Risk-based re-pricing

Issue

Rationale

Options analysis

Option 1: Do Nothing - Rely on the Lending Code
Option 2: Provide consumers with better information about risk-based re-pricing decisions
Option 3: Define factors that lenders can take into account when re-pricing due to risk
Option 4: Limit the size and/or frequency of existing debt re-pricing
Option 5: Prohibit re-pricing of existing debt

Preferred option

Annex 1: Credit and store cards – background
Annex 2: Sources of revenue for credit and store card providers
Annex 3: International credit card markets and regulation
Annex 4: Specific impact tests
Summary: Intervention & Options

Department /Agency: Department of Business Innovation & Skills
Title: Impact Assessment of credit card and store card consultation

Stage: Final  Version: 2  Date: March 2010


Available to view or download at:
http://www.bis.gov.uk/creditconsultation/response

Contact for enquiries: Philip O'Donnell/Kalvin Bahia  Telephone: 020 7215 6764/5587

What is the problem under consideration? Why is government intervention necessary?
Concerns have been raised in relation to credit and store card lending by Government, Parliament and consumers. These have been partially addressed by regulatory reforms and market adjustments. However, recent evidence (rising credit and store card complaints, debt advice demand for credit and store cards issues and increasing credit card arrears) has 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.
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 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 area and are provided in the section summary sheets.
The Government’s preferred package is to: allocate payments to the debt accruing the highest interest rate first; ensure that the minimum payment covers interest, fees/charges and 1% of the balance for new accounts, as well as sending targeted information to habitual minimum payers; improve consumer understanding and information in relation to unsolicited credit limit increases and re-pricing.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? A post-implementation review will be undertaken after 3 or 5 years.

Ministerial Sign-off
For final proposal/implementation 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:

..................................................................................................................Date: March 2010
<table>
<thead>
<tr>
<th>Policy Option: Government’s preferred package</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’ |
| Industry – implementation costs on IT systems changes, staff training, information and communication with customers (£65m–£100m pa); reduced interest income as balances are reduced and/or paid off sooner (£276m–£301m pa, transferred to cardholders). |

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Costs (excluding one-off)</th>
<th>Total Cost (PV)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Yrs</td>
<td>£ 65m-100m</td>
<td>£ 2,441m-2,691m</td>
</tr>
</tbody>
</table>

### ANNUAL BENEFITS

| Description and scale of key monetised benefits by ‘main affected groups’ |
| Cardholders – reduced interest costs of borrowing (£276-301m pa, transferring from card providers). |

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Benefits (excluding one-off)</th>
<th>Total Benefit (PV)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Yrs</td>
<td>£ 276m-301m</td>
<td>£ 2,376m-2,591m</td>
</tr>
</tbody>
</table>

### Key Assumptions/Sensitivities/Risks

Reversing the allocation of payments could lead to reduction in promotional rates and cash advance facilities. Lenders may attempt to recoup lost income through higher fees/interest rates and/or reduced credit limits. Increased information for credit limit increases and re-pricing may not change customer behaviour if it causes information overload and confusion.

### Price Base

<table>
<thead>
<tr>
<th>Year 2008-9</th>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 Years</td>
<td>£ -65m to -100m</td>
<td>£ -82.5m</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>(Increase - Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 0</td>
</tr>
</tbody>
</table>

### Key:

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

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. In a recent survey, the vast majority of consumers (79%) expressed a high level of satisfaction with their credit cards.

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.¹ 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.²

3. A wealth of evidence has been presented in response to the consultation and, after due consideration, a voluntary package of measures has been agreed with industry. Evidence has shown that some problems were not as prevalent or pernicious as previously thought (e.g. unsolicited credit limit increases, risk-based re-pricing) and, where problems have been identified, targeted measures have been proposed, such as sending information to those consistently making minimum payments about the implications of their repayment behaviour. Finally, we have responded to consumer concern regarding the allocation of payments by achieving a full reversal, so that debts with the highest interest rate will be paid off first. This should lead to savings for a significant proportion of cardholders.

Background

4. Credit cards are an increasingly important element of consumer borrowing. Consumers value the flexibility of credit cards; there are now over 60 million credit cards in circulation in the UK, used by over 30 million consumers in an average 160 million transactions a month, up from 25 million cards and 80 million transactions per month at the end of 1994.³ Credit card usage continues to remain strong, despite the downturn; net lending for credit cards amounted to £2.3 billion in 2009, in contrast to -£3.3 billion for other types of unsecured lending.⁴ In contrast, store card use is much lower; there are approximately 15 million store cards in issue, generating around 52 million annual transactions.⁵ General customer satisfaction with credit cards is high, with 79% of those questioned in a recent survey commissioned by the UK Cards Association expressing satisfaction with their cards.

5. The credit card industry is also a key contributor to the overall UK economy, both as an employer (providing jobs for over 110,000 people) and a facilitator of commerce, providing liquidity worth £22 billion of projected GDP growth over 3 years.⁶ In addition, small businesses can also be significant users of credit cards, as a means of managing cashflow and a convenient payment mechanism. In contrast, activity on store cards

¹ Such as the Consumer Credit Act 2006 and the introduction of the Summary Box by APACS in 2005
² Credit card Accountability, Responsibility and Disclosure Act
³ Latest figures from January 2010, 1994 are earliest figures available (Source: BBA)
⁴ Source: Bank of England
⁵ Source: FLA
⁶ Source: UK Cards Association
seems to be declining, with latest figures (December 2009) from the Finance and Leasing Association (FLA) indicating that monthly new business was down by 3% compared to the previous month; quarterly growth down by 6% and annual growth down by 13%.

6. 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.

7. In addition, credit and store cards have already been subject to a substantial amount of regulatory intervention (such as HM Treasury Select Committee investigations, the OFT’s intervention on default fees, the Competition Commission’s investigations into store cards and payment protection insurance, the Consumer Credit Act 2006), with more to come (such as the 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.

Issue

8. 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. The four main areas are: allocation of payments, minimum payments, unsolicited credit limit increases and risk-based re-pricing. An additional area is simplicity and transparency, which has not been analysed in significant depth, but is addressed here for the purposes of completeness.

9. The UK is not alone in considering further regulatory intervention in relation to credit and store cards. Recent reforms in the US have seen the introduction of new measures relating to credit cards and there is significant crossover between some of these issues and some longstanding concerns that have been voiced by Government in relation to credit cards, these are set out below.

10. Although aggregate statistics reveal a general increase in consumer indebtedness, 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, just under 20% of store card holders have less than £500 outstanding, compared to only 6% of credit card holders. In the extreme, 6% of credit cardholders have balances in excess of £10,000, with less than 1% having a balance exceeding £25,000.

11. Given that research suggests that around 70% of credit and store card holders regularly pay off their balance in full, around 30% of credit and store card customers effectively provide the majority of the revenue for credit and store card providers, mostly 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 consumers have come to particularly value, such as cashback, airline travel, retail discounts and other special offers.

12. However, there are adverse consequences of offering credit, especially at higher interest rates, to less creditworthy consumers. Defaults on credit cards have risen significantly in the last year, with £4.1 billion written off in 2009, compared to £3.2 billion in 2008. In their recent Precious Plastic report, Price Waterhouse Coopers (PwC) state that they expect

---

7 http://www.fla.org.uk/research/news/220210_december_consumer_stats. Given this disparity, most of the available data relates to credit card borrowing; however, store cards and credit cards are relatively similar products, which mean that arguments related to product features are just as likely to apply to store cards as credit cards in the discussion that follows.

8 Further detail available in Annexes 1 and 2

9 http://www.berr.gov.uk/whatwedo/consumers/consumer-white-paper/index.html

10 Further detail on these (and regulatory measures introduced in other countries) is available in Annex 3

11 This includes those who always or usually repay in full; source: YouGov DebtTrack (November 2009)
write-offs on credit cards to continue to rise, from around 7% of outstanding balances in 2009 to around 9% this year.\textsuperscript{12}

13. Evidence available from advice agencies (such as CCCS\textsuperscript{13} and Citizens Advice) shows that consumers’ need for debt advice mainly relates to credit and store cards. 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.\textsuperscript{14} Complaints about store cards have also risen, albeit from a low base (372 in 2008/9, up from 110 the previous year). 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 2009, from 73,500 in the first half of 2006 to over 160,000 in the first half of 2009.\textsuperscript{15}

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

15. 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. For example, Money Advice Trust submitted that Business Debtline customers have unsecured personal debt, which is estimated to be an average of £30-35,000, but in some cases can be in excess of £100,000.\textsuperscript{16} However, it is not clear how much of this debt has been incurred on credit cards.

16. Survey data provided by the UK Cards Association shows that credit card ownership among the self-employed is slightly higher than those employed full or part-time.\textsuperscript{17} Data on business use of credit cards suggest a significant increase from 2005, when there were 126,000 cards used in transactions worth £684m, to 2008, when there were 481,000 cards used in transactions worth £2.6 billion.\textsuperscript{18}

17. It is difficult to interpret this data; it could imply that use of personal credit cards for business purposes is less likely as business credit card use has increased, or it could be that the increased prevalence of business credit cards reflects a shift towards preferences for using credit cards among the business community, which would suggest that the use of personal cards for business purposes might be likely to increase.

\textbf{Allocation of payments}

18. Almost every credit card charges different interest rates on different types of transaction, e.g. balance transfers, purchases and cash advances. Although there is no ‘universal’ policy on allocation of repayments, general industry practice is for the most expensive debts held on a credit or store card to be paid off last. There are also credit cards available that offer a ‘positive’ allocation of payments (i.e. where the debt being charged at the highest interest rate is paid off first), which is of greatest benefit to consumers in terms of reducing the amount of interest paid.

19. However, the extent to which consumers particularly value this aspect of the card is unclear and it does not seem to have played a significant part in the switching behaviour of credit card customers. Current best practice guidelines state that the statements and pre-contractual materials for credit cards must contain information on the allocation of

\begin{itemize}
\item \textsuperscript{12} http://www.pwc.co.uk/eng/publications/precious_plastic.html
\item \textsuperscript{13} Consumer Credit Counselling Service
\item \textsuperscript{14} Credit cards are now the most complained-about product in the ‘banking and credit’ category, accounting for 34% of all complaints received last year
\item \textsuperscript{15} http://www.fsa.gov.uk/pubs/other/complaints_data09.pdf
\item \textsuperscript{16} Money Advice Trust, Response to BIS consultation
\item \textsuperscript{17} An average of 2.6 cards for the self-employed, compared to 2.4 for those employed full or part-time; in addition 15% of the self-employed have five or more cards, compared to 10% for those employed full or part-time.
\item \textsuperscript{18} UKCA, Response to BIS Consultation (January 2010)
\end{itemize}
payments. Despite this, evidence suggests that a significant proportion of cardholders are not aware of how their repayments are currently allocated.

20. Furthermore, evidence suggests that action to explain to credit card holders how payment allocation affects interest charges does not improve consumers’ understanding. This may suggest the potential for investigating whether it is necessary to intervene more directly in order to address this issue.

Minimum payments

21. The level of minimum payments varies across providers and customer-risk segments, but the Lending Code currently states that the minimum payment must cover at least the interest incurred. This is intended to ensure that the total outstanding balance does not increase over time (provided there is no further spending on the card). However, this does not include fees and charges, which means that despite making the minimum payment, a customer’s outstanding balance may still increase.

22. The flexibility offered by minimum payments on credit and store cards enables consumers to manage their finances as their personal circumstances change over a period of time. For example, consumer research found that around 15% of those making the minimum payment did so because they were taking advantage of a promotional rate/offer.

23. However, 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. In any given month, the minimum payment is made on around one-fifth of accounts, but for around one-third of these, the minimum payment is made only once a year; the proportion on which minimum payment is made for 12 consecutive months is very small (3% of all credit card holders). This indicates that minimum payments could be problematic for a minority of vulnerable card users who build up high levels of debt and who habitually make the minimum payment.

24. In addition, consumer research indicated a general lack of awareness of the consequences of making minimum payments. It was suggested that consumers who habitually made the minimum payment had either a poor understanding of the long-term consequences or they could only afford to make minimum payments as the level of debt was too high. Other consumers felt that their debt was so large that they could not envisage ever clearing it, so there was no point in making more than the minimum payment.

25. There was a perception that some consumers may choose to make the minimum payment when they could afford to repay a higher amount as they primarily considered the short-term costs of repayment, rather than the long-term consequences. There was also a perception that many card users who make the minimum payment could afford to pay a higher amount and would budget to do so if the minimum payment was increased. Some consumers, including some of those currently paying the minimum, even said they would welcome being ‘made’ to repay the debt sooner rather than being ‘allowed’ to put it off.

Unsolicited credit limit increases

26. 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. The proportion of accounts receiving an unsolicited credit limit increase is almost 20%, of which the vast majority (around 85%) were unsolicited. Limit increases can be offered to all customers, but evidence shows that they are a key feature of “low and grow” lending to higher-risk customers.

27. Concerns have previously been raised about the potential association between unsolicited credit limit increases and financial difficulties. Under current requirements, 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. 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.

28. Evidence shows that there is no direct link between customers receiving an unsolicited limit increase and getting into financial difficulties, such that they default on their loan. BIS consumer research also showed that the vast majority of cardholders receiving an unsolicited increase (84%) did not react to a limit increase and that it was unimportant to them; 6% contacted their lender to request that it remain unchanged, while a small minority (3%) stated that they increased their spending.

29. Although this evidence suggests that unsolicited limit increases do not induce people to borrow more than they can afford, it does show that they lead to higher spending and some consumer groups argue that they encourage people to borrow more than they might rationally intend, with attendant debt servicing costs. Some consumers may be concerned about unsolicited limit increases, if they are aware of their tendency towards buying on credit without due regard for the financial consequences.

Risk-based re-pricing

30. During 2008, concerns were raised in respect of anecdotal evidence that 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. The Government took action to address concerns related to re-pricing 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 sets out certain limitations on circumstances in which risk-based re-pricing is permitted. All credit card and store card providers signed up to this Statement of Fair Principles, which were implemented from January 2009 and incorporated into the Lending Code.

31. Since the implementation of these principles, reports indicate that the very worst examples of re-pricing of existing debt had been eliminated, with the volume of complaints falling since January 2009. However, evidence suggests that there is limited take-up of the option to close credit card accounts and repay balances at existing rates, with only 1% of those receiving an increase doing so. Furthermore, industry-commissioned research shows that less than half of consumers are aware of this option.

32. Evidence suggests that re-pricing is not as prevalent as first thought, although it remains important that accounts that are re-priced are done so in a justifiable and proportionate manner. 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.

Simplicity & transparency

33. A recent report on credit card comparisons found that the complex nature of credit cards adds to the difficulties that consumers face when attempting to choose a credit card that best suits their needs. This difficulty is compounded by low levels of financial capability, which can make it even harder for certain consumers to choose products that best suit their needs. For example, recent research commissioned by BIS found that 27% of consumers did not use any sources of information in choosing their credit card. In addition, consumers generally trusted their provider and therefore believed it was unnecessary to review terms on their active cards.

34. This complexity can also mean that it is difficult for consumers to understand the available information. Previous survey data shows that understanding among cardholders varied considerably, with only one in six claiming to have a ‘very good understanding’ of credit cards. Consumer understanding of sample credit card offers was not particularly high; only one-quarter of credit card holders found the information easy to understand.
35. Steps have been taken to try and improve the information provided to consumers, through both self-regulatory and Government intervention. However, providing more information can sometimes be ineffective if consumers feel they are faced with too much choice or information. According to consumer research commissioned by BIS, consumers complained that they regularly received booklets setting out new terms and conditions, but would ignore this information as they felt it was too difficult to decipher what the implications of the changes were.

36. BIS consumer research also indicated a variety of ways to improve the information provided to them, including: reducing the overall amount of information, highlighting important information, making information easier to understand and targeting specific information that reflected the way the card was being used.

Rationale

37. 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.

38. 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.

39. 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 card. It also indicated that most people are poor at choosing financial products and often do not seek independent advice.

40. 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.

41. 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.

42. 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’.

43. 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,

19 http://www.fsa.gov.uk/pubs/other/fincap_baseline.pdf
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.\(^{23}\)

44. 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.

45. 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.

46. 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).

47. 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%).

48. 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.\(^{24}\)

49. 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.

50. 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.\(^{25}\) 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.\(^{26}\)

51. 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 almost 40% of respondents agree with the statement ‘financial services are complicated and confusing to me’, with nearly 30% disagreeing.\(^{27}\)


\(^{25}\) 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

\(^{26}\) ‘Warning! Too much information can harm’, Better Regulation Executive and National Consumer Council (2007)

\(^{27}\) Source: YouGov DebtTrack (November 2009)
52. 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). 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.

53. 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. Other important examples include ‘anchoring’ (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”. This has been put forward as a potential explanation for the 'endowment effect', where consumers value a particular item more if they own it, compared to when they do not) and inertia/procrastination, leading to ‘status quo’ bias (where consumers can tend towards the ‘default’ option).

54. 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 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).

55. 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, then providing more information can confuse consumers and lead to poorer decisions.

56. 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 and over-deliberate or otherwise misuse information. 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. This raises the possibility that a consumer may not adequately understand the consequences of late payment or excessive borrowing.

57. 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. 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.

---

28 Or at least, in the aggregate, that rationality provides a fair approximation for individuals’ collective preferences
29 ‘The framing of decisions and the psychology of choice’; Tversky & Kahneman (1981)
31 ‘Experimental tests of the endowment effect and the Coase theorem’; Kahneman, Knetsch & Thaler (1990)
32 ‘Status quo bias in decision making’; Samuelson & Zeckhauser (1988)
34 ‘Belief in the law of small numbers’, Kahneman & Tversky (1971)
35 ‘Relationships Among Information Search Activities When Shopping for a Credit Card’; Lee & Hogarth (2000)
As these terms are often contained in the advertising materials (such as leaflets and mail shots), consumers may be unlikely to read the contract.\textsuperscript{36}

58. 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.

59. 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.

60. 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.\textsuperscript{37} 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.

61. 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 traditional economic theory.\textsuperscript{38} 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.\textsuperscript{39} 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.

62. 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

63. The overarching objective of the proposed reforms 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 that 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;

\textsuperscript{36} ‘Credit card survey’; OFT (2004)
\textsuperscript{37} http://www.ausubel.com/creditcard-papers/adverse.pdf
\textsuperscript{38} First introduced by Phelps and Pollak (1986); Huffman and Barenstein (2004) provide evidence that UK household expenditure patterns are consistent with hyperbolic discounting
\textsuperscript{39} http://www.ausubel.com/creditcard-papers/time-inconsistency-credit-card-market.pdf
• 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.

64. Specific objectives for each section are included where relevant.

Options analysis

65. Following the Government’s consultation, which was published on 27 October 2009 and closed on 19 January 2010, a number of responses from industry, Government departments, consumer groups and individual consumers were considered along with research commissioned by the Department for Business, Innovation and Skills (BIS).

66. Any potential reform also needs to strike the right balance between maintaining access to credit for consumers and promoting responsible lending, while preserving a viable consumer credit industry. The Government is mindful of the difficult macroeconomic environment in which credit card providers are operating and must ensure that credit card lending remains an innovative and profitable sector. It is also important that 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. 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.

67. This impact assessment has been revised to reflect updated evidence that was submitted in response to the consultation and research commissioned by the Government. In particular, the following sources of information are drawn upon:

• Consumer research: the Government commissioned TNS-BMRB to conduct research focusing on: consumers’ current experience of using credit and store cards; how consumers think they would be affected by, and respond to, various options for reform; consumer preferences around trade-offs arising from proposed reforms. The UK Cards Association commissioned GfK NOP to conduct similar research.

• International Comparisons: the Government also commissioned Auriemma Consulting Group to research features of international credit card markets and how they are regulated. A number of markets outside of the UK, particularly the US and Canada, have recently implemented new regulatory proposals related to credit cards. The study provided evidence on: market structure and credit card usage in other countries; regulation and its impact on both industry and consumers.

• Account Data: as part of its response to the consultation, the UKCA submitted analysis carried out by Argus Information and Advisory Services. Argus received detailed account-level and longitudinal data covering 75% of the UK credit card market. A dataset covering a two year period 2007-2009 was created in order to conduct account-level analysis.

68. The remaining sections analyse the options according to the four main areas that were put out for consultation:

• Allocation of payments
• Minimum repayments
• Unsolicited credit limit increases
• Risk-based re-pricing

40 http://www.bis.gov.uk/creditconsultation
41 The one significant UK issuer that does not subscribe to Argus’ services provided data to the company for their portfolio in order to ensure greater coverage of the UK market.
Preferred options

69. The Government has decided to introduce five new rights for credit and store card users. All of the proposed changes have the support of lenders and will therefore be implemented voluntarily. The five new rights are:

- **Right to repay**: consumers’ repayments will be allocated to the debt with the highest interest rate first. For consumers opening new accounts, the minimum payment will always cover at least interest, fees and charges, plus 1% of the principal to encourage better repayment practice.

- **Right to control**: consumers will have the right to choose not to receive credit limit increases in the future and the right to reduce their limit at any time.

- **Right to reject**: consumers will be given more time to reject increases in their interest rate and their credit limit.

- **Right to information**: consumers at risk of financial difficulties will be given guidance on the consequences of paying back too little; and all consumers will be given clear information on increases in their interest rate and their credit limit, including the right to reject.

- **Right to compare**: consumers will have an annual statement that allows for easy cost comparison with other providers.

70. How these rights relate to the choices that have been made in individual areas is set out below. The Government has agreed with credit and store card providers that these measures will come into effect by the end of the year, with the exception of the change to minimum payment levels for new customers, for which some lenders will need more time to implement. In addition, consumers who are at risk of financial difficulties will be protected through a ban on increases in their credit limit as well as a ban on increases in their interest rate.

Allocation of payments

71. The Government’s preferred option is to reverse the allocation of payments, so that repayments are allocated first to the debts attracting the highest interest rate. This falls under the **right to repay** in the Government response.

72. Evidence collected by both the UKCA and BIS shows that consumers are not happy with the existing practice regarding the allocation of payments. Although there are existing credit cards available that already offer an allocation of payments that is entirely in favour of the consumer, consumers do not seem to understand the implications of different allocation policies and research suggests that the provision of additional information (i.e. option 2) does not seem to improve consumer understanding.

73. In terms of reforming the allocation of payments, consumer support was strongest for reversing the allocation, rather than alternative versions of reform. The proposal put forward by the UKCA in its response, i.e. a full reversal of the allocation of payments, except for the minimum payment, was not felt to address the difficulties of those who would benefit most from the reform. This has been amended in the agreed voluntary solution to also incorporate minimum payments, so that the allocation of payments has been fully reversed.

Minimum payments

74. The Government’s preferred option is to provide improved information to ‘habitual’ minimum payers and to introduce a new level of minimum payment (i.e. fees, interest and charges plus 1% of the outstanding balance) for new accounts. This falls under two of the rights included in the Government response: the **right to repay** to encourage better repayment practice, and the **right to information** about consumers at risk of financial
difficulties being given guidance on the consequences of paying back too little. Lenders have agreed to implement these reforms voluntarily.

75. Evidence shows that consumers do not seem to understand the implications of consistently making the minimum payment and would value the provision of more targeted information to those for whom it would benefit. In terms of changes to the minimum payment, consumers were not in favour of the inclusion of an additional ‘recommended’ minimum payment on statements, as this is likely to be confusing for cardholders and may not lead to the desired changes in repayment behaviour (e.g. could dissuade consumers from making full repayments).

76. Although evidence indicates that increasing the level of minimum payments could lead to a significant proportion of consumers being unable to meet their repayments, there was some limited support for encouraging better repayment behaviour. To avoid these adverse effects, a new level of minimum payment (1% of the balance, plus fees, interest and charges) has been introduced, but only for new accounts. This could also have the benefit of potentially deterring cardholders from accumulating unsustainable levels of credit and store card debt. In addition, there is evidence that some lenders are already experimenting with increasing the minimum payment for new customers to reduce risk.

Unsolicited credit limit increases

77. The Government’s preferred option is to provide better information and rights for consumers about unsolicited credit limit increases. This falls under three of the rights included in the Government response: the right to control a credit limit; the right to reject a limit increase; and the right to information about how consumers can manage their credit limits. Lenders have agreed to implement these reforms voluntarily.

78. Evidence collected by both the UKCA and the Government show that unsolicited credit limit increases are not associated with financial difficulty or over-indebtedness. This is due to issuers mainly targeting accounts that are of low risk and have low or medium utilisation rates. Furthermore, quantitative research shows that the vast majority of customers are apathetic to unsolicited increases and do not spend significantly more on their credit cards if they receive an increase.

79. In this context, the impact and potential risks associated with interventionist approaches (such as banning unsolicited credit limit increases) are disproportionate given the scale of the problem. The preferred option represents a proportionate and targeted solution for the minority of cardholders that are tempted by unsolicited credit limit offers, but would rather not increase their spending, as they will have more options to ensure that their limits remain unchanged.

Risk-based re-pricing

80. The Government’s preferred option is to provide better information to consumers about all types of re-pricing, in addition to strengthening their right to reject any APR increase. The latter involves ensuring that consumers have an additional 30 days after an increase in their interest rate comes into force to decide to reject the increase and pay down the card at its existing rate. This is on top of the 30 days’ notice that lenders must currently give consumers and therefore means that cardholders have 60 days to make a decision. Lenders have agreed to implement these reforms voluntarily.

81. This preferred option falls under two of the rights included in the Government response: the right to reject a price increase; and the right to information about how re-pricing is practiced by lenders. Evidence collected by both the UKCA and the Government show that high-risk accounts are more likely to receive a price increase than low and medium-risk accounts. Furthermore, re-priced accounts are not significantly associated with financial difficulty or over-indebtedness. Quantitative research shows that a majority of customers understand and accept the rationale behind risk-based re-pricing if it is properly explained to them. In this context, the impact and potential risks associated with
interventionist approaches are disproportionate given the scale of the problem. The preferred option represents a proportionate solution to the asymmetric information problem.

82. The scope of the reforms have been extended to all types of re-pricing, both risk-based and portfolio, because research evidence showed that the lack of consumer understanding applied to re-pricing in general. It also ensures a completely transparent relationship between the lender and borrower

Simplicity & transparency

83. In the consultation, three specific ideas were suggested: providing consumers with an annual statement about their credit and store card usage, developing a benchmarking or labelling system for credit and store cards and designing a basic, cheap and accessible credit card that consumers could use with confidence.

84. As in the case of other options, there was wide acceptance of the merits of improving information to consumers, but many highlighted the risks of information overload. Industry has agreed to work with consumer groups to develop an annual statement and to consider its content and format. The annual statement will give consumers clear information about how much it has cost them to use their card over the year, including information on all interest and charges for the year.

85. Consumers were particularly positive about the suggestion for simpler labelling. HM Treasury has commissioned (unpublished) consumer research, carried out by GfK NOP, which showed that there is a need for greater fairness, transparency and clarity to help consumers make more effective and confident decisions when selecting financial products.

86. A number of concerns were raised about the practicalities of implementing a basic credit card (e.g. difficult to make such a product competitive as other credit card products may already deliver many of the benefits). In addition, previous evidence shows that, where lenders have developed such products in the past, there has been little take-up by consumers.

87. Overall, the costs of implementing this voluntary package of measures are estimated to be £2,441m-£2,613m over 10 years, compared to benefits of £2,376m-£2,513m over the same period. This is composed of one-off implementation costs of £65m-£100m and annual costs (in the form of interest income lost by lenders, which is transferred to consumers in the form of lower overall interest payments) of £276m-292m.

Risks

88. 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.\footnote{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.}

89. In relation to these unintended consequences, there have already been changes in the US following implementation of their recent legislation; 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.\footnote{Source: Reuters – ‘US credit card issuers pare lending limits’, 28 August 2009} Since the passing of the US CARD Act in May 2009, experts have estimated that the amount of available credit has been reduced by $1.2 trillion, and the
number of sub-prime credit cards issued in the US in September 2009 was nearly two-thirds less than those issued 12 months previously.\textsuperscript{45}

90. 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.

91. Previous analysis has suggested the existence of ‘waterbed effects’ that may occur as a result of regulatory intervention to constrain an industry’s profitability.\textsuperscript{46} In terms of the agreed voluntary package of measures above, overall these are not as interventionist as the equivalent regulation in the US. Therefore, we would not expect the impact to be as severe in terms of reduced credit limits, increased interest rates, introduction of fees and/or the erosion of reward schemes.

92. In the context of the pressures on profitability for credit and store card lenders, a further reduction in revenue would leave lenders facing a number of choices, which are not necessarily mutually exclusive: absorbing some (or all) of the reduction in revenue; offering less attractive promotional rates through shorter promotional periods at less generous interest rates, and/or recouping revenue from cardholders by other means (e.g. higher rates of interest or annual fees).

93. Evidence has been provided by UK industry on the potential secondary effects of the agreed changes, in terms of how the lost interest income (£276m-292m) could be recouped through either an increase in the overall interest rate charged on credit cards or the levying of an annual fee.

94. As an indication, if all of the lost interest income were recouped through increased interest rates across all accounts, this would equate to an increase of 0.64%-0.67%. Although an increase in the interest rate was not popular when tested with consumers as part of BIS-commissioned research (see below), it is difficult to analyse how any potential increase might impact on consumer behaviour.\textsuperscript{47}

95. Obviously, an increase in the interest rate paid by individuals on their outstanding credit or store card borrowing would lead to additional costs being imposed on consumers through an increase in the total amount of interest paid (and therefore transferred to lenders in the form of interest income). For those customers that have different types of balance, this would negate some portion of the transfer received as a result of the change to the allocation of payments. However, those cardholders with a single type of outstanding balance (and therefore not benefiting from the change to the allocation of payments) may incur additional costs through paying more interest over the life of the balance.

96. It is also possible that an increase in the overall interest rate would disincentivise future spending by those cardholders who did not already have an outstanding balance on their credit or store card. This would lead to lower overall borrowing on credit and store cards, which may have a consequent impact on interest income for lenders and potentially consumer spending in the overall economy.

97. In terms of the secondary effects if all of the lost interest income associated with the agreed changes were recouped through annual fees, these would vary from around £5.02-£5.31 per account (or £7.85-£8.35 per active account). This is an overly simplistic analysis, as issuers would need to assess a complex range of issues (including how consumers use their cards, their riskiness of their portfolio, how fees might impact on...

\textsuperscript{45} Source: Argus ‘Q1 2008 – Q3 2009 Credit Card Payments Study’. The number of sub-prime cards issued in September 2008 as a percentage of total accounts opened was 1.8%. In September 2009 this figure dropped by two thirds to 0.7%.

\textsuperscript{46} For further detail on waterbed effects, please see Annex 2.

\textsuperscript{47} Without further detail on the interest elasticity of money demand, it is difficult to quantify the overall potential macroeconomic impact.
consumer behaviour) before setting the level of any new fees. Many credit and store cards currently available in the UK do not currently levy an annual fee, so any increase could have quite a significant impact.

98. If this increase in fees were to apply across all cardholders, then some consumers who had not benefited from the change to the allocation of payments (i.e. those who pay off their balance in full each month, or who only have a single kind of balance on their card) would incur some additional costs as a result of the change.

99. These potential consequences were explained in principle for consumers in the BIS-commissioned research. It was felt that an increase in the interest rate for all was unacceptable, but there was considerable scepticism about whether card providers would actually impose this on credit card users. According to the consumer research, the other consequences (no balances transfers, no cash withdrawal facility or decreased credit limits) were all seen as consequences that would reduce access to credit (primarily for more vulnerable groups) and were therefore seen as more acceptable.

100. Given the importance of these secondary effects in determining the overall impact of these measures on consumers, it will be necessary to monitor developments in this area very closely in the future.
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
The Government’s preferred option is to allocate payments to the debt accruing the highest interest rate first.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? A post-implementation review will be undertaken after 3 or 5 years.

Ministerial Sign-off For final proposal/implementation 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:

...............................Date: March 2010
### 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>
<tbody>
<tr>
<td><strong>ANNUAL COSTS</strong></td>
<td>Description and scale of key monetised costs by 'main affected groups'</td>
</tr>
<tr>
<td>One-off (Transition) Yrs</td>
<td>Industry: implementation costs of producing necessary information and integrating into customer communication (£5m-10m)</td>
</tr>
<tr>
<td>£ 5m-10m</td>
<td><strong>Average Annual Cost</strong> (excluding one-off)</td>
</tr>
<tr>
<td>£ Unknown N/A</td>
<td><strong>Total Cost (PV)</strong> £ 5m-10m</td>
</tr>
<tr>
<td><strong>Other key non-monetised costs</strong> by 'main affected groups'</td>
<td></td>
</tr>
<tr>
<td>Industry: potential reduction in interest income as balances are reduced and/or paid off sooner through changes in consumer repayment behaviour (transferred to cardholders)</td>
<td></td>
</tr>
<tr>
<td><strong>ANNUAL BENEFITS</strong></td>
<td>Description and scale of key monetised benefits by 'main affected groups'</td>
</tr>
<tr>
<td>One-off</td>
<td><strong>Average Annual Benefit</strong> (excluding one-off)</td>
</tr>
<tr>
<td>£ 0</td>
<td><strong>Total Benefit (PV)</strong> £ Unknown</td>
</tr>
<tr>
<td><strong>Other key non-monetised benefits</strong> by 'main affected groups'</td>
<td></td>
</tr>
<tr>
<td>Cardholders: changes in consumer repayment behaviour as a result of increased transparency, leading to benefits through reduced interest costs of borrowing (transferred from lenders)</td>
<td></td>
</tr>
</tbody>
</table>

**Key Assumptions/Sensitivities/Risks**
If greater information provision leads to at least some consumers changing their repayment behaviour, then there will be a transfer from lenders to cardholders; as a result, some providers may be incentivised to alter their allocation of payments. However, this could lead to adverse impacts on availability of promotional rates and cash advance.

<table>
<thead>
<tr>
<th>Price Base Year 2008/9</th>
<th>Time Period Years N/A</th>
<th>Net Benefit Range (NPV) £ -5 to -10m</th>
<th>NET BENEFIT (NPV Best estimate) £ -7.5m</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Impact on Admin Burdens Baseline (2005 Prices)</th>
<th>(Increase - Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase £ 0</td>
<td>Decrease £ 0</td>
</tr>
</tbody>
</table>

**Net Impact** £ 0

| 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

| Description and scale of key monetised costs by ‘main affected groups’ |
| Industry: implementation costs of £30m-£40m (80% on IT systems changes, 20% on staff training and other costs); Industry: reduced interest income as balances are reduced and/or paid off sooner (£120m pa, transferred to cardholders)

<table>
<thead>
<tr>
<th>One-off (Transition)</th>
<th>Yrs</th>
<th>Average Annual Cost (excluding one-off)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 30m-40m</td>
<td></td>
<td>£ 120m</td>
</tr>
</tbody>
</table>

Total Cost (PV) £ 1,063m-1,073m

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

Consumers: potential costs to all cardholders if lenders take action to recoup lost income, for example through increased fees/interest rates and/or reduced credit limits; also potential for greater complexity in credit card pricing, resulting in customer confusion

### ANNUAL BENEFITS

| Description and scale of key monetised benefits by ‘main affected groups’ |
| Cardholders: reduced interest costs of borrowing (£120m pa, transferred from card providers)

<table>
<thead>
<tr>
<th>One-off</th>
<th>Yrs</th>
<th>Average Annual Benefit (excluding one-off)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 0</td>
<td></td>
<td>£ 120m</td>
</tr>
</tbody>
</table>

Total Benefit (PV) £ 1,033m

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

Those consumers affected by the change in allocation of payments are more likely to be high-risk customers, which means that they might benefit from paying off their balance sooner, thereby reducing their exposure to the risk of over-indebtedness.

---

**Key Assumptions/Sensitivities/Risks**

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

---

**Price Base Year:** 2008-9  
**Time Period Years:** 10  
**Net Benefit Range (NPV):** £ -30m to -40m  
**NET BENEFIT (NPV Best estimate):** £ -35m

---

**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 regulation  
**What is the total annual cost of enforcement for these organisations?** £ 0  
**Does enforcement comply with Hampton principles?** Yes  
**Will implementation go beyond minimum EU requirements?** N/A  
**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</th>
<th>Decrease</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 0</td>
<td>£ 0</td>
<td>£ 0</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>

**ANNUAL COSTS**

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry: implementation costs of £30m-£40m (80% on IT systems changes, 20% on staff training and other costs); Industry: reduced interest income as balances are reduced and/or paid off sooner (£265m pa, transferred to cardholders)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Costs</th>
<th>One-off (Transition)</th>
<th>Yrs</th>
<th>£ 30m-40m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td>£ 265m</td>
<td>10</td>
<td>Total Cost (PV) £ 2,311m-2,321m</td>
</tr>
</tbody>
</table>

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

**ANNUAL BENEFITS**

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cardholders: reduced interest costs of borrowing (£265m pa, transferred from card providers)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>BENEFITS</th>
<th>One-off</th>
<th>Yrs</th>
<th>£ 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td>£ 265m</td>
<td>10</td>
<td>Total Benefit (PV) £ 2,281m</td>
</tr>
</tbody>
</table>

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

Those consumers affected by the change in allocation of payments are more likely to be high-risk customers, which means that they might benefit from paying off their balance sooner, thereby reducing their exposure to the risk of over-indebtedness.

**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. Lenders may take action to recoup lost income, for example through increased fees/interest rates and/or reduced credit limits; potential for greater complexity, resulting in customer confusion.

**Price Base**

Year 2008-9

**Time Period**

Years 10

<table>
<thead>
<tr>
<th>Net Benefit Range (NPV)</th>
<th>£ -30m to £ -40m</th>
<th>NET BENEFIT (NPV Best estimate)</th>
<th>£ -35m</th>
</tr>
</thead>
</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 regulation
- **What is the total annual cost of enforcement for these organisations?**
  - £ 0
- **Does enforcement comply with Hampton principles?**
  - Yes
- **Will implementation go beyond minimum EU requirements?**
  - N/A
- **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
  - Increase | £ 0 | £ 0 | £ 0 | £ 0
  - Decrease | £ 0 | £ 0 | £ 0 | £ 0
- **Are any of these organisations exempt?**
  - No | No | No | No

- **Impact on Admin Burdens Baseline (2005 Prices)**
  - Increase | £ 0 | Net Impact | £ 0 |
  - Decrease | £ 0 | (Net) Present Value

**Key:**

- Annual costs and benefits: Constant Prices

---

24
## Summary: Analysis & Evidence

### Policy Option: Payments
allocated to cash advance first

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

### ANNUAL COSTS

**Costs**

<table>
<thead>
<tr>
<th>Description</th>
<th>Description and scale of key monetised costs by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Industry: implementation costs of £30m-£40m (80% on IT systems changes, 20% on staff training and other costs); Industry: reduced interest income as balances are reduced and/or paid off sooner (£200m pa, transferred to cardholders)</td>
</tr>
</tbody>
</table>

**Annual Cost**

<table>
<thead>
<tr>
<th>Description</th>
<th>Description and scale of key monetised costs by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Other key non-monetised costs by ‘main affected groups’</td>
</tr>
<tr>
<td></td>
<td>Consumers: potential costs to all cardholders if lenders take action to recoup lost income, for example through increased fees/interest rates and/or reduced credit limits; potential for greater complexity, resulting in customer confusion.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Costs</th>
<th>Average Annual Cost (excluding one-off)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£200m</td>
</tr>
<tr>
<td></td>
<td>10 years</td>
</tr>
<tr>
<td></td>
<td>Total Cost (PV)</td>
</tr>
<tr>
<td></td>
<td>£1,752m-1,762m</td>
</tr>
</tbody>
</table>

### ANNUAL BENEFITS

**Benefits**

<table>
<thead>
<tr>
<th>Description</th>
<th>Description and scale of key monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cardholders: reduced interest costs of borrowing (£200m pa, transferred from card providers)</td>
</tr>
</tbody>
</table>

**Annual Benefit**

<table>
<thead>
<tr>
<th>Description</th>
<th>Description and scale of key monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Other key non-monetised benefits by ‘main affected groups’</td>
</tr>
<tr>
<td></td>
<td>Those consumers affected by the change in allocation of payments are more likely to be high-risk customers, which means that they might benefit from paying off their balance sooner, thereby reducing their exposure to the risk of over-indebtedness.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Average Annual Benefit (excluding one-off)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£200m</td>
</tr>
<tr>
<td></td>
<td>10 years</td>
</tr>
<tr>
<td></td>
<td>Total Benefit (PV)</td>
</tr>
<tr>
<td></td>
<td>£1,722bn</td>
</tr>
</tbody>
</table>

### 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

### 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 regulation

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

£0

### 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</th>
<th>Decrease</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£0</td>
<td>£0</td>
<td>£0</td>
</tr>
</tbody>
</table>

Key:

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

Allocation of payments

101. Generally, industry practice is for the most expensive debts held on a credit or store card to be paid off last. Evidence suggests that a significant proportion of cardholders are either not aware that this practice takes place or do not understand its implications for their interest costs. Combined with promotional offers and a lack of consumer understanding about different interest rates being applied to different forms of borrowing, this practice 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.

102. Research, commissioned both by BIS and the UK Cards Association, suggests that consumers are not happy with current practices regarding the allocation of payments. Survey data found that between 39 and 47% of consumers would prefer their repayments to be allocated first to debts with the highest interest rate.48

103. Action to alter the allocation of payments would result in a significant loss of interest income to industry (over £250m per year for full reversal), but this would be gained by consumers in the form of reduced interest payments. Such benefits would be conferred on a minority of cardholders; 70% of accounts (representing 55% of balances) would see no benefit. If action is taken to recoup this lost income, for example, through the introduction of annual fees, increased interest rates or cessation of cash withdrawal facilities (or some combination of these), then this could lead to costs being imposed on some consumers, without seeing any benefits.

Background

104. Almost every credit card charges different interest rates on different types of transaction, e.g. balance transfers, purchases and cash advances. Consumer awareness of this appears relatively high; research commissioned by the UKCA shows that two-thirds of credit card holders knew this already.49 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%.50

105. 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.

106. 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

---

49 UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
50 http://files.ots.treas.gov/comments/bdc5cc5c-1e0b-8562-eb23-ff7159e49505.pdf
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 it is likely that those in the former group have higher levels of financial capability, are 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.

107. Industry analysis shows that this type of activity (known as ‘surfing’), only accounts for a small share of overall balances (less than 0.2% of monthly revolving balances) and results in only a small loss of interest, roughly £1.1m per month, or £13m per year. As industry has an interest in discouraging ‘surfing’ behaviour as much as possible, action has also been taken to limit the extent of such cross-subsidisation. For example, balance transfer fees (typically 2-3% of the promotional balance) cover part of the cost of servicing promotional balances and therefore provide a deterrent to ‘surfers’.

108. 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.

109. In both the US and Canada, legislation has been introduced in relation to the allocation of payments, which reverses the typical UK practice, for any payments made in excess of the minimum payment. 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%.

110. 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; and
- 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.

111. Furthermore, the Lending Code states that every monthly credit card statement should include “A brief summary on the allocation of payments on the front or back of the statement (or a link from an online statement)”. Therefore, it is questionable whether this information is sufficient to enable consumers to understand how repayments are

---

51 Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010)
52 In 2008, the average proportion of accounts charged-off was 13% for those with a cash balance and 4% for those without
53 This is also the basis of a proposal made by the UK Cards Association in their submission to the consultation, i.e. that any payment in excess of the minimum payment be allocated first to the highest-cost debt, with the minimum payment being allocated at the discretion of the issuer
55 http://www.lendingstandardsboard.org.uk/docs/lendingcode.pdf
56 ‘Credit card survey’, OFT (2008)
structured, and whether they are enabled to make rational decisions based on this information.

113. The OFT is currently preparing Irresponsible Lending Guidance, which previously listed “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.\(^57\)

114. 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.\(^58\)

115. 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.

116. 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.

Issue

117. Even if consumers are aware that the allocation of repayments to pay off the cheapest debt first is common practice (which, according to research, seems to be the case for between 30% and 60% of cardholders), they may not realise that their repayments do not prevent them potentially accruing interest at a higher interest rate. Evidence from consumer research commissioned by the UKCA found that awareness among consumers of the implications of the allocation of payments was limited to the most financially sophisticated.\(^59\) According to research commissioned by BIS, when the practice was explained to consumers, they felt it was very confusing and difficult to understand because it was thought to be counterintuitive. Furthermore, it was felt that credit providers were intentionally adopting practices that were confusing, in order to hide costs from card users.\(^60\)

118. Despite this, the UKCA submitted that allocation of payments accounted for less than 1% of overall complaints between January and October 2009.\(^61\) Given the widespread opinions of consumers captured through commissioned research, this relatively low level of complaints is likely to reflect a lack of understanding of the implications around allocation of payments, or possibly inertia on the part of consumers to take action.

119. 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.

120. This has been supported by industry analysis of actual credit card account-level data (detailed below), which indicates that the loss of interest income to credit card providers,

\(^{57}\) ‘Irresponsible lending – OFT guidance for creditors’, OFT (2009)
\(^{58}\) [http://www.nationwide.co.uk/creditcard/GoldCard/order_of_payments.htm](http://www.nationwide.co.uk/creditcard/GoldCard/order_of_payments.htm)
\(^{59}\) UKCA, Appendix 5 of the Response to BIS Consultation: GfK Qualitative Research Management Report (January 2010)
\(^{60}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
\(^{61}\) UKCA, Response to BIS Consultation (January 2010)
and hence spending on credit card interest repayments saved by cardholders, is about half that estimated by Nationwide on an annual basis.

121. Furthermore, industry analysis indicates that there a substantial proportion of cardholders, representing just over 70% of all credit card accounts and 55% of credit card balances, for whom the allocation of payments will have no effect, as they only have one type of balance and hence only a single interest rate associated with their borrowing.62

122. 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.

123. The proportion of credit card customers falling into this first category is relatively small, accounting for around 9% of all accounts, with an average balance of £2,200. Balance transfer activity has also fallen slightly over the last couple of years (as shown in the chart below), from a peak of over 1.5% of accounts per month in early 2008 to just under 1% of accounts by mid-2009. However, industry analysis also shows that balance transfer activity is concentrated among low-risk accounts, with over 20% of all balance transfers accounted for by lowest-risk accounts, while only 1.5% is accounted for by highest-risk accounts.63

124. Nevertheless, industry analysis of account-level data shows that, following a balance transfer, both cash balances and non-promotional purchase balances increase by more than those accounts without a balance transfer. This occurs in conjunction with a significant reduction in the promotional balance, so that overall balance declines slightly, compared to an account without a balance transfer. However, the effective interest costs for balance transfer customers rises steadily throughout the year following a balance transfer, as the proportion of higher-cost balances builds up. This is not conclusive proof of the potential problem set out above, as it is not clear whether customers are rationally choosing to build up the balances, while taking advantage of a promotional rate to pay down their other debts, or whether these balances are building up due to a mistaken belief that they are being paid off through their regular repayments.

<table>
<thead>
<tr>
<th>Proportion of accounts with balance transfer (by month), 2007-2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
</tr>
<tr>
<td>1.8%</td>
</tr>
<tr>
<td>1.6%</td>
</tr>
<tr>
<td>1.4%</td>
</tr>
<tr>
<td>1.2%</td>
</tr>
<tr>
<td>1.0%</td>
</tr>
<tr>
<td>0.8%</td>
</tr>
<tr>
<td>0.6%</td>
</tr>
<tr>
<td>0.4%</td>
</tr>
</tbody>
</table>

Source: Argus, ‘UK Credit Card Payments Study’ (2010)

62 Argus, ‘UK Credit Card Payments Study’ (2010); this single interest rate could be either a promotional or non-promotional rate.
63 Argus, ‘UK Credit Card Payments Study’ (2010)
125. According to BIS-commissioned research, all groups of consumers felt that balance transfers were useful and valuable. Respondents who used balance transfer facilities highly valued the facility as a way to spread costs and repay debt over a longer period. However, there was also a perception that balance transfers encouraged consumers to take on higher levels of debt. For example, those consumers who considered themselves to have less self-control felt that balance transfer presented an opportunity to get into more debt.\(^{64}\)

126. The current allocation of payments may also limit 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.\(^{65}\)

127. Although evidence shows that those taking advantage of balance transfers are more likely to be aware of current practices on the allocation of payments, qualitative consumer research commissioned by BIS suggests that they may not. Respondents who had transferred a balance said they did so to pay off more expensive debts, and balance transfers were generally perceived as a way to avoid paying off interest on a high debt, whilst reducing other debts.\(^{66}\)

128. 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).

129. We believe the problems associated with the allocation of payments are more acute for this second group of consumers. This group, which (according to industry analysis) represents approximately 28% of all credit card accounts, is likely to include a significant number of vulnerable consumers, who may have limited choices of other borrowing vehicles.\(^{67}\) According to BIS-commissioned consumer research, 42% of consumers making minimum payments also withdrew cash on their credit cards.\(^{68}\)

130. 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.\(^{69}\) Industry analysis shows that accounts with some cash balance element are more likely to result in default than those accounts without a cash balance, across all customer risk categories.

131. 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

---

\(^{64}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

\(^{65}\) 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%.

\(^{66}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

\(^{67}\) I Argus, ‘UK Credit Card Payments Study’ (2010); indeed, the proportion of high-risk consumers with a cash balance (60%) is much higher than the average, while the proportion of low-risk consumers (10%) is much lower

\(^{68}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

\(^{69}\) ‘Overstretched: People at risk of financial difficulties’, Kempson & Atkinson (2006)
store cards are not as common as they are with credit cards, we understand that some store card issuers do allow cash withdrawals.

**Rationale**

132. 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 features to include in a summary box on a credit card statement, 46% of respondents chose order of repayments.

133. A recent research paper[^70] found that general awareness among US consumers around the allocation of credit card repayments was low, but those least likely to answer correctly were those with lower levels of personal financial knowledge and those on lower incomes.[^71] However, different research found that around half of consumers (involved in testing of information disclosures around payment allocation) understood that banks first allocated payments to debts with the lowest interest rate.[^72] A US consumer survey conducted for BIS found that 42% thought their payments would first be allocated to the lowest-interest debt.[^73]

134. Evidence on awareness of UK consumers was collected through commissioned research. Research commissioned by BIS (conducted after the launch of the consultation) found that (as an unprompted response) around 30% of respondents believed their credit or store card repayments were allocated first to debts with the lowest interest rate.[^74] A different survey commissioned by BIS (also asking for unprompted answers) found that 48% of respondents thought that payments would be allocated first to the balance with the lowest interest rate.[^75]

135. Research conducted by UK Cards Association (UKCA) asked respondents (following an explanation that most lenders apply repayments to balances with the lowest interest rate first) whether or not they knew this already; 59% responded that they did.[^76] Awareness was higher among those who were taking advantage of a promotional offer (71%), which shows awareness among those most likely to benefit from the current practice on allocation of payments. However, there were similarly high levels of awareness among minimum payers, which seems to imply that awareness is independent of a likelihood of benefiting from it.

136. Despite this, qualitative industry research found that only a small minority (the most financially sophisticated/empowered) were aware of the system and able to explain it. Even some who had experienced it were oblivious to, or unable to make sense of, what was happening in relation to their allocation of payments and why.

137. It is difficult to account for the discrepancies in these responses. It is possible that differences in the style of question between the BIS-commissioned research and the UKCA-commissioned research could account for at least some proportion of this.[^77]

[^70]: ‘What’s draining your wallet? The real cost of credit card advances’, Frank (2008)
[^71]: 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
[^74]: YouGov DebtTrack, November 2009. However, this question did include a substantial number of ‘don’t know’ responses (47%). Additionally, 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.
[^76]: UKCA, Response to BIS Consultation (January 2010)
[^77]: The style of question could be important here – according to the industry research, 24% of those who did not know that there were different interest rates professed to know that repayments were allocated first to debts with the lowest interest rate, which seems an odd finding. In their response, UKCA do concede that they would expect a response to an open question (like the one asked in the BIS-commissioned research) to be lower than the style of question used in the UKCA research.
However, this does not explain the difference between the two BIS-commissioned surveys (30% and 48% choosing lowest interest rate first).

138. Nevertheless, there is still a substantial proportion of consumers (between 40% and 70%, according to the evidence above) who do not think that repayments are currently allocated first to paying off their debts with the lowest interest rate first.\(^{78}\) This lack of awareness on the part of consumers suggests the presence of asymmetric information.

139. It could be argued that the presence of a credit card that has a ‘positive’ allocation of repayments (Nationwide\(^ {79}\)) 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.

140. However, the evidence showing low consumer awareness would suggest that many cardholders are not aware of their current repayment arrangements, let alone the features of a different card.\(^ {80}\) 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.

141. Indeed, research conducted in the US on amendments to information provided to credit card holders found that the inclusion of a specific clause to explain how payment allocation affects interest charges did not improve consumers’ understanding.\(^ {81}\) This may suggest the potential for investigating whether it is necessary to intervene more directly in order to address this issue. As indicated above, even when the current practice around allocation of payments was explained to consumers as part of research (both that commissioned by BIS and the UKCA), consumers found it very confusing and difficult to understand. In addition, UKCA research found that, although consumers accepted that credit card providers have to make money, current practice on allocation of payments was felt to be a rather ‘dishonourable’ way of doing so.\(^ {82}\)

Options analysis

142. 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.

143. 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, as shown by the US research. There is therefore a case for arguing that a successful policy intervention would alter the allocation of payments in the consumer’s favour, as has been partially introduced through recent reforms in the US.

144. 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

---

\(^{78}\) As will be true for the overwhelming majority of cases

\(^{79}\) Saga also provide a credit card with an alternative repayment order: [http://www.saga.co.uk/finance/spf/visa_card/](http://www.saga.co.uk/finance/spf/visa_card/)

\(^{80}\) And this is not necessarily one of the key characteristics that consumers may focus on when choosing their card

\(^{81}\) ‘Design and testing of effective truth in lending disclosures’, Macro International (2008)

\(^{82}\) UKCA, Appendix 5 of the Response to BIS Consultation: GfK Qualitative Research Management Report (January 2010)
present severe difficulties for consumers to accurately assess their outstanding balance, and the associated interest rate.\textsuperscript{83} Such an option may also present significant challenges in terms of explaining these arrangements to customers.

145. Further options were offered by respondents to the consultation, such as a ‘first in, first out’ policy, i.e. allocating repayments to debts incurred in a reverse chronological order, so that debts incurred most recently are paid off first. However, this is likely to create as much confusion (if not more) than the conventional chronological approach set out above.

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

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

147. 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’.

148. 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

149. 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.

150. In assessing this option, we are mindful of the potential for ‘information overload’ and that more information may not always be helpful to consumers. Indeed, that the Lending Code stipulates that every monthly credit card statement should have information on allocation of payments, but awareness amongst cardholders is still much less than universal, indicates that provision of further information is not always successful. In addition, US research suggests that the provision of specific information explaining payment allocation policies does not improve consumer understanding.

Costs

151. 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.

152. Evidence provided by industry suggests that implementation costs associated with producing additional information and making policies around allocation of payments

\textsuperscript{83} Though this may not necessarily be the case for recent entrants to the UK credit card market
clearer (i.e. through updating lender websites, additional customer service training and customer notification) could amount to £5m-10m.

Benefits

153. 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. 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, including credit cards.

154. Indeed, the US research referenced above found that the provision of additional information on payment allocation did not improve consumer understanding. This suggests that there are limits to the ability of information to improve the situation. According to research commissioned by BIS, consumers felt that information was a less effective option, as information was typically ignored by customers. In any case, it is difficult to estimate what proportion of consumers (if any) might change their behaviour, even if they fully understood how the allocation of payments was structured.

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

155. This option would see a monthly payment being divided up and used to reduce outstanding debts on a pro-rata basis. As set out above, approximately 70% of credit card accounts (accounting for 55% of balances) would not see any benefit from a change to the current allocation of payments, concentrating the benefits of this option among roughly 15 million credit card accounts.

Costs

156. This option will reduce the total amount of interest paid on balances, which 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). Industry analysis indicates that this transfer would amount to £241m over two years, or an average of approximately £120m per year.

157. 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. Industry estimates suggest that a combination of IT system changes (comprising 80% of the costs), along with staff training and customer communication (comprising 20% of the costs), would amount to one-off costs of £30m-40m.

158. Given these complexities involved with this option, this could lead to increased customer confusion. The potential for increased confusion among cardholders was raised in the consumer research commissioned by BIS, as it was felt that this option would be overly complex. However, consumer research commissioned by the UK Cards Association...
found that consumers preferred this option, as it was felt to be comprehensive, fair and reasonable, reflecting consumer usage behaviour, but balanced against consumer rights.

159. 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. In the context of the pressures on profitability for credit and store card lenders mentioned earlier, a further reduction in revenue would leave lenders facing a number of choices, which are not necessarily mutually exclusive: absorbing some (or all) of the reduction in revenue; offering less attractive promotional rates through shorter promotional periods at less generous interest rates, and/or recouping revenue from cardholders by other means (e.g. higher rates of interest or annual fees). These are covered in more detail in the risks section below.

160. In relation to this policy area, there may also be specific problems in relation to the cash advance facility currently offered by lenders. Lenders would then be faced with a decision of increasing the price of cash advances, increasing the cost of purchases to compensate, or withdrawing the cash advance facility altogether. In addition, if promotional rates were lowered or promotional periods shortened, those consumers who currently derive benefits from utilising balance transfers would be be disadvantaged and those benefits reduced.

Benefits

161. 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. This is equal to the interest income lost by industry, i.e. £120m per year.

162. Looking at the distributional impact of this saving on interest payments, high-risk customers are most likely to benefit; industry analysis shows that under this option, those in high-risk segments should save nearly £4 a month in interest payments, with those in low-risk segments savings less than £1 a month. 88

Option 4: Allocate repayments to the most expensive debt first

163. This is similar to the model first proposed under the US CARD Act, which stated 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.

164. During its passage through Congress, this aspect of the US CARD Act was amended so that minimum payments would continue to be applied to debts with the lowest interest rate, while any payments in excess of the minimum would be allocated to the highest-cost debt. This model also forms the basis of a proposal made by the UK Cards Association in their submission to the consultation, i.e. that any payment in excess of the minimum payment be allocated first to the highest-cost debt, with the minimum payment being allocated at the discretion of the issuer.

165. Again, the impact of this option would affect approximately 30% of credit card accounts (roughly 15 million accounts, representing 55% of balances).

Costs

166. This would result in a significant transfer from credit and store card providers (in the form of lost interest income) to consumers (in the form of lower interest payments). Nationwide estimated this transfer to be £509m, while analysis of similar changes in the US estimated that lost annual interest income would be over $1 billion. 89

88 Argus, ‘UK Credit Card Payments Study’ (2010)
89 Morrison Foerster (August 2008)
167. Industry analysis of UK credit card account-level data found that the impact of this option would be a loss in interest income of £533m over two years, or an average of approximately £265m per year.

168. There are two main contributing factors to the overall revenue impact: those with a combination of cash & non-cash balances (accounting for around 60% of the impact) and those with a combination of promotional & non-promotional balances (accounting for around 40% of the impact). As higher-risk customer segments have a higher proportion of cash/non-cash balances\(^90\), the revenue impact is greatest in these high-risk accounts.\(^91\)

169. The UKCA proposal, which would exempt minimum payments from this reversal of payment allocation, would result in a much lower loss of interest income; £248m over two years, or an average of approximately £125m per year.

170. Industry have also estimated implementation costs associated with this option, e.g. IT system changes (accounting for 80% of costs), staff training and customer communication (accounting for 20% of costs), to be £30m-40m.\(^92\)

171. 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). Industry analysis suggests that, in order to compensate for the lost income under this option, purchase APRs on promotional accounts would have had to increase by approximately 2.75 percentage points.

172. However, it is difficult to anticipate any dynamic effects associated with this change, i.e. how this might affect consumer behaviour and usage. For example, a higher purchase APR for those promotional accounts with an existing balance would increase the amount of interest income from these customers; on the other hand, it may reduce the amount of interest income for those promotional accounts that do not already have a balance, as additional spending may be disincentivised. In their impact assessment, Oxera suggest that the number and duration of promotional offers available from lenders will decline and those consumers who take advantage of such offers will pay more.\(^93\)

173. An additional consideration under this option is that the competitive advantage currently held by Nationwide in relation to 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.

174. The likelihood of charge-off for accounts with any cash balance is higher than for those without a cash balance: in 2008, the average proportion of accounts charged-off was 13% for those with cash and 4% for non-cash accounts.\(^94\) This makes cash withdrawal a more risky activity and, if the payment allocation is fully reversed, this means that lenders would not receive compensating income for this higher-risk activity to cover the incremental losses associated with cash withdrawal. Therefore, it is likely that costs to consumers who use this facility will rise, and some lenders may withdraw the cash advance facility altogether.

**Benefits**

175. 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

---

\(^{90}\) The average for all accounts is 26%; however, this rises to 60% for those in the highest-risk category and falls to 10% for those in the lowest-risk category

\(^{91}\) As stated above, the average contribution to the overall revenue impact is 60% across all accounts; however, this rises to 82% in the highest-risk category and falls to 64% in the lowest-risk category

\(^{92}\) These costs do not differ if the minimum payment is exempted

\(^{93}\) Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010)

\(^{94}\) Argus, ‘UK Credit Card Payments Study’ (2010); this was also the case across all customer risk segments
their outstanding credit or store card balance and the total interest cost of borrowing, equal to the amount of interest income lost by industry (i.e. £265m per year).

176. As set out above, the amount of lost interest income (and hence the benefits to individuals) is greatest for those customers in a high-risk category. This equates to a maximum saving on interest payments of around £9.50 per month for high-risk customers, falling to less than £1 per month for low-risk customers.95

177. Such savings are therefore concentrated among a relatively small number of cardholders. Industry analysis shows that 68% of customers will not see any monetary benefit under this option, with just over 1% of customers benefiting by more than £90 per year.96

178. Under the UKCA proposal, the interest saving (totalling approximately £125m per year) is more moderate, weighted much less in favour of high-risk customers, around £3.50 for high-risk customers, falling to £0.50 for low-risk customers.97

179. This option was the one most favoured by consumers in the BIS-commissioned research, as it was consistent with consumers’ expectations and would also have a positive effect on consumers’ perception of credit providers.98

**Option 5: Allow consumers to pay off cash advance first**

180. 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. Industry analysis shows that the average proportion of credit card accounts with an existing cash balance is 28% (representing over 15 million accounts).99

181. Similarly to option 4, this option may also confer greater benefits on vulnerable consumers. As shown in the chart below, although the proportion of credit card accounts making cash withdrawals has been steadily declining across all risk categories since 2007, high-risk accounts remain more than twice as likely to include a cash balance.100 Additional industry analysis shows that the average cash balance (as at July 2009, for those accounts that have them) was £822, though the average balance for high-risk customers was also more than twice as much as for low-risk customers.101

---

95 Argus, ‘UK Credit Card Payments Study’ (2010)
96 Argus, ‘UK Credit Card Payments Study’ (2010)
97 Argus, ‘UK Credit Card Payments Study’ (2010)
98 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
99 Argus, ‘UK Credit Card Payments Study’ (2010)
100 The main source of growth on cash acquisition has been through debt cards - the value of cash withdrawals on debit cards has grown by a factor of 2.5 since 2005
101 Argus, ‘UK Credit Card Payments Study’ (2010)
182. Meanwhile, consumer research commissioned by BIS found that the incidence of cash withdrawal on credit cards is higher among those in financial difficulties\textsuperscript{102} and those that make minimum payments.\textsuperscript{103}

**Costs**

183. As cash advance users are a relatively small group, the reduction in lender revenue is not quite as significant as a total reversal of the current pricing structure. Industry analysis shows that the costs in terms of lost interest income would amount to £394m over two years, an average of roughly £200m per year.

184. As set out above, cash withdrawal is associated with a greater likelihood of default. Hence a system of payment allocation that does not allow lenders to receive compensating income for this higher-risk activity would make it less likely that the incremental losses associated with cash withdrawal would be covered. This would most likely lead to a reduction in the profitability of providing a cash facility, and lenders may increase the cost of providing cash advances, so that pricing reflects the risk associated with such transactions, which would lead to increased costs to consumers who use this facility and the potential withdrawal of such a facility by some lenders. The reduction in utility for those consumers who withdraw cash is difficult to quantify.

185. The implementation costs associated with this option are estimated to be £30m-40m, of which 80% is accounted for by IT system changes and 20% by staff training and customer communication.

**Benefits**

186. 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. According to the BIS-commissioned research, this option was seen as less positive by consumers, mainly as it did not address the issue of balance transfers. In addition, a concern was raised that it could potentially encourage more consumers to withdraw cash on their credit card.\textsuperscript{104}

---

\textsuperscript{102} TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); 57% had withdrawn cash, compared to an average of 27% for all cardholders

\textsuperscript{103} TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); 42% had withdrawn cash, compared to an average of 27% for all cardholders

\textsuperscript{104} TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
187. We do not have a calculated benefit on a per-consumer basis, but industry analysis shows that the proportion of credit card accounts with an existing cash balance is 28% (representing over 15 million accounts). If the aggregate interest saving were distributed equally across all these accounts, that would imply that each account would save approximately £13 a month in interest payments. However, as the proportion of accounts with a cash balance is higher amongst high-risk consumers, they are likely to benefit to a greater degree than low-risk consumers.

Risks

188. 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. In their impact assessment, Oxera suggests that lenders could be likely to: shorten the promotional period for balance transfer deals, reduce the availability and worsen the terms of promotions available to existing customers, and/or employ higher interest rates or fees for cash withdrawals or reduce the availability of cash withdrawals altogether.

189. This is consistent with the position in the United States following the implementation of the relevant provision in the US CARD Act, which has resulted in the reduced attractiveness of promotional deals, with smaller promotional periods and less attractive promotional interest rates. The UKCA response includes some evidence on this issue; the proportion of balance transfers that involve a fee has increased by 6.6% in the year to June 2009, to around 87%; the fee as a percentage of the transaction amount increased by 49% in the year to June 2009 and now stands at around 2.9%. In addition, the proportion of new accounts with a balance transfer that involved a fee has risen by 23.1% in the year to June 2009; the amount of the fee has increased by 22.9% to 2.8%.

190. Evidence has been provided by industry on the potential secondary effects of changes to the allocation of payments, in terms of how the lost interest income could be recouped through either an increase in the overall interest rate charged on credit cards or the levying of an annual fee.Obviously, an increase in the interest rate paid by individuals on their outstanding credit or store card borrowing would lead to additional costs being imposed on consumers (transferred to lenders), that would negate some portion of the transfer as a result of changing the allocation of payments. However, it is possible that an increase in the interest rate would disincentivise future spending by those cardholders who did not already have an outstanding balance on their credit or store card.

192. In terms of the secondary effects, if all of the lost interest income associated with changes to the allocation of payments were recouped through annual fees, these would vary from around £2.20 per account (or £3.40 per active account) for option 3 to £4.80 per account (or £7.60 per active account) for option 4. This is an overly simplistic analysis, as issuers would need to assess a complex range of issues (including the potential impact on consumer behaviour) before setting the level of any new fees. Many credit and store cards currently available in the UK do not currently levy an annual fee, so any increase could have quite a significant impact on consumer behaviour.

105 Argus, ‘UK Credit Card Payments Study’ (2010); this proportion varies across risk segments, with over 60% of high-risk accounts having a cash balance, compared with less than 10% of low-risk accounts
106 UKCA, Response to BIS Consultation (January 2010)
107 As discussed earlier under ‘risks’ in the summary section
108 Without further detail on the interest elasticity of money demand, it is difficult to quantify the overall potential macroeconomic impact
193. These potential consequences were explained in principle for consumers in the BIS-commissioned research. It was felt that an increase in the interest rate for all was unacceptable, but there was considerable scepticism about whether card providers would actually impose this on credit card users. The other consequences (no balances transfers, no cash withdrawal facility or decreased credit limits) were all seen as consequences that would reduce access to credit (primarily for more vulnerable groups) and were therefore seen as more acceptable.\footnote{TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)}

194. Testing of potential implications was also conducted in consumer research commissioned by the UKCA, which seems to agree with the BIS consumer research, in that the prospect of introducing annual fees was much less popular than curtailing of promotional or lower interest rates. The survey found that those in favour of a full reversal of the allocation of payments (i.e. option 4) fell from 44\% to 18\% when told that this might mean that credit cards come with an annual fee in the future, compared to a fall from 44\% to 29\% when told that this might mean credit cards no longer offered promotional or lower interest rates.\footnote{UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)}

195. If cash is paid off first, then pricing methodologies to cover the incremental losses associated with the higher risk of default for cash withdrawers would not be realised. This could then lead to an increase in the price of cash advances, an increase in the cost of purchases or a withdrawal of the cash advance facility. Cash withdrawals were considered a necessary buffer during emergencies, however there was a strong perception that, if the facility was not offered, consumers would budget their expenditure to do without it, or use alternative sources of credit. Needless to say, this assumes that such consumers have access to such alternative sources.

**Preferred option**

196. The Government’s preferred option is to reverse the allocation of payments, so that repayments are allocated first to the debts attracting the highest interest rate. This falls under the right to repay in the Government response. Lenders have agreed to implement this reform voluntarily.

197. As discussed earlier, evidence collected by both the UKCA and BIS shows that consumers are not happy with the existing practice regarding the allocation of payments. Although there are existing credit cards available that already offer an allocation of payments that is entirely in favour of the consumer, consumers do not seem to understand the implications of different allocation policies and research suggests that the provision of additional information (i.e. option 2) does not seem to improve consumer understanding.

198. In terms of reforming the allocation of payments, consumer support was strongest for option 4, rather than options 3 or 5. The proposal put forward by the UKCA in its response (i.e. a full reversal of the allocation of payments, except for the minimum payment) was not felt to address the difficulties of those who would benefit most from the reform.
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

The Government’s preferred option is to send information to habitual minimum payers, and to increase
minimum payments for new accounts to cover interest, fees and charges, plus 1% of the balance.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of
the desired effects? A post-implementation review would be undertaken after 3 or 5 years.

Ministerial Sign-off For final proposal/implementation 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:

...................................................................................................... Date: March 2010
### Policy Option: Improve information transparency

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

<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><strong>One-off (Transition)</strong></td>
<td>Industry: implementation costs of £5m-10m</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
<td>£ Unknown (10 yrs) Total Cost (PV) £ Unknown</td>
</tr>
</tbody>
</table>

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

Industry: potential reduction in interest income as balances are reduced and/or paid off sooner (transferred to cardholders) through changes in consumer repayment behaviour.

<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><strong>One-off</strong></td>
<td>£ 0</td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
<td>£ Unknown Total Benefit (PV) £ Unknown</td>
</tr>
</tbody>
</table>

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

Cardholders: changes in consumer repayment behaviour as a result of increased transparency, leading to benefits through reduced interest costs of borrowing (transferred from lenders).

### Key Assumptions/Sensitivities/Risks

It is assumed that greater information provision would lead to at least some consumers changing their repayment behaviour; if increases in information provision improve transparency, but not consumer understanding, then this could have little or no impact on consumer behaviour.

<table>
<thead>
<tr>
<th>Price Base</th>
<th>Year 2008-9</th>
<th>Time Period</th>
<th>10</th>
<th>Net Benefit Range (NPV) £ -5m to -10m</th>
<th>NET BENEFIT (NPV Best estimate) £ -7.5m</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>UK</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>Self-regulation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>N/A</td>
<td></td>
<td></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>
<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>
<td></td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>No</td>
<td></td>
<td></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>
<td>Large</td>
<td></td>
</tr>
<tr>
<td>Are any of these organisations exempt?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Impact on Admin Burdens Baseline (2005 Prices)</td>
<td>(Increase - Decrease)</td>
<td>Increase £ 0</td>
<td>Decrease £ 0</td>
<td>Net Impact £ 0</td>
<td></td>
</tr>
</tbody>
</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

<table>
<thead>
<tr>
<th>One-off (Transition)</th>
<th>Yrs</th>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>£5m-10m</td>
<td></td>
<td>Industry: implementation costs of £5m-10m</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average Annual Cost (excluding one-off)</th>
<th>£ Unknown</th>
<th>N/A</th>
<th>Total Cost (PV)</th>
<th>£ Unknown</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

Industry: 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)

### Annual Benefits

<table>
<thead>
<tr>
<th>One-off</th>
<th>Yrs</th>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>£0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average Annual Benefit (excluding one-off)</th>
<th>£ Unknown</th>
<th>N/A</th>
<th>Total Benefit (PV)</th>
<th>£ Unknown</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></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, and this might result in further charges (as above)

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV) £-5m to -10m</th>
<th>NET BENEFIT (NPV Best estimate) £-7.5m</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>N/A</td>
<td>£-5m to -10m</td>
<td>£-7.5m</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 regulation

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

£0

**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></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Are any of these organisations exempt?**

No

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

Increase £0

Decrease £0

Net Impact £0

**Key:**

Annual costs and benefits: Constant Prices

(Net) Present Value
## Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Increase minimum payment level</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>Costs</th>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition)</td>
<td>Industry: implementation costs of £20m-30m; Industry: potential reduction in interest income as balances are reduced and/or paid off sooner (£330m-1,440m pa, transferred to cardholders)</td>
</tr>
<tr>
<td>Yrs</td>
<td>▪ £ 20m-30m</td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td>▪ £ 330m-1,440m</td>
</tr>
<tr>
<td>Yrs</td>
<td>▪ 10</td>
</tr>
<tr>
<td>Total Cost (PV)</td>
<td>▪ £ 2,861m-12,425m</td>
</tr>
</tbody>
</table>

**Other key non-monetised costs by 'main affected groups'**
Consumers: increased minimum payment may induce some cardholders to repay less, thereby increasing their amount of interest paid over the life of the balance; some consumers may not be able to afford higher minimum payments and may fall into over-indebtedness as a result.

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off</td>
<td>Cardholders: 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 (£330m-1,440m pa, transferred from card providers)</td>
</tr>
<tr>
<td>Yrs</td>
<td>▪ £ 0</td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td>▪ £ 330m-1,440m</td>
</tr>
<tr>
<td>Yrs</td>
<td>▪ 10</td>
</tr>
<tr>
<td>Total Benefit (PV)</td>
<td>▪ £ 2,841m-12,395m</td>
</tr>
</tbody>
</table>

**Other key non-monetised benefits by 'main affected groups’**
Consumers: potential reduction in over-indebtedness, to the extent this may have resulted from sustained minimum payments at a lower level.

### Key Assumptions/Sensitivities/Risks
Policy can be implemented without immediately imposing higher minimum payments on customers who cannot currently afford them. If the profitability of card lending is reduced as a result, this may result in offset increases in interest rates or increases/introduction of 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>2008-9</td>
<td>10</td>
<td>£ -20m to -30m</td>
<td>£ -25m</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 regulation

### What is the total annual cost of enforcement for these organisations?
£ 0

### Does enforcement comply with Hampton principles?
Yes

### Will implementation go beyond minimum EU requirements?
N/A

### 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>£ 0</td>
<td>£ 0</td>
<td>£ 0</td>
<td>£ 0</td>
</tr>
</tbody>
</table>

### Are any of these organisations exempt?
No

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

<table>
<thead>
<tr>
<th>Increase</th>
<th>Decrease</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 0</td>
<td>£ 0</td>
<td>£ 0</td>
</tr>
</tbody>
</table>

**Key:**
Annual costs and benefits: Constant Prices
(Net) Present Value
Minimum payments

199. 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 the Lending Code states that: “…the minimum monthly repayment covers more than that month’s interest”.\(^{111}\) Although the Lending Code also states that this amount should be sufficient to avoid an increase in the total outstanding balance over a 12-month period (provided there is no further spending on the card), this does not necessarily take into account any fees or charges incurred. This means that, although an individual is making the minimum payment, their balance may increase, possibly even without any additional spending on the card.

200. Currently, the average minimum payment is 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). Overall, survey evidence indicates that around 70% of credit and store card holders pay off their balance in full every month. In any given month, the minimum payment is made on around 20% of accounts, with 12% doing so regularly and a small minority of accounts (3%) doing so for 12 consecutive months.\(^{112}\) This implies that the population of those making the minimum payment is fluid, but the minimum payment is only made annually on around one-quarter of accounts, which implies that although the membership of the group making the minimum payment varies from month to month, with most not making the minimum payment for long, the overall population from which it is drawn is not that large.

201. Consumer research found that consumers had various reasons for making the minimum payment, including being on a promotional rate/offer and prioritising the repayment of other debts. A significant proportion said that they could not afford to pay more and would struggle if minimum payments were increased. However, research indicated that consumers did not understand the implications and consequences of regularly making the minimum payment and would value improved information on this.

202. In light of this, the Government’s preferred option is to implement a notification to be sent to habitual minimum payers, setting out the extent to which their repayment levels are servicing their debts. In addition, the Government is proposing to bring in a new minimum payment level for new credit and store card accounts, covering interest, fees and 1% of the outstanding balance. This is intended to help to prevent consumers from accumulating unsustainable levels of debt on their credit and store cards.

Background

203. 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 (following the conclusion of its investigation in 2006, the Competition Commission ordered that this warning also be included in all store card statements).\(^{113}\) 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.

204. 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

\(^{111}\) [http://www.lendingstandardsboard.org.uk/docs/lendingcode.pdf](http://www.lendingstandardsboard.org.uk/docs/lendingcode.pdf)

\(^{112}\) Argus, ‘UK Credit Card Payments Study’ (2010)

\(^{113}\) This reads: “if you make only the minimum payment each month, it will take you longer and cost you more to clear your balance”.
report on minimum repayments, the Treasury Select Committee felt that the above warning set out above did not go far enough and supported the introduction of such scenarios showing the cost of repeatedly making the minimum repayment.

205. 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 care lenders to provide a similar minimum payment warning (as set out above) and to state the estimated interest the following month if only the minimum payment is made.

206. In terms of further relevant developments, the OFT will publish its Irresponsible Lending Guidance in Spring 2010. The draft Guidance stated 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”.

207. However, it is not yet clear to what extent the final version of the Guidance will change from this. 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.

208. The Consumer Credit Directive (due to be implemented by January 2011) 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”.

209. Although the US CARD Act did not include a specific provision on minimum payment levels, the Office of the Comptroller of the Currency (OCC), which charters, regulates and supervises all national banks, published the Account Management and Loss Allowance Guidance for Credit Card Lending in 2003. This called for credit card lenders to require minimum payments that amortized a borrower’s current balance over a ‘reasonable period of time’. By the end of 2005, lenders that fell under the remit of the OCC (approximately 75% of the industry) were expected to comply with a minimum payment floor that, at the very least, covered interest charges, fees and paid down 1% of the outstanding balance. This immediately affected new accounts and was phased in for existing balances.

Issue

210. 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. In their response, the UKCA acknowledge that habitually making the minimum payment may be considered by credit card lenders in identifying those consumers in, or approaching, financial distress. Nonetheless, the UKCA highlight the low proportion of complaints accounted for by minimum payments: less than 0.05% of all complaints.\(^\text{115}\)

\(^{114}\) http://files.ots.treas.gov/48917.pdf

\(^{115}\) UKCA, Response to BIS Consultation (January 2010)
211. Consumer research commissioned by BIS found that, although the vast majority of cardholders felt that 6 months was a reasonable period to repay outstanding credit/store card debts, the distribution looked very different among those consumers actually making the minimum payment. Among this latter group of customers, the distribution was more even, with a higher proportion feeling that a longer time period (such as 1-2 years or 3-5 years) was most reasonable.

![Reasonable period to repay outstanding debt](image)

Source: TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

212. These opinions may also then be reflected in the repayment behaviour of individuals. Industry analysis of account-level data for credit cards shows that, based on current balances (i.e. assuming no further spending), payment rates (assuming that payments do not increase or decrease) and interest rates (assuming there is no re-pricing, risk-based or otherwise), the actual repayment period varies significantly across customer risk categories.

![Expected repayment period in years, by customer risk category](image)

Source: Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010)

213. While the overall average repayment period is 2.6 years, the repayment period increases to 11.8 years for the highest-risk customers, but falls to 0.9 years for the lowest-risk customers. This is because average payment rates are higher and average balances lower as customer risk falls; the average interest rate across risk categories is not significantly different.
**Level of minimum payments**

214. 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?.

215. Industry analysis shows that the average minimum payment level for credit card accounts is 3%, though accounts in the highest-risk segment had a higher minimum payment level (5%). At almost every level, the actual repayment level exceeds the contractually-required minimum payment.

![Minimum payment & actual payment level, by customer risk](chart)

**Customer risk category**

<table>
<thead>
<tr>
<th>Minimum payment level</th>
<th>Actual payment level</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>45%</td>
<td></td>
</tr>
<tr>
<td>50%</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** Argus, ‘UK Credit Card Payments Study’ (2010)

216. In addition, earlier research found that reducing the minimum payments on credit cards was a lender practice associated with financial difficulties. Industry analysis of account-level data found that charge-off rates for those accounts consistently making the minimum payment (4.1%) was significantly higher than those accounts making more than the minimum payment (1.3%). However, it is difficult to assign causality on this basis, i.e. concluding that making the minimum payment (or the level at which it was set) was the reason for the financial difficulty. In order to help identify those at risk of financial difficulty, from the end of 2008 credit card lenders began sharing additional information on account management, including whether consumers pay only the minimum.

217. Minimum payments set at a low level could have a huge impact on the total amount of interest and the time it takes a consumer to repay the debt. As an illustrative 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. However, industry analysis of account-level data shows that it is

---

116 ‘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.

117 Argus, ‘UK Credit Card Payments Study’ (2010)


119 Argus, ‘UK Credit Card Payments Study’ (2010)

120 This is known as the Behavioural Data Sharing (BDS) project
unlikely that many credit card holders would continue to make the minimum payment over such a sustained period (see below).

**Proportion of cardholders making minimum payments**

218. Previous research has not provided a definitive view on the proportion of credit and store card holders that make the minimum payment, and how regularly they might do so.\(^{121}\) The best evidence for credit cards, provided by the UK Cards Association, suggested that the minimum payment was regularly made on almost 14% of all active accounts in 2008 (up from 12.5% in 2006), corresponding to around 12% of cardholders.\(^{122}\)

219. Industry analysis of account-level data shows that the minimum payment is made on just over 20% of credit card accounts per month (representing around 30% of balances), with around 27% of accounts on which a minimum payment has been made in the last year.\(^{123}\) The most comparable consumer research (commissioned by BIS) found that 21% of consumers ‘frequently’ made the minimum payment on their credit or store card.\(^{124}\)

220. The proportion of cardholders regularly making only minimum repayments on their credit cards is smaller. Previous evidence suggested that between 3-12% of cardholders regularly made the minimum payment. Further consumer research, commissioned both by BIS and industry, found that 8-9% of cardholders regularly make the minimum payment on their credit or store card.\(^{125}\) Industry analysis shows that the minimum payment was regularly made on 12% of credit card accounts.\(^{126}\) According to consumer research commissioned by BIS and the UKCA, between 69% and 75% of consumers said they paid off their balance in full every month. The BIS consumer research also showed that the likelihood of paying the minimum payment was higher for those in financial difficulty (21%), compared to the overall average.\(^{127}\)

221. For store cards, evidence from the Competition Commission’s 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.\(^{128}\) This would seem to accord with FLA (Finance and Leasing Association) data, which shows that over 50% of store card accounts have no outstanding balance. BIS-commissioned consumer research also found that there was a similar proportion of store card holders that regularly made the minimum payment (7%).\(^{129}\)

**Frequency of making minimum payments**

222. Industry analysis of account-level data shows that the composition of those cardholders making the minimum payment is likely to be fluid. Of those making the minimum payment, 3 in 10 do so only once, with those making more than ten minimum payments in a 12-month period accounting for around one-sixth of all minimum payers.\(^{130}\) As a result, those regularly making the minimum payment account for only a very small proportion of total cardholders, with those making more than ten representing less than 5% overall

---

\(^{121}\) In 2004, Oxera suggested that the population of those making minimum repayments was a fluctuating one, with very few cardholders remaining as a minimum payer for a significant period ['Are Households Over-Indebted?’, Oxera]

\(^{122}\) Data showed the proportion of cardholders that paid off the minimum balance on at least one of their cards

\(^{123}\) Argus, ‘UK Credit Card Payments Study’ (2010); this last figure has increased slightly from the previous year, though this may not necessarily reflect declining affordability


\(^{125}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)

\(^{126}\) Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010); based on 3 consecutive minimum payments during Q2 2009

\(^{127}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)


\(^{129}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

\(^{130}\) Argus, ‘UK Credit Card Payments Study’ (2010)
223. For those consumers making 24 consecutive minimum payments across 2 years, the figure is smaller again, at 1.3%. The average number of minimum payments per year increases with risk, from 0.75 for low-risk accounts to 2.92 for high-risk accounts.¹³¹

224. Consumer research (commissioned both by BIS and by industry) asked respondents about the frequency of making the minimum payment. The proportion of credit and store card holders that said they made the minimum payment every month was consistent at around 30% of those who revolve their balance, equivalent to around 8% of all credit and store card holders.¹³²

225. BIS-commissioned consumer research also asked about the length of time for which respondents made the minimum payment. This showed that a significant proportion of both credit and store card holders had made the minimum payment for more than 5 years: 12% of regular minimum payers for credit cards and 19% of regular minimum payers for store cards (equating to around 1% for both credit and store card holders).¹³³

Profile of cardholders making minimum payment

226. In terms of the type of consumer making the minimum payment, research previously found that the likelihood of making the minimum payment was higher among those in financial difficulties, those paying more than 25% of income on unsecured credit repayments¹³⁴ and those in lower socio-economic groups.

227. Consumer research, commissioned by both BIS and industry, found slightly different characteristics associated with regularly making the minimum payment. Industry research found that the likelihood of regularly paying the minimum was higher for individuals who were single, worked part-time, in a lower socio-economic and were aged 25-44.¹³⁵ BIS-commissioned consumer research found that the characteristics associated with regularly paying the minimum were those aged 18-24, those working less than 8 hours per week, those in large households, those living in local authority-rented accommodation and those with 3 or more children.¹³⁶

¹³¹ UKCA, Response to BIS Consultation (January 2010)
¹³² TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
¹³³ TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
¹³⁵ UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
¹³⁶ TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); the impact of financial difficulties on the likelihood of paying the minimum gave too small a sample
228. Industry analysis of account-level data found that the incidence of paying the minimum payment increased with customer risk: those making the minimum payment (just over 20% across all accounts) made up around 35% of high-risk accounts, but only around 12% of low-risk accounts. The likelihood of paying the minimum was also higher among high-utilisation accounts, from 10% for those accounts using less than 10% of their limit, steadily increasing to 26% for those accounts using between 50-60% and up to 37% for those using more than 90% of their limit. Looking at the age of the account (vintage), there was little difference in terms of the proportion of accounts making the minimum payment.\(^{137}\)

229. For those customers regularly making only the minimum payment (12% across all accounts\(^ {138}\)), the proportion again increased with risk: among high-risk customers around 25% made only the minimum payment, whereas the figure was around 6% for low-risk customers. High-risk customers are also less likely to make at least one payment in excess of the minimum: this represented around 80% of high-risk accounts, but approximately 94% of low-risk accounts.\(^ {139}\)

230. Previous evidence from the Competition Commission investigation on store cards found 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.\(^ {140}\) Industry analysis shows that this pattern is roughly repeated for credit card data: the average balance for those accounts paying more than the minimum is £1,190, compared to £3,240 for those accounts paying only the minimum.\(^ {141}\)

**Reasons for making minimum payments**

231. While concerns have been expressed regarding those consumers who make the minimum payment on a regular basis, 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 well-informed 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. For example, for those consumers taking advantage of a promotional offer, they may prefer to make only the minimum payment during the promotional period.

232. Qualitative research commissioned by BIS found that many consumers had made the minimum payment at some point in the past, even if they now usually paid their balance in full each month. It was suggested that having the option to make a minimum payment was important at expensive times of the year (e.g. Christmas) or when making large purchases. There was also a perception that it may be necessary to make the minimum payment for unexpected expenditures (e.g. emergency home or care repairs).\(^ {142}\)

233. Consumers also made use of the minimum payment facility to repay balance transfers slowly, whilst avoiding additional cost. Industry analysis of account-level data shows that the likelihood of regularly making only the minimum payment on credit cards\(^ {143}\) is higher for those accounts with a promotional balance (nearly 20% of accounts), compared to those without a promotional balance (just over 10% of accounts). The likelihood of making at least one payment in excess of the minimum is also higher for those accounts

\(^{137}\) Argus, ‘UK Credit Card Payments Study’ (2010)

\(^{138}\) Ibid; based on 3 consecutive minimum payments during Q2 2009

\(^{139}\) Ibid

\(^{140}\) Competition Commission, ‘Store cards market investigation’ (2006); average balance of £800, compare to an average balance of £250

\(^{141}\) Argus, ‘UK Credit Card Payments Study’ (2010); it should be noted that the former group includes full repayers

\(^{142}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

\(^{143}\) Based on 3 consecutive minimum payments during Q2 2009
without a promotional balance (almost 90%), compared to those with a promotional balance (just over 80%).\textsuperscript{144}

234. In terms of other reasons for making the minimum payment on credit cards, consumer research (both that commissioned by BIS and by industry) found that around 15% of those making the minimum payment said they did so because they were taking advantage of a promotional rate/offer. Another broadly consistent reason given across the different consumer surveys (by around 16-24% of respondents) was a desire to pay off more expensive debts elsewhere.\textsuperscript{145}

235. However, the most popular reason among credit card holders was that they could not afford to pay any more. Problems of comparability across the different surveys (e.g. questionnaire design) makes it difficult to give a definitive view on what proportion of consumers this applies to, but it represents somewhere between 40% and 67%.

236. The reasons given by store card holders were similar for those prioritising the payment of a debt elsewhere (14%) and those who could not afford more (45%), but those regularly paying the minimum due to a promotional rate or offer was much lower (3%).\textsuperscript{146}

237. Industry analysis of credit card accounts on which the minimum payment was made for 3 consecutive months between April and June 2009, found that (on average across risk bands) 15% of accounts had a promotional rate during this period. A further 55% were paying by direct debit (but did not have a promotional rate), which industry analysts considered to be a ‘rational’ reason for paying the minimum payment.\textsuperscript{147}

238. However, taking into account the behavioural biases detailed in the rationale section and the BIS consumer research, which found that a minority of individuals admitted to setting up a direct debit and then forgetting to pay off more, seems to suggest that not all of these consumers paying by direct debit will be doing so ‘rationally’. Furthermore, the UKCA’s response details how direct debits are used to make payments on 15% of credit card accounts, with the vast majority of these (75%) set to the minimum. They conclude that “…most cardholders who set up a Direct Debit to make the minimum payment do so in order to ensure that they do not incur a late or missed payment charge.”\textsuperscript{148}

239. Notwithstanding this, industry analysis for credit card accounts shows that almost 30% of accounts that regularly make the minimum payment (representing around 3 million accounts\textsuperscript{149}) are not doing so ‘rationally’.

**Consequences of making minimum payment**

240. Industry analysis of account-level data shows that those consistently making only the minimum payment between Q2 2008 and Q2 2009 achieved a greater balance reduction than those paying more than the minimum.\textsuperscript{150} When this analysis is limited to only those revolving balances, those paying only the minimum still reduce their balances by more than those paying more than the minimum, but the difference in the reduction is much smaller (1 percentage point, instead of 3).\textsuperscript{151}

241. In both cases, the reduction in balance among the highest-risk customers is lower for those that make only the minimum payment.

\textsuperscript{144} Argus, ‘UK Credit Card Payments Study’ (2010)
\textsuperscript{145} TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); Auriemma Consulting Group, ‘International Regulatory Research’ (2010); UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
\textsuperscript{146} TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); this might reflect the lower prevalence of promotional offers on store cards relative to credit cards
\textsuperscript{147} Argus, ‘UK Credit Card Payments Study’ (2010)
\textsuperscript{148} UKCA, Response to BIS Consultation (January 2010), p.129
\textsuperscript{149} On the basis that the proportion of those making the minimum payment is around 20% per month
\textsuperscript{150} Argus, ‘UK Credit Card Payments Study’ (2010); an average reduction of 12% for those paying only the minimum and 9% for those paying more than the minimum
\textsuperscript{151} Ibid.
Behavioural considerations

242. Any policy intervention in this area will apply directly to the 20% of cardholders who make the minimum payment in any given month, with the greatest impact on the 12% who frequently make the minimum payment. However, research suggests that minimum repayment levels could also influence the payment behaviour of those cardholders who repay more than the minimum payment, with the minimum payment acting as an “anchor” upon which they base their own levels of repayment.152

243. Further analysis by Professor Stewart (based on data for 126,000 credit card holders from 11 different credit card providers) has found that increasing the minimum payment level is associated with 3 main effects:

- an increase in the proportion of cardholders making the minimum payment, as those who currently pay less than the required level are moved up the repayment scale;
- an increase in the proportion of cardholders making a partial repayment, but the average level of partial repayment is lower as the minimum repayment increases, and
- a reduction in the proportion of cardholders making a full repayment, which appears to be due to the ‘anchoring’ effect.

244. This suggests that if the minimum payment were increased, there would be fewer full repayments and smaller partial repayments. Therefore, while a higher minimum payment could help those cardholders that regularly make the minimum payment to pay off their debt sooner and at a lower cost (provided they can afford the higher payments), a much larger fraction of cardholders may end up making smaller payments and thus pay more interest as a result. As an example of this net effect, for a representative credit card holder with a £500 balance and a £5,000 credit limit, an increase in the minimum payment from 2% to 3% would reduce the average repayment from 80% of the balance to two-thirds (66%) of the balance.153

Rationale

245. Qualitative consumer research commissioned by BIS revealed a perception that allowing consumers to make minimum payments could be problematic for a minority of vulnerable card users who had built up high levels of debt and who habitually made the minimum payment. It was suggested that consumers who habitually made the minimum payment had either a poor understanding of the long-term consequences or they could only afford to make minimum payments as the level of debt was too high. A slight variation on this latter group was those consumers who felt that their debt was so large that they could not envisage ever clearing it, so the consequences of consistently making only minimum payments did not feel particularly ‘real’ to them and there was therefore no point in making more than the minimum payment.154

246. 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 changing the minimum payment could have an effect on all cardholders, including those that pay more than the minimum. For example, increasing the minimum payment was found to be associated with a reduction in the proportion of cardholders that repaid in full and a reduction in the proportion of those making partial payments (i.e. those in excess of the minimum but less than the full amount). Overall, this could then lead to a higher proportion of cardholders paying a greater amount of interest.

247. 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

---

154 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010); similar views were also reflected in the UKCA-funded research, conducted by GfK NOP
'virtuous' actions that have delayed benefits, such as saving for their future/retirement, or paying off more than the minimum payment on their credit/store card bills. This could be due to issues of impatience, driven by hyperbolic or quasi-hyperbolic discounting.

248. As part of BIS-commissioned research, discussion among consumers indicated a lack of awareness of the consequences of making minimum payments. There was a perception that some consumers may choose to make the minimum payment when they could afford to repay a higher amount as they primarily considered the short-term costs of repayment, rather than the long-term consequences of servicing credit card debt over a long period.

249. Indeed, when respondents were given material which illustrated the cost of repaying a debt by only making minimum payments, virtually all of the respondents were shocked and reported that their friends had also been shocked and surprised about the how long debts took to pay off, as they had thought that the minimum payment would also pay off part of the debt, not just the interest.\footnote{TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)}

250. 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.

**Options analysis**

251. 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 would be the impact of recent economic conditions on many consumers’ personal finances.

252. 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.

253. 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.

254. 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).

255. 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
256. 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 Spring 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.

257. 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
258. 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.156

259. It would seem that consumers have problems with the information they receive in relation to credit cards. For example, research by the OFT found that only 54% of respondents were able to identify the correct minimum repayment level on a sample credit card agreement.157 In addition, consumer research commissioned by UK Cards Association found that 43% of those who said they make the minimum payment every month did not know what their minimum payment was in percentage terms.158 Although this latter point could simply reflect low financial acuity among certain consumers, this does suggest a role for improving information in relation to minimum repayments on credit cards.

260. If the underlying problem is a lack of information, an appropriate remedy might be to increase the amount of information provided to cardholders. However, research commissioned by BIS found that consumers felt they already receive a lot of information from card providers and additional information was very likely to be ignored.159 This might indicate a potential for ‘information overload’ due to an excessive amount of information, in which case a potential solution would be to reduce the amount of information provided to cardholders.

261. However, the consumer research commissioned by the UKCA pointed towards a desire for more information around, and greater understanding of, the implications of minimum payments.160 It may be that the way in which that information is currently presented makes it difficult for consumers to understand these implications. Respondents to the BIS-commissioned consumer research thought that putting a different warning on credit card statements, which showed how long it would take to repay the debt, was likely to be effective and received strong support. It was felt that it may be helpful to remind consumers that making the minimum payment has little effect on consumers’ debt.161

156 Imposing no constraints, except with regards to information on overdrafts and changes to borrowing rates
158 UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
159 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
160 UKCA, Appendix 5 of the Response to BIS Consultation: GfK Qualitative Research Management Report (January 2010)
161 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
262. This additional kind of information is very similar to that which is now 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.

263. 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.

264. In their response, the UK Cards Association has proposed that credit card lenders separately contact ‘habitual’ minimum payers (definition to be agreed) every 6 months to remind them of the implications of their behaviour.

Costs

265. Under this option, there will be costs of implementation for credit and store card providers. Previous estimates based on proposed changes to US practices were up to $30m in one-off costs (incorporating programming system changes and modifications to customer service systems)\textsuperscript{162}, with potential ongoing costs of $23m\textsuperscript{163} to $27m\textsuperscript{164} (including postage and handling higher numbers of calls from cardholders). However, firm estimates have now been provided by UK industry and amount to one-off costs of £5m-10m.

266. 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. It has not been possible to determine what proportion of consumers might change their repayment behaviour on the basis of this information and therefore what the overall impact on lender revenues might be. However, this reduction in revenues would effectively be a transfer to consumers in the form of lower overall interest payments.

Benefits

267. 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 will depend on a number of different factors, including their card usage.

268. Research in the US\textsuperscript{165} asked a small sample of cardholders to choose between 3 potential information disclosures\textsuperscript{166}: a customised (personally 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.\textsuperscript{167}

\textsuperscript{163} 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.
\textsuperscript{165} GAO (2006)
\textsuperscript{166} 112 cardholders
\textsuperscript{167} 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.
269. 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.

270. 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) as has been suggested by the UKCA in their proposal. If such targeted information was to be sent to those consumers that make at least 6 minimum payments within a 12-month period, this would account for around 40% of credit card minimum payers, i.e. just over 10% of all credit card holders (around 5m accounts).

Option 3: Set a ‘recommended’ minimum payment

271. 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).

272. According to BIS-commissioned consumer research, payment by direct debit was the most popular option for those repaying their bills in full each month (chosen by 30%). Industry intelligence suggests that most (if not all) card providers offer a choice of only the minimum amount or full repayment. As discussed above, the vast majority of direct debits (75% overall) are for the minimum, but under this option an alternative amount between the minimum and full repayment could potentially be offered or selected (set in either nominal or percentage terms).

273. 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 indicates that this period might be a reasonable estimate of the average life of a credit card agreement issued in the current UK market.

274. 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.

275. As noted earlier, some consumers may choose to make only the minimum payment on their debts. If consumers are also offered a recommended minimum payment, it is not clear how many would choose to do so. Indeed, BIS-commissioned consumer research displayed little support for a recommended higher payment amount on statements, as respondents thought that consumers were already able to choose to pay any amount over the minimum payment. However, consumer research commissioned by the UKCA

---

168 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
169 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. However, this is contingent on them having made no further spend on their card.
170 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
noted that even among those currently habitually using minimum payments, some were in favour of higher recommended payments.\textsuperscript{171}

276. In the BIS consumer research, there was also a perception that consumers who were disciplined enough to pay more than the minimum payment would not choose to pay a higher amount.\textsuperscript{172} This is linked to the empirical work on ‘anchoring’ set out earlier; the recommended minimum payment could potentially offer consumers another ‘anchor’ on which to base their repayments. It is difficult to know how this might affect consumer repayment behaviour.\textsuperscript{173} In his response to the consultation, Professor Stewart notes that a recommended minimum payment is likely to benefit some consumers while disadvantaging others, and that whichever payment option is chosen as the ‘default’ is likely to have a large effect on behaviour. A potential risk is that a ‘recommended’ payment offered between the minimum and full repayment may dissuade customers from making a full repayment, which would lead to an increase in the total amount of interest paid.

Costs

277. This option entails implementation costs for industry, which have been estimated as one-off costs of £5m-10m.

278. However, certain features of this option are potentially complex to implement and understand, 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.

279. 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.

280. 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.

281. 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.

Benefits

282. As set out earlier, it is difficult to assess how many consumers might benefit under this option, particularly for those consumers who ‘revolve’ their balance and can afford to pay

\textsuperscript{171} UKCA, Appendix 5 of the Response to BIS Consultation: GfK Qualitative Research Management Report (January 2010)

\textsuperscript{172} TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

\textsuperscript{173} 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.
more than the minimum payment, but currently do not do so.\textsuperscript{174} These consumers should clear their outstanding balance over a shorter repayment period and at a corresponding lower overall cost.

283. In addition, depending on how the recommended minimum payment is presented, consumers could 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**

284. 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.

285. As set out earlier, such a change could have a significant benefit for those currently paying less than the minimum, by reducing the time it takes to repay a debt and the total cost of borrowing over the life of the balance. However, empirical research suggests that increasing the minimum payment could have potentially offsetting effects for those cardholders currently paying more than the minimum\textsuperscript{175}, which might lead to them paying more interest overall.

286. 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 minimum payments were increased, some consumers may be unable to afford their repayments, which could lead to more people experiencing short-term repayment difficulties as they struggle to pay the higher minimum payment.

287. Industry-commissioned survey evidence found that 10% of respondents already find it difficult to make the minimum payment.\textsuperscript{176} In terms of any increase to the minimum payment, survey evidence commissioned by BIS found that 13% said it would ‘severely affect’ their ability to pay bills, with a further 46% saying it would ‘slightly affect’ their ability to pay bills.\textsuperscript{177} For those people 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. A survey conducted by R3 asked insolvency practitioners whether they considered raising the minimum payment would push more people into insolvency; almost 40% agreed, with nearly 55% disagreeing.\textsuperscript{178}

288. Responses to the consultation from the general public indicate a strong opposition to this measure, on the grounds that many people would fall into severe financial difficulty. In addition, respondents to the consumer research commissioned by BIS recognised that some consumers who were in financial difficulty would struggle to make higher repayments and therefore increasing the minimum payments was considered ‘draconian’. However, there was also a perception that many card users who make the minimum payment could afford to pay a higher amount and would budget to do so if the minimum payment was increased. Some consumers, including some of those currently paying the minimum, even said they would welcome being ‘made’ to repay the debt sooner rather than being ‘allowed’ to put it off.\textsuperscript{179}

\textsuperscript{174} Potentially due to issues around ‘anchoring’ or biases towards a ‘default’ of the minimum payment
\textsuperscript{175} By reducing the proportion of those paying off their balance in full, and increasing the proportion making partial repayments (with those repayments being lower in value)
\textsuperscript{176} UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
\textsuperscript{177} Auriemma Consulting Group, ‘International Regulatory Research’ (2010)
\textsuperscript{178} R3, Response to BIS consultation
\textsuperscript{179} TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
289. It is difficult to assess what proportion of consumers might fall into this latter category, but survey evidence suggests that around 40% of those regularly making the minimum payment (i.e. around 2.5m cardholders) would not have any difficulty in meeting the higher level of repayment if it were increased (or even doubled).\textsuperscript{180}

290. Any potential adverse effects could be ameliorated through appropriate transitional arrangements. For example, if a higher level of minimum payments were only applied to new agreements, this would not impact on the current debts (and hence repayment levels) of cardholders, some of whom may be highly indebted. According to the UKCA response, there were 12.5 million credit card applications between January and October 2009, of which 48% were declined.\textsuperscript{181} Assuming this rate of application (and proportion declined) remains the same, this would imply that there are nearly 8 million new credit card agreements on an annual basis. Having a higher level of minimum payments on these new accounts, before a significant level of debt has been accumulated, could potentially help to deter cardholders from borrowing as much as they might under a system with lower minimum payments.

291. In addition, having a higher level of minimum payments for new customers to deter them from accumulating significant amounts of debt could also have benefits for lenders, by reducing the risk of default. In their response, the UKCA mention that Oxera have found evidence that some lenders are already experimenting with increasing the minimum payment for new customers to reduce risk.\textsuperscript{182}

292. A potential drawback of only applying this change to new accounts could be additional 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.

293. In their response, the UKCA state that a new minimum payment level for new accounts would not be in consumers’ interests, as it would reduce the flexibility of payment associated with credit cards (that cardholders value), prevent some cardholders from taking up promotional offers if they could not afford the higher minimum and, if the cost could not be absorbed, would place upward pressure on interest rates and introduction of annual fees.\textsuperscript{183}

Costs

294. If there is an increase in minimum repayment levels, 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;
- 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.

295. 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. 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).

\textsuperscript{180} UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010); Auriemma Consulting Group, ‘International Regulatory Research’ (2010)
\textsuperscript{181} UKCA, Response to BIS Consultation (January 2010)
\textsuperscript{182} Ibid.
\textsuperscript{183} Ibid.
With regards to the first of these, industry has estimated that the implementation costs incurred under this option as a result of system changes (irrespective of the new level of minimum payments) would be £20m-30m.

The second and third elements will be dependent on the new level of minimum payments that is set. Industry have provided cost estimates for four new minimum payment scenarios: a minimum payment of 3% of balances, a minimum payment of 4% of balances, a minimum payment of 5% of balances and a minimum payment of 1% of balances, plus interest and fees.

Although average minimum payment levels are currently 3% across all accounts, there are still a significant proportion of accounts that have a minimum payment below 3%, mostly concentrated in the higher-risk categories, as shown earlier. Overall, approximately 30% of accounts (around 15m accounts) pay less than 3% of their balance, though this varies substantially across customer risk segments; almost 60% of highest-risk accounts currently pay less than 3%, compared to just over 10% of the lowest-risk accounts. This also means that the additional payment necessary for these customers to meet a 3% minimum payment level differs, ranging from just over £30 a month to £55 a month (with an average additional payment of £43 a month).

If the minimum payment was increased to 3%, it has been calculated that this would involve a loss of interest income to lenders of £540m per year, on average. As explained above, this would be a transfer to cardholders, so would have no net effect overall.

If minimum payments were increased to 4%, this would affect 36% of accounts (18m accounts) that currently pay less than this, but again this varies across risk categories; from nearly 70% of the highest-risk customers to 13% of the lowest-risk customers. The additional necessary payment to meet the new 4% level is also higher, at over £70 a month on average, but ranging from £60 to over £80 a month. If this were applied to current balances, this would entail a loss of interest income to lenders of £975m per year on average, which would be transferred to cardholders in the form of lower overall interest payments.

If minimum payments were increased to 5%, this would affect nearly 40% of accounts (20m accounts) that currently pay less than this, but again this varies across risk categories; from over 75% of the highest-risk customers to 15% of the lowest-risk customers. The additional necessary payment to meet the new 5% level is also higher, at £100 a month on average, but ranging from £90 to £110 a month. If this were applied to current balances, this would entail a loss of interest income to lenders of £1,440m per year on average, which would be transferred to cardholders in the form of lower overall interest payments.

If minimum payments were changed to 1% plus interest and fees, 20% of accounts (10m accounts) currently pay less than this, but again this varies across risk categories; from nearly 50% of the highest-risk customers to only 6% of the lowest-risk customers. The additional necessary payment for these customers to meet the new minimum payment level would be £30 a month on average, but ranging from £25 to £35 a month. If this were applied to current balances, this would entail a loss of interest income to lender of £330m per year on average, which would be transferred to cardholders in the form of lower overall interest payments.

However, account-level analysis shows that a certain proportion of customers currently paying the minimum payment could pay less if a new minimum payment of 1%/plus fees and interest was introduced. Overall, this equates to around 3% of all cardholders, or

---

184 This last option is based on the recommended practices enforced by the OCC in the US, set out earlier
185 Oxera, 'An economic assessment of BIS’s proposals for credit card regulation' (January 2010)
186 Ibid.
187 Ibid.
188 Ibid.
approximately 1.5m accounts, the majority of which is concentrated among the low-risk accounts (who are less likely to make the minimum payment in any case).\(^{189}\) This potential reduction in the minimum payment could lead to more interest being incurred over the life of a balance for some consumers, but (on the basis of the empirical evidence collected earlier) could also imply a potential increase in both the proportion of consumers making the full repayment and the proportion of consumers making a partial repayment in excess of the minimum.

304. It is unclear how many of those cardholders would be unable to meet their repayments under each of these scenarios. Industry-commissioned survey evidence asking about consumer responses to a doubling of the minimum payment\(^{190}\) found that 22% of regular minimum payers would find it difficult to make the new minimum payment level, with a further 29% possibly finding it difficult.\(^{191}\)

305. However, if a new level of minimum payment (e.g. 1% plus fees and interest) was introduced only for new accounts, this would not create any repayment difficulties for current cardholders. There may be a potential cost to industry in terms of interest that they might have expected to earn on debts incurred by new cardholders (that would then be transferred to cardholders in the form of lower overall interest payments). However, as a new minimum payment level would be likely to influence a cardholder’s behaviour (and therefore how much they might borrow) it is not possible to estimate what the level of this lost interest income might be. The benefits associated with such an approach are assessed below.

**Benefits**

306. 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, as a positive effect on those 12% of cardholders who regularly make minimum repayments, and (according to empirical research) indirectly, as a negative effect on those who make more than the minimum repayment, by potentially reducing the proportion of those repaying in full and increasing the proportion of those making partial repayments (and reducing the amount repaid).

307. Under each of the scenarios above, this benefit would be equal to the loss of interest income for industry identified above, i.e. £540m per year for an increase to 3%; £975m per year for an increase to 4%; £1,440m per year for an increase to 5%, and £330m per year for a change to 1%, interest and fees, and will result in no net impact.

308. 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. Although there is no direct link between minimum payments and over-indebtedness, it could be that current minimum payment levels have facilitated a level of borrowing that, were they to be subject to a ‘shock’ (such as loss of employment or unexpected increase in bills) could push them into over-indebtedness.

309. If a new level of minimum (for example, 1% plus fees and interest) was introduced only for new accounts, there would be no corresponding benefits to existing consumers associated with increased repayments (as there would be no lost interest income for lenders). However, there could be a benefit of preventing consumers accumulating a level of debt at which they might be at risk of falling into over-indebtedness.

\(^{189}\) BIS analysis of industry data, contained in Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010)

\(^{190}\) Closest to approximating the 5% minimum payment scenario, given current minimum payment levels

\(^{191}\) UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
Risks

310. 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.

311. 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.

312. In terms of quantifying this, if it is assumed (on the basis of survey data) that 20-30% of consumers currently paying the minimum would not be able to meet their repayments if it were increased, then this would imply that the number of accounts this applies to would range from 2m to 6m accounts, depending on what level the minimum payment was changed to.

313. A further risk under option 3 might emerge if the recommended minimum payment were to become the default payment option for direct debit mandates. This could risk the recommended payment effectively becoming the minimum payment, but at a higher level. It is difficult to quantify this risk without further detail on the level of any ‘recommended’ minimum payment and more evidence on how consumer behaviour might be affected. To mitigate this risk, this option could allow consumers to pay only the minimum payment when necessary.

314. 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.

315. 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. Evidence has been provided by industry on the potential secondary effects of changes to minimum payments, in terms of how the lost interest income could be recouped through either an increase in the overall interest rate charged on credit cards or the levying of an annual fee.

316. The secondary effects on the overall interest rate all relate to versions of option 4 (increasing minimum repayments) and range from an increase of 0.76% (for changing to 1% plus fees and interest to an increase of 3.3% (for increasing to 5%). Although an increase in the interest rate was not popular with consumers, it is difficult to analyse how any potential increase might impact on consumer behaviour.\(^\text{192}\) Obviously, an increase in the interest rate paid by individuals on their outstanding credit or store card borrowing would lead to additional costs being imposed on consumers (transferred to lenders), that would negate some portion of the transfer as a result of changing the minimum payment level. However, it is possible that an increase in the interest rate would disincentivise future spending by those cardholders who did not already have an outstanding balance on their credit or store card.

317. In terms of the secondary effects if all of the lost interest income associated with changes to minimum payments were recouped through annual fees, these would vary from around £6 per account (or £9.45 per active account) for 1% plus fees and interest to £26.20 per account (or £41.30 per active account) for increasing to 5%. This is an overly simplistic

\(^{192}\) Without further detail on the interest elasticity of money demand, it is difficult to quantify the overall potential macroeconomic impact
analysis, as issuers would need to assess a complex range of issues (including the potential impact on consumer behaviour) before setting the level of any new fees. Many credit and store cards currently available in the UK do not currently levy an annual fee, so any increase could have quite a significant impact on consumer behaviour.

Preferred option

318. The Government’s preferred option is to provide improved information to ‘habitual’ minimum payers and to introduce a new level of minimum payment (i.e. fees, interest and charges plus 1% of the outstanding balance) for new accounts. This falls under two of the rights included in the Government response: the right to repay to encourage better repayment practice, and the right to information about consumers at risk of financial difficulties being given guidance on the consequences of paying back too little. Lenders have agreed to implement these reforms voluntarily.

319. Evidence shows that consumers do not seem to understand the implications of consistently making the minimum payment and would value the provision of more targeted information to those for whom it would benefit (option 2). In terms of changes to the minimum payment, consumers were not in favour of the inclusion of an additional ‘recommended’ minimum payment on statements (option 3), as this is likely to be confusing for cardholders and may not lead to the desired changes in repayment behaviour (e.g. could dissuade consumers from making full repayments).

320. Although evidence indicates that increasing the level of minimum payments could lead to a significant proportion of consumers being unable to meet their repayments, there was some limited support for encouraging better repayment behaviour. To avoid these adverse effects, a new level of minimum payment (1% of the balance, plus fees, interest and charges) has been introduced, but only for new accounts. This could also have the benefit of potentially deterring cardholders from accumulating unsustainable levels of credit and store card debt.
What is the problem under consideration? Why is government intervention necessary?
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. There is a bias in some consumers’ behaviour in terms of self-control, where they have limited willpower and make impulse purchases which are later regretted. Such consumers are considered to have bounded self-control (which can result in time-inconsistent preferences) and as such might prefer to commit to a more optimal spending plan. Unsolicited credit limit increases may cause these consumers to deviate from this plan by inducing expenditure that they would not have otherwise made. Concerns have also been raised that unsolicited credit limit increases are associated with financial difficulty.

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 are 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 information
- Ban unsolicited credit limit increases
- ‘Opt-in’ for unsolicited limit increases
- Limit on size and/or frequency of credit limit increases
The Government’s preferred option is to improve consumer understanding and information.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? A post-implementation review will be undertaken after 3 or 5 years.

Ministerial Sign-off For final proposal/implementation 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: March 2010

65
<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>
<tbody>
<tr>
<td><strong>ANNUAL COSTS</strong></td>
<td>Description and scale of key monetised costs by ‘main affected groups’</td>
</tr>
<tr>
<td>One-off (Transition)</td>
<td>Industry: estimated implementation costs of producing necessary information/messages/leaflets and other communication with customers (£5m - 10m).</td>
</tr>
<tr>
<td>£ 5m-10m</td>
<td></td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td>£ Unknown</td>
</tr>
<tr>
<td><strong>AVERAGE ANNUAL BENEFIT</strong></td>
<td>Description and scale of key monetised benefits by ‘main affected groups’</td>
</tr>
<tr>
<td>One-off</td>
<td></td>
</tr>
<tr>
<td>£ 0</td>
<td></td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td>£ Unknown</td>
</tr>
</tbody>
</table>

**Key Assumptions/Sensitivities/Risks**

Consumers may not read or understand the additional information provided, particularly if the policy results in information overload. This would not lead to a change in customer behaviour.

**Price Base** Year 2008-9  **Time Period** Years 10  **Net Benefit Range (NPV)** £ -10m to -5m  **NET BENEFIT (NPV Best estimate)** £ -7.5m

- 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-regulation
- What is the total annual cost of enforcement for these organisations?  £ 0
- Does enforcement comply with Hampton principles?  Yes
- Will implementation go beyond minimum EU requirements?  N/A
- 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
<table>
<thead>
<tr>
<th>Increase</th>
<th>£ 0</th>
<th>Decrease</th>
<th>£ 0</th>
<th>Net Impact</th>
<th>£ 0</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>
<td></td>
</tr>
</tbody>
</table>

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

| Increase | £ 0 | Decrease | £ 0 | Net Impact | £ 0 |

**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>

### 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 (Transition)</td>
<td>Industry: estimated implementation costs of producing necessary information and communication (£5m - 10m); reduced interest income (£27m-291m) as unsolicited limits are capped. Cardholders: reduction in net spending (£154m-1,648m) for those affected by the cap (1-13% of accounts would not receive a credit limit increase, depending on threshold).</td>
</tr>
<tr>
<td><strong>£ 5m-10m</strong></td>
<td></td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td></td>
</tr>
<tr>
<td><strong>£ 181m – 1,939m</strong></td>
<td>10</td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong></td>
<td><strong>£ 1,563m – 16,700m</strong></td>
</tr>
<tr>
<td>Other key non-monetised costs by 'main affected groups'</td>
<td></td>
</tr>
</tbody>
</table>

### 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>Cardholders: reduction in credit card interest payments, £27m-£291m, affecting 1-13% of accounts depending on the threshold.</td>
</tr>
<tr>
<td><strong>£ 0</strong></td>
<td></td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td></td>
</tr>
<tr>
<td><strong>£ 27m – 291m</strong></td>
<td>10</td>
</tr>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
<td><strong>£ 232m – 2,505m</strong></td>
</tr>
<tr>
<td>Other key non-monetised benefits by 'main affected groups'</td>
<td></td>
</tr>
</tbody>
</table>

**Key Assumptions/Sensitivities/Risks** 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, withdrawal of low and grow lending). Potential for greater complexity, resulting in customer confusion.

### Price Base and Time Period

| Price Base Year | 2008-9 | Time Period Years | 10 | Net Benefit Range (NPV) | £ -14,195m to £ -1,331m | NET BENEFIT (NPV Best estimate) | £ -7,763m |

### 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? OFT, Trading

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

### Does enforcement comply with Hampton principles? Yes

### Will implementation go beyond minimum EU requirements? N/A

### 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>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
</tr>
</tbody>
</table>

### Are any of these organisations exempt? No

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

| Increase | £ Negligible | Decrease | £ 0 | Net Impact | £ Negligible + |

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

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

#### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
<th>Industry: estimated implementation costs to industry, for example IT systems changes, staff training, communication (£30m - 40m); reduced interest income (£330m) as fewer credit limits are increased. Cardholders: reduction in spending (£3,290m) for 15% of accounts that would no longer receive an unsolicited credit limit increase.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off (Transition) Yrs</strong></td>
<td>£ 30-40m</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
<td>£ 3,620m</td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong></td>
<td>£ 31,190m-31,200m</td>
</tr>
</tbody>
</table>

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

#### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
<th>Cardholders: reduction in credit card payments (£1,422m) and interest (£330m) for 15% of accounts that would no longer receive an unsolicited credit limit increase.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off</strong></td>
<td>£ 0</td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
<td>£ 1,752m</td>
</tr>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
<td>£ 15,081m</td>
</tr>
</tbody>
</table>

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

Cardholders: reduction in credit and store card balances would reduce indebtedness. Consumers with bounded self-control would not make unplanned spending.

**Key Assumptions/Sensitivities/Risks** Assume cardholders would not have borrowed without the limit increase. Lenders may exit or increase revenue from other sources; potential reduction in availability of credit (especially to high-risk borrowers, withdrawal of "low and grow lending"). Risk of adverse selection, as cardholders requesting a limit increase are more likely to default on their payments.

### Price Base

- **Year 2008-9**
- **Time Period Years 10**
- **Net Benefit Range (NPV) £ -20,569m to -16,109m**
- **NET BENEFIT (NPV Best estimate) £ -16,114m**

**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?** OFT, Trading Standards

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

**Does enforcement comply with Hampton principles?** Yes

**Will implementation go beyond minimum EU requirements?** N/A

**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>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Increase</th>
<th>Decrease</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ Negligible</td>
<td>£ 0</td>
<td>£ Negligible +</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Policy Option: ‘Opt-in’ for unsolicited credit limit</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></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>Industry: estimated implementation costs, for example IT systems changes (£30m-40m); potential reduction in interest income (£135m) if consumers do not opt in to limit increases. Cardholders: reduction in net spending (£766m) for those who do not opt in (approximately 6% of total accounts).</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
<td>£ 901m</td>
</tr>
<tr>
<td><strong>Total Cost (PV)</strong></td>
<td>£ 7,786m-7,796m</td>
</tr>
</tbody>
</table>

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

## ANNUAL BENEFITS

<table>
<thead>
<tr>
<th></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>Cardholders: reduction in interest payments (£135m) for 6% of accounts that do not opt in to unsolicited limit increases.</td>
</tr>
<tr>
<td><strong>Average Annual Benefit (excluding one-off)</strong></td>
<td>£ 135m</td>
</tr>
<tr>
<td><strong>Total Benefit (PV)</strong></td>
<td>£ 1,162m</td>
</tr>
</tbody>
</table>

Other key non-monetised benefits by ‘main affected groups’
Cardholders: reduction in credit and store card balances may reduce indebtedness. Consumers with bounded self-control would be able to commit to planned spending.

### Key Assumptions/Sensitivities/Risks
Assume that 41% of cardholders would decline a limit increase. Lenders may exit or seek to increase revenue from other sources (e.g. interest rates, fees), also potential reduction in availability of credit (especially to high-risk borrowers). Lenders argue this option is tantamount to a ban. Potential for greater complexity, resulting in customer confusion.

### Price Base
Year 2008-9

### Time Period
Years 10

### Net Benefit Range (NPV)
£ -13,864m to -2,922m

### NET BENEFIT (NPV Best estimate)
£ -6,628m

### 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?
OFT, Trading Standards

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

### Does enforcement comply with Hampton principles?
Yes

### Will implementation go beyond minimum EU requirements?
N/A

### 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)

<table>
<thead>
<tr>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
</tr>
</tbody>
</table>

### Are any of these organisations exempt?
No, No, No, No

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

<table>
<thead>
<tr>
<th>Increase</th>
<th>Decrease</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ Negligible</td>
<td>£ 0</td>
<td>£ Negligible +</td>
</tr>
</tbody>
</table>

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

Unsolicited credit limit increases

321. 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 customers can 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.

322. Longstanding concerns have been raised in relation to unsolicited credit limit increases, following findings that such increases could be associated with financial difficulty. Research suggests that the practice results 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.

323. 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. Specifically, unsolicited credit limit increases may cause some consumers to deviate from an optimal spending plan by inducing expenditure that they would not have otherwise made.  

Background

324. The following graphs show the percentage of accounts that have received a credit limit increase during the period July 2007-July 2009 and the average amount that limits increased by.

![Percentage of Accounts with a Credit Limit Increase (July 2007-July 2009)](image-url)

Source: Argus, UK Credit Card Payments Study (2010)

193 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.
325. These cannot be disaggregated between unsolicited and solicited increases, although confidential submissions by issuers showed that around 85% of credit limit increases were unsolicited in the first ten months of 2009. 194 The proportion of accounts receiving a credit limit increase was 27% in the year ending June 2008 and 18% in the year ending June 2009, demonstrating that they have declined sharply as a result of the economic downturn. The average limit increase during the two year period was £1,055. It increased in the first half of 2009 due to the greater influence of customer initiated requests, which are usually of greater value, and a reduction in unsolicited limit increases.

326. 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. 195

327. 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. 196 In the second report of the 2004-5 session, it was noted that APACS (now the UKCA) had incorporated a set of best practice guidelines into the Banking Code (now the Lending Code), but had decided against restrictions on unsolicited credit limit increases. 197

328. Under current requirements in the Lending Code, lenders must provide notice to customers of any increase in their credit limit and should make an assessment of a customer’s ability to repay. Typical industry practice is to credit check all customers before offering a higher limit, and the Lending Code also stipulates that credit limit increases for credit cards should not be offered on accounts that are in arrears and should not be granted for accounts that fall below credit scoring thresholds. Lenders must also explain to customers how they can refuse the limit increase. 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.

194 Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010), p.36. 3.5 million accounts received an unsolicited credit limit increase compared with 0.6 million accounts receiving a solicited increase.
196 http://www.parliament.the-stationery-office.co.uk/pa/cm200304/cmselect/cmtreasy/125/125.pdf
197 http://www.parliament.the-stationery-office.co.uk/pa/cm200405/cmselect/cmtreasy/274/274.pdf
329. Some of these obligations will be placed on a statutory footing by the Consumer Credit Directive, which comes into force in January 2011. 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.

330. In addition, the OFT’s draft Irresponsible Lending Guidance, due to be published in Spring 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; and
- failing to remove any such credit facility following receipt of a specific request from the borrower to do so.

331. 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 Standards Board. These standards commit lenders to:

- undertake appropriate checks to assess a customer’s ability to repay before increasing their credit limit;
- provide customers with information about the credit limit increase in a clear and concise manner;
- make clear that customers have the option to opt out of receiving a limit increase;
- make clear that customers have the option to notify their lender that they would prefer their credit limit to be reduced;
- make it as convenient as possible for customers to advise their card provider of their preference; and
- ensure that staff are able to explain to customers why they have had their limit increased and the options available to them.

Issue

332. 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 can be 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. The lender will monitor the accounts during the first months of operation, and weed out those customers who represent a poor credit 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.

333. The distribution of accounts receiving a credit limit increase in the second quarter of 2009 was skewed towards accounts with lower credit limits, demonstrating the prevalence of ‘low and grow’ strategies. Further evidence submitted by the UKCA also showed that the

---

198 The Lending Standards Board succeeded the Banking Code Standards Board in November 2009.
average limit increase was approximately £700 for those with an initial limit of less than £1,000 but rose significantly (in some cases by more than £1,400) for those with higher limits. It was also shown that issuers tend to target limit increases after customers have been on their books for more than 12 or 24 months, when they have sufficient experience of the consumer.  

199

By contrast, 5% of cardholders had actively applied for a change in their credit limit in the past year (approximately two thirds of these were an increase), most of which (89%) were accepted.  

334. The practice of unsolicited credit limit increases appears to remain relatively common, as shown above. This is supported by consumer research commissioned by the Government, which showed that 20% of credit or store card holders received an unsolicited credit limit increase during the previous 12 months.  

By contrast, 5% of cardholders had actively applied for a change in their credit limit in the past year (approximately two thirds of these were an increase), most of which (89%) were accepted.

335. The impact of unsolicited limit increases is not entirely clear, although there is sufficient evidence to draw some conclusions. There is no direct link between customers receiving a credit limit increase and getting into financial difficulties, such that they default on their loan. This is shown in the graph below (based on data for the third quarter of 2008), which strongly suggests that granting a customer a credit limit increase does not increase their probability of bad debt, relative to someone that did not receive a limit increase. Other data submitted by the UKCA showed that unit loss rates were lower for accounts that received a credit limit increase compared to similar accounts that did not.

Source: Argus, UK Credit Card Payments Study (2010)

199 Argus, 'UK Credit Card Payments Study' (2010). Approximately 10% of accounts receiving an unsolicited increase in the second quarter of 2009 had been on the books for less than 12 months. Around two thirds (67%) had been on the books for more than 2 years.

200 TNS-BMRB, 'Credit and Store Card Research' (March 2010)

201 TNS-BMRB, Quantitative Consumer Research Tabulations. The GfK NOP survey, commissioned by the UKCA, collected data on whether cardholders had ever requested a credit limit increase. This showed that 11% had made a request that was approved and 3% made a request that was declined.

Cumulative Bad Debt (August 2008 – July 2009)

Source: Argus, UK Credit Card Payments Study (2010)

336. Consumer research also showed that the vast majority (84%) of cardholders receiving an unsolicited credit limit increase did not react to the increase and that it was unimportant to them. 6% contacted their lender to request that their limit remain unchanged while a small minority (3%) stated that they increased their spending. It is possible that there is a difference between self-reported and actual behaviour, as qualitative research showed that consumers considered unsolicited increases to be a spending temptation. However, there is little evidence to suggest that the practice contributes to severe financial difficulty.

337. 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. Furthermore, the majority of credit offered to individuals remains unused; the average utilisation of credit limits in July 2007-July 2009 for active accounts was 34%.

338. Evidence submitted by the UKCA also indicates that of those accounts receiving limit increases during the past two years, the majority are low risk (although the proportion that is medium risk increased during the first half of 2009). Separate data also shows that accounts with a medium level of utilisation are much more likely to receive a limit increase than those with low and high levels of utilisation. The latter is intuitive as accounts with low levels of utilisation are unlikely to make use of a limit increase and accounts with a high rate may be too risky, as they experience greater loss rates and are more likely to go into arrears.

---

203 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

204 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)

205 Argus, ‘UK Credit Card Payments Study’ (2010).

206 Argus, ‘UK Credit Card Payments Study’ (2010). Utilisation refers to the account balance as a percentage of the credit limit. High utilisation is defined as an a utilisation rate of 66% or more whilst medium and low are defined as 33%-66% and less than 33% respectively. In each month between July 2007-January 2009, around 5-7% of accounts with medium utilisation received a credit limit increase compared to 1-2% for high utilisation accounts and 1-3% for low utilisation accounts. The monthly proportions dropped significantly in February-July 2009 to around 3% for medium utilisation accounts and less than 1% for the others.
Distribution of Risk Segments Amongst Accounts with a Credit Limit Increase (July 2007 – July 2009)

High Risk Accounts are defined as having a Unit Loss Rate (ULR) of 4% or more
Medium Risk Accounts have a ULR of 1%-4%
Low Risk Accounts have a ULR of less than 1%

Source: Argus, UK Credit Card Payments Study (2010)

339. Although the majority of consumers (67%) are aware that lenders can offer unsolicited increases and, of those that receive them, 84% indicate that it has no effect on their behaviour, the practice does lead to more borrowing by consumers in absolute terms. For accounts with a credit limit increase in April 2009, average monthly spending increased during the following six months by approximately 5.1% of the limit increase. In the third quarter of 2008, accounts that received a limit increase had higher balances in the months after the increase. It is worth noting, however, that some of this would have been driven by individuals who actively requested a limit increase and who will therefore almost certainly increase their spending. There is also likely to be an affect of customers taking up balance transfer offers and a shift of spend from other cards, as well as genuine new spend.

340. In terms of purchasing behaviour, data for the same quarter showed that accounts with a limit increase saw a spike in purchases in the first two months followed by a decline to below their pre-increase levels. This may indicate that, in some cases, consumers use a limit increase to bring forward spending that they had planned to make further down the line.

341. A recent study in the US also 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 (similar to the increase in balances mentioned above). This figure was larger for cardholders starting near their credit limit and the increase could lead to additional interest costs of up to £5.5m for that month.

207 TNS-BMRB, 'Credit and Store Card Research' (March 2010)
208 Oxera, ‘An economic assessment of BIS’ s proposals for credit card regulation’ (January 2010), p.48. The consultant indicated that this is a rough estimate based on relatively simple analysis and that certain factors such as seasonal effects were not controlled for. It was calculated by comparing the average monthly spend in the preceding three months from January-March 2009 to the following six months from May-October 2009. The uplift in spend as a percentage of the sum of limit increases granted was 5.06%.
210 http://idei.fr/CORE/articles/gross_souleles.pdf
211 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
342. Although this evidence suggests that unsolicited credit limit increases do not induce people to borrow more than they can afford, it does show that they lead to higher spending and some consumer groups argue that they encourage people to borrow more than they might rationally intend, with attendant debt servicing costs. 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. This was brought out in the qualitative work conducted by TNS-BMRB, which showed that consumers were more aware of their spending when they used cash. Some respondents, particularly regular borrowers, did not perceive credit as their own money and instead could consider it as ‘free money’.  

343. There is also some limited support for this view from attitudinal survey evidence:

- 31% of respondents agreed with the statement, ‘Buying things on credit does not feel like spending’;
- 16% agreed with statement, ‘I am impulsive and tend to buy things even when I can’t really afford them’;
- 15% 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
- 8% agreed with the statement ‘If lenders offer me money I will take it’

344. 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 commissioned by the UKCA shows that 89% of credit card holders knew what their credit limit was.

345. It has also been suggested that some lenders may make it difficult for consumers to set their own limit at the outset. Despite Lending Code commitments to ensure consumers are aware that they can decline a limit offered, it is not clear that consumers understand this right. When analysing consumers that had received an unsolicited credit limit change in the past 12 months, survey evidence showed that one-in-ten cardholders contacted their lender to request that the limit remain unchanged. 83% of cardholders that made this

---

212 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
213 Source: YouGov DebtTrack (November 2009)
214 UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
request found it extremely to fairly easy to contact their lender, although this result should be interpreted with caution due to a small base. 215

346. Consumer groups had 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 argued 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. Survey evidence shows that this concern is not particularly prevalent. Of the cardholders that received an unsolicited limit change but did not contact their lender, the majority either did not care (55%) or were happy with the change (26%). No respondents were worried about the impact on riskiness and how banks may perceive them. 216

Rationale

347. There is a bias in some consumers’ behaviour in terms of self-control, where they have limited willpower and make impulse purchases which are later regretted. 217 Such consumers are considered to have bounded self-control. Although the evidence presented above shows that this is not a problem for the vast majority of consumers, it does exist for some credit card users when borrowing is easier. Qualitative research commissioned by the UKCA showed that a minority of respondents admitted that they struggled to resist the temptation posed by a higher credit limit. 218 This is supported by TNS-BMRB’s qualitative research, which states that for some respondents, “unsolicited increases felt ‘less real’, and could lead to people to making unplanned spends with it, without considering the long term costs”. 219

348. Oxera also concluded that, “while not applying to the majority or even a significant number of cardholders, there is likely to be a sub-set of cardholders who may not have the self-discipline to assess their ability to repay an increased level of spend when made available to them”. 220 Although it is not possible to identify to size of this sub-set of cardholders, the existence of the behavioural bias implies that, for certain customers receiving an unsolicited limit increase, choosing not to utilise this higher limit is unlikely to be sufficient protection.

349. 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.

350. Research conducted by GfK NOP also highlighted a contentious issue that cardholders had with unsolicited credit limit increases, namely that they are issued with “little or no communication with, or warning to, the customer”. This implies that the principles in the Lending Code regarding the provision of clear and concise information about the limit increase and option to opt out have not been fully adhered to by lenders. This issue was considered to be a concern for a number of reasons, for example at the theoretical level (that companies should not be able to change the nature of an agreement without explicitly informing the customer) and because it took control away from the customer in

---

215 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
216 Ibid
217 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)
218 UKCA, Appendix 5 of the Response to BIS Consultation: GfK NOP Qualitative Research Management Report, p.8 (January 2010). Oxera provided an example of one cardholder that indicated that “she would always be tempted by increased credit availability, even though she knew it would be likely to increase her indebtedness”. (Oxera, p. 53)
219 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
220 Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010), p.53
favour of an advantage to the credit card provider, unbalancing the relationship between borrower and lender.\textsuperscript{221}

\textbf{Options analysis}

351. 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 higher risk consumers, who may look to more expensive and less suitable forms of credit as a result.

352. 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

\textbf{Option 1: Do Nothing}

353. Under this option, the issues 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 the OFT’s Irresponsible Lending Guidance) will bring some additional clarity to this area for consumers.

354. 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, as a minimum, that lenders must explain the amount of the initial credit limit, and how the credit limit may change over time.

355. 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 in Spring 2010), the Lending Code and industry best practice guidelines, it may go some way to address concerns regarding unsolicited limit increases, in particular concerns around the ease with which they are able to decline a new credit facility.

\textbf{Option 2: Better information for consumers about unsolicited credit limit increases}

356. Improving transparency for consumers about the reasons for a credit limit increase and their options in accepting or declining this offer could encourage more consumers to actively manage their credit limits.

357. A 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 change or ask for their limit to be decreased could be achieved through online banking services as well as by making it easier for people to contact their lender directly.

358. The UKCA, in its response to the consultation, has offered to commit to the following: provide a customer with 30 days notice in advance of the change to the limit; provide clarity on the multiple channels by which the customer can opt out; provide clarity that the customer can opt out of an individual increase and/or any increases in the future; and

\textsuperscript{221} UKCA, Appendix 5 of the Response to BIS Consultation: GfK Qualitative Research Management Report, p.8 (January 2010)
provide cardholders with a means to decrease their limit that does not require personal interaction (e.g. online or automated telephone service). Furthermore, credit card companies have agreed to observe a ban on limit increases for consumers at risk of financial difficulties. The definition would be developed by issuers and debt advice agencies.

359. In addition, Government has outlined the importance of ensuring that consumers have the right to tell their credit card company at any time that they wish to reduce their current limit, without incurring any sort of penalty. This is currently one of the requirements in the Lending Code.

**Costs**

360. Provision of additional information to consumers (over and above that identified in relation to option 1) will entail costs for lenders in generating and communicating this information to customers, especially if it is sent in a separate notification. Lenders have estimated this cost to be £5-10 million.

361. 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.

362. If this option results in more card holders refusing an unsolicited credit limit increase, it is possible that they will not spend as much as they would have with the increase. In terms of the lender-customer relationship this will mean that for those cardholders not paying their balance off in full, the consumer will save money on interest payments whilst the lender will lose income. These costs (and benefits below) cannot be quantified as there is no evidence that indicates the number of cardholders that would opt out of an unsolicited credit limit increase if they had the above information.

**Benefits**

363. 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.

**Risks**

364. There is risk that consumers may not read and/or understand the additional information provided, especially if they already receive a large amount of information. In this case the policy would lead to information overload. Qualitative analysis conducted by TNS-BMRB showed that information options can have limited impact because it is often ignored by consumers. This could be mitigated by ensuring that communication regarding unsolicited credit limit increases is separate and both clear and concise.

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

365. As part of the industry best practice proposals put forward by the UK Cards Association, there is a ban on increasing a customer’s credit limit more than once in a six-month period. Furthermore, evidence submitted by the UKCA in response to the consultation shows that in the July 2007-July 2009 period, only 7 per cent of accounts received more than one credit limit increase over the two years. Therefore, limiting the frequency of individual limit increases is unlikely to have a significant impact.

---

222 UKCA, Response to BIS Consultation (January 2010), pp. 119-122. This also includes a revised Statement of Principles. [http://www.theukcardsassociation.org.uk/view_point_and_publications/what_we_think/-/page/881](http://www.theukcardsassociation.org.uk/view_point_and_publications/what_we_think/-/page/881)

223 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

224 Argus, ‘UK Credit Card Payments Study’ (2010).
366. However, it may be desirable to limit the size of any single limit increase to a maximum proportion of the existing credit facility in order to mitigate any risk of lenders offering larger increases to compensate for the fact that they cannot offer them more frequently.

Costs

367. Under this option, lenders would incur communication costs and some programming costs to amend their systems to set limits for particular cardholders. This has been estimated to be £5-10 million by industry. 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.

368. 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.

369. In quantifying the costs, consumer research by TNS-BMRB and data provided by the UKCA for the second quarter of 2009 has been used. The latter indicates the distribution of accounts with a credit limit increase and the average increase amount by pre-increase credit limit. Proportional credit limit increases are calculated by dividing the average credit limit increase by the mid-point of the pre-increase credit limit band. This is a large simplification and does not fully reflect the distribution of credit limits within each band, nor does it reflect the variation in the size of limit increases (it also includes solicited credit limit increases as these could not be disaggregated). The following tables show the impact of setting thresholds by absolute and proportional values respectively.

### Impact of absolute thresholds

<table>
<thead>
<tr>
<th>Limit Increase threshold (£ absolute)</th>
<th>% Credit limit increases affected</th>
<th>Estimated reduction in annual consumption (£ million)</th>
<th>Estimated annual reduction in lender revenue/gain in consumer surplus (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>500</td>
<td>88</td>
<td>1,648</td>
<td>291</td>
</tr>
<tr>
<td>750</td>
<td>73</td>
<td>1,363</td>
<td>241</td>
</tr>
<tr>
<td>1000</td>
<td>67</td>
<td>1,252</td>
<td>221</td>
</tr>
<tr>
<td>1500</td>
<td>45</td>
<td>835</td>
<td>148</td>
</tr>
<tr>
<td>2000</td>
<td>39</td>
<td>725</td>
<td>128</td>
</tr>
<tr>
<td>3000</td>
<td>19</td>
<td>352</td>
<td>62</td>
</tr>
<tr>
<td>4000</td>
<td>12</td>
<td>220</td>
<td>38</td>
</tr>
<tr>
<td>5000</td>
<td>8</td>
<td>154</td>
<td>27</td>
</tr>
</tbody>
</table>

Source: BIS Analysis based on TNS-BMRB Data

---

225 Respondents that received an unsolicited limit increase were asked about the magnitude of the increase. 15% did not know and have therefore been omitted from this analysis. It is implicitly assumed that the same distribution applies to this segment of cardholders.
Impact of proportional thresholds

<table>
<thead>
<tr>
<th>Limit Increase threshold (% proportion)</th>
<th>% Credit limit increases affected</th>
<th>Estimated reduction in consumption (£ million)</th>
<th>Estimated reduction in lender revenue/gain in consumer surplus (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>81</td>
<td>1,513</td>
<td>267</td>
</tr>
<tr>
<td>30</td>
<td>56</td>
<td>1,046</td>
<td>185</td>
</tr>
<tr>
<td>40</td>
<td>45</td>
<td>841</td>
<td>149</td>
</tr>
<tr>
<td>50</td>
<td>33</td>
<td>616</td>
<td>109</td>
</tr>
<tr>
<td>80</td>
<td>18</td>
<td>336</td>
<td>60</td>
</tr>
</tbody>
</table>

Source: BIS Analysis based on Argus Data for 2009 Q2, UK Credit Card Payments Study (2010)

370. Across the full range of potential thresholds, this implies a possible reduction in annual consumption of £154m-£1,648m per year and an estimated reduction in lender revenue of £27m-£291m per year.

371. The effect on consumption and lenders’ revenue is calculated by multiplying the impact of banning all unsolicited credit limit increases by the proportion of limit increases affected by the threshold. This again is a simplification as it does not reflect variation in spending increases (for example, one might expect that cardholders with lower initial limits spend a greater proportion of their limit increase than those with higher limits). However, the calculations provide a useful estimate of the impact of setting specific thresholds. For example, setting an absolute limit of £1,000 may not have a significant impact on low and grow customers but the costs to both the economy and lenders remain significant. By contrast, setting a high proportional limit (e.g. 80%) may not have a relatively large effect on consumption or lenders’ revenue (because they could still offer increases to low risk customers with high limits) but it could restrict access to credit for high-risk customers that are the target of low and grow strategies.

Benefits

372. Under this option, the ability of some cardholders to borrow would be constrained, though this may be beneficial for those customers that use a credit limit to deliberately constrain their spending. Consumers that are directly affected by the policy would also pay lower interest costs on their balances. The benefit would be equivalent to the potential reduction in lender revenue, i.e. £27m-£291m per year (see tables above), as it represents an economic transfer from lenders to consumers.

373. 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 (provided the limit was set at an appropriate level).

Risks

374. The impact of this policy obviously depends on the limit deemed acceptable. If it is set such that the majority of unsolicited limit increases would be prohibited, there is a risk that lenders will set higher limits during the card application process and they may recoup lost revenue by increasing interest rates or fees and charges. Depending on the threshold set, interest rates could increase across all revolving balances by up to 0.68%, assuming that higher interest rates are the only way in which lost revenue would be recouped, lenders do not absorb any reduction in profit and that rate increases are applied evenly across all accounts. Issuers would also have to factor in changes in consumer behaviour in response to price increases. Setting proportional thresholds is likely to reduce credit access for high-risk customers.
Option 4: Ban all unsolicited limit increases

375. 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 likely mean that limits would be increased only where consumers had actively made a decision that they wished to be able to borrow more.

376. 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.

Costs

377. Lenders would incur communication and programming costs to amend their systems to set limits for particular cardholders. This has been estimated to be £30-40 million by industry.

378. 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. Evidence submitted by the UKCA shows that although accounts receiving an unsolicited limit increase do not have a higher probability of default, this is not the case for accounts that actively request a credit limit increase. One lender indicated that their default rate for accounts subject to an unsolicited limit increase is 2.6% compared to 3.1% for their total book. For those accounts that have requested an increase, the rate is 5.4%. 226 Therefore, 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 commissioned by the UKCA suggests that approval rates for such applications is approximately 78%. 227

379. On the other hand, some cardholders that are of low or medium risk and who would have been offered an unsolicited increase may actively request a limit increase and, if approved, would not have a high probability of default. This suggests that the current rate of default for solicited limit increases is not an accurate indicator of the rate that would exist if they were the only means for cardholders to increase their credit limits.

380. 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. The industry has estimated that the impact of banning unsolicited credit limit increases would have caused a reduction in revenue of £305 million in 2008-9 and £354 million in 2007-2008. Taking an average, the annual cost of this option in terms of lost income to lenders is estimated at £330 million per year.

381. Lenders also argue that this option could 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, by effectively prohibiting “low and grow” strategies, 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.

382. There is also a possibility that such action might prevent lenders from temporarily extending a customer’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.

---

226 UKCA, Response to BIS Consultation (January 2010), p. 92.
227 UKCA, Appendix 4 of the Response to BIS Consultation: GfK NOP Quantitative Consumer Research Tabulations, (January 2010). This was in response to a question regarding whether cardholders had ever requested an increase. It is probable that approval rates will have fallen during the economic downturn. The lender mentioned in the UKCA response suggested that only 25% of accounts requesting a limit increase are approved.
Furthermore, unlike the other areas under consultation, where policies largely result in an economic transfer of producer surplus to consumers, the prohibition of unsolicited credit limit increases has a material effect on the economy as a whole by reducing consumption. As discussed earlier, it is estimated that for accounts with a credit limit increase in April 2009, the average monthly uplift in spend as a percentage of the limit increase granted was 5%. It is likely that the increase is greater for individuals with a lower initial limit. However, as there is no disaggregated data on the proportion of the limit increase that is spent according to initial limits, it is assumed that a rate of 5% is constant for limit increases throughout the year. This suggests that consumption using credit cards could fall by up to £3,290 million per year, although this is likely to be an over-estimate as some of it will be accounted for by customers taking up balance transfer offers and shifting their spending from other cards. 

This figure is reasonably consistent with data submitted by the UKCA, which shows that banning unsolicited credit limit increases would have reduced balances in 2009 by 2.96% or £1,868 million (assuming total outstanding balances are £63.1 billion indicated in the UKCA response), if one considers that not all of the extra spending will manifest itself in balances (as shown above, most credit limit increases are given to lower risk cardholders who are more likely to pay off their balances in full). This indicates that consumers paid back £1,422 million of the debt incurred as a result of unsolicited credit limit increases and if one assumes that they would have spent this in the absence of receiving an increase, then the net increase in consumption that is induced by unsolicited credit limit increases is £1,868 million. Therefore, this represents the annual economic cost of banning the practice. The arithmetic mean between 2008 and 2009 figures has not been taken in this case because the above calculation for reduction in credit card expenditure is based on 2009 data only. However, an upper bound annual cost of £2,385 million can be considered.

Benefits

Given the link between increased credit limits and outstanding card balances, a ban on unsolicited limit increases will result in lower interest costs for consumers on their credit and store card balances. Specifically, if lenders lose £330 million per year in interest income then this would be transferred back to consumers, in addition to £1,422 million that consumers borrowed and were able to pay back.

Furthermore, consumer indebtedness would fall by £1,868 million as individuals would not increase their borrowing relative to a scenario where they receive an unsolicited credit limit increase. However, this is not an economic benefit as it represents the value of consumption that would not take place in the absence of unsolicited credit limit increases.

In cases where unsolicited increases cause a borrower to default on repayment or become over-indebted, the foregone increase in consumption could be interpreted as a benefit. Indeed, had evidence shown that a significant proportion of cardholders default following an unsolicited increase, the reduced consumption would not be considered a cost, as it would result in a number of consumers avoiding financial difficulty. However, as

---

228 This figure is derived using credit limit increase data for the year ending June 2009. For each month, the number of accounts with a credit limit increase is calculated by multiplying that month’s CLI rate by 55 million (the number of credit card accounts in the UK in the middle of 2009). This number is then multiplied by the average credit limit increase during that month to derive the total value of credit limit increases. The monthly uplift in spending is 5% of this figure. It is assumed that this is constant across the remaining months in the year (i.e. those receiving a CLI in Month 1 spend 5% of the increase in all 12 months, those receiving a CLI in Month 2 spend 5% of the increase in 11 months etc.). The figures are aggregated to estimate the annual increase in consumption and then multiplied by 0.85 to reflect confidential returns from issuers that 85% of credit limit increases were unsolicited for most of 2009. The figure is higher, £4.4 billion, if one assumes that the annual rate of unsolicited credit limit increases is 20% (as suggested by the TNS-BMIRB survey). It increases to £6.6-9.9 billion if the monthly uplift in spend is 10-15%, which was the case in the US earlier last decade. If the monthly uplift in spend is 5% but levels off after 3-6 months, the increase in consumption is £1.22-2.27 billion.

229 UKCA, Response to BIS Consultation (January 2010), p. 28. The reduction in balances in 2008 would have been £2,385 million (3.78%).
discussed above, there is no association between unsolicited credit limit increases and bad debt. Consumers who increase their expenditure largely do so in a responsible and affordable manner.

388. There is no conclusive evidence that this policy would have significant distributional effects in terms of transferring benefit from high income to low income households (which would require the benefits to be weighted to take into account the fact that low income households have higher marginal utilities of consumption)\(^ {230}\). As discussed above, the distribution of unsolicited credit limit increases is skewed to low and medium risk accounts, although there is no necessary association between low risk and high income. However, the consumer survey commissioned by the Government does not show that the distribution of cardholders receiving an unsolicited limit increase was skewed to low-income households.

389. Cardholders that received an unsolicited credit limit increase during the past 12 months were more likely to be married (76%) and of working age (88%), although the likelihood of having a child was reasonably even (44%)\(^ {231}\). If one considers the gross income quintiles for couples with children and no children, then according to the survey\(^ {232}\) around 10-15% of cardholders with an unsolicited increase were in the first two quintiles. Approximately 25% were in the third quintile, 20-25% were in the fourth quintile and 40-45% were in the upper quintile\(^ {233}\).

*Risks*

390. The net reduction in consumption, £1,868 million, assumes that cardholders would not have increased their total spending without receiving an unsolicited credit limit increase (that is they would not have borrowed from elsewhere). If this does not hold, then the cost of the policy falls. However, it seems reasonable to assume that any expenditure that the consumer had planned before the limit increase would have been made regardless of the credit card lender’s decision, which is arguably exogenous to the cardholder.

391. Another risk of banning unsolicited credit limit increases, which was identified by Oxera\(^ {234}\), is that it may lead lenders to set higher limits at the point of application. Given that their knowledge and information about the customer will be relatively limited at this point (particularly for monoline providers), it may not contribute to a policy of responsible lending.

392. Lenders have asserted 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.

393. If one assumes that lenders would not absorb any reduction in profit and that they would recoup all lost income (£330 million) by increasing interest rates evenly across all revolving balances, then credit card interest rates would increase by 0.77%. Alternatively lenders could make up the lost revenue just by charging an annual fee, either on all accounts or on active accounts. In this case, a fee of £6 would be applied to all accounts or £9.46 for active accounts. However, lenders are unlikely to respond in this way as they would need to assess account behaviour and details before setting specific fees.


\(^{231}\) TNS-BMRB, Quantitative Consumer Research Tabulations.

\(^{232}\) Specifically for respondents that received an unsolicited limit increase and gave their gross weekly income.

\(^{233}\) It should be noted that respondents gave their weekly income by bands rather than exact figures, therefore these distributions are not precise.

\(^{234}\) Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010), p.53.
Increasing interest rates would have two opposing impacts on lenders’ income; the price
increase would have a positive impact but if consumers respond by reducing their
expenditure on the card then expected returns may decline. Therefore, lenders would
have to analyse a number of complex variables and scenarios before deciding how to
respond. Furthermore, it is more likely that they would recoup lost revenue by more than
one method (e.g. increase interest rates and fees) and they may also accept some
reduction in profit.

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

394. 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).

395. 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 or for each individual limit increase, but customers would be
able to change the way their limits are determined during the life of the agreement if they
choose.

**Costs**

396. This option would entail some implementation costs for lenders, estimated to be £30-40
million. There is also likely to be ongoing costs incurred through the offers made to
customers, such as time for customer service staff and/or notification, though this could be
minimised 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.

397. 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.

398. By setting the default to ‘opt-in’, it is likely that some consumers will not accept a credit
limit increase either due to inertia or apathy. In the consumer survey commissioned by the
UKCA, 73% of cardholders indicated that they were happy with their current limit.235 In
another question, respondents were asked whether they would ever decline a credit limit
increase if their provider offered one; 41% stated that they would do so. If one assumes
that this would reduce the effect of unsolicited credit limit increases on both lender income
and net consumption in the economy by the same proportion, then annual consumption
would fall by £766 million per year and lender income would fall by £135 million per
year236.

---

235 UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations,
(January 2010)

236 The proportion did not significantly change according to social class, working status, minimum payers or
income. There was some variation in terms of cardholders’ pre-limit increase, with 39% saying they would decline if
their limit was less than £1,000, 27% if their limit was £1,000-£3,000 and 50% if their limit was more than £3,000.
However, when using this with above data for the second quarter of 2009 (which showed the distribution of credit
limit increases and average line increase by pre-increase limits), the total value of limit increases affected did not
significantly change (43%). This is due to the distribution of limit increases being almost evenly split between
accounts with pre-increase limits of less than £3,000 (45%) and more than £3,000 (55%).
Benefits

399. 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, it could reduce the outstanding balance for credit and store card holders, which would in turn reduce the amount of interest paid on borrowing. The benefit received would be in the form of a transfer from lender surplus and would therefore be £135 million per year.

400. 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. Qualitative work conducted by GfK and TNS-BMRB showed that some cardholders with bounded self-control knew that having higher limits would lead to higher borrowing. By giving these consumers an easier option to refuse a limit increase, it allows them to better commit to future expenditure plans. Furthermore, unlike option 4, it does not prohibit low and grow strategies and maintains credit access for high-risk consumers.

401. This is consistent with analysis conducted by Oxera, which suggested that an opt in may fulfil a role of providing the option of a commitment device for some consumers, while not jeopardising credit access for high-risk customers. In particular, it would arguably enable the policy to focus on cardholders with “poor impulse control” but less so on those who are also affected by ‘inertia’. However, they also indicated that, ‘it is uncertain whether the opt-in would provide these desired benefits for one group while not imposing undesired costs on another’.  

Risks

402. There is a risk that restricting provision of unsolicited credit card limit increases, in this case by setting the default option to opt-in, 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 increased indebtedness). Lenders may also recoup revenue reductions by increasing interest rates or fees and charges. If they were to recover all lost income (£135 million) by increasing interest rates evenly across all revolving balances, then credit card interest rates would increase by 0.31%. Alternatively an extra fee could be levied either on all accounts (£2.45) or on active accounts (£3.87) although as with option 4, a more complex assessment would be required and it is likely that they would recoup lost revenue by more than one method (e.g. increase interest rates and fees).

403. In their response to the consultation, the UKCA indicated that lenders would have to assume that consumers will not opt in to unsolicited limit increases and, therefore, the impact would be the same as a complete ban (option 4). This is based on evidence showing that 73% of consumers were satisfied with their current limit and 86% said they would not request an increase. However, this question refers to cardholders actively seeking an increase rather than opting into an offer that has been made by the lender. In this context, the figure seems to be an over-estimate. Nevertheless, results from a sensitivity analysis shows how costs vary according to differing rates of opt-in. A rate of 18% is also included as the GfK NOP survey showed that, when asked if cardholders would get in touch with their credit card company to accept any increase that was offered, a total of 82% indicated that they would do so, either by telephone (47%), email (29%) or letter (6%).

---

237 UKCA, Appendix 5 of the Response to BIS Consultation: GfK Qualitative Research Management Report, pp. 8-9 (January 2010)
238 TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)
239 Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010), p.54.
240 UKCA, Response to BIS Consultation (January 2010), p. 118.
241 UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010)
### Assumption 1: Proportion of cardholders that decline opt-in

<table>
<thead>
<tr>
<th></th>
<th>86%</th>
<th>18%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated reduction in consumption (£ million)</td>
<td>1,606</td>
<td>336</td>
</tr>
<tr>
<td>Estimated reduction in lender income/increase in consumer surplus (£ million)</td>
<td>284</td>
<td>59</td>
</tr>
</tbody>
</table>

404. Qualitative research conducted by TNS-BMRB shows that, when presented with this option, respondents thought that some consumers with bounded self-control would remain tempted to accept the credit limit increase.\(^{242}\) If this occurred, the opt-in would not fully address the issue.

405. Consumers would have to be made fully aware of the change as those familiar with current practice may continue to assume that their limit automatically increases, which could lead to spending above their current limit (incurring default fees). This would involve an upfront cost to ensure that the changes are sufficiently communicated to all cardholders.

406. In Canada, the Credit Business Practices Regulations that were published on 30 September 2009 (with an effective date of 1 January 2010) included a clause that issuers cannot increase the credit limit on a borrower’s credit card without obtaining the borrower’s express consent to do so. Consent can be given in written, electronic or verbal form but if the borrower’s consent to the increase is given orally, the issuer must (without delay) provide confirmation of that consent to the borrowing in writing, in paper or electronic form. Consumers can opt-in to receiving credit limit increases at any time during the life cycle of their account (i.e. they do not have to opt in to every limit increase).

407. Due to the short amount of time since the Canadian regulations took effect, it is not possible to analyse the impact of this specific regulation. However, research commissioned by BIS into international credit card markets shows that Canadian issuers have responded to the regulations as a whole (which include a provision that payments above the minimum are allocated to the most expensive debt first, a minimum payment warning and an advance notice of interest rate increases) by restricting credit availability and increasing the cost of credit in terms of interest rates and fees.\(^{243}\)

**Preferred option**

408. The Government’s preferred option is to provide better information and rights for consumers about unsolicited credit limit increases. This falls under three of the rights included in the Government response: the right to control a credit limit; the right to reject a limit increase; and the right to information about how consumers can manage their credit limits. Lenders have agreed to implement these reforms voluntarily.

409. As discussed earlier, evidence collected by both the UKCA and the Government shows that unsolicited credit limit increases are not associated with financial difficulty or over-indebtedness. This is due to issuers mainly targeting accounts that are of low risk and have low or medium utilisation rates. Furthermore, quantitative research shows that the vast majority of customers are apathetic to unsolicited increases and do not spend significantly more on their credit cards if they receive an increase. In this context, the impact and potential risks associated with options 3-5 are disproportionate given the scale of the problem. Option 2 represents a proportionate and targeted solution for the minority.

---

\(^{242}\) TNS-BMRB, ‘Credit and Store Card Research’ (March 2010)

\(^{243}\) Auriemma Consulting Group, ‘International Regulatory Research’
of cardholders that are tempted by unsolicited credit limit offers but would rather not increase their spending, as they will have more options to ensure that their limits remain unchanged.
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’). Government is concerned that industry self-regulation may not have been effective in protecting consumers from unjustifiable interest rate increases on existing debt, and that risk-based re-pricing is not sufficiently transparent. Intervention may be required on both equity grounds (if price increases are unjustifiable) and in order to fill the information gap for consumers, such that they are fully aware as to what behaviour and characteristics constitute ‘high-risk’ and how they can avoid risk-based price increases.

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 are 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
The Government’s preferred option is to improve the transparency of risk-based decisions.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? A post-implementation review will be undertaken after 3 or 5 years.
### Summary: Analysis & Evidence

<table>
<thead>
<tr>
<th>Policy Option: Improve information about risk-based re-pricing</th>
<th>Description: Proposals for changes to practices around re-pricing of existing credit card and store card debt</th>
</tr>
</thead>
</table>

#### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
<th>Industry: implementation costs of producing necessary information and integrating into customer communication (£5m - £10m); potential reduction in interest income as balances are reduced and/or paid off sooner (£11m-36m pa) through changes in consumer repayment behaviour.</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition)</td>
<td>Yrs</td>
</tr>
<tr>
<td>£ 5m-10m</td>
<td></td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td></td>
</tr>
<tr>
<td>£ 11m-36m</td>
<td>10</td>
</tr>
<tr>
<td>Total Cost (PV)</td>
<td>£ 100m-320m</td>
</tr>
</tbody>
</table>

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

#### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
<th>Cardholders: changes in consumer repayment behaviour as a result of increased transparency, leading to benefits through reduced interest costs of borrowing for 2% of accounts (£11m-36m pa, transferred from lenders). It is estimated that 2% of total accounts would change their behaviour after receiving an APR increase, thus paying less interest.</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off</td>
<td>Yrs</td>
</tr>
<tr>
<td>£ 0</td>
<td></td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td></td>
</tr>
<tr>
<td>£ 11m-36m</td>
<td>10</td>
</tr>
<tr>
<td>Total Benefit (PV)</td>
<td>£ 95m-310m</td>
</tr>
</tbody>
</table>

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

### Key Assumptions/Sensitivities/Risks

Assume 14% of re-priced accounts (equivalent to 2% of total accounts) would reject price increase. Alternatively, information may not lead to a change in customer behaviour. Risk of information overload, which could increase customer confusion.

#### Price Base

<table>
<thead>
<tr>
<th>Year 2008-9</th>
<th>Time Period</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ -10m to -5m</td>
<td>£ -7.5m</td>
<td></td>
<td></td>
</tr>
</tbody>
</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>N/A</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>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual cost (£-£) per organisation (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>

<table>
<thead>
<tr>
<th>Impact on Admin Burdens Baseline (2005 Prices)</th>
<th>Increase (£)</th>
<th>Decrease (£)</th>
<th>Net Impact (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Increase - Decrease)</td>
<td>£ 0</td>
<td>£ 0</td>
<td>£ 0</td>
</tr>
</tbody>
</table>

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

---

90
### 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>
<th>Implementation costs to industry (£5m - £10m).</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off (Transition)</strong> Yrs</td>
<td>£ 5m-10m</td>
</tr>
<tr>
<td><strong>Average Annual Cost</strong> (excluding one-off)</td>
<td>£ Unknown</td>
</tr>
</tbody>
</table>

*Other key non-monetised costs by ‘main affected groups’*
Reduced interest income as balances are reduced and/or paid off sooner (unable to quantify without a specific set of re-pricing criteria).

#### 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><strong>Average Annual Benefit</strong> (excluding one-off)</td>
</tr>
</tbody>
</table>

*Other key non-monetised benefits by ‘main affected groups’*
Cardholders: reduced interest costs of borrowing (unable to quantify without a specific set of re-pricing criteria). Increase in certainty/predictability for cardholders around potential increases in interest rates, which could facilitate financial planning and budgeting (possibly reducing the risk of over-indebtedness).

#### Key Assumptions/Sensitivities/Risks

Constraint on ability to change interest rates on existing balances could reduce tolerance to risk; potential consequence could be reduction in availability of credit, particularly to vulnerable customers, or increases in initial fees and/or interest rate across all borrowers.

#### Price Base

<table>
<thead>
<tr>
<th>Year 2008-9</th>
<th>Time Period Years 10</th>
<th>Net Benefit Range (NPV) £ -10m to -5m</th>
<th>NET BENEFIT (NPV Best estimate) £ -7.5m</th>
</tr>
</thead>
</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?  
  OFT, Trading Standards
- What is the total annual cost of enforcement for these organisations?  
  Negligible
- Does enforcement comply with Hampton principles?  
  Yes
- Will implementation go beyond minimum EU requirements?  
  N/A
- 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)

<table>
<thead>
<tr>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
<td>Negligible</td>
</tr>
</tbody>
</table>

#### Are any of these organisations exempt?

- No

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

<table>
<thead>
<tr>
<th>(Increase - Decrease)</th>
<th>£ Negligible</th>
<th>Decrease</th>
<th>£ 0</th>
<th>Net Impact</th>
<th>£ Negligible +</th>
<th>(Net) Present Value</th>
</tr>
</thead>
</table>

**Key:**  
Annual costs and benefits: Constant Prices
## 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>Category</th>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition)</td>
<td>Implementation costs to industry, e.g. IT systems changes (£5m - £10m); reduced interest income as balances are reduced and/or paid off sooner (£2m-171m pa, depending on the threshold).</td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td>£ 2m-171m</td>
</tr>
<tr>
<td>Yrs</td>
<td>10</td>
</tr>
</tbody>
</table>

**Total Cost (PV):** £ 22m-1,482m

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Category</th>
<th>Description and scale of key monetised benefits by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off</td>
<td>Cardholders: reduced interest costs of borrowing (£2m-171m pa, transferred from lenders). It is estimated that 0.1-10% of total accounts would receive a lower price increase (or none at all), depending on the threshold.</td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td>£ 2m-171m</td>
</tr>
<tr>
<td>Yrs</td>
<td>10</td>
</tr>
</tbody>
</table>

**Total Benefit (PV):** £ 17m-1,472m

### Key Assumptions/Sensitivities/Risks

Constraint on ability to change interest rates on existing balances could reduce tolerance to risk; potential consequence could be reduction in availability of credit, particularly to vulnerable customers, or increases in interest rates and/or fees across all borrowers.

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

<table>
<thead>
<tr>
<th>Category</th>
<th>Increase</th>
<th>Decrease</th>
<th>Net Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual cost (£-£) per organisation (excluding one-off)</td>
<td>£ Negligible</td>
<td>£ 0</td>
<td>£ Negligible +</td>
</tr>
</tbody>
</table>

**Key:**

- **Annual costs and benefits:** Constant Prices
- **(Net) Present Value**
<table>
<thead>
<tr>
<th>Summary: Analysis &amp; Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Policy Option:</strong> Prohibit re-pricing of existing debt</td>
</tr>
<tr>
<td><strong>Description:</strong> Proposals for changes to practices around re-pricing of existing credit card and store card debt</td>
</tr>
</tbody>
</table>

### ANNUAL COSTS

<table>
<thead>
<tr>
<th>One-off (Transition)</th>
<th>Yrs</th>
<th>Description and scale of key monetised costs by 'main affected groups'</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 30m-40m</td>
<td></td>
<td>Implementation costs to industry, e.g. IT systems changes, staff training (£30m - £40m); reduced interest income as balances are reduced and/or paid off sooner (£222m pa, transferred to cardholders)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average Annual Cost (excluding one-off)</th>
<th>10</th>
<th>Total Cost (PV)</th>
<th>£ 1,941m-1,951m</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 222m</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>One-off</th>
<th>Yrs</th>
<th>Description and scale of key monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 0</td>
<td></td>
<td>Cardholders: reduced interest costs of borrowing for 13% of accounts (£222m pa, transferred from lenders)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average Annual Benefit (excluding one-off)</th>
<th>10</th>
<th>Total Benefit (PV)</th>
<th>£ 1,911m</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 222m</td>
<td></td>
<td></td>
<td></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 on existing balances would reduce tolerance to risk; potential consequences could be reduction in availability of credit, particularly to vulnerable customers, increases interest rates and/or fees across all borrowers.

### Price Base

<table>
<thead>
<tr>
<th>Price Base</th>
<th>Year 2008-9</th>
<th>Time Period</th>
<th>Years 10</th>
<th>Net Benefit Range (NPV)</th>
<th>£ -40m to -30m</th>
<th>NET BENEFIT (NPV Best estimate)</th>
<th>£ -35m</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>
<td></td>
<td></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>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Which organisation(s) will enforce the policy?</strong></td>
<td>OFT, Trading</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>What is the total annual cost of enforcement for these organisations?</strong></td>
<td>Negligible</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Does enforcement comply with Hampton principles?</strong></td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Will implementation go beyond minimum EU requirements?</strong></td>
<td>N/A</td>
<td></td>
<td></td>
<td></td>
<td></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>
<td></td>
<td></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>
<td></td>
<td></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>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Annual cost (£-£) per organisation (excluding one-off)</strong></td>
<td>Micro</td>
<td>Small</td>
<td>Medium</td>
<td>Large</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Are any of these organisations exempt?</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Impact on Admin Burdens Baseline (2005 Prices)</strong></td>
<td>Increase</td>
<td>£ Negligible</td>
<td>Decrease</td>
<td>£ 0</td>
<td>Net Impact</td>
<td>£ Negligible +</td>
<td></td>
</tr>
</tbody>
</table>

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

Risk-based re-pricing

410. Interest rates on credit and store cards are subject to change, which reflects their nature as unsecured and revolving 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)\(^\text{244}\), 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”).\(^\text{245}\)

411. 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.\(^\text{246}\)

412. 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.

413. Government is concerned that industry self-regulation may not have been effective in protecting consumers from unjustifiable interest rate increases 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

414. 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 implies an increase in the last of these components.

415. 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.

416. 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 (see Annex 1 for further details). While consumers might be able to understand how changes in the base rate can impact on savings or mortgage products, 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.

\(^{244}\) Some lenders only engage in this form of re-pricing

\(^{245}\) Risk-based re-pricing applies to most of the largest credit and store card providers, but not all

\(^{246}\) 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.
Consumer groups also report incidences of re-pricing in the absence of an obvious increase in risk.

417. Evidence submitted by the UKCA during the consultation shows that the percentage of accounts receiving a price increase fell at the start of 2008 and has hovered around 1.3 per cent of accounts per month (approximately 2 per cent of balances) during the period between July 2007 and July 2009. This accounted for approximately 20 per cent of accounts in total. The UKCA also showed that in January-October 2009, 6.4 million accounts were re-priced upwards. If grossed up to 12 months, this implies an annual rate of 14 percent. This is consistent with consumer research carried out by TNS-BMRB, which showed that around 13% of cardholders had their interest rate increased on one of their cards during the previous 12 months. The average size of the increases regularly varied around an average of 4.3 percent during this period. This is also consistent with the consumer survey, which showed that for those cardholders receiving an APR increase, more than half (57%) received an increase of 1-5 percentage points.

**Percentage of Accounts with an APR Increase (July 2007 – July 2009)**

[Graph showing percentage of accounts with an APR increase from July 2007 to July 2009]

Source: Argus, UK Credit Card Payments Study (2010)

**Average Size of APR Increases (July 2007 – July 2009)**

[Graph showing average size of APR increases from July 2007 to July 2009]

Source: Argus, UK Credit Card Payments Study (2010)

247 UKCA, Response to BIS Consultation, p. 157.
248 TNS-BMRB, ‘Credit and Store Card Research’, p.97. It should be noted that around one third (32%) of respondents could not answer the question on re-pricing, suggesting that a large proportion of people may not look at their bills regularly enough to know whether they have received an APR change.
249 TNS-BMRB, ‘Credit and Store Card Research’, p.98.
418. Consumers’ risk can also improve, in which case their accounts should receive an APR decrease. This practice also occurs, at an average rate of 1.2 percent of accounts per month during 2008-2009, although this includes promotional balances. Research commissioned by the Government showed that 4 per cent of cardholders reported receiving a price decrease in the past 12 months. This is consistent with confidential issuer returns for January – October 2009, which showed that around 18 per cent of accounts were re-priced, of which 75 per cent were re-priced upwards (13.5% of total) and 25 per cent downwards (4.5% of total). In terms of the size of the average APR decrease, if promotional balances are removed from the calculation then it drops significantly from the July 2007-July 2009 average of 14 per cent, for example to 2.6 per cent in the second quarter of 2009.

419. The Government took action to address concerns related to re-pricing 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 has since been incorporated into the Lending Code. With regards to risk-based re-pricing, the Code commits lenders to:

- 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;
- 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; and
- consider offering an alternative product (if there is one available) at an equivalent or lower rate of interest.

420. In addition, the Code undertakes that credit and store card lenders will not increase a borrower’s rate where:

- consumers have failed to make two or more consecutive minimum monthly repayments;
- consumers have already agreed a repayment plan for the account; or
- the credit or store card company has been formally notified by a not-for-profit debt agency that consumers are discussing a repayment plan with them.

421. All credit card and store card providers signed up to the Statement of Fair Principles, and the clauses have been observed since January 2009.

422. Since the implementation of these practices, reports from the Financial Ombudsman Service (FOS) have indicated that the very worst examples of re-pricing of existing debt have been nipped in the bud, with the volume of complaints received by the FOS falling since January 2009. It is also shown further below that the Statement and the Lending Code have been effective in relation to preventing APR increases during the first 12 months that consumers hold their card.

423. However, evidence suggests that there is limited take-up of the option to close credit card accounts and repay balances at existing rates. Research commissioned by the Government shows that of those consumers that received an APR increase, only 1 per

---

250 UKCA, Response to BIS Consultation, p. 175.
251 TNS-BMRB, ‘Credit and Store Card Research’. This is consistent with industry research, which showed that 8 per cent of consumers reported receiving a decrease in the past two years (UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations).
253 UKCA, ‘Response to A Better Deal for Consumers: Review of the Regulation of Credit and Store Cards: A Consultation’ (January 2010), p. 176
254 http://www.theukcardsassociation.org.uk/best_practices/-/page/681/
cent took up the option to reject the increase and agree a repayment plan for the existing balance. Furthermore, research commissioned by the UKCA shows that less than half (45 per cent) of cardholders know that this is an option.

424. The majority of borrowers who are subject to an upward re-price are choosing to remain with their current lender and accept the increase in interest on their existing debt, with almost half (47%) continuing to use their card and 12 per cent accepting the rate change but not using the card further. It is not clear whether the latter group would have been better off closing their account but were not aware of the option, or whether they made an informed decision to pay the higher interest rate in order to maintain their access to credit. For those individuals that received an APR increase in the last 12 months, one in five did not request an explanation. Of those that did, 58% indicated that the change was adequately explained and 75% of these cardholders felt that the change was reasonable.

425. Evidence submitted by the UKCA in response to the consultation is also ambiguous. By comparing two cohorts in the third quarter of 2007 that mainly differ by the fact that one group received an interest rate increase, the data shows that 87% of accounts in the control group were still active after 12 months compared to 79% of re-priced accounts. However, a similar analysis for accounts in the second quarter of 2008 shows that the percentage of accounts closed after 12 months was fairly similar for those that were re-priced (87%) and those that were not (88%). Once again, it is not clear whether this is due to not knowing about the opt-out options (which was available from January 2009) or because cardholders wanted/needed to maintain access to a credit line.

426. 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 scheme to organ donation. 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**

427. 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 debt. Evidence presented above suggests that re-pricing is not as prevalent as first thought, although it remains important that accounts that are re-priced are done so in a justifiable and proportionate manner.

---

255 TNS-BMRB, ‘Credit and Store Card Research’. The UKCA indicated that in the January-October 2009 period, opt-out rates ranged from below 1% to almost 5% across different lenders (UKCA, Response to BIS Consultation, p.157).
256 UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010).
257 TNS-BMRB, ‘Credit and Store Card Research’.
258 TNS-BMRB, ‘Credit and Store Card Research’.
259 Argus, UK Credit Card Payments Study (2010). A similar trend was observed for balance attrition. Revolving balances spiked in the months following a re-price but after 12 months fell to a level that was similar to the surviving revolving balances in the control group.
260 ‘For better or for worse: default effects and 401(k) savings behavior’, Choi, Laibson, Madrian & Metrick (2004)
428. 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\%\textsuperscript{262}, 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.\textsuperscript{264} 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.

429. Furthermore, despite pressures on profitability from declines in other sources of revenue and rising costs, it would not be 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.

430. Evidence presented by credit card lenders shows that a greater proportion of high risk accounts receive an APR increase than low risk accounts. Furthermore, the average increase for high risk accounts is greater, as they are associated with a higher probability of default.\textsuperscript{265} Accounts that are very high risk are less likely to be re-priced than those that are high risk. From January 2009, when the Statement of Principles took effect and committed lenders not to re-price accounts in financial difficulty (e.g. have agreed a repayment plan), the rate for high risk accounts temporarily dropped below that for medium and even low risk accounts. Although it then increased after the first quarter, it has remained below the two year average. This suggests that the initial Statement, followed by the Lending Code, have been reasonably effective in this regard.

**Percentage of Accounts with an APR Increase by Risk Segment (July 2007 – July 2009)**

![Percentage of Accounts with an APR Increase by Risk Segment (July 2007 – July 2009)](image)

*Very High Risk Accounts are defined as having a Unit Loss Rate (ULR) of 8% or more*
*High Risk Accounts have a ULR of 4%-8%*
*Medium Risk Accounts have a ULR of 1%-4%*
*Low Risk Accounts have a ULR of less than 1%*

*Source: Argus, UK Credit Card Payments Study (2010)*

\textsuperscript{262} Average outstanding credit card balance in 2007, according to APACS estimates
\textsuperscript{263} Average interest-bearing rate for credit cards in July 2009, according to Bank of England data
\textsuperscript{264} Source: Which? online credit card repayment calculator
\textsuperscript{265} Oxera, ‘An economic assessment of BIS’s proposals for credit card regulation’ (January 2010), p.56.
431. APR increases were higher for accounts that represented a greater risk to issuers, with monthly average sizes ranging from 2-8%. It is also worth noting that average APRs across risk bands did not significantly vary during the 2007-2009 period. Low risk accounts had an average APR of approximately 16% whilst high risk accounts paid an average of 19% (the rate was 17.5% for very high risk customers).\textsuperscript{266}

432. In terms of the distribution of accounts receiving an APR increase during the July 2007 – July 2009 period, the chart below shows that the majority were low or medium risk. This is due to the majority of accounts residing in these ranges and because not all re-pricing is risk based. For example, it could be due to a general increase in costs (portfolio re-pricing).

433. With regards to distribution according to utilisation, in the second quarter of 2009, almost one quarter of accounts that received an APR increase had a utilisation rate of less than 10 per cent\textsuperscript{267}. It is important to note, however, that this distribution is largely due to the fact that the majority of accounts do not have very high utilisation rates. In terms of the proportion of accounts that received a price increase by utilisation, 0.6 percent of accounts with an utilisation rate of less than 10 per cent received an increase in the second quarter of 2009. Two per cent of accounts with utilisation rates of 40-50% and 50-60% received a price increase and the proportion was 3.4 per cent for those with a utilisation rate of more than 90 per cent. This is partly because higher utilisation can indicate higher risk.

434. Although this evidence does not indicate whether the size of APR increases are proportionate to the increase in risk, it does show that accounts with high utilisation rates and/or of high risk are more likely to receive a price increase. Furthermore, data for the second quarter of 2009 shows that almost all accounts with a price increase had been on lenders’ books for more than 12 months. Accounts were more likely to receive a price increase if they had been on the books for 2-3 years, followed by those that had existed for 1-2 years and 3-5 years\textsuperscript{268}. This suggests that the Statement of Principles/Lending Code has been effective in preventing APR increases during the first 12 months that consumers hold their credit card (or that such a practice was largely followed before January 2009 as well). The Code also prohibits more than one increase for every 6 months after that; during the July 2007 – July 2009 period only 3.5 per cent of accounts received more than one APR increase.\textsuperscript{269}

\textsuperscript{266} Argus, UK Credit Card Payments Study (2010)
\textsuperscript{267} Argus, UK Credit Card Payments Study (2010)
\textsuperscript{268} UKCA, Response to BIS Consultation, p. 174.
\textsuperscript{269} UKCA, Response to BIS Consultation, p. 172.
435. A separate problem that was identified in the Government’s consultation was the 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 necessary on equity grounds. However, evidence submitted during the consultation indicates that this is not a prevalent issue. As shown above, customers who are considered to be very high risk are less likely to receive an interest rate increase than those who are considered high risk. Furthermore, upon comparing two cohorts that have similar characteristics but differ in that one group has received a price increase and the other has not, the graph below shows that a re-price did not have a significant effect on the probability of charge-off for accounts in the second quarter of 2008 (2.3 per cent compared to 1.9 per cent).\(^{270}\) Similar evidence was submitted by the UKCA for the third quarter of 2007, although in this case the cumulative charge-off rates were lower (just less than 1.5 per cent).

\[\text{Observed Unit Charge-Off Rate}^{271} \text{ for 2008 Q2}\]

\(^{270}\) The fact that charge-off rates are slightly higher for re-priced accounts could either be due to the APR increase or it could be due to high risk and/or utilisation (which prompted the re-price).

\(^{271}\) This graph shows the percentage of the original number of accounts in the increase or control groups being classified as charged-off by the month after the increase.
436. Data for accounts in the second quarter of 2009 also suggests that cards with relatively low initial interest rates are most likely to have the highest increases in proportional terms. This suggests that high-risk customers, who are more likely to have higher APRs, will rarely see their interest rates increase by more than one third. The existence of a U-shaped trend in the average size of the APR increase (i.e. the highest APR increases go to those with either very low or very high initial APRs) indicates that significant re-pricing is required for accounts at the lower end, where risk was not sufficiently factored in during the initial pricing decision.

### Average and proportional size of APR increase by pre-increase price (2009 Q2)

![Average and proportional size of APR increase by pre-increase price (2009 Q2)](image)

*Source: Oxera analysis based on Argus, UK Credit Card Payments Study (2010)*

437. Further evidence submitted by the UKCA also shows that in the second quarter of 2008, only 4.9% of high-risk accounts received an APR increase of more than 14 percentage points. The majority (77%) received an increase of 1-6 percentage points. For the highest-risk accounts that received an upward re-price, 8.9% increased by more than 14 percentage points whilst approximately two thirds (68%) increased by 1-6 percentage points.

### Rationale

438. The above evidence shows that lenders both increase and decrease APRs and that higher increases are given to consumers that are relatively riskier. This suggests that the credit card market has been able to move towards a separating equilibrium, where lenders can gradually observe the types of consumers and therefore offer separate contracts that are designed or updated according to risk. This is more efficient than the main alternative, a pooling equilibrium, where lenders cannot infer the riskiness of consumers and therefore have to offer the same contract to everyone, regardless of risk. Furthermore, although there is no conclusive evidence to show that price increases are proportionate and justifiable, the data shows that they are not as excessive as previous

---

273 Argus, UK Credit Card Payments Study (2010).
274 Data for the second quarter of 2009 also shows that low risk accounts are more likely to receive APR decreases (1.5% for the lowest risk accounts compared to 0.8% of the highest risk accounts). Source: Argus Analysis (2010).
275 In this case, type is defined by risk
anecdotal evidence may have suggested. This indicates that intervention is not required on equity grounds.

439. However, other evidence suggests that an asymmetric information problem remains in the market. Consumer research commissioned by the Government showed that one third (32%) of cardholders did not know whether their APR on their credit card had changed in the previous 12 months. For those that did know and had received an APR change, 82% could not state exactly how much it had changed by.\textsuperscript{276} Research commissioned by the UKCA shows that one third (34%) of cardholders do not know that the interest rate can change on their cards.\textsuperscript{277} Qualitative research supports these findings, with a number of respondents not even aware of the interest rate on their credit card\textsuperscript{278} and also not aware of risk-based interest increases or how risk is assessed.\textsuperscript{279}

440. Therefore, 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 could then exploit (or potentially exacerbate) this lack of awareness. It is therefore necessary to fill this information gap, such that cardholders are fully aware as to what behaviour and characteristics constitute ‘high-risk’ accounts and how they can avoid receiving risk-based price increases.

Options analysis

441. A flexible pricing structure 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.

442. 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.

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

1. Rely on the Lending Code
2. Provide consumers with better information about risk-based re-pricing decisions
3. Define considerations that 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: Do Nothing - Rely on the Lending Code

444. This option would continue the status quo, with lenders continuing to follow the Lending Code, and would have the least impact on lenders. However, it might not improve the current situation for consumers, insofar as transparency is concerned. Although the evidence presented above suggests that frequent APR increases and re-pricing in the first 12 months are not significant problems, and that the re-pricing of highest risk cardholders has declined, the problem of information asymmetry remains one year after the Statement of Principles took effect.

\textsuperscript{276} TNS-BMRB, ‘Credit and Store Card Research’, p. 97 and Quantitative Consumer Research Tabulations.

\textsuperscript{277} UKCA, Appendix 4 of the Response to BIS Consultation: GfK Quantitative Consumer Research Tabulations, (January 2010).

\textsuperscript{278} UKCA, Appendix 5 of the Response to BIS Consultation: GfK Qualitative Research Management Report, p. 9 (January 2010).

\textsuperscript{279} TNS-BMRB, ‘Credit and Store Card Research’, p. 101.
Option 2: Provide consumers with better information about risk-based re-pricing decisions

445. The Lending Code currently provides that credit card companies will explain why an interest rate has been increased if a consumer requests it. 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. Specifically, Government considers it important that lenders always send a separate interest rate increase communication to consumers facing an interest rate increase at least 30 days before the change. This would explain in clear language how their rate is changing, that they have the right to reject the increase and how that can exercise that right.

446. Another means of improving information is 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. In its response to the consultation, the UKCA offered to develop and distribute a leaflet, ‘Risk-Based Pricing Explained’, which explains how pricing works, why it is necessary and what options consumers have available to them (including the ‘opt out’). Given the complexity of re-pricing decisions, it is argued that it would have to be explained in generic terms rather than giving consumers specific reasons for a price increase.

447. 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.

448. 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.

Costs

449. This option would entail implementation costs for providers, in terms of meeting the provision of further information requirements (for example leaflets and communication with customers). Industry has estimated these costs to be £5-10 million.

450. Lenders would also lose interest income if more cardholders were aware of the factors affecting their risk and therefore changed their behaviour to avoid being re-priced. On the other hand, certain changes such as making the minimum payment less regularly might also reduce default rates and expected losses, in which case income may rise. It is not possible to quantify this impact as there is no indication as to how consumer behaviour may change.

451. It is also possible that improved information would make more consumers aware of the option to close their account and repay the remaining balance at the existing interest rate. As discussed above, 12% of consumers subject to a re-price currently accept the change but stop using the card.\textsuperscript{280} Industry-commissioned research suggested that this rate is approximately 16%. If one takes the average of these estimates and assumes that these consumers would take advantage of the opt-out if they were aware of it, the annual cost to lenders can be estimated by taking 14% of £222 million (the cost to industry of imposing a ban on re-pricing existing balances, see Option 5 below). This implies an annual cost of

\textsuperscript{280} This does not significantly vary according to most segments, although younger cardholders were more likely to stop using the card as were cardholders with children. Caution should be attached to this finding, however, due to small base sizes.
£31 million to lenders. As discussed earlier, it is likely that some consumers would find it optimal to pay the new interest rate as a way of keeping their credit card and maintaining an important line of credit. Therefore, this is likely to be an over-estimate, although it may be counteracted by some cardholders using the extra information to adjust their behaviour such that they are less likely to be re-priced. In this case, they would continue to pay off their card at the same rate.

Benefits

452. 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 which cannot make that clear link would be harder to explain.

453. An important finding from the Government’s commissioned research is that for those individuals that received a re-price in the last 12 months, one in five did not request an explanation. However, of those that did, 58% indicated that the change was adequately explained and 75% of these cardholders felt that the change was reasonable.\textsuperscript{281} The proportion fell to 65% when only APR increases are considered. This suggests that the majority of consumers understand and accept the rationale behind their re-price when it is properly explained to them.

454. Assuming that all cardholders that opted to stop spending after an upward re-price also decided to close their account and repay at the existing interest rate, they would pay less interest and the £31 million cost to lenders would be transferred to consumers.

Risks

455. The results of a sensitivity analysis show how the costs and benefits to lenders and consumers vary depending on the opt-out rate. Industry and Government research suggested rates of 16% and 12% respectively. The UKCA indicated that in the January-October 2009 period, opt-out rates ranged from below 1% to almost 5% across different lenders. Therefore, it is plausible that the rate could level off at 5%.

\begin{tabular}{|c|c|c|}
\hline
\textbf{Assumption 1: Proportion of cardholders opt-out of re-price and pay remaining balance at existing rate} & 5\% & 12\% & 16\% \\
\hline
\textit{Estimated reduction in lender income/increase in consumer surplus (£ million)} & 11 & 27 & 36 \\
\hline
\end{tabular}

456. 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, which could increase customer confusion and would not improve consumer understanding (or behaviour). This was highlighted in qualitative research, which showed that information is only useful if it is clear and easy to understand; otherwise, it is usually ignored.\textsuperscript{282} This could be an issue in the case of explaining re-pricing decisions, which are often based on credit scoring models that are complex and which may not be obviously related to changes in consumers’ risk profiles.

\textsuperscript{281} TNS-BMRB, ‘Credit and Store Card Research’, p. 99.
\textsuperscript{282} Ibid, p. 104
Option 3: Define factors that lenders can take into account when re-pricing due to risk

457. 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.

458. 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

459. Under this option, lenders would entail some programming costs to amend their systems. This has been estimated to be £5-10 million by industry.

460. 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.

461. 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.

462. It is not possible to quantify any costs and benefits for this option without having a specific set of criteria to undertake the analysis. Risk-based re-pricing is based on credit scoring models that are continuously updated and refined and can also vary according to lender. A typical score will contain a number of inputs and variables that can range from external data, repayment and borrowing behaviour on the card, transaction types (e.g. by merchant type, size and frequency) to behaviour in respect of products offered by other parts of the issuing bank. Each variable will have a different impact and each issuer will also have a different business and pricing model. Therefore, estimating the impact of this option requires a detailed set of criteria in order to assess the extent to which lenders would have to change their risk models and how it would affect specific accounts. Such criteria have not been set out before, during or after the consultation.

Benefits

463. 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.

Risks

464. Restricting lenders’ flexibility to re-price the balance of a particular cardholder is likely to reduce annual revenue and increase the cost of lending to risky customers. This could result in a higher starting interest rate, and issuers could also increase interest rates and fees on other accounts in order to recover the extra costs. It may also force lenders to decline applications from vulnerable or financially excluded consumers.

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

465. There are already voluntary limits on the frequency of existing debt re-pricing contained in the Lending Code, set out above. Although this could be expanded (and possibly placed on a statutory basis), the evidence presented above shows that voluntary regulation has been effective in terms of prohibiting frequent re-pricing and ensuring that accounts are...
not re-priced within their first year. However, an additional option is to restrict rate increases such that they can be no more than a certain percentage more than the current rate (or subject to an absolute maximum rate).

Costs

466. Under this option, lenders would entail some programming costs to amend their systems. This has been estimated to be £5-10 million by industry. The following tables show the impact of setting price increase thresholds by absolute and proportional values respectively. Across the full range of potential thresholds, this implies a possible reduction in lender revenue of £2m-£171m per year.

### Impact of absolute thresholds on APR Increases

<table>
<thead>
<tr>
<th>Threshold (percentage point absolute)</th>
<th>% Re-prices Affected</th>
<th>Estimated annual reduction in lender revenue/gain in consumer surplus (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>77</td>
<td>171</td>
</tr>
<tr>
<td>4</td>
<td>44</td>
<td>98</td>
</tr>
<tr>
<td>6</td>
<td>12</td>
<td>27</td>
</tr>
<tr>
<td>8</td>
<td>8</td>
<td>18</td>
</tr>
<tr>
<td>10</td>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: BIS Analysis based on Argus Data, UK Credit Card Payments Study (2010)

### Impact of proportional thresholds on APR Increases

<table>
<thead>
<tr>
<th>Threshold (% proportion)</th>
<th>% Re-prices Affected</th>
<th>Estimated reduction in lender revenue/gain in consumer surplus (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>100</td>
<td>222</td>
</tr>
<tr>
<td>20</td>
<td>53</td>
<td>118</td>
</tr>
<tr>
<td>30</td>
<td>20</td>
<td>44</td>
</tr>
<tr>
<td>40</td>
<td>6</td>
<td>13</td>
</tr>
<tr>
<td>80</td>
<td>6</td>
<td>13</td>
</tr>
</tbody>
</table>

Source: BIS Analysis based on Argus Data, UK Credit Card Payments Study (2010)

467. The effect on lenders’ revenue is calculated by multiplying the impact of banning all the re-pricing of existing debt by the proportion of price increases affected by the threshold. This calculation is simplistic in that it does not take into account variations in risk and assumes that lenders that wanted to re-price accounts above the set threshold would not do so\(^{283}\). In practice, they are likely to re-price by the maximum amount allowed in which case the cost estimates are higher than they should be, although this could be counteracted by forcing lenders to re-adjust their pricing models. However, the tables provide a useful indication of the impact of setting specific thresholds. As discussed earlier the majority of price increases range from 2-6 per percentage points, thus setting a limit in this region would have a significant impact on lender income. A higher absolute threshold is arguably unnecessary given the low number of accounts that are affected, although it

---

\(^{283}\) Though it is worth noting that data for the second quarter of 2009 shows that the size of APR increases are fairly constant across the risk bands (2-6 percentage points).
could be a useful way of prohibiting extreme price increases without having a significant impact on lenders’ profitability.

468. Similarly for proportional thresholds, the majority of increases range from 10-30 per cent and so setting the limit in this region would have the most impact. However, in this case although setting higher limits (e.g. more than 50%) does not have a significant impact on revenue, it may affect credit access for riskier customers that are initially under-priced and, therefore, require a relatively large proportional increase in order to reflect their probability of default and expected loss given default. Restricting lender action in this manner would require them to re-assess card applications from certain customers.

469. Lastly, 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

470. Customers that would have been re-priced above a specific threshold would not have to pay as much interest on their debt. This benefit would take the form of a transfer from lenders (quantified above, £2-171 million per year).

471. 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.

Risks

472. 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 could result in a higher starting interest rate, given that the flexibility to re-price the balance of a particular customer would be curtailed.

Option 5: Prohibit re-pricing of existing debt

473. 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.

474. 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

475. 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. Lenders have estimated this cost to be £30-40 million.

476. There is also a cost to lenders in terms of reduction in revenue. The UKCA calculated that prohibiting risk-based re-pricing would have reduced industry income by £228.6 million in 2007-08 and £215.9 million in 2008-09. By taking the arithmetic mean of these figures, the estimated annual cost to lenders is £222 million. This is equivalent to 35 basis points of outstanding balances, which is not significantly different to an estimate in a US study284. In both instances, the loss takes the form of a transfer to cardholders, which produces no net impact for the proposal overall.

477. 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

---

284 Morrison Foerster (August 2008)
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.

478. 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. If the policy were further combined with a ban on unsolicited credit limit increases, thus preventing low and grow strategies, it would also severely inhibit credit card access for high risk customers.

**Benefits**

479. 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.

480. As discussed above, consumers subject to a re-price would benefit from an economic transfer (£222 million per year) as they would not have to pay as much interest on their existing debt. The following graph shows the distribution of the estimated annual benefit for (approximately 772,000) accounts that were subject to a price increase in the second quarter of 2009. The majority would have saved less than £60 in interest payments per year, although unsurprisingly higher risk customers would have benefitted to a greater extent.

![Graph showing distribution of estimated annual £ impact per accounts of risk-based pricing (2009 Q2)](image)

**Very High Risk Accounts are defined as having a Unit Loss Rate (ULR) of 8% or more**
**High Risk Accounts have a ULR of 4%-8%**
**Medium Risk Accounts have a ULR of 1%-4%**
**Low Risk Accounts have a ULR of less than 1%**

*Source: Argus, UK Credit Card Payments Study (2010)*

481. There is no conclusive evidence to suggest that this policy would have significant distributional effects in terms of transferring benefit from high income to low income households (which would require the benefits to be weighted to take into account of the fact that low income households have higher marginal utilities of consumption). As discussed above, the distribution of re-pricing is skewed to low and medium risk accounts. Even if only risk-based re-pricing is considered, there is no necessary association

---

between high risk and low income as risk is determined by a large number of factors. Furthermore, the consumer survey commissioned by the Government does not show that the distribution of cardholders subject to an APR increase was skewed to low income households.

482. Cardholders that received a price increase during the past 12 months were more likely to be married (67%), of working age (85%) and not have children (60%).[^286] If one considers the gross income quintiles for couples with no children, then according to the survey[^287] around 13% of consumers with an APR increase were in the first two quintiles. Approximately 21% were in the third quintile, 22% were in the fourth quintile and 44% were in the upper quintile.[^288]

**Risks**

483. As set out earlier, the ability to price flexibly, according to the risk of the borrower, is a fundamental feature of credit card lending. If the possibility of changing the price offered to consumers is constrained (in this case to new balances only) this could lead to significant reductions in the availability of credit, particularly for the highest-risk customers.

484. Constraining the scope for changing interest rates would reduce the profitability of credit and store card lending. This could lead to some providers being forced to exit the market, or increase revenue from other aspects of card lending to compensate. The UKCA have indicated that if all of the reduction in revenue (£222 million) was recovered by interest rate increases, then rates would increase by 0.5% across all revolving balances. This is a similar charge to a calculation derived by the US study discussed above. Alternatively, an extra fee could be levied on all accounts (£4.04) or on active accounts (£6.36), although it is more likely that lenders would make use of a number of revenue enhancements and that they would not be applied uniformly across all accounts or balances. Consideration would also have to be given to consumer response to such measures. Qualitative research conducted by TNS-BMRB showed that although consumers looked at this option favourably, and were willing to accept reductions in credit access, they were not willing to accept interest rate or fee increases.[^289]

485. In the US, where the CARD Act prohibits the re-pricing of existing debt (barring certain exceptions[^290]), the restriction of a key risk mitigation tool has led to a reduction in credit availability and an increase in the cost of credit (interest rates and fees) in advance of the effective regulation date.[^291] The approval rate in 2007 for a credit card targeted at the mass market in the US was approximately 25% but this has recently fallen to 15%. Credit card applications are particularly likely to be rejected from credit-impaired consumers and individuals that have not previously used a credit product (e.g. students, consumers who have historically used debit products). As a result of such unintended consequences, it is expected that further corrective regulations will need to be implemented in the next 1-2 years.[^292]

486. Furthermore, some issuers in the US have indicated that they will cease to offer credit and/or store cards to their customers due to the challenges and costs associated with regulatory compliance, as they are not confident in their ability to manage their future risk. Given that the six largest issuers have more than 90% of outstanding balances, the exit of

[^286]: TNS-BMRB, Quantitative Consumer Research Tabulations.
[^287]: Specifically for respondents that received an APR increase and gave their gross weekly income
[^288]: It should be noted that respondents gave their weekly income by bands rather than exact figures, therefore these distributions are not precise.
[^289]: TNS-BMRB, ‘Credit and Store Card Research’
[^290]: For example when a promotional rate expires, when an account is being priced variably or in the event of default
[^292]: Ibid
small and medium issuers is unlikely to affect credit access but it may reduce competition and innovation in the market.  

487. The UKCA presented other evidence on the US credit card market. For example, total credit lines fell by 16.9% ($1 trillion) in the year to June 2009 whilst aggregate purchase amounts fell by 12.4%. A greater number of accounts (36.4% in the year to June 2009) have received a credit limit decrease whilst re-pricing has increased across both low and high risk accounts. The percentage of accounts that received a re-price increased by 180.4%, with an average increase of 6.1%, whilst 4.3% more accounts received an annual fee (particularly affecting high risk accounts). New accounts in 2009 were much more likely to be low risk compared to 2008 and the average credit limit for new accounts fell by 5%. In the second quarter of 2009, 349 million credit card offers were mailed to consumers compared to more than 1 billion in the same quarter of 2008.  

488. The CARD Act was signed into law on 22 May 2009, and did not take effect until 22 February 2010, therefore these market trends are much more likely to be attributable to the declining economic environment. However, they may indicate the potential impact of reducing lenders’ tolerance to risk during a period of economic difficulty.  

489. Despite the impacts mentioned above, it is expected that the credit card industry in the US will adapt to the regulation and develop products that reflect the new market conditions. There are already examples of this in the US, for example American Express recently introduced the new Zync card, a charge card targeted at young adults. Chase have also implemented a Blueprint feature on some of their credit cards, which allows users to pay off or revolve purchases at a transactional level (e.g. they can revolve larger purchases but pay off smaller ones).  

Preferred option  

490. The Government’s preferred option is to provide better information to consumers about all types of re-pricing, in addition to strengthening their right to reject any APR increase. The latter involves ensuring that consumers have an additional 30 days after an increase in their interest rate comes into force to decide to reject the increase and pay down the card at its existing rate. This is on top of the 30 days notice that lenders must currently give consumers and therefore means that cardholders have 60 days to make a decision.  

491. The preferred option falls under two of the rights included in the Government response: the right to reject a price increase; and the right to information about how re-pricing is practiced by lenders. As discussed earlier, evidence collected by both the UKCA and the Government shows that high risk accounts are more likely to receive a price increase than low and medium risk accounts. Furthermore, re-priced accounts are not significantly associated with financial difficulty or over-indebtedness. Quantitative research shows that a majority of customers understand and accept the rationale behind risk-based re-pricing if it is properly explained to them. In this context, the impact and potential risks associated with options 3-5 are disproportionate given the scale of the problem. Option 2 represents a proportionate solution to the asymmetric information problem.  

492. The scope of the reforms have been extended to all types of re-pricing, both risk-based and portfolio, because research evidence showed that the lack of consumer understanding applied to re-pricing in general. It also ensures a completely transparent relationship between the lender and borrower. Lenders have agreed to implement these reforms voluntarily.  

---  

293 Ibid  
294 UKCA, Response to BIS Consultation, pp. 219-220.  
### Specific Impact Tests: Checklist

<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: Credit and store cards – background

Consumer borrowing in the UK

493. 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.

494. 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 unsecured credit) by the end of 2005, falling to around £54 billion in July 2009. Thereafter, it remained fairly constant at £54-55 million until the end of 2009.296 In contrast, the store card market is much smaller, with approximately £1.9 billion in outstanding balances as of December 2008.297

![Outstanding credit card borrowing, 1987-2009](source: Bank of England)

Card use and holding

495. Credit cards are an increasingly important element of consumer borrowing. Consumers value the flexibility of credit cards; there are now 60 million credit cards in circulation in the UK, covering between 130 million and 200 million transactions a month in 2009, up from 25 million cards and 80 million transactions per month at the end of 1994.298 In contrast, there were approximately 15 million store cards in issue in 2009, resulting in around 52 million annual transactions.

---

296 In 2009 prices, deflated using Retail Prices Index. This is less than the figure given by the UKCA, approximately £63 billion, because it does not take into account securitised loans, along with related liabilities.

297 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).

298 Latest figures from July 2009, 1994 are earliest figures available (Source: BBA)
496. Given the disparity between credit and store card use, 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.

497. 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 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.

498. 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.

499. 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%.

500. However, credit card holding differs significantly across types of consumers. It 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).

501. 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.

502. According to survey data, a credit card was the most popular unsecured credit product applied for in the last 6 months, with 9% of respondents applying. Of these, almost one-third (28%) were declined. In comparison, only 2% of respondents applied for a store card, although the proportion that was declined (17%) was lower than for credit cards.

Credit card lending

503. 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 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

504. This growth in indebtedness has coincided with a rise in credit card lending. 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. This shows that credit card usage was significantly higher at the beginning of this current recession compared to the previous recession of the early 1990s.
505. Industry analysis suggests that consumers may make increasing use of ‘relying’ 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 £1 billion in 2009, credit card lending increased by £2.3 billion.\(^\text{300}\)

506. 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.

507. 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

\(^{300}\) Source: Bank of England
capacity to support their businesses through the downturn, incurring significant debts as a result.

508. 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%.  

Repayments

509. 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 increased to 95% in 2009.

![Average monthly repayment and repayment-lending ratio for credit cards, 1998-2009](image)

Source: Bank of England

510. However, this aggregate picture masks a more complex picture at the level of individual cardholders. According to data from the 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. This varied 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

511. Credit card net lending has increased steadily since 1993, from an average of £50 million per month to over £1 billion 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


302 Although this includes those taking advantage of promotional offers
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](chart)

Source: Bank of England

512. 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).

513. 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 2009 was 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**

514. 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.

515. 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.
Write-offs on credit cards rose from an average monthly value of £35 million in 1995 to £800 million in 2008. Average monthly write-offs increased further in 2009, with the UKCA 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 US write-off rates have now increased to over 11% (as of January 2010).

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, but expectations regarding future defaults may have peaked.
518. Recent reports suggest that the losses on unsecured consumer debt are likely to worsen; an International Monetary Fund (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 over 11% by January 2010. Historic norms from previous recessions suggest that the default rate for credit card loans is typically around 7-9%.

519. Another report from the IMF estimated 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. Assuming this is 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.

520. 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. 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 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.

521. 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.

522. 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.

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

**Interest rates**

523. 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.

524. As can be seen from the chart below, between 1999 and 2004 the ‘quoted’ credit card interest rate has broadly fallen in line with the ‘effective’ interest rate, 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.

525. 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.

---

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

---

306 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.

307 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.
527. 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.

528. There are differing cost structures within credit card businesses, 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.

529. 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%.

Arrears

530. 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).

531. 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.

532. 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.

533. 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.

Market characteristics

534. 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, before Lloyds TSB and HBOS merged, RBS was the leading provider in terms of credit cards in issue, but only third-largest when analysed by proportion of outstanding credit card borrowing.

---

308 The roll rate represents the number of accounts that move into the next overdue category, expressed as a percentage.
309 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.
535. 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 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.

536. 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.

537. 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.310 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.

538. 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.

Credit Cards and Financial Difficulty

539. According to consumer research, 3% of cardholders are in structural arrears, that is they are 3 or more consecutive payments behind with a credit card or any other bill. As a subjective indicator, 2% of cardholders consider it a heavy burden to keep up with their card repayments, whilst 14% consider it somewhat of a burden. Other survey data about actions undertaken in order to help make ends meet indicates that 25% of respondents had borrowed more on their credit card or took out a loan. This 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.

540. Evidence available from advice agencies shows that consumers’ need for debt advice mainly relates to credit and store cards. For CCCS (Consumer Credit Counselling

310 Those with customers that also have current accounts, which are much more likely to be bank providers
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 nearly 20% of all debt enquiries to Citizens Advice, the most frequent enquiry.

541. 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 160,000 in the first half of 2009.

542. 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.

543. 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.\(^{311}\)

544. 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.

**Balance Transfers**

545. 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; by 2009, the number of transfers had fallen to less than half that peak, at 5.2 million, representing a total of £10.6 billion.

![Balance Transfers, 2001-2009](chart.png)

**Source:** British Bankers’ Association

\(^{311}\) 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
A survey towards the end of 2008 showed an increase in 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.

Store cards

Card use

There is a significant overlap between ownership of credit cards and store cards. Research commissioned by BIS suggested that 89% of store card holders also own a credit card. This is consistent with evidence collected for the Competition Commission inquiry into store cards.

The table below illustrates the profile of those that used at least one store card in the last 6 months compared to those that used at least one credit card and the general population. It shows that regular store card users are more likely than credit card users and the general population to be women, whilst individuals aged 18-24 are under-represented in both card groups. Store card users are also less likely than others to work full-time.

<table>
<thead>
<tr>
<th>General pop 18+ (BARB 2 years ending December 2008)</th>
<th>Regular card user who has used at least one store card in the last 6 months</th>
<th>Regular card user who has used at least one credit card in the last 6 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td><strong>Gender</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>48</td>
<td>29</td>
</tr>
<tr>
<td>Female</td>
<td>52</td>
<td>71</td>
</tr>
<tr>
<td><strong>Age</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18-24</td>
<td>11</td>
<td>4</td>
</tr>
<tr>
<td>25-34</td>
<td>17</td>
<td>14</td>
</tr>
<tr>
<td>35-44</td>
<td>19</td>
<td>20</td>
</tr>
<tr>
<td>45-54</td>
<td>17</td>
<td>20</td>
</tr>
<tr>
<td>55-64</td>
<td>15</td>
<td>21</td>
</tr>
<tr>
<td>65+</td>
<td>20</td>
<td>21</td>
</tr>
<tr>
<td><strong>Working status</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Full time</td>
<td>48</td>
<td>36</td>
</tr>
<tr>
<td>Part time</td>
<td>10</td>
<td>18</td>
</tr>
<tr>
<td>Not working/retired/working less than 8 hours/week</td>
<td>42</td>
<td>45</td>
</tr>
</tbody>
</table>

Source: TNS-BMRB

Store card users are also likely to value different features of their card than credit card users. Research by TNS-BMRB showed that store card holders highly valued reward schemes, and signing up offers (including discounts). A significant minority also valued low interest rates or interest free periods. Users that pay off their card in full were more

---

likely to have selected reward schemes or discounts compared with minimum payers, who are more likely to value the ability to spread large payments over time. This is consistent with research commissioned by the Competition Commission during their inquiry into the store card market in 2006. Card users with revolving balances were more likely to cite payment methods as an attraction rather than discounts and reward schemes (i.e. offering a convenient method and not wanting to pay in cash). The most common level of discount was 6-10%.

550. For most people, the decision to take the store card was made without pre-planning; 10% indicated that it was a spur of the moment decision whilst 73% said that it was suggested by staff. The research also showed that although sales staff tend to be involved in the application process, a significant minority (42%) were not informed about the interest rate. Nevertheless, more than half (57%) of those who did not know the interest rate but found it out after taking the card said that would have gone ahead in any case.

551. Qualitative research by TNS-BMRB supports the finding that store cards are often used as an immediate or short-term form of borrowing. Respondents indicated that they only used their store card when they can benefit from a transaction, either from a discount or using an interest free period to spread the cost of a large purchase, and then close the card. The research also suggests that consumers feel better informed when applying for a credit card, compared to a store card. There is a perception that it is easier to access impartial information about credit cards whereas, in contrast, store staff are the primary sources of information for store cards and a number of respondents felt that they were fairly ill-informed on the subject. This suggests that store card applications are relatively rushed and/or impulsive compared to credit card applications, which respondents felt were more considered.

552. The consumer survey commissioned by BIS also collected data on repayment behaviour of card users that do not pay off their store cards in full each month. Almost half of respondents (44%) said that the amount outstanding on their last bill was under £250, whilst fewer than one-in-ten said they owed over £750. This is consistent with FLA data that the average amount outstanding on store card accounts is £142 and is significantly less than the average credit card balance of £2,000.

553. An estimate was also made for the proportion of the outstanding balance that was paid off in the cardholder’s previous statement, once again for users that do not pay off in full. This suggested that the mean amount repaid on a store card was 39%, with a third of respondents paying back 20% or less of their total outstanding balance. This was significantly higher than the repayment rates for credit cards, where half of respondents reported paying 20% or under of their outstanding balance (the mean amount repaid was 24%), perhaps unsurprisingly given store cards generally carry lower balances. Qualitative research also showed that respondents perceived store cards to be more expensive than credit cards and this motivated them to repay their debt more quickly. The FLA indicated that APRs on store cards range from 19.9% to 29.9%, whilst the average APR for credit cards is 17.1%.

554. Store card users with revolving debt also tend to use different methods in paying off their balances compared to credit card users and cardholders that pay off in full. They are relatively less likely to pay using direct debit from a bank account and more likely to pay over the telephone. Unlike credit card holders, store card users also have the option to pay in the store (which 6% of revolvers do).

**Lending**

316 Ibid. Research by TNS-BMRB also showed that half of store card users made a decision to obtain a card after talking to a member of staff or simply chose on the spur of the moment at the till.
317 The FLA response to the Government’s consultation also argued that store cards provide an immediate form of credit that enables a customer to purchase an item without having to wait for a card to be sent through the post.
555. 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.

![Value of store card transactions, 1994-2009](image)

Source: Finance and Leasing Association, Datamonitor

556. 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 around £2.5 billion and the value of outstanding balances has fallen by about one-third from the peak in 2004.

![Store card activity, 2001-2008](image)

Source: Finance and Leasing Association

557. 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>

Source: Finance and Leasing Association

558. In their response to the Government consultation, the FLA indicated that all store card providers operate a ‘low and grow’ approach. Credit limits usually start at around £250 (but in some cases may be as low as £100), with data from two major providers suggesting that less than 1% of customers had limits of more than £2,000. The majority of customers have limits between £300 and £1,000.

559. 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.

560. 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.

561. 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.

562. 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.

563. 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

564. 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.

---

318 Credit and debt cards (2008)
565. Creation Financial Services\textsuperscript{319} 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.

\textsuperscript{319} Now known as LaSer UK
Annex 2: Sources of revenue for credit and store card providers

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

- interest, fees (including annual fees) and other charges;
- interchange fees;
- default/penalty fees and
- ancillary products and services, for example card-related insurance income (payment, purchase, price and card protection insurance where relevant).

567. 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. However, given that around 70% of credit and store card holders regularly pay off their balance in full, this would imply that around 30% of credit and store card customers are providing the majority of this revenue. 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.

568. 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.

569. 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.

570. 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.

571. 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.

---

320 Lenders have stated that these can only be set at a level to cover costs
321 This income represents the value of premiums collected from cardholders net of payments to insurance underwriters
Revenue composition

572. 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.

573. 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.³²²

574. 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.

575. 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.

576. 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

577. 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.

578. 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.

579. 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.

580. 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

581. 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.

Card associations, such as Visa or Mastercard, assess and set the amount of these fees.
582. 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%. The UKCA also indicated that an agreement between Visa and the European Commission in 2002 lead to a long term reduction in interchange levels, with levels approximately 20-30% lower than they were in 2002.

583. 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.

584. Although the fee seems a small proportion, given the significant level of transaction volumes and values associated with credit cards (in particular), it 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.

585. 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).

586. 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

---


325 UKCA Response to BIS Consultation, p. 30

326 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
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

587. 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.

588. 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.

589. 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.

590. 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.

591. 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 the lost revenue in other areas, such as annual fees or higher interest rates, or to face lower levels of profitability.

592. 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

593. 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

594. 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.

595. 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

---

327 Georgetown University Law Center
329 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
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: PPI penetration rates on credit cards, by volume, 2002-2008

<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)

596. 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.

597. 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.

598. 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. This result was robust to controls for the difference in risk already observed, captured in credit risk scores.

330 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
331 For 2007, this represented around 13% of credit card business
332 This result was robust to controls for the difference in risk already observed, captured in credit risk scores
Overall profitability

599. 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.\(^{333}\)

600. 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%.

601. 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.\(^{334}\)

602. 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
- the ‘open’ market, i.e. all other lenders (without relationships with current account customers).

603. 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.\(^{335}\) 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.

604. 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

605. 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.

\(^{333}\) ‘Credit cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers’ (2006)

\(^{334}\) 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)

\(^{335}\) As they tended to attract more price-sensitive customers
606. 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.

607. 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.

608. 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.

609. 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.

336 'The “waterbed effect” and price regulation’, Schiff (2008)
337 'Precious plastic 2007 – consumer credit in the UK’, PwC (2007)
Annex 3: International credit card markets and regulation

610. Recent reforms in other countries, particularly the US and Canada, have seen the introduction of new measures relating to credit cards, a number of which are similar to the proposals considered in the Government consultation.

611. The following table compares the number of credit card accounts and outstanding balance in other countries compared to the UK. The markets that are most similar to the UK in terms of their wide use of credit cards are the US and Canada. However, there are some differences between the countries in terms of card use. For example, a greater proportion of cardholders in the US (60%) carry a balance on their credit cards compared to Canada and the UK (both around 30%).

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of credit card accounts (m)</th>
<th>Outstanding balance (£ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>475</td>
<td>287</td>
</tr>
<tr>
<td>UK</td>
<td>50</td>
<td>64</td>
</tr>
<tr>
<td>Canada</td>
<td>72</td>
<td>37</td>
</tr>
<tr>
<td>Australia</td>
<td>14</td>
<td>20</td>
</tr>
<tr>
<td>Japan</td>
<td>324</td>
<td>2</td>
</tr>
<tr>
<td>France</td>
<td>34</td>
<td>30</td>
</tr>
<tr>
<td>Spain</td>
<td>20</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Auriemma Consulting Group

612. Consumers in the US tend to be more orientated towards using credit cards than debit cards, with the reverse true in the UK. The 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.

613. In 2007, the average outstanding credit card balance for US families was £4,492 ($7,300); in the UK it was £1,856. The average credit limit in the US was £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.

614. Research into other credit card markets, commissioned by BIS, indicates that US credit card companies significantly reduced their credit exposure in 2009, due to high levels of delinquency and loss. The average credit limit in the US was estimated to be $8,800 (approximately £5,900) compared to around £5,000 in the UK. The average outstanding balance has also fallen to $2,500 (£1,700) in the US, compared to £2,000 in the UK.

**Regulation**

615. The UK currently has relatively low levels of regulation and self-regulation in the credit card sector when compared to other countries such as the US and Canada (which have both recently introduced reforms in the market). For example, the Lending Code is a self-imposed voluntary code of practice, which sets standards of good lending 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.

616. Moreover, the Lending 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.

617. Following the Credit Card Summit held with industry in November 2008, the industry introduced new principles relating to risk-based re-pricing and these have since been incorporated into the Lending Code. The Code 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.
618. The Code 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.

619. 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 Lending Code, where further regulation could protect consumers, for example, the level of minimum payments and the allocation of repayments for credit cards.

US reforms

620. Recent reforms in the US have seen the introduction of new measures relating to credit cards. The CARD Act was signed into law on 22 May 2009 and took effect on 22 February 2010. The stated goal of the CARD Act is to “establish fair and transparent practices relating to the extension of credit under an open end consumer credit plan, and for other purposes”. The 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’340, ‘double-cycle’ billing341, penalty interest rates342)
- 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, Lending Code requirements on 30-day notice periods for changes to terms and conditions and requirements on assessment of ‘ability to pay’) and
- 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. limit interest rate increases on existing balances, allocate payments above the minimum to the debt accruing the highest interest rate first)

621. Although the CARD Act did not include a specific provision to set minimum payments, the Office of the Comptroller of the Currency (OCC), which charters, regulates and supervises all national banks, published the Account Management and Loss Allowance Guidance for Credit Card Lending in 2003. This called for credit card lenders to require minimum payments that amortized a borrower’s current balance over a ‘reasonable period of time’. By the end of 2005, lenders that fell under the remit of the OCC (approximately 75% of the industry) were expected to comply with a minimum payment floor that, at the very least, covered interest charges, fees and paid down 1% of the outstanding balance. This immediately affected new accounts and was phased in for existing balances. Lenders continued to have scope to set minimum payments above this level, although research by Auriemma Consulting Group suggests that minimum payments in the US have recently decreased in order to relieve consumers’ financial burden and reduce the probability of delinquency.

Canadian Reforms

622. In Canada, the Credit Business Practices Regulations were amended on 30 September 2009, with an effective date of 1 January 2010. The amendment included a number of

339 Unless otherwise stated, the remaining sections in this Annex have been referenced from a BIS-commissioned report ‘International Regulatory Research’ (Auriemma Consulting Group, March 2010)
340 Where default on one payment leads to all creditors classifying accounts with them as being in default, despite a customer not missing a payment
341 Where interest charges accrue not only on the current balance but also on the previous month’s
342 Where the interest rate charged on outstanding balances increases upon a customer entering default (i.e. missing a payment)
provisions that are similar to those in the US CARD Act and/or proposals in the UK consultation. These include:

- minimum payment warnings and disclosures of the length of a repayment period will be included on statements;
- payments are first applied to the minimum payment and any additional funds will be applied to debts accruing interest at the highest rate first;
- express consent must be given for consumers to be eligible for credit limit increases and advance notice of rate increases must be given (existing balances cannot be re-priced as part of existing regulation)

Other markets

623. Research commissioned by BIS also looked into other international markets with recent or pending regulation affecting the credit card industry. However, the majority were not relevant to the areas covered by the Government’s consultation (for example, regulations in Australia and Switzerland capped interchange fees).

Impact of regulations

624. The US and Canadian credit card industries responded to their respective reforms implementing significant systems, strategy and IT changes. The restriction placed on lenders’ ability to price accounts according to risk (particularly in the US) has been particularly significant. Together with other provisions, for example regarding allocation of payments, it has resulted in reduced access to credit and higher costs (e.g. interest rates and fees). The approval rate in 2007 for a credit card targeted at the mass market in the US was approximately 25% but this has recently fallen to 15%. During 2009, interest rates increased by approximately 2-4 percentage points, depending on card type, issuer and risk profile. It is expected that issuers will be more reluctant to offer credit cards to consumers that are reformed debtors and the new-to-credit population (e.g. students, consumers who have historically used debit products but now seek credit).

625. Some issuers, particularly small and medium sized lenders, have indicated that they will cease to offer credit and/or store cards due to the challenges and costs associated with regulatory compliance, in conjunction with the recent economic downturn. This is unlikely to effect credit availability because, in both the US and Canada, the six largest issuers are responsible for more than 90% of outstanding credit card balances. However, it may reduce competition and innovation in the market. It is also possible that further corrective regulation will be required as a result of these unintended consequences.

626. The UKCA presented other evidence on the US credit card market. For example, total credit lines fell by 16.9% ($1 trillion) in the year to June 2009 whilst aggregate purchase amounts fell by 12.4%. A greater number of accounts (36.4% in the year to June 2009) have received a credit limit decrease whilst re-pricing has increased across both low and high risk accounts. The percentage of accounts that received a re-price increased by 180.4%, with an average increase of 6.1%, whilst 4.3% more accounts received an annual fee (particularly high risk accounts). New accounts in 2009 were much more likely to be low risk compared to 2008 and the average credit limit for new accounts fell by 5%. In the second quarter of 2009, 349 million credit card offers were mailed to consumers compared to more than 1 billion in the same quarter of 2008.

627. The CARD Act was signed into law on 22 May 2009, and did not take effect until 22 February 2010; therefore these market trends (which reflect changes up to mid-2009) are much more likely to be attributable to the declining economic environment. However, they may indicate the potential impact of reducing lenders’ tolerance to risk during a period of economic difficulty.

343 UKCA, Response to BIS Consultation, pp. 219-220.
Despite the impacts mentioned above, it is expected that the credit card industry in both the US and Canada will adapt to the regulation and develop products that reflect the new market conditions. There are already examples of this in the US, for example American Express recently introduced the new Zync card, a charge card targeted at young adults. Chase have also implemented a Blueprint feature on some of their credit cards, which allows users to pay off or revolve purchases at a transactional level (e.g. they can revolve larger purchases but pay off smaller ones).


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 (i.e. non-monoline lenders), they could potentially be less affected 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 (i.e. monoline lenders), 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 in any case, so these options may not have a significant impact on competition.

However, by placing limitations on how firms are able to allocate repayments to reduce outstanding credit or store card balances, the ability of lenders to offer balance transfers is likely to be curtailed. For example, following the implementation of the CARD Act in the US (where payment allocation has been reversed for any payments in excess of the minimum), the proportion of balance transfers that involve a fee increased by 6.6% in the year to June 2009 to around 87%. Overall, the fee as a percentage of the transaction amount increased by 49% over the same period and now stands at 2.7%.

Given that balance transfers have hitherto been an important tool in encouraging consumers to switch their credit or store card provider, a reduction in the availability of balance transfers might potentially have a negative effect on switching, which might reduce competition in the market overall.

The impact of changes to the allocation of payments 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 initial 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 it. 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. If lenders differ significantly in the proportion of borrowers who regularly make the minimum payment, this could disadvantage some lenders more than others. The introduction of a new level of minimum payment for new customers should not raise any barriers to entry for new potential providers. However, this increase may potentially raise barriers for those customers looking to switch who have already built up significant levels of debt, who would then be subject to an increase in their minimum payment that they might not be able to afford (and hence could not 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 4, unsolicited limit increases would be removed as a potential feature on which credit and store card providers could compete for customers. Survey evidence discussed above suggest that consumers are largely apathetic to unsolicited increases, thus it is unlikely that cardholders would respond by reducing their spending or seeking access to alternative types of lending.

Given the reduction in lender income that the policy would induce, issuers may have less scope to compete in terms of reward schemes for existing and new cardholders. However, the most significant impact of banning unsolicited credit limits would be to restrict lenders’ low and grow strategies. Although this would impact on all lenders’ portfolios, it would particularly affect issuers that have relatively high-risk portfolios.

The Government received a response to its consultation from such an issuer, which is reliant on offering low limits and conducting monthly re-assessments for small incremental line increases. Banning unsolicited increases could force such issuers to exit the market and potentially exclude their customers from accessing a credit card. UKCA data for the second quarter of 2008 shows that approximately 107,000 high risk accounts received a credit limit increase (out of a total of 3.77 million). This suggests that 428,000 accounts per year could be excluded from credit card borrowing under this option.

Although the impact would not be as severe, by imposing limits on the size and/or frequency of credit limit increases, option 3 would also constrain the extent to which credit and store card providers can use credit limit increases as a competitive tool.

**Risk-based re-pricing**

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

---

344 UKCA Response to BIS Consultation, p. 86
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 most lenders in the same way, it may not have a significant impact on competition. However, to the extent that some issuers have better information on customer risk than others, the policy could affect the latter to a greater extent (although they would still be able to re-price new balances).

The UKCA indicated that the setting of an interest rate at the point of application is based on external credit reference agency information and/or on current account or other product information. Therefore, lenders such as high street banks have more initial information than monoline providers and hence could be less affected by a ban on re-pricing existing debt. Lenders that only conduct portfolio re-pricing would not be affected at all.

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.\(^{345}\)

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 gather detailed evidence about the extent of business borrowing on credit cards, but data on business use of credit cards provided by UKCA suggests a significant increase since 2005, when there were 126,000 cards used in transactions worth £684m, up to 2008, when there were 481,000 cards used in transactions worth £2.6 billion.

In terms of individuals using personal credit cards for business purposes, we have not been able to gather any data. However, Money Advice Trust submitted that Business Debtline customers have (potentially substantial) unsecured personal debt, which is estimated to be an average of £30-35,000, but in some cases can be in excess of £100,000. However, it is not clear how much of this debt has been incurred on credit cards. In addition, survey data provided by the UK Cards Association shows that credit card ownership among the self-employed is slightly higher than those employed full or part-time.\(^{346}\)

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/creditcardconsultation/response](http://www.bis.gov.uk/creditcardconsultation/response)).

\(^{345}\) [http://www.ikano.net/aboutus.php](http://www.ikano.net/aboutus.php)

\(^{346}\) An average of 2.6 cards for the self-employed, compared to 2.4 for those employed full or part-time; in addition 15% of the self-employed have five or more cards, compared to 10% for those employed full or part-time.