Oxera

An economic assessment of BIS's proposals for credit card regulation

Prepared for
The UK Cards Association

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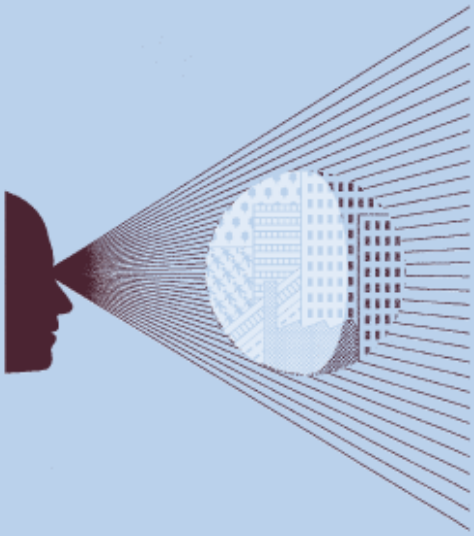

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1.1 Remit and objectives

The UK Cards Association has commissioned Oxera to conduct an economic assessment of the proposals in relation to credit cards put forward by the Department for Business, Innovation & Skills (BIS) in its 2009 Consultation Paper.[1]

BIS is considering a range of proposals in relation to the following four business practices:

– allocation of payments (AoP)—this is the order in which any repayments by cardholders with more than one type of balance will be allocated in reducing the outstanding balances;

– minimum payment requirement—this is the lowest amount a cardholder is required to pay of the outstanding balances each month;

– unsolicited credit limit increases (UCLI)—this refers to the industry practice of increasing the credit limit available to the cardholder without seeking explicit consent;

– risk-based re-pricing (RBRP)—this refers to the industry practice of adjusting the interest rate on existing and new balances based on a reassessment of risk profiles.

The BIS Consultation Paper was published together with an Economic Impact Assessment paper.[2] The assessment in this Oxera report addresses the questions and issues in the BIS Economic Impact Assessment paper.

1.2 Approach

Oxera's assesses each of the four business practices in three steps.

– *Explanation of existing business practice*—this first step provides a short explanation of existing business practices, together, where relevant, with an analysis of data on existing practices. Understanding the rationale and logic behind existing business practices is a useful starting point to analyse the concerns identified by BIS and to think through the potential impact of the proposals on issuers and consumers.

– *Assessment of the rationale behind the BIS proposals*—BIS identifies various potential concerns about how the business practices may harm consumers or specific groups of consumers. Its assessment is based primarily on anecdotal evidence and some initial analysis of data available in the public domain, and is therefore necessarily limited in scope. This second step in Oxera's assessment consists of a detailed empirical analysis aimed at establishing whether the aforementioned business practices indeed harm consumers in practice. In other words, it assesses whether an intervention, and to some extent what type of intervention, would be justified.

– *Assessment of the impact of the BIS proposals*—if the analysis indicates that a business practice harms consumers and an intervention may be required, it is good practice to assess the impact of the proposals. This is the third step in Oxera's assessment. It examines whether the proposals indeed address the concerns identified by BIS and

[1] Department for Business, Innovation and Skills (2009), 'A Better Deal for Consumers, Review of the Regulation of Credit and Store Cards: A Consultation', October.

[2] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October.

whether there could be any (unintended) negative consequences on all, or certain groups of, consumers. Where relevant, the report also discusses interactions between proposals on different measures (eg, RBRP and unsolicited credit limit increases, UCLI). For each topic, BIS sets out various proposals. Oxera's assessment focuses in the first instance on the proposal that is likely to be most far-reaching, and then, where relevant, comments on the others.

This report does not provide a detailed analysis of all the costs (including, for example, compliance costs) and benefits of the proposals put forward by BIS. When BIS has finalised its analysis and its proposals have been refined, such an assessment could be conducted, in line with best practice.

1.3 Data and information sources

Oxera's assessment and analysis are supported by several sources of information, including the following.

– *Interviews with a sample of issuers*—Oxera conducted interviews with a number of issuers in the UK to inform its understanding of both the rationale and working of existing business practices subject to the review and the possible impact of BIS proposals. Oxera also spoke to several issuers in the USA on the impact of the US CARD Act.

– *Argus Information & Advisory Services (Argus) dataset*—Argus undertook an analysis of issuers' data relevant to the four topics examined in BIS's Consultation Paper.[3]

– *Supplementary data from issuers*—further data from issuers was collected by the UK Cards Association in confidential returns and subsequently made available to Oxera in anonymised and aggregated form.

– *Consumer research*—the UK Cards Association and GfK NOP designed qualitative and quantitative surveys that were subsequently conducted among a representative sample of cardholders in the UK. The surveys focus mainly on understanding consumers' awareness and understanding of issuers' business practices and the way consumers use credit cards. As it is challenging to cover all relevant issues in sufficient detail in a quantitative consumer survey, a complementary qualitative survey was undertaken which allowed the issues to be explored in greater depth. The survey results should be considered indicative of consumer thinking, but do not on their own provide conclusive evidence. Therefore, where possible, the results from the surveys are presented alongside other evidence, such as an analysis of issuers' data.

– *Economic literature*—where relevant, Oxera's assessment draws on economic literature in relation to consumer credit.

Oxera has sense-checked the results of the Argus analysis where possible, aided by conversations with issuers. The analysis itself was undertaken by Argus. The following additional information can be provided about the dataset.

– *Representativeness*—Argus collected data from issuers representing around 75% of the UK credit card market, which means that the data gives a comprehensive picture of the UK market.

– *Time period*—the Argus study covers the period from July 2007 to July 2009, which is the longest period for which consistent data could feasibly be analysed within the time

[3] Argus Information and Advisory Services (2010), UK Cards Association Analytical Dataset, January.

frame of the consultation process. This means that part of the dataset may be directly affected by the economic downturn. Where the downturn may have significantly affected the results in a particular way, this has been noted in the assessment. Several aspects of the results of the data analysis are measured in relative rather than absolute terms; for example, by comparing part of the dataset with a proxy control group (discussed further below). It is unlikely that these relative changes have been significantly affected by the economic conditions.

– *Risk bands*—various measures presented in this report have been broken down by risk band. Each issuer in the UK uses custom risk and behaviour scores. To compare and benchmark measures by risk, Argus has developed standardised risk segments (based on unit loss rates) numbered from 1 to 9, where 1 represents cardholders with the highest risk profile and 9 cardholders with the lowest risk profile. In some cases, these risk bands are aggregated into categories: 'low' (risk bands 7 to 9); 'medium' (risk bands 4 to 6); 'high' (risk bands 2 and 3); and 'very high' (risk band 1). This is explained in more detail in the Argus slide pack.[4]

– *Proxy control groups*—when increasing credit limits or increasing the interest rates for existing credit cardholders, some issuers define a control group—ie, a group of cardholders that does not receive a credit limit or interest rate increase but has the same characteristics as those that do receive an increase. This allows an issuer to assess the impact of its policies by undertaking an analysis and comparing the behaviour of those who received an increase with those in the control group. In its dataset, Argus cannot observe this control group and therefore proxies it by identifying cardholders who are similar across a range of metrics as those who did receive an increase (in credit limit or interest rate), apart from the fact that they did not receive an increase for at least three months. By definition, such a proxy control group will never be the same as the 'real' control group; for example, some members of the proxy control group may in fact have received an increase in the credit limit within the time period studied (although after the initial three months). The results of the proxy control group analysis should therefore be interpreted with care. Although not necessarily providing conclusive evidence, this does constitute useful indicative evidence. Where relevant, Oxera asked issuers whether they could confirm the results of the Argus analysis on the basis of their own internal analysis using control groups. This has been reported in the assessment.

1.4 Structure of the report

For convenience, the structure of this report follows the order in which the four topics are discussed in the BIS Economic Impact Assessment: section 2 discusses AoP, section 3 minimum payments, section 4 UCLI, and section 5 re-pricing of existing debt.

The main findings are summarised below.

1.5 Summary of main findings

This section summarises the main findings of Oxera's economic impact assessment of BIS's proposals for credit card regulation.[5]

Allocation of payments

BIS's rationale for proposing changes to the regulations surrounding AoP stems from concerns related to consumer understanding and distributional issues. BIS is concerned that the normal industry practice of paying off the cheapest debt first is not well understood by

[4] Argus (2010), 'UK Credit Card Payments Study', January, slide 50.

[5] Department for Business, Innovation and Skills (2009), 'A Better Deal for Consumers, Review of the Regulation of Credit and Store Cards: A Consultation', October.

consumers.[6] At the same time, BIS notes that balance transfer deals (also called 'promotional balances') for some cardholders may be cross-subsidised by other cardholders, potentially raising distributional concerns.[7] BIS's proposals, which range from improving information disclosure to reversing the typical industry allocation hierarchy,[8] are intended to address these issues.

The evidence presented in this report does not support the concerns about the effects of the existing allocation of payment order, as identified by BIS.

– Data shows that those cardholders who 'game the system' by transferring balances and then not making any additional transactions are a relatively insignificant group. These 'surfer' balances account for a small share of overall balances[9] and the lost interest income resulting from surfers not paying a standard transactions APR on their balances is insignificant.[10] This suggests that any distributional issues would also be small.

– While it is the case that some cardholders and cash users pay significant interest charges (reflecting the higher risk of cash users), the data also shows that reversing payment allocation would have only a limited effect: almost 90% of cardholders would save less than £10 a year, and only 1.1% would save more than £90 a year.[11]

A reversal of payment allocation would be likely to cause issuers to respond in order to compensate for the loss in revenue. This could have an impact on both the availability and the pricing of credit card products. Issuers may reduce the availability of balance transfer deals or the duration of those offers remaining. In the USA, the recent CARD Act has introduced partial reversal of payment allocation;[12] anecdotal evidence is that issuers are reducing both the duration and the availability of balance transfer offers.

On the pricing side, issuers may increase balance transfer fees or post-promotional APR rates. It is also possible that 0% deals would be replaced by slightly higher rates. Anecdotal evidence from the USA suggests that 0% deals are no longer available to existing customers at all and fewer deals are available for new customers. Furthermore, some issuers have been raising balance transfer fees. Each of these changes, if implemented in the UK, could make the balance transfer product less transparent and less attractive to consumers.

The finding from the data that almost 90% of cardholders would save less than £10 a year from reversing payment allocation, and only 1.1% would save over £90 a year, suggests that changing the payment allocation would not address the concerns BIS may have about the level of interest payments made by some cardholders. This also implies that none of the intermediate solutions (eg, proportional allocation or cash first) would be effective. Improving informational transparency, however, may be helpful in addressing a possible lack of consumer understanding.

Minimum payment requirement

BIS's proposals to modify existing practices surrounding minimum payments are motivated by concern that consumers making repeated minimum payments are using a short-term product for long-term borrowing needs.[13] This results in them paying off debt slowly, incurring

[6] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 82.

[7] Ibid., para 86.

[8] Ibid., para 110.

[9] Surfers here are defined as those with balance transfers who pay no interest for 15 months.

[10] Argus (2010), 'UK Credit Card Payments Study', January, slide 59.

[11] Ibid., slide 57.

[12] The Credit Card Accountability Responsibility and Disclosure Act of 2009 reverses payment allocation for all payments made in excess of the minimum payment.

[13] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 144.

a high level of interest over the life of the loan and increasing indebtedness.[14] Given the undesirable effects, BIS considers that cardholders may be making only the minimum payment because they do not understand the implications of doing so.[15] Alternatively, BIS cites research suggesting that the minimum payment itself can influence what consumers pay, by acting as an 'anchor' for what consumers consider an appropriate payment to be.[16] To address these concerns, BIS is proposing options ranging from improving information transparency to imposing a higher minimum payment rate.[17]

– Consumer research and data from issuers provide limited support for the idea that consumers anchor their views on the minimum payment; those cardholders who make the minimum payment tend to cite rational reasons for doing so. For example, it may be reasonable for a cardholder to make the minimum payment if they have a promotional offer or cannot afford to pay more.

– The less a cardholder pays, the longer it will take to repay a debt. BIS calculates that it would take 29 years and three months to pay off an average balance of £1,856 using a 2% minimum payment.[18] However, the data shows that very few people consistently make the minimum payment even over 12 months (3.1% in the year ending June 2009).[19] Therefore, paying the minimum for an extended period, such as the BIS 29-year estimate, would not seem a realistic scenario. Using actual balances, payment rates and APRs, payment periods range from 0.9 years for risk band 9 (the lowest risk band) to 11.8 years for risk band 1 (the highest risk band).[20]

Increasing the required minimum payment would be likely to exacerbate short-term financial difficulties for some cardholders (as recognised by BIS[21]). Around three-quarters of the accounts with the highest risk, for example, currently pay less than 5% of their balance,[22] and at least some of those minimum and partial payers are likely to find it difficult to pay 5%. When asked whether they would still be able to make minimum payments if the rate were doubled, 10% of minimum payers surveyed said that they already incur difficulties in meeting the minimum payment, and a further 51% identified that they either 'might' or 'would definitely' find it difficult to meet the increased minimum repayment.[23]

While it is clear that cardholders paying more each month will pay less interest, it is less clear that raising minimum payments is an effective way to encourage cardholders to do so. Counter-intuitively, perhaps, a study based on 126,000 credit card statements found that higher minimum payments (3% versus 2%) are associated with an increased likelihood of making the minimum payment. As noted by the author, this finding is still under investigation, but suggests that the ramifications of changing the minimum payment extend well beyond those currently paying the minimum.[24] It also suggests that introducing some form of 'recommended minimum' payment could cause some cardholders currently paying amounts in excess of the recommendation to pay less. This potential 'anchoring effect' is recognised

[14] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 145 and 206.
[15] Ibid, para. 136.
[16] Ibid., para 153.
[17] Ibid., para 163.
[18] Ibid., para 195.
[19] Argus (2010), 'UK Credit Card Payments Study', January, slide 312.
[20] Ibid., slide 298.
[21] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 198.
[22] Argus (2010), 'UK Credit Card Payments Study', January, slide 323.
[23] GfK NOP survey, p. 43.
[24] Stewart, N, Matthews, W., Navarro Martinez, D. and Harris, A. (2009), 'A model of credit card repayment', The University of Warwick, December.

by BIS, although, as noted above, the survey evidence does not necessarily support the finding.[25]

Improving information transparency could make more consumers aware of the detrimental impact of making repeated minimum payments, as well as potentially countering the 'anchoring effect'. The provision of additional information would, however, need to be done sensitively since some studies have found that more information does not always lead consumers to make better decisions (ie, consumers may be confused due to perceived information overload).[26]

Unsolicited credit line increases

BIS's rationale for proposing regulatory changes is that UCLI may lead to higher balances than cardholders would choose to hold,[27] at least partly because consumers may not understand that they can decline UCLI.[28] The implication is that this could lead to financial difficulty and/or indebtedness,[29] especially among vulnerable groups. [30] To address this concern, BIS is proposing a range of changes, from offering better information regarding UCLI, to potentially banning them.[31]

The evidence presented in this report does not support the concerns identified by BIS. UCLI are given primarily to low-risk, medium-utilisation customers. Where CLI are granted to higher-risk customers, this appears to be done in a way that is consistent with the 'low and grow' policy. As discussed further below, 'low and grow' enables issuers to extend credit to higher-risk customers who might not otherwise gain access.

There is also limited evidence to support BIS's concern that CLI might result in a higher incidence of financial difficulty. While CLI may result in increased balances to some extent, it does not appear to be associated with an increase in bad debt.

As alluded to above, UCLI are a necessary part of the 'low and grow' policy which enables issuers to extend credit to the near-sub-prime and sub-prime segments. Banning UCLI may therefore result in (near) sub-prime consumers who do not currently have credit cards being unable to obtain them and being forced to use alternative (and often more expensive) forms of credit. Existing (near) sub-prime cardholders would also be disadvantaged, in that they would be unable to obtain new cards and thus be locked into their existing credit cards.

While not causing a noticeable increase in financial difficulty, 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. To the extent that this causes concern, it would seem most desirable to address it in a way that does not remove the ability of card issuers to adjust credit limits for other consumers, particularly high-risk consumers whose access to credit relies on issuers' ability to adjust limits.

It is possible that the opt-in mechanism proposed by BIS would fulfil this role of providing the option of a commitment device for some consumers while not jeopardising credit access for high-risk consumers. Arguably, this would focus in particular on cardholders with poor impulse control, but less so on those also affected by inertia. It is uncertain whether the opt-

[25] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, pares 186-191.

[26] For example, a 2004 OFT study found that 'too much information' was the second most popular reason given for why consumers could not understand a sample credit card agreement. See Silber, M., Marchant, N. and Westra, B. (2004), 'Credit Card Survey', study report prepared for the Office of Fair Trading, March.

[27] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 223–24.

[28] Ibid., para 228.

[29] Ibid., para 4.6.

[30] Ibid., para 234.

[31] Ibid., para 236.

out mechanism would provide these desired benefits for one group while not imposing undesired costs on another. It would therefore seem advisable to conduct additional research (perhaps through a pilot study) to assess the efficacy and costs and benefits of such an option before introducing it across the industry.

Risk-based re-pricing

The motivation behind BIS's proposals to modify regulations around RBRP of existing debt is the concern that issuers are not sufficiently transparent in their re-pricing decisions.[32] In particular, BIS implies that re-pricing may be driven more by issuers' declining profitability than by changes in cardholder risk.[33] BIS also notes that, due to limited take-up of the option to close credit card accounts following a re-price, some cardholders may not be able to avoid increases, resulting in them paying more interest.[34] BIS is proposing a range of measures to address these concerns, from providing more information about increases to a ban on the re-pricing of existing debt.[35]

– It is beyond the scope of this report to assess the extent to which actual re-pricing is solely driven by changes in the risk profile. However, the data suggests that re-pricing generally applies to the higher-risk accounts within each risk band. Also, accounts with a higher utilisation rate are much more likely to be re-priced than those with lower utilisation. Furthermore, in practice, re-pricing works both up- and downwards.

– The majority of accounts are not re-priced regularly. Data for the period between July 2007 and July 2009 suggest that approximately 90% of accounts are not re-priced in any given year. Furthermore, re-pricing appears to have a limited effect on balances compared with a proxy control group, which suggests that re-pricing does not result in increased overindebtedness.[36]

– While it is the case that cardholders make limited use of the opt-out following a re-price, there is evidence that cardholders do react to re-pricing. More generally, evidence on relatively high rates of switching in the credit card market implies that cardholders can avoid rate increases.

Removing issuers' ability to re-price existing debt could have a number of implications. If issuers knew that they could not impose a re-price, they would be less likely to offer credit in the first place. As high-risk borrowers are the most likely to be re-priced, lower credit availability would be most likely to affect these borrowers. Issuers may also decide to extend smaller amounts of credit initially. This strategy assumes, however, that no restrictions would be placed on UCLI (and hence the 'start low and grow' approach). If issuers' ability to increase credit limits were also to be restricted, this would make it even more likely that issuers would cease entirely to extend credit to high-risk customers in the first place.

Furthermore, issuers would need to recover the losses resulting from the inability to re-price. This could be done in several ways, but one option would be to raise the initial interest rates and APRs applicable to new cards by an amount that would compensate them for the estimated losses to be incurred from not being able to re-price. This would result in an increase in cross-subsidisation as some cardholders would have rates on existing debts that were higher than would be justified by risk-based pricing, and so would be cross-subsidising higher-risk cardholders. On the other hand, some cardholders would have rates lower than would be justified on risk-based grounds, which may encourage them to accumulate a higher balance than they otherwise would.

[32] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 273.
[33] Ibid., para 285.
[34] Ibid., para 280.
[35] Ibid., para 294.
[36] Argus (2010), 'UK Credit Card Payments Study', January, slide 165.

While banning re-pricing would seem inadvisable for the reasons discussed, there may be a role for increased information on how credit scores are determined and how re-pricing decisions are made. However, the benefits of additional information would need to be assessed first. Also, the additional information would have to be provided in a clear and considered way that did not exacerbate 'information overload', particularly given the complexity of credit scoring and re-pricing models.

2 Allocation of payments

The issue of payment allocation is relevant to all credit cardholders with multiple types of balances. Current practice among most issuers is that any repayments by cardholders with more than one balance will be allocated to balances with lower interest rates. This practice, which facilitates balance transfers and debt consolidation, requires cardholders to pay back first any credit that they have received for free (or at a discount).

BIS is concerned that the practice of paying off the cheapest debt first is not well understood by customers and may mean that cardholders' indebtedness increases without them being aware.[37] At the same time, BIS is concerned that balance transfer deals for some cardholders may be cross-subsidised by other cardholders, potentially raising distributional concerns.[38] BIS's proposals, which range from improving information disclosure to reversing the typical industry allocation hierarchy,[39] are intended to address these issues. This section evaluates existing practices, the rationale for BIS's proposals and the likely effects of reversing the payment allocation.

2.1 Existing practice

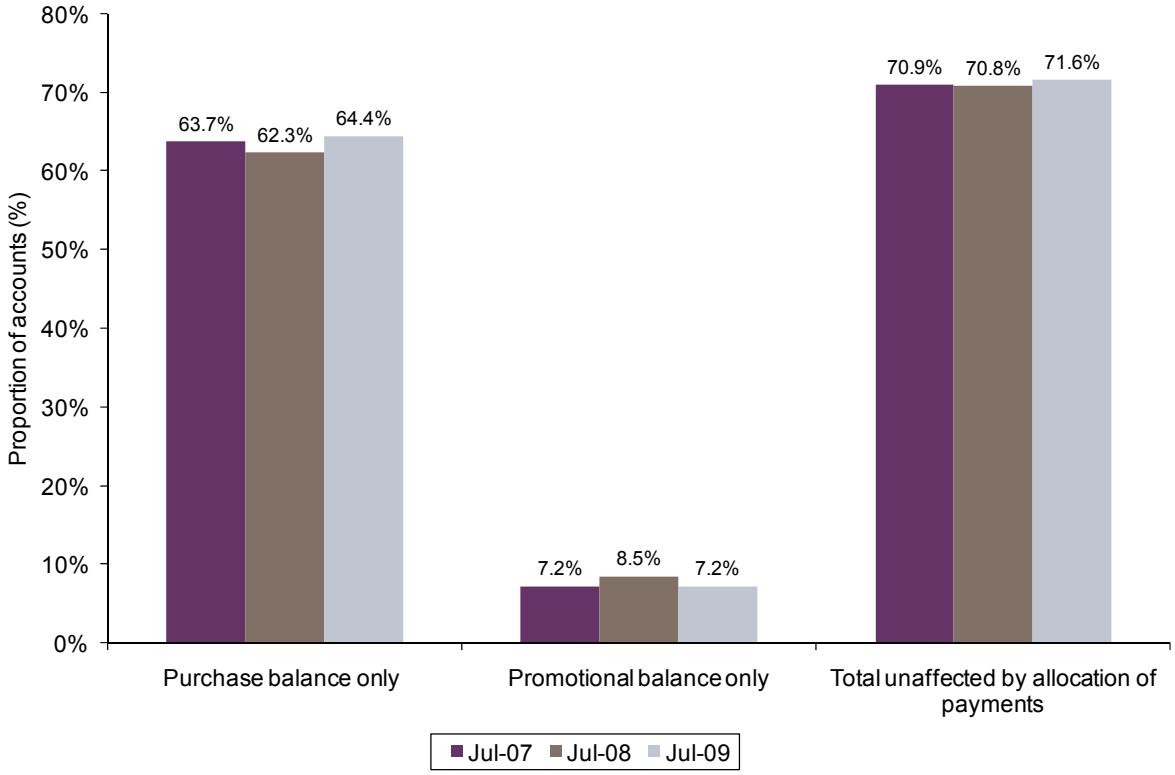
AoP refers to the order in which any cardholder payment is allocated to different outstanding balances. In this context an outstanding balance refers to an amount due in one month that is unpaid and therefore carried over into subsequent months. A cardholder can have more than one type of balance if, for example, they transferred a £1,000 balance from another card, withdrew £100 in cash and made £500 in purchases during a month, but only paid £75 off at the end of the month. This consumer would then have a promotional balance, a cash balance and a transaction balance.

This means that only cardholders with multiple balances are affected by the payment allocation, while those who only have one balance or who pay their balances in full each month are not. Figure 2.1 shows that between 62% and 64% of account holders use their cards only to make purchases (ie, not as a credit facility). This would include account holders who pay off their balance in full each month (known as 'transactors'), but also those who may not pay off each month and therefore have a 'revolving balance' (known as 'revolvers'). These revolvers would not be affected by payment allocation because they have only one balance and any payment made would go towards paying down this single balance.

Figure 2.1 also shows that another 7–8% of cardholders have a promotional balance resulting from a balance transfer, but have not made any additional purchases or cash withdrawals ('promotional balance only'). Thus any payments would go towards paying off the balance transfer and so payment allocation would not affect these cardholders. Overall, around 71–72% of account holders are unaffected by payment allocation at any point in time; the rest of this section discusses the remaining 28–29% of cardholders.

[37] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 82.
[38] Ibid., para 86.
[39] Ibid., para 110.

Figure 2.1 Proportion of accounts unaffected by changes to the allocation of payments



Note: Promotional balances were defined as balances with an APR lower than at 6%. The analysis excludes charged-off and closed accounts.
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 18.

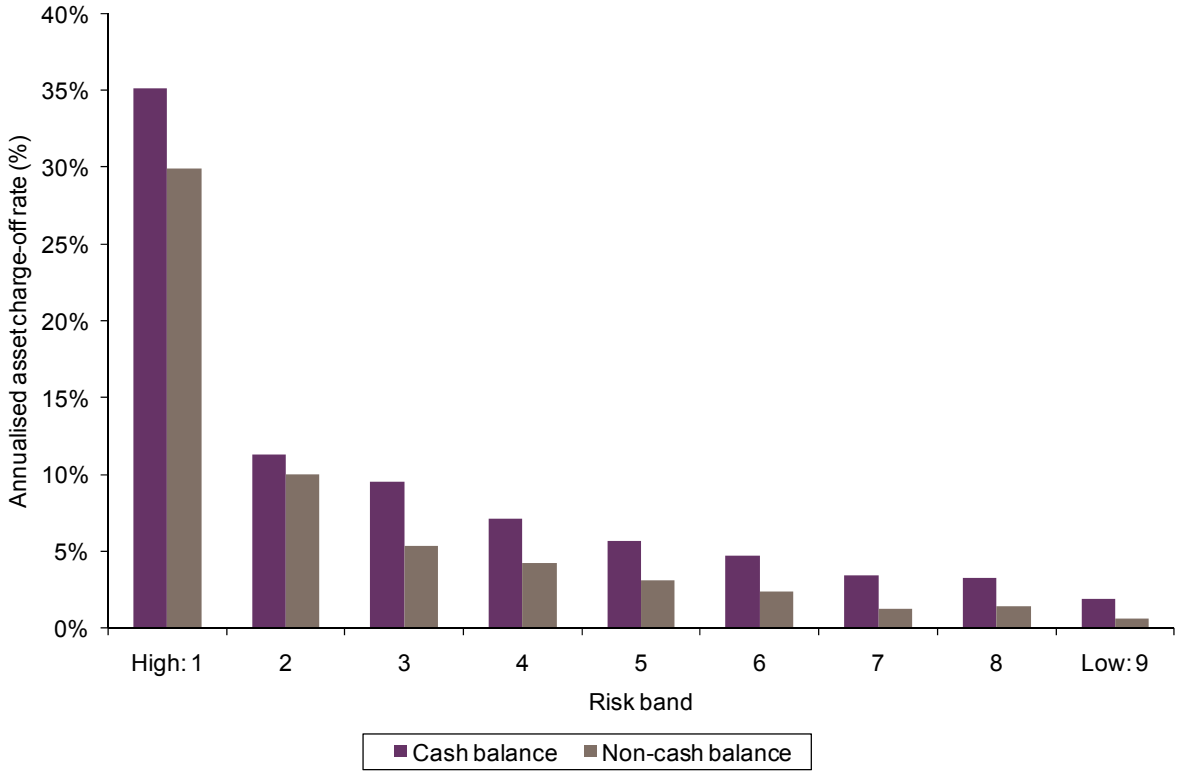
Current practice among most issuers is to allocate the repayments first to the balance with the lowest interest rate. If the customer has a promotional balance, this would therefore typically be paid off first, followed by transactions and then cash (which usually carries the highest interest rate). In the example above, if the customer's £75 payment went towards paying off the promotional balance, the remaining promotional balance would be £925, while the consumer would also have a £100 cash balance and £500 in transactions. The customer would then incur interest charges on both the cash and transaction balances (assuming the promotional balance carried a 0% interest rate[40]).

The business logic behind this practice is that cardholders are first paying off what they received for free (or at a discount), since they are receiving a benefit that carries a cost for issuers to provide.

It is also worth noting that cash interest rates are highest because cash users are generally riskier than non-cash users, even within a given risk band. Figure 2.2 shows that the charge-off rate is generally higher for cash users than for non-cash users.

[40] Not all promotional balances are at 0%; some may have discounted interest rates instead, sometimes for the life of the balance.

Figure 2.2 Observed annualised asset charge-off rate by Q2 2008 cash balance status per risk band



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 28.

2.2 Assessment of rationale for change

BIS puts forward three possible reasons why the current practice may need to be changed.

1) **Lack of consumer understanding**—BIS is concerned that many consumers are not aware of how payments are allocated and may therefore behave differently to how they would otherwise.[41]

2) **Distributional effects of payment allocation**—BIS is concerned that cardholders that only have a promotional balance (and therefore obtain credit at a relatively low price) may be subsidised by other revolvers.[42]

3) **Indebtedness**—as a consequence of their lack of awareness, BIS believes that consumers could be using their cards in ways that increase indebtedness[43] (eg, using credit cards to withdraw cash which incurs relatively high interest payments and is paid off last).[44]

These are discussed in turn below.

2.2.1 Is there a lack of consumer understanding of allocation of payments?

BIS refers to qualitative research conducted by the OFT in 2004 which showed that many consumers were unaware of how repayments on credit cards were allocated towards

[41] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 82.
[42] Ibid., para 86.
[43] Ibid., para 82.
[44] Ibid., para 99.

different balances.[45] In response to this study, the UK Cards Association (then known as APACS) introduced best-practice guidelines on how the AoP hierarchy is to be explained in a cardholder's statement summary box.[46] The UK Cards Association guidelines require that issuers provide a 'succinct description of the order in which payments will be allocated to the account' and give examples of how this might be done, such as:

> If you do not pay off your balance in full we will allocate your payments to balances with a 0% APR before balances with higher APRs*.
>
> OR
>
> If you do not pay off your balance in full payments we receive are applied first towards lower rate, promotional or balance transfer offers before cash advances or purchases*.
>
> OR
>
> If you do not pay off your balance in full when you make a payment it will be used to pay off any special offer, balance transfer or promotional offers before any cash withdrawals or standard rate purchases*.
>
> * For full information on allocation of payments see section x.x of the terms and conditions.[47]

Since then, there has been limited investigation into the effectiveness of the summary box in spreading understanding of AoP. One recent study cited by BIS, carried out on behalf of Moneysupermarket.com, suggests that only around one-third of credit cardholders are aware of the typical AoP hierarchy.[48] BIS considers that this result constitutes evidence of an asymmetric information problem.[49]

In assessing whether the survey results constitute evidence of an asymmetric information problem, it is to be noted that some cardholders may never have more than one balance at a time. This may explain why some cardholders are not aware of the payment allocation hierarchy.[50]

BIS suggests that part of the reason for consumers' limited understanding may be the way in which issuers present the information. A 2008 OFT survey found that the language used by issuers to disclose credit card information varied considerably.[51] It should be noted that this finding was not specific to payment allocation, although payment allocation was one of the features examined by the study. Using a series of examples (one of which concerned payment allocation) on how to present information in a way that facilitated consumer understanding, the OFT also found that presenting the results in tabular or bullet form, rather than text, would be useful.[52]

In the GfK NOP survey commissioned by the UK Cards Association, the typical payment allocation hierarchy was explained to cardholders, who were then asked whether they had

[45] OFT (2004), 'Credit card survey', March, p. 43.

[46] The UK Cards Association (2006), 'Best practice guidelines', Cardholder statement Summary box, pp. 8–10. See http://www.theukcardsassociation.org.uk/files/publications/exisiting_publications/cards/credit_card02-cardholderstatementsummarybox.pdf.

[47] Ibid.

[48] Moneysupermarket (2009), 'Almost two-thirds of credit card users don't understand that their cheapest debt is paid off first', October 26th.

[49] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 105.

[50] The survey, undertaken by Opinium Research for Moneysupermarket.com, did not ask respondents whether they were transactors or revolvers.

[51] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 91 and 100.

[52] OFT (2008), 'Credit card comparisons', February, para 5.36.

been aware of the practice.[53] 66% of respondents replied that they had known this, with slightly more in social class A/B (72%) than D/E (63%).[54] Revolvers indicated even higher levels of awareness (71–72%)[55] than transactors (53%), as would be expected since the AoP issue is relevant for revolvers only—some transactors may hardly ever use the credit facility of a credit card or never have more than one balance. Of the revolvers who were unaware of payment allocation, 31% said they were surprised by the result, while the comparable figure for transactors was 42%.[56] Also, cardholders who were enjoying a promotional offer claimed higher levels of awareness (71%) of the typical payment allocation hierarchy than those who were not on a promotional offer; when explained about the hierarchy, only 55% who were not on a promotional offer said that they had known about it already.[57]

BIS is concerned that knowledge of payment allocation practice is particularly low among younger consumers.[58] The survey evidence does not support this; as shown in Table 2.1, the claimed understanding of payments allocation among 18–24-year olds was virtually the same as for those aged 25–34 and 35–44.[59]

Table 2.1 Knowledge of existing allocation of payments practice by age cohort

Age	% of respondents with knowledge of existing AoP practice
18–24	55
25–34	55
35–44	56
45–54	59
55–64	68
65+	59

Note: This shows the percentage of respondents in each cohort who, when asked, 'If you don't pay off your balance in full, most credit card providers will allocate the payment you make to the part of your balance with the lowest interest first. Would you say you…?', responded that they 'knew this already'.
Source: GfK NOP survey, p. 217.

Overall, while the results of the quantitative survey suggest a reasonably high level of awareness, these results must be treated with caution. The quantitative survey does not indicate whether cardholders actually understand the implication of the AoP. In addition to its quantitative survey, GfK therefore conducted qualitative research to explore the issues in greater depth. Reactions by focus group members suggest that some of them did not understand payment allocation and its implication for their balances before having it explained in detail. It is therefore not entirely clear whether cardholders are fully aware and fully understand AoP. Whether the payment allocation affects consumers in practice to a significant extent is examined below.

[53] GfK NOP survey, p. 220: 'If you don't pay off your balance in full, most credit card providers will allocate the payment you make to the part of your balance with the lowest interest first. Would you say you '. Knew this already/Did not know this and it surprises you/Did not know this but it doesn't surprise you?'
[54] Ibid., p. 211: 'Most credit card companies charge a different rate of interest on different borrowing. For example, there might be a low rate of interest on a balance transfer, another rate of interest on spending and another for cash advances. Would you say you… Knew this already/Did not know this and it surprises you/Did not know this but it doesn't surprise you?'
[55] Ibid., p. 220.
[56] Ibid., p. 220.
[57] Ibid., p. 220.
[58] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Initial Equality Impact Assessment, October, para 29.
[59] GfK NOP survey, p. 217.

2.2.2 Distributional effects of promotional balances

BIS has expressed concern that cardholders with transactions balances are subsidising those with promotional balances who do not make any additional transactions (ie, 'surfers').[60]

Card issuers offer promotional balances to new customers as a marketing tool to encourage customers to switch. While financing a 0% (or discounted) balance transfer is not initially profitable for the issuer, the idea is that the costs will be recovered from these cardholders at a later stage. This is a common practice across many industries; contracts can be offered whereby a consumer can enjoy a low temporary introductory rate on an adjustable-rate product, such as a mortgage and Internet and telephone services. This practice may encourage switching in mature market segments.

Issuers also offer promotional balances to existing customers by giving them the option to transfer to their credit card, at a low rate, debt they may have elsewhere. This facilitates debt consolidation and may also be a way to retain customers who would otherwise use another provider to consolidate debt.

Regardless of whether the promotional balance is given to a new or existing customer, the cardholder also benefits from paying average interest charges below the standard rate. A cardholder with an equal transactions and promotional balance will face negligible interest charges on the promotional balance, and so the total amount of interest paid will be close to half the amount that would be due if the promotional balance did not exist.

Issuers have confirmed that the standard APR which applies to purchases following the promotional period is no higher than the standard APR that applies to cardholders without promotional balances. Thus, there is no possibility that a cardholder with a promotional balance would ever be paying a higher APR than they would have without the balance transfer.

The practice also means that if cardholders continue to spend after transferring a balance, they will shift gradually from the promotional rate to the standard rate, since the effective rate paid will be a balance-weighted average of the promotional rate and the standard rate (for either cash or transactions).

While it is intended that issuers recover the initial costs of the promotional balance over the life of the relationship with the cardholder, there is a small group of cardholders who 'game the system' by transferring a balance, not making any additional transactions, and transferring the balance again at the end of the period (or paying it down completely). While this may be rational behaviour from the perspective of the individual cardholder, it does not allow the issuer to recover the costs of the promotional period from those cardholders. BIS is therefore concerned that these 'surfers', as they are known in the industry, are subsidised by those who do not take out a balance transfer at all and those who do make additional transactions after receiving a promotional balance.[61] As surfers are typically concentrated in low-risk bands, this may raise distributional concerns.

To assess the extent of cross-subsidisation, it would be preferable to examine cardholder or portfolio profitability over time, rather than as a snapshot. This would address whether cardholders on promotional programmes are being cross-subsidised. As an alternative, the degree of cross-subsidisation will be informed by looking at the size of the surfer population and their balances. This is the group that are definitely paying below cost for their borrowing, as they borrow only on promotional programmes. If the group of surfers is not large, the extent of cross-subsidisation should be limited.

[60] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 82.
[61] Ibid., para 82.

Data shows that surfer balances account for a small share of overall balances. In Q2 2007, balance transfers for surfers amounted to an average of £85.1m per month, or less than 0.2% of total revolving balances of £48.0 billion.[62] The interest lost from surfers not paying a standard transactions APR on their balances amounts to approximately £1.1m per month[63] and is insignificant, implying that any distributional issues would also be small. The cross-subsidy would be further reduced if the balance transfer fees paid by any user of promotional balances (including surfers) were taken into account.

It is not surprising that the cross-subsidy is limited. There are a number of market constraints that limit the extent of cross-subsidisation. First, the industry has an interest in minimising surfing behaviour as much as possible, since issuers do not want a group of consumers that is loss-making. To discourage surfers, issuers have introduced fees for balance transfers. These fees—typically 2–3% of the promotional balance—cover part of the cost of servicing the promotional balance and therefore provide a deterrent to surfers. Second, there are alternative options available in the market. Consumers who value the benefit of reverse allocation can choose cards with different allocation methods. Some issuers, for example, have a standard policy of using payments to pay down the highest-interest balance first.

2.2.3 Does the allocation of payments increase indebtedness?

BIS is concerned that consumers who may not understand payment allocation could be using their cards in ways that increase their indebtedness.[64]

The potential for AoP to result in increased indebtedness is a result of the different APRs applicable to different types of balance. Figure 2.3 shows the average APR applicable to accounts with more than one type of balance (which would therefore be affected by payment allocation). As can be seen, the APRs applicable to promotional balances are much lower than those charged on cash, transaction balances, or 'expired promotional' balances.[65] For example, cardholders with a transaction balance in addition to their promotional balance paid on average 3.0% on promotional balances (including balance transfer fees), much lower than the rate applicable to transactions of 17.75%.

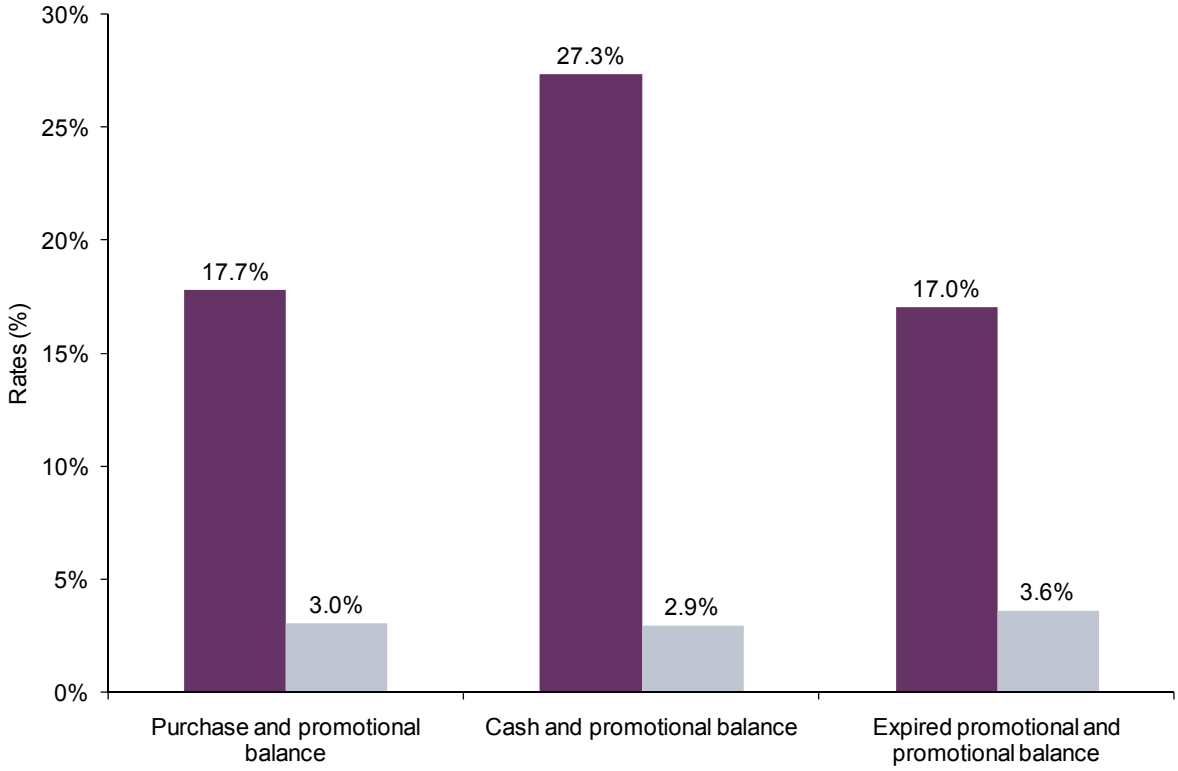
[62] Surfers here are defined as those with balance transfers who pay no interest for 15 months. As most promotional periods are 12 months, specifying that no interest is paid for 15 months captures those cardholders who either pay down the balance or transfer it elsewhere. On the other hand, some promotional offers run for 15 months, so surfers using these offers would not be captured here. Furthermore, some promotional offers may be at low rates of interest rather than 0%, although these are less likely to be used by surfers. ''If 'near surfers' (defined as those who pay interest three or fewer times during a 15-month period) are included in the analysis, combined balance transfers of surfers and near-surfers would still be very small (£178m, or 0.4% of total revolving balances).

[63] Argus (2010), 'UK Credit Card Payments Study', January, slide 59. Interest lost from near-surfers (as defined above) is an additional £1.2m per month.

[64] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 82 and 100.

[65] On many promotional offers, the 0% or discounted rate is for a finite period, following which the balance reverts to a standard rate—referred to in Figure 2.3 as an 'expired promotional' rate.

Figure 2.3 APR by balance type



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 64.

As noted in section 2.1, all cardholders with multiple balances (28–29% of all accounts) are affected by payment allocation, although the extent of this effect depends on the combination of balances they hold. The majority of affected accounts are combinations of cash and transaction balances rather than promotional balances. Over three-quarters of affected accounts in July 2008 are those *without* promotional balances (ie, some combination of cash, transaction and expired promotional balances). Of those, more than 80% have cash and transaction balances.[66] The result of this mix of balances is that payment allocation has less of an effect than it would if the majority of affected accounts had, for example, promotional and cash balances. This is because the difference between interest rates on cash balances and transaction balances is much smaller than that between the interest rates on cash and promotional balances.

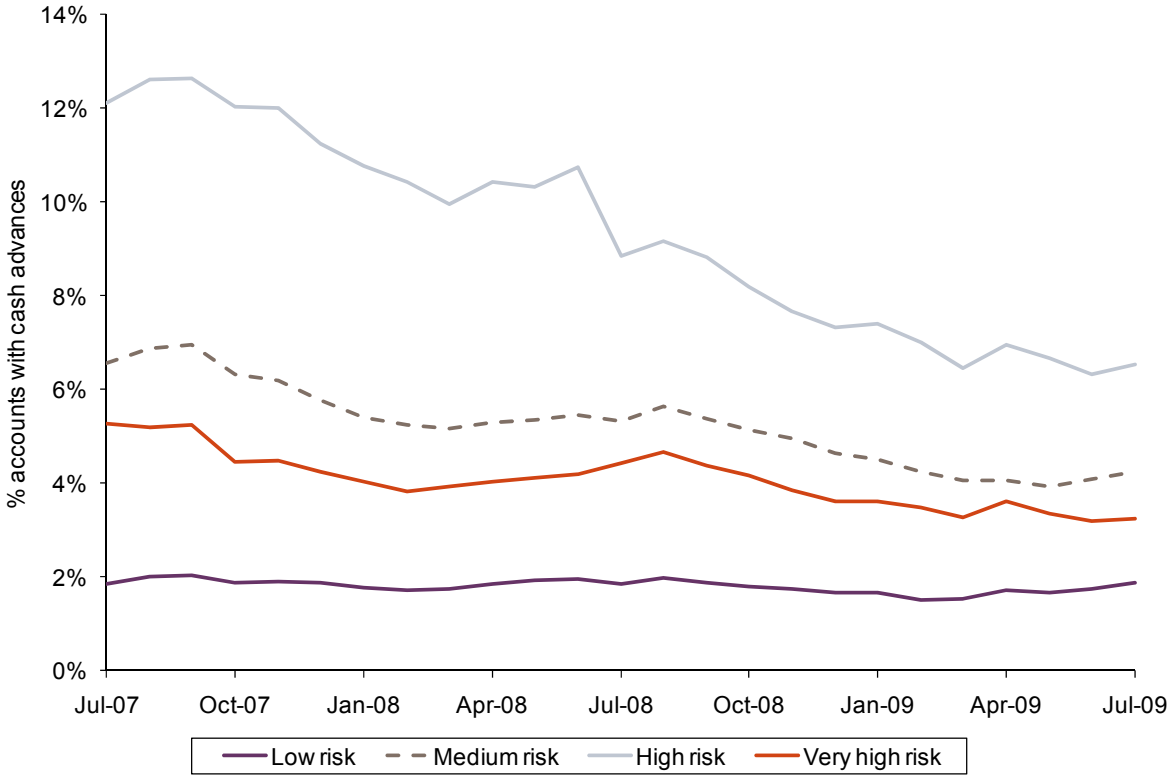
BIS appears to consider that the problem of indebtedness is particularly applicable to cardholders who hold both cash and non-cash balances, since cash attracts the highest rates of interest and is therefore paid off last.[67]

The number of cardholders making cash withdrawals on their cards is relatively small for low- and medium-risk accounts, and declining in all risk bands—see Figure 2.4.

[66] Argus (2010), 'UK Credit Card Payments Study', January, slides 18–19.

[67] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 100.

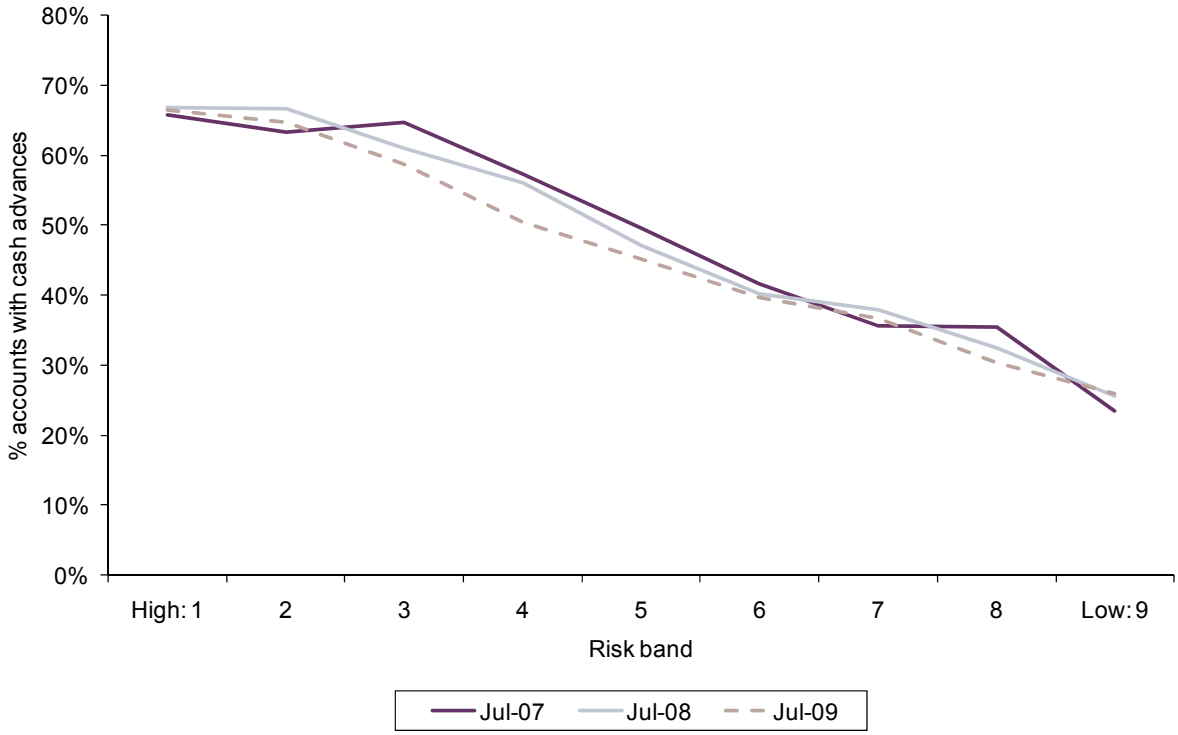
Figure 2.4 Cash advances by risk segments, July 2007–July 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 54.

Although the number of cardholders making cash withdrawals is declining, a large number of cardholders with revolving balances hold cash balances, as shown in Figure 2.5. For the riskiest band shown (risk band 1), the likelihood of having an active account with a cash advance balance is about 66–67%. This compares with about 24–26% for the lowest risk band account holders (risk band 9). The relatively large share of accounts with a cash balance (as opposed to withdrawing cash) reflects the fact that cash balances are paid off last.

Figure 2.5 Percentage of accounts with a cash advance balance among accounts revolving a balance by risk, Q2 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 62.

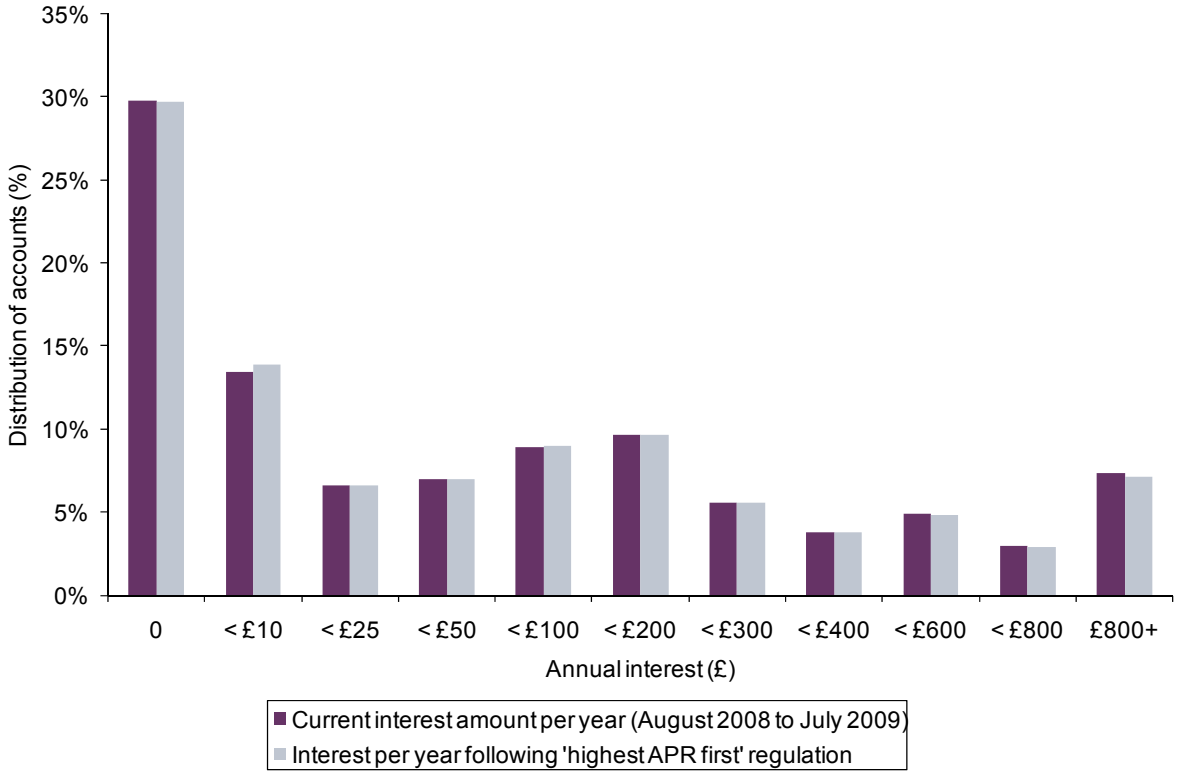
BIS considers that this group of cardholders is likely to be more vulnerable and less able to afford the interest rates charged on cash withdrawals; it accepts that higher interest rates on cash reflect the higher risk of these cardholders to issuers.[68]

Effect of reversing payment allocation

Figure 2.6 shows the share of all accounts (including transactors, cash users and those with promotional balances) paying different levels of annual interest under current and reversed payment allocation. The first point to note is that a significant share of cardholders (around 7%) pays more than £800 per year in interest. However, this share is hardly changed by reversing payment allocation. Figure 2.7 shows that 68% of accounts are unaffected by the reversal, and for another 20% their annual interest payments would change by less than £10 per year. Only 1.1% of accounts would save more than £90 per year from the reversal of payment allocation. This suggests that reversing the AoP will have only a limited effect.

[68] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 99–100.

Figure 2.6 Distribution of accounts by annual interest under current and reversed payment allocation



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 57.

Figure 2.7 Distribution of accounts by annual £ impact per account for 'highest APR first' regulation

Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 57.

2.3 BIS proposals

In contrast to the current method of allocating payments towards the balance with the lowest interest rate first, BIS has proposed the following alternatives.

– **Do nothing**.[69]

– **Greater information transparency**.[70] This would make it more explicit to consumers up front and/or in monthly statements that their payments are allocated to lower interest rate debt first, and the impact that this may have on indebtedness.

– **Allocating initial payments proportionately to all balances**.[71] Under this proposal, if a cardholder has a balance, of which half is promotional, 30% is transactions and 20% is cash, 30% of any payment would go towards the transaction balance and 20% to the cash balance; only half of the payment would go towards the promotional balance (instead of 100% currently).

– **Allocating initial payments to cash,[72] but not specifying the allocation of any subsequent payments**. If issuers did not make any changes other than placing cash balances at the top of the payment hierarchy, then, for a consumer with three balances, a payment would be allocated first to cash, then to the promotional balance and then to transactions.

– **Reversing payment allocation** (ie, paying off the most expensive debts first).[73] This would also typically mean paying off the cash balance first, if one exists, followed by transaction balances and finally promotional balances.

The following section discusses the impact of some of BIS's proposals.

2.4 Impact of proposals

A reversal of payment allocation would be likely to cause issuers to respond in order to compensate for the loss in revenue. There could be both an output effect and a price effect. On the output side, users of balance transfer deals could be most directly affected, as issuers may reduce the availability of balance transfer deals or the duration of those offers remaining. In the USA, the recent CARD Act has introduced partial reversal of payment allocation;[74] anecdotal evidence is that issuers are reducing both the duration and availability of balance transfer offers.

On the pricing side, issuers may increase balance transfer fees or post-promotional APR rates. It is also possible that 0% deals would be replaced by slightly higher rates. In the USA, anecdotal evidence suggests that 0% deals are no longer available to existing customers, fewer deals are available on new acquisitions, and some issuers have been raising balance transfer fees. Each of these changes could make the balance transfer product less transparent and less attractive to consumers.

Another possible reaction by issuers would be to increase the transactions APR associated with promotional accounts. Under current allocation practices, the effective interest earned

[69] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 111–12.
[70] Ibid., paras 113–16.
[71] Ibid., paras 117–22.
[72] Ibid., paras 129–33.
[73] Ibid., paras 123–28.
[74] The Credit Card Accountability Responsibility and Disclosure Act of 2009 reverses payment allocation for all payments made in excess of the minimum payment.

on balances in accounts with one promotional and one non-promotional balance is 1.58% per month. Under reverse allocation, the effective interest would fall by 25 basis points to 1.33%. To maintain the same revenue overall, issuers would need to raise the transactions APR for promotional accounts by 2.75 percentage points per year, to 17.56%.[75]

As discussed in section 2.2, BIS's rationale for proposing changes to current industry practice was based on a lack of consumer understanding, distributional concerns associated with balance transfers, and concern that the allocation method used by most issuers may contribute to overindebtedness. While the evidence on consumer understanding is inconclusive, BIS's other concerns in relation to payment allocation do not seem to be supported by the empirical analysis. In particular, this section has presented evidence suggesting that surfers impose a comparatively small cost on issuers and therefore present limited distributional concerns. Furthermore, reversing payment allocation has a limited effect on the size of interest payments incurred by cardholders.

The finding from the data that almost 90% of cardholders would save less than £10 a year from reversing payment allocation, and only 1.1% of cardholders would save over £90 a year, suggests that changing the payment allocation would not address the concerns BIS may have about the level of interest payments made by some cardholders. This also implies that none of the intermediate solutions (eg, proportional allocation or cash first) would be effective. Improving informational transparency, however, may be helpful in addressing a possible lack of consumer understanding.

[75] Argus (2010), 'UK Credit Card Payments Study', January, slide 58.

3 Minimum payment requirement

The minimum payment is the lowest amount a cardholder is required to pay of the outstanding balances each month. It is a feature of the credit card as a unique loan product which allows the borrower the flexibility to choose whether to pay just the minimum payment required in a month, or any amount above it up to the full outstanding balance. The minimum payment requirement covers, at least, the ongoing costs of credit provision, thereby avoiding negative amortisation,[76] and provides a mechanism for issuers to evaluate potential financial distress.

BIS is concerned that consumers making repeated minimum payments do not understand the implications; in so doing, they use a short-term product for long-term borrowing needs,[77] and pay off the debt slowly, incurring a high level of interest over the life of the loan.[78] Also, BIS notes that some consumers 'anchor' their views onto the minimum payment and latch onto it as an appropriate rate of repayment.[79] BIS is concerned about the impact that making repeated minimum payments may have on consumer indebtedness.[80] To address these concerns, BIS is proposing options ranging from improving information transparency to imposing a higher minimum payment rate.[81]

3.1 Current practice

Minimum payment requirements have historically been subject to industry self-regulation, which has evolved over time. In 2004, in testing consumer understanding of required minimum payments, the OFT found that, when presented with a simple hypothetical expenditure scenario, most consumers (60–62%) were not able to say what their minimum payment would be.[82]

In October 2004 the industry developed a 'health warning' to appear on customer credit card statements in order to deter cardholders from repeatedly making the minimum repayment. As per the guidelines of the UK Cards Association, the warning reads:

> If you make only the minimum payment each month, it will take you longer and cost you more to clear your balance.[83]

At the same time, issuers agreed that additional information should be included within pre- or post-contract information to explicitly highlight to the customer that the minimum repayment amount does not constitute a repayment schedule.

In February 2005, to assist those consumers who found themselves in financial difficulty, the UK Cards Association (then APACS) developed guidelines to direct card issuers to display a

[76] Negative amortisation occurs when the balance increases over time because payments are insufficient to cover the interest or other fees on the account.
[77] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 144.
[78] Ibid., para 145.
[79] Ibid., para 153.
[80] Ibid., paras 145 and 206.
[81] Ibid., para 163.
[82] Office of Fair Trading (2004), 'Credit card survey', prepared for the OFT by FDS International Ltd, March, p. 32.
[83] The UK Cards Association (2006), 'Best Practice Guidelines', Minimum repayment health warning. See: http://www.theukcardsassociation.org.uk/files/publications/exisiting_publications/cards/credit_cardminimumrepaymenthealthwarning.pdf.

warning message on all statements, including a telephone number for customers to contact if they require debt advice. This message reads:

> If you are unable to make the minimum payment please contact us as soon as possible by calling xx.[84]

The 2008 Banking Code requires that minimum payments should at least cover interest payments in order to prevent negative amortisation and to be consistent with the practice of responsible lending.

As mentioned by BIS,[85] some issuers go beyond what is required by the Banking Code and present scenarios showing how long it would take to pay off a given debt if only the minimum payment is made. This is in line with recommendations by the Treasury Select Committee in its 2003–04 report on the transparency of credit card charges.[86]

In practice, minimum payments vary by issuer. Most contractual minimum payment amounts tend to be 2–4% of the outstanding balance, or a minimum amount such as £5 or £10, whichever is greater. Furthermore, some issuers have started introducing higher minimum payments (for new cardholders). For example, some issuers have moved, or are considering moving, to a higher required rate of minimum payment which covers transaction fees, interest and about 1% of the outstanding credit card balance. This is in line with the Office of the Comptroller of the Currency requirements that negative amortisation be avoided and that debts be repaid in a 'reasonable amount of time'.[87]

The actual minimum payment required varies by risk type. As shown in Figure 3.1, the actual minimum payment required by very-high-risk cardholders is on average around 5%, and is above the average minimum payment required from low-, medium- and high-risk consumers, which has remained stable at about 3% over the past two years. These larger percentage payments by high-risk customers are partly a function of the 'floor' amounts discussed above and may also reflect a higher share of high-risk cardholders being on specially arranged payment plans.

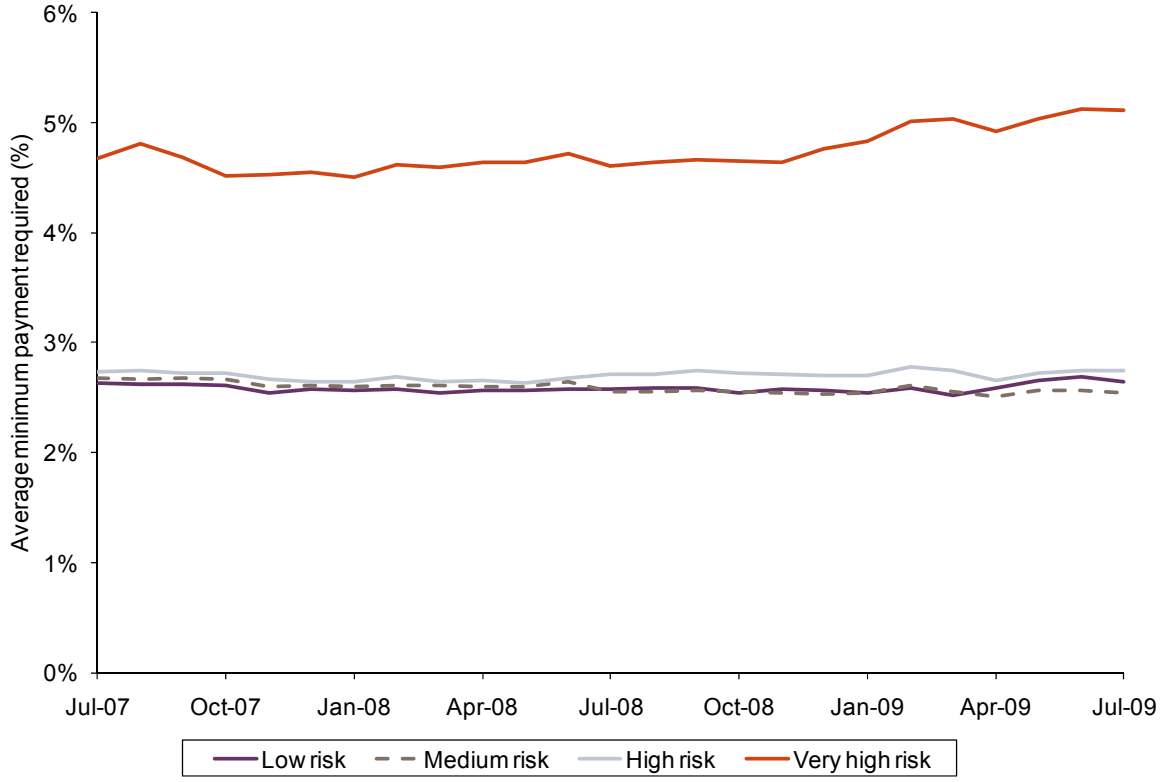
[84] The UK Cards Association (2006), 'Best Practice Guidelines', Debt advice health warning. See: http://www.theukcardsassociation.org.uk/files/publications/exisiting_publications/cards/credit_carddebtadvicehealthwarning.pdf.

[85] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 139.

[86] House of Commons Treasury Committee (2003), 'Transparency of Credit Card Charges', First Report of Session 2003–04, Volume 1, December, para 99.

[87] Comptroller of the Currency, Administrator of National Banks (2005), 'Comptroller Dugan Expresses Concern about Negative Amortization', press release, NR 2005-117, December 1st.

Figure 3.1 Average minimum payment required by risk segment, July 2007–July 2009

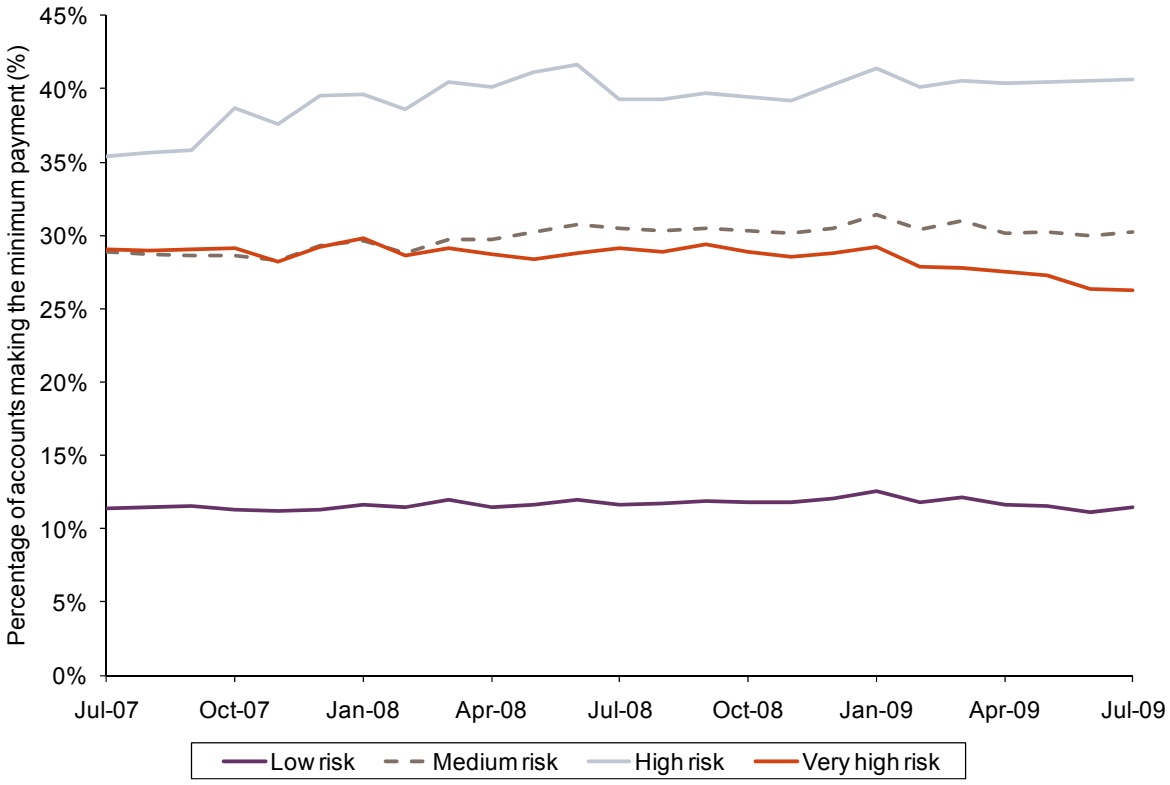


Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 248.

Overall, around 20% of cardholders made the minimum payment in any given month between July 2007 and July 2009.[88] Figure 3.2 shows that higher-risk customers are more likely to pay only the minimum required; for example, in each month in the period between July 2007 and July 2009 between 35% and 40% of high-risk customers made only the minimum payment, while the proportion of low-risk consumers who made only the minimum payment was much lower, at just over 10%. Very-high-risk customers were less likely than high-risk customers to make the minimum payment—this is a function of the greater number of very-high-risk customers being on repayment plans.

[88] Argus (2010), 'UK Credit Card Payments Study', January, slide 265.

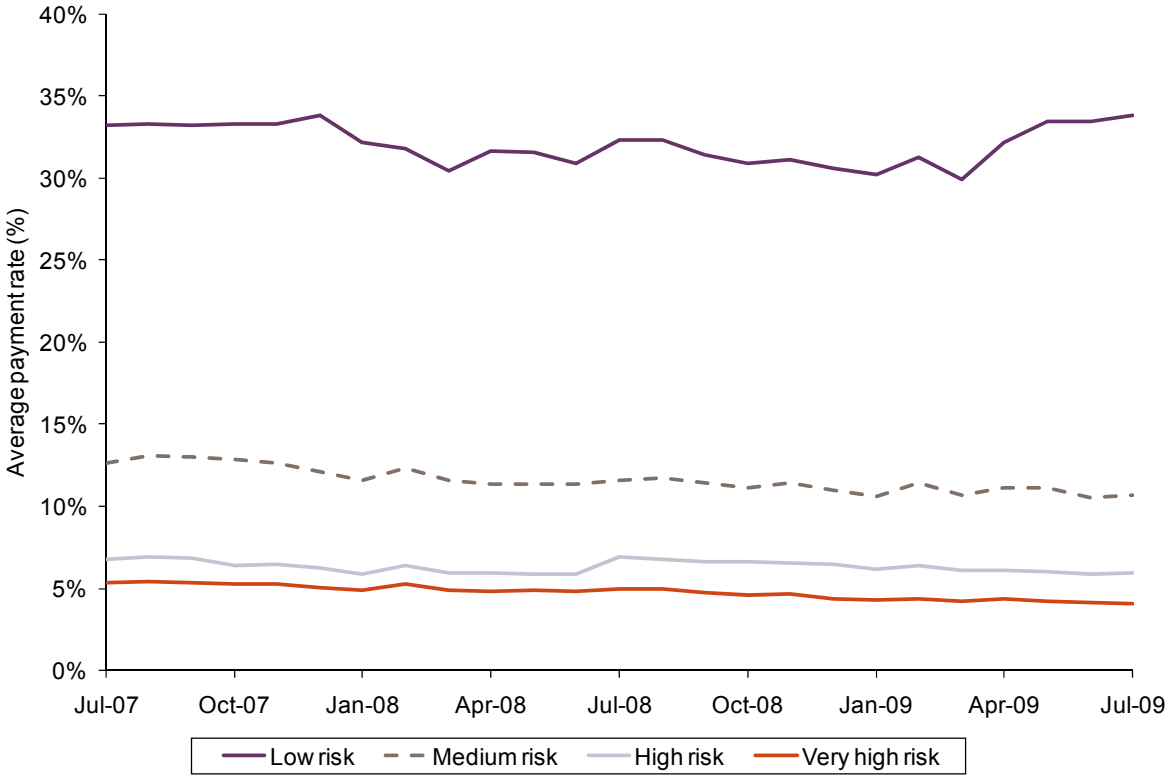
Figure 3.2 Percentage of accounts making the minimum payment in the month shown by risk segment, July 2007–July 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 249.

Figure 3.3 shows the actual payments made by different risk segments. As can be seen, for most risk segments, the actual payment rate is well above the minimum required for that segment (see Figure 3.1). On the other hand, the average payment rate for very-high-risk segments (4.8%) is approximately the same as the average required rate (4.7%). This is consistent with a large share of high-risk cardholders making the minimum payment each month (as shown in Figure 3.2); however, as discussed below, few people consistently make the minimum payment over multiple periods.

Figure 3.3 Average payment rate by risk segment, July 2007–July 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 248.

3.2 Rationale behind BIS proposals

BIS mentions two main reasons for intervention.

– **Lack of consumer understanding**. Consumers may not understand how long it will take to pay off the balance when only paying the minimum, or how much interest they will be paying. As such, some consumers making regular minimum payments, and revolving their credit card balances, may be using what should be a short-term facility for longer-term needs.[89]

– **Indebtedness**. BIS notes that cardholders who regularly make the minimum payment will end up paying more interest over the life of the loan. BIS also implies that the current level of minimum payment contributes to overindebtedness.[90]

These issues are addressed below.

3.2.1 Do consumers understand minimum payments?

BIS notes that some cardholders may not understand the implications of making the minimum payment. The implication is that BIS considers that some revolvers could afford to pay more, but that the minimum payment requirement acts as an 'anchor' and biases payments towards the minimum.

Consumer research conducted by GfK NOP provides some useful insights into the degree of consumer understanding of minimum payments and the reasons why consumers make the minimum.

[89] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 144.
[90] Ibid., para 206.

Although, when interviewed, around 43% of cardholders making the minimum payment did not remember what the percentage minimum payment on their card was,[91] most cardholders seem to have clear reasons for why they pay the minimum.

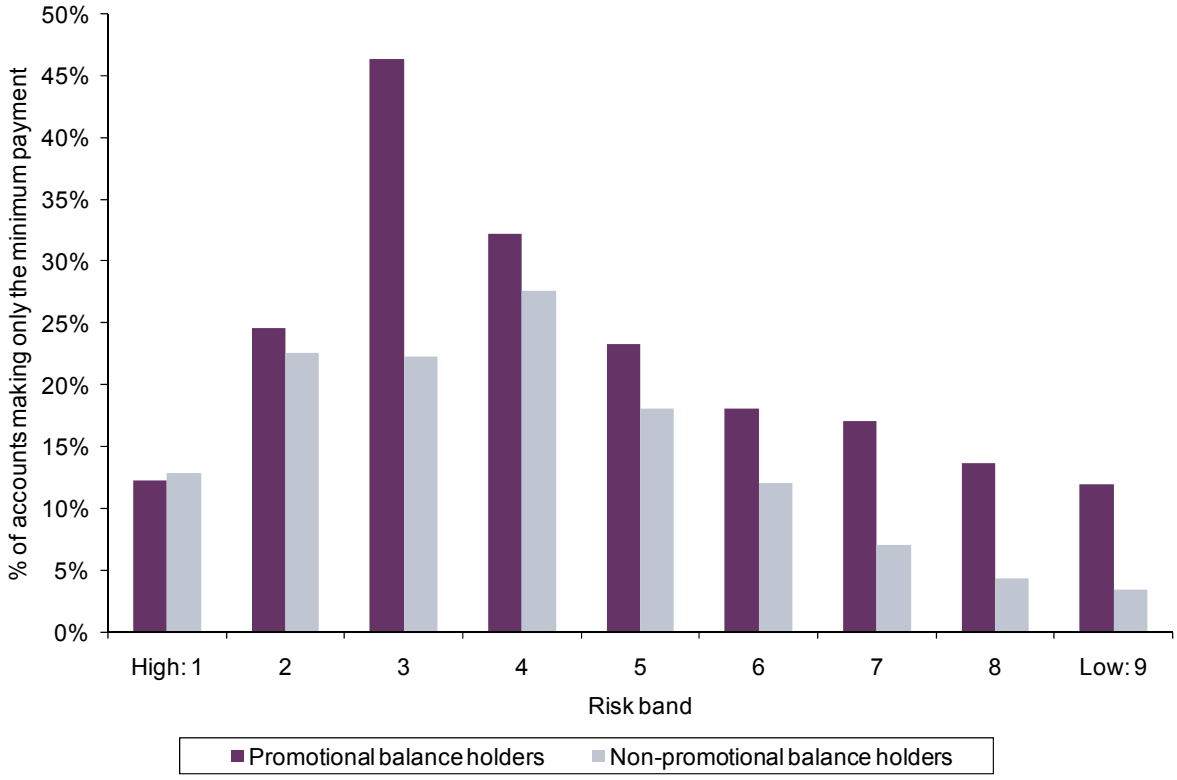
Of cardholders making the minimum payment, 15% did so because they had a promotional balance and wanted to take full advantage of this.[92] Another reason why some consumers may make the minimum payment is affordability. Of those who stated that they made only the minimum payment on at least one of their cards, 56% noted that this was because they could not afford to pay more.[93] Other consumers (24%) stated that they had more expensive debts elsewhere. If this is the case, this would also imply that making the minimum payment would be rational, although, for most households, credit card credit is typically more expensive than other forms of credit such as personal loans and mortgages. This could indicate that there may be some cardholders who could afford to pay more.

Empirical data from issuers is consistent with the finding that many cardholders make the minimum payment for rational reasons. For example, a large share of consumers who consistently made the minimum payment in Q2 2009 did so by direct debit (between 35% and 78%, depending on the risk band).[94] Cardholders with promotional balances would rationally pay only the minimum for the duration of the promotional period, as discussed above. Other cardholders may want to ensure that they do not incur late fees on the minimum, while also giving themselves the option to make additional payments at any time during the month.

Figure 3.4 below confirms that promotional balance holders are more likely to make only the minimum repayment across the risk bands. For example, in the least risky category, 12% of customers with promotional balances made the minimum payment in every month of Q2 2009 compared with around 3% of customers with non-promotional balances.

[91] GfK NOP survey, p. 37.
[92] Ibid., p. 31.
[93] Ibid, p. 36.
[94] Argus (2010), 'UK Credit Card Payments Study', January, slide 272.

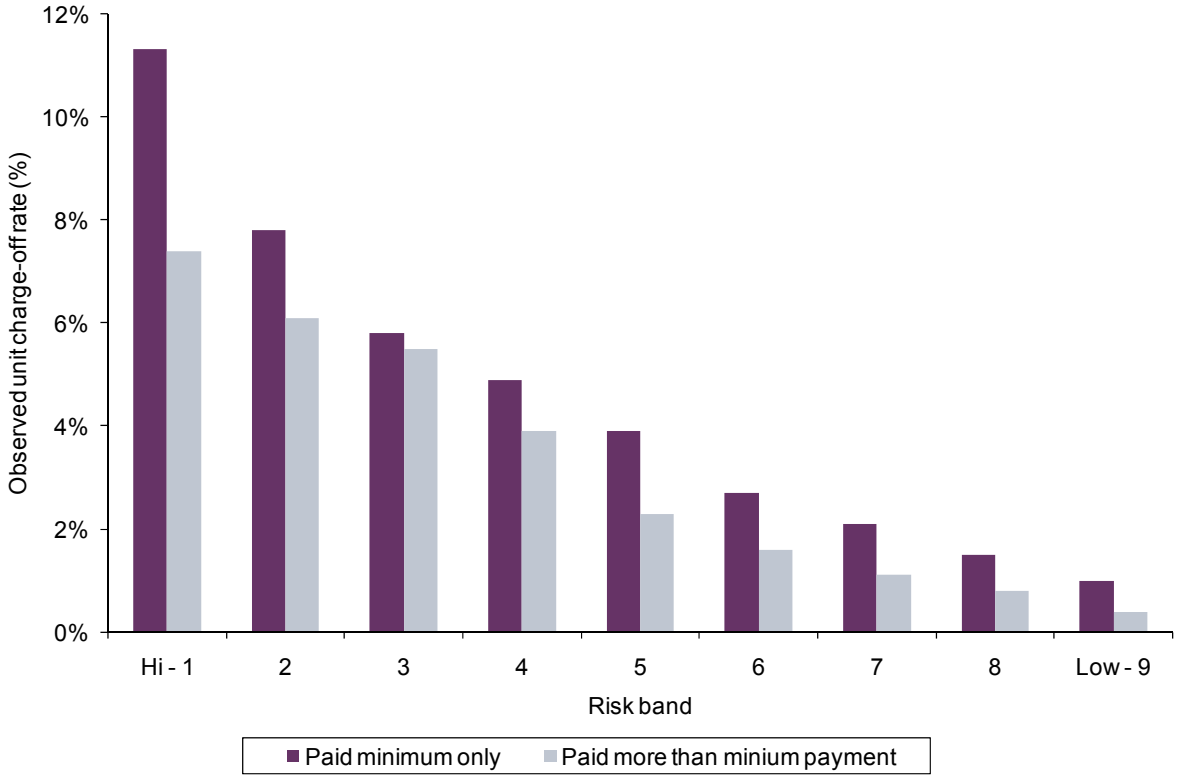
Figure 3.4 Percentage of accounts making only the minimum payment in Q2 2009, split by promotional balance status, by risk band



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 256.

Data on charge-off rates is also consistent with the survey finding that many consumers who make use of the option to pay the minimum do so for reasons of affordability. Figure 3.5 shows that the charge-off rate is higher for those who only made the minimum required payment each month in Q2 2008, relative to those who paid more than the minimum in each month. Indeed, for those accounts in the riskiest band in Q2 2008, the unit charge-off rate by Q3 2009 was 11% for those who made the minimum payment, but only 7% for those who made more than the minimum payment.

Figure 3.5 Observed unit charge-off rate by Q3 2009 for minimum payment status in Q2 2008, per risk band



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 259.

There is also evidence to show that most cardholders who pay the minimum do so only occasionally, which seems consistent with making the minimum payment for reasons of financial flexibility. Approximately 25% of accounts made a minimum payment at some point between July 2007 and June 2008, while 27% did so in the following year.[95] Only a small portion of these cardholders regularly make the minimum payment; in Q2 2009, 11.6% of accounts consistently made the minimum payment every month of the quarter.[96] For the year ending in June 2008, only 2.4% of cardholders made the minimum payment consistently over 12 months. The comparable figure for the year ending in June 2009 was 3.1%.[97]

Overall, the evidence suggests that the vast majority of cardholders who make the minimum payment have a rational reason for doing so. While the problem of 'anchoring' mentioned by BIS may still be relevant for some cardholders, it is not strongly supported by the survey evidence, so it is difficult to estimate its importance. However, it is clear that very few cardholders consistently make the minimum payment (not more than 3.1%) over a year. In other words, even if there were any anchoring, it is either a relatively small group of cardholders (not more than 3.1%) or they make only a limited number of minimum payments per year (which arguably may not be considered anchoring).

3.2.2 Does making the minimum payment increase indebtedness?

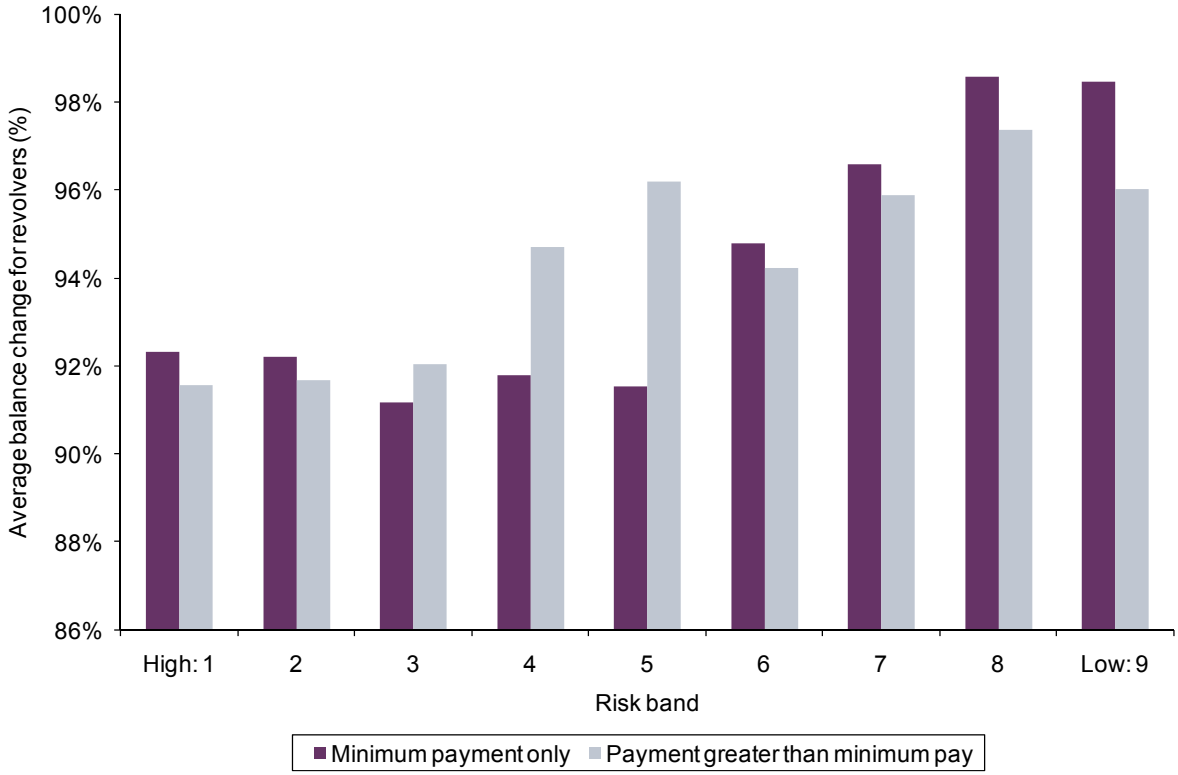
BIS has also expressed concerns that making the minimum payment could lead to increased indebtedness, partly due to the interaction between the minimum payment and the AoP to the cheapest balance first.[98] As discussed further below, BIS suggests that increasing the

[95] Argus (2010), 'UK Credit Card Payments Study', January, slide 267.
[96] Ibid., slide 3.
[97] Ibid., slide 312.
[98] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 145.

minimum payment could lead to a quicker reduction in balances and therefore a reduction in the amount of interest paid.

Figure 3.6 shows the change in balance over the year ending Q2 2009 for cardholders making the minimum payment in every month of Q2 2008. For all risk bands, even those paying the minimum manage to reduce their balances over a year. The figure also shows that, for low- and high-risk bands, cardholders who paid more than the minimum in each month of Q2 2008 see a greater reduction in balance over the year, as one would expect. Somewhat surprisingly, for risk bands 3, 4 and 5, cardholders paying the minimum in Q2 2008 had managed to pay off more of their balance over the following year compared with those making more than the minimum payment in Q2 2008. This may be indicative of greater volatility in payment levels among these risk bands.

Figure 3.6 Average percentage balance change for revolvers from Q2 2008 to Q2 2009 by Q2 2008 payment status, by risk band



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 311.

Part of the reason for BIS's concern about indebtedness stems from the amount of time it can take to repay debts. BIS has indicated that it would take 29 years and three months to pay off an average balance of £1,856 using a 2% minimum payment, but that this would fall to eight years and one month if the minimum payment were raised to 3%.[99] It is indeed the case that paying just the minimum means that it takes longer to pay off the balance.

However, this concern does not seem to be supported by the data. In practice, cardholders pay more than the minimum—Table 3.1 shows that even those in the highest risk band pay around twice the minimum, on average. Using actual balances, payment rates and APRs,

[99] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 195.

payment periods range from 0.9 years for risk band 9 (the lowest risk band) to 11.8 years for risk band 1 (the highest risk band).[100]

Arguably, there could be some cardholders who have a much lower payment rate than the average per risk band in Table 3.1. However, the data shows that there are very few who consistently make the minimum payment even over 12 months (3.1% in the year ending June 2009).[101] Therefore, paying the minimum for an extended period such as BIS's 29-year estimate would not seem a realistic scenario.

Table 3.1 Estimated amortisation period by risk band, based on current balances, APRs and payment rates

Risk band	Current balance (£)	Current payment rate (%)	Current APR (%)	Expected amortisation period in years
High 1	3,006	4.2	17.5	11.8
2	2,860	6.0	19.3	8.0
3	2,901	6.0	19.2	8.0
4	2,764	7.8	19.2	6.0
5	2,520	10.8	17.7	4.3
6	2,388	13.3	17.0	3.4
7	1,829	20.7	16.5	2.2
8	1,538	27.6	16.0	1.6
Low 9	1,184	43.5	16.4	0.9
Overall	2,015	17.5	17.1	2.6

Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 298.

3.3 BIS proposals

The options proposed by BIS to address its concerns are as follows.

– **Do nothing**.[102] Under this option, BIS would take no further action, but notes that the OFT's Irresponsible Lending Guidance, due to be published in March 2010, may place requirements on lenders.[103]

– **Improve information transparency**.[104] Under this option, issuers may be required to disclose to cardholders at the start of the credit relationship, and/or on periodic statements, information setting out more explicitly the consequences of regularly making only the minimum payment.[105] As examples of the types of information required, BIS suggests that statements could show total spending, total payments to date, a calculation of the time to repay the full balance at the minimum payment level, or the current rate of payment.[106]

[100] Argus (2010), 'UK Credit Card Payments Study', January, slide 298.
[101] Ibid., slide 312.
[102] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 164–65.
[103] Ibid., para 164.
[104] Ibid., paras 166–80.
[105] Ibid., para 166.
[106] Ibid., para 168.

– **Set a recommended minimum payment**.[107] BIS suggests that, under this option, a 'recommended' minimum payment could be established at a level higher than the current contractual minimum payment, which would ensure that debts are repaid in a 'reasonable' amount of time, assuming no further spend.[108] The recommended minimum payment could be set voluntarily by industry,[109] or agreed jointly between issuers and consumers.[110]

– **Increase the minimum payment**.[111] With this option, BIS proposes that the minimum payment for all cardholders (or for a specific sub-set of cardholders) would increase. This is intended to allow for repayment of the existing balance over a shorter time period with a lower level of interest over the lifetime of the loan.[112] However, BIS acknowledges that an increase in the minimum payment could lead to consumers experiencing short-term repayment difficulties.[113]

The section that follows focuses on examining the impact of raising the minimum payment, but also touches on some of the other options.

3.4 Impact of BIS proposals

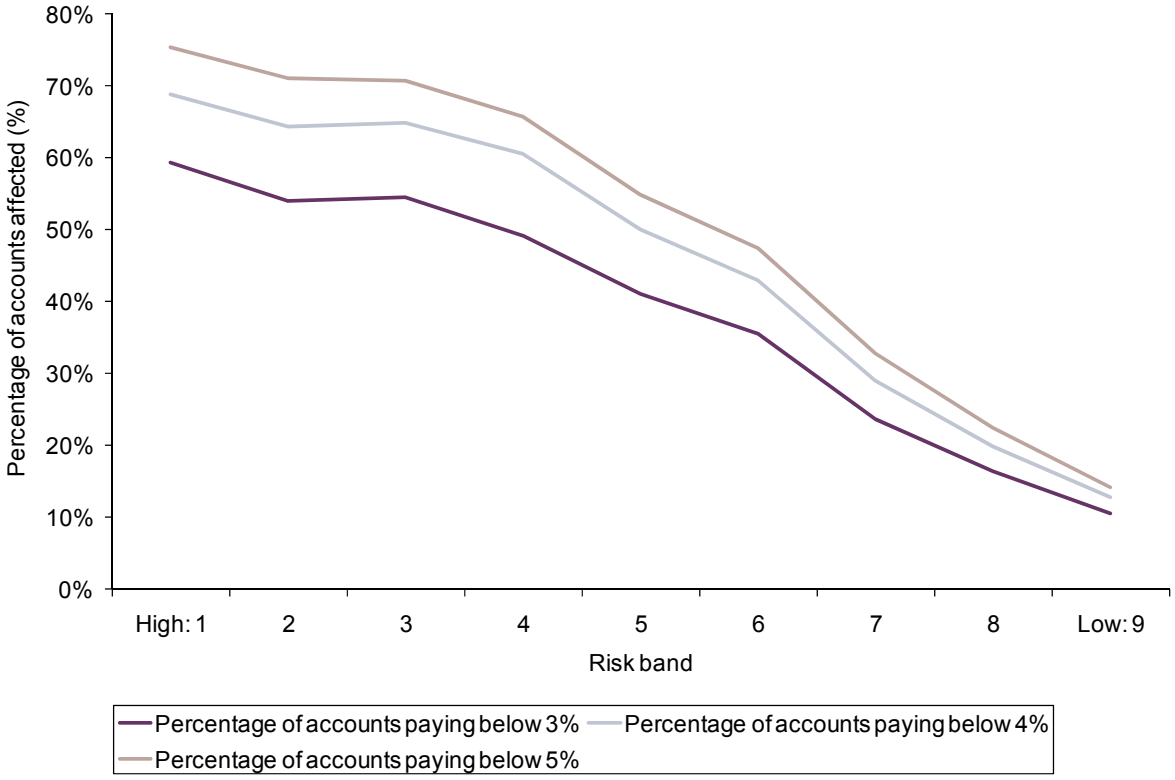
Increasing the required minimum payment may actually exacerbate financial difficulties for some cardholders, at least in the short or medium term, as recognised by BIS.[114] Approximately 30% of cardholders in March and June 2009 paid less than 3% of their balances, and so would be affected by an increase in the minimum payment to this level. As would be expected, high-risk and high-utilisation accounts are the greatest affected.

The survey evidence is consistent in showing that, for those consumers who make minimum payments, an increase in the required rate of repayment would lead to difficulty. When asked whether the consumer would still be able to make minimum payments if the rate were doubled, 39% replied in the affirmative, but 10% said that they already incur difficulties in meeting the minimum payment, and a further 51% identified that they either 'might' or 'would definitely' find it difficult to meet the increased minimum repayment.[115] While these figures are likely to be inflated by the economic downturn, they do suggest that a significant number of people would potentially be negatively affected.

Figure 3.7 summarises the number of accounts that would be affected by raising the minimum payment to 3%, 4% and 5%. As can be seen, approximately three-quarters of the highest-risk accounts would be affected if the minimum payment were raised to 5%.

[107] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 181–93.
[108] Ibid., paras 181–83.
[109] Ibid., para 182.
[110] Ibid., para 184.
[111] Ibid., paras 194–210.
[112] Ibid., para 194.
[113] Ibid., para 201.
[114] Ibid., para 198.
[115] GfK NOP survey, p. 43.

Figure 3.7 Accounts affected by 3%, 4% and 5% required minimum payment, by risk band

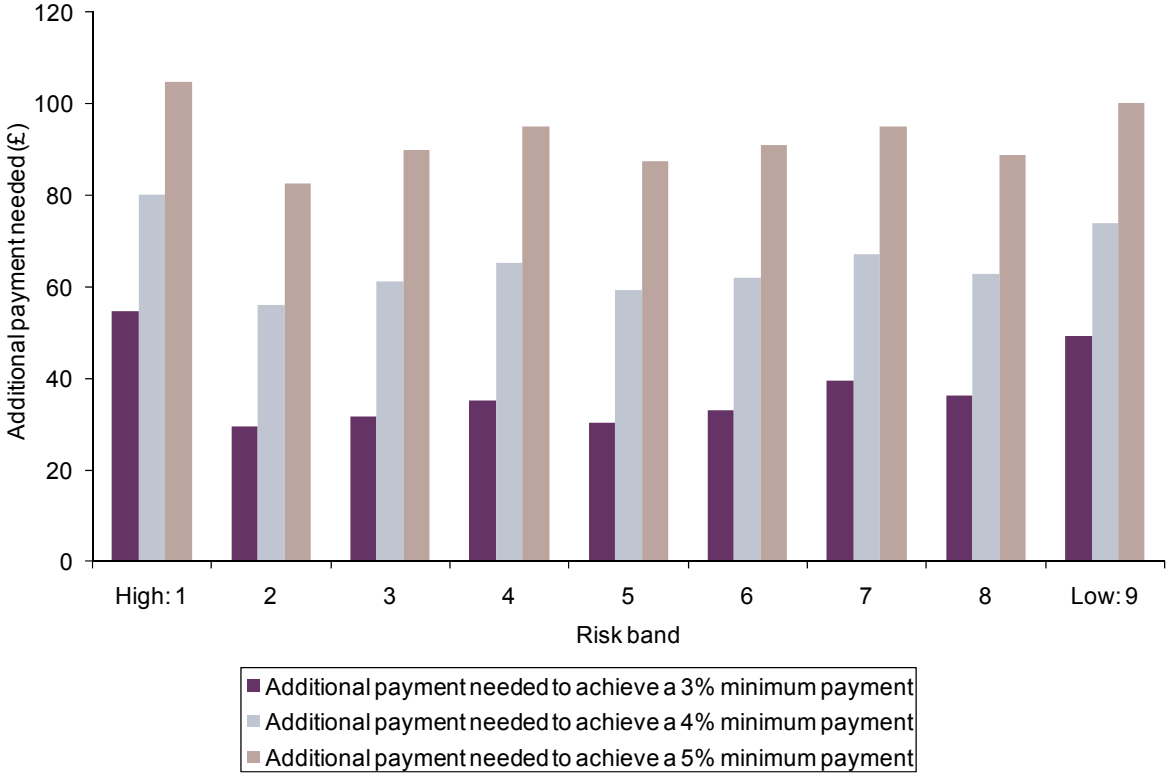


Note: Calculated as the average of March and June 2009 data.
Source: Argus (2010), 'UK Credit Card Payments Study', January, slides 321–323.

It is also relevant to examine the amount by which the minimum payment would increase each month, given the actual balances held by cardholders in different risk bands. Figure 3.8 shows the impact on the monthly payment of raising the minimum payment to 3%, 4% and 5% for affected accounts affected, by risk band. Raising the minimum payment to 3% would increase average monthly payments by around £38 across risk bands, while the respective figures for 4% and 5% are £65 and £93. For some cardholders, it is likely that these extra payments would be unaffordable, as recognised by BIS.[116]

[116] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 198.

Figure 3.8 Additional payment needed to achieve a 3%, 4% and 5% minimum payment for those currently paying less, by risk band, Q2 2008



Source: Argus (2010), 'UK Credit Card Payments Study', January, slides 279–281.

Raising the minimum payment rate reduces somewhat the financial flexibility that is valuable to those cardholders who are rationally paying the minimum amount while they are on a promotional offer, or are repaying more expensive debt elsewhere.

As discussed in section 3.2, BIS's rationale for proposing additional regulation in relation to minimum payments was based on a lack of consumer understanding and concern that the current system may contribute to overindebtedness. This section has presented evidence suggesting that most consumers have rational reasons for making the minimum payment and that relatively few do so on a regular basis.

The less consumers pay each month, the longer it takes them to repay their existing debt, and the more interest is incurred. The problem, however, is likely to be the initial level of indebtedness, and it is unclear whether raising the minimum payment is the best way to encourage consumers not to incur this debt. Furthermore, raising the minimum payment could have effects on those cardholders currently paying more than the minimum but less than the full amount.

Counter-intuitively, perhaps, a study based on 126,000 credit card statements found that higher minimum payments (3% versus 2%) are associated with an increased likelihood of making the minimum payment. As noted by the author, this finding is still under investigation, but suggests that the ramifications of changing the minimum payment extend well beyond those currently paying the minimum.[117] It also suggests that introducing some form of 'recommended minimum' payment could cause some cardholders currently paying amounts in excess of the recommendation to pay less. This potential 'anchoring effect' is recognised

[117] Stewart, N, Matthews, W., Navarro Martinez, D. and Harris, A. (2009), 'A model of credit card repayment', The University of Warwick, December.

by BIS, along with the complexity of communicating the mechanics of the scheme to consumers.[118]

Arguably some of the negative effects of raising the minimum could be addressed by increasing the minimum payment only for new cards. However, this could raise other concerns. For example, it may make it more difficult for some cardholders who occasionally or frequently pay the minimum payment to switch card issuers, since this would require them to pay a higher minimum payment. In particular, this could affect the more vulnerable cardholders who pay the minimum because they cannot afford to pay more.

It may be that improving information transparency would make more consumers aware of the detrimental impact of making repeated minimum payments, as well as potentially countering the 'anchoring effect' mentioned above. However, the provision of additional information would need to be done sensitively since some studies have found that more information does not always lead consumers to make better decisions (ie, consumers may be confused due to perceived information overload).[119] This would require consumer testing and a clear analysis of the costs and benefits to the consumers.

[118] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 186–191.

[119] For example, an OFT (2004) study found that 'too much information' was cited as the second most popular reason for why consumers couldn't understand a sample credit card agreement. See OFT (2004), 'Credit card survey', prepared for the OFT by FDS International Ltd, March,

4 Unsolicited credit limit increases

Under current industry practice, a credit limit (the maximum a customer may borrow on a credit card) is set for a new account largely on the basis of customer characteristics 'visible' to issuers at the time of application. As the issuer learns more about the customer's risk profile—for example, by monitoring expenditure and repayment patterns—this limit tends to increase over time. Known as 'low and grow', this policy is particularly important in facilitating the extension of credit to higher-risk customers.

BIS is concerned that unsolicited credit limit increases (UCLI) lead to higher balances than cardholders would choose to hold[120] and implies that this could lead to financial difficulty and/or indebtedness,[121] especially among vulnerable groups. [122] Therefore, BIS is proposing a range of changes, from offering better information regarding UCLI, to potentially banning them.[123] This section evaluates existing practices, the rationale for BIS's proposals and the likely effects of banning UCLI.

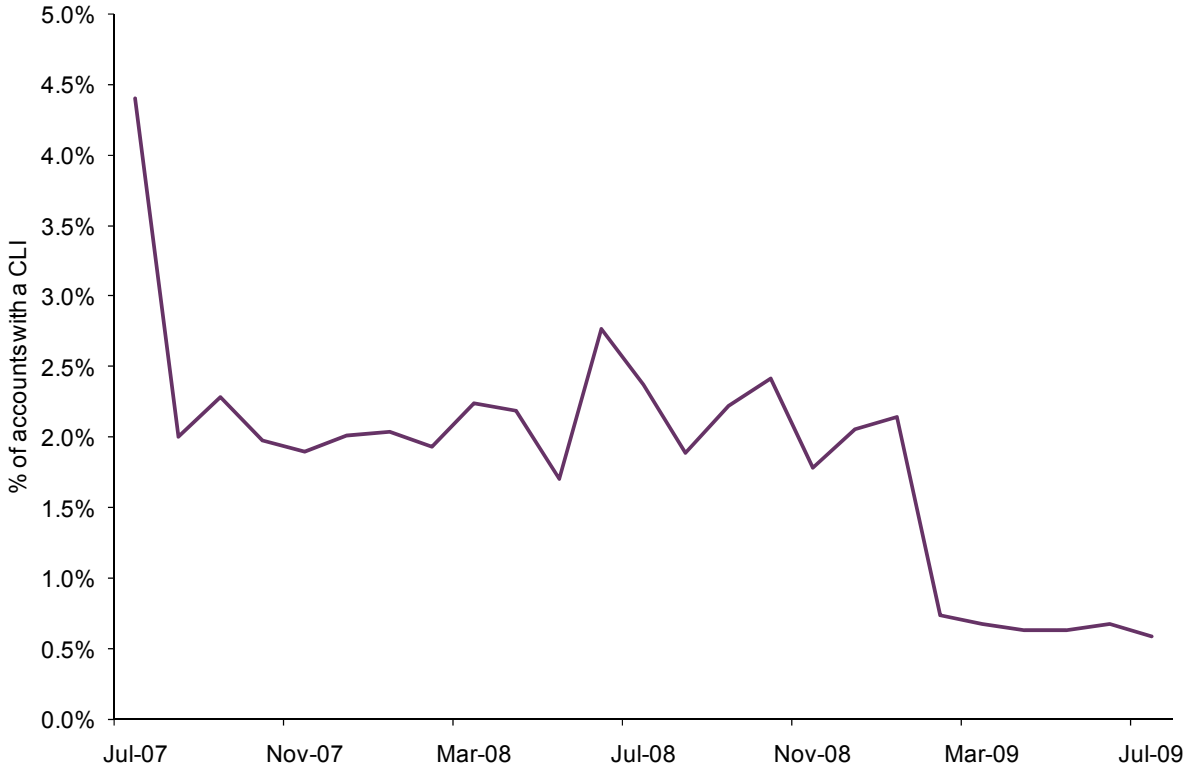
4.1 Current practices

Credit limits, the contractual maximum that credit card holders may borrow, are set individually on application, but may be increased at the issuer's discretion. If done without the cardholder's request, this is known as an unsolicited credit limit increase. Confidential returns from issuers show that, in aggregate, around 85% of credit limit increases (CLI) were unsolicited in the first ten months of 2009. Over this period, 3.5m accounts received UCLI, compared with 0.6m accounts that received a CLI after an increase had been requested by the cardholder (ie a solicited increase). A further 1.1m customers requested an increase but were declined. This highlights that there is some degree of adverse selection—high-risk cardholders are more likely to ask for an increase in credit limit than lower-risk cardholders.

Between July 2007 and July 2009, an average of 1.85% of accounts received CLI each month—the annual rate was 27.4% in the year ending June 2008 and 18.2% in the year ending June 2009.[124] This data, supplied by Argus, does not distinguish between solicited and unsolicited CLI. The average limit increase for these cardholders has been £1,055. As shown in Figure 4.1, the number of CLI granted declined sharply in 2009 in response to the economic downturn.

[120] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, paras 223–224, October.
[121] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', para 4.6, October.
[122] Ibid., para 234.
[123] Ibid., para 236.
[124] This is consistent with the figure of 20% in the past 12 months given by BIS in the Economic Impact Assessment (para 212).

Figure 4.1 Percentage of accounts with credit limit increases



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 71.

CLI are currently governed by industry best-practice guidelines that have been in effect since December 31st 2005.[125] These guidelines specify some of the checks that issuers must perform before granting CLI (unsolicited or otherwise), in order to ensure that CLI are given only to those cardholders who can afford it. In particular, no limit increases should be given to accounts in arrears, and credit checks must be with reference to both internal and external information (from credit reference agencies), rather than just account performance data.

The guidelines also seek to ensure that consumers are properly informed about any limit increases on their accounts, and that they are aware that they can decline any increases given. Consumers may also proactively contact issuers to opt out of any future CLI, or even request a credit limit decrease.

Credit limits can thus be moved up or down on a solicited or unsolicited basis. As discussed further below, UCLI are used to facilitate a number of practices associated with responsible lending, including 'low and grow' policies for high-risk lenders and debt consolidation.

All increases, whether solicited or unsolicited, must be accompanied by a credit check to assess affordability. On the other hand, issuers must honour solicited decreases (ie, where the customer requests that a limit be lowered). The ability to change limits both upwards and downwards is part of what makes credit cards a flexible product; credit limits can be tailored to cardholders' needs.

4.2 Assessment of rationale for changes

BIS cites two main concerns in relation to UCLI.

[125] The UK Cards Association (2006), 'Best Practice Guidelines', Credit card limit increases, http://www.theukcardsassociation.org.uk/files/publications/exisiting_publications/cards/creditcardlimitincreases.pdf

– **Lack of consumer understanding of credit limit increases**. BIS suggests that consumers may not have sufficient control over their credit limits since they may not understand how they are set or that increases can be declined.[126] Alternatively, consumers may behave impulsively.[127] Both of these factors could lead them to spend and borrow more than they intend.

– **Indebtedness**. BIS expresses concern that UCLI may be associated with financial difficulty and indebtedness,[128] noting that, to the extent that UCLI may be associated with financial difficulty, especially among vulnerable consumers, there may be a case for intervention.[129]

These concerns are clearly related. A lack of consumer understanding of CLI or a lack of self-control which leads consumers to spend and borrow more than they intend may contribute to indebtedness. This section presents empirical survey evidence to evaluate consumers' understanding of UCLI and on the empirical effect of granting CLI on consumer spending, balances and delinquency.[130] In particular, the profile of cardholders receiving CLI is examined, alongside the role of UCLI in responsible lending in order to establish whether vulnerable consumers may be particularly affected.

4.2.1 Are vulnerable consumers receiving UCLI?

One element of assessing whether consumers are being encouraged to spend more than they intend, and are thereby potentially getting into financial difficulty, is to examine the profile of consumers receiving CLI. The issuer guidelines described above should mean that consumers who are unable to afford more credit are not given CLI.

Figure 4.2 shows that between 0.87% and 9.24% of accounts in each risk band received a CLI in the second quarter of 2008. The highest-risk accounts (band 1) were the least likely to receive a CLI; only 0.87% of accounts in that category received an increase, some of which may have been solicited rather than unsolicited. As explained above, issuers' data indicates that around 85% of CLI are unsolicited.[131] Issuers explained to Oxera that a large proportion of the requests are from high-risk cardholders—the aforementioned estimate of 0.87% refers to CLI and therefore overestimates the actual percentage of UCLI.

Figure 4.3 shows the distribution of accounts receiving an increase. Comparing Figures 4.2 and 4.3 shows that low-risk accounts make up the largest share of accounts receiving a CLI, even though only a relatively small share (7.2%) of those in the lowest-risk category receive a CLI. This is because 34% of accounts are in the lowest-risk band.[132]

[126] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, para 228, October.

[127] Ibid., para 232.

[128] Ibid., para 228.

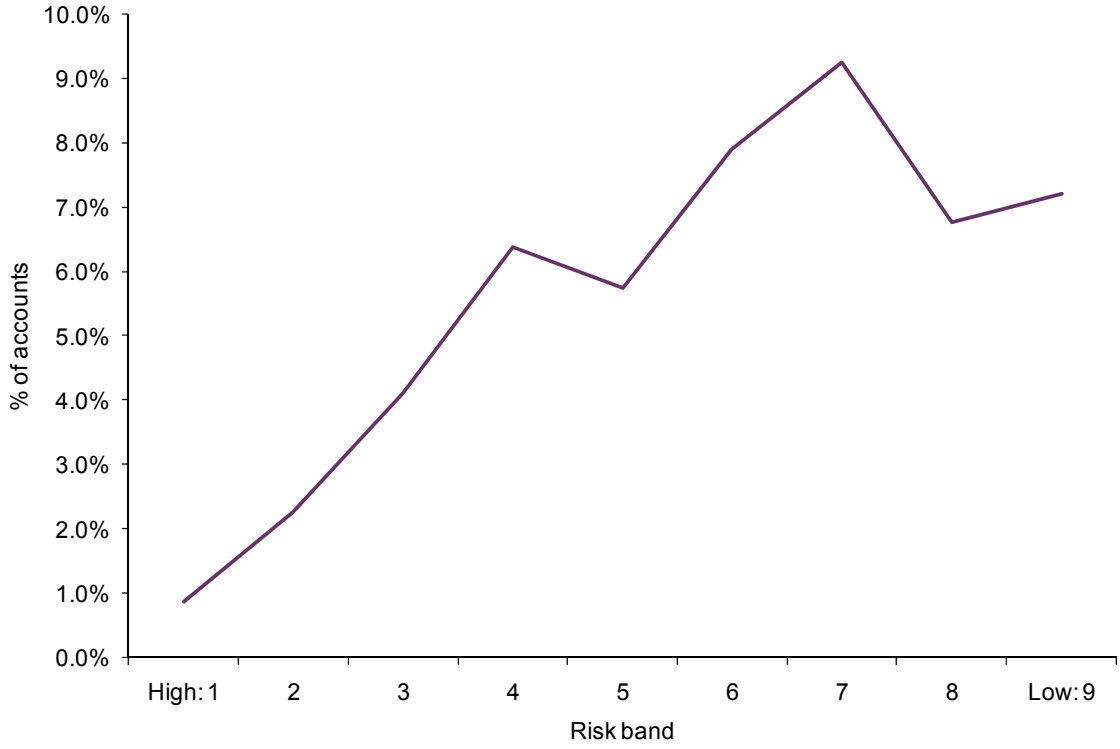
[129] Ibid., para 234.

[130] The nature of the Argus data is such that it is not possible to distinguish between a solicited or unsolicited credit limit increase. Thus, while it is possible in a survey to ask customers whether an increase was unsolicited, in examining the behaviour of customers who have received a CLI, it is not possible to distinguish between the behaviour of those receiving a solicited versus an unsolicited credit limit increase.

[131] Based on the first ten months of 2010.

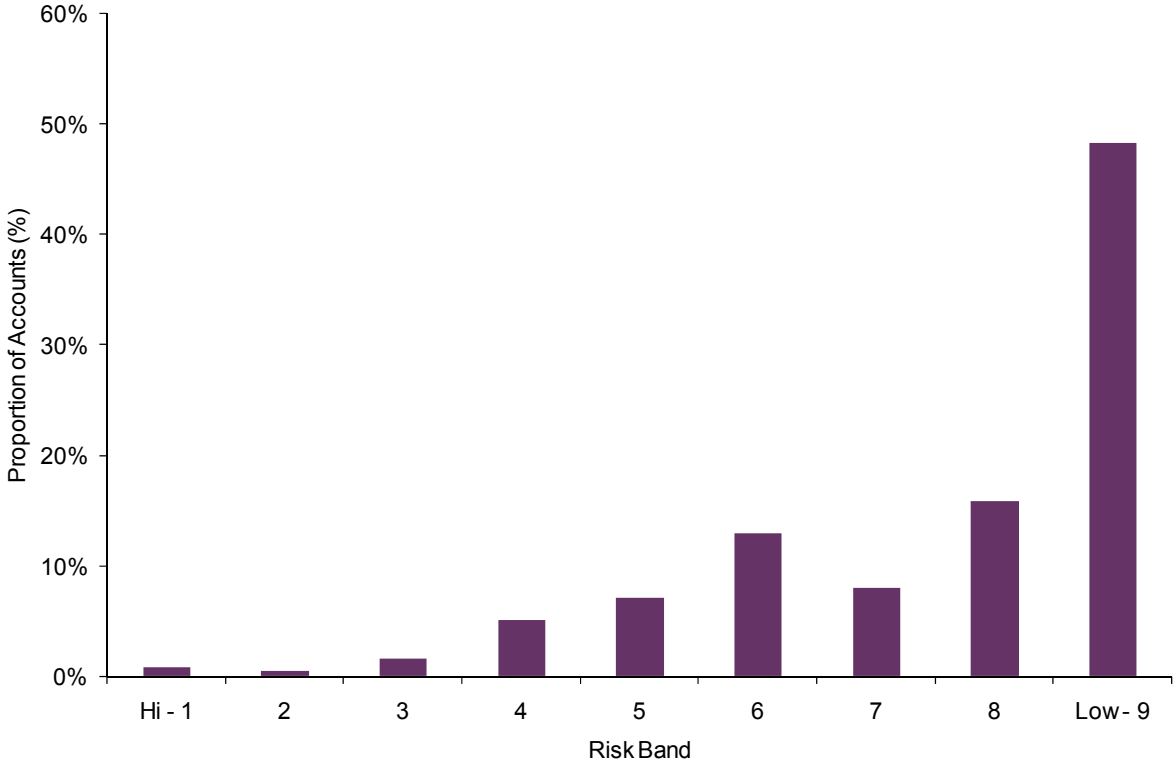
[132] Argus (2010), 'UK Credit Card Payments Study', January, slide 152.

Figure 4.2 Percentage of accounts with a credit limit increase by risk, Q2 2008



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 96.

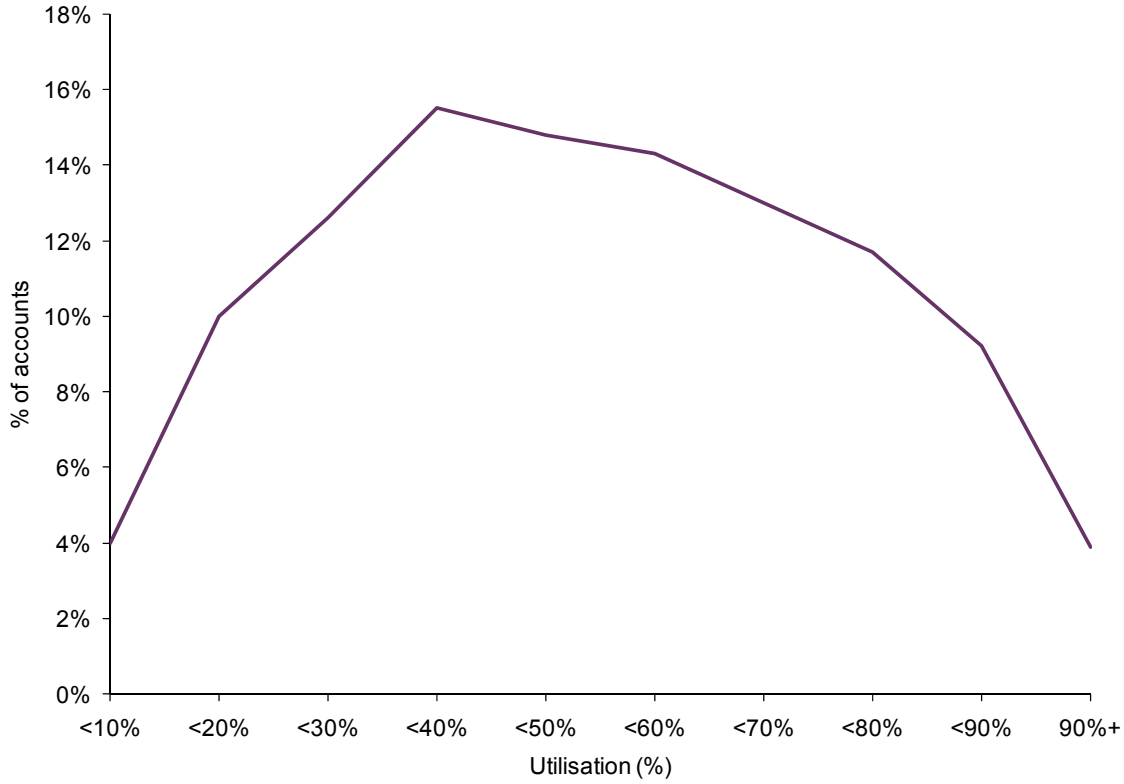
Figure 4.3 Distribution of accounts receiving a limit increase by risk band, Q2 2008 (%)



Note: The level of CLI for high-risk bands is likely to overstate the degree of UCLI in this band because some cardholders in this band are likely to have requested increases.
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 74.

The data also shows that accounts with a medium level of utilisation are more likely to receive limit increases. Figure 4.4 illustrates that accounts with either very low or very high utilisation rates are unlikely to receive CLI. This is not surprising: accounts with very low utilisation would be unlikely to use any portion of a limit increase and so it would not be rational for the issuer to incur the capital charge associated with the higher limit. (Regulation requires issuers that are banks to put aside a certain amount of capital in line with the credit limits across their whole portfolio.) Accounts with high utilisation would be likely to use a CLI, but may be too risky and would not meet responsible lending criteria.

Figure 4.4 Percentage of accounts with a CLI by utilisation, Q2 2008

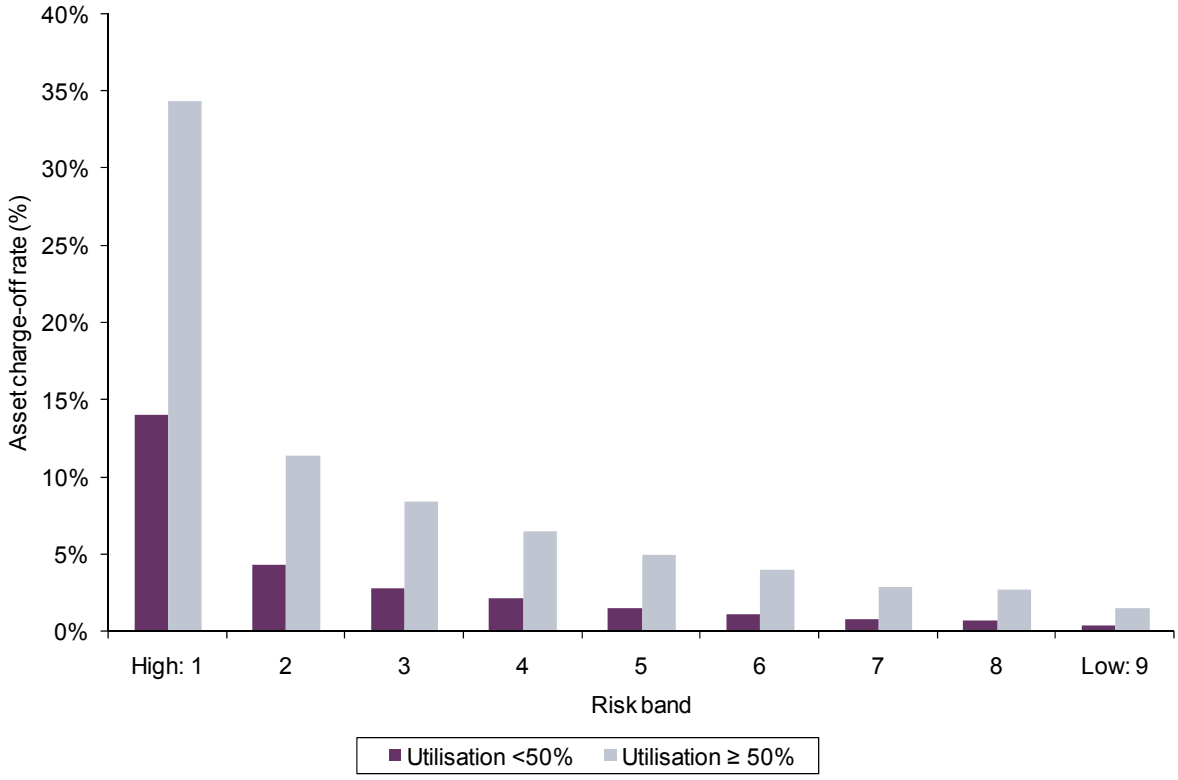


Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 98.

The rationale for not giving limit increases to higher utilisation accounts is that accounts with a higher utilisation rate experience considerably greater loss rates across all risk bands. Within each risk band, higher utilised accounts are much more likely to go into arrears in the following year than lower-utilised accounts. This is illustrated by Figure 4.5, which shows that, for accounts with utilisation rates in excess of 50% in mid-2008, across the risk bands highly utilised accounts were more likely to have defaulted by Q3 2009 than those accounts that had shown lower utilisation rates a year earlier.

In summary, the analysis shows that CLI are mainly targeted at customers in lower risk bands.

Figure 4.5 Observed asset charge-off rate by Q3 2009 for utilisation status in July 2008 per risk band



Note: Analysis for accounts from Q3 2008 to Q3 2009, based on accounts with good standing as at Q2 2008.
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 162.

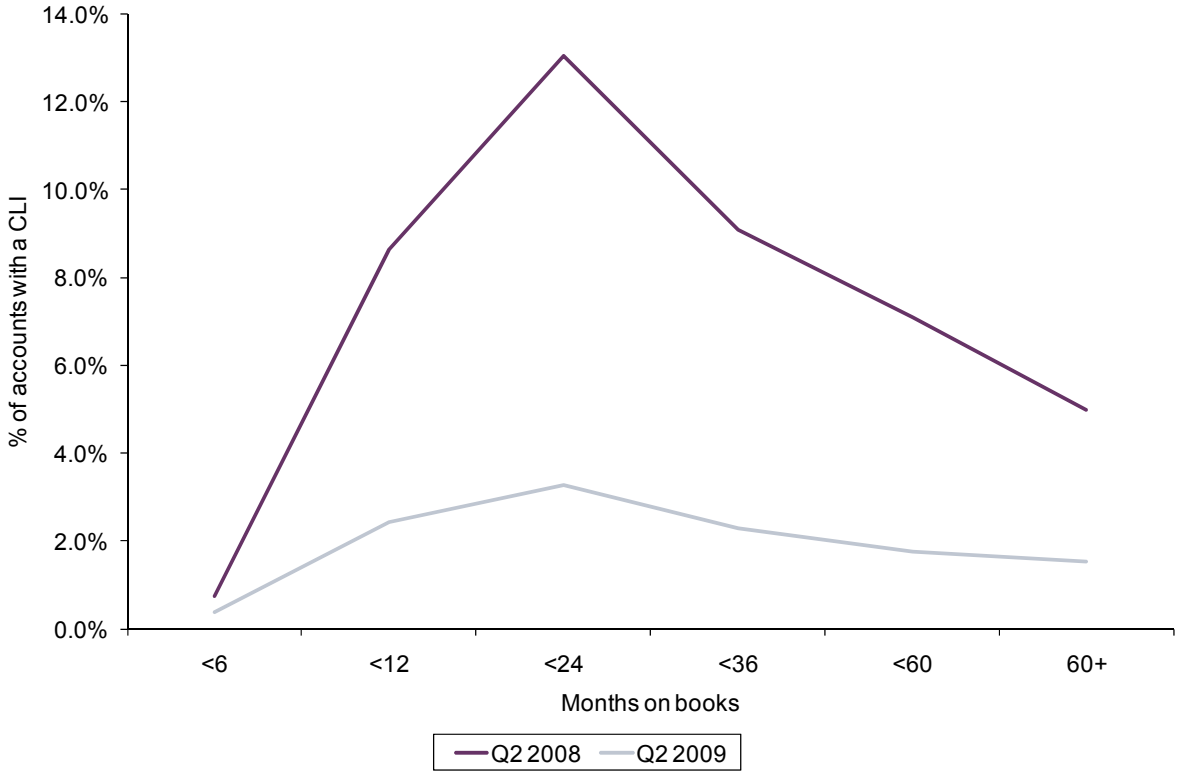
4.2.2 Are UCLIs consistent with responsible lending?

This section examines the role of UCLI in responsible lending more generally, having considered the profile of accounts that are being given increases.

Low and grow

As shown in Figure 4.6 below, most increases are granted to mature accounts, whether high- or low-risk, on the grounds that a card issuer will have more limited information about the risk profile of an applicant than about a mature card user. In the case of a monoline issuer, only information from external credit reference agencies is typically available, while high-street banks may have additional information on applicants who are also current account holders. Given that less information is available, it is common practice for issuers to grant a given applicant an initially low limit. As the issuer learns more about the customer's risk profile, expenditure and repayment patterns, this limit may increase over time.

Figure 4.6 Percentage of accounts with a CLI by number of months on books



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 76.

Being able to grant an initially conservative credit limit and then increase it later (known as 'low and grow') is particularly important in relation to high-risk groups, consumers in the near-sub-prime and sub-prime segments of the market. For these customers, typical industry practice is to grant a very low initial credit limit, sometimes as low as £200. Issuers then increase credit limits for those customers who exhibit good behaviour.

Figure 4.7 below shows that most accounts that are given a credit limit increase start with relatively low initial credit limits,[133] suggesting that the ability to increase these limits is important for granting credit to these groups. As the initial credit limit increases, fewer accounts receive increases. Accounts with an initial limit above £10,000 initially appear to be an exception, but this is most likely a result of aggregating all credit limits above £10,000. Survey data shows that 16% of those in social class D/E had limits of less than £1,000, compared with just 7% of those in social class A/B.[134]

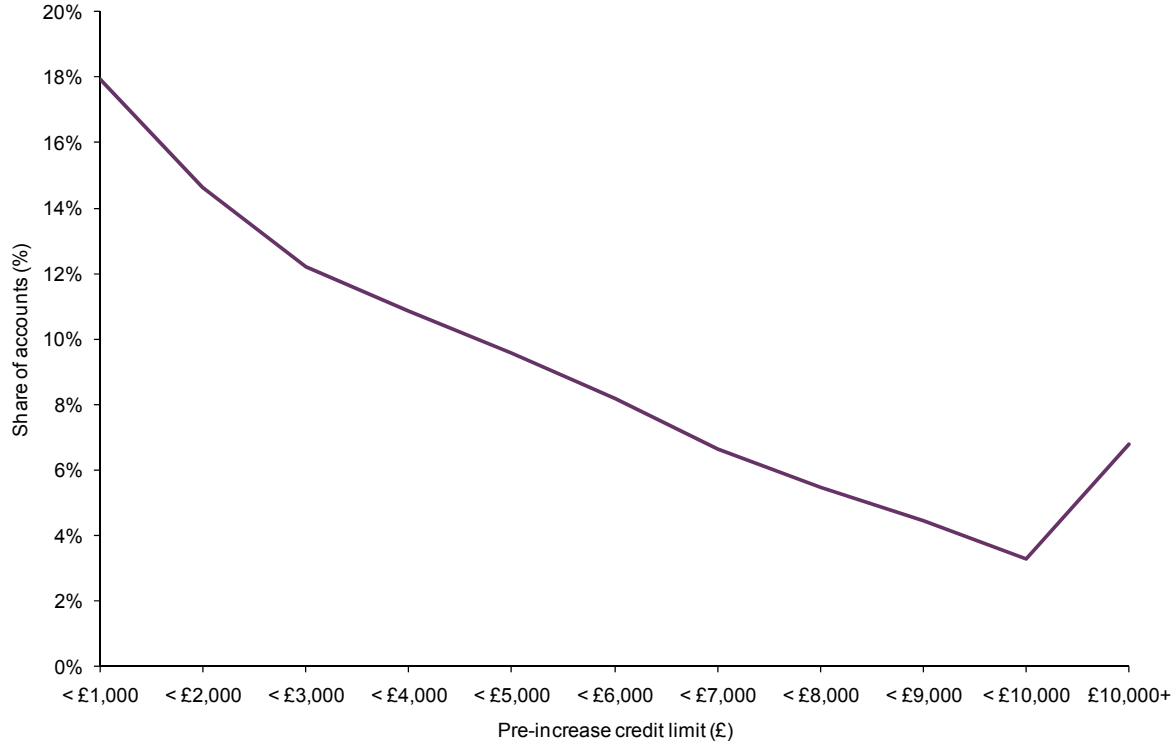
Furthermore, accounts with initial credit limits under £1,000 are more likely to receive CLI than any other group (see Figure 4.8).[135] The increases received by cardholders with these low initial limits, however, are lower than those received by other groups of cardholders (Figure 4.9). This is consistent with the 'low and grow' approach.

[133] Argus (2010), 'UK Credit Card Payments Study', January, slide 103.

[134] GfK NOP survey, p. 49.

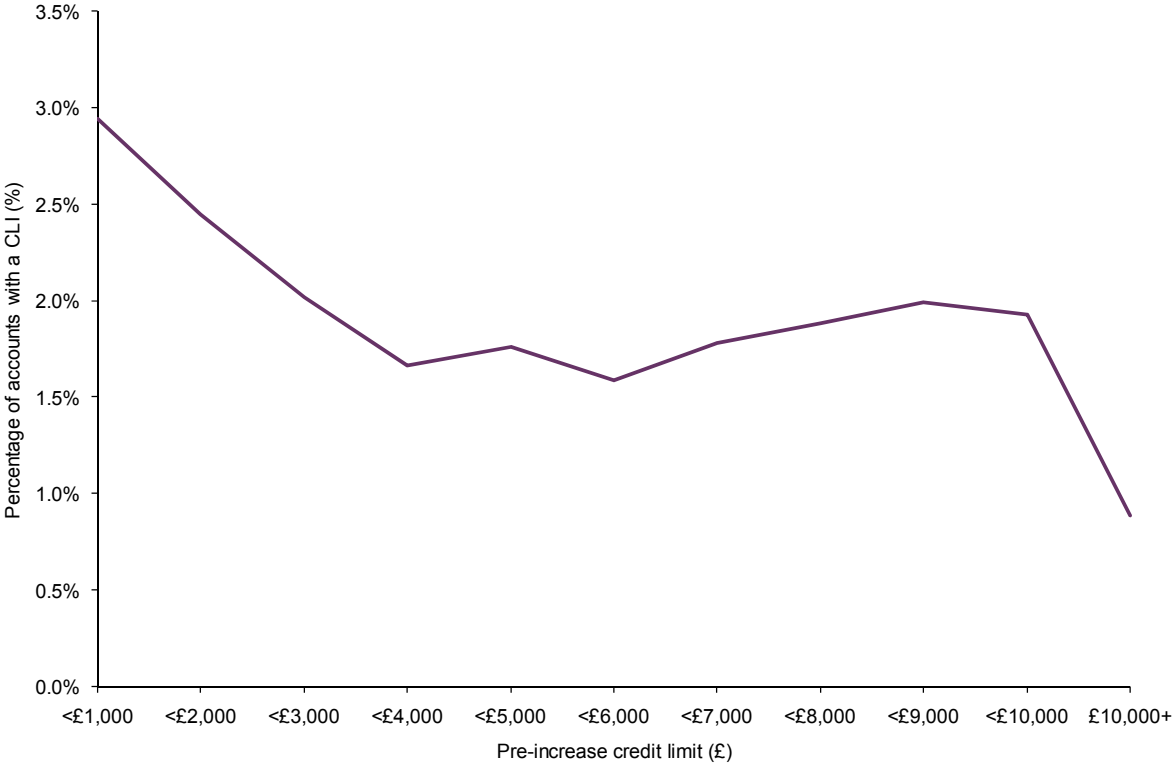
[135] Accounts with a credit limit above £10,000 appear to be particularly unlikely to receive an increase. This would be consistent with setting high initial limits for very-low-risk cardholders but then not modifying them again. In other words, there may not be a need to use 'low and grow' with very-low-risk cardholders.

Figure 4.7 Distribution of accounts with a credit limit increase by pre-increase credit limit, Q2 2009



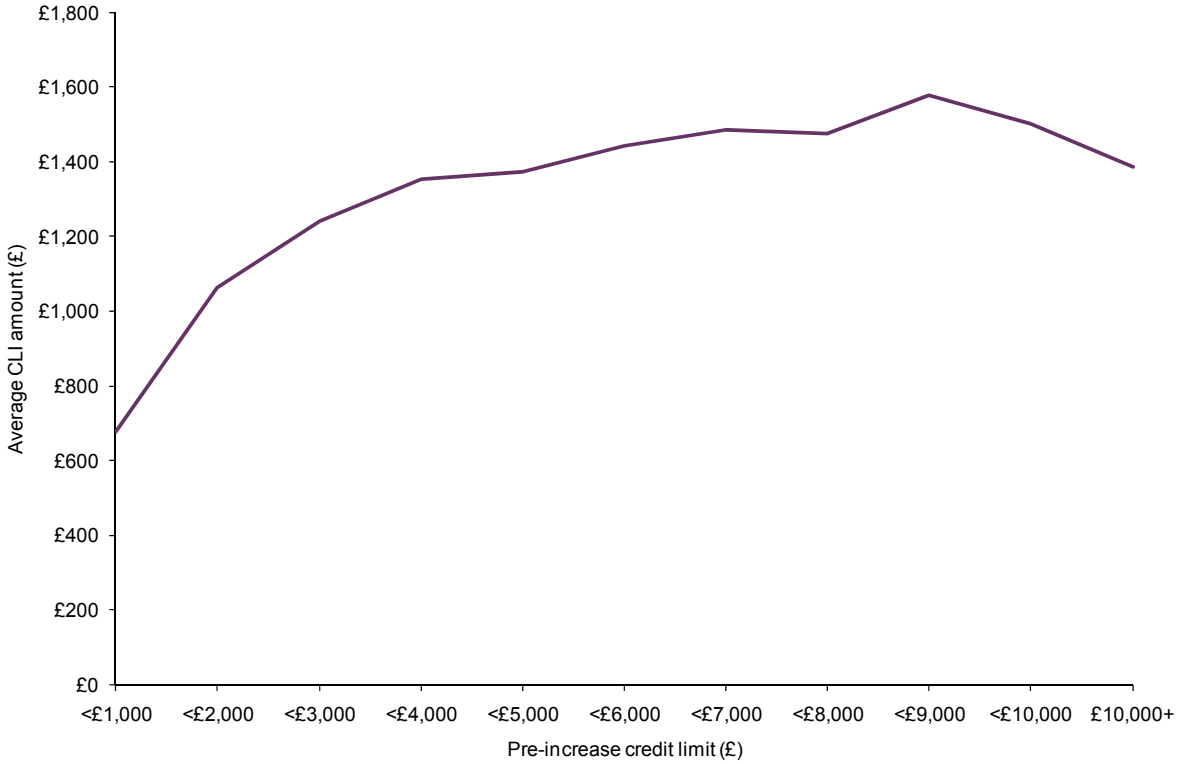
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 103.

Figure 4.8 Percentage of accounts with a credit limit increase by pre-increase credit limit, Q2 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 103.

Figure 4.9 Average credit limit increase amount by pre-increase credit limit, Q2 2009

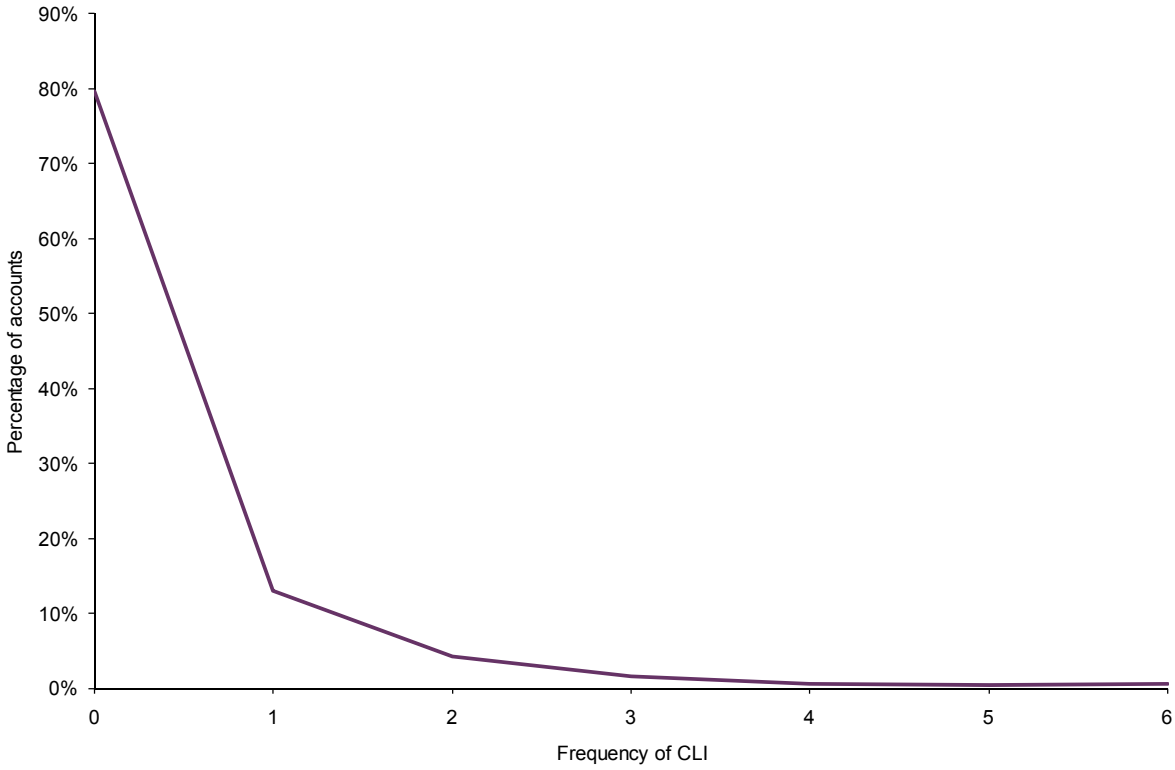


Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 103.

Size and frequency of increases

Many issuers will not grant UCLI on accounts less than 6 or 12 months old, and some issuers also limit the frequency of subsequent limit increases. From the issuer's perspective, it is rational to pause for several months in between increases because this allows issuers to observe the customer's behaviour at a given level of credit before considering granting them an increase. Figure 4.10 shows that for around 80% of accounts the credit limit was not changed at all, while for 13% the credit limit was only changed once in a two-year period.

Figure 4.10 Percentage of accounts by frequency of credit limit increase, July 2007 to July 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 90.

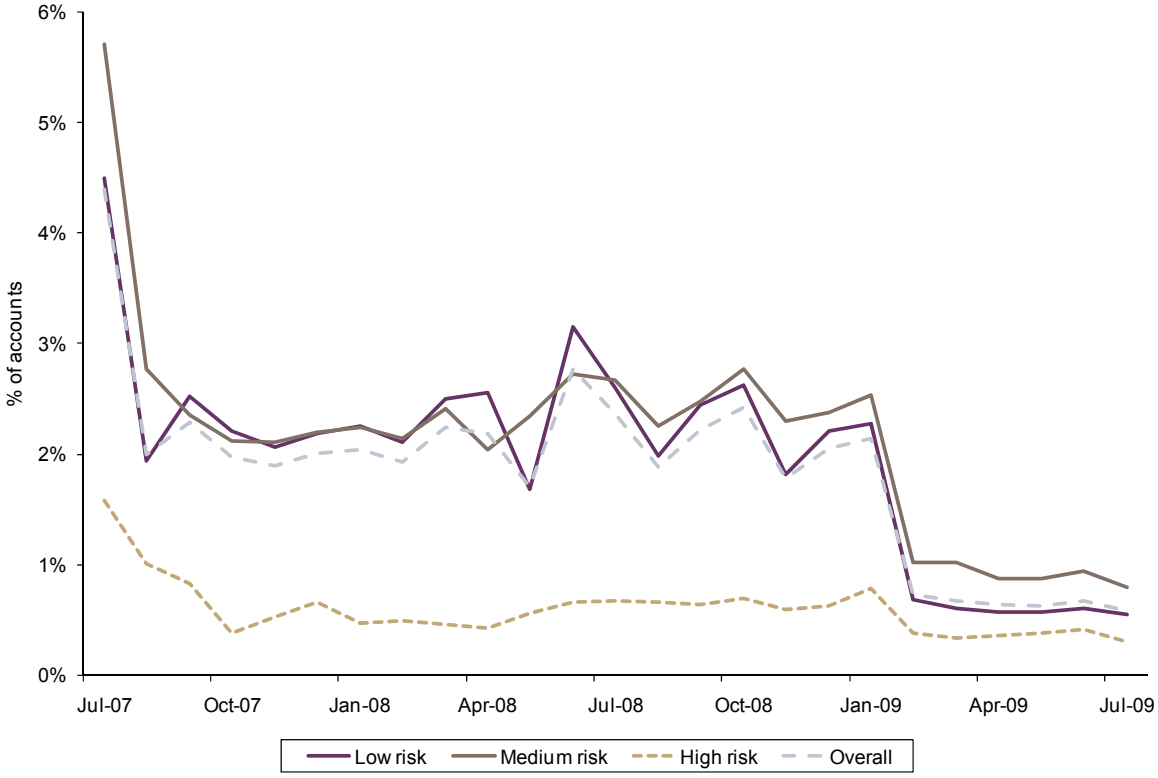
The GfK NOP consumer survey shows that about half of cardholders (51%) who had received an increase viewed the event as 'neutral', with the remainder split as to whether they viewed the increase positively or negatively. Among social groups D/E, views were slightly more weighted towards viewing the increase as negative rather than positive (40% versus 28%), with the remainder being neutral.[136]

Recently, card issuers have been actively reducing the number of CLI offered, as shown in Figure 4.11.[137]

[136] GfK NOP survey (2009), p. 73.

[137] Argus (2010), 'UK Credit Card Payments Study', January, slide 72.

Figure 4.11 Percentage of accounts with CLI by risk segments



Note: 'High risk' accounts: unit loss rate of 4%+; 'medium risk' accounts: unit loss rate between 1% and 4%; 'low risk' accounts: unit loss rate less than 1%.
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 72.

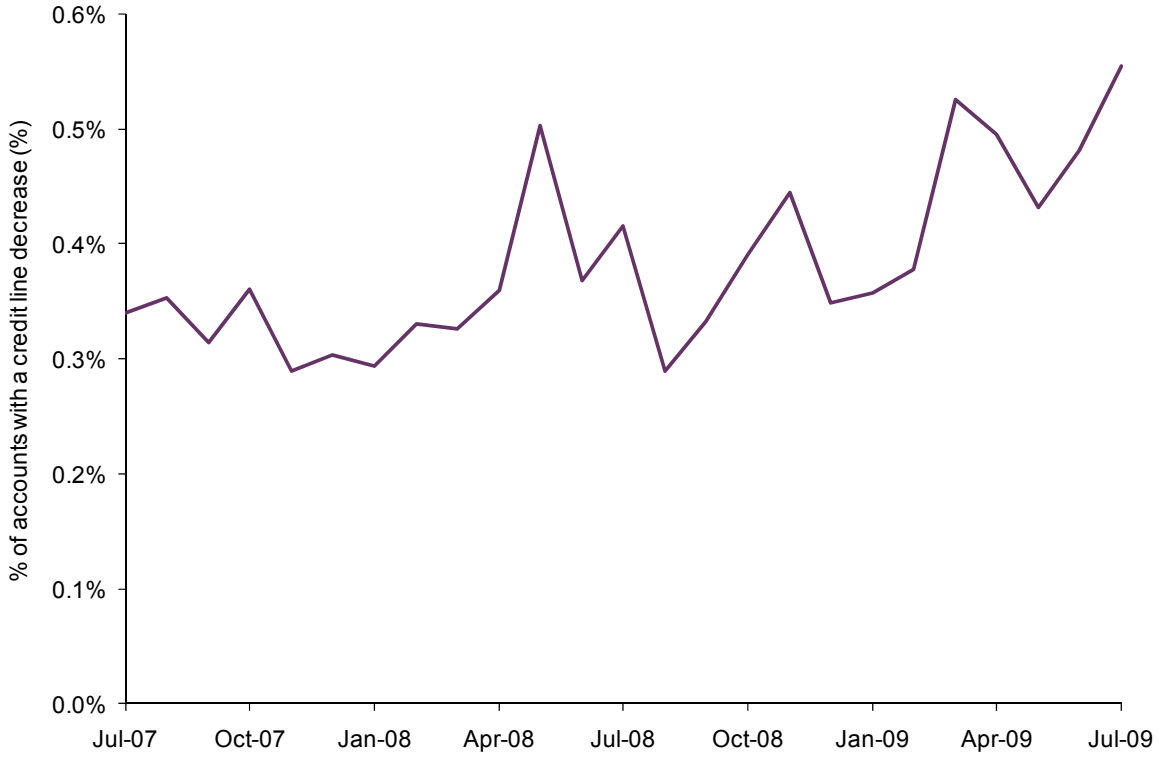
Credit limit decreases

Another development is the greater prevalence of credit limit decreases, consistent with the economic downturn when consumers can afford less and credit becomes more expensive. Figure 4.12 shows that a higher share of accounts each month is receiving credit limit decreases.[138] In the first ten months of 2009, more accounts received credit limit decreases (4.7m) than increases (4.1m[139]). While this is due to the unusual circumstances of the recession,[140] it shows that issuers actively respond to changed circumstances.

As with CLI, respondents were mixed in their reactions to decreases; for those who had received a limit decrease, 33% saw this as a neutral change, 42% saw it as positive or very positive, and 21% saw it as a negative or very negative occurrence.[141] This illustrates that credit limit increases and decreases will never be completely in line with cardholders' expectations. Issuers tend to focus on both cardholders' affordability and needs (ie, the extent that they would use some of the credit limit increase).

[138] Argus (2010), 'UK Credit Card Payments Study', January, slide 87.
[139] This includes 0.6m CLI granted following a customer request.
[140] In the first ten months of 2008, 9.9m cardholders received credit limit increases (of which 0.9m resulted from a customer request) while just 2.8m received limit decreases.
[141] GfK NOP survey (2009), p. 109.

Figure 4.12 Percentage of accounts with a credit limit decrease



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 87.

4.2.3 Do consumers understand UCLI?

BIS notes that consumers have a high level of awareness of their credit limits in general; data from Australia showed that over 90% knew either 'exactly' or 'roughly' what their credit limit was.[142] Survey data in the UK also shows a relatively high level of awareness; 78% of respondents indicated that they knew their credit limit.[143]

Instead, BIS is concerned that, despite Banking Code commitments to ensure that consumers are aware that they can decline a limit offered, consumers may not understand how to do so, or may believe that doing this would have an adverse impact on their credit score. Industry data shows that only a small share of consumers have declined UCLI (0.6% in the first ten months of 2009).

Survey respondents were largely aware that CLI may be granted on an unsolicited basis, with 72% affirming that they know this happens. Here, revolvers showed a greater awareness of the practice, with 80% indicating that they knew CLI could be granted on an unsolicited basis, compared with 69% of transactors. Just 11% of revolvers indicated they had not known and were surprised by the practice, compared with 19% of transactors.

Cardholders seem to rely on issuers to revise their limits periodically. 85% of respondents had never requested an increase,[144] and 86% claimed that they would not do so in the future.[145] Furthermore, 73% of respondents were satisfied with their current limit. This could

[142] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 225,
[143] GfK NOP survey, p. 49. An additional 11% declined to answer the question, with just 11% saying they did not know their credit limit.
[144] Ibid., p. 79.
[145] Ibid., p. 85.

imply that they were not dissatisfied with past increases, but would not want any more in the future.[146]

Indeed, when asked whether they would ever decline a credit limit increase, 57% said that they would not do so.[147] Of those who would not decline an increase, most (87%) simply said they would not bother.[148] Only 11% said it might affect their credit rating, while 2% did not know and 6% cited other (unlisted) reasons.

Overall, the results of the survey suggest that cardholders do understand UCLI (72%) but are not motivated to manage the credit limits themselves. Most are satisfied with the current limit (73%), would not request an increase (86%) or would not decline one (57%).

4.2.4 Do UCLI increase indebtedness?

Even if consumer understanding of UCLI were considered to be problematic, ultimately the question is whether UCLI are associated with increased incidence of indebtedness and financial difficulty, particularly among vulnerable groups.[149]

BIS notes that the issue of UCLI leading to financial difficulty and overindebtedness was raised in 2003 by the Task Force for Overindebtedness. Since then, the industry has implemented a much greater degree of self-regulation, as discussed in section 4.1 above. Since the implementation of these measures, BIS has not found any definitive evidence on a link between indebtedness and UCLI.[150]

BIS is therefore seeking evidence on the degree to which UCLI are associated with financial difficulty and overindebtedness, in particular for more vulnerable consumers.[151]

Purchase behaviour

Cardholders do tend to increase purchases in the initial months following a credit limit increase, which is consistent with a widely cited US study (also referenced by BIS).[152] This is not surprising; as discussed above, issuers target cardholders with a middle level of utilisation, who are less risky than high-utilisation cardholders and more likely to spend some share of the increase than low-utilisation cardholders.

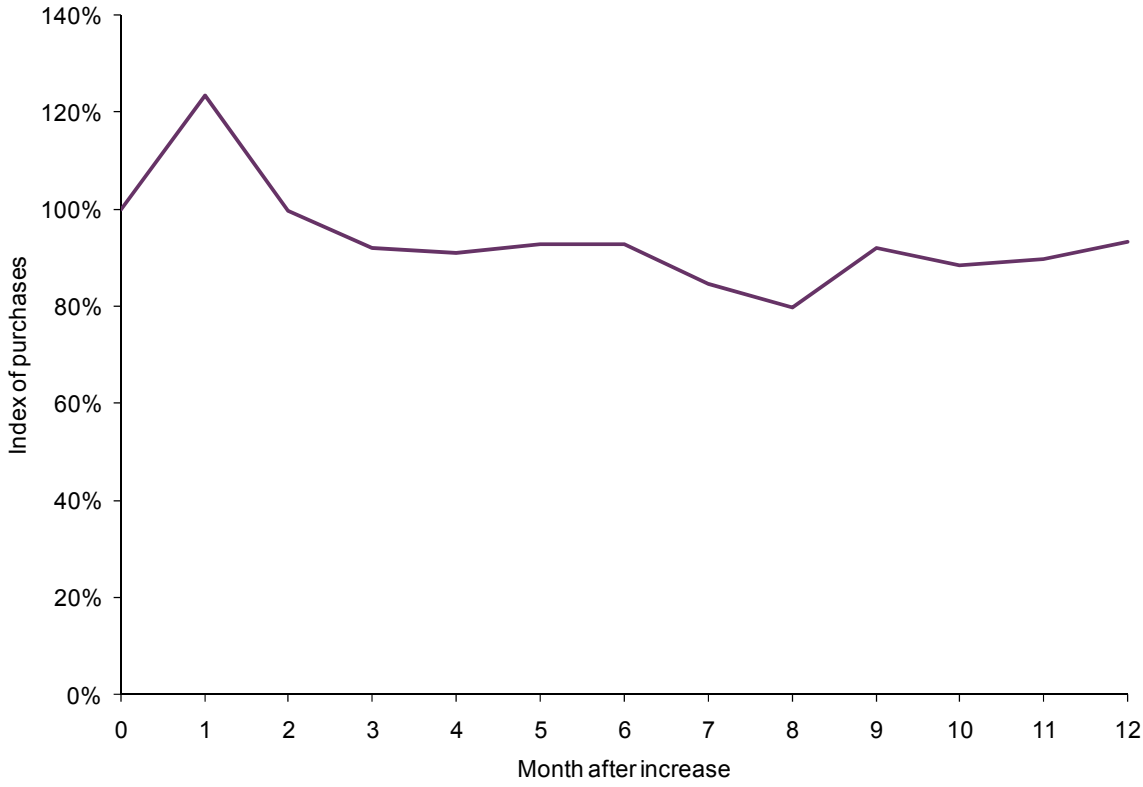
BIS has suggested that this increase in spend may be due to consumers being impulsive;[153] however, the increase in spending is typically much less than the increase in credit limit. For accounts with a credit limit increase in April 2009, the increase in spend in the subsequent six months was 5.1% of the credit limit increase.[154] This may suggest that consumers do control their behaviour and assess what they can afford. This is a rough estimate based on a relatively simply analysis—other factors such as seasonal effects may also play a role. However, a sophisticated econometric analysis on the basis of US data also shows that consumers spent much less than the increase in the limit (an average of 10–14% of an

[146] GfK NOP survey, p. 55.
[147] Ibid., p. 91.
[148] Ibid., p. 97.
[149] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 234.
[150] Ibid. para 228.
[151] Ibid., para 234.
[152] Gross, D.B. and Souleles, N.S. (2000), 'Consumer Response to Changes in Credit Supply: Evidence from Credit Card Data', Wharton Financial Institutions Center, Working Paper, p. 11, February.
[153] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 224.
[154] Argus (2010), 'UK Credit Card Payments Study', January, slide 135. This is calculated by comparing the average monthly spend in the preceding three months from January to March 2009 to the following six months from May to October 2009. The uplift in spend as a percentage of the sum of limit increases granted was 5.06%.

increase).[155] Cardholders who spent a large share of an increase would be judged as riskier by issuers and would be unlikely to receive further increases.

Furthermore, monthly purchases actually fall below previous levels after the first few months. This result holds for increases given in both the third quarter of 2007 and the third quarter of 2008. It is likely, however, that this absolute decrease in purchases is at least partly the result of the economic downturn (see Figure 4.13). However, it may also reflect cardholders deciding to reduce their spending in order to reduce the increase in revolving balance.

Figure 4.13 Index of purchases for accounts with a CLI in Q3 2008



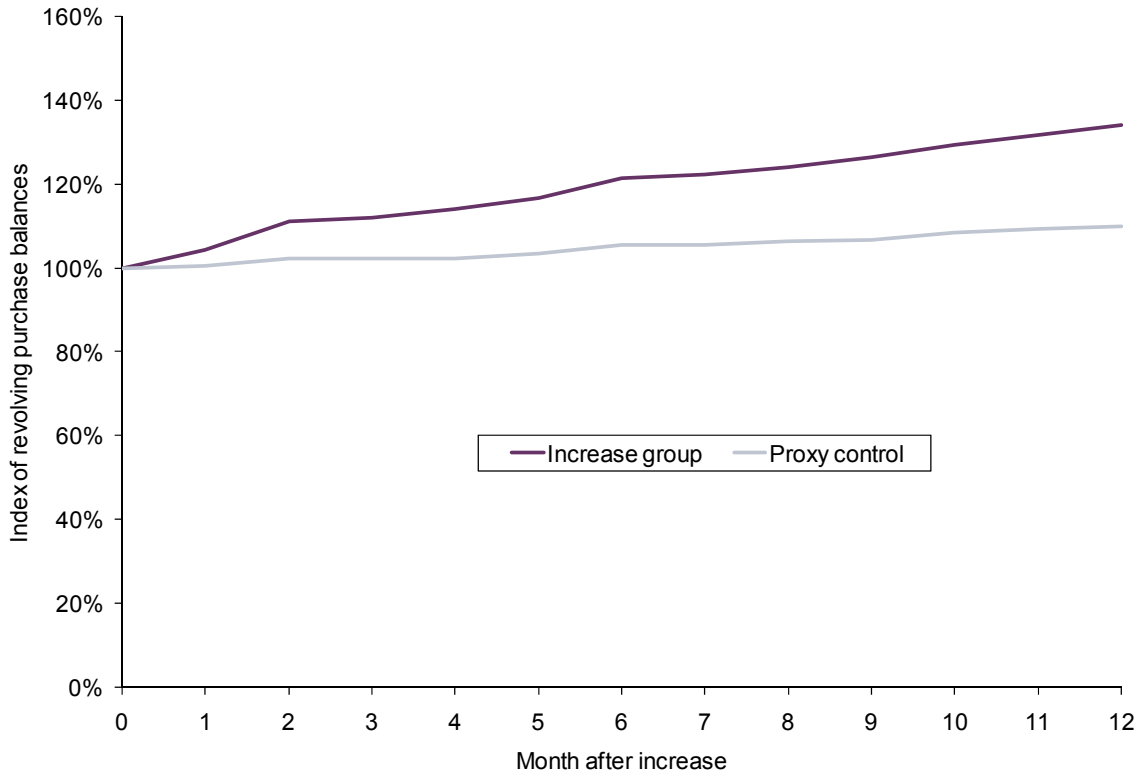
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 79.

Effect on balances and default rates

Despite the lower long-term average purchase levels, there is evidence that balances increase in the months following limit increases, in comparison to those of a proxy control group (see Figure 4.14). It is possible that CLI are associated with (in general, limited) increased levels of indebtedness, although, as discussed below, this does not contribute to financial difficulty. Another explanation is that the initial increase is driven by the activities of those cardholders who request credit limit increases themselves, since one would expect that their expenditure would increase.

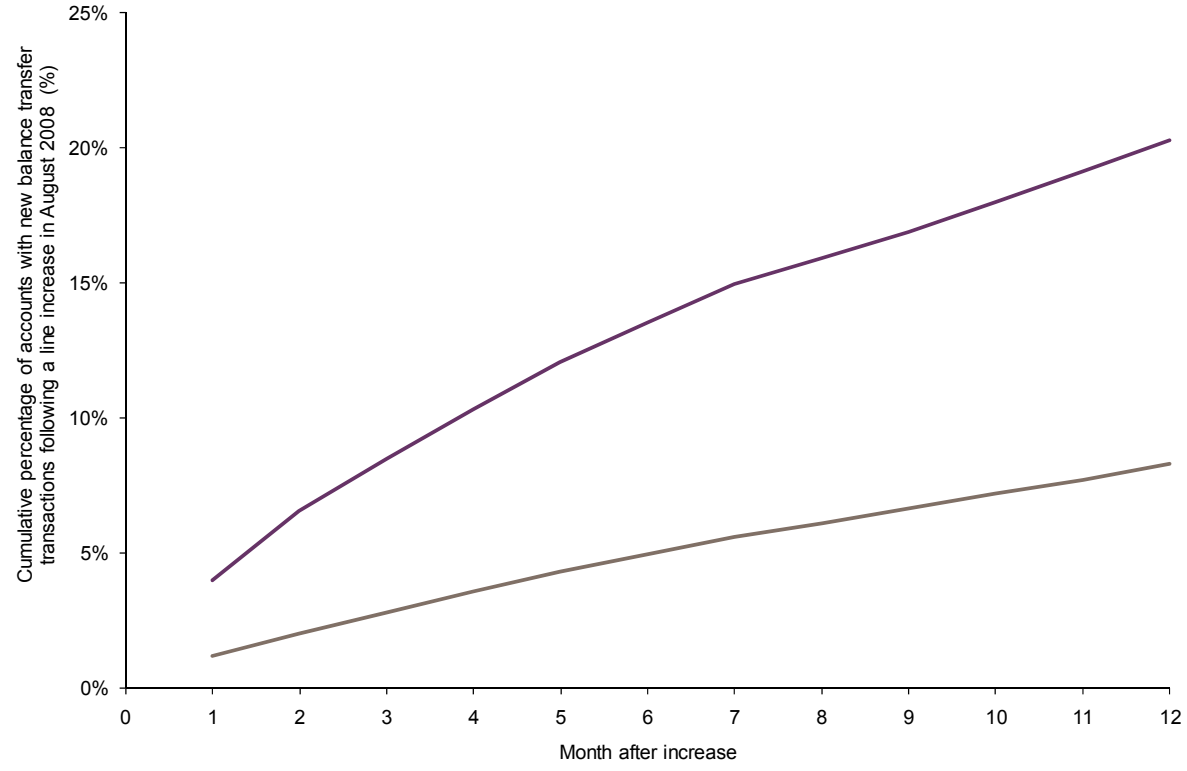
[155] Gross, D.B. and Souleles, N.S. (2002), 'Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence from Credit Card Data', *The Quarterly Journal of Economics*, p. 152, February, as cited in 'Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 223.

Figure 4.14 Index of revolving purchase balances for Q3 2008 (increase group versus proxy control)



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 78.

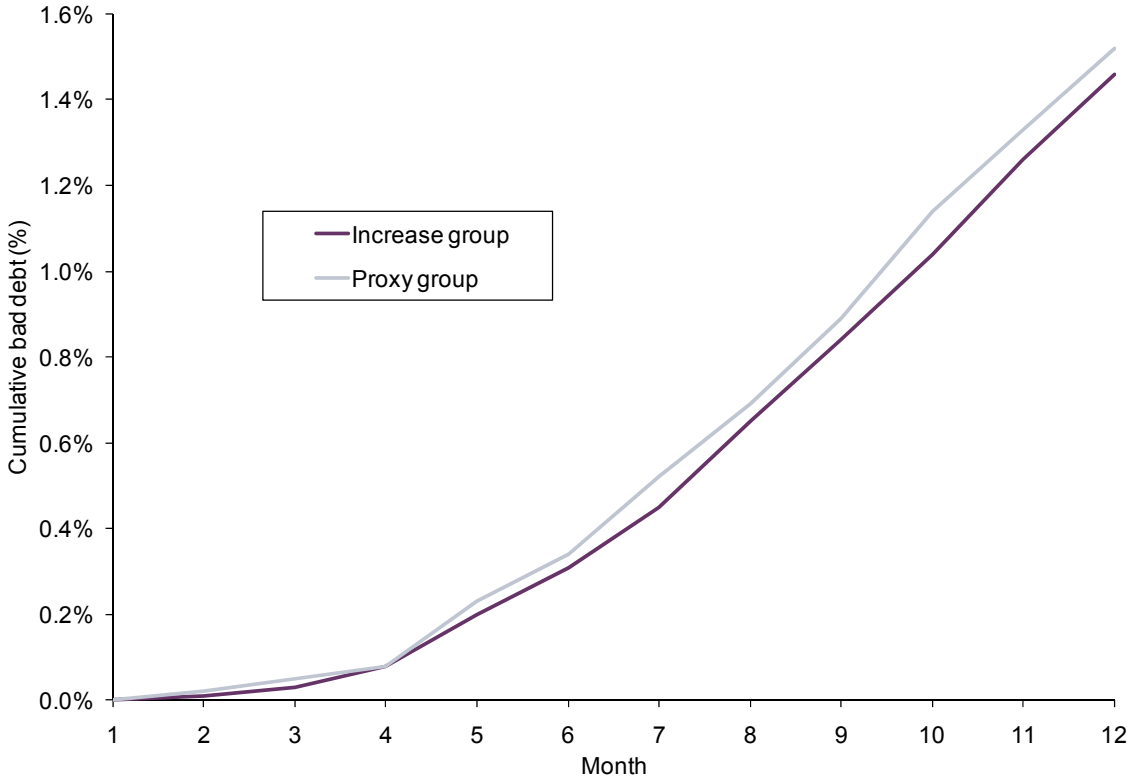
Figure 4.15 Cumulative percentage of accounts with new balance transfer transactions in the 12 months following a limit increase in August 2008 relative to the proxy-control group



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 126.

Figure 4.16 shows that there is no significant differences between the cumulative bad debt for accounts having received a credit limit increase in Q3 2008 compared with the proxy control group. The absolute increase in bad debt for both groups is most likely due to the economic downturn.

Figure 4.16 Cumulative bad debt for CLI versus no CLI (control), August 2008–July 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 95.

This evidence is consistent with that from the Australian market cited by BIS, noting that default rates for cardholders receiving limit increases are not significantly different from the overall population.[156]

As explained in section 1, when increasing credit limits, issuers typically define a control group—ie, a group of cardholders that does not receive a UCLI but have the same characteristics as those that do receive a UCLI. This allows issuers to assess the impact of UCLI. In its data, Argus cannot observe this control group and therefore proxies it by identifying cardholders with exactly the same characteristics as those that receive a UCLI apart from the fact that they did not receive a UCLI for at least three months following the increase. By definition, such a proxy control group will never be the same as the real control group—for example, it may be that some members of the proxy control group did in fact receive an UCLI within the time period studied. The results of the proxy control group analysis should therefore be interpreted with care. Although it does not provide conclusive evidence, it is indicative of there not being any significant increase in financial difficulty resulting from UCLI. A couple of issuers that have undertaken their own control group analysis confirmed to Oxera that their analysis also shows that UCLI do not result in a significant increase in financial difficulty.

[156] Consumer Action Law Centre (2008), 'Congratulations, You're Pre-Approved! An analysis of credit limit upselling letters', August, as cited in Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 222.

4.2.5 Summary of rationale

The previous sub-sections have examined the practices used by issuers to grant UCLI. The data suggests that:

– UCLI enables issuers to have a 'low and grow' policy, which can apply to new applicants regardless of risk, but is particularly important for high-risk consumers;

– more generally, UCLI also enables issuers to give increases in credit limits to existing cardholders (mainly low-risk, low-utilisation ones), who may find it convenient to have a higher limit and can afford it. Credit cards are a flexible product and this gives a means for credit limits to be tailored to cardholders' needs;

– cardholders do understand UCLI (72%) but are not motivated to take credit limits into their own hands. Most are satisfied with the current limit (73%), would not request an increase (86%), or would decline one (57%).

– It is possible that CLI result in increased balances to some extent,. However, CLI do not appear to be associated with an increase in bad debt.

4.3 BIS proposals

BIS is considering a range of options to modify current practices to varying degrees, as follows.[157]

– **Do nothing**: BIS notes that the implementation of the Consumer Credit Directive is likely to result in greater disclosure surrounding credit limits—the Directive will place the guidelines of the Banking Code on a statutory footing[158] and the new Lending Code (discussed in section 4.1 above) will also strengthen self-regulation regarding CLI.

– **Better information for consumers about UCLIs**: this option would appear to formalise the changes that BIS anticipates will result from the Consumer Credit Directive and best-practice measures proposed by the UK Cards Association.

– **Limits on the size and/or frequency of individual limit increases**: this would constrain the frequency of re-pricing to every six months and impose a limit on the size of the re-price as a share of the starting balance.

– **Ban on all unsolicited limit increases**: this would prevent issuers from changing the initial credit limit except at the cardholder's request. Issuers' ability to lower a cardholder's limit would not be affected.

– **Allow consumers to opt in to receive unsolicited limit increases**: this would allow consumers to specify in advance whether they wished to be considered for unsolicited CLI.

The following section examines the impact of banning UCLI altogether, as the most far-reaching of the proposed measures, and also discusses the opt-in possibility.

4.4 Impact of BIS proposals

The most severe consequence of banning UCLI would be likely to be experienced by high-risk borrowers. As noted above (and by BIS[159]), it is standard practice with high-risk

[157] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 236.
[158] Ibid., paras 216–217.
[159] Ibid., paras 220–221.

borrowers to extend very low initial limits of credit and then increase them slowly over time to those borrowers exhibiting good behaviour. Since, in general, it is not profitable for issuers to have customers on low credit limits and it is too risky to grant larger limits initially, issuers would be reluctant to offer credit cards to high-risk borrowers at all if they were not able to choose which borrowers receive subsequent increases.

As far as Oxera is aware, no issuers have been able to extend credit to the near sub-prime and sub-prime segment by adopting any strategy other than 'low and grow', for which UCLI is necessary. Banning UCLI may therefore result in (near) sub-prime consumers who do not currently have credit cards being unable to obtain them and being forced to use alternative (and often more expensive) forms of credit, such as home credit, loan sharks or pawn shops.

Existing (near) sub-prime cardholders would also be disadvantaged in that they would be unable to obtain new cards and thus be locked into their existing credit cards. Among other effects, this would reduce or eliminate their ability to opt out of any re-pricing and so reduce switching (discussed in section 5).

Removing the flexibility for issuers to increase the credit limit may lead to them setting higher limits at application. Issuers will have to assess the potential increase in write-offs as a result of higher limits at application (when less information is available than later on) and the potential increase in profits as a result of higher usage of credit. Although setting higher credit limits at application could be rational and profitable for issuers across their entire portfolio, it would not necessarily contribute to a policy of responsible lending. In other words, banning UCLI could make issuers move away from their responsible 'low and grow' policies to higher credit limits at the point of application. The link between the level of credit limits at application and UCLI is also illustrated by anecdotal evidence from an issuer which historically did not offer UCLI to customers. When the issuer began to offer UCLI, the initial limits granted to applicants decreased.

A ban on UCLI may also affect the degree of competition in the market by having an impact on consumers' ability to switch between providers. A new card provider that has less information about a cardholder than the existing provider would need to offer a lower initial limit. Without UCLI, the potential switcher would know that it would take repeated requests over months or years to reach the existing limit. This may deter the cardholder from seeking to switch in the first place.

Competition between monolines and banks may also be affected. By definition, monolines typically will not have any information about an applicant other than that which is available from credit reference agencies. They therefore rely on gaining information about customers through experience. Banks, by contrast, may already have additional information about the behaviour of an applicant since the applicant may hold other products. This gives banks an advantage over monolines in selecting an initial credit limit. This advantage would arguably become more important if the ability to grant UCLI were removed.

As discussed in section 4.2, BIS's rationale for proposing additional restrictions on issuers' ability to grant UCLI was based on a lack of consumer understanding and concern that UCLI may contribute to overindebtedness. This section has presented evidence suggesting that most consumers have a reasonable understanding of UCLI and has also demonstrated limited support for the concern that there is any increase in indebtedness following UCLI.

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. For example, in the qualitative GfK NOP survey, one cardholder indicated that she would always be tempted by increased credit availability, even though she knew it would be likely to increase her indebtedness. To the extent that this issue is relevant to a sub-set of cardholders, it would seem most desirable to address it in a way that does not remove the ability of card issuers to

adjust credit limits for other consumers, particularly high-risk consumers whose access to credit relies on the ability of issuers to adjust limits.

It is possible that the opt-in proposed by BIS would fulfil this role of providing the option of a commitment device for some consumers while not jeopardising credit access for high-risk consumers. Arguably, this would focus in particular on cardholders with poor impulse control, but less so on those who are also affected by inertia. It is uncertain whether the opt-in would provide these desired benefits for one group while not imposing undesired costs on another. Thus, it would seem advisable to conduct additional research to assess the efficacy and costs and benefits of such an option before introducing it across the industry.

5 Re-pricing of credit

For cardholders who carry a balance forward into the next month, interest is charged at a rate reflecting the risk that the borrower may not repay the balance. As the issuer learns more about the consumer's expenditure, repayment patterns and risk characteristics, and as the consumer's risk profile changes, the interest rate on their credit card may be adjusted to reflect their risk profile more accurately. This is known as 'risk-based re-pricing'. Re-pricing can also occur as a result of changes in other credit card account costs or revenues—for example, funding costs, which would change issuers' costs of serving accounts irrespective of the risk profile.

BIS is concerned that issuers are not sufficiently transparent in their re-pricing decisions,[160] and in particular it implies that re-pricing may be driven more by issuers' declining profitability than by changes in cardholder risk.[161] BIS also notes the possibility that, due to limited take-up of the option to close credit card accounts following a re-price, some cardholders may not be able to avoid increases, resulting in them paying more interest.[162] BIS is proposing a range of measures, from providing more information about increases to a ban on the re-pricing of existing debt.[163]

5.1 Current practice

At the time of application, card issuers set the APR associated with a particular credit card based on a range of factors, including funding costs and estimates of the card applicant's risk. On application, however, less information is available on the applicant's riskiness in comparison to that available for existing customers. Monoline issuers, in particular, will typically only have information from credit reference agencies. As the relationship with a cardholder evolves, the card issuer gains additional information about the cardholder, and the cardholder's circumstances may change. These changes (in actual or perceived riskiness) may lead the issuer to revise its estimate of the cardholder's riskiness.

Any re-evaluation of a cardholder's perceived risk of default will change the cost to the issuer of any existing debt held by the cardholder due to the need to set aside capital for bad debt charges, as well as changing the cost of any new debt incurred by the cardholder. BIS does not dispute issuers' use of risk-based pricing for new debts incurred by existing cardholders, but (as discussed further below) the most far-reaching of the BIS proposals would prohibit the re-pricing of existing debt, the cost of which would also be affected by the change in the riskiness of cardholders.

The benefits of risk-based pricing have been well documented in the literature. This form of pricing is considered to be efficient and to enable lenders to serve a large part of the population.[164] It also encourages the efficient use of the credit facility by cardholders. In

[160] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 273.

[161] Ibid., para 285.

[162] Ibid., para 280.

[163] Ibid., para 294.

[164] See, for example, the widely cited article by Rothschild and Stiglitz (1976), which focus on risk-based pricing in insurance and shows that the ability to set prices based on risk will result in the widest coverage at the lowest prices. Once risk-based pricing is not possible (in the case of the article, due to the unobservability of risk), certain segments of the population are no longer served. Rothschild, M. and Stiglitz, J. (1976), 'Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information,' *Quarterly Journal of Economics*, **90**:4, 630–49. For an understanding of the economic characteristics of the demand and supply of credit, see, for example, Bertola, G., Disney, R. and Grant, C. (2006), 'The Economics of Consumer Credit Demand and Supply', in G. Bertola, R. Disney, and C. Grant (eds.), *The Economics of Consumer Credit*, MIT Press.

particular, cardholders who experience a deterioration in their risk profile are encouraged to borrow less as a result of the increase in the cost of credit.

Re-pricing is currently governed by self-regulation. At the Credit Card Summit of November 2008, the industry developed a range of principles to cover the circumstances, alternative options, frequency and transparency of interest rate increases.[165] Among other measures, issuers agreed to offer cardholders the option of closing the account and repaying the remaining balance at the existing rate of interest, within a reasonable period of time (an 'opt-out' clause). Additionally, issuers agreed not to increase interest rates when the customer experienced financial difficulty,[166] or within the first 12 months of a customer having a credit card (or every six months thereafter).

In practice, re-pricing occurs only infrequently. Between July 2007 and July 2009, 80% of accounts were not re-priced upwards at all, while less than 5% were re-priced twice or more.[167] This suggests that in a given year, roughly 90% of accounts are not re-priced at all. The average size of the increase was 4.3% over the period between July 2007 and July 2009.[168]

Data shows that higher-risk accounts are more likely to be re-priced than lower-risk accounts (see Figure 5.1). Fewer very high-risk accounts (risk band 1) are re-priced than those in risk band 2. This is not surprising since accounts in the riskiest band are more likely to be in financial difficulty and, based on the industry guidelines, accounts in difficulty cannot be re-priced.

When re-pricing takes place, higher-risk accounts are re-priced by a larger amount (see Figure 5.2). This is because the (new) probability of default is affected by both the amount by which the credit score has deteriorated (say, one risk band level), and the absolute level of the credit score itself, irrespective of the change. Thus, for a given deterioration in risk (say one credit score band), higher-risk accounts will be re-priced more because they are associated with a higher probability of default.

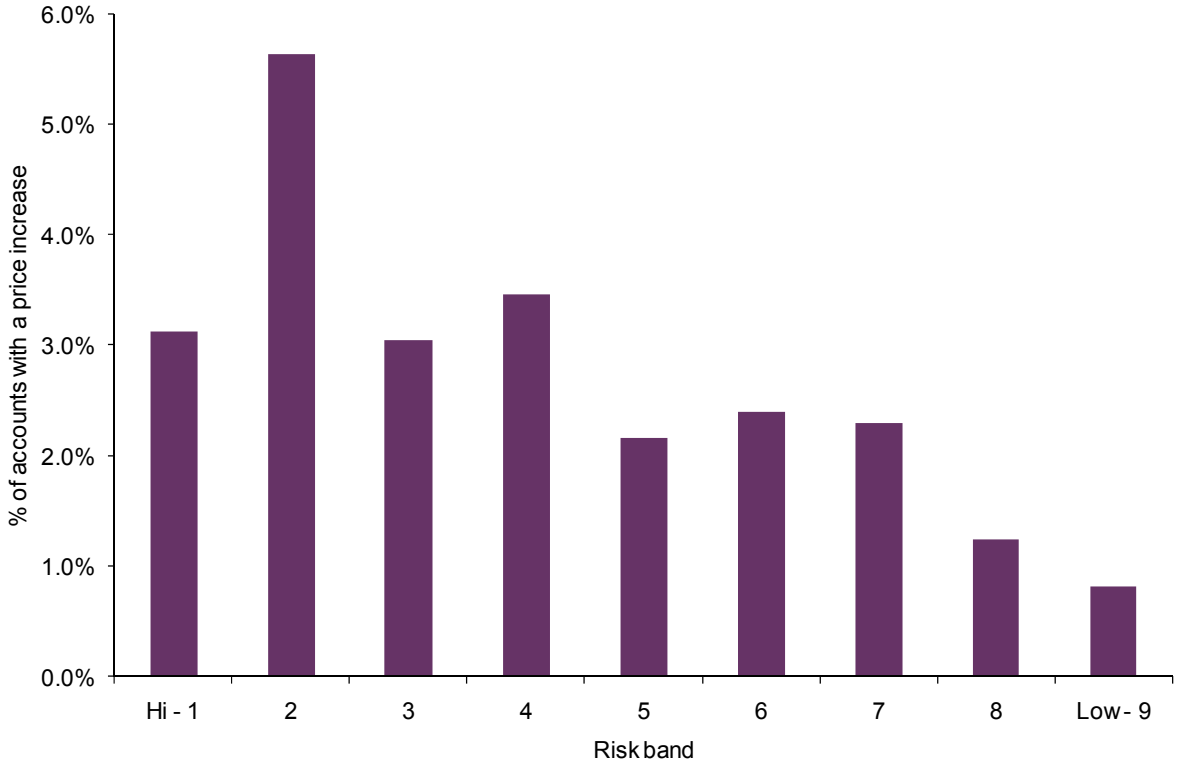
[165] The UK Cards Association (2009), 'Credit Card Summit commitments', http://www.theukcardsassociation.org.uk/best_practices/-/page/681/

[166] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 277. The Statement of Fair Principles guides lenders not to increase a borrower's rate where consumers have failed to make the last two consecutive minimum monthly payments; consumers have already agreed a repayment plan for the account; or the issuer has been informed by a not-for-profit debt agency that consumers are discussing a repayment plan with them.

[167] Argus (2010), 'UK Credit Card Payments Study', January, slide 219.

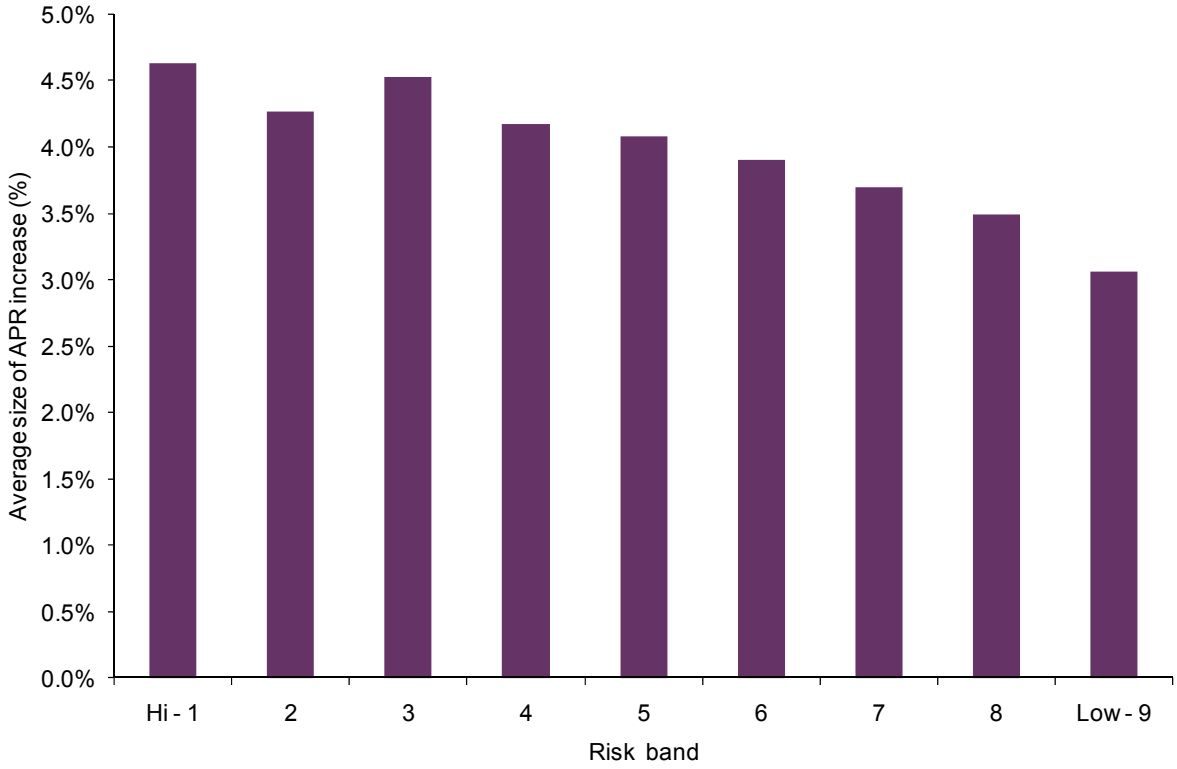
[168] Ibid., Slide 14.

Figure 5.1 Percentage of accounts with a price increase by risk, Q2 2008



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 175.

Figure 5.2 Average size of APR increase by risk, Q2 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 152.

5.2 Rationale behind BIS proposals

BIS puts forward three possible reasons why the current practice may need to be changed.

– **Increases in interest rate may be unjustified**. BIS suggests that card issuers may be using interest rate increases on credit cards to compensate for declining profitability elsewhere, rather than reflecting genuine changes in risk.[169,170]

– **RBRP may harm vulnerable consumers**. BIS notes that vulnerable consumers may already be in financial difficulty even before a re-price,[171] and that the increase in repayments associated with a re-price may exacerbate financial difficulty.[172]

– **Self-regulation may be ineffective in protecting vulnerable consumers**. BIS is concerned that cardholders may be unable to avoid increases, and notes that cardholders appear to have made limited use of the option to close credit card accounts and repay balances at existing rates, following a rate increase.[173]

These concerns are addressed in the following sub-sections.

5.2.1 Are increases in interest rates justified?

The industry guidelines discussed above were introduced in response to concerns raised in 2008 that some cardholders faced increases in rates that were not properly explained and that, moreover, the size of these increases was sometimes large enough to result in a doubling of interest rates.[174] BIS notes that, since the introduction of the industry guidelines in January 2009, the volume of complaints has fallen and anecdotal evidence suggests that increases have been smaller.[175]

The way in which issuers assess whether accounts should be re-priced varies per issuer, from the use of sophisticated models that take into account a wide range of factors such as purchase and repayment behaviour, to a simpler approach where only certain predefined factors or types of behaviour (eg, a certain number of late payments) can trigger a change in interest rate. Most, if not all, issuers also typically take into account competitive conditions in the market. Thus, if their risk analysis suggests that a re-pricing would be justified but market conditions would not allow them to do so (given interest rates offered by competitors), the proposed increase may not be implemented.

It is beyond the scope of this report to assess the extent to which actual re-pricing is solely driven by changes in the risk profile of individual cardholders or other factors applicable to a whole group of cardholders. Such an assessment would require a detailed analysis of the models issuers have in place and/or an ex post empirical analysis of the relationship between re-pricing and the profile of cardholders.

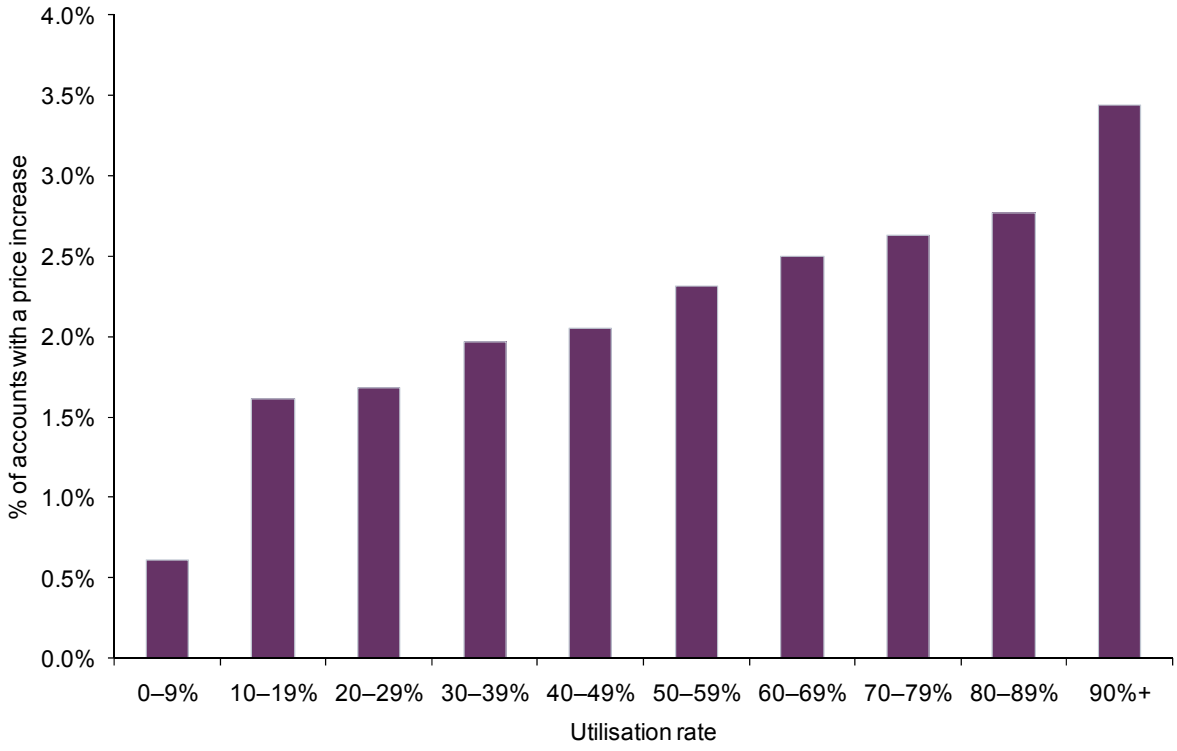
A key question is whether re-pricing is driven by changes in the risk profile and result in interest rates that are competitive. In this respect, a number of comments can be made on the basis of the evidence gathered by issuers.

As explained above, re-pricing is relatively limited in terms of the proportion of accounts that are re-priced, the frequency with which they are re-priced and the level of the increase. This suggests that the re-pricing is targeted at a specific group of cardholders. Furthermore, the importance of the risk profile in this is illustrated by the fact that re-pricing generally applies to the higher-risk accounts within each risk band. Accounts with a higher utilisation rate are much more likely to be re-priced than accounts with lower utilisation. For example, Figure 5.3

[169] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, paras 284–285, October.
[170] Ibid., para 51.
[171] Ibid., para 291.
[172] Ibid., para 54.
[173] Ibid., para 280.
[174] Ibid., para 275.
[175] Ibid., para 279.

shows that 3.4% of accounts which have utilisation rates of 90%+ were re-priced in Q2 2009, compared with only 0.6% of accounts with utilisation rates of less than 10% being re-priced in the same period.

Figure 5.3 Percentage of accounts with a price increase by utilisation, Q2 2009



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 154.

Account utilisation—defined as the share of the credit limit which is used by the cardholder each month—is an indicator of risk, with higher utilisation rates indicating higher risk. As discussed in section 4 on UCLI, the unit charge-off rates observed over time are higher for accounts with relatively high utilisation rates. Within each risk band, accounts with utilisation rates above 50% in July 2008 had higher charge-off rates. In the highest risk band, for example, 2.5% of accounts with utilisation below 50% had been charged off, compared with 28% of accounts with utilisation in excess of 50% being charged off by Q3 2009.

Comparing changes in standard APRs on new cards to re-pricing on existing cards can give a rough indication of whether changes in interest rates on existing accounts are in line with competitive conditions. Between the year ending July 2008 and the year ending July 2009 (the period for which data is available), rates on both new and existing cards increased for all risk groups, reflecting the worsening economic climate. Rates on new accounts increased between 1.0% and 3.6%, while rates on existing accounts increased between 4.0% and 5.3%, depending on the risk band.[176] While across all risk categories the rates on new accounts increased less than rates on existing accounts, this partly reflects greater selectiveness on the part of issuers in accepting new accounts, even within risk bands.

Finally, in practice, re-pricing works in both directions, upwards and downwards.[177] When consumers were asked about whether they had ever had a re-pricing, 23% of those surveyed reported that the interest rate on at least one of their cards had increased in the last two

[176] Oxera calculations based on Argus (2010), 'UK Credit Card Payments Study', January, slide 151 and Argus (2010), 'UK Credit Card Payments Study', January, slide 240.
[177] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards—A Consultation', Initial Inequality Impact Assessment, October, para 52.

years,[178] while 8% reported a decrease in the same period.[179] 10% of both A/B and D/E groups reported having had a decrease: 23% of respondents in A/B reported receiving an increase; the figure for respondents in band D/E was 20%.

The data from surveys is also consistent with confidential issuer returns covering the period from January to October 2009. These show that, in aggregate, 11m accounts (roughly 18% of the total) were re-priced, of which 75% were re-priced upwards and 25% downwards. Data for the second quarter of 2009 shows that the average size of downward re-price was 2.6% compared with 4.2% for accounts re-priced upwards over the same period.[180]

5.2.2 Has risk-based re-pricing contributed to financial difficulty?

Irrespective of the fairness of re-pricing, BIS notes that re-pricing can result in a significant increase in the size of repayments.[181] This may be particularly problematic for more vulnerable consumers who are already in financial difficulty.[182]

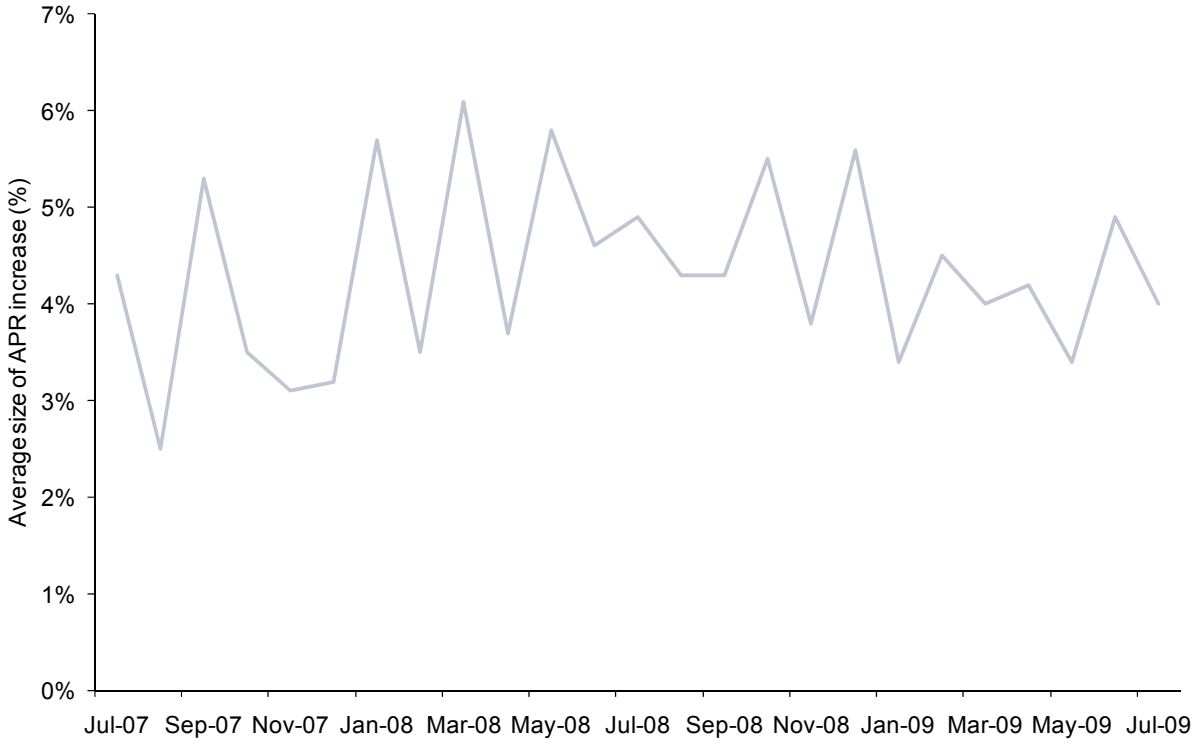
This sub-section examines the impact of re-pricing on indebtedness and financial difficulty.

Evidence on size and frequency of increases

BIS cites examples of an increase in interest rate of 15 percentage points (from 18% to 33%),[183] including cases of some consumers facing a doubling of their interest rate.[184] Information presented below on the size and frequency of rate increases shows that these examples are not typical. Figure 5.4 shows the average increase in APR for re-priced accounts (by month) for the period from July 2007 to July 2009 to be 4.3%, and in a range from 3% to 6%. Although it is difficult to draw conclusions on the trend over time (given the volatility of the data), there would not appear to be a clear upward trend that would suggest that issuers may be attempting to boost profitability with larger increases.

[178] GfK NOP survey (2009), p. 157.
[179] Ibid. p. 181.
[180] Argus (2010), 'UK Credit Card Payments Study', January, slide 169 and Argus (2010), 'UK Credit Card Payments Study', January, slide 232.
[181] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 283.
[182] Ibid., para 291.
[183] Ibid., para 283.
[184] Ibid., para 275.

Figure 5.4 Average size of APR increase, July 2007–July 2009



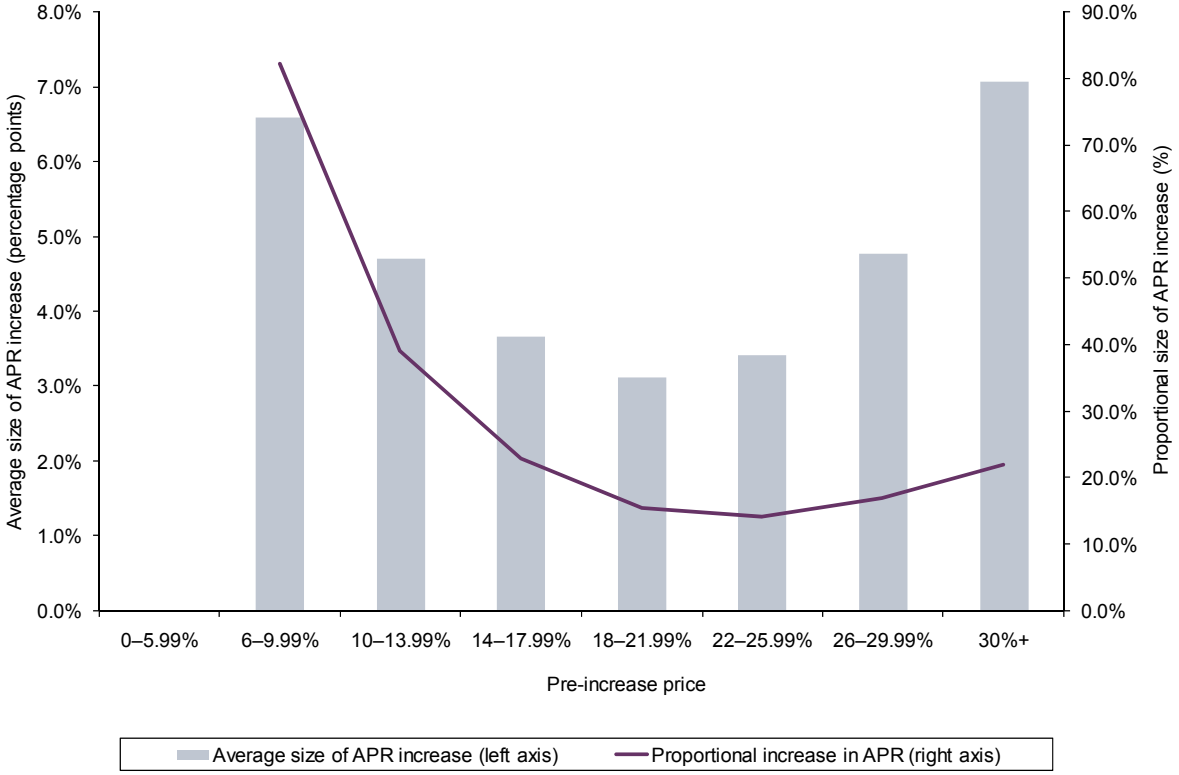
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 150.

Information on the size of increase in interest rate broken down by initial interest rate[185] also shows that it is unlikely that any high-risk cardholders would have experienced a doubling in interest rate. Figure 5.5 below shows that only accounts with initially low interest rates (less than 10%[186]) experience increases of more than 50% of the pre-increase level.

[185] Argus (2010), 'UK Credit Card Payments Study', January, slide 182.

[186] Discussions with issuers suggest that very low rates reflect historical rather than current offers.

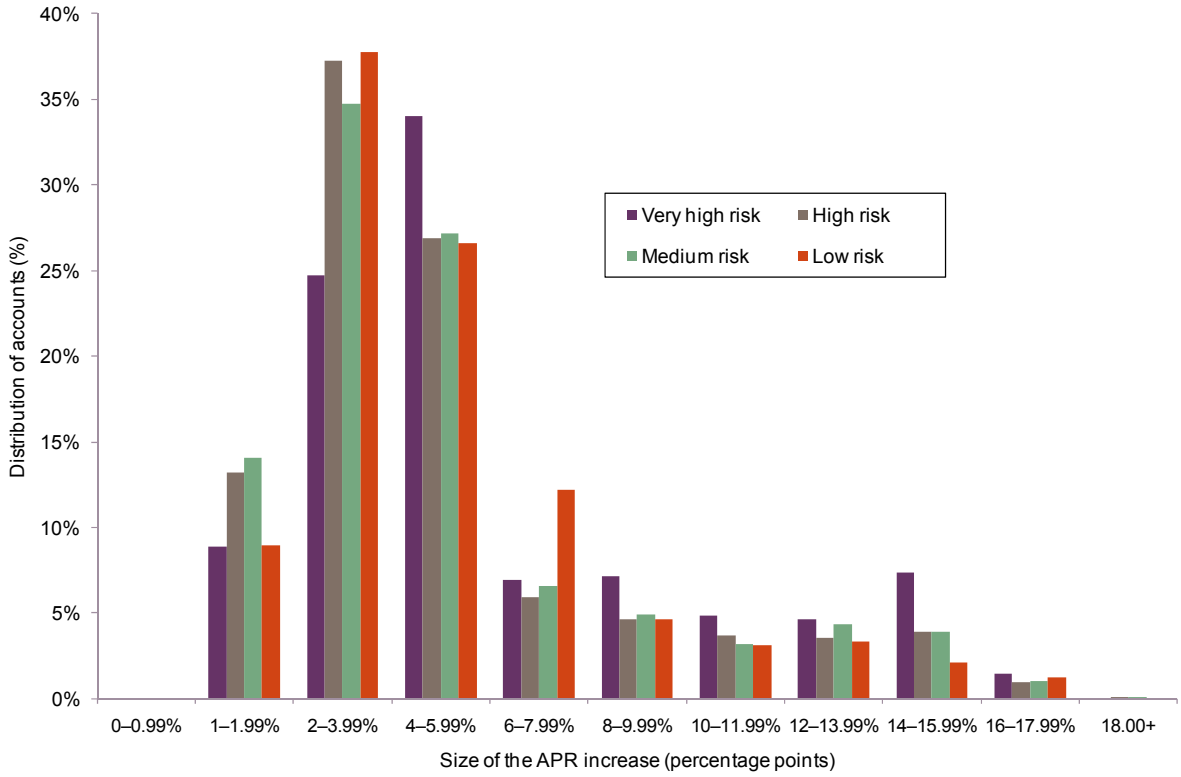
Figure 5.5 Average and proportional size of APR increase by pre-increase price, Q2 2009



Source: Oxera analysis based on Argus (2010), 'UK Credit Card Payments Study', January, slide 182.

Some issuers have policies to cap the size of any given re-price (for example at 5 percentage points). Data on the distribution of rate increases also shows that the BIS example of a 15% increase in APR is highly unusual. Figure 5.6 below shows that the number of accounts which received APR increases of 14–15.99 percentage points in Q2 2008 was low—only 3.9% of high-risk accounts received this increase, and only 0.96% of high-risk accounts received an APR increase of 16–17.99 percentage points.

Figure 5.6 Distribution of accounts by size of the APR increase across risk categories, Q2 2008



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 206.

The frequency of re-pricing is controlled through self-regulation such that new accounts are not re-priced in the first 12 months and mature accounts are not re-priced more than every six months. As explained above, data for the period between July 2007 and July 2009 suggests that approximately 90% of accounts are not re-priced in any given year.

Contribution to indebtedness and financial difficulty

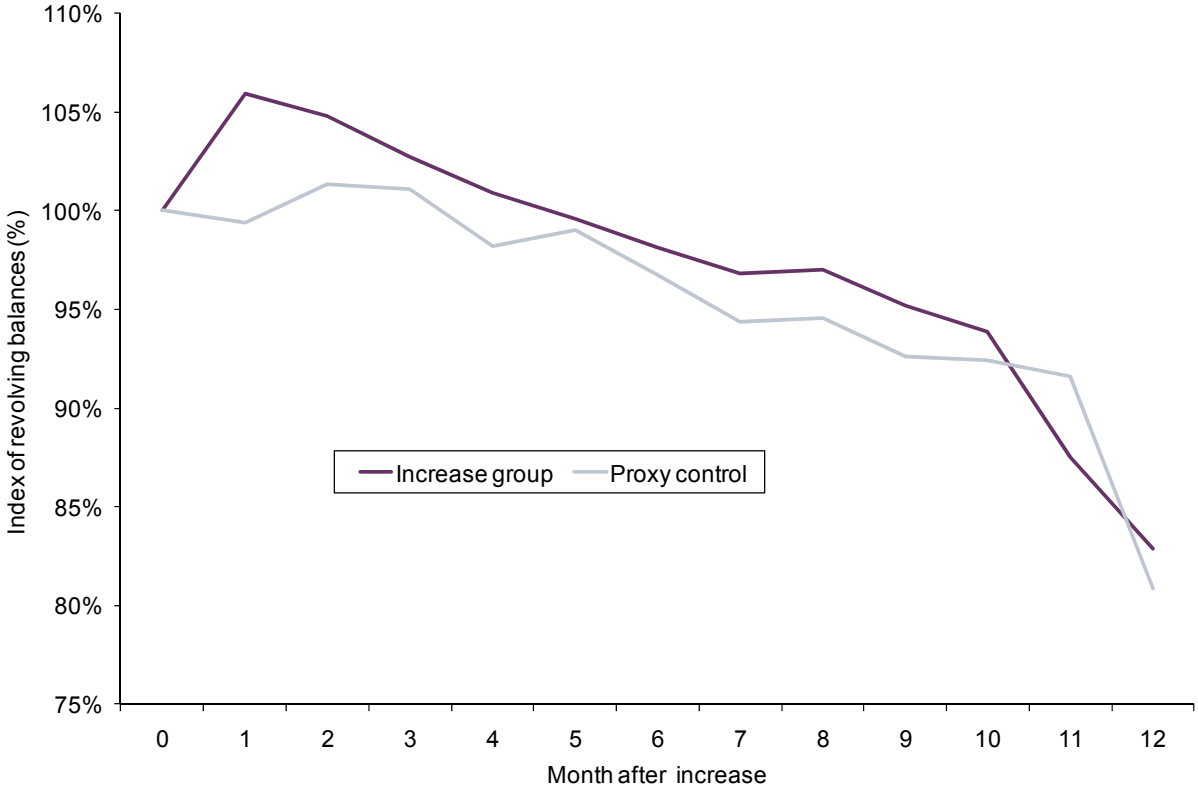
It is possible to examine the effect of re-pricing on indebtedness, as measured by revolving balances. Figure 5.7 below shows that revolving balances initially rise following an upwards re-price, but then fall below the original level. For the group of cardholders who received an increase in price in the second quarter of 2008, revolving balances a year after the re-price were around 80% of the pre-crisis balance.[187] This is almost identical to the reduction experienced by the proxy control group,[188] suggesting that the re-price made little difference. This is consistent with the finding that re-pricing has a fairly small impact on overall monthly payments for most cardholders. In Q2 2009, re-pricing increased payments by less than £25 for 92% of those re-priced (ranging from 85% of high-risk accounts to 97% of low-risk accounts).[189]

[187] Argus (2010), 'UK Credit Card Payments Study', January, slide 165.

[188] A control group would be a randomly selected sub-set of the group of cardholders who would otherwise be re-priced—and by definition could only be identified by issuing banks. Argus constructs a 'proxy control group' that is identical to the group of re-priced cardholders in terms of risk, vintage, pre-increase (or decrease) APR, credit limit and utilisation, which is not re-priced for at least three months following the re-price of the 'target' group.

[189] Argus (2010), 'UK Credit Card Payments Study', January, slide 231.

Figure 5.7 Index of revolving balances Q2 2008, increase group versus proxy control group



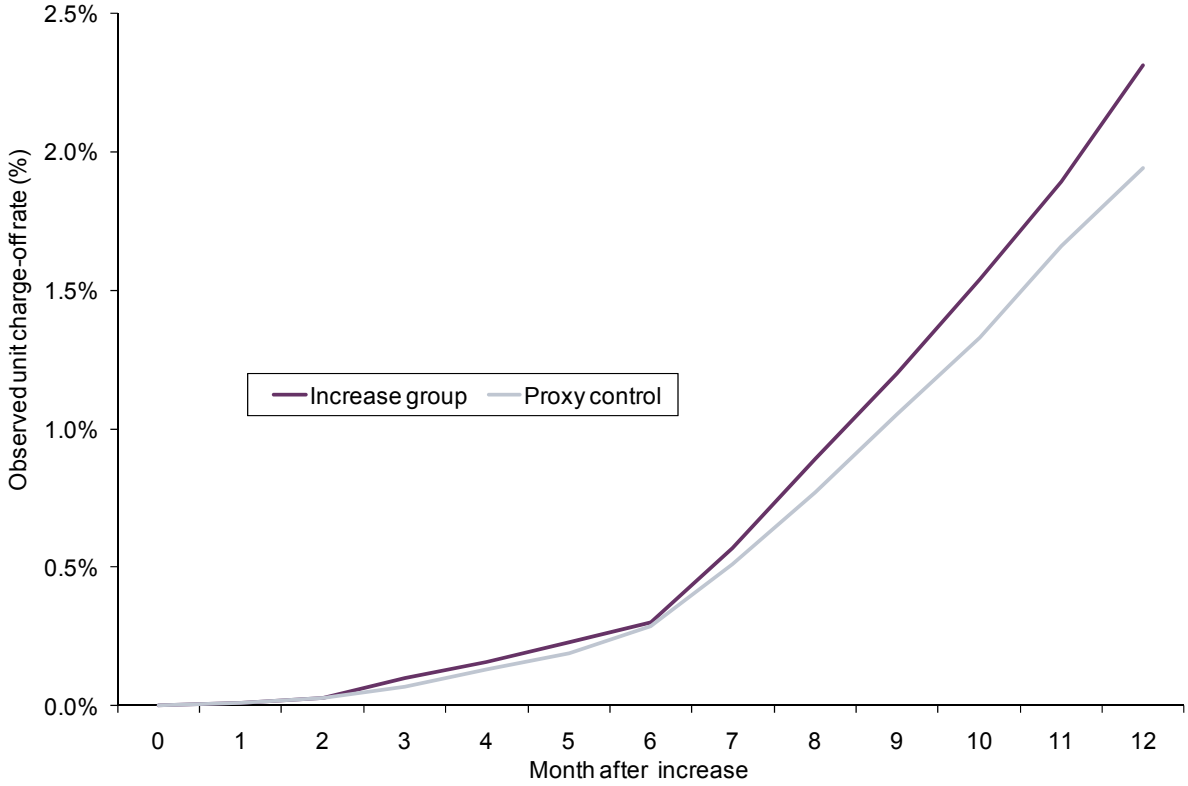
Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 165.

By comparing the charge-off rate for cardholders who have received an increase in interest rates with that of the proxy control group, it is also possible to estimate the effect, if any, of re-pricing on financial difficulty. Figure 5.8 shows that issuers charged off around 2% of accounts in the 12 months to June 2009, and that this rate is only slightly higher for cardholders who have received an increase in interest rate in comparison to the proxy control group.[190] The difference between the charge-off rate for the increase group (2.3%) and the proxy control group (1.9%) is around 0.4 percentage points and therefore relatively small—ie, it would be equivalent to a movement within risk band 5 (as defined in section 1 and used throughout this report) rather than across risk bands.

The charge-off rates for both groups show the effect of the economic downturn. In the 12 months ending in September 2007, cumulative charge-off rates were closer to 1.5%. This period also exhibited no significant difference in the charge-off rates experienced by the increase group compared with the proxy control group. A couple of issuers that have undertaken their own control group analysis confirmed to Oxera that their analysis also shows that RBRP does not result in a significant increase in charge-off rates.

[190] Argus (2010), 'UK Credit Card Payments Study', January, slide 166.

Figure 5.8 Observed unit charge-off rate for Q2 2008, increase group versus proxy control group



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 166.

5.2.3 Has self-regulation been effective?

Despite the minimal impact of re-pricing on indebtedness and financial difficulty, BIS appears to be concerned that cardholders may not be able to avoid the increased interest costs resulting from re-pricing. As discussed in section 5.1, these concerns were addressed by the Statement of Principles, which came into force in January 2009. This introduced an opt-out whereby cardholders can choose to close an account that has been re-priced and repay balances at the existing rate.[191] BIS notes, however, that very few cardholders have chosen to exercise this option. BIS raises the possibility that the low take-up of the opt-out clause may reflect difficulty in switching or obtaining new credit.

This sub-section assesses both the use of the opt-out and consumer switching more generally.

Evidence on use of opt-out

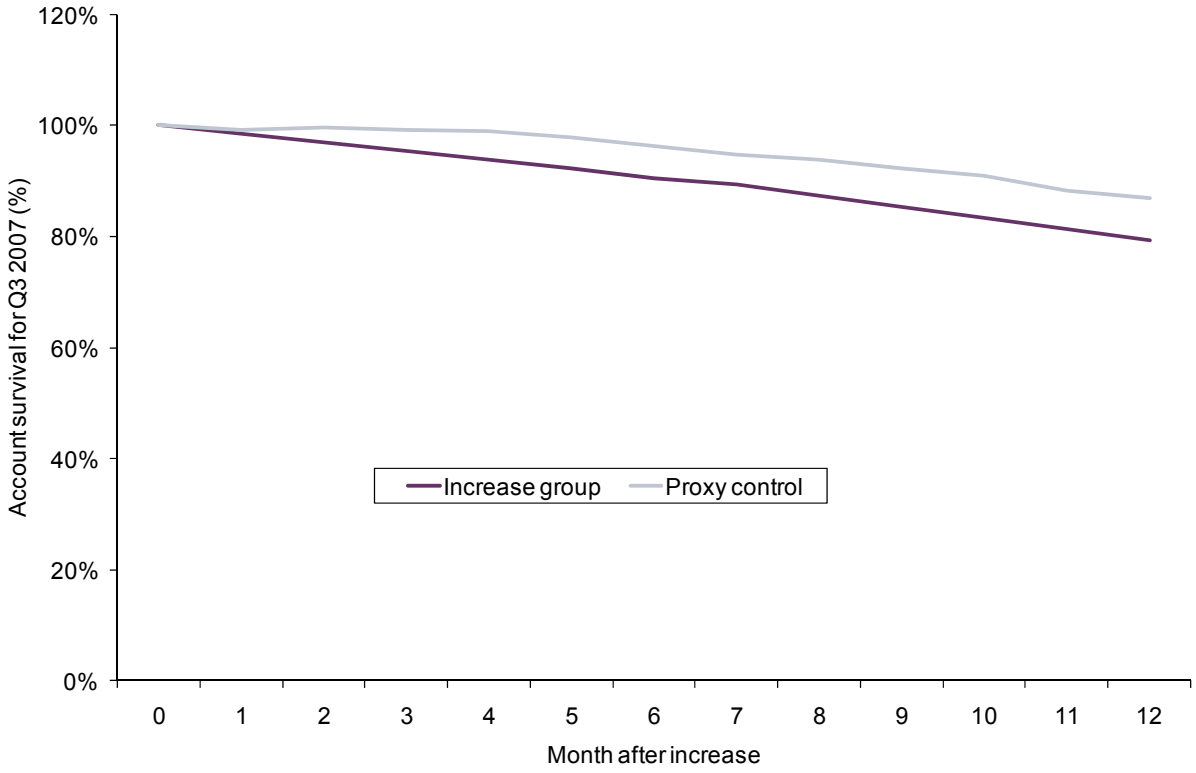
While not presenting specific figures, BIS notes that cardholders have made limited use of the opt-out. Confidential data from issuers shows that, in aggregate, between less than 1% and 5% of accounts that were re-priced between January and October 2009 chose to opt out. Consumer survey data suggests a higher opt-out rate of 6%.[192] When asked whether they were aware that it was possible to opt out of a price increase, 45% of respondents

[191] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, para 280.
[192] GfK NOP survey, p. 169.

indicated that they knew this already.[193] This did not vary significantly by social class or payer status (ie, transactor versus revolver).[194]

Data from Argus does not show whether cardholders have taken the opt-out, but the data can be used to show whether cardholders are reacting to an increase. Compared with a proxy control group, cardholders whose rates had been increased in the third quarter of 2007 showed higher levels of attrition; a year following the increase, just 79.4% of accounts were still active, while 86.9% of accounts in the proxy control group remained active. This suggests that cardholders were reacting to re-pricing.

Figure 5.9 Account survival for Q3 2007, increase group versus proxy control group



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 163.

This pattern changed for accounts re-priced in the second quarter of 2008; the share of accounts that closed a year after a re-price was approximately the same for both the proxy control group and the group of re-priced accounts.[195] This could indeed be consistent with cardholders experiencing difficulty in finding alternative sources of credit in the current economic climate. However, this is a temporary issue—limits in credit availability are likely to become less severe as economic conditions improve. It suggests that when credit is available, cardholders do indeed respond to price increases.

Evidence on switching

The ability of cardholders to avoid rate increases is related to the rate of switching more generally. A high switching rate for credit cards suggests that cardholders are unlikely to be 'locked in' or unable to react to increases in the interest rate on their cards. A greater willingness of customers to switch also constrains card issuers' ability to raise rates for existing customers.

[193] GfK NOP survey, p. 176.
[194] Ibid., pp. 175 and 178.
[195] Argus (2010), 'UK Credit Card Payments Study', January, slide 163.

BIS notes that consumer switching for financial products (including credit cards) has historically been low, citing information from the Cruickshank review conducted in 2000.[196]

More recent evidence suggests that consumers do switch providers; of the 58m credit card accounts held in February 2008,[197] a Datamonitor article in that month cited research by MoneyExpert.com showing that 5.9m people had switched credit cards in the previous six months.[198] Assuming that this six-month period was representative, this would suggest that 11.8m people switch credit cards each year, roughly equivalent to an annual switching rate of 19.7% (11.8m customers switching divided by 58m account holders). This is high compared with other markets; for example, the switching rate in the market for home insurance is 6%,[199] in fixed telephony 4%,[200] in gas 13%[201] and in electricity 22%.[202]

Furthermore, another study cited by BIS implies that consumers do not perceive high barriers to switching—a survey towards the end of 2008 showed that 22% of cardholders intended to switch providers over the following 12 months. This was a slight increase over the start of 2008, when 19% said they planned to switch.[203]

Data on account attrition rates can also be used to estimate switching. If it is assumed that cardholders who close their accounts are likely to open another one, the number of people who close accounts would represent the number of those switching.[204] In the year to June 2009, 14.2% of cardholders closed their accounts.

Ability to switch

Regardless of the general level of switching, BIS expressed concern that some cardholders may not be able to switch away in response to a price increase, either because of a status quo bias or the inability to obtain new credit. If switching rates are again estimated by attrition rates, Figure 5.10 below shows that between 6.5% and 17.5% of accounts are closed each year. Although it suggests that higher-risk accounts are less likely to close account, in absolute terms and compared with other markets, a switching rate of between 6.5% and 10% is not low and shows that even high-risk cardholders are able to switch.

[196] Cruickshank, D. (2000), 'Competition in UK Banking, A Report to the Chancellor of the Exchequer', March, para 4.74.

[197] British Bankers' Association (2008), 'Credit card statistics', April 4th.
See http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=470&a=13275

[198] Datamonitor (2008), 'Credit Card Shuffle Continues as Switching Rises in UK, says MoneyExpert', February 11th.

[199] Estimated annual figure from a five-year total between 2000 and 2005 based on National Consumer Council (2005), 'Switched on to Switching? A Survey of Consumer Behaviour and Attitudes, 2000 –2005', November, p. 3.

[200] Estimated annual figure from a five-year total between 2000 and 2005 based on National Consumer Council (2005), 'Switched on to Switching? A Survey of Consumer Behaviour and Attitudes, 2000 –2005', November, p. 3.

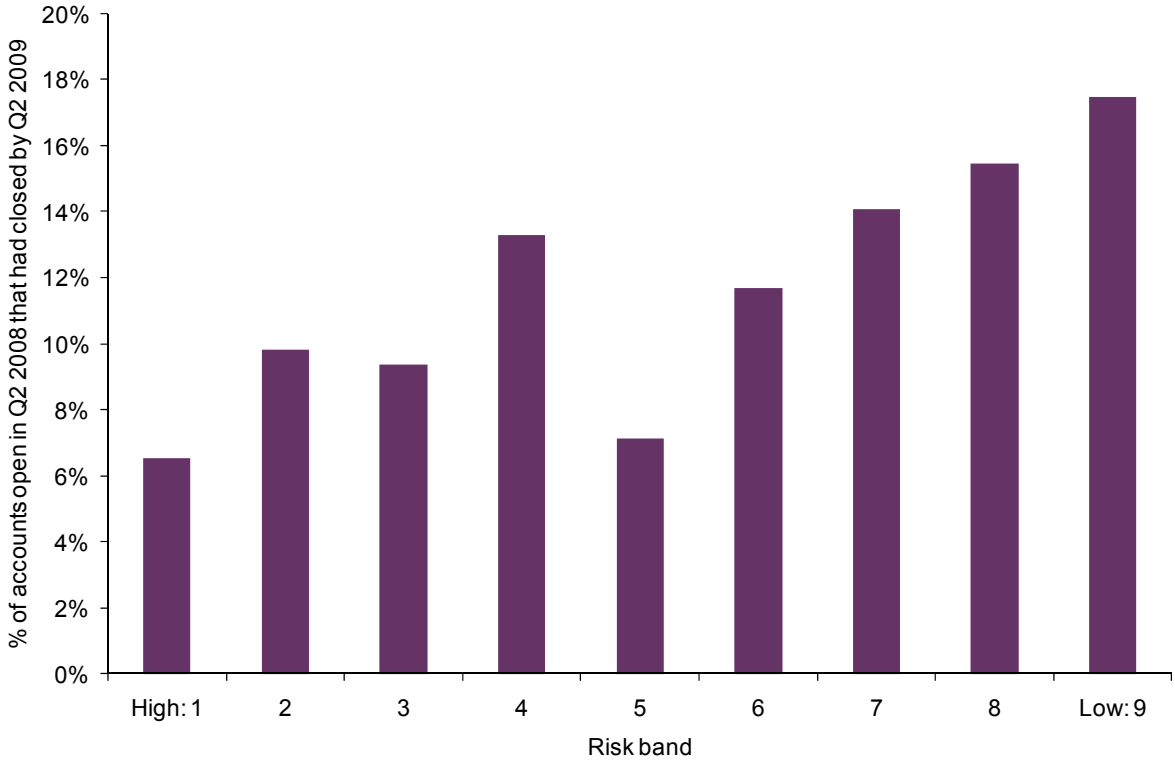
[201] For 2003, Ofgem (2004), 'Domestic Competitive Market Review 2004', p. 70, April.

[202] For 2003, Ofgem (2004), 'Domestic Competitive Market Review 2004', p. 75, April.

[203] *Which?* (2008), 'Credit card transfers rise as recession looms', September 16th.

[204] Some of this may be due to a reduction in multiple cardholding. However, arguably even this could still be considered switching—there would simply be a longer time period between opening a new account and closing the old account.

Figure 5.10 Percentage of accounts open in Q2 2008 and closed by Q2 2009, by risk band



Source: Argus (2010), 'UK Credit Card Payments Study', January, slide 233.

With regard to credit availability, confidential data from issuers shows that the number of new accounts opened during the period of January to October 2009 fell by almost 30% compared with the same period in 2008. Of accounts opened, low-risk accounts predictably made up a larger share (78% versus 66%).[205] This suggests that higher-risk customers may indeed be having difficulty obtaining credit, though this is likely to ease as economic conditions improve.

5.2.4 Summary of rationales

As outlined at the beginning of this sub-section, the three reasons put forward by BIS for potential changes to the current regime are:

– increases in the interest rate may be unjustified;

– RBRP may exacerbate financial difficulty among vulnerable consumers;

– self-regulation may be ineffective in protecting vulnerable consumers.

First, with regard to the first reason, it is beyond the scope of this report to assess the extent to which actual re-pricing is driven solely by changes in the risk profile. However, the data suggests that re-pricing generally applies to the higher-risk accounts within each risk band. Also, accounts with a higher utilisation rate are much more likely to be re-priced than accounts with lower utilisation. In addition, available data on the frequency and size of increases shows that increases have not become larger or more frequent over time. Finally, a substantial number of cardholders have also had their accounts re-priced downwards.

Second, BIS is concerned that RBRP may cause financial difficulty among vulnerable consumers, citing examples of increases being as high as 15%, or of the interest rate being

[205] Argus (2010), 'UK Credit Card Payments Study', January, slide 235.

doubled. Information on the average size and distribution of re-pricing shows that such increases in APR are unusual and the size of the average APR increase over the past two years shows no clear upward trend. Furthermore, there is no evidence that re-pricing has a significant impact on indebtedness; the revolving balances of consumers a year after a re-price are almost identical to those of a proxy control group, implying little impact of the increase on indebtedness. Charge-off rates for those who receive a re-price and those who do not are also similar.

Third, BIS expressed concern that self-regulation has not been effective in enabling cardholders to avoid the increased interest costs resulting from re-pricing. Although few cardholders have exercised the opt-out clause, evidence on attrition rates from earlier years shows that cardholders do respond to price increases. Evidence on switching also implies that consumers are able to react to a re-price by changing provider.

5.3 BIS proposals

BIS is considering a range of options to modify current practices to varying degrees, as follows.

– **Rely on Statement of Principles**.[206] This option maintains the status quo, with risk-based rate increases continuing to be subject to the restrictions discussed above.

– **Provide consumers with better information about RBRP decisions**.[207] Instead of providing a customer with an explanation as to why their account has been re-priced only on request, issuers may be required under this option to explain why the rate has been increased at the same time as notification of the rate increase is given.

– **Define considerations that it would be fair for lenders to take into account when changing an individual's price on grounds of risk**.[208] Under this approach the circumstances in which it would be considered fair to change an individual's price on the grounds of risk would be clearly defined. BIS envisages that these criteria would be developed in consultation with lenders and consumers.

– **Limit the size and/or frequency of existing debt re-pricing**.[209] Under this option the issuers' voluntary limits on the frequency and size of re-pricing could be expanded, and potentially placed on a statutory footing.

– **Prohibit re-pricing of existing debt**.[210] This could take the form of a complete ban on any re-pricing of existing debt, or of more specific prohibitions on risk-based re-pricing. BIS notes that such intervention could be achieved by limiting the circumstances in which issuers could re-price existing debt to general movements in the cost of funds or base rates.

The following section examines the impact of banning RBRP altogether, as the most far-reaching of the proposed measures, and also discusses some of the intermediate options.

[206] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards— A Consultation', Economic Impact Assessment, October, paras 295–96.
[207] Ibid., paras 297–302.
[208] Ibid., paras 303–307.
[209] Ibid., paras 308–311.
[210] Ibid., paras 312–321.

5.4 Impact of banning re-pricing

BIS recognises that there could be a number of implications of removing issuers' ability to re-price existing debt.[211] It would probably limit the availability of credit to high-risk customers (who would otherwise be most likely to be re-priced). If issuers knew that they could not impose a re-price, they would be less likely to offer credit in the first place. Issuers may also decide to extend smaller amounts of credit initially. If a cardholder's riskiness changed (or had been estimated incorrectly), this strategy would minimise the amount of mis-priced debt that the issuer would be unable to re-price. '

This strategy assumes, however, no restrictions would be placed on UCLI (and hence the 'low and grow' approach). If issuers' ability to increase credit limits were also to be restricted (as discussed in section 4), this would make it even more likely that issuers would cease entirely the extension of credit to high-risk customers in the first place.

Furthermore, issuers would need to recover the losses resulting from the inability to re-price. This could be done in a number of ways, but one option would be to raise the initial interest rates and APRs applicable to new cards by an amount that would compensate them for the estimated losses to be incurred from not being able to re-price. This would result in an increase in cross-subsidisation, as some cardholders would have rates on existing debts that were higher than would be justified by risk-based pricing, and so would be cross-subsidising higher-risk cardholders. On the other hand, some cardholders would have rates lower than would be justified on risk-based grounds, which may encourage them to accumulate a higher balance than they otherwise would.

As discussed in section 5.2, BIS's rationale for proposing additional restrictions on issuers' ability to re-price was based on a possible lack of justification for increases and concerns that re-pricing may contribute to financial difficulty among vulnerable consumers. Furthermore, BIS expressed concern that consumers may be unable to avoid increases.

This section has presented evidence suggesting that overall the amount of re-pricing (as measured by the share of accounts re-priced) is fairly low. Furthermore, this section has demonstrated limited support for the concern that there is any increase in charge-off rates following RBRP. Finally, while consumers have made limited use of the opt-out, survey data suggests that they are aware of the option. Data on attrition and switching rates indicates that consumers are able and willing to take action if they are dissatisfied with their cards.

It is, however, the case that issuers' credit scoring models are typically complex and that, as a result, re-pricing decisions may not appear to be directly related to changes in consumers' risk profiles. This could suggest a role for increased information on how credit scores are determined and how re-pricing decisions are made. However, the benefits of additional information would need to be assessed first. Furthermore, the additional information would have to be provided in a clear and considered way that did not exacerbate 'information overload'. Given the complexity of credit scoring and issuers' re-pricing models, it would seem sensible to conduct a bespoke study on what elements of re-pricing decisions consumers would find most useful and how these points could best be communicated.

[211] Department for Business, Innovation and Skills (2009), 'Review of the Regulation of Credit and Store Cards – A Consultation', Economic Impact Assessment, October, paras 315–317.

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