attributable to a lack of information, in which case an appropriate remedy might be to increase the amount of information provided to cardholders. However, it could equally be due to an excessive amount of information, leading to ‘information overload’ and ultimately hindering consumer understanding, in which case a potential solution would be to reduce the amount of information provided to cardholders. A third potential explanation is that, although consumers feel they receive sufficient information, the way in which that information is presented makes it difficult to understand. In this latter case, it may be worthwhile exploring different ways of presenting information to cardholders that might increase their understanding. We are seeking to gather evidence to ascertain which of these three explanations is the most likely, which will then inform the selection and design of appropriate policy options.

156. As mentioned above, research looking at minimum repayments on credit cards suggests that the presence of a psychological bias related to ‘anchoring’ might be relevant in this context. The study found that the presence of a minimum payment could be sufficient to reduce the amount many people chose to pay on their bills, leading to further interest payments.

157. The presence of a minimum payment had a particularly large effect on those who chose to pay more than the minimum, but less than the full amount. When a suggested minimum payment was given, the average repayment made was 70\% lower, an average of £99 (23\% of the balance), while those not given any required minimum payment paid an average of £175 (40\% of the balance). Based on these data, it was estimated that minimum payment information could lead to a doubling of the interest paid by this group of customers over the lifetime of the debt.

158. Given certain biases in consumer behaviour (e.g. overconfidence in estimating costly actions or future self-control), consumers may not make rational choices regarding certain ‘virtuous’ actions that have delayed benefits, such as saving for your future/retirement, or paying off more than the minimum payment on your credit/store card bill. This could be due to issues of impatience, driven by hyperbolic or quasi-hyperbolic discounting. Under these circumstances, consumers can deviate from the optimal choice – for example, under-saving or under-contributing to their pension, or possibly paying no more than the minimum amount on their credit or store card bill. In such circumstances, it may therefore be legitimate to offer consumers a ‘commitment’ mechanism to overcome their problems of commitment, such as tying them into a regular payment, which could obviate this bias.


\textsuperscript{67} ‘Credit card survey’, OFT (2004)
Options analysis

159. Evidence indicates that the proportion of cardholders making minimum repayments has increased in recent years. There are likely to be a number of factors that are responsible for this rise, not least of which the impact of recent economic conditions on many consumers’ personal finances.

160. However, it is clear that despite the mechanisms developed by industry and regulatory authorities so far, a significant minority of cardholders make the minimum payment and therefore continue to pay off debt very slowly and at a high overall interest cost. For some cardholders, particularly those who only infrequently make a minimum payment, this may be a rational choice to use the flexibility of credit and store cards to manage their finances as their personal circumstances change over a period of time. For others, however, particularly those cardholders who could pay more than the minimum payment, but chose not to, it may be that they do not recognise the true impact of making minimum payments.

161. It is therefore important to investigate whether action is needed to improve cardholders understanding of the consequences of making a minimum payment. It may also be prudent to look at what could be done to ensure that minimum payments are set at a level which would enable repayment over a ‘reasonable’ period and at a ‘reasonable’ cost.

162. In considering any measures in this area, it is important to try and take account of all potential consequences that might arise. In particular, it is noted that minimum payments are not an issue for the vast majority of cardholders who pay off their balance in full every month. Any potential intervention requires a balance between the needs of the different groups of cardholders who make minimum payments – those who, for example, use minimum payments as a flexible tool to manage their finances, those who may not fully understand the consequences of making the minimum payment and those who cannot afford to repay more than the minimum payment. We will also need to consider how action in this area might affect the credit and store card market more generally and might impact on the range of products and offers available to cardholders (e.g. 0% balance transfers).

163. This review proposes investigation of a number of potential policy options in this area:

1. Do nothing;
2. Improve information transparency;
3. Set a recommended minimum payment;
4. Increase the minimum payment.

Option 1: Do nothing

164. Under this option, no further action would be taken beyond that identified above – i.e. the OFT’s Irresponsible Lending Guidance, due to be published in January 2010. It is not possible at this point to determine the final version of this guidance and therefore precisely what requirements will be placed upon lenders.

165. However, it is unclear the extent to which this additional information and guidance could improve consumer awareness of the impact of regularly making the minimum payment and consequently influence consumer repayment behaviour, in order to address the problems identified above.

Option 2: Improve information transparency

166. This option would involve imposing information requirements that set out the consequences of regularly making only the minimum payment more explicitly to cardholders at the start of a credit and store card relationship, and/or on monthly or annual statements. Action in this area would need to be consistent with the forthcoming implementation of the Consumer Credit Directive, which restricts additional requirements for pre-contractual
information, but allows for more flexibility on post-contractual information and provides Member States with considerable freedom regarding the adequate explanations that must be given.  

167. This information would be intended to help illustrate to cardholders the way in which their payment levels affect the costs of their borrowing, though the precise form of this information is undecided. As mentioned above, we are seeking to gather evidence on the reasons behind the lack of awareness identified earlier, which will inform whether the provision of further information, or how it is presented, could potentially bring benefits for cardholders.

168. One potential option could be to make it clear to cardholders that regularly make only the minimum repayment that such payments will cover only a small proportion of the total outstanding debt. A range of potential indicators could be used to achieve this – for example, statements could show total spending, total payments to date, a calculation of the time to repay the full balance at the minimum payment level, or the current rate of payment.

169. Periodic statements could also include simple illustrative scenarios indicating how much it will cost and how long it will take to repay the outstanding balance if only the minimum payment is made. An alternative scenario could show the implications if a larger proportion of the balance were to be repaid or if the consumer repays the same proportion of the debt as they have done in the preceding 6 months.

170. This additional kind of information is very similar to that which will be required in the US, following the reforms set out in the CARD Act of 2009. Lenders will need to display on periodic statements how long it will take to pay off the existing balance – and the total interest cost – if the cardholder pays only the minimum payment. They will also need to display the payment amount and total interest cost to pay off the existing balance in a reasonable period, deemed to be 36 months.

171. A second option would be to include illustrative scenarios, setting out how much credit will cost if only the minimum payment is made every month. It could also include information about how much money and time could be saved if a larger amount is repaid each month instead of the minimum payment. This option is similar to the recommendations of the HM Treasury Select Committee in its 2005 report, which looked at minimum repayment levels on credit cards.

Costs

172. Under this option, there will be costs of implementation for credit and store card providers. A priori and without more detailed information on the nature of the required disclosures, it is difficult to assess the magnitude of these costs. While costs associated with re-programming statement generation systems could be more substantial, costs associated with the notification of customers are likely to be minimal, as this would be achieved through regular contact with cardholders via their monthly statement.

173. A recent paper looking at customised information disclosures for minimum payments in the US found that the estimates of implementation costs varied substantially, from $9m to as much $57m in the first year for large issuers. This largest cost was split between one-off costs ($30m, incorporating programming system changes and modifications to customer service systems) and ongoing costs ($27m, including postage and handling higher numbers of calls from cardholders).

---

68 Imposing no constraints, except with regards to information on overdrafts and changes to borrowing rates
69 'Credit card charges and marketing', HM Treasury Select Committee (2005)
71 This cost comprised many elements, including: programming, postage, customer service and staff training. The largest element of this cost was postage – however, it could be that such costs have declined as more cardholders choose to receive their statements electronically, though there will undoubtedly be costs associated with system changes.
174. Cost estimates submitted by credit card issuers for implementing proposals on customised information disclosures for minimum payments on credit cards proposed in California in 2002, indicate first year costs of $41m, of which $23m was ongoing and $18m one-off costs.\(^72\)

175. In addition, if information requirements lead to more consumers increasing their repayments, then this will lead to costs for industry in terms of the interest that would otherwise have been incurred and paid by consumers. However, this is effectively a transfer of revenue to consumers, so will have no net effect on the overall proposals.

**Benefits**

176. If increased information transparency leads to changes in behaviour for at least some consumers, then this could lead to improvements in terms of time taken to repay debts and the total cost of credit and store card borrowing. However, such changes may depend on their card usage.

177. Research in the US\(^73\) asked a small sample of cardholders to choose between 3 potential information disclosures\(^74\): a customised (personalised) disclosure, a generic disclosure or no disclosure at all. The preferences for different types of consumer varied with their card use – over half (57%) of ‘revolver’ cardholders (i.e. those who typically carry balances on their cards) preferred a customised disclosure. For those cardholders who pay their balances in full, the majority (60%) said they would prefer either generic disclosures or none at all.

178. The reasons for preferring customised disclosures centred on receiving account-specific information, reflecting changes based on their transactions, and providing more information than a generic disclosure. Those consumers against customised disclosures said they did not need such information, because they already understood the consequences of making minimum payments or because they paid their credit card balances in full each month.

179. The research suggested that customised disclosures would influence cardholders to make larger payments or change how they use their credit cards. However, customised disclosures might not affect the behaviour of cardholders who make minimum payments, because they may not be able to afford to pay more. Providing customised disclosures to all cardholders could have limited impact for certain customers – for example, those who pay off their balance in full each month, or those with limited financial capability and the relatively small proportion of cardholders that regularly make only minimum repayments. It may then be more efficient to provide targeted information to certain ‘at risk’ customers, who may benefit most from such information – e.g. those who regularly revolve their balance, or those who make 6 consecutive minimum repayments. However, the cost of identifying these ‘at risk’ customers could potentially be substantial and difficult to define, in addition to the likely significant cost of producing such disclosures.

180. Requiring lenders to improve the information they provide to consumers on minimum repayments should put consumers in a better place to make more informed choices on their borrowing. However, there is no guarantee that consumers would read or even follow advice to make more than the minimum payment. As stated above, depending on the extent to which consumers feel they already receive sufficient information, this could lead to information overload and further compromise consumer understanding and/or awareness.

---

\(^{72}\) California Minimum Payment Statute, 2002. Companies were required to include at least 3 generic examples of how long it would take to pay off various balances, and customers who made only minimum repayments for 6 consecutive months would get a ‘minimum balance warning’ and a referral to a credit counselling service.

\(^{73}\) GAO (2006)

\(^{74}\) 112 cardholders
Option 3: Set a ‘recommended’ minimum payment

181. Under this option, a ‘recommended’ minimum payment would be set at a level higher than the current minimum payment, which is a contractual obligation. Consumers could be encouraged to make the recommended payment, rather than the minimum payment (e.g. lenders could offer for direct debit mandates to be set at the higher, ‘recommended’, payment; consumers could ‘opt in’ to making the recommended minimum payment).

182. The recommended minimum payment could be set voluntarily by industry, but it would be expected that repayment should be made over a ‘reasonable’ period of time. In the US, this has been determined at 36 months for the provision of information on minimum payments, and anecdotal evidence shows that this period is a reasonable estimate of the average life of a credit card agreement issued in the current UK market.

183. However the level is agreed, consumers may make the assumption that at the end of the period, say 36 months, they would be free of debt on their cards, provided that they have made no further spend on their card.

184. There are a variety of potential methods for implementing this option, which makes them not necessarily mutually exclusive from other options considered: for example, the ‘recommended’ minimum payment could be agreed jointly between the consumer and the credit or store card lender by linking it to a particular repayment period or level (similar to option 4), or it could be delivered through information-based transparency measures (as set out in option 2), by including information on how much money and time could be saved if the ‘recommended’ payment is made each month instead of the minimum payment.

185. As noted earlier, some consumers may rationally choose to make only the minimum payment on their debts. If consumers are asked to ‘opt in’ to the recommended minimum payment, it is not clear how many would choose to do so. If the recommended minimum payment were to become the default payment option for direct debit mandates, some vulnerable consumers may struggle in the short term to make this higher payment on their outstanding balance. This could risk the recommended payment effectively becoming the minimum payment, but at a higher level. To mitigate this risk, this option should allow consumers to pay only the minimum payment when necessary.

Costs

186. This option could entail significant implementation costs for industry, as calculations would have to be made about the ‘recommended’ payment, which could change from month to month if there was additional spending on the card. As the repayment period could differ between individual consumers and change over time, this is likely to be significantly more complex for lenders to calculate and may substantially increase implementation costs for credit and store card operators.

187. However, certain features of this option are potentially complex, both for the credit and store card providers and for the cardholders. This option operates on the assumption that there would be no further spend on the card and the debt would be repaid in the set period, which would effectively turn a revolving credit product into a fixed-term lending product. There may also be scope for customer confusion, as consumers may struggle to understand why they still have an outstanding balance at the end of their agreed repayment period.

188. Additional spending on the card could also lead to further complications, with distinct but overlapping repayment periods applying to different individual debts. As a result, this option is likely to require the provision of significant additional information to consumers to enable them to make an informed decision about the most suitable repayment period.

189. As repayments are based on the outstanding balance there could be an increase in ongoing costs, as providers would need to continuously update the minimum ‘recommended’ payment. This could then lead to significant variations in repayment levels,
which would be of particular concern to more vulnerable cardholders who may not be able to manage fluctuations in payments.

190. In addition, it may be difficult to agree at what level the recommended payment should be set. If it is an outcome of a discussion between the consumer and the credit and store card lender, this will require both to make informed decisions about what might constitute a reasonable payment, on which they may have contrasting views. Such decisions are likely to require significant additional information to be sent to cardholders, in order for them to make an informed decision about the most appropriate repayment period. Combined with additional information about the potential for distinct but overlapping repayment periods, this could result in ‘information overload’ for many consumers, and even if it is read, they may have difficulty understanding it.

191. Although research has identified problems of consumers ‘anchoring’ their repayment around the contractual minimum, this could potentially confuse consumers by offering another ‘anchor’ at the recommended minimum payment level. It is difficult to know what the outcome of this might be. For example, it is possible that setting a ‘recommended’ payment may discourage some consumers from making payment above this level, as they may see it to be a ‘desirable’ repayment level. In this case, some consumers may repay less of their outstanding balance that they otherwise would, because they mistakenly believe that the ‘recommended’ payment is the payment they should ideally make.

Benefits

192. It is difficult to assess how many consumers might benefit under this option – those consumers who ‘revolve’ their balance and can afford to pay more than the minimum payment, but currently do not do so, potentially due to issues around ‘anchoring’ or biases towards a ‘default’ of the minimum payment. These consumers should clear their outstanding balance over a shorter repayment period and at a corresponding lower overall cost.

193. In addition, depending on how the recommended minimum payment is presented, consumers should have a greater degree of control over their borrowing and should be able to make a more informed decision over their repayment profile.

Option 4: Increase the minimum payment

194. Under this option, the minimum payment for all cardholders (or potentially for a sub-set of defined cardholders) would increase, thereby ensuring earlier repayments of the existing balance over a shorter period of time with a lower level of interest over the lifetime of the loan.

195. Such a change could have a significant impact on the time it takes to repay a debt and the total cost of borrowing over the life of the balance. For example, on an average credit card balance of £1,856 and an interest rate of 17.6%:

- At a 2% minimum repayment level, it would take 29 years and 3 months, at a total interest cost of £3,368;
- At a 5% minimum repayment level, it would take 8 years and 1 month, at a total interest cost of £658.

196. One element of this option could be to limit the minimum payment increase to a certain group of cardholders, though we will need to consider how to identify and define them. This could also involve costs to credit and store card providers in providing separate minimum payment calculations for different types of cardholders. As an indirect consequence, it is also possible that differentiating cardholders in this way may impact on the range of providers and products available to these specific groups.
197. Given these kinds of consequences, any proposed increase in the minimum payment, even to a sub-set of cardholders, will have to be carefully analysed and its implementation carefully managed.

Costs

198. If there is an increase in the repayment levels – both directly, by those who regularly make the minimum repayment, and indirectly, by those who make more than the minimum repayment (as suggested by the research referred to earlier) – there will be two primary sources of costs:

- costs to industry in implementing system changes to account for changes in the level of minimum payments, and
- costs for those consumers that are unable to afford the new higher level of minimum repayment, but would previously have been able to afford the minimum repayments at their lower level and, as a result, are pushed into severe financial difficulties.

199. There will also be costs to industry in terms of the interest that would otherwise have been incurred and paid by consumers, but this is effectively a transfer to consumers, so will have no net effect on the overall proposals.

200. If these costs are ultimately passed on to cardholders, this could result in higher prices in various guises – for example, through higher interest rates or the introduction of fees associated with the use of credit cards (annual fees, transfer fees).

201. Currently, relatively low minimum payment levels provide cardholders with some flexibility in the way in which they manage their finances, and may help to ease the pressures on more vulnerable cardholders at times of financial strain (albeit at the risk of increased interest charges and potential difficulties in paying off the loan in the long term). If appropriate transitional measures cannot be identified, an increase in minimum repayment levels could lead to more people experiencing short-term repayment difficulties, as they struggle to pay the higher minimum payment. If those people are unable to keep up with the higher monthly repayments, this could lead to a significant worsening of customers’ financial situation and could draw them to other, less suitable, borrowing products. However, there are a number of ways in which this risk could be mitigated.

202. Some of these short-term difficulties could be eased through appropriate transitional arrangements – for example, only apply the higher level to new agreements, introduce phased increases over time or only introduce higher repayments when balances fall below a certain level.

203. We do not have any robust information about the distribution of credit and store card repayments. However, a sample of repayments suggests that increasing minimum repayment levels up to, for example 5%, would affect over 5 million credit card holders.

204. However, it is unclear how many of those cardholders would be unable to meet their repayments under that scenario. We would welcome further evidence in this area and this consultation forms an important part of that evidence-gathering process.

Benefits

205. A higher level of minimum repayments – provided that cardholders can meet them – will lead to outstanding borrowing being paid off sooner, which will reduce the amount of total interest paid. This will apply both directly – to those 14% of cardholders who regularly make minimum repayments – and indirectly – to those who make more than the minimum repayment, but use the minimum repayment figure as an “anchor” when deciding the level of their repayment. This is the complement to the loss of interest income for industry identified above, and will result in no net impact.

206. Over the longer term, a higher level of minimum payments could lead to a reduction in the incidence of over-indebtedness among customers and the problems associated with this, such as absence from work, adverse health impacts and relationship breakdown.
Risks

207. As set out above, one major potential risk under options 3 and 4 is that increasing the level of minimum repayments may lead to cardholders being unable to meet their repayments, which could worsen their financial situation and lead them into problems associated with over-indebtedness – e.g. adverse health impacts, absence from work, relationship breakdown etc.

208. This increase in financial distress could be compounded for those that have multiple credit or store cards, as those with multiple cards are more likely to be in a precarious financial position. Therefore, by worsening that situation, this could have wider impacts across a number of cards.

209. An increase in the minimum repayment level (under options 3 and 4) will also reduce the amount of interest income received by credit and store card providers (that will then be transferred to cardholders), which may result in declines in profitability for credit and store card providers. Given the difficult economic circumstances in which they are operating, this could potentially lead to some providers exiting the market.

210. However, an alternative potential outcome of a decline in the profitability of credit and store card lending as a result of increased minimum repayments is increased costs to cardholders elsewhere. For example, this could take the form of an increase in interest rates or the introduction or increase in fees and charges.
What is the problem under consideration? Why is government intervention necessary?
Concerns were raised in relation to unsolicited credit limit increases after findings that such increases were associated with financial difficulty. Credit card companies argue that the flexibility to increase credit limits allows them to be more responsible in their lending. Consumer groups argue that these limit increases, which are usually unsolicited, tempt consumers into more debt than they can manage. The Government is concerned that the practice of offering limit increases on an unsolicited basis does not give customers enough control over how much credit they should be able to access. It is desirable, that borrowers make their own assessment of the affordability of any new credit facility and their ability to repay.

What are the policy objectives and the intended effects?
As set out above, the main objective of this review is to secure a better deal for consumers, giving them improved control of their credit and store card borrowing whilst also ensuring that regulation is proportionate and targeted.
In choosing the most appropriate policy option, we will be guided by their potential to contribute to achieving the outcomes outlined earlier.

What policy options have been considered? Please justify any preferred option.
Under this policy area, four options have been considered:
- Improve consumer understanding
- Ban unsolicited credit limit increases
- ‘Opt-in’ for unsolicited limit increases
- Limit on size and/or frequency of credit limit increases
All of these are compared against a ‘do nothing’ option, with no preferred option at this stage.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?
If further action is necessary, a post-implementation review would be undertaken after 3 or 5 years.

Ministerial Sign-off For consultation stage Impact Assessments:
I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister:

[Signature] Date: October 2009
## Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Better information for consumers</th>
<th>Description: Proposals for changes to practices around unsolicited limit increases on credit cards and store cards</th>
</tr>
</thead>
</table>

### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
</table>

#### One-off (Transition) Yrs

£ TBC

#### Average Annual Cost (excluding one-off)

£ TBC

#### Total Cost (PV) £ TBC

Other key non-monetised costs by 'main affected groups'

Industry – implementation costs to deal with all potential options, including staff training and customer service resource in fielding customer enquiries

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
</table>

#### One-off Yrs

£ TBC

#### Average Annual Benefit (excluding one-off)

£ TBC

#### Total Benefit (PV) £ TBC

Other key non-monetised benefits by 'main affected groups'

Consumers – more proactive approach to managing credit limits, including addressing information problems for lenders

### Key Assumptions/Sensitivities/Risks

Increased consumer understanding may not lead to a change in customer behaviour

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV) £ TBC</th>
<th>Net Benefit (NPV Best estimate) £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>UK</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>TBD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ TBC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual cost (£-£) per organisation (excluding one-off) Micro Small Medium Large</td>
<td>No No No No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Impact on Admin Burdens Baseline (2005 Prices)** (Increase - Decrease)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>£ TBC</th>
<th>Decrease of</th>
<th>£ TBC</th>
<th>Net Impact</th>
<th>£ TBC</th>
</tr>
</thead>
</table>

Key: **Annual costs and benefits: Constant Prices** | **(Net) Present Value**
### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Limit size/frequency of limit increases</th>
<th>Description: Proposals for changes to practices around unsolicited limit increases on credit cards and store cards</th>
</tr>
</thead>
</table>

#### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Yrs</th>
<th>£ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition)</td>
<td>£ TBC</td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Total Cost (PV): £ TBC**

**Other key non-monetised costs by 'main affected groups'**

- Industry – potentially significant implementation costs associated with system changes, potential reduction in interest income (transfer to cardholders)

#### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Yrs</th>
<th>£ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off</td>
<td>£ TBC</td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Total Benefit (PV): £ TBC**

**Other key non-monetised benefits by 'main affected groups'**

- Consumers – potential reduction in credit and store card balances, which might reduce interest costs (transfer from card providers); also, possible reduction in problems associated with over-indebtedness

### Key Assumptions/Sensitivities/Risks

If credit limits do not make significant contribution to problems of over-indebtedness, no reduction in these problems for customers; if unsolicited increases are key to profitability, lenders may exit or seek to increase revenue from other sources (e.g. interest rates, fees, charges), also potential reduction in availability of credit (especially to high-risk borrowers)

### Price Base

<table>
<thead>
<tr>
<th>Year</th>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ TBC</td>
<td>£ TBC</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### What is the geographic coverage of the policy(option)?

- UK

### On what date will the policy be implemented?

- 2010

### Which organisation(s) will enforce the policy?

- TBD

### What is the total annual cost of enforcement for these organisations?

- £ TBC

### Does enforcement comply with Hampton principles?

- Yes

### Will implementation go beyond minimum EU requirements?

- No

### What is the value of the proposed offsetting measure per year?

- £ TBC

### What is the value of changes in greenhouse gas emissions?

- £ TBC

### Will the proposal have a significant impact on competition?

- Yes

### Annual cost (£-£) per organisation (excluding one-off)

<table>
<thead>
<tr>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>£ TBC</th>
<th>Decrease of</th>
<th>£ TBC</th>
<th>Net Impact</th>
<th>£ TBC</th>
</tr>
</thead>
</table>

**Key:**

- Annual costs and benefits: Constant Prices
- (Net) Present Value
### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Ban unsolicited limit increases</th>
<th>Description: Proposals for changes to practices around unsolicited limit increases on credit cards and store cards</th>
</tr>
</thead>
</table>

#### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off (Transition)</strong> Yrs</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Total Cost (PV)** £ TBC

Other key non-monetised costs by 'main affected groups'

- Industry – implementation costs associated with system changes and recalibration of decision models, potential reduction in interest income (transfer to cardholders);
- Consumers – potential costs where short-term over-borrowing on credit or store card could lead to default charges or declined transactions.

#### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off</strong> Yrs</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Total Benefit (PV)** £ TBC

Other key non-monetised benefits by 'main affected groups'

- Consumers – potential reduction in credit and store card balances, which might reduce interest costs (transfer from card providers); also, possible reduction in problems associated with over-indebtedness.

#### Key Assumptions/Sensitivities/Risks

- If credit limits do not make significant contribution to problems of over-indebtedness, no reduction in these problems for customers;
- If unsolicited increases are key to profitability, lenders may exit or seek to increase revenue from other sources (e.g. interest rates, fees, charges), also potential reduction in availability of credit (especially to high-risk borrowers).

#### Price Base

<table>
<thead>
<tr>
<th>Year</th>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Years</td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

- **What is the geographic coverage of the policy/option?** UK
- **On what date will the policy be implemented?** 2010
- **Which organisation(s) will enforce the policy?** TBD
- **What is the total annual cost of enforcement for these organisations?** £ TBC
- **Does enforcement comply with Hampton principles?** Yes
- **Will implementation go beyond minimum EU requirements?** No
- **What is the value of the proposed offsetting measure per year?** £ 0
- **What is the value of changes in greenhouse gas emissions?** £ 0
- **Will the proposal have a significant impact on competition?** No

<table>
<thead>
<tr>
<th>Annual cost (£-£) per organisation (excluding one-off)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
</tr>
<tr>
<td>£ TBC</td>
</tr>
</tbody>
</table>

- **Are any of these organisations exempt?** No

#### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>Decrease of</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ TBC</td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Key:**

- Annual costs and benefits: Constant Prices
- (Net) Present Value
### Summary: Analysis & Evidence

#### Policy Option: ‘Opt-in’ for unsolicited credit limit increases

**Description:** Proposals for changes to practices around unsolicited limit increases on credit cards and store cards

<table>
<thead>
<tr>
<th><strong>ANNUAL COSTS</strong></th>
<th>Description and scale of key monetised costs by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off (Transition)</strong></td>
<td>Yrs</td>
</tr>
<tr>
<td><strong>Average Annual Cost</strong> (excluding one-off)</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

Other key non-monetised costs by ‘main affected groups’

- Industry – minor implementation costs associated with system changes, potential reduction in interest income (transfer to cardholders)

<table>
<thead>
<tr>
<th><strong>ANNUAL BENEFITS</strong></th>
<th>Description and scale of key monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off</strong></td>
<td>Yrs</td>
</tr>
<tr>
<td><strong>Average Annual Benefit</strong> (excluding one-off)</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

Other key non-monetised benefits by ‘main affected groups’

- Consumers – potential reduction in credit and store card balances, which might reduce interest costs (transfer from card providers); also, possible reduction in problems associated with over-indebtedness

#### Key Assumptions/Sensitivities/Risks

If credit limits do not make significant contribution to problems of over-indebtedness, no reduction in these problems for customers; if unsolicited increases are key to profitability, lenders may exit or seek to increase revenue from other sources (e.g. interest rates, fees, charges), also potential reduction in availability of credit (especially to high-risk borrowers)

#### Price Base and Time Period

- **Net Benefit Range (NPV)**: £ TBC
- **NET BENEFIT (NPV Best estimate)**: £ TBC

<table>
<thead>
<tr>
<th><strong>Year</strong></th>
<th><strong>Time Period</strong></th>
<th><strong>Net Benefit Range (NPV)</strong></th>
<th><strong>NET BENEFIT (NPV Best estimate)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>What is the geographic coverage of the policy/option?</strong></td>
<td>UK</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>On what date will the policy be implemented?</strong></td>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Which organisation(s) will enforce the policy?</strong></td>
<td>TBD</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>What is the total annual cost of enforcement for these organisations?</strong></td>
<td>£ TBC</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Does enforcement comply with Hampton principles?</strong></td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Will implementation go beyond minimum EU requirements?</strong></td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>What is the value of the proposed offsetting measure per year?</strong></td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>What is the value of changes in greenhouse gas emissions?</strong></td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Will the proposal have a significant impact on competition?</strong></td>
<td>No</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Annual cost (£-£) per organisation</strong> (excluding one-off)</th>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

#### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th><strong>Increase of</strong></th>
<th>£ TBC</th>
<th><strong>Decrease of</strong></th>
<th>£ TBC</th>
<th><strong>Net Impact</strong></th>
<th>£ TBC</th>
</tr>
</thead>
</table>

**Key:**
- Annual costs and benefits: Constant Prices
- (Net) Present Value
Overview

211. A customer’s credit limit – the maximum they may borrow on a credit card – is initially set during the application process for the card. The limit is typically altered gradually as the consumer becomes better known to the issuer and taking account of any changes to their circumstances. Credit card companies argue that the flexibility to increase credit limits allows them to be more responsible in their lending, as this allows customers to demonstrate their financial capability before any increase in their credit limit is offered. Consumer groups argue that these limit increases, which are usually unsolicited, tempt consumers into more debt than they can manage.

212. Longstanding concerns have been raised in relation to unsolicited credit limit increases, following findings that such increases were associated with financial difficulty. Unsolicited limit increases are relatively common – latest survey evidence indicates that almost one-fifth of cardholders have received one in the last 12 months. Research suggests that credit limit increases result in increases in balances and the fact that consumers do not have to consent to such ‘offers’ could lead to higher credit limits than consumers would necessarily choose.

213. The Government is concerned that the practice of offering limit increases on an unsolicited basis does not give customers enough control over how much credit they should be able to access. Whilst lenders only offer higher limits to customers who appear to be able to afford it and are a ‘good’ credit risk, their information is imperfect and they may not be able to take account of all relevant information, or respond to a sudden change in a borrower’s circumstances. It is desirable, therefore, that borrowers also make their own assessment of the affordability of any new credit facility and their ability to repay.75

Background

214. The practice of increasing credit limits on credit cards without the express consent of the cardholder was raised as a potential issue in the second report of the Task Force on Over-indebtedness in 2003. The report found that the automatic raising of credit limits on credit and store cards was associated both with financial difficulties and high levels of spending on repayments of existing borrowing. The report also contained research which found this to be quite prevalent – 28% of those with a credit card and 10% of those with a store card had received an increase in their limit in the last 12 months, and in more than 90% of cases the increase was unsolicited.76

215. This issue was revisited in the first Treasury Select Committee report of the 2003-4 session and it was recommended that there should be a restriction on the absolute amount of any unsolicited credit limit increase.77 In the second report of the 2004-5 session, it was noted that APACS had incorporated a set of best practice guidelines into the Banking Code, but had decided against restrictions on unsolicited credit limit increases.78

216. Under current requirements in the Banking Code, lenders must provide notice to customers of any increase in their credit limit and are obliged to make an assessment of a customer’s ability to repay. Typical industry practice is to credit check all customers before offering a higher limit. Lenders must also explain clearly that customers can decline a limit

75 It should be noted that the Government does not propose to constrain lenders’ ability to unilaterally decrease a consumers’ credit limit. The right to reduce a customer’s limit without their consent – as long as this is done fairly and reasonably, within the bounds of existing consumer protection and equality rules – is critical to lenders’ ability to protect borrowers and themselves from problem debt and to advance their legitimate commercial interests.
76 Task force on tackling over-indebtedness, Second report (2002)
77 http://www.parliament.the-stationery-office.co.uk/pa/cm200304/cmselect/cmtreasy/125/125.pdf
78 http://www.parliament.the-stationery-office.co.uk/pa/cm200405/cmselect/cmtreasy/274/274.pdf
increase and ways in which they can do so. Consumers can choose not to use the new limit, and lenders argue that these provisions offer sufficient protection for those who want to control their access to credit, whilst leaving other customers with the flexibility to increase their spending (e.g. to deal with unforeseen emergencies) without applying to their bank for more credit.

217. These obligations will be placed on a statutory footing by the Consumer Credit Directive, which comes into force in June 2010. This will place a requirement on lenders to conduct creditworthiness checks (including consulting any relevant database) before offering a limit increase. The Directive will also require providers to give prospective borrowers an adequate explanation of the product before entering into an agreement. For credit and store cards, this is likely to mean in practice, as a minimum, that lenders must explain the amount of the initial credit limit, and how the credit limit may change over time.

218. In addition, the OFT’s draft irresponsible lending guidance – due to be finalised in early 2010 – identifies the following practices in relation to credit limit increases as likely to call into question a firm’s fitness to hold a consumer credit licence:

• Raising a borrower’s credit limit without notifying the borrower and/or without the borrower’s consent
• Failing to lower a borrower’s credit limit following receipt of a specific request from the borrower to do so
• Providing a borrower with a new or additional credit facility following receipt of a specific request from the borrower not to do so
• Failing to remove any such credit facility following receipt of a specific request from the borrower to do so.

219. The UK Cards Association, on behalf of the credit card industry, has recently proposed new best practice standards on unsolicited limit increases, to be enforced by the Lending Code Standards Board. These standards would commit lenders to:

• Provide customers with a clear and transparent written notification of an unsolicited limit increase by means of a specific communication;
• Make clear that consumers have the option to decline a new limit;
• Make clear that consumers have the option to notify their lender that they would actually prefer the credit limit to be reduced;
• Make it as convenient as possible for customers to advise their card provider of their preference;
• Fully assess whether a customer is likely to be able to manage a higher credit limit, with reference to all the information available to them;
• Not increase a borrower’s limit more than once every 6 months, and
• Ensure that staff are able to explain to customers why they have had their limit increased and the options available to them.

Issue

220. It is standard practice for credit and store card companies to grant their customers higher credit limits on an unsolicited basis; that is, without the customer having requested an increase. Limit increases are offered to all customers, but they are a key feature of “low and grow” lending to higher-risk customers. The risk of such customers defaulting is higher, so lenders can only justify very low initial limits – lenders indicate that this could be £250 for credit cards and around £150 for store cards. The lender will monitor the accounts during the first months of operation, and weed out those customers who represent a poor credit

79 Which will succeed the Banking Code Standards Board in November 2009
risk by leaving their limits very low, whilst successively increasing the limits of those who manage their accounts effectively. Usually it is made clear to customers that ‘good performance’ is rewarded with a higher limit.

221. The practice of unsolicited credit limit increases appears to remain relatively common – a Which? survey reported that 71% of cardholders received an unsolicited credit card limit increase. A recent survey of credit card holders by uSwitch revealed that unsolicited credit limit changes are still quite common – 22% of cardholders had the credit limit changed without their consent in the last 12 months, with the vast majority of these (19%) receiving an increase, for which the average increase was £1,538. In contrast, 13% of cardholders had actively applied for an increase in their credit limit, most of which (9%) were accepted.

222. However, the impact of these unsolicited increases is unclear. According to lenders, there is no direct link between customers receiving an unsolicited limit increase and getting into financial difficulties, such that they default on their loan. Card companies monitor customers who receive an unsolicited limit increase against control groups and generally find that risk of default does not increase when customers are given a higher limit. This is supported by analysis from the Australian credit card market, which suggests that default rates for credit card users accepting pre-approved credit limit increases are not significantly different than for all credit card users. Further, the vast majority of credit offered to individuals remains unused – the average share of credit limit used in 2008 was just over 27%.

223. Such increases, however, do tend to lead to more borrowing by consumers in absolute terms. A recent study in the US found that increases in credit limits generated an immediate and significant rise in debt – on average, 10-14% of any increase in the credit limit. This figure was larger for cardholders starting near their credit limit. This increase could lead to additional interest costs of up to £5.5m for that month.

224. Whilst individual unsolicited limit increases do not appear to directly lead people to borrow more than they can afford, consumer groups argue that they do encourage people to borrow more than they might rationally intend, with attendant debt servicing costs and consequences for the sustainability of their financial situation. With an unsolicited increase there is a greater risk that a consumer will spend on their card without giving due consideration to what it will cost them, how they intend to repay it or what they will do if they experience financial difficulties in the future. There is some limited support for this view from attitudinal survey evidence:

- 30% of respondents agreed with the statement, ‘Buying things on credit does not feel like spending’;
- 15% agreed with statement, ‘I am impulsive and tend to buy things even when I can’t really afford them’;

---

81 ‘Credit card providers throw £8.8 billion of unrequested credit at consumers’, 2 July 2009
82 Those accepting credit limit increases: 0.3% in 90 days default after 6 months; 0.5% in 90 days default after 15 months; average for all credit card users: 0.6% in 90-180 days default. It is unclear from this work precisely what is meant by “acceptance” – this implies an “opt-in” feature which differs from the UK position where unsolicited limit increases are generally automatically granted. (Source: ’Congratulations, you’re pre-approved’!, Consumer Action Law Centre, Aug 2008)
83 Aggregate outstanding balances on active accounts as a proportion of aggregate credit limits, according to Uk Cards Association estimates
84 [http://idei.fr/CORE/articles/gross_souleles.pdf](http://idei.fr/CORE/articles/gross_souleles.pdf)
85 Assuming an average credit card interest rate of 17.6% (Bank of England, 12-month average of July 2008-June 2009), an average limit increase of £1,500, that 19% of cardholders receive an unsolicited increase and that 31% of cardholders do not pay off their balance in full each month
86 Source: YouGov Debt Tracker
• 11% agreed with the statements, ‘If I want something, I am prepared to buy it on credit and think about how I will repay the money afterwards’, and ‘I would rather buy things on credit than save up’, and
• 6% agreed with the statement ‘If lenders offer me money I will take it’

225. Some consumers may be concerned about unsolicited limit increases, because if they are aware of their tendency towards buying on credit without due regard for the financial consequences, a fixed limit on their credit or store card may help guard against reckless spending. Consumer awareness of their credit limit appears to be quite strong – survey evidence from Australia indicates that 92% of credit card holders knew what their credit limit was.  

226. Consumer representatives have also queried whether lenders are genuinely making responsible lending decisions when offering higher limits. They argue that lenders frequently grant such increases even though there does not appear to have been a material improvement in a borrower’s circumstances.

227. It has also been suggested that some lenders may make it difficult for consumers to set their own limit at the outset, and despite Banking Code commitments to ensure consumers are aware that they can decline a limit offered, it is not clear that consumers understand or find it easy to exercise this right. Consumer groups have expressed concerns that some borrowers may be reluctant to decline a higher limit which is offered in case this affects their credit rating or is interpreted by lenders as a sign that they are worried about their ability to manage their finances. Industry argues that this is a misconception and that, if anything, having lower limits overall is likely to improve a consumer’s credit score, rather than impair it. However, if this perception is widely held among consumers it may discourage them from exercising greater control.

228. The lack of consumer control about the timing and scale of limit increases, alongside low financial capability and potential difficulties of rejecting an offered limit, could lead to higher credit limits than consumers would prefer. It has not been possible to determine or quantify the contribution of unsolicited credit card limit increases to a general increase in consumer indebtedness. Nevertheless, the ease of access associated with automatically-granted credit seems to offer greater scope for irresponsible borrowing than credit which consumers must actively apply for.

Rationale

229. Although lenders currently undertake precautions before offering higher credit limits to customers, through credit scoring and an assessment of their ability to repay, the information upon which they base their decision is imperfect. This could be due to something that the lender was not aware of before making the offer, or could result from a sudden change in a borrower’s financial circumstances. This could lead to unsolicited limit increases being offered to customers that would not have been made, had the lender had access to complete information about the borrower.

230. In addition, the nature of the unsolicited ‘offer’ made to consumers is that the increase will apply to their credit card account, unless they actively contact their lender to decline it. As the current ‘default’ for unsolicited credit limit increases is for consumers to accept them, it is possible that more customers currently ‘accept’ their credit limit increase than would prefer to do so, but do not take action to decline it.

231. FSA financial capability research suggests that consumers do not seek independent financial advice, and so may see credit extended to them by their bank as evidence that this is in their best interests, which may not necessarily be the case.

---

87 75% knew exactly and 17% roughly (source: ‘Financial stress and its impact’, Wesley Mission research (2006))
232. An additional bias in consumer behaviour that may be relevant in this context is self-control, where consumers have limited willpower leading, for example, to impulse purchases, which are later regretted. There is some support for its existence in relation to credit, suggesting that individuals have greater difficulty exercising self-control when borrowing is easier. This could be further supported by the empirical evidence mentioned earlier, showing that 15% of respondents agreed with the statement, ‘I am impulsive and tend to buy things even when I can’t really afford them’.

233. The existence of this behavioural bias implies that, for certain customers receiving an unsolicited limit increase, choosing not to utilise this higher limit is not likely to be sufficient protection.

234. Although it does not appear that unsolicited credit limit increases contribute towards an increase in the likelihood of default, we are seeking to gather evidence on the extent to which unsolicited limit increases are associated with financial difficulties and other customer characteristics (e.g. low income, low socio-economic group). If it seems as though such increases are associated with characteristics of more vulnerable consumers, then this could provide evidence in favour of intervention on equity grounds. This consultation will play a crucial part in collecting that evidence.

Options analysis

235. It is important that consumers are encouraged to take responsibility for actively managing their credit limits and that they are able to do so easily and from a position of complete information. However, caution must be taken to ensure that measures to promote greater consumer control of credit limits do not unduly constrain access to credit and store cards for consumers, who may look to more expensive and less suitable forms of credit as a result.

236. The options under consideration in relation to this policy area are:

1. Do nothing
2. Better information for consumers about unsolicited credit limit increases
3. Limits on the size and/or frequency of individual limit increases
4. Ban all unsolicited limit increases
5. Allow consumers to opt-in to receive unsolicited limit increases

Option 1: Do Nothing

237. Under this option, the problems set out above in relation to unsolicited credit limit increases will remain. It is likely that the provisions introduced through the Consumer Credit Directive (and potentially through OFT’s irresponsible lending guidance) will bring some additional clarity to this area for consumers.

238. As discussed above, implementation of the Consumer Credit Directive will require lenders to conduct creditworthiness checks before offering a limit increase, along with an adequate explanation of the product. For credit and store cards, this is likely to mean in practice, as a minimum, that lenders must explain the amount of the initial credit limit, and how the credit limit may change over time.

239. The industry best practice measures proposed by the UK Cards Association would go further than existing practice in a number of ways that seem to address some aspects of concern. For example, customers would receive a specific letter or leaflet informing them of a credit limit increase, rather than this being included on their monthly statement, as is the current practice, and customer attention would be explicitly drawn to their ability to reduce their credit limit as well as their ability to retain their existing limit.

---

\[88 \text{ This may arise from a set of consumer preferences in which the future is discounted heavily (such as hyperbolic discounting), and results in time-inconsistent preferences (i.e. making a future choice today, that they would not necessarily choose in the future)}\]
240. It is difficult to assess at this stage how much this will alter the balance of control over credit limits in favour of the consumer. Based on the current draft, the OFT’s final guidance (due to come into force early next year) and industry best practice guidelines (if they are agreed and enforced) may go some way to address public concerns regarding unsolicited limit increases, in particular concerns around the ease with which they are able to decline a new credit facility. The issuance of this guidance will inform policy development in this area.

**Option 2: Better information for consumers about unsolicited credit limit increases**

241. Improving transparency for consumers about the reasons for a credit limit increase and their options in accepting or declining this offer, as suggested in the proposed best practice guidelines set out above, could encourage more consumers to actively manage their credit limits.

242. As discussed under option 1, separate specific communication when a new limit is granted could help enhance consumer awareness – they may be more likely to focus on this information if it comes as a separate letter rather than alongside other information on their statement. This letter could also make clear to customers that declining a higher limit or choosing to reduce their limit will not have a negative impact on their credit record to address any potential misunderstanding. Making it more convenient for consumers to decline a limit or ask for their limit to be increased could be achieved through online banking services as well as by making it easier for people to contact their lender directly.

**Costs**

243. Provision of additional information to consumers – over and above that identified in relation to option 1 – could entail costs for lenders in generating and communicating this information to customers, especially if this is to be sent in a separate notification. There is also a risk that consumers may not read and/or understand the additional information provided (especially if they already receive a large amount of information, which risks information overload), or may continue to be reluctant to contact their lender to refuse a limit increase.

244. There are also likely to be ongoing costs to lenders in terms of explaining reasons for changes to customer credit limits – this would increase resource costs in terms of training and staff time, especially customer service staff.

**Benefits**

245. This approach could offer longer-term benefits by raising consumer awareness of how their credit limits are determined and could encourage consumers over time to take a more proactive approach to managing their limit. Increased consumer understanding of the process for determining credit limits could also give customers incentives to address any shortfall in information that might exist for providers in making their decision about an individual’s credit limit.

**Option 3: Limits on size and/or frequency of individual limit increases**

246. As part of the industry best practice proposals put forward by UK Cards Association, there would be a ban on increasing a customer’s credit limit more than once in a six-month period. However, discussions with industry suggest that the commitment to a minimum frequency of six months is unlikely to affect many consumers, as it would appear few currently have their limits increased more frequently than this.

247. If a longer time period were adopted, it might be desirable to also limit the size of any single limit increase to a maximum proportion of the existing credit facility, to mitigate any risk of lenders offering larger increases to compensate for the fact that they could offer them less frequently.
Costs

248. Under this option, lenders might entail some programming costs to amend their systems to set limits for particular cardholders. If there was a single limit across all cardholders, it is likely that these costs would be lower than if there were different constraints on limits able to be offered to different groups of cardholders.

249. This option would not give borrowers any greater direct responsibility for the decision to take on a larger credit limit. Consumer groups have also expressed concern about introducing credit constraints for consumers, if lenders also applied these limitations to consumer requests for higher limits as well as lender-initiated increases. This could limit consumers’ ability to request a higher limit if, for example, they were going on holiday or wanted to make a one-off large purchase. These credit constraints could lead to consumers seeking credit from elsewhere, possibly higher-cost sources, or unlicensed lenders.

Benefits

250. Under this option, the possibility for cardholders to borrow would be constrained, though this may be beneficial for those customers where they use a credit limit to deliberately constrain their spending. This could then lead to a reduction in problems associated with over-borrowing (e.g. stress-related health issues, absence from work, relationship breakdown).

251. A further advantage of this approach is that it would not represent a fundamental change to existing practice, so there would be little risk of a withdrawal of ‘low and grow’ lending to more marginal customers. It may be that measures of this sort could be further built upon to provide for additional consumer protection.

Option 4: Ban all unsolicited limit increases – increases only to be given in response to a specific consumer request

252. Under this option, consumers would only be granted access to additional credit if they make a positive request for a higher limit (and subject to credit assessment by the lender). The requirement to make such a request would mean that limits would only be likely to be increased where consumers had actively made a decision that they wished to be able to borrow more.

253. Under this option, lenders would be precluded from offering customers pre-approved limit increases but could promote the fact that customers can request a higher limit. Some consumers already proactively seek to increase their credit limit – according to the survey evidence above, 13% of cardholders applied for an increase in the last 12 months, with 9% of this 13% accepted.

Costs

254. Lenders argue that this approach would undermine lending to higher-risk customers, for whom a “low and grow” strategy would be much harder to successfully operate due to problems of adverse selection. According to lenders, consumers who actively request more credit are more likely to default than others, as demand for more credit may be a sign of financial difficulties that are not evident to the lender. This means that lenders are more likely to refuse increased limits to consumers who proactively request one – survey evidence above suggests that approval rates for such applications is approximately 70%. This compares to approval rates for credit and store card applications of typically 70-80%, based on survey evidence.89

255. Lenders have asserted that if they are unable to offer limit increases to existing as well as new customers, profitability would decline. They believe that they would make losses and would be forced to recoup this lost revenue (along with revenue lost on a reduction in new lending) from other sources, such as higher interest rates or increases in fees and charges.

89 Source: YouGov Debt Tracker
Some lenders whose business model relies more heavily on ‘low and grow’ custom have said that their profitability could be sufficiently compromised to force them to exit the market.

256. Lenders argue that this option could also have long-term implications for approaches to credit decisioning, as decision models would need to be recalibrated. This could limit the availability of credit to riskier consumers in the short to medium term, resulting in borrowers who are unable to access a credit or store card seeking more expensive forms of credit or even borrowing from unregulated lenders.

257. Although consumer groups support a ban on unsolicited limit increases, some have expressed concern that such action might prevent lenders from temporarily extending a consumer’s limit in response to short-term over-borrowing where a consumer has had to use their card in an emergency. In this circumstance, the consumer would be likely to incur a default charge or could have their transaction declined.

258. The cumulative impact of these refused transactions could be significant - in Australia, it was estimated that the potential reduction in consumption resulting from a ban on credit limit extensions could be around A$30bn per year (around £13.5bn). However, such risks could potentially be mitigated by implementing a ban in a way that allows some flexibility to deal with temporary short-term over-borrowing.

Benefits

259. Assuming that the link between increased credit limits and outstanding card balances holds, a ban on unsolicited limit increases may result in lower interest costs for consumers on their credit and store card balances. This would represent a transfer from credit and store card providers to consumers, with no net impact on the overall option.

260. Where unsolicited credit limit increases have contributed to problems of indebtedness, these would be avoided and consumers would have complete control over their borrowing limits.

Option 5: Allow consumers to opt-in to receive unsolicited limit increases

261. An alternative approach would be to give consumers the ability to ‘opt in’ to receiving unsolicited limit increases. Some consumer representatives have gone further, calling for a more flexible approach, whereby consumers would be granted a wider range of choices about how their limits will be managed and changed at the outset of their contract. For example, consumers could be granted the right to set their own limit at the outset (within the bounds of what lenders are prepared to lend).

262. If customers chose to receive unsolicited limit increases, they could also decide their frequency. Consumers could also, if desired, set a maximum limit beyond which they do not wish their credit line to ever be raised. These decisions could be taken at the time an agreement is entered into, but customers would be able to change the way their limits are determined during the life of the agreement if they choose.

Costs

263. This option would likely entail minimal implementation costs for lenders, as offering cardholders the potential to ‘opt in’ to receiving unsolicited credit limit increases would not be significantly onerous. It is likely that there would be some additional ongoing costs incurred through the offers made to customers, such as time for customer service staff and/or notification, though this could be one-off and potentially achieved at minimal cost through electronic means. However, ongoing costs associated with administering the accounts of consumers that chose not to ‘opt in’ would be similar to those for option 4.

264. A fully flexible approach would be likely to increase the complexity for both consumers and lenders, who would have to develop IT systems which could accommodate a wide range of possible permutations. For store cards, the fully flexible approach could lead to additional complications, as the application would be handled by the staff of the relevant retailer, who may lack the expertise to fully explain to prospective borrowers what their options are.

265. Under this option, consumers that ‘opt in’ would not have control over their credit limit. As credit and store card agreements can last decades in some cases, consumers will not be in a position to predict how their personal circumstances may change in future. Moreover, consumers might be concerned that expressing a reluctance to accept limit increases could limit their chances of future applications being approved. Indeed, consumers who are unwilling to accept limit increases on an unsolicited basis may well be less profitable for lenders and therefore more likely to be declined a card as a result.

**Benefits**

266. By allowing consumers to ‘opt in’ to receiving unsolicited limit increases, this could potentially address problems of cardholders receiving unwanted increases. Similarly to the previous option, this could reduce the outstanding balance for credit and store card holders, which would in turn reduce the amount of interest paid on borrowing.

267. In addition, this option could limit the extent to which consumers that use credit limits as a deliberate constraint on their spending having their limits increased and potentially increasing their indebtedness as a result. Where unsolicited credit limit increases have contributed to problems of indebtedness, these would be avoided and consumers would have complete control over their borrowing limits.

**Risks**

268. As set out above, there is a risk that any action to restrict provision of unsolicited credit card limit increases may have unintended consequences. For example, it might lead to more credit card accounts being introduced with inappropriately larger limits in some cases (possibly contributing towards the potential for increased indebtedness), or cut off access to credit for lower-income groups, who typically start with small limits and work up (‘low and grow’).

269. Card companies have also stated that if a ban was applied to existing as well as new customers, profitability would decline. This is because lenders will have set the price and terms of their contracts with existing customers in the expectation that they would be able to increase their limits over time if they were creditworthy and appeared likely to use a higher limit. If they are prevented from increasing limits for those customers, they will be unable to recover the expected value for that customer and will have effectively under-priced the card. This lost revenue, and revenue lost through an overall reduction in new lending would have to be recouped from other sources such as higher interest rates or fees and charges. Alternatively, some providers whose business model relies heavily on ‘low and grow’ might see their profitability so compromised that they chose to exit the market altogether.
What is the problem under consideration? Why is government intervention necessary?
Interest rates on credit cards are subject to change, which reflects their nature as unsecured products. A borrower’s interest rate can be affected by the costs of serving that individual customer or group of customers, where the risk of default has changed (resulting in ‘risk-based re-pricing’). Risk based re-pricing can result in an individual’s cost of credit falling, as well as rising, if their risk of default has fallen. Anecdotal evidence indicates that some consumers have been subject to significant increases in interest rates, apparently without sufficient explanation. Government is concerned that industry self-regulation may not have been effective in protecting consumers from unjustifiable interest rate rises on existing debt, and that risk-based re-pricing is not sufficiently transparent.

What are the policy objectives and the intended effects?
As set out above, the main objective of this review is to secure a better deal for consumers, giving them improved control of their credit and store card borrowing whilst also ensuring that regulation is proportionate and targeted.
In choosing the most appropriate policy option, we will be guided by their potential to contribute to achieving the outcomes outlined earlier.
Overall, intervention in this area should result in any re-pricing of existing debt being justified, proportionate and transparent.

What policy options have been considered? Please justify any preferred option.
Under this policy area, four options have been considered:
- Improve transparency of ‘risk-based’ decisions
- Define considerations for risk-based re-pricing
- Limit on size and/or frequency of re-pricing existing debt
- Ban on re-pricing of existing debt
All of these are compared against a ‘do nothing’ option, with no preferred option at this stage.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?
If further action is necessary, a post-implementation review would be undertaken after 3 or 5 years.

Ministerial Sign-off
For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister:

Keir Starmer

Date: October 2009
## Policy Option: Improve information about risk-based re-pricing

### Description:
Proposals for changes to practices around re-pricing of existing credit card and store card debt

### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off (Transition)</strong></td>
</tr>
<tr>
<td><strong>Yrs</strong></td>
</tr>
<tr>
<td><strong>£ TBC</strong></td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
</tr>
<tr>
<td><strong>£ TBC</strong></td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong></td>
</tr>
<tr>
<td><strong>£ TBC</strong></td>
</tr>
</tbody>
</table>

Other key non-monetised costs by 'main affected groups':
Industry – implementation and resource costs of producing necessary information, explaining it to customers and integrating into customer communication

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off</strong></td>
</tr>
<tr>
<td><strong>Yrs</strong></td>
</tr>
<tr>
<td><strong>£ TBC</strong></td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
</tr>
<tr>
<td><strong>£ TBC</strong></td>
</tr>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
</tr>
<tr>
<td><strong>£ TBC</strong></td>
</tr>
</tbody>
</table>

Other key non-monetised benefits by 'main affected groups':
If greater transparency induces changes in consumer behaviour, could exert greater competitive pressure on lenders to reduce prices

### Key Assumptions/Sensitivities/Risks

Increased consumer understanding may not lead to a change in customer behaviour, which would not alter competitive incentives for lenders (therefore no potential for reduction in prices)

### Price Base Year

<table>
<thead>
<tr>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>£ TBC</strong></td>
<td><strong>£ TBC</strong></td>
<td></td>
</tr>
</tbody>
</table>

- What is the geographic coverage of the policy/option? UK
- On what date will the policy be implemented? 2010
- Which organisation(s) will enforce the policy? Self-regulatory
- What is the total annual cost of enforcement for these organisations? £ TBC
- Does enforcement comply with Hampton principles? Yes
- Will implementation go beyond minimum EU requirements? No
- What is the value of the proposed offsetting measure per year? £ 0
- What is the value of changes in greenhouse gas emissions? £ 0
- Will the proposal have a significant impact on competition? No
- Annual cost (£–£) per organisation (excluding one-off) Micro Small Medium Large
- Are any of these organisations exempt? No No No No

### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>Decrease of</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ TBC</td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Key:**
Annual costs and benefits: Constant Prices (Net) Present Value
## Summary: Analysis & Evidence

**Policy Option:** Define considerations for risk-based re-pricing  
**Description:** Proposals for changes to practices around re-pricing of existing credit card and store card debt

### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition) Yrs</td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
</tr>
</tbody>
</table>

#### Costs

<table>
<thead>
<tr>
<th>Other key non-monetised costs by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry – potentially significant implementation costs associated with system changes</td>
</tr>
</tbody>
</table>

#### Benefits

<table>
<thead>
<tr>
<th>Other key non-monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumers – increase in certainty/predictability for cardholders around potential increases in interest rates, which could facilitate financial planning and household budgeting (possibly reducing the risk of over-indebtedness)</td>
</tr>
</tbody>
</table>

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off Yrs</td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
</tr>
</tbody>
</table>

#### Benefits

<table>
<thead>
<tr>
<th>Other key non-monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumers – increase in certainty/predictability for cardholders around potential increases in interest rates, which could facilitate financial planning and household budgeting (possibly reducing the risk of over-indebtedness)</td>
</tr>
</tbody>
</table>

### Key Assumptions/Sensitivities/Risks

Constraint on ability to change interest rates could reduce tolerance to risk – potential consequence could be reduction in availability of credit, particularly to vulnerable customers, or increases in initial interest rate across all borrowers

### Price Base

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>UK</td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>Self-regulatory</td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ TBC</td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ 0</td>
<td></td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ 0</td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Annual cost (£-£) per organisation (excluding one-off)</td>
<td>Micro</td>
<td>Small</td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

### Impact on Admin Burdens Baseline (2005 Prices)

<table>
<thead>
<tr>
<th>Increase of</th>
<th>Decrease of</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ TBC</td>
<td>£ TBC</td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Key:**  
Annual costs and benefits: Constant Prices  
(Net) Present Value
### Summary: Analysis & Evidence

| Policy Option: Limit size/frequency of re-pricing existing debt | Description: Proposals for changes to practices around re-pricing of existing credit card and store card debt |

#### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition) Yrs</td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong></td>
</tr>
</tbody>
</table>

Other key non-monetised costs by 'main affected groups'

Industry – potentially significant implementation costs associated with system changes, which could differ by individual customer account

#### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off Yrs</td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
</tr>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
</tr>
</tbody>
</table>

Other key non-monetised benefits by 'main affected groups'

Consumers – increase in certainty/predictability for cardholders around potential increases in interest rates

#### Key Assumptions/Sensitivities/Risks

Constraint on ability to change interest rates could reduce tolerance to risk – potential consequence could be reduction in availability of credit, particularly to vulnerable customers, or increases in initial interest rate across all borrowers

#### Price Base Year | Time Period Years | Net Benefit Range (NPV) £ TBC | NET BENEFIT (NPV Best estimate) £ TBC
--- | --- | --- | ---
What is the geographic coverage of the policy/option? | UK |
On what date will the policy be implemented? | 2010 |
Which organisation(s) will enforce the policy? | TBD |
What is the total annual cost of enforcement for these organisations? | £ TBC |
Does enforcement comply with Hampton principles? | Yes |
Will implementation go beyond minimum EU requirements? | No |
What is the value of the proposed offsetting measure per year? | £ 0 |
What is the value of changes in greenhouse gas emissions? | £ 0 |
Will the proposal have a significant impact on competition? | No |
Annual cost (£-£) per organisation (excluding one-off) | Micro | Small | Medium | Large |
Are any of these organisations exempt? | No | No | No | No |

#### Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

| Increase of | £ TBC | Decrease of | £ TBC | Net Impact | £ TBC |
--- | --- | --- | --- | --- | ---

Key:

- Annual costs and benefits: Constant Prices
- (Net) Present Value

---

62
### Policy Option: Prohibit re-pricing of existing debt

**Description:** Proposals for changes to practices around re-pricing of existing credit card and store card debt

### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Description</th>
<th>Key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ANNUAL COSTS</strong></td>
<td></td>
</tr>
<tr>
<td><strong>One-off (Transition) Yrs</strong></td>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong></td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Other key non-monetised costs by 'main affected groups':**
- Industry – major implementation costs associated with system changes, which could differ by individual customer account.
- Consumers – potential for increased customer confusion, as this could lead to multiplicity of interest rates.

<table>
<thead>
<tr>
<th>Description</th>
<th>Key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ANNUAL BENEFITS</strong></td>
<td></td>
</tr>
<tr>
<td><strong>One-off Yrs</strong></td>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
<td>£ TBC</td>
</tr>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
<td>£ TBC</td>
</tr>
</tbody>
</table>

**Other key non-monetised benefits by 'main affected groups':**
- Consumers – increase in certainty/predictability for cardholders around interest rates, which could facilitate financial planning or household budgeting.

#### Key Assumptions/Sensitivities/Risks

Removing ability to change interest rates would reduce tolerance to risk – potential consequences could be reduction in availability of credit, particularly to vulnerable customers, or increases in initial interest rate across all borrowers.

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV) £ TBC</th>
<th>NET BENEFIT (NPV Best estimate) £ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>UK</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>TBD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ TBC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual cost (£-£) per organisation (excluding one-off)</td>
<td>Micro</td>
<td>Small</td>
<td>Medium</td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)</th>
<th>£ TBC</th>
<th>£ TBC</th>
<th>£ TBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decrease of</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Key:**
- Annual costs and benefits: Constant Prices
- (Net) Present Value
Overview

270. Interest rates on credit cards are subject to change, which reflects their nature as unsecured products. This applies both to rates on future spending and, by the majority of lenders, for rates charged on existing balances. There are two main factors which could lead to a change in interest rates:

- changes in the cost to the lender of providing credit to all customers, which applies across a whole lending portfolio (such as changes in the cost of funds),\(^1\), and
- changes in the cost of serving an individual customer or group of customers, due to a change in the risk of default (resulting in “risk-based re-pricing”).\(^2\)

271. The way that lenders manage risk requires significant investment, and goes to the heart of how lenders try to secure a competitive advantage. The likelihood of an individual defaulting (measured by their credit score) is significantly influenced by customer behaviour – for example, previous defaults, how a credit limit is utilised, number of cash advances, and how other products by the same lender are used. Where behaviours are statistically associated with consumers not meeting their payments, lenders will assign a higher risk score to consumers who behave in a similar way.\(^3\)

272. Risk based re-pricing can result in an individual’s cost of credit falling, as well as rising, if their risk of default has fallen. Some lenders will periodically review information on the account performance of an individual, and decide whether an account should be re-priced (up or down). Other lenders will use a recognisable event as a trigger for a review, such as two late payments in the last 12 months.

273. Government is concerned that industry self-regulation may not have been effective in protecting consumers from unjustifiable interest rate rises on existing debt, and that risk-based re-pricing is not sufficiently transparent. Intervention in this area should result in any re-pricing of existing debt being justified, proportionate and transparent.

Background

274. There are many components that are reflected in an interest rate on credit and store cards. As set out in the Competition Commission’s report into store cards, these elements comprise: operating costs, insurance income, funding cost, costs for intangible assets and provisions for bad debt. The basis for ‘risk-based’ re-pricing would seem to imply an increase in the last of these components.

275. During 2008, it was reported that some consumers were being subject to significant increases in interest rates, apparently without sufficient explanation. Anecdotal evidence suggested that in extreme cases this resulted in a doubling of consumers’ interest rates with little prior warning, apparently due to risk-based re-pricing.

276. The Government took action to address these concerns by convening a credit card summit with lenders in November 2008. Following the summit, credit and store card providers produced a Statement of Fair Principles, which stated that they will:

- Give consumers at least 30 days notice of any increase in the interest rate paid on a credit card, if it is being changed as a result of risk-based re-pricing.

---

\(^1\) Some lenders only engage in this form of re-pricing
\(^2\) Risk-based re-pricing applies to most of the largest credit and store card providers, but not all
\(^3\) They can only observe an action, but do not necessarily know whether an individual genuinely poses an increased risk of default – their decision is based on the fact that consumers who have behaved this way in the past have been more likely to default.
• Give consumers the option to close their credit card account and repay the balance at the existing interest rate, within a reasonable period.

• Not increase a consumer’s interest rate for the first 12 months that a credit card is held; or more often than once every 6 months after that.

• Explain why an interest rate has been increased, if consumers ask.

• Offer an alternative product (if there is one available) at an equivalent or lower rate of interest.

277. The Statement of Fair Principles also undertakes that credit and store card lenders will not increase a borrower’s rate where:

• Consumers have failed to make the last two consecutive minimum monthly payments;

• Consumers have already agreed a repayment plan for the account; or

• The credit or store card company has been told by a not-for-profit debt agency that consumers are discussing a repayment plan with them.

278. All credit card and store card providers signed up to this Statement of Fair Principles, which were implemented from January 2009.94

279. Since the implementation of these principles, reports from the Financial Ombudsman Service (FOS) have indicated that the very worst examples of re-pricing of existing debt had been nipped in the bud, with the volume of complaints received by the FOS falling since January 2009. There is anecdotal evidence that rate rises are more limited in scale, with at least one lender introducing a moratorium on risk-based increases, which would suggest that the summit and Statement of Fair Principles put a ceiling on the worst behaviour.

280. However, evidence suggests that there is limited take-up of the option to close credit card accounts and repay balances at existing rates. The majority of borrowers who are subject to a re-price are choosing (albeit passively) to remain with their current lender and have their existing debt re-priced at a higher rate of interest. This could be due to the desire of borrowers to maintain their relationship with their credit card provider (and in the current economic climate, the concern that they would not get a more favourable deal from another provider).

281. The fact that borrowers have to make a positive choice to close their account may also have an impact on the low levels of take-up. As mentioned earlier, ‘status quo’ bias can lead to more consumers following a ‘default’ option (whatever that may be), even where this may not align with their preferences. This has been shown in a variety of contexts, from enrolment in a pension saving scheme95 to organ donation.96 Here, the ‘default’ option is for customers to have their borrowing re-priced, which may partially explain the low levels of take-up. Other individuals may be choosing not to opt out of their relationship with their existing provider, so that they can maintain their access to credit and pay off their balance, even if this is now at a higher interest rate. Moreover, in the current economic climate, some consumers may have a limited scope for switching to other credit products.

Issue

282. As discussed above, concerns were originally raised in respect of anecdotal evidence which suggested the prevalence of sudden and significant increases in interest rates on credit card borrowing that were also effective on a customer’s existing borrowing.

94 http://www.theukcardsassociation.org.uk/best_practices/-/page/681/
95 ‘For better or for worse: default effects and 401(k) savings behavior’, Choi, Laibson, Madrian & Metrick (2004)
283. The impact of changes in interest rates on the level of the repayments could be substantial. If we use as an example a loan for £1,856 at 18%, then a consumer making a regular monthly payment of £50 would pay a total of £771 in interest over 4 years and 4 months. If however, the interest rates were to increase to 33%, total repayments would increase to £2,840 over 7 years and 9 months. The impact of changes to interest rates can therefore result in significant increases in repayments. Consequently, it is important that customers are protected from unjustified increases.

284. Evidence suggests that such action could be an important source of revenue for credit and store card providers. Despite the differences between the UK and US credit card markets identified in Annex 3, evidence from the Joint Economic Committee estimates that approximately 15% of US profits on credit cards comes from changing the interest rate on existing balances.

285. Despite pressures on profitability from declines in other sources of revenue and rising costs, it is not acceptable for lenders to use risk-based re-pricing in order to compensate for these pressures, rather than in response to genuine changes in consumer risk. If customer interest rate increases are not explained adequately, this could give rise to the perception that re-pricing has in fact been driven by other factors than their own risk profile. Consumers with limited choices of credit products could therefore bear the brunt of lenders’ increased wholesale costs, giving rise to questions of equity and fairness.

286. The US CARD Act prohibits the re-pricing of existing debt, except in certain circumstances. These include the expiration of promotional rates, an increase in index for variable rate accounts, and default re-pricing. The latter marks a fundamental difference between the US and UK systems; in the UK the Statement of Fair Principles commits lenders not to raise rates whether the customer has missed two consecutive payments or is in financial difficulty. The opposite applies in the US, where customers in default are subject to risk-based re-pricing.

287. Furthermore, these price increases have been seen by consumers in the context of falling base rates and falling interest rates on other unsecured and secured credit products, as shown earlier. While consumers might be able to understand how changes in the base rate can impact on savings or mortgage products, it seems that interest rate increases on credit cards can be unpredictable and may not be well-explained. It has been suggested that consumers do not understand why they have been subject to a re-price and what they can do to improve their situation in order to reduce their interest rate. Consumer groups report incidences of re-pricing in the absence of an obvious increase in risk.

288. Anecdotal evidence suggests that some consumers are using their cards sub-optimally, acting on (possibly mistaken) assumptions of how lenders would view this behaviour. For example, we have heard of consumers who have been afraid to turn down an increase in their credit limit, in case it gave their lender the impression that they were in financial difficulty, and would lead to the lender re-pricing their existing debt at a higher rate as a result. Improving transparency about how a customer’s risk profile relates to their cost of credit could ensure consumers acted on more reasonable assumptions, and made better use of their cards as a result.

289. Further measures on transparency would need to be considered in the context of the amount of information currently provided by lenders to their customers. There is a tangible risk of information overload (identified earlier), which could increase customer confusion and would not improve consumer understanding.

97 Average outstanding credit card balance in 2007, according to APACS estimates
98 Average interest-bearing rate for credit cards in July 2009, according to Bank of England data
99 Source: Which? online credit card repayment calculator
100 $2.7 billion, out of profits of $18 billion
Rationale

290. Given that over three-quarters of credit card holders did not know what APR applied to their card, it could be argued that consumer awareness around interest rates is low, which indicates asymmetric information between lenders and borrowers. Changes to the relevant interest rate on a particular card that are not adequately understood by consumers – as suggested by the anecdotal evidence set out above – could then exploit (or potentially exacerbate) this lack of awareness.

291. A further argument for intervention is the potentially vulnerable nature of consumers that are subject to a re-pricing of their debts. If they are already in a difficult financial position, then it could be argued that intervention is justified on equity grounds.

Options analysis

292. A flexible pricing structure, where prices can be lowered as well as raised, is a particularly important feature of credit cards, as it provides for responsible lending decisions in relation to an open-ended unsecured product. Credit cards have balances that can fluctuate significantly from month to month, with repayment patterns that may be neither consistent nor predictable. The ability to modify certain aspects of a credit card agreement to accommodate changes over time, either to the economy or the creditworthiness of customers, is important.

293. It is recognised that restricting the ability of lenders to re-price loans in response to such changes could lead to significant consequences, such as a reduction in the availability of credit card lending or higher universal interest rates to compensate for any potential deterioration in borrowers’ risk.

294. This review proposes investigation of a number of potential policy options in this area:

1. Rely on the Statement of Principles
2. Provide consumers with better information about risk-based re-pricing decisions
3. Define considerations that it would be fair for lenders to take into account when changing an individual’s price on grounds of risk
4. Limit the size and/or frequency of existing debt re-pricing
5. Prohibit re-pricing of existing debt

Option 1: Rely on Statement of Principles

295. This option would continue the status quo, with lenders continuing to follow the Statement of Fair Principles. A key element of the consultation is to collect and assess evidence of how the Statement of Fair Principles has operated in its first year. This option would have the least impact on lenders, but also might not improve the current situation for consumers, insofar as transparency is concerned.

296. In order to evaluate whether industry self-regulation has been sufficiently effective, we will need to see evidence of how consumer detriment has been reduced as a result of its first year of operation.

Option 2: Provide consumers with better information about risk-based re-pricing decisions

297. The statement of principles currently provides that credit card companies will explain why an interest rate has been increased if a consumer requests. Taking into account issues around 'status quo' bias and evidence that suggests a lack of proactive consumers, a more effective way of increasing transparency might be to require credit card companies to provide an explanation to consumers alongside any notification of a rate increase.
298. One way of achieving this might be to provide a detailed explanation of how a re-priced individual’s cost of credit is calculated, perhaps breaking down the cost of credit into components relating to general re-pricing (applicable to all customers) and specific re-pricing (linked to an individual consumer’s risk). By setting out the factors which contribute to a lender’s assessment of individual risk, this would help consumers to understand why their price had gone up or down.

299. Alternatively, rate increases could be required to be explicitly linked to a change in a consumer’s circumstances (and for this to be explained to the consumer). Other measures might include a standardisation of how re-pricing is communicated to customers (along best practice lines), and ways to help customers behave in ways that would improve their future price.

Costs

300. This option might entail implementation costs for providers, in terms of meeting the provision of further information requirements. However, without further detail on the precise nature of these disclosures, it is difficult to estimate the overall cost of these measures.

301. Under this option, consumers would have to take action if they felt that they had received an unjustified increase in their interest rate. This may be more difficult for certain types of customer, such as those with low levels of financial capability, or those whose choice of credit products may be limited by current economic circumstances.

Benefits

302. An important benefit would be that consumers would have more information, putting them in a position from which they may be able to alter their behaviour to exert more competitive pressure on lenders to reduce price, when they have clearly demonstrated improved credit behaviour or personal circumstances. The perception that risk-based pricing is only a ‘one-way street’ would therefore be tackled. Lenders would also come under pressure to re-price only as a result of individual behaviour, as risk-based approaches (rather than re-pricing across all customers) which cannot make that clear link would be harder to explain.

Option 3: Define considerations that it would be fair for lenders to take into account when changing an individual's price on grounds of risk

303. Improvements in transparency would rely on individual consumers to switch lenders or seek redress if they feel that they have been subjected to an unjustified increase in their interest rate. An alternative approach may be to define the circumstances in which it would be considered fair to change an individual’s price on the grounds of risk.

304. This could provide greater clarity and certainty for both consumers and lenders, as a clear definition of the factors which lenders can legitimately take into account when changing a consumer’s price (on the basis of risk) would provide a clear benchmark against which FOS and consumer groups could assess complaints from individual consumers. Such a list of criteria would need to be developed in consultation with both lenders and consumers and be flexible enough to respond to developments in credit scoring and modelling techniques.

Costs

305. Constraints on a lender’s ability to re-price the debts of existing customers is likely to increase the risk on any given credit facility. This could result in the supply of credit to vulnerable consumers becoming prohibitively costly. This option could also result in a higher starting interest rate, given that the flexibility to re-price the balance of a particular customer would be curtailed.

306. Transparency around the reasons for re-pricing could also potentially result in customers being able to ‘game’ the system. That is, they could undertake activities that would possibly mask their ‘true’ underlying risk, making it unobservable to the lender. This could result in
inappropriate lending, or possibly a reluctance of lenders to offer credit in certain circumstances.

**Benefits**

307. Under this option, cardholders would have a greater degree of certainty about the factors that determine their interest rate. This could also give greater certainty to cardholders about any likely changes in their interest rate, which might make it easier to manage their borrowing and repayments, through facilitating financial planning for the future.

**Option 4: Limit the size and/or frequency of existing debt re-pricing**

308. There are already voluntary limits on the frequency of existing debt re-pricing contained in the statement of principles, set out above. This could be expanded (and possibly placed on a statutory basis) with a commitment that rate increases would be no more than a certain percentage more than the current rate (or subject to an absolute maximum rate) and/or increased more frequently than twice a year.

**Costs**

309. As for option 3, constraints on a lender’s ability to re-price the debts of existing customers could reduce the supply of credit, particularly to vulnerable consumers. This option could also result in a higher starting interest rate, given that the flexibility to re-price the balance of a particular customer would be curtailed.

310. In addition, restrictions on re-pricing could limit the potential benefits to consumers who might otherwise have seen their interest rates lowered as a result of risk-based re-pricing.

**Benefits**

311. This option would improve transparency and should make rate rises more predictable for consumers, helping them to better manage their borrowing. However, it may be more effective to ensure that any rate increases are objectively justifiable rather than potentially artificially capped at a specified ceiling, which could unduly constrain pricing decisions.

**Option 5: Prohibit re-pricing of existing debt**

312. A prohibition on the re-pricing of existing debt would follow what has been implemented in the US under the CARD Act. This could comprise a complete ban on any re-pricing of existing debt, or a more specific prohibition on risk-based re-pricing. Such intervention could be achieved by limiting the circumstances in which lenders could re-price existing debt to general movements in the cost of funds or base rates.

313. Under this option, borrowers would have certainty when they borrowed money on a credit card that their interest rate on that debt would not change. However, this would not prevent lenders charging different rates for new debt.

**Costs**

314. This option presents major systems implications for lenders and would entail significant costs in terms of changes to systems used for risk modelling and pricing.

315. Analysis from the US suggests that the revenue impacts of such a ban could be considerable – up to $2.7 billion per year in terms of lost interest.\(^{101}\) This would then take the form of a transfer to cardholders, which would produce no net impact for the proposal overall. However, lenders could seek to recoup this lost revenue through other means, such as a reduction in credit availability, reduction in available credit limits or an increase in interest rates, which could potentially apply across all customers. Simulation of these

\(^{101}\) Morrison Foerster (August 2008)
scenarios for the US market suggests that, for example, interest rates might increase by half a percentage point across all customers.

316. Additionally, this measure could lead to increased confusion for consumers: over time, consumers carrying balances for more than a year could become subject to several different rates, and providers would also be very likely to increase the starting interest rate across all customers. Lenders would face a variable risk profile, but would be constrained by a fixed income stream, so would logically charge more for initial borrowing. If this were combined with measures to reverse the way payments are currently allocated, the availability of cheap introductory offers may be severely limited.

317. As in the previous option, the availability of credit to high-risk customers is likely to be severely curtailed, leading them to seek alternative, possibly more detrimental, forms of borrowing. This could result from the provision of lower credit limits, as if lenders do not know the risks associated with a particular borrower, they would be reluctant to grant them a significant amount of credit.

Benefits

318. As discussed above, there would be benefits to cardholders in terms of certainty around exactly how much they would have to repay on their credit and store card borrowing. This should make financial planning easier and improve their ability to manage their borrowing.

Risks

319. As set out earlier, the ability to price flexibly, according to risk of borrower, is a fundamental feature of credit card lending. If the possibility of changing the price offered to consumers is removed, or constrained in some way, this could lead to significant reductions in the availability of credit, particularly for the highest-risk customers.

320. In addition, removing or constraining the scope for changing interest rates could substantially reduce the profitability of credit and store card lending. This could lead to some providers being forced to exit the market, or changes to raise revenue from other aspects of card lending to compensate – e.g. increases in the interest rate offered to all cardholders, the introduction or increase in fees and charges associated with credit card use.

321. It is difficult to quantify the impact of such changes. However, in 2007 PwC estimated that forthcoming anticipated regulatory intervention could lead to costs for industry of £1 billion, which would result in either an increase in credit card interest rates of 2 percentage points or an universal annual fee of £15.  

---

Comparison of options:
Outcomes are classified as having a positive (+) or negative (-) effect in each case

<table>
<thead>
<tr>
<th>Policy area</th>
<th>Options</th>
<th>Income</th>
<th>Cost</th>
<th>Customer</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Allocation of payments</strong></td>
<td>Greater information transparency</td>
<td>Unlikely to have material impact</td>
<td>Industry would incur new operating costs (+)</td>
<td>Raise understanding of product features</td>
</tr>
<tr>
<td></td>
<td>Allocate payments on a pro rata basis</td>
<td>Significant source of existing income likely to be removed (-)</td>
<td>Changes to order of payments will require fundamental changes to core card processing systems (+ + +)</td>
<td>May lead to withdrawal of cash option (-); likely withdrawal of many promo balance transfer offers (-)</td>
</tr>
<tr>
<td></td>
<td>Highest interest rate first</td>
<td>Material income stream would be removed with immediate effect (- - -)</td>
<td></td>
<td>Reduce financial stress for vulnerable cash users (+)</td>
</tr>
<tr>
<td></td>
<td>Cash advance first</td>
<td>Significant income reduction (- -)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Minimum payments</strong></td>
<td>Improve information transparency</td>
<td>Some reduction in interest income likely (-)</td>
<td>Industry would incur new operating costs (+)</td>
<td>May help budgeting (+)</td>
</tr>
<tr>
<td></td>
<td>Set recommended minimum payment</td>
<td>Likely to raise overall repayments rate significantly and thereby reduce interest income (-)</td>
<td>Would require major systems changes and customer explanations (+ +)</td>
<td>Likely considerably higher payments, stress vulnerable (-); new concept may confuse (-)</td>
</tr>
<tr>
<td></td>
<td>Increase minimum payment</td>
<td>Some reduction in interest income likely as overall repayment level increases (-)</td>
<td>Likely increase risk costs as stressed customers default (+)</td>
<td>Increase financial stress, particularly on multiple card holders (+); reduced product flexibility to match cashflow (+)</td>
</tr>
<tr>
<td><strong>Unsolicited credit limit increases</strong></td>
<td>Improve consumer information</td>
<td></td>
<td>Industry would incur new operating costs (+)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ban unsolicited credit limit increases</td>
<td>Significant income reduction as levels of spending and borrowing are effectively constrained (- - -)</td>
<td></td>
<td>Reduces ability to evolve product as consumer situation changes (-); 'low and grow' segment at risk (-)</td>
</tr>
<tr>
<td></td>
<td>Opt-in to receiving unsolicited credit limit increases</td>
<td>Likely to have significant impact on income as above (- -)</td>
<td>Higher negative select among customers seeking limit increases may raise impairment costs (-)</td>
<td>Potential confusion when new limit offered but consumer does not opt in but uses card – may incur fees</td>
</tr>
<tr>
<td></td>
<td>Limit size and/or frequency of limit increases</td>
<td>Some reduction in interest income likely as growth in limits is slowed (-)</td>
<td></td>
<td>Opt-out increases transparency benefit (+)</td>
</tr>
<tr>
<td><strong>Re-pricing of existing debt</strong></td>
<td>Increase transparency of re-pricing decisions</td>
<td>Higher propensity for customers to switch (-)</td>
<td>New costs from increased communication (+)</td>
<td>Improved understanding and awareness (+)</td>
</tr>
<tr>
<td></td>
<td>Define considerations for lenders to undertake risk-based re-pricing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Limit size and frequency of existing re-pricing</td>
<td>Constrain ability to raise margin for higher-risk customers (- -)</td>
<td>No specific impact</td>
<td>Likely to increase sense of control</td>
</tr>
<tr>
<td></td>
<td>Prohibit re-pricing of existing debt</td>
<td>Remove ability to raise margin on higher risk customers (- - -)</td>
<td>Potentially systems changes to decouple new and old price level (+ +)</td>
<td>Introduces new product complexity; high risk of confusion owing to multiple price points for debt (- -)</td>
</tr>
</tbody>
</table>
Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

<table>
<thead>
<tr>
<th>Type of testing undertaken</th>
<th>Results in Evidence Base?</th>
<th>Results annexed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competition Assessment</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Small Firms Impact Test</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Legal Aid</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Sustainable Development</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Carbon Assessment</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Other Environment</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Health Impact Assessment</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Race Equality</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Disability Equality</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Gender Equality</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Human Rights</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Rural Proofing</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
Annex 1: Sources of revenue for credit and store card providers

322. The primary sources of income for credit and store card issuers includes some or all of the following:

- Interest income
- Interchange fees
- Default/penalty fees
- Card-related insurance income – e.g. payment, purchase, price and card protection insurance where relevant

323. Profits on credit and store cards are generally derived by subtracting the interest expenses incurred on the sources of funds (e.g. savings deposits for banks, wholesale funding for monoline providers) that they use to make loans, from the interest revenues they earn on those loans. The difference between interest revenues and their interest expenses represents their net interest income.

324. Revenues from non-interest sources, such as fees, are added to its net interest income and then all other expenses, including amounts owed on loans that now appear uncollectible (write-offs) and the expenses of operating the bank, including staff salaries and marketing expenses, are subtracted.

325. Bad debt is a strong determinant of profitability, which can change throughout the economic cycle. Analysis of profitability among major high-street UK banks, as part of the Cruickshank Report in 2000, found that much of the variation in profits over the preceding 10 years could be attributed to bad debts. The Competition Commission’s market investigation into store cards found that, on average, costs associated with bad debts accounted for 20% of store card operator costs.

326. There have been increases over the last 12 months or so in the provision for bad debts – particularly for credit cards, as shown in the chart below. This has been further supported by recent forecasts by the IMF, which suggest that such losses are likely to increase in the future – possibly to as much as $174 billion across the EU.

---

103 This income represents the value of premiums collected from cardholders net of payments to insurance underwriters
Revenue composition

327. Evidence from the US indicates that the majority of credit card issuer revenues (around 70% in 2003-2005) came from interest charges, with an increasing portion attributable to penalty interest rates. Of the remaining issuer revenues, penalty charges/fees were estimated to account for around 10% and the rest from interchange fees and other types of consumer fees.

328. Although we do not have access to comparable figures for the UK, data on operating profits from 2002 indicates that, out of a total of €2.8 billion operating profit for credit card providers, the vast majority (nearly 80%) is accounted for by interest charges, with the remainder made up of fees.  

329. Very few card providers report solely on their credit card issuing business, which makes it difficult to ascertain the relative importance of the various income sources, but Barclaycard is one of the few that does. According to the Barclays 2008 annual report, interest income accounted for 55% of total income for Barclaycard, 40% from fee and commission income, 2.5% from transaction-based income (likely to be primarily interchange fees) and 1% from insurance income, with the rest coming from other sources.

330. Data collected by the Competition Commission during its investigation into store cards in 2006 found that the composition of revenue (based on 2004 data) was: 67% accounted for by interest income; 17% by insurance income; 12% by late payment fees and charges, and 4% by other income.

331. The importance of interest income as a source of profit means that UK issuers are particularly sensitive to the size of account balances and relies heavily on those cardholders who do not pay off their balance in full each month (also known as ‘revolvers’).

Influence of different delivery models

332. As an unsecured lending product segment, credit cards are an important source of revenue for bank providers – the OFT market study into personal current accounts found that credit cards account for 13% of retail banking revenues. However, credit cards are also an important payment instrument and these revenues (and subsequent profits, as identified above) tend to be used as a cross-subsidy for other payment products, as shown in the chart below.

Chart: Estimated aggregate UK operating profit across different payment instruments, 2002


---

333. Analysis from the Cruickshank report indicated that such revenues could be vulnerable to entry by non-bank providers, as consumers did not tend to shop around for additional financial products, instead selecting them from a bank, with which they already had a relationship. This is supported by earlier survey evidence, which shows that the majority of consumers had not shopped around when choosing their most recent credit card, basing their choice mainly on a recommendation by their bank. In the Cruickshank report, it was concluded that this lack of shopping around meant that banks were able to sustain higher prices for products than non-banks.

334. Other non-bank credit and store card providers – who do not therefore offer such payment services, also known as ‘monoline’ providers – can therefore enter the card issuing market and compete for these profits. Evidence from the UK market suggests that such providers have captured a significant share of the credit card issuing business, reducing the amount available for banks, along with the less profitable remainder of the payments business.

335. It is difficult to evaluate the extent to which UK card lender profits derived from interest income has been reduced through entry, primarily of non-bank providers, as so few report their credit card business separately. However, anecdotal evidence and industry intelligence would suggest that it has.

Interchange fees

336. Every card transaction involves a customer (or cardholder) and a retailer, along with their respective banks (known as the ‘issuing’ bank and ‘acquiring’ bank respectively). Interchange fees are collected by issuing banks when they send payments for purchases to acquiring banks, as a cost of providing the payment network service. As this payment network entails costs but benefits both the merchant and the buyer, it must price its service such that the two sides participate in the network.

**Figure: A four-party transaction**

337. It does this by setting interchange fees at levels that will maintain balance in the incentive structures of issuing banks (banks that issue credit cards) and acquiring banks (banks that service merchants and process their credit card transactions). The precise level of interchange fees is unknown, but the Cruickshank Report in 2000 noted that the average Mastercard interchange fee was 1.1% of the transaction value. More recent evidence suggests that this may have fallen to 0.79%.

---

105 Card associations, such as Visa or Mastercard, assess and set the amount of these fees.

338. This fall in interchange fees has coincided with a series of regulatory interventions – the OFT is investigating both Visa’s and MasterCard’s current methods of setting interchange fees applicable to domestic transactions; cross-border interchange fees are also coming under scrutiny from the European Commission. The timing of any final resolution by the Commission or OFT is uncertain, but it is likely that any action would result in interchange fees being reduced.

339. Although this seems a small proportion, given the significant level of transaction volumes and values associated with credit cards (in particular), this can amount to a large overall revenue stream. For example, it is estimated that in 2004, interchange fees were a source of $25 billion in revenue for card issuers in the US. Using aggregate transaction values for credit cards in 2008 (just over £100 billion) and the interchange fee levels above, this would imply that revenue from interchange could be between £800 million and £1 billion annually.

340. However, the pricing structure of interchange fees is complex, depending on the card association, the type and size of merchant, the type of card, and the type of transaction. Higher interchange fees tend to be associated with merchants that sell high-margin items (e.g. hotels, car rentals), premium credit cards that offer more rewards and telephone or Internet-based transactions (to compensate for the greater risk of fraud associated with transactions that are not conducted in person).

341. According to Professor AJ Levitin, ‘because interchange is based on transaction volume, it creates an incentive for banks to issue as many cards as possible, regardless of the creditworthiness of the borrower. By creating a huge revenue stream unrelated to credit risk, interchange encourages card issuers to engage in reckless lending’. In particular, for those customers who pay off their bill in full every month, credit card issuers will not make a significant amount of money from late fees and interest charges and instead make money on the interchange fees generated by their transactions.

Penalty fees

342. A penalty fee may be payable for not meeting the requisite payments under the terms of a contract. There is, however, some debate as to whether or not such charges should be entirely cost-based or induce some element of deterrence.

343. It has also been argued that card issuers may have been overly aggressive in their assessment of penalty fees. Some recent research estimated that, despite action by OFT to reduce credit card default charges below £12, revenue from penalty fees amounted to £213 million last year. It was estimated that one in five cardholders had incurred a penalty fee, with 5.7 million customers incurring more than three charges.

344. The Financial Ombudsman Service report that they have continued to receive a steady stream of complaints about default charges. Such penalty fees could significantly increase the costs of using cards for some consumers.

345. In a statement made in April 2006, the OFT indicated that it considered the principles outlined in relation to credit card default charges to also apply to default charges in other standard agreements with consumers, including those relating to store cards.

346. This could considerably reduce the revenue earned from store cards too, also rendering them less profitable. Therefore, issuers will be faced with the option of attempting to earn

---

107 The Commission issued a decision notice in December 2007, stating that MasterCard’s cross-border interchange fees are in breach of European competition law. MasterCard has appealed this decision, and a similar decision is expected in relation to Visa’s cross-border interchange fees

108 Georgetown University Law Center


110 Applied by credit card companies where a customer pays late or misses a payment, and sometimes where a customer exceeds the credit limit on their card
the lost revenue in other areas, such as annual fees or higher interest rates, or to face lower levels of profitability.

347. The main problem with raising interest rates is that store cards tend to carry high interest rates already, and issuers are likely to be hesitant about increasing them still further. On the other hand, the introduction of an annual fee would make store cards immediately less attractive to potential cardholders.

Other fees

348. In addition to penalty fees and interchange fees, the remaining non-interest revenues for card issuers include fees such as annual fees, cash advance fees, balance transfer fees, and other fees from their cardholders. According to estimates by industry analysts in the US, such revenues represent 8-9% of total issuer revenues.

Insurance income

349. Insurance income has been strongly affected by the recent Competition Commission market investigation into the supply of Payment Protection Insurance (PPI). This includes PPI on credit cards and concluded that lenders have an unfair advantage selling PPI with credit products, resulting in an uncompetitive market where consumers are overcharged. From 2010, banks or retailers making a loan or credit offer must wait a week before they can sell PPI to the borrower.

350. The Competition Commission concluded that the credit card sector does not appear to have been as reliant on income from PPI in recent years. PPI penetration has historically been lower and income from PPI generally less significant than, for example, personal loans. The value of PPI sold in relation to credit cards has declined from £970m in 2006 to £801m in 2007 and the prevalence of credit card PPI has also declined steadily over recent years, as shown in the table below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Penetration rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>33</td>
</tr>
<tr>
<td>2003</td>
<td>39</td>
</tr>
<tr>
<td>2004</td>
<td>31</td>
</tr>
<tr>
<td>2005</td>
<td>26</td>
</tr>
<tr>
<td>2006</td>
<td>22</td>
</tr>
<tr>
<td>2007</td>
<td>21</td>
</tr>
<tr>
<td>2008*</td>
<td>21</td>
</tr>
</tbody>
</table>

* - 2008 figures for first six months only

Source: Competition Commission (2008)

---

111 Based on Gross Written premium – the amount of money paid by customers, net of insurance premium tax – which is used by underwriters and distributors to assess scale of business

112 For 2007, this represented around 13% of credit card business
351. Although PPI income has fallen, this is a relatively immaterial income stream in the credit card market. There was little movement in PPI income related to credit cards between 2003 and 2007 and on average, such income made up only 11 per cent of total net income. The CC noted that credit card providers have greater reliance on income through interchange fees, product fees and other charges, such as late payment charges. This additional income was estimated at £2.5 billion in 2006, in addition to net interest income, which was estimated to be £3.3 billion. Evidence on net interest margins and provision rates for the UK credit card market as a whole for 2006 was 12% and 7% respectively.

352. It is difficult to estimate the impact of these changes on PPI income, but some credit card providers claimed that they do not believe a viable return is achievable without PPI income and would have to consider their continued participation in the market. However, none of the parties said that their credit card business would have been loss-making without PPI revenues. Nor did the CC find evidence of this from documents provided, such as board papers, strategy documents and management accounts.

353. Another potential impact would be on availability of credit. Submissions to the CC investigation commented that PPI income was an important aspect affecting the viability of the supply of credit to high-risk customer segments, including for credit cards. For credit cards, the CC found that consumers with PPI were more likely to go into arrears or default on repayments than non-PPI customers, with the value of protected credit card balances being written off approximately twice as high as the value of unprotected credit card balances written off. 113 A common theme among respondents to the CC inquiry was that a reduction in PPI income would affect higher-risk credit customers more than those with lower credit risk.

Overall profitability

354. Despite the higher rate of losses associated with cards, the US Government Accountability Office concluded recently that credit card lending generally was the most profitable type of consumer lending in the US, due to the high interest rates that issuers charge and variable rate pricing. 114

355. As part of their PPI investigation, the CC looked at the underlying profitability of credit cards, which suggested that the market as a whole (excluding PPI income) was profitable between 2004 and 2008, with return on equity (RoE) dropping slightly over this period, from 35% to 25%.

356. However, the CC acknowledged that, although aggregate profitability in the credit card sector was positive, this did not preclude the fact that some firms may have made economic losses during that period. This was shown by one lender’s estimates of the profitability for its credit card businesses in 2002-7, which indicated declining returns on capital over the period. During this time, its returns had barely achieved its cost of capital in 2002-5 and it had made economic losses in 2006 and 2007. 115

357. Submissions to the CC investigation agreed that the credit card sector had in aggregate been profitable over the last five years before taking into account PPI income, but said that profitability had not been universal across all firms or time periods. It was suggested that the credit card market – similarly to that for personal loans – was split into two distinct sub-markets:

- the ‘captive’ market, i.e. those lenders with existing relationships with current account customers, and

---

113 This result was robust to controls for the difference in risk already observed, captured in credit risk scores
114 ‘Credit cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers’ (2006)
115 It was noted by the CC that these conclusions were sensitive to the method of capital attribution used (i.e. Basel I or Basel II)

78
• the ‘open’ market, i.e. all other lenders (without relationships with current account customers).

358. In terms of these distinct groups, it was submitted that ‘open’ market lenders made significantly lower profits than ‘captive’ market lenders, due to higher marketing costs, lower margins and lower quality of available risk data on borrowers. Separate industry estimates of profitability in 2007 were 0.5% return on assets, which was said to be barely above break-even. However, it was suggested that ‘open’ market players were significantly below this average.

359. Overall, the CC found that impairment costs for bad debt was the single most important factor impacting on credit card profitability between 2003 and 2007 – they more than doubled, from £1.5 billion to £3.1 billion. Funding costs also increased during the period (by 76%), but outstanding balances only increased by 18%. This was the main driver in the decline in net interest margin over the period (from 67% to 54%).

Waterbed effects

360. As identified in the earlier option analysis under the different policy areas, lenders have said that regulatory intervention that further constrain the profitability of credit or store card lending could result in changes to certain features of card lending, such as fees, charges and interest rates. This has been observed in practice for US card issuers following the recent introduction of the CARD Act and this has also been seen in relation to some UK issuers, who have begun to introduce fees for certain activities (e.g. not using your card, known as ‘dormancy’ fees) or increasing existing fees and charges.

361. Academic research has characterised such activities as evidence of a ‘waterbed effect’ – where pressing down on one part of the ‘bed’ causes another part to rise. This was first identified in relation to price regulation of multi-product firms, but could equally apply to different aspects of a single product with many features, such as a credit or store card.

362. It is difficult to estimate what the potential impact of introducing some of the measures outlined in relation to these 4 policy areas. However, previous work by PwC in relation to credit card regulation suggested that, if regulatory action were to impose costs on industry of £1 billion, this would result in an increase in credit card interest rates of 2 percentage points or the introduction of an universal fee of £15 for cardholders. Similar claims about waterbed effects were also made in relation to the OFT’s investigations into default fees for credit cards and unauthorised overdraft charges.

363. As part of its investigation into PPI, the CC asked lenders for evidence on the possible scale of waterbed effects on credit prices, if PPI income were to decrease. The majority of lenders said that they would respond to a large loss of PPI income by raising interest rates, by increasing credit score cut-offs or some combination of the two. In relation to credit cards, in order to offset the potential loss of PPI income, interest rates would have to rise by around 4 percentage points.

364. The existence of this waterbed effect implies that beneficial regulation that creates costs can lead to increases of other prices can cause losses that might even offset the benefits of regulation. This can be particularly problematic if the populations targeted by the regulation are different from those impacted by the subsequent changes unintentionally brought about by the regulation.

---

116 As they tended to attract more price-sensitive customers
Annex 2: Credit and store cards – background

Credit card use and holding

365. Overall, there were around 1.6 billion credit card transactions in 2008, for a value of just over £100 billion. As can be seen from the chart below, the use of credit cards has increased significantly over the last 10 years, with the number of transactions increasing by half, along with a doubling in the value of those transactions.

![Credit card usage, 1998-2008](image1)

Source: UK Cards Association

366. Survey data suggests that credit cards are now the most popular unsecured credit instrument. The number of adults holding a credit card has declined to just over 30 million in 2008, from a peak of well over 31 million in 2005. Since 2005, cardholding has fallen across most socio-economic groups – with the biggest fall for those in socio-economic groups D and E – but has increased for adults in groups A and B. This suggests a move amongst issuers towards higher net-worth consumers.

367. There has been a steady rise in the number of cardholders who regularly (i.e. at least once per month) use their credit cards to make purchases, rising from 19.7 million in 2007 to 20.5 million in 2008.

![Regular users of credit cards, 1998-2008](image2)

Source: UK Cards Association

368. In 1989, 39% of households had a credit card, with 13% having two or more. By 2002, the proportion of card-holding households had increased to 52% and the proportion with two or
more to 21%. In 2008, this had increased to 62% of all households and the proportion with two or more cards had risen to 24%.

369. However, credit card holding differs significantly across types of consumers. Overall, the average number of credit (and charge) cards per person was 2.3 in 2008; however, the average number of cards for those in socio-economic group AB was 2.7, while those in groups D and E had an average of 1.9 and 1.4 cards respectively. In terms of multiple cardholding, around 70% of cardholders in group AB had more than one card, but this figure was much lower (around 33%) for those in group E. There is less variation in terms of cardholding by age group – cardholding was 66% for those aged 25-34, rising to 76% for those aged 55-64.

370. Balance transfers are an important feature of credit card lending, having been introduced in 2000. They reached a peak of popularity in 2004, with 12.6 million transfers and a total value of £21.3 billion. Since then, however, activity has declined – in 2008, the number of transfers was down to 7.8 million, totalling £14.4 billion.

![Balance transfers, 2001-2008](source: British Bankers’ Association)

371. A survey towards the end of 2008 showed an increase the proportion of credit card holders who were intending to switch their existing balance onto a new card. However, research indicates that credit card firms have been withdrawing 0% balance transfer deals over the last 12 months – as of November 2008, there were around 97 balance transfer deals (of at least 10 months’ duration) available, compared to 103 in October 2007. The average period of an introductory offer has fallen from 10.1 to 9.5 months. This could result in many consumers being disappointed, as more recent research suggests, which finds that around 10% of credit card applications have been declined in the past year, with 57% of those being for a balance transfer.

---

121 [http://www.bankingtimes.co.uk/07112008-credit-card-balance-transfer-offers-decline/](http://www.bankingtimes.co.uk/07112008-credit-card-balance-transfer-offers-decline/)
Credit card lending

372. According to Bank of England data, gross lending on credit cards has increased steadily, from just under £3 billion per month in 1993 (earliest data available), peaking at nearly £11.5 billion per month in early 2005 and now stands at just over £10 billion per month.

![Monthly average gross credit card lending, 1993-2009](source: Bank of England)

Repayments

373. Repayment data is only available from late 1997 onwards, but has followed a similar upward trend – starting at around £5 billion per month, rising to an average of over £10 billion per month in 2004. However, since the beginning of 2009, aggregate monthly repayments have been below £10 billion. Nevertheless, repayments as a proportion of gross lending have increased from around 87% in 1999 to a peak of 97% in 2006. This figure fell to 95% in 2008, but has increased to 96% in 2009 to date.

![Average monthly repayment and repayment-lending ratio for credit cards, 1998-2009](source: Bank of England)

374. However, this aggregate picture masks a more complex picture at the level of individual cardholders. According to data from UK Cards Association, 60% of cardholders paid off their balance in full every month, and 9% did so in most months. Around 12% of cardholders paid off only the minimum balance on at least one of their cards.\(^{123}\) This varied

---

\(^{123}\) Although this includes those taking advantage of promotional offers
substantially according to socio-economic group, with 80% of those in group AB repaid their credit card balance every month or most months, but this fell to 56% for those in groups D and E. In terms of age, those cardholders aged 25-34 were least likely to pay off their balance in full every or most months, with 50% doing so last year.

**Net lending**

375. Credit card net lending has increased steadily since 1993, from an average of £50 million per month to over £1billion in one month in early 2004. During this time, annual average growth rates for net credit card lending increased from around 10% to 25% (in 1998) – this could be due to a lag in repayments on credit card lending and/or low levels of write-offs. As Bank of England data on repayments is not available prior to 1997, it is difficult to be sure which of these potential explanations is more valid; however, write-offs on credit card lending was fairly stable until 1999 (see below), which might give weight to this explanation.

![Average monthly net credit card lending & average monthly growth rate, 1993-2009](source: Bank of England)

376. Net lending for credit cards peaked, along with gross lending, in 2004. Since then, credit card lending flows declined, falling to a monthly average of £170 million in 2007. This period saw a slight decline in gross lending, a steady level of repayments (with averages consistently in excess of £10 billion per month) and continued rise in write-offs, that saw average monthly write-offs double from under £400 million to almost £800 million (see below).

377. In 2008, net lending increased slightly to a total of £4.2 billion for the year. Gross lending increased slightly, with repayments remaining strong, but there was a moderation in the growth of write-offs. Net lending in the first half of 2009 has been more subdued, with a monthly average almost half that of 2008 (£190 million per month, compared to over £350 million per month). Gross lending and repayments have both fallen slightly, with a slight increase in write-offs, which may have contributed to this decrease.

**Write-offs**

378. As discussed earlier, write-offs on credit cards have been gradually increasing since 1995, rising from an average monthly value of £35 million to £800 million in 2008. Average monthly write-offs have increased further in 2009, with UK Cards Association noting that the costs associated with delinquency and write-offs both worsened during 2008 – the average aggregate value of all delinquent accounts as a proportion of outstanding balances increased to 16.4% in 2008, while write-offs accounted for 6.4% of outstanding balances.
Data from Moody’s suggests that annualised write-off rates have now increased to 9.37% (as of May 2009).

![Average monthly write-offs on credit card lending, 1993-2009](image)

Source: Bank of England

379. Qualitative information from lenders provided to the Bank of England regarding defaults on credit card lending (and the associated costs) shows that defaults have increased markedly since early 2008 and expectations regarding future defaults remain high in the forthcoming quarter.

![Defaults on credit card lending, 2007-2009](image)

Source: Bank of England

380. A further recent report from the International Monetary Fund indicates that write-offs on credit card lending could be expected to deteriorate even further in 2009. It estimates that total UK consumer debt is nearly £1.5 trillion, with predictions that a total of up to 7% (£104 billion) could be written off.\(^{124}\) Assuming this was equally distributed across all credit products according to their share of current lending, this would imply a total write-off of around £24 billion for credit cards. This would represent a significant increase on 2008 levels, when a total of £3.2 billion in credit card lending was written off.

Interest rates

381. Between 1999 and 2004, effective interest rates across all credit cards declined by around 4 percentage points, from around 14% to 10%. During this period, effective interest rates on only interest-bearing balances fell by a similar amount, with quoted interest rates falling by slightly more (5 percentage points). This coincided with a fall of 2 percentage points in both the base rate and the 3-month interbank lending rate.\(^{125}\)

![Interest rate comparison, 1995-2009](source: Bank of England)

382. Between 2004 and late 2008, the base rate and interbank lending rate increased by 1.5 and 2.5 percentage points respectively. Effective interest rates across all credit cards also increased by around 2.5 percentage points. However, effective interest rates on interest-bearing credit card balances increased by around 4 percentage points.

383. Since late 2008, there have been well-documented falls in both the base rate and interbank lending rate – of 4.5 and 5 percentage points respectively – but credit card interest rates have remained relatively unchanged, even increasing slightly.

384. Between 1999 and 2004, the ‘quoted’ credit card interest rate\(^{126}\) has broadly fallen in line with the ‘effective’ interest rate\(^{127}\), which might imply that many consumers were regularly renewing their balance through balance transfers, to take advantage of lower promotional rates. Since 2004, the average ‘quoted’ credit card interest rate has stayed roughly the same, and has fallen below the ‘effective’ rate. This may imply that, as the availability of balance transfers and promotional deals with low interest rates to consumers has declined, there has been an increase in the amount of interest income being paid to issuers.

385. There are differing cost structures within credit card businesses (see Annex 1 for more details), which can mean that some providers are more self-contained than other arms of banking. It was noted in the Cruickshank review that banks were able to sustain higher prices for products such as loans and credit cards than non-banks, due to the potential for cross-subsidisation within a bank.

386. As noted earlier, write-offs associated with credit cards have risen slightly in the first half of 2009 and this will have contributed to the increased costs for providers across all credit cards.

\(^{125}\) LIBOR, used here as a proxy for the cost of funds to credit card issuers.

\(^{126}\) This rate is based on a sample of interest rates offered to new customers, collected by the Bank of England and then weighted according to market share of lenders. Where there are multiple rates, the lowest rate is taken.

\(^{127}\) This rate is based on the interest income received by issuers, divided by outstanding balances and then weighted according to the market share of lenders.
Arrears

387. An additional cost that contributes towards the provision of credit cards is delinquency. During 2008, the number of credit card accounts in 1-month arrears fell to a monthly average of 0.88 million, from an average of 0.93 million in 2007 (accounting for 2.8% and 2.6% of active accounts in those respective years).

388. However, the ‘roll rate’ from 1 overdue payment to 2 overdue payments has worsened slightly, from 31% in 2007 to 33% in 2008. Analysis from UK Cards Association indicates that this slight rise in delinquencies is coming from the ‘back book’ (i.e. accounts that have been open for longer than one year) and that recently-acquired accounts are of a higher average quality due to improvements in account vetting procedures.

389. Survey evidence suggests that there is a significant overlap between ownership of credit cards and store cards, with around 84% of credit card holders also holding at least one store card. This compares well to evidence collected for the Competition Commission inquiry into store cards, which found that 89% of store card holders also had a credit card.

Market characteristics

390. According to 2007 data from market reports (shown in the chart below) the credit card market is relatively concentrated, with 5 or 6 providers having a market share in excess of 10 per cent. This varies by whether number of cards or outstanding borrowing is used as a determining factor – for example, RBS is the leading provider in terms of credit cards in issue, but is only third-largest when analysed by proportion of outstanding credit card borrowing.

![Credit card market share, 2007](chart.png)

**Note:** Since 2007, Lloyds TSB has merged with HBoS

Source: Mintel

391. The above data shows that non-bank (‘monoline’) providers – such as MBNA and Capital One – have successfully captured a significant proportion of market share. Collectively, these two firms account for 18.5% of the number of cards in issue and almost 25% of the proportion of outstanding balances. These substantial shares, acquired over a relatively

---

128 The roll rate represents the number of accounts that move into the next overdue category, expressed as a percentage

129 When evaluated on both of the measures (number of cards and outstanding balances), the Herfindahl-Hirschman Index (HHI) for identifiable providers is in excess of 1,000, which would meet the OFT threshold for a ‘concentrated’ market. In any case, this will have increased since the merger of Lloyds TSB and HBoS in 2008
short period of time, would suggest that entry into the credit card market is possible and barriers to entry for this market are relatively low.

392. However, it is important to consider whether such entry is sustainable – the data above also show that bank providers tend to have a smaller share when analysed by outstanding borrowing, compared to analysis by number of cards in issue. This situation is reversed for non-bank providers. This would tend to imply that credit card customers of non-bank providers have a larger than average balance compared to customers of bank providers.

393. It is unclear whether this might support the earlier distinction between ‘captive’ and ‘open’ markets – i.e. that providers with predominantly ‘captive’ customers have higher profitability. On the one hand, customers with larger balances are more likely to pay interest on their borrowing and so would earn more interest income for providers. However, if such large balances are not sustainable, such customers might be more likely to default, leading to higher costs associated with bad or delinquent debt.

394. It is therefore difficult to ascertain the profitability of these relative portfolios and conclude whether such entry by non-bank providers can provide an effective long-term constraint on bank providers of credit cards.

**Store cards**

**Lending**

395. As can be seen from the table below, store card activity has been declining for a number of years. The numbers of cards, accounts and transactions all peaked in 2002, with over 24 million cards, 23 million accounts and nearly 140 million transactions. The value of transactions peaked in the following year, at almost £5.5 billion, and the value of outstanding balances in the proceeding year, at nearly £3 billion.

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of transactions (£ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>2.5</td>
</tr>
<tr>
<td>1995</td>
<td>3.0</td>
</tr>
<tr>
<td>1996</td>
<td>4.0</td>
</tr>
<tr>
<td>1997</td>
<td>4.5</td>
</tr>
<tr>
<td>1998</td>
<td>5.0</td>
</tr>
<tr>
<td>1999</td>
<td>4.5</td>
</tr>
<tr>
<td>2000</td>
<td>4.0</td>
</tr>
<tr>
<td>2001</td>
<td>3.5</td>
</tr>
<tr>
<td>2002</td>
<td>5.5</td>
</tr>
<tr>
<td>2003</td>
<td>4.5</td>
</tr>
<tr>
<td>2004</td>
<td>3.0</td>
</tr>
<tr>
<td>2005</td>
<td>2.5</td>
</tr>
<tr>
<td>2006</td>
<td>2.0</td>
</tr>
<tr>
<td>2007</td>
<td>1.5</td>
</tr>
<tr>
<td>2008</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: Finance and Leasing Association

396. Since then, however, the number of cards and accounts has fallen by just over one-third, while the number of transactions has fallen by more than half. Overall, the value of transactions has dropped to £3 billion and the value of outstanding balances has fallen by about one-third from the peak in 2004.

---

130 Those with customers that also have current accounts, which are much more likely to be bank providers
397. During 2008, the value of outstanding balances on store cards fell to £1.9 billion, an average of £142 per account. With 55.2 million transactions and a total spend of £3.0 billion during the year, the average store card was used 3.6 times, with spending of £196 per card and an average transaction value of £55. These are low when compared with credit cards, which were used on average 24.7 times for purchases in the UK during 2008 with spending of £1,525 and an average transaction value of £62.

Table: Store card outstanding balances, 2003-2008

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of outstanding balances (£bn)</th>
<th>Average outstanding balance (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>2.8</td>
<td>121</td>
</tr>
<tr>
<td>2004</td>
<td>2.9</td>
<td>124</td>
</tr>
<tr>
<td>2005</td>
<td>2.5</td>
<td>140</td>
</tr>
<tr>
<td>2006</td>
<td>2.2</td>
<td>162</td>
</tr>
<tr>
<td>2007</td>
<td>2.1</td>
<td>131</td>
</tr>
<tr>
<td>2008</td>
<td>1.9</td>
<td>127</td>
</tr>
</tbody>
</table>

398. Mintel predict that the number of store cards in issue will fall further in the future, reaching 14.3 million in 2011. There are a number of potential explanations for this continued decline.

399. First, the significant publicity surrounding store card interest rates and media coverage of the Competition Commission investigation into the industry has put into question the value for money offered by these products in the minds of consumers.

[^131]: Credit and debt cards (2008)
400. In combination with this, a number of store card providers have migrated store card customers with good credit ratings and histories onto credit card products.

401. The rationale behind this migration is that, although credit cards generally have a lower interest rate compared with store cards, they also have much higher credit limits and wider acceptance, thereby giving more scope for the customer to build up a higher outstanding balance on the card, albeit at a lower interest rate. Due to likely impact of reductions in default fees in terms of reduced revenue and profitability, more retailers may be encouraged to convert their portfolio to a general purpose revolving card.

402. It is likely that some brands will maintain a loyal customer base of store card holders that keep the card due to the additional benefits that come with the card, such as exclusive cardholder evenings and fashion previews.

Market characteristics

403. As discussed above, store card activity has declined over the last 5 years or so. Nevertheless, based on latest data available (2007), there is one significant provider of store card services – GE Money, with over 60% of all cards in circulation. However, in March 2008 GE Money divested its store cards business to Santander.

![Chart: Market shares of store card providers, 2007](chart)

**Source: Mintel**

404. Creation Financial Services\(^{132}\) is the second-largest provider, followed by Argos/GUS, and then Marks and Spencer and John Lewis (with the latter two both issued by HSBC). However, the market position of both of these latter providers is falling, as they only issue credit cards to new customers and, as such, the number of store cards is being eroded over time.

\(^{132}\) Now known as LaSer UK
Annex 3: Credit card regulation and usage – UK-US comparison

405. Recent reforms in the US have seen the introduction of new measures relating to credit cards, including: a ban on unfair rate increases; prevention of unfair fee traps; plain sight and language disclosures; and additional protection for students and young people. There are, however, some fundamental differences between the US and the UK in terms of the regulatory environment and credit usage.

Regulation

406. The UK has relatively high levels of regulation and self-regulation in the financial sector, when compared to other countries such as the US. For example, the Banking Code is a self-imposed voluntary code of practice, which sets standards of good banking practice for financial institutions when dealing with personal customers. It requires banks to behave fairly and responsibly towards customers and to keep them informed, and covers a wide variety of financial products, including current and savings accounts, overdrafts, payment services, and cards.

407. Moreover, the Banking Code requires that customers are given 30 days’ notice of changes to terms and conditions that are disadvantageous to consumers and to warn customers when promotional rates are coming to an end. It also requires credit card lenders to assess consumers’ ‘ability to pay’ and to set out sources of free money advice. Following the OFT’s statement in April 2006 concerning the fairness of default fees on credit cards, default fees in the UK have tended to be set at a maximum of £12.

408. Following the Credit Card Summit held with industry in November 2008, the industry introduced new principles relating to risk-based re-pricing. The statement of principles requires lenders to give 30 days’ notice of any increase in interest rates due to risk-based re-pricing and allows customers to close accounts if they so desire.

409. The statement of principles also sets out that interest charges should not be raised within the first 12 months of opening a credit card account and should not be increased more than every 6 months after that. It also states that interest rates should not be increased where the customer has failed to make the last two consecutive monthly payments or more, where there is an agreed repayment plan in place, or where the credit card company has been contacted by a not-for-profit debt agency.

410. These statements of principles have been incorporated into the Banking Code and provide additional consumer protection. These changes are evidence of how self-regulatory solutions can offer a quick response to address emerging issues affecting consumers in the credit market. There are other areas, not covered by the Banking Code, where further regulation could protect consumers, for example, the level of minimum payments and the allocation of repayments for credit cards.

Credit card usage

411. Consumers in the US tend to be more orientated towards using credit cards than debit cards, with the reverse true in the UK. Holding of credit cards is higher in the US – for example, the Federal Reserve Survey of Consumer Finance reported that in 2007, 73% of families had credit cards, with an average of 5.6 cards per adult in 2007. This compares to an average of 1.5 cards per adult in the UK for the same period. The frequency of use of credit cards is also much higher in the US than the UK, with an annual average of 100 purchases made in the US in 2007, compared with 43 in the UK.

412. In 2007, the proportion of US families carrying a balance was 46%, at an average of £4,492 ($7,300); in the UK the proportion of credit cards with an outstanding balance was 3%, with an average outstanding of £1,856. The average credit limit in the US is £11,073 ($18,000), compared with £5,129 in the UK, and there are much higher levels of point-of-sale authorisations (90%), making it easier for customers to spend over their credit limit. It was estimated that in the fourth quarter of 2008, 13.9% of US consumer disposable income went to service revolving debt, whilst debt servicing costs in the UK accounted for 4.1% of disposable income. The higher incidence and level of outstanding balances in the US tend to result in lower APR rates than in the UK, though there are also differences in how APR is calculated.

413. As well as differences in size and dynamics of the credit card markets of the US and the UK, there are also a number of practices that US credit card companies have adopted that do not occur in the UK. These include “universal default” – where default on one payment leads to all creditors classifying accounts as in ‘default’ despite not missing a payment – and “double-cycle” billing, where interest charges accrue not only on the current balance but also on the previous month’s.
Annex 4: Specific impact tests

Competition assessment

Although none of the proposals examined in this impact assessment directly limit the number or range of suppliers, it is possible that some of the options in different policy areas could have a potentially significant adverse impact on competition.

In general, measures that indirectly have the potential to reduce the interest income received by credit and store card lenders could have differential impacts, depending on the business model employed.

As some lenders have the ability to cross-subsidise between credit or store cards and other lending products, they could potentially be less impacted and able to sustain a larger fall in interest income from credit and store cards, provided that other lending products could offset these losses sufficiently for them to continue earning profits. However, for other lenders that focus only on providing credit or store card lending, this loss of interest income could be more critical to their overall profitability and they may be forced to exit the market, which would reduce the degree of competition in this market.

That said, it is unlikely that this would be a significant problem, as the earlier analysis indicates that credit cards in particular are a significant source of income for providers, compared to other types of lending products (and other payment instruments). Therefore, a significant reduction in interest income from credit or store cards is likely to impact equally heavily on both types of lender. The ultimate impact in terms of potential lender exit is unquantifiable at this stage, as we do not know the precise underlying profitability of all credit and store card lenders.

Allocation of payments

Under options 3-5, the order in which repayments are allocated is constrained and this limits the ability of credit and store card providers to compete on this feature. However, preliminary survey evidence would suggest that this feature is not an important one for consumers in choosing their credit and/or store card, so this may not have a significant impact on competition.

The impact of such a change could also have differential impacts on lenders, as the degree of reduction in interest income depends on the composition of their customers’ credit or store card balances. For example, those with customers who have a particularly high proportion of high-interest balances would stand to lose more interest income than those with customers who have a lower proportion of high-interest balances. As outlined above, options 3-5 would also likely result in reduced interest income for credit and store card providers.

Under option 4 (highest interest rate first), the competitive advantage that Nationwide currently hold in relation to this allocation of payments would be eroded. However, such a change could give Nationwide a potentially unfair advantage, in that such systems are already in place and so it would not incur any transitional or implementation costs in moving to such a system.

However, these options would not raise any barriers to entry for new potential providers, or customers looking to switch between providers.

Minimum repayments

Under option 4, the minimum repayment level would be increased, which would remove the ability of credit and store card providers to offer a repayment level below that, although they would still be free to set a repayment level above that. However, generally we would expect competition on this card feature to operate in a downwards direction – i.e. for providers to offer lower repayment rates than their competitors. Therefore, it could be considered to impose a constraint on competition.

However, it is not clear the extent to which consumers value this feature in choosing their card and therefore how significant this constraint could be. In any case, it is likely that the impact of
such a change would be the same for different types of lender and would also not raise any barriers to entry for new potential providers, or customers looking to switch.

Similarly to the previous policy area, this would also likely result in reduced interest income for credit and store card providers.

**Unsolicited limit increases**

Under option 3, unsolicited limit increases would be removed as a potential feature on which credit and store card providers could compete for customers. It is unclear to what extent unsolicited increases in a credit limit would be important to consumers choosing a credit or store card, or considering switching between providers. It is therefore difficult to assess what the overall impact on competition might be. In any case, it is likely that the impact of such a change would be the same for different types of lender and would also not raise any barriers to entry for new potential providers, or customers looking to switch.

In addition, by imposing limits on the size and/or frequency of credit limit increases, option 5 constrains the extent to which credit and store card providers can use credit limit increases more generally as a competitive tool.

**Re-pricing of existing debt**

Defining certain conditions under which lenders can undertake risk-based re-pricing may impact on competition, by affecting lenders in different ways, depending on the propensity of their customers to display those pre-defined characteristics. For example, if missing one payment is defined as one of those conditions, those credit and store card lenders with an inherently riskier customer portfolio will be more able to re-price their debt, which may give them a competitive advantage.

By imposing limits on the size and/or frequency of re-pricing for existing debt, option 4 constrains the extent to which credit and store card providers can change their interest rates on existing debt, but this should affect all lenders in the same way, so is unlikely to have a significant impact on competition.

Under option 5, re-pricing of existing debt would be removed as a possibility for credit and store card providers. Since this should also affect all lenders in the same way, it is unlikely to have a significant impact on competition.

These options do not appear to raise barriers to entry for new potential providers, or barriers for customers looking to switch.

**Small firms impact test**

Based on the available market data, it appears that there are very few providers of credit and store card lending that could be considered as ‘small’ firms. Even ‘smaller’ providers of store and credit card finance can be substantial businesses. For example, a ‘small’ store card lender such as Ikano (with a market share of 2.2%), has a lending portfolio of €2.5 billion.

One way in which small firms may benefit from these reforms is as credit (or store) card customers, rather than suppliers. This is because business lending to sole traders and partnerships will be covered, up to a value of £25,000.

It has not been possible to ascertain the size of this market, but we will be making every effort to do so throughout the consultation period, and would invite stakeholders to submit any relevant evidence to us.

---

Equalities impact test

After initial screening as to the potential impact of this policy/regulation on race, disability and gender equality it has been decided that there will not be a major impact upon minority groups in terms of numbers affected or the seriousness of the likely impact, or both.

For a more detailed consideration of equality issues, please see the equality impact assessment (available at: http://www.bis.gov.uk/creditconsultation).