

Credit card market study: interim report

November 2015



We are asking for comments on this Interim Report by 8 January 2016

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Abbreviations used in this paper

APR	Annual Percentage Rate
BTs	Balance transfers
CMA	Competition and Markets Authority
CONC	Consumer Credit Sourcebook
CP	Consultation paper
EU	European Union
FCA	Financial Conduct Authority
HCSTC	High-cost short-term credit
OFT	Office of Fair Trading
ONS	Office of National Statistics
PCA	Personal current account
PBT	Profit before tax
PCWs	Price comparison websites
PSR	Payment Systems Regulator
SME	Small and medium-sized enterprises

1.

Executive summary

Interim findings

We found that in most of the market, competition is working fairly well for consumers. Consumers value the flexibility offered by credit cards and use them in different ways, for example making secure payments and collecting rewards, spreading the costs of purchases or as an emergency credit facility, for paying off other debt, or for building credit history.

Firms compete strongly for custom on some features – not only for new consumers but also for ‘back book’ consumers (existing borrowers with balances). However, competition is focused primarily on introductory promotional offers and rewards, with less competitive pressure on interest rates outside promotional offers and other fees and charges. We want to ensure industry is clear about fees and charges, so consumers can focus on the overall cost of using credit cards.

The market is moderately concentrated but there has been new entry in recent years. However, higher credit risk consumers have a more limited choice of products and providers than lower risk consumers. The main barriers to serving this segment, other than commercial viability, appear to be the reputational and regulatory risks associated with higher risk and higher cost lending.

Our evidence suggests many consumers are open to switching – each year around 14% of consumers with a credit card take out a new one – and firms do not consider a lack of switching to be a significant barrier to entry or expansion. However some consumers with higher risk profiles are less willing to shop around for fear of affecting their credit record, and we are proposing remedies to address this.

All lending activity carries default risk. That said, we are concerned about the scale of potentially problematic debt in this market including for consumers who are just above the default level. We found that around 6.9% of cardholders (about 2 million people) are in arrears or have defaulted. We estimate a further 2 million people have persistent levels of debt that some may be struggling to repay, and that a further 1.6 million people are repeatedly making minimum payments on their credit card debt. 8.9% of credit cards active in January 2015 (5.1 million accounts) will – on current repayment patterns and assuming no further borrowing – take more than 10 years to pay off their balance.

Consumers in default are extremely unprofitable and firms are active in contacting consumers who miss payments and triggering forbearance at this point. However, consumers with persistent levels of debt or who make minimum payments are profitable. Firms therefore have fewer incentives to address this and we found that most firms do not routinely intervene to address this behaviour. We consider that there is more firms could do to help those with persistently high credit card debt to reduce debt burdens before they become problematic, and to prompt those repeatedly making minimum payments to repay quicker when they are able to. We believe the incentives for firms in this market can be realigned in this area.

0% balance transfer offers are a significant feature of this market (accounting for a quarter of outstanding balances) – they are popular with consumers and provide an important focus for competition between providers. Nonetheless, the increase in the number and length of offers has raised some concern: first, whether consumers understand the product and the fees they will incur; and second, whether balances that are currently interest-free are storing up future debt problems.

We expect firms to be clear about the fees associated with such deals, and are keen to find ways to help consumers assess and compare the total cost of credit on such deals. As regards future debt problems, we found that these deals are generally not available to those with higher credit risk, and that in current economic conditions the stock of lending appears affordable. As with any credit product, however, concerns would increase should economic conditions change.

Interim proposals on remedies

We identified a range of potential remedies to make the market work better for consumers. We are now keen to engage with stakeholders to take forward a package that addresses the issues we have found. Measures to help consumers find the best deal include enabling better access by consumers to their transaction data, boosting the role of comparison sites, ensuring consumers can search the market without damaging their credit score, and prompting consumers when they are nearing the end of a promotional period.

To reduce problematic credit card debt we propose measures to give consumers more control over credit limits and utilisation, and measures to encourage consumers to pay off debt quicker when they can afford to. We also propose that firms do more to identify earlier those consumers who may be struggling to repay and take action to help them manage their repayments. We want to ensure the incentives for firms in this sector align with good consumer outcomes.

We consider that this package of remedies could have significant impact in addressing the concerns we identified. We are interested to hear views on these proposals and how we can best take them forward.

- 1.1** In November 2014, we launched a market study into credit cards, having taken over regulation of consumer credit in April 2014. We wanted to build a sound understanding of the market and assess whether it was working well in the interest of consumers.
- 1.2** Consumers value the flexibility and convenience of credit cards and they are an extremely popular product. Around 60% of UK adults hold at least one credit card. There are currently about 30 million credit cardholders in the UK, with an estimated £61 billion of outstanding credit card balances – or an average of £2,000 per person.¹ This is one of the largest areas of unsecured lending within our regulatory remit, and represents 32.5% of total unsecured personal borrowing in the UK.²
- 1.3** This report presents our **interim findings** of our market study. In it we set out our views based on our work to date on how competition works in this market and on outcomes for consumers. We also outline some potential remedies that might address some of our findings.
- 1.4** We investigated three areas in the market study:
- The extent to which consumers drive effective competition through shopping around and switching.
 - How firms recover their costs across different cardholder groups and the impact of this on the market.
 - The extent of unaffordable credit card debt; in particular whether some consumers are over-borrowing or under-repaying on their balances and whether firms have incentives to provide unaffordable credit that leads to consumer detriment.

The extent to which consumers drive effective competition through shopping around and switching

- We found that **firms compete strongly** for custom and there are a range of promotional offers available. However, we found less competitive pressure on interest rates outside of promotional offers and on other fees and charges and consumers do not always focus on such costs.
- There has been some **market entry** – five new firms have begun offering credit cards in recent years – and they have been able to gain market share. We found fewer firms were willing to serve higher risk consumers and there was less choice for these consumers.
- **Consumers are engaged and willing to switch** with over half claiming to shop around when choosing their credit card and around 14% of existing consumers take out a new credit card a year. Most consumers do not perceive material barriers to switching, and firms do not consider a lack of switching to be a significant barrier to entry or expansion.

¹ According to UK Cards, at the end of Q4 2014 outstanding balances stood at £61.1 billion. This total can be split into interest-bearing and non-interest-bearing. Around 42% of all outstanding balances in Q4 2014 were non-interest bearing.

² UK Cards, *UK Card Payments* (2015) publication

- 1.5** The credit card market offers a range of products to meet varied consumer needs. Consumers value the flexibility offered by credit cards and use them in different ways, for example paying off other debt (balance transfer cards), borrowing (0% purchase cards and standard low-rate cards), everyday spending (rewards cards), and building credit history (low and grow cards).
- 1.6** Attractive introductory promotional offers are a common feature. Along with an increasing prevalence of long term low rate products, they provide strong incentives for consumers to switch. Evidence suggests half of those taking out a credit card shop around first, and that around 14% of existing credit cardholders take out a new credit card in a year. Most consumers do not perceive material barriers to switching, and firms do not consider a lack of switching to be a significant barrier to entry or expansion.
- 1.7** However, we find competition is focused on a small number of features such as promotional offers and rewards, and when choosing a credit card consumers often disregard important features, such as long-term interest rates or fees and charges (e.g. balance transfer fees), that can add significantly to costs. We also found that some consumers end up not using their credit cards in the way they expected when they took them out, adding to the complexity of finding the best deal.
- 1.8** Price comparison websites (PCWs) play an important role in this market. For consumers they can help navigate complex products and reduce search costs by comparing products in one place and for firms they can help attract consumers. We found that of those consumers who shopped around, 66% used one or more PCW and found them useful. However, we found a number of limitations to the effectiveness of PCWs in helping consumers navigate product complexity – for example, ranking criteria may not be sufficiently capable of reflecting the individual’s credit card usage pattern. We also found that PCWs on the whole did not make clear how they were funded and whether they compared the whole of the market.
- 1.9** On the supply side, the market is moderately concentrated³ and there are material costs of entry, such as significant sunk costs and a high level of expertise and data. However, these do not appear insurmountable – five firms have begun issuing their own credit cards in recent years (Metro Bank, Sainsbury’s Bank, Tesco Bank, TSB and Virgin Money) with some of these firms originally entering the market through joint ventures or partnerships with existing credit card issuers.
- 1.10** We also found that higher credit risk consumers have a more limited choice of products and providers than low risk consumers.⁴ The main barriers to serving this segment, other than commercial viability, appear to be the reputational and regulatory risks associated with higher risk and higher cost lending. We also found higher credit risk consumers have concerns about whether other firms would offer them a credit card and the impact of multiple applications on their credit score, which discourages some from shopping around.
- 1.11** We looked at whether consumers were in fact choosing the best deal, in particular whether those paying interest on purchases could have benefitted from choosing a lower cost card. Most accounts transact a lot and borrow a little, so the cost of borrowing for these is small.
- 1.12** However, for those who borrow more, the potential savings from choosing a cheaper credit card are clear and significant. For example, 8% of accounts in our sample incurred over £100

³ The estimates of market concentration use the Herfindahl-Hirschman Index (HHI) measure of market concentration. This is calculated by adding together the squared values of the percentage market shares of all firms in the market. It therefore takes account of the different sizes of market participants as well as their number. The Office of Fair Trading’s Merger Assessment Guidelines (September 2010, OFT1254) indicate that a market with an HHI exceeding 1,000 may be regarded as concentrated. The HHI scores for the credit card market indicate that it is slightly above that threshold with an HHI in 2014 of 1171 based on number of accounts and 1496 based on value of borrowing.

⁴ However, one firm has recently launched a new credit card targeted at this segment.

interest on purchases a year in the first two years after taking out their credit card. We estimate that consumers on these accounts pay on average £225 a year in interest on purchases of which they could save over £150 by choosing a cheaper credit card. This suggests that there is more that could be done to help consumers navigate the complexity of offers in this market and increase borrowers' focus on all the costs. We return to this below in our discussion on remedies.

- 1.13** Competitive pressure on conditional fees and charges such as default fees, foreign exchange fees or cash advance fees is limited, as consumers pay little attention to these. Business models are not predicated on these charges generating significant revenue (our analysis shows these charges represent around 5% to 12% of overall firm revenue.) Nonetheless we have found concerning practices by some firms, for example charging default fees several times per default event. This is not widespread across the market and we are pursuing these concerns with the individual firms in question.

How firms recover their costs across different cardholder groups and the impact of this on the market

- We found that **firms were not targeting particular groups of consumers in order to cross-subsidise others**. Where cross-subsidisation did occur we did not find that it materially affected competition in the credit card market.
- The Interchange Fee Regulation is likely to reduce firm income between 5% and 10% but we do not expect this to result in significant changes to credit card products.

- 1.14** As noted in our Terms of Reference⁵, stakeholders suggested to us that there is considerable cross-subsidisation in the credit card market and our study sought to establish whether this was the case and the effect it might have on competition. We therefore assessed whether the way firms recover their costs across consumer groups has an anticompetitive effect on the market (e.g. by creating barriers to entry or expansion), or results in certain groups being unduly disadvantaged.
- 1.15** We found firms typically design products to at least break-even over a five-year period for all behavioural types targeted – in other words we did not find firms targeting particular groups or behavioural types with a view to cross-subsidising others. Furthermore, we did not find evidence that cross-subsidies materially restrict entry or expansion in the market – firms' responses to our market questionnaire did not cite the lack of a captive 'back book' of consumers as a prohibitive barrier to entry, given consumers' willingness to switch.

⁵ FCA, *Credit card market study terms of reference* (2014) MS14/6.1: www.fca.org.uk/static/fca/documents/market-studies/ms14-6-1.pdf

- 1.16** In response to stakeholder concerns, we considered specifically whether there was a cross-subsidy from ‘revolvers’ (those who make use of the revolving credit facility) to ‘transactors’ (those who primarily use the card for payment). We found that products targeting transactors were profitable or breaking even – in particular, products designed to encourage high levels of spending can make significant profits from transactor behaviour. We did not find evidence that firms need to convert transactors into revolvers over time to break even on such accounts. That said, firms typically make higher profits from revolvers than transactors and, as noted above, we believe there is more that can be done to address borrowing costs.
- 1.17** We also considered how the cap on Interchange Fees would affect firms’ profitability and their product design and strategy. Firms’ estimates of the reduction in income from the cap averaged 5% to 10%. Firms with proportionally higher levels of transacting type consumers will face proportionally bigger losses in income. Firms say they will respond by offering more products with a small or increased annual fee or diluting rewards schemes. These developments do not give us direct cause for concern where appropriately communicated to consumers (whereas we would be concerned, for example, if the loss of interchange revenue led to increases in conditional charges which are less susceptible to competitive pressures). However, in a market where there are competitive pressures on firms we would expect to see continued attempts to gain business and minimise the impact of such changes on consumers. We will consider any changes to firms’ response to the cap on Interchange Fees as we progress this study.
- 1.18** In light of our findings we do not propose to take any further action in relation to how firms recover costs or cross-subsidisation.

The extent of unaffordable credit card debt

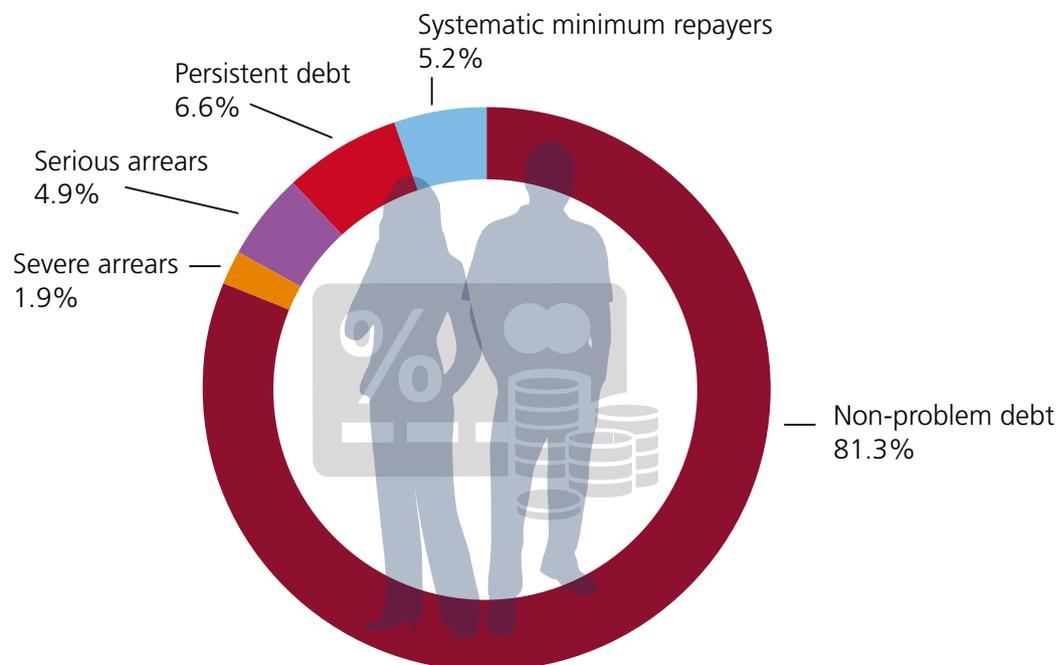
- **6.9% of cardholders (around 2 million) were in arrears or default** – we found that firms take steps to avoid lending to consumers who cannot ultimately repay and cardholders who default are not profitable. We found firms were generally proactive in contacting consumers when they began to miss payments.
- **A further 6.6% of cardholders (around 2 million) have persistent high levels of credit card debt** which they may be struggling to repay – these consumers are profitable for firms and there was little evidence to suggest firms intervene to help consumers address persistent debt burdens unless they miss payments.
- **A further 5.2% of cardholders (around 1.6 million) make systematic minimum repayments** – these consumers make slow inroads in their debt repayment but are not necessarily struggling. Again, these consumers are profitable for firms.
- On balance transfers, we found that almost **half of accounts repaid the full amount of the balance transferred by the end of the promotional period**. This increased to 60% three months later and 71% six months later. We considered that balance transfers do not appear to be materially contributing to problem credit card debt; however, if wider economic conditions were to change significantly then the proportion of consumers unable to pay is likely to increase.

- 1.19** A major difference between credit cards and many other credit products is that both the amount borrowed and the repayment schedules are flexible. Subject to meeting the minimum repayment, the consumer can decide how much to repay each month. This allows consumers to opt for a very low repayment rate which may be necessary to tide them over in the short term. Over a longer period, however, lower monthly payments imply a longer time to repay and, in turn, a higher total cost. This can have implications for the wider financial situation, including their ability to meet other commitments including basic household expenditure.
- 1.20** There is no standard definition of problem debt in the credit card market. We used a series of indicators to assess the scale and nature of debt that is potentially problematic. These are:
- Defaults and arrears
 - Credit limit utilisation
 - Systematic minimum payment behaviour
 - Debt service costs
 - Time to repay
- 1.21** We found that of the 31 million active consumers in the last year, 1.9% (600,000 people) have been in default or have been at least six months in arrears, and 4.9% (1.5 million people) have missed three or more repayments and are either in or have been in arrears. These consumers are more prevalent amongst those with high credit risk and in the more deprived demographic segments.
- 1.22** We looked at credit limit utilisation, since persistent high utilisation can also be an indicator of debt problems. We found that 6.6% (2.1 million people) of active consumers maintained a credit limit utilisation of on average 90% or more over the year while incurring interest. This was present across all credit risk groups and demographic segments but was more prevalent in higher risk consumer segments.
- 1.23** We also looked at systematic minimum payment. We recognise that this is a weaker indicator of problem debt and that this group includes consumers who are not struggling. Nonetheless, it indicates that consumers are taking longer to repay their credit card debt (with associated costs) than perhaps they need to. We found that 5.2% (1.6 million people) of active consumers in the last year repeatedly made only minimum payments while incurring interest.⁶ This repayment behaviour also appears across all credit risk groups and demographic segments.⁷

6 Consumers that have made 9 or more minimum repayments in the last year while also incurring interest (i.e. excluding consumers on 0% interest deals).

7 In the figures we have reported the consumers worst state. For example, if a consumer had a high and persistent credit limit utilisation rate and had been charged off, they would be included in the 1.9% of those consumers identified as charged off or have been in at least six months arrears, rather than accounted for in the 6.6% of consumers identified as having persistently high utilisation rates.

Indicators of potential problem credit card debt



1.24 Lastly, we looked at the total debt servicing costs consumers pay relative to the amount borrowed, and at the length of time they take to pay off credit card debt. We found:

- 1% of credit cards opened after January 2010 (360,000 accounts) paid debt service costs over five years exceeding the amount borrowed. Those in arrears or with persistent levels of debt incurred the highest cost.
- 8.9% of credit cards active in January 2015 (5.1 million accounts) will – on current repayment patterns and assuming no further borrowing – take more than 10 years to pay off their balance. Again, those in arrears or with persistent levels of debt take the longest to repay.

1.25 We therefore consider that we have identified a mixture of:

- People struggling under a debt burden that has become problematic; and
- People paying more in debt service cost and taking longer to pay off debt than they need to. While these people may not regard their debt as problematic, it is more expensive than it needs to be and there is some risk that it becomes problematic in the future.

1.26 Our view at this stage is:

- **Some bad debt is a feature of all credit activity** – borrowing is never risk-free, as ability to repay is affected by life events (e.g. losing a job). Both borrowers and lenders take a degree of risk entering into any kind of credit agreement.
- **Behavioural biases may lead to over-borrowing and under-repayment** – there are known patterns of consumer behaviour that will tend to lead to over-borrowing and under-repayment. These include optimism bias (consumers typically over-estimate their ability to repay), framing effects (consumers perceive costs expressed in % terms as being smaller than the same costs expressed in £), and the anchoring effect of minimum repayment amounts (consumers will tend to pay what their lender suggests).

1.27 We wanted to understand whether firms had a commercial incentive to respond to these biases by over-lending or under-collecting. We therefore examined whether the types of lending identified were profitable.

1.28 On incentives, we found that firms make losses on defaulting consumers, so have strong incentives to avoid lending that has this outcome. However, we found that consumers with systematic minimum payment behaviour or high levels of utilisation are profitable, suggesting that firms have little incentive to screen these consumers out or to intervene when they identify such behaviour.

1.29 We looked at how firms assess credit risk and affordability. Both are elements of creditworthiness as defined in our rules: credit risk is an assessment of the likelihood a consumer will default, whereas affordability is an assessment of how easily a consumer can meet credit card repayments at a given credit limit. We found that firms invest significant effort in assessing credit risk, i.e. the likelihood that a consumer will default. Firms tend to conduct separate assessments of affordability, and these are noticeably less sophisticated. The FCA is undertaking wider work on its expectations as regards creditworthiness across consumer credit markets and we will take forward our thinking through that process.⁸

1.30 We also looked at forbearance. Firms have a range of forbearance procedures, designed to support consumers struggling with repayments, including reduced or suspended interest payments and charges. They are generally proactive in contacting consumers to initiate these procedures when consumers begin to miss payments. However we found little evidence of firms intervening with consumers currently meeting minimum repayments but exhibiting other signs of potentially problematic debt (e.g. maintaining a high credit limit utilisation). We believe there is more that could be done to intervene earlier with consumers exhibiting signs of potentially problematic debt, and discuss possible measures below.

1.31 We also considered balance transfers. The total amount of money held in balance transfers was £14bn (roughly a quarter of outstanding balances) at the end of 2014 and 22% of new accounts in 2014 involved a balance transfer. We considered whether balance transfer products were storing up future debt problems. These problems may arise once current promotional offers expire if consumers are then unable to service the debt or enter into another promotional balance transfer deal. We found that the terms offered to consumers varied by their perceived credit risk and that consumers with a perceived lower credit risk were typically offered the most favourable terms, such as a longer 0% introductory offer period. Consumers with a perceived higher risk tended not to be accepted for balance transfer deals so they are unlikely to comprise a significant proportion of outstanding balances.

⁸ FCA, *Business Plan* (2015/16): <http://www.fca.org.uk/static/documents/corporate/business-plan-2015-16.pdf>

- 1.32** We estimate that almost half of accounts repaid the full amount of the balance transferred by the end of the promotional period. This increased to 60% three months later and 71% six months later. Therefore, balance transfers do not currently appear to be materially contributing to problem credit card debt. However, if wider economic conditions were to change significantly then, as with any credit product, the proportion of consumers unable to pay is likely to increase.
- 1.33** Our view at this stage is:
- **Firms make losses on consumers that default** so they have a strong incentive not to lend to these consumers. However, firms have fewer incentives to avoid lending to consumers who have persistent debt or make systematic minimum repayments because they are profitable to the firm.
 - **Firms have a range of forbearance procedures** to help consumers clearly struggling to repay but could do more to intervene earlier and assist consumers who show signs of potentially struggling.

Interim proposals on remedies

- 1.34** Having identified a number of concerns (outlined above) we considered what action might address them. As set out in our market study guidance⁹, this could range from new rules (including changes to or withdrawal of existing rules) to supervision or enforcement actions and proposing enhanced industry self-regulation.
- 1.35** In this section we outline our **early thinking** on what actions might help the market work better for consumers in the two areas where we have identified concerns: 'shopping around and switching' and 'affordability and problem debt'.
- 1.36** The purpose of sharing our thinking at this interim stage is to engage with stakeholders on the themes identified and discuss workable solutions. The next stage will involve a more formal assessment of the effectiveness and proportionality of any potential interventions, before we present and consult upon any firm proposals (with supporting analysis) in our final report. When considering potential action we will consider the constraints from relevant EU and domestic legislation, and will take account of existing or proposed self-regulatory codes or guidance.
- 1.37** We are keen to engage with stakeholders on ways of taking our work forward, having regard to relevant initiatives in this or other areas and our wider work on smarter consumer communications.¹⁰

⁹ FCA, *Market Studies and Market Investigation Guidance* (2015): www.fca.org.uk/news/fg15-09-market-studies-and-market-investigation-references

¹⁰ FCA, *Smarter Effective Communications* (2015): <http://www.fca.org.uk/news/smarter-effective-communications>

Shopping around and switching

1.38 As explained above, the market is complex, often for good reason, given the flexibility of the product and the fact that usage patterns may vary. Nonetheless, this makes it difficult for consumers to compare offers and identify the best one for them. We believe there is scope to boost the role of third party intermediaries in cutting through the complexity consumers face when seeking the best deal. In particular, we consider that the market could be improved in the following ways:

- ***With the consent of consumers, open access to credit card usage data to other market participants:*** Similar approaches are already underway in relation to personal current accounts, for example, the Government is currently trialling the Midata initiative¹¹ and there is increasing use of Application Programming Interfaces (APIs) in the banking area.¹² We could look to build on these to develop comparable solutions for the credit card sector. The aim would be to enable consumers to consent to third parties (e.g. price comparison websites, or competing credit card providers) accessing their transaction history data, to be able to provide bespoke quotations linked to the consumer's pattern of spending and repayment.
- ***Clearer standards for price comparison websites (PCWs):*** We have recently consulted on proposed additional standards for PCWs comparing high-cost short-term credit (HCSTC) products.¹³ Taking into account the responses we receive to this consultation, we will consider whether, and if so how, similar standards might be introduced in relation to credit cards.

1.39 We expect that the above measures would enhance transparency about credit card products and their features, such as balance transfer fees, that will enable consumers to more easily choose the best deals.

1.40 We found promotional offers were common in this market, and were an important spur for switching. Nonetheless, consumers are not always aware of when their promotional period will end or the benefits of repaying their debt or shopping around. We therefore consider that the market could be improved by:

- ***Providing timely information to prompt consumers to repay their credit card debt or shop around once promotional offers have expired:*** We can see benefit in firms providing pro-active warnings to consumers (e.g. through text alerts, mobile applications, and/or emails) reminding them when their promotional offer is due to expire and the rates they will pay on any balances outstanding on their account at that point.
- ***Promoting and facilitating the use of quotation searches:*** We found that some consumers with higher credit risk are dissuaded from shopping around due to worries about the impact of multiple application searches on their credit score. We are already considering measures to promote and facilitate the use of quotation searches across all credit sectors¹⁴ and the evidence from this market study will feed into this work.

1.41 Other concerns around conditional charges and other aspects of terms and conditions were firm-specific rather than market-wide. Given that the market overall is working well we will pursue these concerns with the firms in question.

11 Gov.UK, Is your bank giving you the best deal? Find out using new online comparison tool (2015): www.gov.uk/government/news/is-your-bank-giving-you-the-best-deal-find-out-using-new-online-comparison-tool

12 HM Treasury, Call for evidence on data sharing and open data in banking (2015): www.gov.uk/government/consultations/data-sharing-and-open-data-in-banking-call-for-evidence/call-for-evidence-on-data-sharing-and-open-data-in-banking

13 CP 15/33

14 FCA, *Business Plan* (2015/16): www.fca.org.uk/static/documents/corporate/business-plan-2015-16.pdf

Affordability and problem debt

- 1.42** As explained above, we believe there is scope for the market to work better for consumers struggling with credit card debt or paying significant debt servicing costs. The FCA is reviewing its rules on creditworthiness (including affordability) across consumer credit, and our findings in credit cards will feed into this.
- 1.43** We outline below possible steps that could (i) reduce over-borrowing and encourage prompt repayment, thereby reducing the amount of interest and charges that consumers pay as a result of how they use their credit cards; and (ii) encourage earlier firm intervention to identify and help consumers with potentially problematic debt.
- 1.44** In relation to under-repayment, we consider that the following measures could make the market work better for consumers:
- **Disclosures to encourage faster repayment:** Firms could disclose in each monthly statement (i) how long it will take the consumer to repay the current balance and/or (ii) the saving in total cost from repaying more than the minimum and/or (iii) the repayment amount needed to pay off the balance within, say, one year. We are keen to hear from firms that have already trialled or are interested in trialling such an approach.
 - **Provide a wider range of pre-set repayment options:** Firms could offer different pre-set payment options for regular automated payments, for example, reflecting target time to repay. For online payment mechanisms, firms could remove the minimum amount from the range of pre-set options but with a default setting to ensure that at least the minimum is repaid.
- 1.45** A number of stakeholders have asked us to consider simply increasing the minimum repayment across the board, i.e. mandating that consumers pay a much higher amount than currently required by our rules. For some consumers, this could have a significant impact by reducing the repayment flexibility from which many consumers benefit. However, we would be interested to hear further views from stakeholders.
- 1.46** In relation to over-borrowing, we consider that the following measures could make the market work better for consumers:
- **Providing timely information to prompt consumers to take into account how much they are borrowing:** We found some consumers spend more on their credit cards than they expected to. Some firms already provide proactive warnings to consumers (through text alerts, mobile applications, and/or email) reminding them if they are approaching their credit limit or have reached say half their credit limit. We are keen to understand the effectiveness of such warnings and explore the scope for extending this practice across the market.

- ***Giving consumers more control during the lifetime of the credit card on variations, such as an opt-in for credit limit increases:*** Firms are already required to enable consumers to opt out of proposed increases in the credit limit, both individually and across the board. However, there may be merit in requiring consumers to actively opt in to an increase, so they are more in control, and to have to opt in to permitting 'over the limit' transactions. Consumers could also benefit from being able to choose the same payment due date each month, to align with timing of receipt of regular income.

1.47 In relation to potentially problematic debt, we consider the following measure could make the market work better for consumers:

- ***Earlier forbearance:*** We think firms could identify and address potentially problematic debt (e.g. persistent debt or systematic minimum repayment) sooner, before payments are missed and the consumer accumulates interest and charges that could have been avoided. Firms are already required to monitor for signs that consumers may be struggling to repay, but could do more to respond in such cases, for example by contacting the consumer to establish whether they are in financial difficulties and if so, whether to exercise forbearance. In particular we want to explore how to rebalance the incentives for firms in the credit card market to ensure that lower cost alternative credit is offered as a matter of course to those who appear to be building up problem debt after a standard period, for example 12 months.

We recognise the challenges firms face when interacting with consumers in financial difficulties and believe it may be necessary to adopt a stepped approach for intervention. This could range from reminders, through to signposting to debt advice and on to potentially re-structuring the repayment arrangements. We invite views on (i) how those consumers struggling with debt could be identified earlier, (ii) what, if any, stepped approach to intervention could be adopted and (iii) how the interaction at that stage could best be managed.

1.48 There are more radical possible approaches to tackling problem debt. Consumer groups have suggested a cap on the total cost of credit cards, similar to the cap implemented in the HCSTC sector where we have capped the total cost at twice the amount borrowed. At this stage we are not minded to pursue this approach as we consider that the package of remedies we have outlined are more likely to address the concerns identified and work across a highly varied market in terms of consumer behaviours. However we have not ruled out further work if we find that we cannot develop a package of measures that rebalances the incentives for firms. We would be interested to hear views from stakeholders on this point.

Invitation for responses

1.49 We are publishing this interim report to give all interested parties an opportunity to comment on our emerging thinking and analysis. We hope this will help assure the robustness of our findings and promote continued constructive engagement between the FCA, the firms, trade associations, consumer bodies and other interested parties.

1.50 Since launching the study we have collected a significant amount of evidence from credit card firms, and have met a number of market participants, trade bodies and consumer groups. We are grateful to all for their engagement.

1.51 In the report we set out our initial observations on how competition functions in the credit card market and highlight areas of potential concern. We also set out initial thinking on potential remedies and would welcome views from industry and consumer groups on these and how they might be implemented.

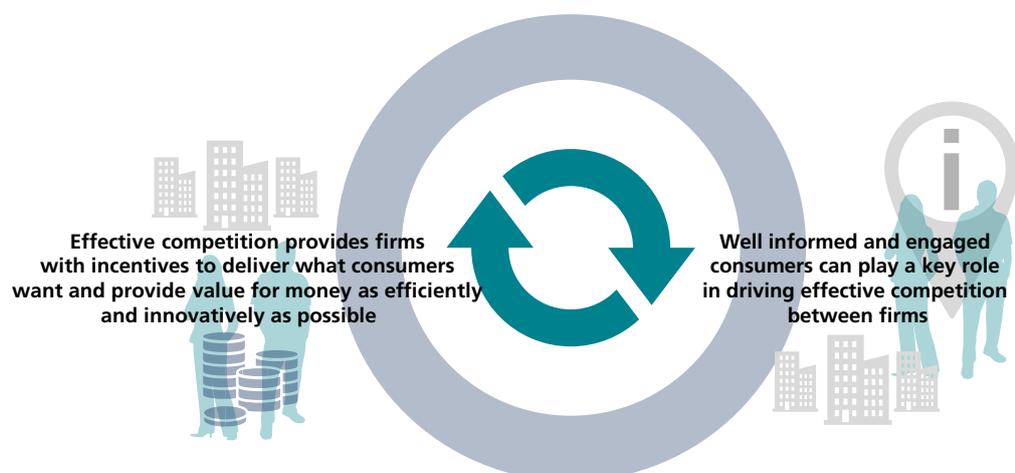
1.52 Please send us your views by 8 January 2016 to creditcardmarketstudy@fca.org.uk.

2. Our approach

Why did we decide to look into the credit card market?

- 2.1** We are carrying out this study to build our knowledge of the credit card market and assess whether the market is working well in the interests of consumers and, if not, to understand why and to identify appropriate ways to improve the situation. The study was launched in November 2014.
- 2.2** The credit card market is large, with around 30 million consumers holding at least one credit card, together having an estimated £61 billion of outstanding balances. This is one of the largest areas of unsecured lending within our remit, and represents 32.5% of total unsecured personal borrowing in the UK.¹⁵ The credit card market is therefore important and if it functions well, can deliver significant benefits to consumers.
- 2.3** In a market where competition is working effectively in the interests of consumers we would expect to see well-informed and active consumers who choose the available products that best suit their needs and use them in an optimal way. In such a market, credit card firms would need to continue to offer competitive products to retain and attract consumers. As illustrated in Figure 1 below, when both the consumer side and firm side of the market are functioning well, this can lead to a 'virtuous circle' of competition and to better outcomes for consumers.

Figure 1: Virtuous circle of competition



¹⁵ UK Cards, *UK Card Payments* (2015) publication

2.4 As explained in our terms of reference¹⁶, when we took over the regulation of consumer credit in April 2014 we were concerned that¹⁷:

- Credit cards provide a free service for many, but the market may not be working well for certain groups of consumers – for example, over-borrowing on credit cards may be a significant problem for some consumers.
- There are a range of behavioural factors at play that may lead consumers not to choose or use cards in a way that best meets their needs – for example, consumers find the multiplicity of credit card features confusing and focus on one or two features when making their selection, there is also evidence that certain consumers select a credit card without considering alternative products, e.g. when responding to direct mail or pre-filled credit card application forms.
- Consumers paying interest on balances may be paying more than they realise or expected. They may also be subsidising users for whom card usage is free.
- Some consumers tend to use up credit limits quickly, repeatedly making minimum payments and not considering how they will repay their credit card debt.
- A proportion of consumers may be using credit cards unsustainably and taking on too much debt.

2.5 In carrying out the market study, we focused on three main areas:

- the extent to which consumers drive effective competition through shopping around and switching
- how firms recover their costs across different consumer groups and what impact this has on the market
- unaffordable credit card debt, in particular whether some consumers are over-borrowing/under-repaying on their balances, and whether firms have incentives to provide unaffordable lending that results in consumer detriment

Scope of the study

2.6 This study focuses on credit card services¹⁸ offered to retail consumers by credit card providers (including banks, monolines and their affinity and co-brand partners) through a range of distribution channels. As set out in our terms of reference, although we have looked at both the borrowing and payment functions of credit cards, we have focused on the use of credit cards as a form of revolving credit, given that this was where most of our initial concerns lay.

2.7 We did not consider the provision of business credit card services to SMEs/corporates as part of the study. Our analysis has captured smaller SMEs (small and medium-sized enterprises) that

¹⁶ FCA, *Credit Card Market Study: terms of reference (2014)*: www.fca.org.uk/static/fca/documents/market-studies/ms14-6-1.pdf

¹⁷ FCA, *Consumer credit research: credit cards (2015)*: www.fca.org.uk/firms/firm-types/consumer-credit/consumer-credit-research/credit-cards

¹⁸ This encompasses a wide range of different credit card products and consumers, as we discuss in Chapter 3.

use their personal credit card for business financing. The study has not specifically covered charge cards and store cards.¹⁹

- 2.8** The regulation of interchange fees and card payment systems more generally falls within the purview of the Payment Systems Regulator (PSR). We therefore do not focus on these issues, although the implications of the Interchange Fee Regulation²⁰ on credit card services offered to retail consumers is reflected in our analysis.
- 2.9** This report is not intended as a compliance report. In relation to some findings or factual scenarios that we have observed we make reference to our rules or to other legal provisions to assist readers. However, the fact that we do not do so in other cases should not be taken as a suggestion or as an implied statement that FCA would view a particular factual scenario or matter as compliant with our rules or other legal provisions.
- 2.10** We sought views on our terms of reference following its publication in November 2014 with respondents broadly supportive of our proposed scope. The feedback we received is summarised in Annex 1.

Why are we publishing an interim report?

- 2.11** We are publishing this interim report to give all interested parties an opportunity to comment on our emerging thinking and analysis. We hope this will help assure the robustness of our findings and promote continued constructive engagement between the FCA, the firms, trade associations, consumer bodies and other interested parties.
- 2.12** Since launching the study we have collected a significant amount of evidence from credit card firms, and have a met a number of market participants, trade bodies and consumer groups.
- 2.13** In this report we set out our initial observations on how competition functions in the credit card market and highlight areas of potential concern. We also set out initial thinking on potential remedies we may consider in light of our final findings.

¹⁹ As set out in the Terms of Reference (para 4.5) this study has not covered charge card and store cards for the following reasons:

- The number of credit cards far exceeds charge cards. Charge cards tend to have higher (or no) credit limits, annual fees, and are often used for corporate purposes. Many charge cards can be used for payments like credit cards, but balances have to be repaid in full at the end of the month, so they cannot be used to borrow for longer periods. Our concerns about revolving credit therefore do not apply.
- Store cards are provided by a retailer (the card issuer can be another institution) and can only be used for purchases with that retailer (so are not part of a card scheme). Store cards typically provide discounts and/or rewards, but tend to have lower credit limits. Retailers are increasingly moving from traditional store cards to offering store-branded credit cards, which have similar features to store cards. Given the trend of these cards becoming store-branded credit cards, we have not included store cards as a focus of the market study.

²⁰ See Annex 2 for more detail on the regulatory framework, including the Interchange Fee Regulation.

The evidence gathered to support our analysis

2.14 To gain a better understanding of the market, we analysed a wide range of data and information. We also met with firms, trade associations and consumer groups, and received input from interested parties in response to our terms of reference.

Consumer research

2.15 To provide information on how consumers shop around and switch credit cards as well as to understand the challenges they face when shopping around and switching, we commissioned an online survey which was completed by 39,837 consumers.

Request for firm data and information

2.16 To understand the supply side of the market, we requested quantitative and qualitative data from credit card firms. Smaller credit card firms received a shortened version of the information request. We asked firms for:

- Financial data on their actual and forecast financial performance at the portfolio and product level. We also asked for details of how they measured performance and for additional details regarding their financing and bad debt policies.
- Strategy documents, including information on their current strategy and business model in relation to credit cards, including affinity and co-brand relationships, product design, pricing and acquisition strategies. We also requested documents detailing how their strategy is impacted by external factors such as competitors, technology and the potential impact of the Interchange Fee Regulation.
- Consumer research they had carried out on consumer behaviour in relation to credit cards, including on searching and comparing credit cards, switching, consumer responses to new products and changes in credit card product features, use of price comparison websites and repayment behaviour.
- Marketing and financial promotion documents and literature as well as copies of the information provided to consumers as part of the application process.
- Credit assessment and approval processes, including how they assess credit risk and affordability, their approach to setting and reviewing credit limits and their forbearance policies.

2.17 We have also undertaken a focused review of a sample of price comparison websites, financial promotions and products' terms and conditions.

Account-level data

2.18 We requested monthly account-level data for 34 million consumers and 74 million active accounts from a sample of 11 credit card firms representing around 80% of the market over a five-year period (Jan 2010 – Jan 2015). The data contained information on monthly balances and repayments, as well as product information such as interest rates and fees.

2.19 This was an extensive data request and we appreciate the effort on the part of the firms in providing this data. Without this granularity we could not have undertaken some of the detailed analysis presented in this report.

Meetings with firms, trade associations and consumer groups

2.20 Over the course of the market study we have also had a number of meetings and engagement events with consumer groups, firms and trade associations. We would like to thank participants at these different events for their time and for their constructive engagement to date.

Literature reviews

2.21 We commissioned two academic literature reviews for the market study: one on consumer behaviour and behavioural biases; and one on affordability. Both reviews are published separately alongside this report.

International comparison

2.22 We conducted an international comparison exercise involving 10 other countries²¹, principally to understand how other jurisdictions have sought to address issues giving rise to concern in the credit card space. As part of this work, we liaised with international regulators and are grateful for their input and assistance. The results of our international comparison exercise can be found in Annex 11.

²¹ Australia, Canada, China, France, Mexico, Singapore, South Korea, Spain, Taiwan, and USA.

3. Market overview

A number of different products within the credit card market enable consumers to use revolving credit to make one-off purchases, carry out everyday spending, refinance existing debt, and build credit history. These include balance transfer cards, 0% purchase cards, combined balance transfer and purchase cards, low-rate cards, credit building cards and reward cards.

Around 60% of UK adults hold at least one credit card product. The market can be broadly segmented by credit risk between lower risk consumers (who have an established credit history) and higher risk consumers (those who are either new to credit, have had negative credit events in the past, or have lower income or are a sole trader or self-employed).

While there are over 20 credit card firms, the market is moderately concentrated with four firms accounting for two-thirds of all outstanding balances. Higher credit risk consumers have less choice of products and providers than lower risk consumers, with four firms accounting for nearly all outstanding balances in this segment.

While there are material costs to entry in the credit card market, we have seen some limited entry in recent years and new entrants have been able to gain significant market share.

56% of new accounts opened in 2014 were opened online, with 30% of all new accounts coming through price comparison websites. The relative importance of different acquisition channels varies by product type and between firms. Direct mail is an important acquisition channel in the higher risk segment, accounting for almost a third of new acquisitions.

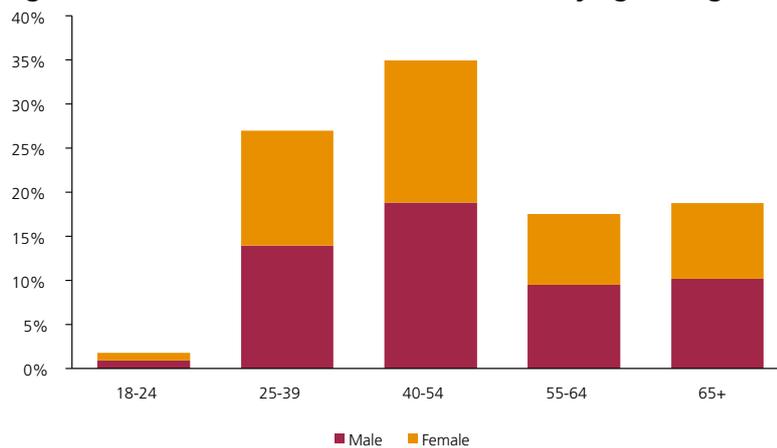
- 3.1** Within the credit card market there is a lot of variety in products, firm strategies and in how consumers use their credit cards. As a result it is important for our analysis to look at issues at a sufficiently granular level, with certain issues applying only to particular segments and/or particular usage behaviours and not across the whole market.

Consumers of credit card products

- 3.2** There are currently around 30 million credit cardholders in the UK, meaning approximately 60% of the UK adult population owns at least one credit card. We estimate that in January 2015, around 46% of credit cardholders held two or more credit cards.

- 3.3** As shown in Figure 2, over a third of card holders are over 55 years of age, with only 2% of card holders aged between 18 and 24. The gender split is fairly even, with slightly more men than women holding a credit card (53% to 47%).

Figure 2: Distribution of credit card holders by age and gender



Source: FCA estimates based on sample of account-level data

Market segments

- 3.4** The market can be segmented by consumer credit risk and by consumer preferences (reflecting the varying ways consumers use their credit cards). We consider each of these in turn.

Credit risk

- 3.5** The willingness of firms to offer consumers particular products, and the terms on which they offer them, will vary depending on the perceived credit risk of the consumer. For example, consumers that are perceived to be higher risk are likely to be offered lower initial credit limits and may be offered products with higher interest rates and shorter (or no) promotional offers.
- 3.6** Firms have stated that consumers typically perceived to be lower risk tend to have a good, established credit history. Consumers are typically perceived to be higher risk because they are either:
- new to credit
 - low income/sole trader/self-employed
 - credit rebuilders (have had negative credit events in the past)

Consumer preferences

- 3.7** Different consumers will use credit cards in varying ways and have particular preferences in what they are looking for in a credit card.²² These preferences may also alter over time as consumers' circumstances change. What consumers are looking for can be broadly broken down into four main categories, with individual consumers looking for products that meet one or more of these attributes:

²² See Annex 3 on consumer survey.

- **Borrowing for purchases** – consumers who want to make new purchases which they intend to pay off over a number of months, either a larger purchase such as a holiday or furniture or regular spending such as utilities.
- **Everyday spending** – consumers who want to use their credit card for everyday spending but with a view to repaying their balance in full every month. In this case consumers may be attracted by rewards, the flexibility of being able to revolve a balance if they need to, or the legal protection²³ that comes with purchasing on a credit card. In our consumer survey rewards was the most common reason for consumers to take out their credit card.
- **Refinancing existing debt** – consumers with existing debt looking for a more cost-effective way to pay down their debt.
- **Building credit history** – consumers who have limited or impaired credit history and want to build (or rebuild) their credit history whilst having access to a revolving credit facility. This was the primary reason for consumers in the higher risk segment taking out a credit card, according to our consumer survey.

3.8 Alongside these four main broad categories, there are a number of other more specific features that consumers could be looking for, such as cash withdrawals, overseas spending or money transfer (where a consumer can transfer funds to their bank account).

Credit card products

3.9 There are a wide range of credit card products currently available to meet these consumer requirements. Each product is made up of a different combination of product features.

Product features

3.10 The main product features are²⁴:

- **Annual interest rate** – the interest rate charged on outstanding balances not paid off in full, once a promotional offer has expired. There may be different interest rates on purchases, cash advances, balance transfers, foreign currency transactions and money transfers.²⁵
- **0% purchase offer** – a promotional offer that allows consumers to spend on their card without incurring interest for a specific period of time.
- **0% balance transfer offer** – a promotional offer that allows consumers to transfer an outstanding balance from one credit card to another and not incur interest on the transferred balance for a specific period of time, usually in return for an up-front fee.
- **Balance transfer fee** – the fee charged by the credit card firm for making a balance transfer. This is typically a percentage of the balance transferred.
- **Annual (or monthly) fee** – a flat fee charged for holding the card.

²³ Under section 75 of the Consumer Credit Act. Other protections include 'chargeback' (under the scheme rules) and limits on liability for unauthorised transactions.

²⁴ These features tend to vary by product.

²⁵ The APR for a credit card is usually the 'go to' rate for purchases (being the most common drawdown mechanism) plus any annual or monthly fee. In calculating the APR, no account is taken of any introductory rate or rates/charges for other drawdown mechanisms such as balance transfers.

- **Rewards** – rewards and loyalty schemes, such as cashback and air miles, where consumers typically get rewards based on their card spend.
- **Credit limit** – the total amount of credit available to the consumer to spend on the card.
- **Default fee** – fees charged typically when a consumer goes over their credit limit, is late making a payment, or when a payment fails.
- **Other** – these include money transfers, foreign transaction fees, cash advance fees and other fees and charges.

Types of credit card

3.11 There are many different possible combinations of these product features as reflected in the wide range of credit cards available. These different credit cards can be broadly grouped into seven main product types²⁶:

- standard
- low-rate
- credit builder
- balance transfer
- purchase
- combined balance transfer and purchase
- rewards

Standard products

3.12 Standard products are those that tend not to have long promotional offers on either balance transfers or purchases. Their main feature is the annual interest rate charged, with the advertised rate typically ranging from 12% to 25%:

- products with an introductory promotional period often revert to this product type at the end of the promotional period.
- some of the smaller banks who offer only one or two products, often only for personal current account consumers, tend to offer this product type.
- reward products also most commonly have these product features.

Low-rate products

3.13 A variant of the standard product is the low-rate product, which offers consumers an on-going lower interest rate, with advertised rates typically between 6.5% and 12%, but usually without any promotional offer on either balance transfers or purchases. For some consumers these could be an alternative to 0% balance transfer or purchase cards for longer term borrowing or for everyday spending.

²⁶ There is a degree of overlap between these product types.

Credit builder products

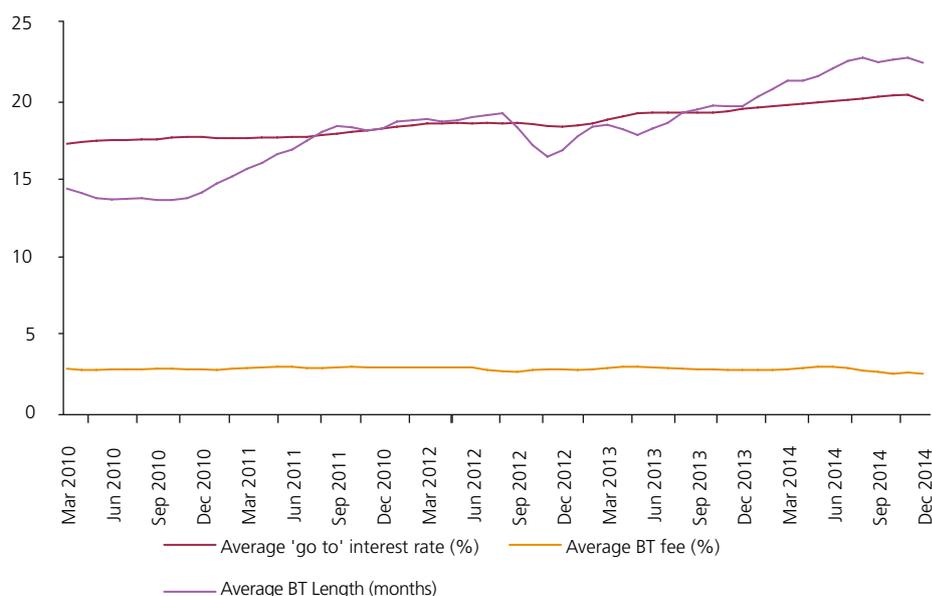
3.14 Credit builder products are the main products offered to higher risk consumers who are looking to build a credit history or improve their credit score. These products have advertised annual interest rates starting around 30%. Along with the higher interest rate, these products tend to be characterised by an initially low credit limit (often £150 to £500) which can then be increased over time based on the consumer's behaviour, so called 'low and grow'.²⁷

Balance transfer products

3.15 Balance transfer cards are primarily designed to appeal to consumers looking to refinance existing credit card borrowing. They offer 0% interest on balances transferred, typically within the first 90 days of account opening, across from another card for a set length of time in return for a percentage up-front fee.

3.16 As shown in Figure 3, the length of balance transfer offers has been steadily increasing over recent years while the balance transfer fee has remained fairly constant. The 'go to' interest rate charged at the end of the promotional period has increased slightly.

Figure 3: Average (mean) terms of 0% balance transfers taken out over time



Source: FCA estimates based on sample of account-level data

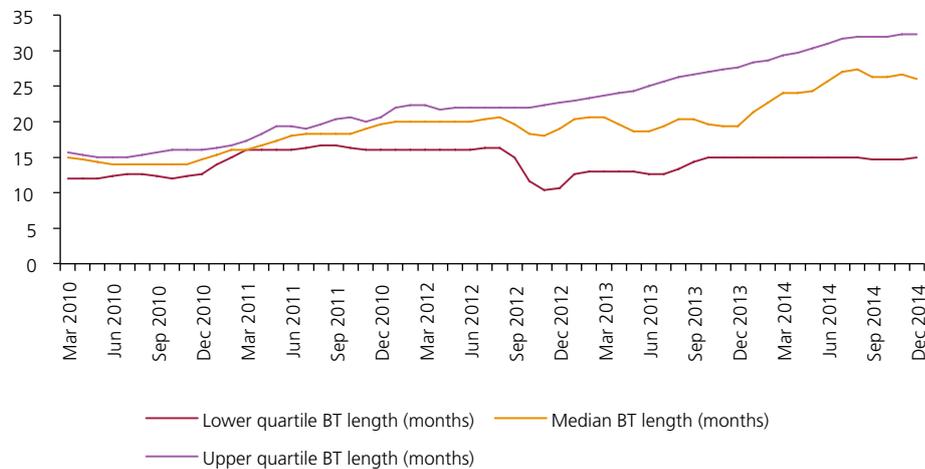
Note: Figures are three month rolling averages (mean)

3.17 There has been increasing fragmentation within the balance transfer space, with a range of balance transfer length and fee combinations now being offered. This can be seen by looking at the median, upper and lower quartile²⁸ lengths of balance transfers over time (Figure 4). In particular, the drop in median length of balance transfers in the second half of 2014 reflects the increasing prevalence of shorter balance transfers with lower fees.²⁹ Over the course of 2015, we have also seen headline balance transfer fees on a number of long length balance transfer products reduced.

²⁷ The interest rate may also decrease over time based on the consumer's behaviour.

²⁸ The upper quartile level indicates that 25% of consumers had a balance transfer length equal to or greater than this level, while the lower quartile level indicates that 25% of consumers had a balance transfer length less than or equal to this level.

²⁹ Over this period the median balance transfer fee dropped from around 3% to 2.7%.

Figure 4: Median length of balance transfers taken out over time

Source: FCA estimates based on sample of account-level data

Note: Figures are three month rolling averages

Purchase products

- 3.18** Purchase products are primarily designed to appeal to consumers who are looking to borrow for new purchases on a credit card. They have an introductory 0% interest offer on new purchases for a number of months.

Combined balance transfer and purchase products

- 3.19** Combined balance transfer and purchase products offer both 0% interest on new purchases as well as 0% interest on balances transferred. There is no fee charged on new purchases, although balance transfers on combined products do usually incur a fee in the same way as standard balance transfer products.

- 3.20** These products can take three broad forms:

- **purchase-led product** – where the purchase promotional period is longer than the balance transfer promotional period;
- **balance transfer-led product** – where the balance transfer promotional period is longer than the purchase promotional period;
- **dual product** – where the balance transfer and purchase promotional periods are of the same or similar length.

Reward products

- 3.21** Reward products offer consumers benefits, discounts or other rewards based on their credit card usage.

- 3.22** There are three main types of reward cards:

- **cashback**, where consumers get a percentage of their card spend back as cash (typically credited to their statement either the following month or annually)

- **affinity/co-brand cards**³⁰, where consumers may receive loyalty points or money-off with the co-brand partner, such as a high-street store, based on their card spend (typically with higher earn rates on spend with the co-brand partner) or charity cards where the firm donates a proportion of card spend to the co-brand charity
- **proprietary schemes** run by the card firm, where consumers receive points for card spend which can be exchanged for vouchers or products from a range of retailers

3.23 Reward products often come with a promotional introductory offer of bonus points or a higher earn rate for the first few months after the card is opened, or when a spending hurdle is reached.

3.24 While most reward cards do not have long introductory purchase or balance transfer offers attached, some 0% purchase and combined balance transfer and purchase cards do have rewards attached. For these cards, some consumers will be attracted by the rewards and may have limited interest in the other features. Others may be attracted by the balance transfer/purchase offer with the rewards not being a significant consideration in their decision making, while for others the overall proposition may be attractive.

Annual (or monthly) fees

Annual fees are most commonly seen on reward cards, although some low-rate and combined balance transfer and purchase products also have them. Most fees are around the £25 per year level, although they go up to £150 for some of the airline co-brand cards. Credit cards with annual (or monthly) fees typically offer a higher level of rewards per pound spent and are therefore primarily targeted at higher spending consumers.

Firms claim that cards with fees tend to have higher consumer engagement and need to offer a very attractive proposition for consumers to be willing to pay for the card.

Based on our analysis of firm submissions, we note that reward schemes are primarily a method for encouraging usage of the card, a key driver of profitability. The reward scheme can especially encourage early use of the card. Typically, an account that spends on the card in the first few months is more likely to be active over a longer period. Where consumers are paying a fee the firm will need to factor the perceived value of the reward scheme to the consumer against the fee charged. The extent to which the reward scheme will improve usage of the card will depend on consumers' perception of this value proposition.

As a result of the Interchange Fee Regulation, a number of firms are considering introducing or increasing annual fees. In some cases, fees may be waived for in the first year or for consumers who reach certain spending thresholds or are paying a large amount of interest.

³⁰ Affinity/co-brand cards are discussed in more detail in Annex 5.

Other product types

3.25 There are a number of other credit card products targeted at specific consumers, for example student cards and cards for private banking customers³¹; or specific consumer requirements, such as cards offering commission-free foreign transactions or money transfers.³²

Innovation

3.26 There have been several innovations in the credit card market in recent years. These have included:

- **Product innovation** – including new product types such as low-rate cards and low or no fee balance transfer cards and new product features such as statement credits when spending a certain amount in a particular retailer.
- **Search innovation** – including tools which allow prospective consumers to get a better idea of their eligibility for particular cards (eligibility checkers) and/or the likely price (quotation searches) without having to submit a full application; these may be offered by price comparison websites seeking to better tailor search results to an individual consumer's needs or by firms.
- **Technological innovation** – new developments such as contactless technology and mobile/online banking have increased convenience for credit card consumers, including new acquisition channels, such as applying via a smartphone. More recently, new innovative payment mechanisms have also entered the market such as Apple Pay and ZAPP, which have further widened potential payment platforms for consumers.

Terms and conditions

3.27 Alongside the product features outlined above, there are a number of terms and conditions associated with credit cards. In this section we summarise the general market practice in relation to four of the key areas of terms and conditions, namely interest-grace periods (often called 'interest-free' periods), minimum payments, consumer re-pricing, and promotional withdrawals.

Interest-grace periods

3.28 Interest starts accruing from the date transactions are applied to the account if consumers do not pay their outstanding balance in full, and stops accruing once the balance is cleared in full. For purchase transactions, provided the borrower repays in full by the due date and cleared the previous month's bill in full, then no interest is charged.³³ There is no interest-grace period on cash withdrawals.³⁴

Minimum payments

3.29 Minimum repayment practices are governed by FCA rules.³⁵ These require the minimum repayment to be an amount equal to at least that amount which repays the interest, fees and charges that have been applied to the customer's account, plus one per cent of the amount outstanding.

³¹ These are often high net worth individuals.

³² Money transfers allow consumers to transfer money from their credit card to their bank account.

³³ If the balance is not repaid in full, interest is charged on the entire balance from the date of each transaction, irrespective of how much is repaid – for example, if you owe £100 and repay £99 you will pay interest on the whole £100 and not just the £1 remaining.

³⁴ This also usually applies for quasi-cash purchases like gift card purchases, foreign currency purchases and gambling transactions as well as credit card cheques.

³⁵ CONC 6.7.5R

3.30 These rules do not apply to agreements made before 1 April 2011.³⁶ However most firms now apply these minimum repayment practices to older accounts as well, although a few continue to apply previous repayment practices to these accounts.

3.31 In Chapter 6, in the context of potential problem credit card debt, we look at consumers who are making systematic minimum repayments while incurring interest.

Consumer re-pricing

3.32 Consumer re-pricing refers to the changing of a consumer's interest rate after the opening of an account and is a common feature of the credit card market.

3.33 We have seen three broad scenarios where consumer re-pricing takes place. These are:

- **Risk-based** – this is carried out by some firms in order to adjust an individual consumer's rate after the account has been opened, to reflect changes in the consumer's risk. Depending on a consumer's behaviour and changing credit score, an account is upwardly or downwardly re-priced to account for risk.³⁷
- **Retention** – firms will sometimes re-price an account downwards in order to offer existing consumers more attractive terms as part of a consumer retention strategy or as part of a consumer reactivation process where an account has been inactive for at least 12 months.
- **Portfolio-wide** – firms re-price groups of consumers as a result of the wider economic, regulatory and competitive environment, for example to reflect changes in funding costs.

Promotional withdrawals

3.34 Some firms have confirmed that they withdraw a consumer's promotional offer (such as their 0% balance transfer offer) if the consumer fails to make a minimum payment by the due date or if the consumer exceeds their credit limit. A few have noted that they are willing to reinstate the offer in some circumstances if the consumer contacts them.

3.35 Based on figures submitted by firms, it appears that, for most firms that withdraw promotional offers, around 5% to 10% of their consumers on promotional offers lose their offer before the end of the promotional period, and for some firms the figure is considerably higher.³⁸ We are pursuing this issue with the individual firms in question.

Providers of credit card products

3.36 As at October 2015, 24³⁹ firms were issuing credit cards in the UK. This is a mix of banks, building societies and monolines. There are a small number of large providers, with four firms holding approximately two-thirds of all credit card balances.

³⁶ CONC 6.7.5R(3) in line with the Lending Code.

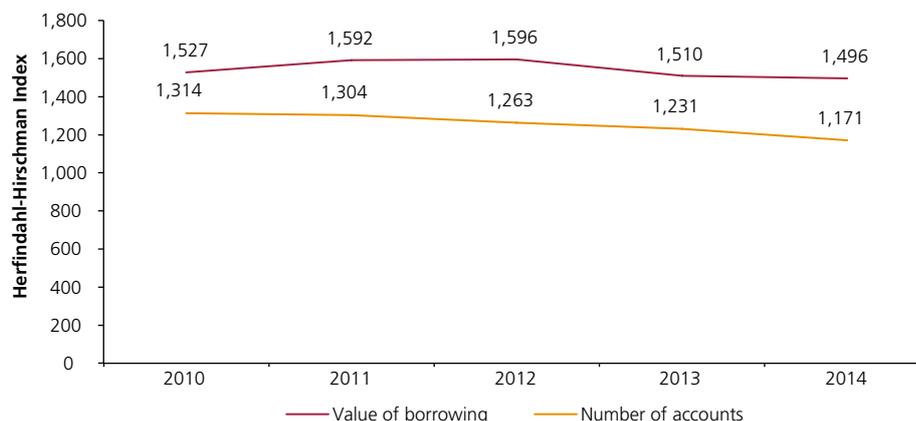
³⁷ CONC 6.7.16R sets out requirements where the interest rate is increased based on the customer's risk.

³⁸ This is broadly consistent with our analysis of the account-level data.

³⁹ We have counted firms at the group level. Some firms have a number of brands beneath this.

3.37 Estimates of market concentration show that the credit card market is moderately concentrated⁴⁰ with concentration declining slightly over the past five years.

Figure 5: Market concentration (across all credit risk) in credit cards over time



Source: FCA calculations based on firms' financial submissions

3.38 Estimates of concentration increase when looking at smaller segments of a market. The higher risk segment of the credit card market is highly concentrated with four firms accounting for virtually all credit card balances in this segment⁴¹ while the lower risk segment is only slightly more concentrated than the overall market.

Entry and expansion

3.39 While there are barriers to entry in the credit card market, caused by the large sunk costs required along with a high level of expertise and data, we have seen some entry in recent years (Metro Bank, Sainsbury's Bank, Tesco Bank, TSB and Virgin Money). Firms that have entered have been able to gain significant market share.

3.40 We consider there to be broadly four possible strategies for entering the credit card market:

- **New entry** – where a completely new firm enters the market and builds a business from scratch. As an entry strategy this is very rare with no completely new firms entering in the last ten years, likely in part due to the barriers to entry outlined above.
- **Joint venture or partnership with existing issuer** – where a firm enters the market through establishing a joint-venture or co-brand partnership with an existing credit card issuer and subsequently acquires their partner's stake and begins issuing their own credit cards. This appears to provide an effective way of obtaining the requisite level of expertise and data to operate in this market. Tesco Bank and more recently Sainsbury's Bank have adopted this strategy.

⁴⁰ The estimates of market concentration use the Herfindahl-Hirschman Index (HHI) measure of market concentration. This is calculated by adding together the squared values of the percentage market shares of all firms in the market. It therefore takes account of the different sizes of market participants as well as their number. The Office of Fair Trading's Merger Assessment Guidelines (September 2010, OFT1254) indicate that a market with an HHI exceeding 1,000 may be regarded as concentrated. The HHI scores for the credit card market indicate that it is slightly above that threshold with an HHI in 2014 of 1171 based on number of accounts and 1496 based on value of borrowing.

⁴¹ We estimate the HHI in 2014 to be just over 3000 for the higher risk segment based on value of borrowing, compared to just under 1600 for the lower risk segment.

- **Strategic portfolio acquisition** – where a firm acquires a credit card portfolio from another credit card issuer. While there have been acquisitions in recent years, these have been primarily by existing firms as a way of expanding their book – for example over the past ten years NewDay has acquired portfolios from three different issuers. The divestment of TSB by Lloyds led to the creation of a ‘new’ credit card firm.
- **Development out of personal current account offering** – where a bank offering personal current accounts (or another financial product) begins issuing their own credit cards. Metro Bank (a challenger bank) entered the credit card market in this way.

3.41 Many firms have been successful at expanding their credit card business and gaining significant market share through organic growth. As mentioned above, there has also been some strategic portfolio acquisition by existing firms in recent years. Firms can also expand by securing new co-brand partnerships, either partners without an existing credit card partner or by winning co-brand partners with an existing credit card from a rival firm.

Acquisition channels

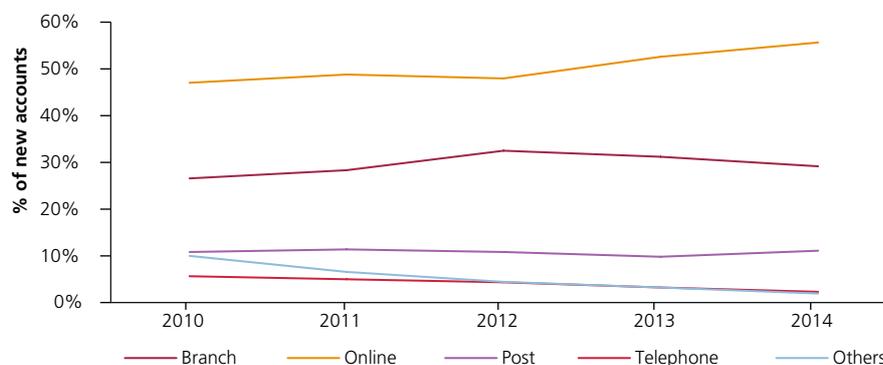
3.42 Firms use a range of different channels to acquire their consumers. These can be broken down into two broad categories:

- **online** – this includes price comparison websites, online marketing, internet search and credit card firms’ own websites
- **offline** – this includes direct mail, telephone and face-to-face marketing. Banks with a high street presence can also take advantage of branches, and this is an important channel for some of these firms

3.43 Firms offering co-brand cards also use their co-brand partner’s retail stores, website and email channels as acquisition channels.

3.44 Overall, (see Figure 6 below), online is the most significant acquisition channel, accounting for 56% of new cards opened in 2014. Approximately 30% of all new cards opened in 2014 were applied for via a price comparison website.

Figure 6: Acquisition channels



Source: FCA calculations based on firms’ account-level data submissions

3.45 The relative importance of different acquisition channels varies significantly between different types of products, different types of consumers, and between firms.

Variation by product type

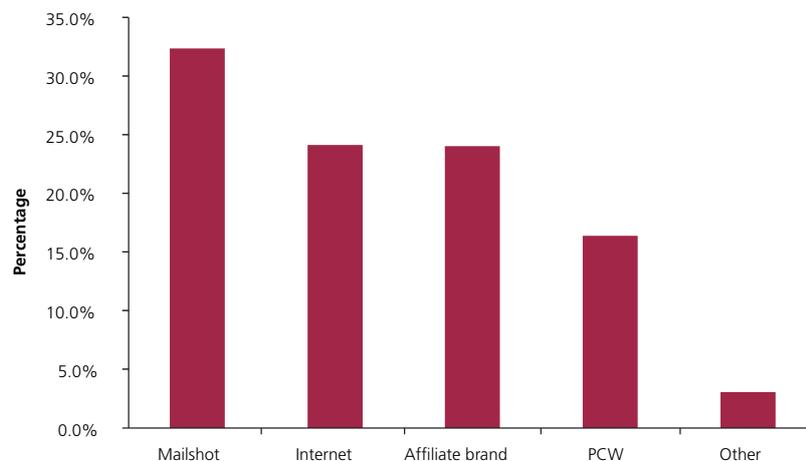
3.46 Price comparison websites are the main acquisition channel for long duration balance transfer cards. However, acquisition volumes via price comparison websites drop off sharply for those products that do not rank near the top of price comparison website results.

3.47 Unsurprisingly, for co-brand cards the co-brand partner is a major acquisition channel, whether that is at point of sale or through targeted marketing to existing consumers. Products without introductory promotional offers, such as low-rate cards, tend to fare less well on price comparison websites, as do rewards cards because of the difficulty in comparing different reward propositions.

Variation by consumer type

3.48 For firms targeting higher risk consumers, direct mail is an important way of attracting consumers and accounted for around 32% of cards in the higher risk segment in 2014 (see Figure 7 below). Some firms also use face-to-face sales in targeting these consumers, although this makes up only a small share of their total acquisitions at present.

Figure 7: Breakdown of acquisition channels (2014) – higher risk consumers



Source: FCA calculations based on firms' account-level data submissions

Variation between firms

3.49 For some banks, branches remain an important acquisition channel for new credit card consumers, while monolines do not have branches that can be used as an acquisition channel and rely more on their digital presence and price comparison websites.

3.50 Variation between firms within a product type can also reflect strategic considerations (for example, firms investing heavily in advertising may see increased sales on their own website) or the competitiveness of the product offering (for example, a less competitive offering on particular product features is likely to attract fewer sales via price comparison websites).

Firm strategies

- 3.51** Firms' strategies in relation to credit cards revolve around effectively managing credit risk and offering products that meet the preferences of the consumers they target.
- 3.52** Different firms have different risk appetites which determine their willingness to lend to higher-risk consumers. Within their risk appetite, firms are in general willing to pursue products (that is, combinations of product features) that are expected to meet internal profitability targets⁴² and that fit with their strategy.
- 3.53** Within the credit card market, there is variation in the wider strategies firms have adopted:
- **The product types focused on** – different products are designed to attract different consumer behaviour types (see Chapter 5 for more detail). Most firms seek to offer a range of product types to appeal to different consumer preferences, although some firms focus more on particular product types, such as rewards. There are only a small number of firms currently competing in the long-duration balance transfer segment (these are a mix of banks and monolines). Other firms have told us that they are not active in this space, either out of choice or because they cannot make the economics of the product work.
 - **The segments focused on** – the higher risk segment is primarily served by monolines, with most of the banks and building societies not operating in this segment of the market. Firms have cited their risk appetite and brand considerations, for example a reluctance to offer headline interest rates above certain levels, as reasons for not offering products in the higher risk segment.
 - **The range of products offered** – in general the number of different products that firms are offering has reduced over the past few years, as firms have sought to consolidate and simplify their propositions. However, there remain differences in approaches between firms. Some choose to have a several different products, each targeting a particular consumer preference, while other firms have fewer products that cater for a wider range of consumer preferences.
 - **Differential pricing** – some firms offer consumers applying for the same card different prices or promotional terms based on their risk profile.⁴³ This means some consumers will not get the headline rate offered but instead will be offered less generous terms. Other firms have a policy of not varying pricing at acquisition in this way and will either offer the consumer the headline terms or decline the application.
 - **Variation by distribution channel** – some firms offer different products and/or pricing across the different distribution channels they use, for example offering better terms or exclusive products on a price comparison website compared to their own website or in-branch. Other firms have chosen to apply consistent pricing across distribution channels.
 - **Existing consumers** – some firms seek to promote loyalty by offering preferential terms or exclusive products to consumers who already have an existing relationship with the firm, for example personal current account holders.

⁴² To put it more technically, firms consider whether the product has an expected net present value (NPV) greater than zero. Typically the discount rate of the NPV model is reflective of the internal hurdle rate required by the product. This is typically set at or above the cost of capital/equity for the firm. An NPV above zero indicates a forecast that will generate a rate of return at or above this required level. Depending on how management information is prepared, similar models made be used that are not NPV models.

⁴³ This is commonly referred to as risk-based pricing.

- **Wider strategic considerations** – for firms that have a wider relationship with consumers than the credit card product, wider strategic considerations may influence their credit card strategy. This includes:
 - banks and building societies who may not offer particular products for wider brand reasons, or be more willing to accept lower returns from certain consumer groups if they are profitable for the wider group
 - retailers who offer credit cards may consider the wider retail group benefits of developing brand loyalty and reducing the cost to the group of consumers paying by credit card
- 3.54** In the higher risk segment, more of the focus is on effectively managing risk. This is typically seen in the ‘low and grow’ approach whereby credit limits are initially set at a low level and then increased over time as the firm learns more about the consumer.
- 3.55** For some products, one of the key drivers of acquisitions is a product’s ranking on price comparison websites. By improving elements of their proposition that drive price comparison websites’ rankings, firms can seek to move their products up the rankings. This not only increases the quantity of applications but also the quality of applications in terms of credit risk. Firms may respond to other firms’ pricing changes in order to maintain their position in the rankings.
- 3.56** Given consumers can hold multiple cards, firms seek to compete to be ‘front of wallet’, that is to gain as large a share as possible of the consumers’ card spend.
- 3.57** Retaining consumers at the end of introductory promotional periods is an important part of firms’ overall strategy. This can be through seeking to deepen the consumer relationship during the promotional period, or through targeted offers as the promotional period comes to an end.

Changes to the market

Interchange Fee Regulation

- 3.58** The most significant change to the market in recent years has been the introduction of Interchange Fee Regulation⁴⁴ which from 9 December 2015 caps consumer credit card interchange fees at 30 bps (0.3%) of transaction value. This means credit card firms’ revenue from interchange will fall from around 80bps⁴⁵ to 30bps. This is a gross reduction of around 60% in interchange revenue across the industry. Estimates from firms suggest this will lead to around a 5% to 10% reduction in overall revenue. In Chapter 5 we discuss the likely impact of the Interchange Fee Regulation on the market.

⁴⁴ European Parliament & European Council, *Regulation (EU) 2015/751 on interchange fees for card-based payment transactions* (2015): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.123.01.0001.01.ENG

⁴⁵ As noted in the Payment Systems Regulator’s CP14/1 (November 2014), interchange fees for consumer credit card transactions have ranged from 0.65% to 1.85% of transaction value, depending on the card payment system (MasterCard or Visa), the card type (e.g. standard or premium) and the transaction type (e.g. Chip & PIN, card not present, etc.). The average interchange fee on such cards has been around 0.8% of transaction value (80bps).

4.

Consumer shopping around and switching

There are a large number of active consumers in the market, with around 6 million new accounts opened in 2014. We find that consumers are engaged and willing to switch. We estimate around 14% of existing credit card consumers took out a new card in 2014. According to our consumer survey, a further 8% compared at least two credit cards but did not take one out. Over half of active consumers in our survey that took out a new credit card in the previous 12 months shopped around (that is, compared at least two cards).

Most consumers do not perceive material barriers to switching between credit cards, and firms do not consider a lack of switching to be a significant barrier to entry or expansion. However, almost a quarter of higher risk consumers said a reason why they did not shop around was that they did not think that any other provider would accept them. Higher risk consumers were also concerned about the impact of multiple applications on their credit rating.

Credit cards are complex products as a result of being used for different purposes and having a variety of different features. Most respondents to our consumer survey claimed that credit cards are not difficult to understand or compare. However, there is also evidence that respondents do not know important features of their credit card and some respondents said they incurred unexpected or higher than expected charges.

We find competition is focused on a small number of features such as promotional offers and rewards, and when choosing a credit card consumers often disregard important features, such as long-term interest rates or fees and charges that can add significantly to costs.

We find that consumers may end up not choosing the best card for them. This may be because:

- they have not been able to effectively compare the different cards available to them
- they have given insufficient weight to certain product features when making their decision or
- their actual card usage differed from what they expected when they took out the card

We found that many consumers could save a large proportion of their interest by choosing a different credit card. However, for most consumers who transact a lot and borrow a little, the potential savings in absolute value are not substantial. In addition, taking into account rewards and other product features, the fact that these consumers are not minimising interest cost does not necessarily mean that they are not on the best deal. For those who borrow more, though, the potential savings from choosing a cheaper credit card are clear and significant.

- 4.1** This chapter outlines our interim findings on the extent to which consumers drive effective competition through shopping around and switching. These emerging findings are based on:
- the results of our consumer survey
 - conversations with consumer groups, firms and trade bodies
 - our account-level data analysis
 - a literature review on consumer behavioural biases

How can consumers drive effective competition through shopping around and switching?

- 4.2** To drive effective competition in the credit card market, consumers need to be both engaged and active. Consumers can drive effective competition by:
- shopping around effectively, by comparing relevant features of the products offered by firms, and
 - monitoring the competitiveness of the products they already hold and switching to get the product(s) which best satisfies what they are looking for (or switching usage between existing cards where one becomes more attractive).
- 4.3** Engaged and active consumers will incentivise firms to compete, allowing those firms that offer good deals to grow their market shares. Credit card firms will only face material competitive constraints from firms offering a more attractive proposition if consumers are aware of these offers and consider them when shopping around for a new credit card or deciding how to use existing cards.
- 4.4** In many markets, active consumers help to protect the interests of the more passive consumers and drive competition in the market as a whole. However, shopping around and switching by active consumers will be less effective at driving competition for the benefit of others if firms are able to segment consumers and price discriminate, such as by offering better deals to active consumers than passive consumers. This can be seen in the credit card market through the attractive promotional rates offered with new accounts.
- 4.5** To understand whether consumers are driving effective competition through shopping around and switching we considered:
- consumers' understanding of credit cards, what drives their choice of credit card, and whether they are able to identify the cheapest product given their usage, and
 - consumer switching behaviour, including reasons for switching and not switching

Understanding and comparing credit cards

Product complexity and comparability

- 4.6** Credit cards are complex products because they are used for different purposes and have a variety of different features. This variation in product features offers consumers choice, meaning

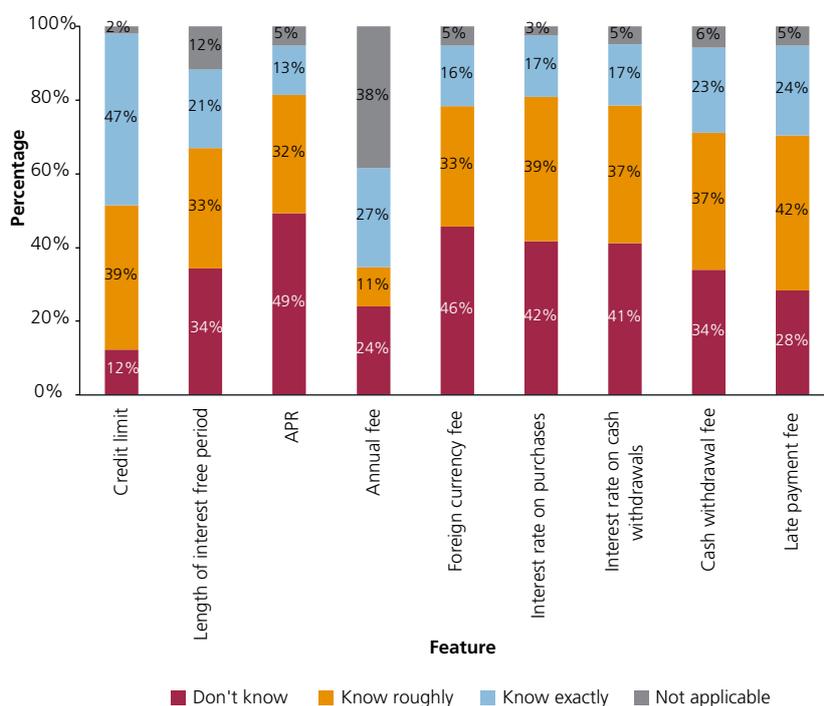
it is more likely they can find a card that closely matches what they are looking for. However, it may also mean that comparing credit card products and choosing the best one is more difficult.

4.7 Our consumer survey shows that many consumers believe that credit cards are easy to understand or compare, with 65% of active credit card users thinking it is easy to understand credit cards and 50% thinking it is easy to compare them.

4.8 The survey also found that some consumers:

- did not know important features of their main credit card – 42% of those who have paid interest on their main credit card in the last 12 months say they do not know their interest rate on purchases; and 46% of consumers who use their main card abroad do not know their foreign currency fee
- with balance transfers may not fully understand how they work – we asked a sample of consumers who had made a balance transfer to or from their main card in the last 12 months a series of three true or false questions about 0% balance transfer deals; 59% of respondents answered all three questions correctly.⁴⁶

Figure 8 – Do you know the current amount or rate for the following features?



Source: FCA Consumer survey⁴⁷

⁴⁶ A recent survey by Which? (see <http://press.which.co.uk/whichpressreleases/0-balance-transfers-misleading-consumers>) found that consumers often struggle to understand the true cost of balance transfer deals.

⁴⁷ Results for “foreign currency fee” are restricted to those that used their main credit card abroad; results for “interest rate on purchases” are restricted to those that paid interest; results for “interest rate on cash withdrawals” is restricted to those that used cash withdrawals; results for “cash withdrawal fee” are restricted to those that used cash withdrawals; and results for “late payment fee” are restricted to those that missed at least one payment. See Annex 3 for further details

Transparency of information

- 4.9** We reviewed⁴⁸ a sample of credit card terms and conditions and financial promotions. We found that information about credit card features is generally available to consumers and, for the most part, appears to be clear and easy to follow, without complicated language. Based on our consumer survey, over 60% of active credit card users said they had received enough information during the application process and 65% said the information they received was clear or very clear.⁴⁹
- 4.10** However, we found that the font used for some documents was too small and at times illegible. We also found that financial promotions did not outline the impact, if any, on the initial promotional offer should a consumer miss or make a late repayment. We considered that this would have been helpful to consumers.
- 4.11** The overall picture on consumers' ability to understand and compare credit cards is mixed. While many consumers report that they understand and can compare credit cards, there is also evidence that many do not know important features of their credit card and some respondents stated they incurred unexpected or higher than expected charges.

Price comparison websites (PCWs)

PCWs play an important role in the credit card market. For consumers they can help navigate complex products and reduce search costs by comparing products in one place. For firms, including new entrants, they can help attract consumers with good credit ratings in high volumes.

Our survey found that PCWs are used by a significant number of credit card consumers (66% of those who shopped around for credit cards). Of those that took out a credit card in the last 12 months after shopping around, 39% said they used one PCW and 27% said they had used two or more, indicating that consumers not only use PCWs to search for suitable credit cards, but that some are also comparing between PCWs. Of respondents that used PCWs, 90% reported that they found them to be either useful or very useful, indicating that consumers value the services.

Nonetheless, our review has highlighted a number of issues that may limit the effectiveness of PCWs in helping consumers navigate product complexity, such as:

- the presentation of headline rate offers may not aid the comparison process because it does not account for the fact that a consumer may not be eligible for that rate/offer
- ranking criteria may not be sufficiently personalised to allow consumers to find products that best suit their needs or may be based on assumptions that do not reflect how they use their credit card
- sometimes cards from providers with whom the PCW does not have a direct relationship are 'hidden' or difficult to find in search results

⁴⁸ See Annex 8 for the review of terms and conditions and Annex 9 for the review of financial promotions. These reviews concentrated on the consumer's journey rather than focussing on compliance with specific rules.

⁴⁹ Excluding those consumers that did not recall these percentages increase – 92% of active credit card users considered that they had received enough information during the application process and 91% said that the information they received was clear or very clear.

- some savings claims are unclear or inaccurate
- several firms offer exclusive deals to PCWs so consumers need to 'multi-home' (i.e. look at more than one PCW) to ensure they receive the best deals
- meaningful comparisons are more difficult for some types of credit cards, such as in the higher risk and rewards segments

We consider that there is scope to boost the role of third party intermediaries (including PCWs) in cutting through the complexity consumers face when seeking the best deal. In Chapter 8 we consider how that can be achieved.

Our review of PCWs can be found at Annex 7.

Shopping around

Extent of shopping around

4.12 The results of our consumer survey show that, of those consumers that took out a credit card in the previous 12 months, 51% said they had shopped around (compared two or more credit cards), 40% said they did not shop around when they took out a card in the last 12 months, and 10% said they did both. In the balance transfer segment, 62% said they had shopped around.⁵⁰ The extent of shopping around appears to have increased in recent years – in 2008 the OFT found that only 32% of consumers shopped around for the card they took out.⁵¹

4.13 A further 8% of consumers compared at least two or more credit cards in the last 12 months but did not take one out. The most common reason cited was they did not find a credit card that better suited their needs than the one they already had.

How consumers shop around

4.14 PCWs play a significant role in shopping around with our survey finding that, of those that took out a credit card in the previous 12 months after shopping around, 39% had used one PCW and 27% used two or more PCWs. Consumers are also positive about the experience of using PCWs with 90% of those in our survey that used PCWs finding them very or quite useful.

4.15 Some consumers report that an existing relationship with a provider is still an important factor in their decision-making, with around a quarter of active consumers in our survey listing having another financial product with the provider as a reason to choose a credit card from them. Consumers' choice of credit card is not limited to their personal current account provider or other firms to which they have an existing relationship – while a third of all active credit card holders stated they had a PCA with the provider of their main credit card, a larger proportion, 42%, did not have any prior relationship with the provider of their main credit card.

What features consumers consider when shopping around

4.16 Given the large number of product features, consumers understandably focus on a few key features when shopping around.

⁵⁰ These figures exclude those who both took out a credit card after considering two or more credit cards and those that took out a credit card without considering other cards, so in practice more people took out credit cards after shopping around.

⁵¹ OFT, *Credit card comparisons* (2008): OFT987

4.17 In the consumer survey, we asked respondents to select up to three of the most important features they considered when shopping around. Most (54%) selected three features but 19% selected only two features; 23% selected only one feature; and 4% were unsure or looked at things the questionnaire did not list.

4.18 Of all respondents that took out a credit card after shopping around:

- 24% selected discounts, rewards and benefits linked to using the credit card
- 21% selected the balance transfer fee
- 21% selected the introductory offer on balance transfers
- 20% selected the annual fee
- 15% selected the APR
- 13% selected the interest rate on purchases

4.19 As would be expected, the features consumers focused on varied depending on the type of card they took out:

- For those consumers looking for a **'low and grow'**⁵² card, around a third focused on only one feature (in part, reflecting that these cards tend to have fewer product features such as balance transfers or other promotional offers). For these consumers, the likelihood of acceptance was the most commonly cited feature (39%), followed by APR or interest rate (31%) and size of the credit limit (20%). 15% considered both the APR and likelihood of acceptance.
- For consumers looking for a **balance transfer** card, 39% cited the balance transfer fee and 37% the introductory offer on balance transfers as features they focused on – 20% of respondents stated that they considered both.
- For consumers looking for a **rewards** card, discounts, rewards and benefits of using the card (39%) and discounts, rewards and benefit linked to taking out the card (26%) were the two most commonly cited features. 24% stated that they considered the annual fee.

Consumer outcomes

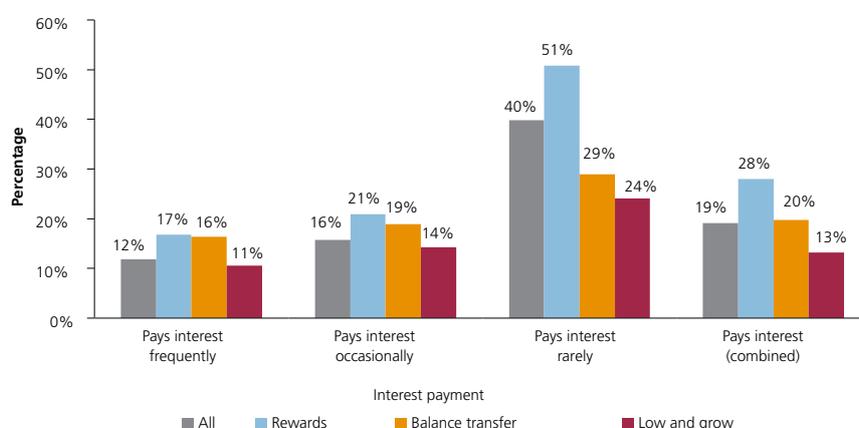
4.20 While consumers look at features that they consider as important for their requirements and circumstances, our consumer survey indicated that they may be neglecting features that are important given how consumers actually use their credit card. For example, of those who paid interest on their main credit card, which they took out in the past year after shopping around:

- 82% did not select interest rate as one of the most important features
- 78% did not select APR as one of the most important features
- 64% did not select either interest rate or APR as one of the most important features

⁵² In the questionnaire we asked respondents whether they had a credit card that was designed for someone with 'no credit or poor credit history' which may or may not be a 'low and grow' card. Given that most cards of this type are 'low and grow' we refer to them as such throughout this chapter for simplicity.

- 4.21** The survey also indicates that the lack of focus may influence consumer outcomes. Figure 9 shows the proportion of respondents who did not expect to pay interest on their main credit card when they took it out but paid interest on it in the last 12 months. Of those who paid interest rarely, 40% did not expect to do so when they took the card out, while 16% of those that ended up paying interest occasionally and 12% of those who paid interest frequently did not expect to do so when they took the card out.

Figure 9: Consumers who did not expect to pay interest on their main credit card when they took it out but paid interest on it in the last 12 months



Source: FCA Consumer Survey

- 4.22** Overall, the survey evidence suggests that consumers are focusing on relevant key product features when choosing their credit cards based on their preferences and circumstances. They may be neglecting other important features that may affect their ability to make good choices. For example, a significant proportion of consumers in our survey (64%) who took out their main credit card in the previous 12 months after shopping around and subsequently paid interest did not select either interest rate or APR as one of the most important features.

Repayment of balance transfers

- 4.23** Based on a sample of the account-level data, we analysed what proportion of consumers repay their transferred balance by the end of the promotional period or in subsequent months.
- 4.24** We estimate that almost half of accounts repaid the full amount of the balance transferred by the end of their promotional period. This increases to 60% three months later and to 71% six months later.
- 4.25** We observe that, overall, 41% of all balances transferred are not repaid by the end of the promotional period. This figure decreases to 20% by the beginning of the sixth month after the end of the promotional period.
- 4.26** These results suggest that there are likely to be consumers who are able to repay but do so with a few months of delay – possibly because they only realise that their promotional period ended when they start incurring interest.

4.27 We also looked into how many consumers are paying off their balance transfer with another balance transfer. We found around 20% of consumers that carried out a balance transfer in 2014 had previously taken out a balance transfer in either 2012 or 2013.

The extent to which consumers who obtain a new credit card make good choices

4.28 There are a few reasons why consumers may not end up choosing the best card for them:

- **They may not have been able to effectively compare the different cards available to them.** For example, consumers may not know the actual terms they will be offered when they apply for a credit card due to firms' differential pricing.
- **They may have given insufficient weight to certain product features when making their decision.** For example, our survey found that, of consumers looking for a balance transfer card, only 20% of respondents stated that they considered both the introductory offer on balance transfers and the balance transfer fee.
- **Their actual card usage differed from what they expected when they took out the card.** For example, 19% of consumers we surveyed who paid interest on their main credit card in the previous 12 months did not expect to do so when they took it out. Our survey found that 64% of those who used their main credit card for cash withdrawals had not expected to when they took it out, and 70% that used a money transfer had not expected to do so when they took out their main credit card.⁵³

4.29 To help understand whether consumers are making good choices when choosing a credit card, we analysed whether consumers paying interest on purchases could have benefitted from choosing a lower cost card.⁵⁴

- We found there is a significant variability in interest rates available to consumers (even when taking into account their credit risk); most accounts that incur interest could save at least some of it by choosing a different card.
- The majority of accounts transact a lot and borrow a little. For example, over 80% of accounts in our sample incurred less than £20 annual interest on purchases in the first two years after taking out their credit card.⁵⁵ Thus, for many consumers, the fact that they are not minimising interest cost does not necessarily mean they are not on the best deal once you take account of the value of rewards and other product features. We therefore consider the results below to be an upper bound.
- We estimate that consumers who pay interest on purchases could save over 60% of the interest they incur by choosing a different card. This amounts to an average saving of less than £50 a year per interest paying account as, on average consumers do not pay much interest in a year (on average less than £75).
- For those who borrow more, the potential savings from choosing a cheaper credit card can be significant. For example, 8% of accounts in our sample incurred over £100 interest on purchases a year in the first two years after taking out their credit card. We estimate that consumers on these accounts pay on average £225 a year in interest on purchases of which they could save over £150 by choosing a cheaper credit card.⁵⁶

⁵³ The results are restricted to those consumers that took out their credit card in the last five years.

⁵⁴ See Annex 4 for methodology and detailed results.

⁵⁵ This applies to accounts that use domestic purchases only.

⁵⁶ Using the median rather than the mean, we find that half of these consumers could save more than £125 per year.

- Potential savings as a proportion of interest paid are similar across different risk categories.

4.30 Consumers are willing to shop around before taking out a credit card and are focusing on some relevant key product features, often the introductory promotional offers⁵⁷, when choosing their credit cards based on their preferences and circumstances. However, they may not end up choosing the best card for them and, as a result, may end up paying more than they might in debt service.

Analysing switching

4.31 Consumers can hold multiple credit cards and can open a new card without closing an existing credit card, or switch usage between existing credit cards. Hence, analysing switching is more complicated than in other markets such as mortgages where consumers close their account when they move from one provider or product to another.

4.32 Switching in the market for credit cards can comprise:

- Consumers opening a new credit card with either their existing provider or a different provider and either close their old credit card or stop using it permanently.
- Consumers opening a new credit card with either their existing provider or a different provider but keep their existing card open.

4.33 Where consumers keep their existing card open, their behaviour could take a number of different forms, for example:

- They may transfer an outstanding balance from the old card to the new card and continue to spend on the old card.
- They may use the new card for new purchases while continuing to pay off the debt on the old card.
- They may use the new card and keep the old card dormant in case they need to use it in the future.
- They may continue to spend and borrow on both cards, utilising the increased overall credit limit.
- They may keep the old card as their primary card and use the new card for particular expenditure, for example foreign transaction spend.

Estimated switching rates

4.34 When looking at estimated switching rates, the rates by themselves do not tell us whether the market is working well or not. For example, it could be that although we observe high switching rates, consumers are making bad choices and switch to worse products. On the other hand, low switching rates are not necessarily a cause for concern if there is evidence of low switching costs (in this case low switching rates may only indicate that consumers are content with their current products).

⁵⁷ The literature review on consumer behaviour and behavioural biases also found empirical evidence to support present bias in the credit card market. See Literature Reviews.

- 4.35** Based on data supplied by firms, we estimate that, in 2014, consumers opened around 6 million new credit cards. Just under half of credit card applications were successful.
- 4.36** From the consumer survey we estimate that about a quarter of new credit cards opened were by consumers without an existing credit card and about three-quarters by consumers with an existing credit card. This is broadly consistent with the account-level data from which we estimate that 13% to 14% of existing consumers opened at least one new credit card in 2014.⁵⁸
- 4.37** Estimates of the percentage of existing consumers who opened at least one new credit card in 2012 and 2013 are slightly higher than the 2014 results at 15% to 16% in 2012 and 14 to 16% in 2013.
- 4.38** Most of those who open a new credit card obtain it from a new provider, and overall it does not appear that higher risk consumers switch significantly less than lower risk consumers.
- 4.39** These figures suggest that over the course of a year, almost one in five credit card consumers opens a new credit card.⁵⁹ When considered alongside those consumers who shop around but decide not to switch, apply for a new card but are unsuccessful, or are on a promotional introductory offer, it suggests that a significant proportion of consumers are active and engaged.

Why consumers switch

- 4.40** As discussed above, within the credit card market there are different types of consumers and their behaviour varies greatly:
- At one end are the so-called 'rate chasers', a cohort of consumers who pay close attention to the products and rates being offered and will tend to switch between products with introductory promotional offers as their existing introductory deal ends. These consumers tend to be very active and engaged.
 - At the other end, there is a group of consumers who pay little attention to their product or what other products are on offer that may better meet their needs. These consumers tend not to be active and engaged and either do not change their credit card or respond to credit cards offered to them without comparing alternatives.
 - In the middle are those consumers who will only occasionally consider switching, often either because of a change in personal or financial circumstances or because of a negative event such as poor consumer service or unexpected fees or charges.

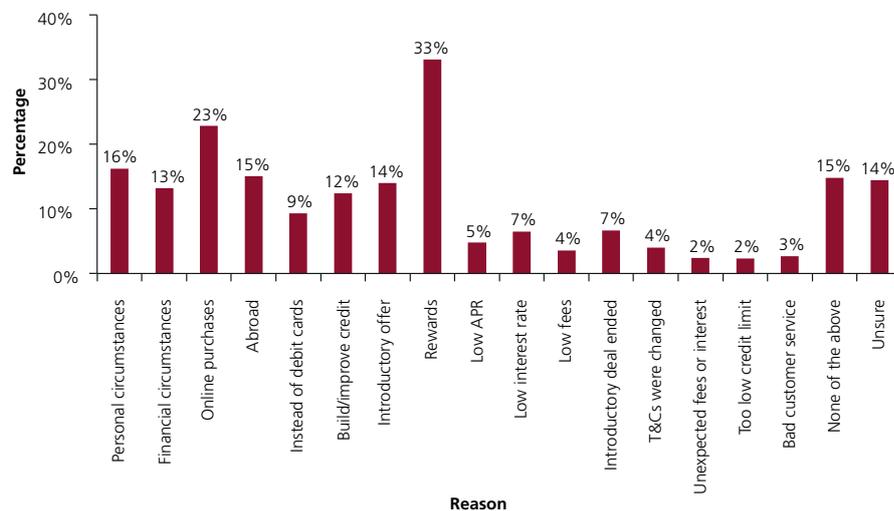
Factors that influenced consumers' decision to choose their main credit card

- 4.41** Our survey asked consumers to select what factor(s) applied when they took out their main credit card. As shown in Figure 10, for respondents overall, the key driver was rewards, followed by online purchases.

⁵⁸ This includes both consumers who kept an existing card open and those who closed their old credit card. We estimate that 3% of existing consumers opened at least one new credit card and closed a previous credit card in 2014.

⁵⁹ This includes existing consumers opening a new card and consumers without an existing credit card opening one.

Figure 10: Which of the following applied when you took out your credit card? I decided to take out a credit card because...



Source: FCA Consumer survey

4.42 As expected, these results varied based on the type of card a consumer took out:

4.43 For **rewards** consumers:

- 60% chose their credit card to benefit from rewards
- 22% to make safe online purchases
- 15% to use it abroad safely⁶⁰
- 15% to benefit from an introductory offer

4.44 For **balance transfer** consumers:

- 28% to benefit from an introductory offer
- 26% because of a change in personal circumstances
- 25% because of a change in financial circumstances
- 23% to make online purchases safely
- 23% to benefit from rewards

⁶⁰ That is, the additional protection afforded by section 75.

4.45 For **low and grow** consumers:

- 36% chose their credit card to build or improve credit history
- 34% because of a change in personal circumstances
- 30% because of a change in financial circumstances
- 23% to make online purchases safely

Reasons for switching without shopping around

4.46 Around 40% of consumers surveyed who took out a credit card in the last 12 months did so without shopping around – about a third of these respondents stated that they did not shop around primarily because the offer from the credit card company selected ‘met their needs’ (32%), it was quick and easy to apply to that company (22%), and they trusted the company (21%).

4.47 We also explored how consumers that did not shop around found their credit card. Over a third responded to an offer from a company. Of these, 29% received the offer in store/branch while 21% received the offer through the post.⁶¹

4.48 For ‘low and grow’ consumers, the most common reason for taking out a credit card without shopping around was the perception that they did not think that any other provider would accept them. They were also nearly three times as likely to cite concerns about their credit rating for not shopping around (13% compared to 5% overall) and were more likely than other groups of consumers to say they received a letter through the post (37% compared to 21% overall).

Why some consumers do not switch

4.49 We also considered why some consumers do not switch. There are two factors that could reduce consumers’ willingness to switch:

- Consumers perceive that the gains from switching are low or non-existent
- Consumers perceive there to be switching costs (including the impact of multiple applications on their credit rating).

Gains from switching

4.50 For many consumers, particularly those on an introductory promotional offer there may be little or no gains from switching. Given the many promotional offers and long-term low rate cards currently available, for many other consumers (particularly those who have not switched for a number of years), there could be material gains from switching.

Switching costs

4.51 Switching costs refer to the real or perceived costs that are incurred when changing credit cards but which are not incurred by retaining the existing credit card. Switching costs may take many forms including:

⁶¹ This result includes both respondents who responded to an offer and those than responded to an advertisement.

- the time and effort involved in searching for a new product and/or provider
- the time and effort involved in switching to a new product and/or provider (for example, completing the application form and setting up payments)
- the time and effort involved in learning how to navigate a new provider's services, for example its internet banking
- the potential impact of multiple credit card applications on credit rating

4.52 Responses to our survey indicate that a perception of switching costs amongst respondents was low.

Impact of multiple applications on credit rating

4.53 Making multiple credit card applications in a short period of time can impact on your credit rating. This may discourage effective shopping around and switching and lead consumers to accept the first card they get offered rather than comparing other options. This appears to be a particular concern in the 'low and grow' segment:

- 16% of those in the 'low and grow' segment who neither considered nor took out a credit card in the previous 12 months say that they did not do so (partly) because they did not want to hurt their credit rating – compared to 4% of all consumers.
- 22% of those in the 'low and grow' segment who compared two or more credit cards in the last 12 months but did not take out one as a result, say they did not take out a credit card because they were worried about the effect of making multiple applications on their credit rating – compared to 16% of all consumers.
- 13% of those in the 'low and grow' segment who took out a credit card without shopping around did not consider other credit cards because they were worried about the impact on credit rating, compared to 5% of all consumers.

4.54 Some firms and PCWs now allow consumers to get an indication of their likelihood of being approved before submitting a full application. At present there is variation between firms on the information provided to consumers. For example, some firms may provide a probability of being approved but not the actual terms that the consumer will be offered if approved. Some firms are also offering 'quotation searches' which do not leave a 'footprint' on the consumer's credit reference file but give an indication of the price and terms the consumer will be offered if they submit a full application (but not necessarily an indication of eligibility).

Impact on firms of shopping around and switching

Shopping around

4.55 The way that consumers shop around and make their purchasing decisions can have an impact on the way that firms design and promote their products. In particular, there is likely to be greater competitive pressure on the features that consumers focus on when choosing a product. Those features that consumers tend not to focus on, or underestimate the importance of (as a result of behavioural biases) or expect not to be relevant to them may be subject to less competitive pressure. For example, this could include post-promotional interest rates and conditional charges such as cash withdrawal fees and default fees, may be subject to less competitive pressure. This is explored further in Chapter 5.

Switching

- 4.56** A lack of switching by consumers can act as a barrier to entry and/or expansion for providers. This is because, if there are insufficient numbers of consumers shopping around or switching, it becomes difficult for new entrants or providers offering more attractive product offerings to gain sufficient market share.
- 4.57** The results set out above and discussions with firms suggest that this is not a serious issue, with a significant number of consumers shopping around or switching over the course of a year for firms to compete for. Indeed, in their submissions to us firms have not identified a lack of switching by consumers as a significant barrier to entry or expansion.

5. Firms' business models and cost recovery

We looked at:

- the share of revenue from conditional charges (default, cash withdrawal and foreign exchange fees)
- the relative profitability of different consumer groups
- the impact of the Interchange Fee Regulation

Conditional charges account for around 5% to 12% of most firms' revenue, with over 80% of revenue coming from a combination of net interest income, interchange fees and balance transfer fees. The relative importance of these revenue streams varies by product and target consumer group.

We find that:

- firms tend to compete strongly on certain product features – the features they compete on differ by product, partly because consumers focus on different features when choosing different products
- while different types of products may have a similar profitability over a five year lifecycle, the profile of that profit varies significantly over time between product types
- the consumer behaviour underlying products' profitability also differs by product.

We do not consider that cross-subsidisation in the credit card market materially restricts entry or expansion in the market. We did not find firms targeting particular groups of consumers or behavioural types with a view to cross-subsidising others – depending on the design of the product any consumer behavioural type can be profitable, except those accounts that default.

We estimate the introduction of the Interchange Fee Regulation will reduce firm income by 5% to 10% on average. Firms that have proportionally higher levels of transacting consumers face bigger losses in income. Firms say they will respond by offering more products with a small or increased annual fee or diluting rewards schemes. These developments do not give us direct cause for concern where appropriately communicated to consumers.

- 5.1** This chapter outlines our interim findings in relation to how firms compete in the market, how firms recover their costs across different consumer groups, and what impact this has on the market. The findings are based on our review of firm data and strategy documents submitted by firms, discussions with firms, and our account-level data analysis.

How firms' business models and cost recovery affect competition

- 5.2** Understanding credit card firms' commercial proposition (how products are designed, the services they offer and how they generate profit) is critical to understanding the competitive dynamics of the credit card market.
- 5.3** As stated in our terms of reference⁶², we want to understand the extent to which product design could inhibit competition or cause consumer detriment. Specifically, we want to explore whether:
- products that create cross-subsidisation between different consumer groups could restrict entry or expansion in the market
 - cross-subsidisation results in certain consumer groups being unduly disadvantaged
- 5.4** To this end, we are interested in understanding the relationship between firms' commercial position, consumer demand and the competitive environment this creates.
- 5.5** In the first half of the chapter we consider firms' revenue streams and their relative importance. We then look at how different types of products make money and the main consumer behaviours driving that profitability.
- 5.6** In the second half of the chapter, we then apply this analysis to understand the impact on competition.

How firms recover costs

- 5.7** As discussed in Chapter 3, firms' strategies in relation to credit cards revolve around effectively managing credit risk and offering products that meet consumer preferences.
- 5.8** Different firms have different risk appetites that determine their willingness to lend to higher-risk consumers. Within their risk appetite, it appears that firms are in general willing to pursue any product (that is, combination of product features) that is expected to meet internal profitability targets.
- 5.9** Product design is intended to match consumers' preferences while meeting these targets. Typically, a close match with consumer tastes leads to a high-performing product.
- 5.10** Firms that better match their product(s) to what consumers are looking for or which are more efficient can offer more attractive product features, attracting more consumers and reaping higher profits. As discussed in Chapter 4, where switching can take place freely, this allows for competition between firms.

⁶² FCA, *Credit card market study terms of reference* (2014) MS14/6.1: www.fca.org.uk/static/fca/documents/market-studies/ms14-6-1.pdf

Revenue streams

- 5.11** Credit card firms have six main revenue streams:
- net interest income
 - interchange income
 - annual (or monthly) fees
 - balance transfer fees
 - default fees
 - other income conditional on consumers using a service, for example cash withdrawal fees and foreign exchange fees.
- 5.12** The relative importance of these revenue streams will vary depending on a particular product's features and target consumer groups. For example, rewards cards tend to have a higher proportion of revenue from interchange income while credit builder cards are likely to have a higher proportion of income from interest and default fees.
- 5.13** Most large firms that offer a range of products typically earn the bulk of their revenue from interest income, interchange fees and balance transfer fees. Of the 19 firms for whom we have data, 15 out of 19 firms made 80% or more of their income from these sources with seven of these 15 firms earning more than 90% of their income from these revenue streams.
- 5.14** Conditional charges such as default fees, cash withdrawal fees and foreign exchange fees accounted for around 5% to 12% of overall firm revenue for 14 of the 18 firms we have this data for.
- 5.15** Default fees, in most cases, are a material but small proportion of total income (around 2% to 7%). For firms operating in the higher risk segment the proportion is higher at around 9%. We found default fees are currently clustering at £12 following the OFT review of default charges in 2009.
- 5.16** We have found practices by some firms (although not across the market) that lead to default fees being charged several times per default event. We are pursuing these with the individual firms in question.

How different products make money and main behaviours driving profitability

- 5.17** To understand competitive dynamics in the credit card market, it is essential to understand how firms think about their business. In this section we look at how different products make money and the main behaviours driving profitability by using the framework typically used by firms to forecast the profitability of their products.
- 5.18** This shows that:
- **Profitability is achieved by choosing a combination of product features that balance various conflicting priorities.** Credit limits need to be set in a way that maximises revenue while minimising the risk and cost of default. The final design must also meet consumer

preferences and attract consumers for whom the product was designed.

- **While different types of products may have a similar profitability over a five year lifecycle the profile of that profit over time varies significantly between product types.** For example, a rewards product has a fairly stable level of profit over the five years, while a 0% purchase product will typically make a loss during the promotional period and then profit following the end of the promotional period.
- **The consumer behaviour underlying products' profitability also differs by product.** For example, the profitability of a purchase product is primarily driven by consumers continuing to revolve a balance once the promotional period is over, while the profitability of a rewards product is driven by high levels of consumer spend. All the main credit card firms design, monitor and evaluate their products using a series of linked mathematical models designed to forecast the profitability of each product. Firms use historical data to predict likely consumer behaviour adjusted to reflect any changes in a product's features. Access to this historical data, along with high investment and expertise, represent the three key costs to entry into the market.

Forecasting profitability

- 5.19** Rather than model individual consumer behaviours, firms typically use a framework that estimates the behaviour of a theoretical 'average' consumer for each month for five years starting from the time the card is issued. These estimates can be multiplied by the predicted number of consumers to provide total revenue and cost figures and can then be evaluated using a variety of financial performance measures.
- 5.20** The estimates of each aspect of the 'average' consumer's behaviour can be graphed, for example, active balance, revolve rate⁶³, profit. These collections of graphs have various names across the industry but are commonly referred to as 'base curves'. By looking at base curves for different product types we are able to gain an insight into:
- how consumers respond to different product structures
 - the main behaviours driving profitability
 - how different product types make money
- 5.21** Below we present the base curves for several types of product to show how different card features and consumer behaviour affect profitability. The base curves are descriptive but their shape is based on the financial forecasting models provided by several firms in response to our information request.

⁶³ The proportion of outstanding balance that attracts interest income.

Why use cohort analysis?

Our analysis mirrors the approach used by firms by using cohorts of consumers. A cohort is a group of consumers who have all taken out the same credit card during the same month.

Most products have a lifecycle. Consumer behaviour and financial performance follow predictable patterns over this lifecycle caused by consumers reacting to the incentives created by the design of the product. For example, active balance tends to spike in the first six months of a balance transfer product then start to decline as the balance is paid off. The number of consumers in a cohort also shrinks over time as consumers switch products or default.

When analysing a credit card product over time, data from a snap shot (for example the first three months of 2015) includes dozens or even hundreds of these cohorts mixed together. Looking at cohorts allows us to examine the product's life cycle, how the product is designed, and how it recovers costs without the distortions created by mixing cohorts at different stages of their lifecycle.

The descriptive base curve analysis in this chapter and our quantitative analysis using the account-level data are based on cohort analysis.

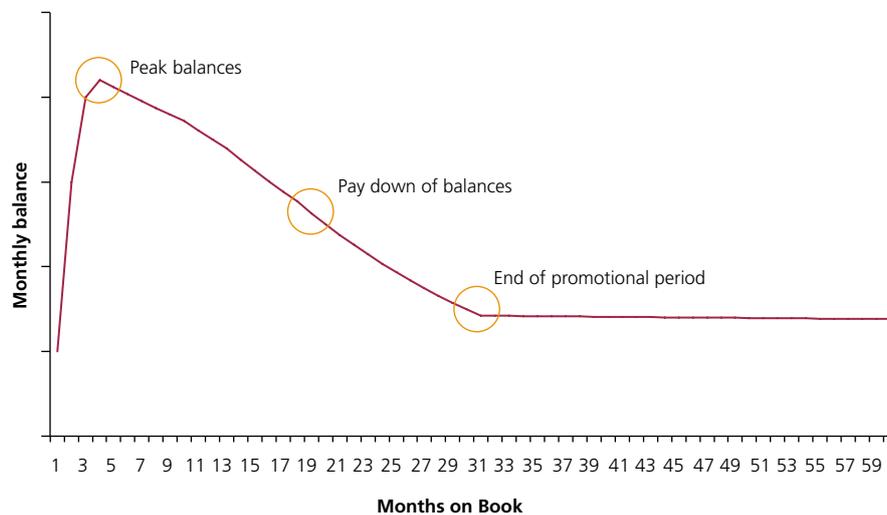
Long-term balance transfer products

- 5.22** We start by analysing a long term balance transfer (BT) product. To show how the forecasting process works, we look at several base curves relating to long term BT products. All the base curves in this section relate to the same cohort except where we examine how base curves change if we further subdivide cohorts according to their risk profile. Each base curve represents a different key variable that impacts profitability.
- 5.23** Later in this chapter we discuss the profitability base curves for other products. Annex 5 provides a complete base curve analysis for all products in line with the analysis of a long term balance transfer product covered in this chapter.
- 5.24** As the base curves will show, balance transfer products, in which a consumer can transfer existing debt from one credit card to another, rely on the initial balance transfer fee and a proportion of consumers revolving their balance once the promotional period ends to maintain profitability.

Active balances

- 5.25** The balance transfer fee and the interest generated at the end of the promotional period are proportional to the value of the balance on long-term BT cards. The higher the outstanding balance the greater the amount of revenue generated. However, higher outstanding balances also increase the expected charge-off cost. Credit card design requires balancing these conflicting factors.
- 5.26** To do this, firms offer different credit limits, with lower risk consumers typically having higher credit limits and therefore higher balances. The base curve for monthly balance on a long-term BT card has a feature shape (see Figure 11 below for an example of a balance transfer product with a 30 month 0% offer).

Figure 11: Example monthly balance for a long-term balance transfer offer

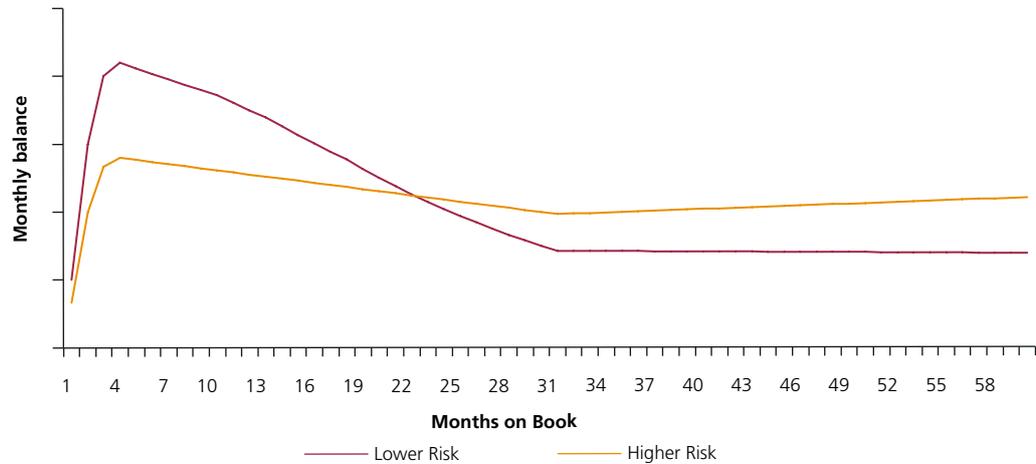


- 5.27** The shape of the base curve is due to consumers' behaviour and their response to the incentives created by the design of the product. For example the precise shape of this curve is dependent on the length of the promotional period. The peak of balances is generally observed in months three to four. This is due to the promotional balance transfer typically needing to be completed in the first 90 days.
- 5.28** The monthly balance in Figure 11 above decreases from months 4 to 30 due to consumers paying down their balance transfer during the promotional period. Pay down begins after the balance is transferred and tends to stabilise at the end of the promotional period. At the end of the promotional period:
- Some accounts in the cohort will have fully paid off and may become dormant or revert to transacting behaviour.
 - A further proportion will continue to revolve a balance which will tend to remain relatively static on average after the promotional period has ended.
- 5.29** As with the peak balance the inflection of the base curve is due to the length of the promotional period. If the promotional period was altered, the rate of pay down (the gradient of the base curve between 'peak balances' and 'end of promotional period') and the period in which balances became relatively constant (the inflection point at 'end of promotional period') would both change in response, reflecting consumers' changing behaviours. These changes would impact the forecast interest income and hence profitability. This dynamic response by consumers to changes in product features is common to credit card profitability modelling, and understanding these dynamics is a key determinant of the accuracy of a firm's models.
- 5.30** Another way in which decisions about the product can affect balances (and ultimately profitability) is risk appetite and credit limit. In Figure 12 below, we consider two different cohorts, one higher risk and one lower risk, and look at their active balance base curves. Both exhibit similar shapes but we note some differences.
- 5.31** The peak balance is lower for the higher risk group. This is caused by firms seeking to limit bad debt costs by imposing lower credit limits on the higher risk group. Limiting active balance

lowers charge off amounts but also limits interest income. Firms need to find the right credit limit for each risk group to balance interest income and bad debt cost.

- 5.32 We also note that the slope of the curve is shallower for the higher risk group indicating the pay down rate is typically lower in the higher risk segments due to a greater propensity towards revolving behaviour by higher risk consumers.

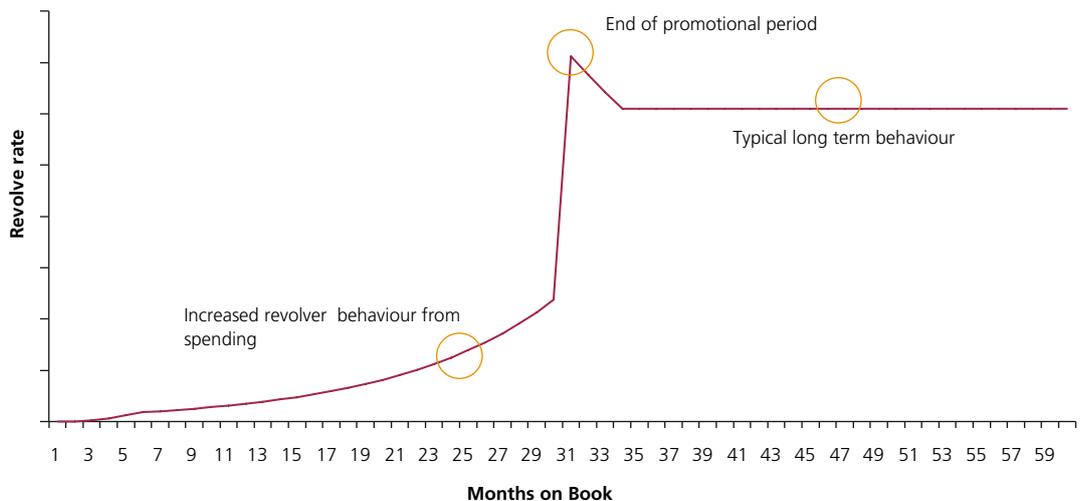
Figure 12: Example monthly balance for a long-term balance transfer offer for a lower risk and a higher risk cohort of consumers



Revolve rate

- 5.33 Interest income is dependent on the revolve rate (the proportion of outstanding balance that attracts interest income). The revolve rate base curve is also a product of consumer behaviour and the structure of the product.

Figure 13: Example monthly revolve rate for a long-term balance transfer offer



5.34 During the promotional period, no interest is charged on the transferred balance although there may be interest charged on new spending (unless a 0% purchase offer is also included as part of the product). Therefore the revolve rate will:

- Remain low until the end of the promotional period though the proportion of income attracting interest does slowly creep up as accounts make new purchases or promotional withdrawal⁶⁴ makes some transferred balances liable for interest charges.
- Spike at the end of the promotional period, as all balances become eligible for interest charges. Typically, those remaining will pay down a proportion of this balance in the six months after the end of the promotional period.
- Subsequently remain high as those remaining will typically be revolving their balance and hence attracting interest charges as with a standard product.

Profit before tax (PBT)

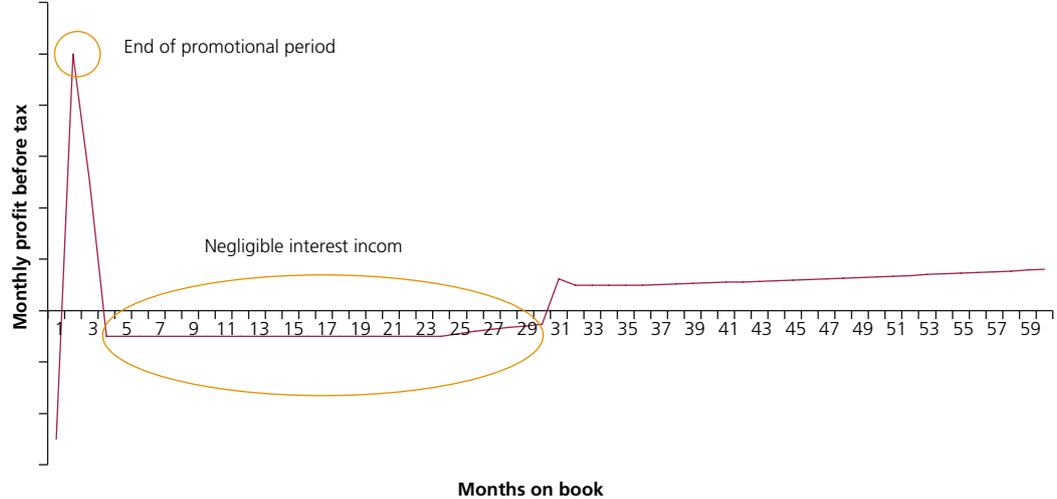
5.35 The distinctive profile of monthly profit before tax on a balance transfer product can be seen in Figure 14 below. Note, this base curve illustrates the average profitability of an account in each month since the product was issued.

5.36 PBT is positive in the first months due to the balance transfer fee income. After the initial positive cash flow, cumulative PBT becomes negative, in our illustration around month 13 as losses accumulate. This is due to reduced interest income in the months where there is the 0% promotional offer, and limited spending on the product combined with running costs for the product.⁶⁵ Income can also be generated by interchange income from purchases and from charges for cash withdrawal, foreign exchange or late payments. However, these are typically small amounts. In our illustration of a 30 month BT product losses made during the promotional period are fully recovered in month 44.

⁶⁴ See paragraph 3.34.

⁶⁵ Base curves can also be plotted to show how cost evolves over time. Typically, the acquisition cost for a cohort is incurred only in the first month. This cost is why PBT base curves typically start out negative since acquisition costs are incurred before revenue is generated. This can be seen in Figure 13 above and in the PBT base curves of other product types below. All other main sources of cost; default, funding and operational costs, are typically forecast as a constant cost over time. Whilst accurate costing is needed to correctly estimate profit levels costs estimated as constant over time do not affect the shape of the PBT base curve, though they do shift the curve up or down, which clearly affects overall product profitability.

Figure 14: Example monthly profit before tax for a long term balance transfer offer



Standard products

- 5.37** A standard product offers different product features and attracts different types of consumers. We can observe how these changes affect the product’s profitability profile by looking at the shape of its profitability base curve, which is a reflection of the forecast behaviour of consumers.
- 5.38** Standard products generate revenue from a steady level of borrowing by consumers. Within a lower risk cohort, average borrowing is typically static in standard products, though it should be noted that the individual accounts that are borrowing in each period may be changing month on month. As a result, the average profit before tax base curve is relatively flat as can be seen in Figure 15(a) below. The initial loss is caused by one-off acquisition costs paid to attract the cohort of consumers.
- 5.39** A credit builder product would have a similar shape. Credit limits for the cohort rise over time (as in a ‘low and grow’ card) this will lead to a stepped profile as shown in Figure 15(b) below. As the credit limit rises over time, so does the value of revolving balance and hence interest income and profit rises.

Figure 15(a): Example monthly PBT for a standard low-rate product in lower risk segment

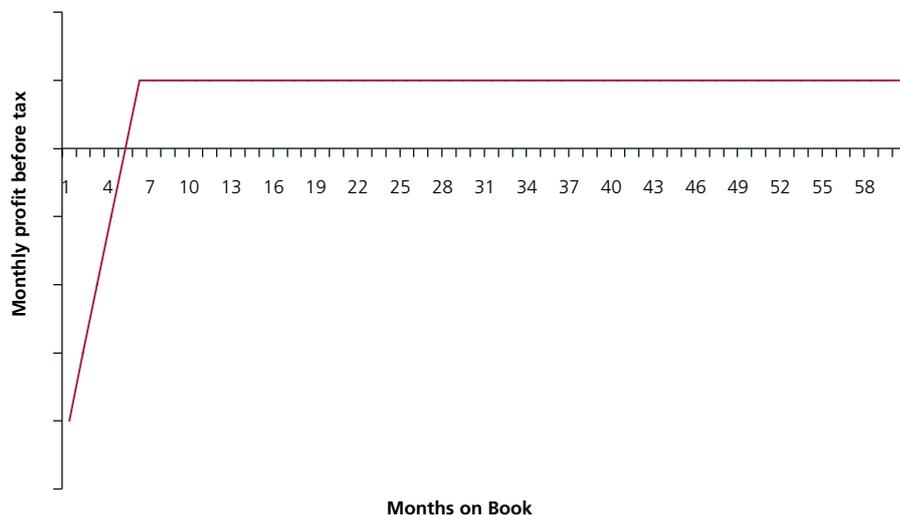
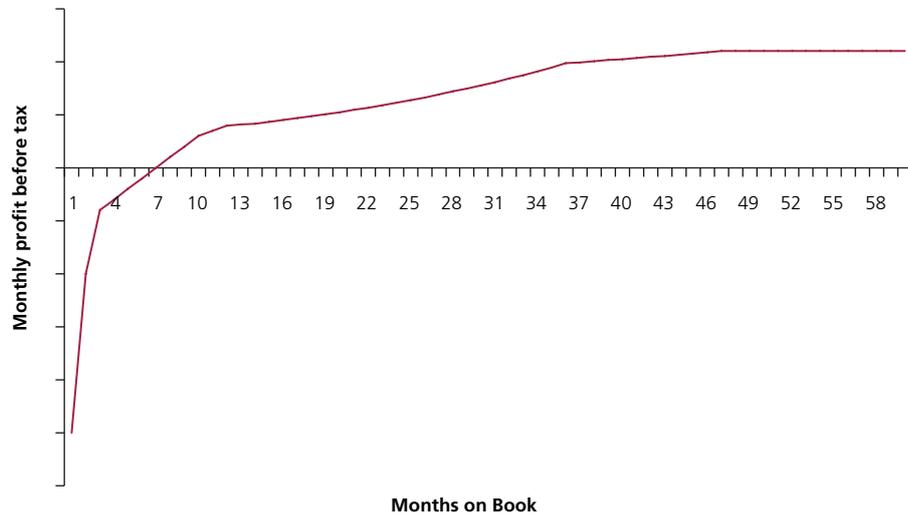


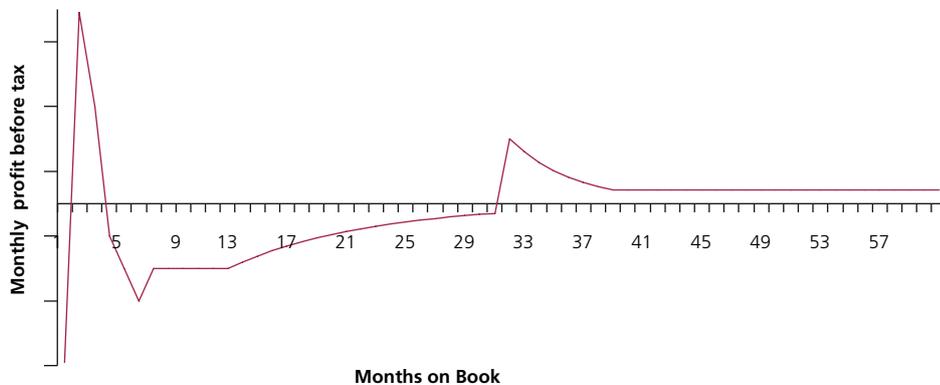
Figure 15(b): Example monthly PBT for a higher risk credit builder product



Combined purchase and balance transfer products

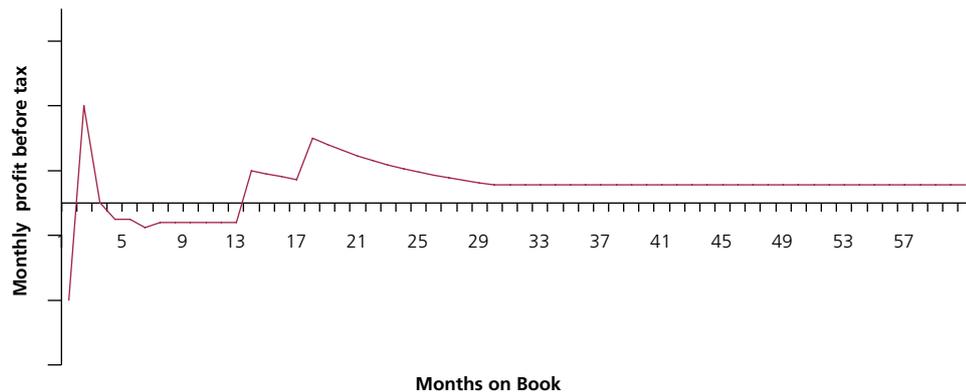
- 5.40** Combined purchase and balance transfer products offer promotional periods of varying lengths during which new purchases or balances transferred to the card attract 0% interest. BT-led products typically have long BT offers and short purchase offers. Dual products have BT and purchase offers of similar length. Purchase-led products have long purchase offers and short BT periods.
- 5.41** BT-led products have a similar profit profile to long-term BT products (discussed above) with the initial spike driven by BT fees but also by the end of the short purchase offer period. During the promotional period accounts are loss-making on average, due to low interest income levels and funding cost, but return to profitability after the end of the BT promotional period. In this example, profit spikes as the promotional period ends but falls back as consumers switch away to other products or finish paying off the transferred balance.

Figure 16(a): Example monthly PBT for a BT-led product (30 month BT, 6 month purchase offer)



5.42 In the dual product the spike caused by BT fees is smaller as fewer consumers in the cohort take out the balance transfer. However, the product returns to profitability more quickly than the BT-led product – the promotional period is shorter and profit spikes due to the end of the BT period, then again with the end of the purchase offer. These spikes are driven by increased interest income caused by interest accruing on the outstanding balance from the promotional period, with profit falling back over time due to switching and repayment.

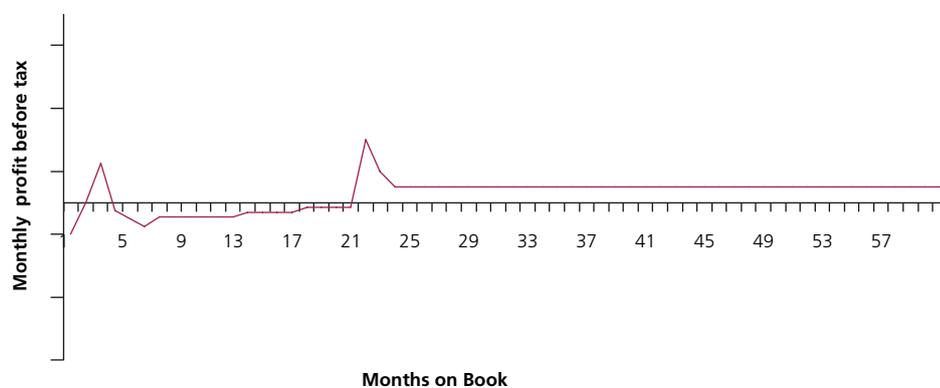
Figure 16(b): Example monthly PBT for a dual BT and purchase product (16 month BT, 12 month purchase offer)



5.43 Purchase-led cards have similar profit spikes. The first peak is driven by BT fees. The second peak corresponds to the end of the purchase offer, when interest begins accruing on outstanding purchase balance.

5.44 In this case, balances transferred are too small for the increase in profit caused by higher interest income at the end of the BT period to make the cumulative PBT positive at that stage, although the losses made during the promotional period are much lower than for BT-led products.

Figure 16(c): Example monthly PBT for a purchase-led product (6 month BT, 20 month purchase offer)



Reward products

5.45 Reward card products typically have a profit base curve similar to either the standard product base curve (pure reward cards) or the purchase-led base curve (reward plus purchase offer) above.

5.46 All profit curves are partly driven by revenue derived from interchange. In the case of reward products the relative importance of interchange will be higher. Profit levels per account are also likely to be higher than for other simple products due to typically higher levels of spending.

Conclusion

5.47 Forecasting consumers' response to the incentives created by a product's design is critical to predicting financial performance and allows firms to accurately set each product feature (for example, interest rates, credit limits, balance transfer duration) so as to achieve a specified expected level of return.

5.48 Where consumer behaviour matches expectations, products are typically profitable provided enough accounts are opened. Additionally, consumers that select cards designed for their typical behaviour tend to be better quality from the firm's point of view, for example, they are more likely to be engaged with the product and are more likely to activate and use the card. While different products focus on different consumer needs, firms can also make profits from other types of consumers using that card as well. For example:

- a firm can generate profitability on a balance transfer card from additional borrowing
- a pure transactor with high spend could be profitable on a mixed BT/purchase offer card
- a reward product may be designed almost entirely to generate additional spend but still makes money from revolving behaviour

5.49 Even loss-making propositions in manageable numbers can have financial and strategic benefits for a firm, though accounts that default carry little benefit and firms do everything they can to screen out these accounts at application.

Impact on competition

5.50 In this section, we consider the implications for competition of this analysis of the behaviours driving profitability.

5.51 Firms wishing to attract consumers have an incentive to compete strongly on those features that consumers focus on, with other features likely to be subject to less competitive pressure. The features on which consumers focus will depend on the type of product they are purchasing and to some extent the features that firms emphasise in their promotions.

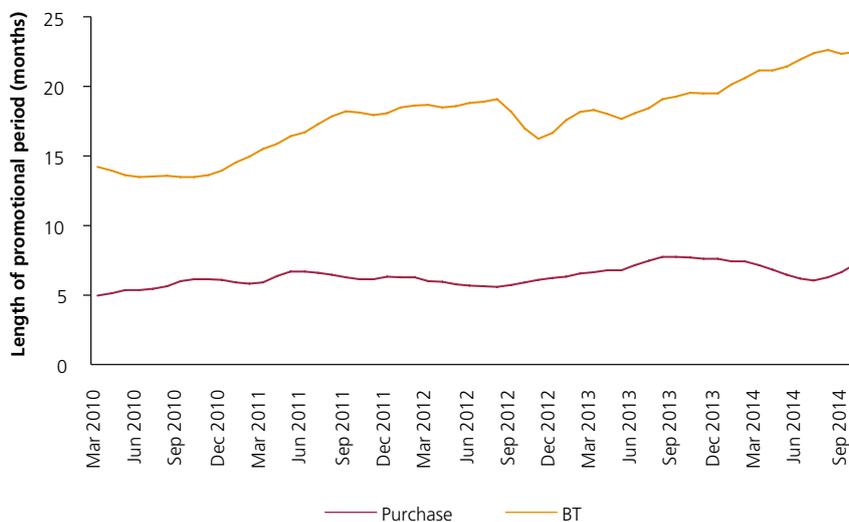
5.52 While evidence suggests that firms compete strongly, competition is not uniform across all the features of a product. The design of each product provides different product features (other than interest rate) on which firms can compete:

- long-term BT products and mixed products can compete on the balance transfer (and purchase offer) length and balance transfer fee
- reward products can compete by offering different reward structures and, where applicable, compete on the annual fee charged

- credit builder products can compete on risk appetite, offering greater access to credit than other competitors

5.53 This can be seen, for example, on long-term balance transfer products and purchase products, where the increase in promotional lengths over recent years (Figure 17(a)) has been offset to some extent by increasing post-promotional interest rates (go-to rate) (Figure 17(b)). This is consistent with our findings from the consumer survey (Chapter 4) that consumers tend to focus more on introductory promotional offers and less on post-promotional interest rates.

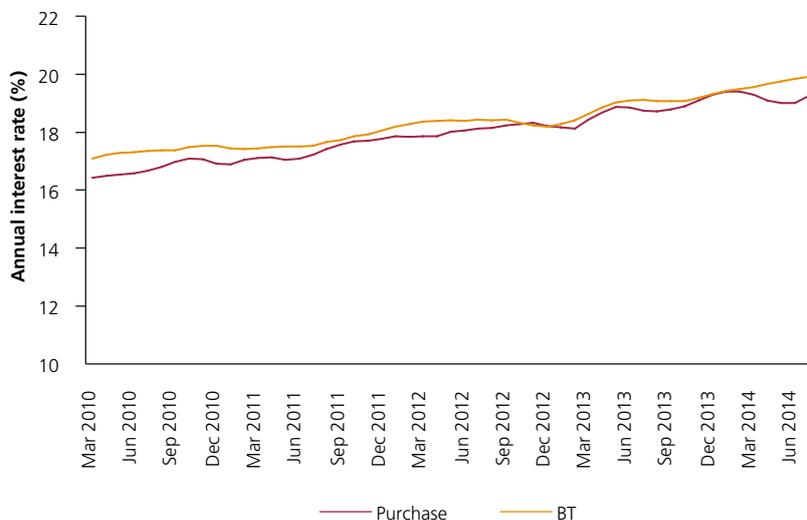
Figure 17(a): Average (mean) lengths of 0% balance transfers and 0% purchase offers taken out over time



Source: FCA estimates based on sample of account-level data

Note: Figures are three month rolling averages (mean)

Figure 17(b) Average go-to interest rates on 0% balance transfers and 0% purchase offers taken out over time



Source: FCA estimates based on sample of account-level data

Note: Figures are three month rolling averages (mean)

- 5.54** The developments in acquisition channels, such as the emergence of price comparisons websites, may have contributed to the increase in competition on these product features. Historically, PCWs only compared cards on a few key metrics. A lead in one or several of these comparison tables led to higher levels of activity and hence more profitable products. Further, a high table placing for a product tended to mean firms attracted better credit risk consumers. For any given risk profile, such an account tended to be more engaged, use the product more heavily, and be less prone to default. Firms may face an incentive to adjust the product features of a proposition so as to be as competitive as possible on features measured by PCWs so long as forecast profits were still met.
- 5.55** As we found in Chapter 4 the features consumers focus on varies between different segments of the market. The consumer survey, found that for consumers in the ‘low and grow’⁶⁶ segment, the likelihood of acceptance was the most commonly cited feature, followed by APR or interest rate.
- 5.56** Higher risk consumers also face a more limited selection of products as fewer firms operate within this segment than elsewhere in the market. Some firms have suggested that they choose not to operate in the higher risk for strategic or brand reasons. Firms also noted that the score card needed to correctly estimate default rates in the higher risk segment differs from score cards used for other products, increasing the cost of expanding into this market.
- Profitability in higher risk segment***
- 5.57** The issues discussed above suggest there may be less competitive pressure on firms in the higher risk segment than in the lower risk segment. We therefore look at relative rates of return between products from both higher and lower risk segments.
- 5.58** To look at the relative rates of return on lending for products offered by different credit card firms, we use our account-level data set. We calculate a return on lending measure by dividing the total profits made by groups of accounts over five years by the outstanding balances of that cohort over five years to produce a monthly rate of return for an average account, which we then annualise.
- 5.59** We found that, between 2010 and 2014, returns were on average higher for higher risk products typically by around 6 percentage points. Returns on some lower risk products were as high as those in the higher risk segment.
- 5.60** Annex 6 lays out how these calculations were performed in detail and demonstrates how altering our methodology did not affect the relative profitability of the two groups. The products used in our analysis were selected to give a representative sample, while also being based on data that was as comparable as possible.
- 5.61** Despite this we are cautious about placing too much weight in this result since:
- Despite an attempt to standardise the account-level data between firms, we are conscious that differences in firm data, driven by differences in firms’ structure, accounting systems and data submissions, make these results illustrative rather than declarative.
 - Methodologically our approach is similar to one performance metric used by the industry although we acknowledge several performance measures are more typically used to give a complete view of profitability. Our analysis focuses primarily on marginal return from products and makes no attempt to factor in economic or regulatory capital costs, which could alter relative profitability.

⁶⁶ As mentioned in Chapter 4, in the consumer survey we asked respondents whether they had a credit card that was designed for someone with ‘no credit or poor credit history’ which may or may not be a ‘low and grow’ card. Given that most cards of this type are ‘low and grow’ we refer to them as such throughout when referring to the consumer survey for simplicity.

- We analysed profitability over five years, in line with standard practice in the industry, however our analysis does not estimate terminal values on accounts and so may be omitting the effect that account longevity can have on firms' incentives.

Cross-subsidisation

5.62 As set out in our terms of reference, we wanted to investigate the existence and impact, if any, of cross-subsidisation in the credit card market.

5.63 Cross-subsidisation is difficult to define and measure. Two common definitions we considered as a lens for our preliminary analysis were:

- The sale of one set of goods or services at a loss enables or increases the sale of another good or service.
- Profits from one group of consumers are used to cover the losses from another.

5.64 Cross-subsidisation is not necessarily anti-competitive or detrimental. We are only concerned about cross-subsidisation where it impacts competition or is actively detrimental to consumer welfare. This includes where it:

- Creates a barrier to entry and expansion
- Results in certain consumer groups being unduly disadvantaged.

5.65 Based on our analysis, we do not consider that cross-subsidisation in the credit card market materially restricts entry or expansion in the market. We did not find firms targeting particular groups of consumers or behavioural types with a view to cross-subsidising others – depending on the design of the product, any consumer behavioural type can be profitable, except those accounts that default. Within a given product, we do not consider that groups of consumers whose behaviour is profitable for the firm are significantly less restricted in their ability to switch than those whose behaviour is loss-making.

Firms' strategies and cross-subsidisation

5.66 Firms' submissions and our own analysis of the models provided by firms, make it clear that cohort analysis (discussed above) is the primary way in which the financial performance of products is managed and forecast. Firms' strategies are focused on creating profitable cohorts of consumers.⁶⁷ In general, we find that each credit card product is designed to be profitable in its own right rather than one credit card product being designed to cross-subsidise another.

5.67 This approach accepts that some consumers within a cohort will behave in a way that creates a loss on individual accounts. This could include very low level transacting behaviour, switching at the end of the promotional period or defaulting. Other consumers will behave in a way that generates sufficient profit such that the expected performance of the cohort as a group is overall profitable. Where firms can screen materially loss-making consumers, such as those likely to default, they do so. In other cases, firms may have strategic reasons for retaining loss-making consumers, for example linked to their retail banking offering.

⁶⁷ While firms can accurately predict the behaviour of a cohort, it is far more difficult for a firm to predict an individual consumer's behaviour. However, most firms are aware which of their products contain an element of cross-subsidisation.

5.68 When looking at actual financial performance we note that individual accounts (or even whole cohorts) can become loss-making if consumer behaviour shifts away from the assumptions made when designing the product. Firms can also make mistakes regarding their forecasting and set prices/credit limits at the wrong level, leading to loss-making accounts.

5.69 While firms are aware of where losses are being made on their products, we do not consider that firms are targeting particular groups of consumers or behavioural types with a view to cross-subsidising others.

Impact of cross-subsidisation on competition

Barrier to entry and expansion

5.70 Cross-subsidisation can be detrimental when it creates a barrier to entry or expansion.

5.71 Products with long promotional periods can involve cross-subsidisation between those accounts that switch at the end of the promotional period and other accounts, as well as cross-subsidisation over time with consumers in general being loss-making during the promotional period and profitable thereafter.

5.72 We find that this can strengthen barriers to entry and expansion that already exist within the market.

5.73 As discussed in Chapter 3⁶⁸, an entrant or expanding firm in the credit card market would require a large amount of investment capital (along with considerable expertise and access to a great deal of consumer data). The prevalence of products with a long promotional period that are expected to make a loss in the first few years with profits not expected until the last couple of years of a five year cycle means an entrant will also require capital to cover the three years of loss-making in order to compete in the market, thus increasing the costs of entry.

5.74 At this stage we do not consider that these costs are significant enough to constitute a material additional barrier:

- Any entrant into the market would require a large amount of investment capital regardless of what product(s) they offered. While products with long promotional periods require higher levels of working capital than other products it seems unlikely that the level of this additional capital would be such that it would prevent the entry of a firm able to raise the capital to enter the credit card market.
- There are various entry strategies into the credit card market.⁶⁹ Firms can enter and gain market share with a number of different products, including those that do not have long promotional periods.

5.75 There are also benefits to competition arising from products with attractive promotional offers such as encouraging switching and increasing competition for existing consumers.

5.76 We therefore do not consider that cross-subsidisation materially restricts entry or expansion in the market, and do not propose to take any further action in relation to how firms recover costs or cross-subsidisation.

⁶⁸ See paragraph 3.39-3.44.

⁶⁹ Ibid.

Certain consumer groups unduly disadvantaged

- 5.77** Cross-subsidisation can also be detrimental if it results in certain consumer groups being unduly disadvantaged.
- 5.78** As discussed above, firms' cohort analysis centres on analysis based on averages, with less consideration given to the distribution of the income generated. In principle, this could mean that a group of consumers within a cohort are making a disproportionate contribution to firm revenue, and be suffering harm as a result.
- 5.79** In this chapter we have shown that different behaviour patterns can be more or less profitable to firms and more or less beneficial to consumers depending on the products being offered.
- 5.80** Within a given product, we do not consider that groups of consumers whose behaviour is profitable for the firm are significantly less restricted in their ability to switch than those whose behaviour is loss-making.
- 5.81** Taken together, we conclude that a strategy that relies on differentiating price to create market conditions where only non-switching consumers are profitable is unlikely and impractical.
- 5.82** In Chapter 6 we use the account-level data to look at the distribution of firm income across consumers. In particular, whether firms' returns on products is due to a small number of very profitable consumers and whether those consumers who may be struggling with problem credit card debt are the most profitable accounts.

Cross-subsidisation between transactors and revolvers

The terms of reference set out our intention to examine in more detail the suggestion that transactors (consumers who typically pay off their balance every month) are cross-subsidised by revolvers (consumers who typically revolve their balance from month to month).

We found that a consumer who revolves their balance is typically more profitable than the same consumer who pays off their balance every month due to the net interest income they generate. However, transactors are typically profitable rather than loss-making and firms' business models are not predicated on turning transactors into revolvers over time.

As transactors typically pay off their balance every month they tend not to attract interest income on their balance. These consumers generate revenue from interchange fees. These fees are derived from the value of transactions made using the card, hence greater spending on the card generates higher revenue. In addition, fees for cash withdrawals, overseas spending etc. are also a source of income from these consumers.

The value of spending is the critical factor that determines if transactors are profitable as cost varies less with spending than revenue. Firms that attract transactors willing and able to spend more will find transactors more profitable. Firms that attract low spending transactors will typically find them less profitable, and in some cases loss-making.

Firms' ability to attract high spending transactors is in part dependent on their strategy. The types of products offered by a firm (and to an extent the marketing and branding of that product including any co-brand partnerships) will determine what types of transactors they attract. If the design of these products is successful, transactors will find that they tend to benefit most from the products offered by these firms and switch to them. Firms that have designed their products to attract transactors will have a higher proportion of naturally high-spending transactors than other firms and would tend to find transactors are more profitable. These products are also more likely to encourage engagement and spending on the card and hence maximise revenue from each transactor in a way that other cards may not.

In addition, to transactors, accounts that end up in default and accounts that quickly switch at the end of promotional periods could also be considered loss-making if considered in isolation and hence be considered subsidised by other consumers.

A consumer can also cross-subsidise themselves over time. This means that while over the lifetime of having the product the consumer is profitable there may be periods when they are loss-making for the firm and other periods when they are profitable. Cross-subsidisation over time is inherent in the design of products with promotional offers. Consumers in general are loss-making during the promotional period and profitable thereafter. Consumers exhibiting transactional behaviour may also cross-subsidise themselves over time, for example they may be loss-making during periods when they spend very little but profitable during periods when they spend more or revolve a balance for a couple of months.

As discussed above we are only concerned with cross-subsidisation where it impacts competition or is actively detrimental to consumer welfare. We do not consider that this cross-subsidisation gives rise to these concerns.

Potential impact of the Interchange Fee Regulation

- 5.83** The Interchange Fee Regulation⁷⁰ caps consumer credit card interchange fees at 30 bps (0.3%) of transaction value. This means credit card firms' revenue from interchange will fall from around 80bps⁷¹ to 30bps. This is a gross reduction of around 60% in interchange revenue across the industry, and equates to around a 5% to 10% reduction in overall revenue.
- 5.84** The firm by firm impact varies significantly, based on a firm's reliance on interchange income. Firms that have a larger proportion of transacting-type consumers facing proportionally bigger losses in income and these consumers becoming less profitable or even loss-making.
- 5.85** The impact on the higher risk segment is likely to be minimal, reflecting the fact that interchange income accounts for a much smaller proportion of overall income in the higher risk segment.

⁷⁰ European Parliament & European Council, *Regulation (EU) 2015/751 on interchange fees for card-based payment transactions* (2015): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.123.01.0001.01.ENG

⁷¹ As noted in the Payment Systems Regulator's CP14/1 (November 2014), interchange fees for consumer credit card transactions have ranged from 0.65% to 1.85% of transaction value, depending on the card payment system (MasterCard or Visa), the card type (e.g. standard or premium) and the transaction type (e.g. Chip & PIN, card not present, etc.). The average interchange fee on such cards has been around 0.8% of transaction value (80bps).

Indeed the changes may lead to more firms entering this segment as a way of diversifying their income streams and attracting more revolving behaviour.

Firm responses

5.86 Firms' responses to the Interchange Fee Regulation can be broadly summarised as:

- trying to reduce the number of transactors/increase the number of revolvers they attract, and/or
- adjusting their commercial proposition to make transactors more profitable.

5.87 As set out in Chapter 3, to achieve either of these, firms can alter one or more of the product features:

- **Rewards** – the reward segment is likely to be hardest hit, given that reward cards attract transacting-type behaviour and rewards have typically been funded by sharing the interchange income with the consumer.
 - Some firms have already intimated that they are likely to dilute or remove reward propositions with others likely to follow.
 - Firms with co-brand partners are likely to look for the co-brand partner to fund a larger proportion of the rewards.
 - Firms are also likely to explore other ways of rewarding consumers such as merchant funded offers, for example, statement credits when spending a certain amount at a particular retailer.
- **Annual fee** – A number of firms are considering introducing or increasing annual fees. In some cases, fees may be waived for consumers who reach certain spending thresholds or are paying a large amount of interest, or in the first year to attract new consumers.
- **Annual interest rate** – The annual interest rate could be altered to increase revenue. A higher annual interest rate could compensate for lower interchange revenue. This potentially creates a mismatch in the product offering, with those exhibiting profitable behaviour finding the price going up. Some firms therefore are considering decreasing their interest rates to encourage revolving behaviour.
- **Other** – Other potential changes include entry into unexplored market segments, for example the higher risk segment, which relies far less on interchange fees, or reducing the number of interest-free days.

5.88 Based on the discussions we have had with firms to date, they say they will respond by offering more products with a small or increased annual fee or diluting rewards schemes.

5.89 These potential developments do not give us direct cause for concern where appropriately communicated to consumers (whereas we would be concerned, for example, if the loss of interchange revenue led to increases in conditional charges which are less susceptible to competitive pressures). However, in a market where there are competitive pressures on firms we would expect to see continued attempts to gain business and minimise the impact of such changes on consumers. We will consider any changes to firms' response to the cap on Interchange Fees as we progress this study.

6. Problem credit card debt

We are concerned about the scale of potentially problematic debt in this market. We have used a series of indicators to assess the scale of potential problems:

- We estimate that 6.9% of cardholders (2.1 million) are in arrears or have been charged-off. The financial and non-financial implications in these cases are likely to be significant. We found that firms take steps to avoid lending to consumers who cannot ultimately repay and cardholders who default are not profitable. We found firms were generally proactive in contacting consumers when they began to miss payments.
- We estimate that a further 6.6% of cardholders (2.1 million) have persistent high levels of credit card debt which they may be struggling to repay. This cycle may begin with relatively minor incidents, but the cumulative welfare implications that follow may be large. These consumers are profitable for firms and there was little evidence to suggest firms intervene to help consumers address persistent debt burdens where they do not miss payments.
- We estimate that a further 5.2% of cardholders (1.6 million) make systematic minimum repayments. We recognise that this is a weaker indicator of problem credit card debt and that this group includes consumers who are not struggling. Nonetheless, it indicates that consumers are taking longer to repay their credit card debt (with associated costs) than perhaps they need to. Again, these consumers are profitable for firms.

We recognise that some bad debt is a feature of all credit activity – borrowing is never risk-free, as the ability to repay is affected by major negative life events (such as divorce, redundancy or long term illness).

However, there are known patterns of consumer behaviour ('behavioural biases') that will tend to lead to over-borrowing and under-repayment. These include optimism bias (consumers typically over-estimate their ability to repay), framing effects (consumers perceive costs expressed in % terms as being smaller than the same costs expressed in £), and the anchoring effect of minimum repayment amounts (consumers will tend to pay what their lender suggests).

Balance transfers do not currently appear to be materially contributing to problem credit card debt. However, if wider economic conditions were to change significantly then, as with any credit product, the proportion of consumers unable to pay is likely to increase.

- 6.1** This chapter outlines our interim findings on problem credit card debt, in particular whether some consumers are over-borrowing/under-repaying on their balances, and whether firms have incentives to provide unaffordable credit that results in consumer harm. The emerging findings are based on our review of firm data and strategy documents submitted by firms, discussions with firms, and our account-level data analysis, as well as the literature reviews on affordability, consumer behaviour and behavioural biases.

Why we are concerned about problem credit card debt

- 6.2** Like other credit products, credit cards can provide a valuable service to consumers by enabling them to substitute future consumption for current consumption, smooth consumption over time, and provide flexibility to manage income and expenditure shocks.
- 6.3** A major difference between credit cards and many other credit products is that both the amount borrowed (subject to credit limits) and repayment schedule are flexible. Subject to meeting the minimum repayment, the consumer can decide how much to repay each month. This allows consumers to opt for very low repayments over a very long period, which may be necessary to tide them over in the short term. Over a longer period, however, lower monthly payments imply a longer time to repay and, in turn, a higher total cost. This can have implications for their wider financial situation, including their ability to meet other credit or non-credit commitments and basic household expenditure.
- 6.4** As set out in our terms of reference⁷², there may be instances where consumers are taking on such levels of credit card debt that they are unable to repay the full credit card balance within a reasonable time-frame (over-borrowing). Or, it may be the case that some consumers are repaying their debt slower than they could, incurring avoidable costs (under-repayment).

Consequences of problem credit card debt

- 6.5** We are concerned that certain consumer segments may be worse off as a result of their usage of one or more credit cards, a situation we refer to here as 'problem credit card debt'. This harm may be in financial or non-financial terms.
- 6.6** Financial harm includes paying high interest rates or fees. Later in this chapter we estimate the total cost consumers pay in debt servicing per account relative to the amount borrowed as an indication of the direct financial impact of credit card debt.
- 6.7** The harm from credit card debt can also be non-financial, such as forgoing essential expenditure or experiencing personal distress.
- 6.8** A survey by Step Change⁷³, a debt charity, found that problem debt can have a negative impact on consumers' physical and mental health as well as resulting in their relationship with family and/or friends getting worse.

⁷² FCA, *Credit card market study terms of reference* (2014) MS14/6.1: www.fca.org.uk/static/fca/documents/market-studies/ms14-6-1.pdf

⁷³ Step Change, *Personal Debt 2014; Statistics Yearbook Findings* (2014)

- 6.9** Another report⁷⁴ showed that debt worries have an impact on people's ability to work, by affecting their attendance or concentration. Consumers might also lose access to cars, telephones or the internet, and may find it more difficult to work or seek employment.⁷⁵
- 6.10** Later in this chapter we also estimate the length of time it would take consumers to pay off all their credit card debt on these accounts. This gives some indication of the non-financial impacts (e.g. because consumers experience the debt for longer).
- 6.11** In launching this market study we considered that two factors may contribute to these outcomes:
- **Over-borrowing** – consumers may be over-confident in their ability to repay or not judge future outcomes appropriately when using their credit card and suffer adverse consequences at a later stage. These outcomes constitute consumer harm, and could potentially have been avoided.
 - **Over-lending** – firms may not face a sufficient incentive to avoid or limit lending to certain consumers who experience harm as a result of the lending.

Credit risk and affordability definitions

In their responses, firms typically distinguished between 'creditworthiness' and 'affordability'. However, as both are elements of 'creditworthiness' as defined in our rules, we use the alternative terms 'credit risk' and 'affordability' instead. Credit risk refers to the likelihood an individual will default and affordability to the ability of an individual to meet future repayments without an adverse impact on their financial situation and being able to make repayments as they fall due within a reasonable period. We refer to credit card debt that is or has become unaffordable as problem credit card debt for convenience.

Causes of unaffordable borrowing by consumers

- 6.12** There are two main potential causes of unaffordable borrowing, namely:
- life-events, such as divorce or redundancy
 - consumer decision-making
- Life-events**
- 6.13** Major life-events, such as divorce or redundancy, can lead to:
- a need for additional borrowing, or
 - what was originally affordable borrowing quickly becoming unaffordable

⁷⁴ Step Change, *Life on the Edge: Towards more resilient family finances* (2014): www.stepchange.org/Portals/0/StepChangeLifeontheEdgereport.pdf

⁷⁵ CMA *Problem Debt – a report commissioned by the Consumer Protection Partnership* (2014): www.gov.uk/government/uploads/system/uploads/attachment_data/file/362689/Problem_debt.pdf

- 6.14** Some bad debt is a feature of all credit activity – borrowing is never risk-free, as the ability to repay can be affected by such life events. Both borrowers and lenders take a degree of risk entering into any kind of credit agreement, and especially where this involves open-end running-account credit such as a credit card.
- 6.15** While credit cards' flexibility on repayments can be helpful in managing short-term implications of life-events, they can also mean that affordability issues may take longer to emerge or be addressed.
- 6.16** Step Change reports that unemployment continues to be the reason given most often by their clients for seeking debt advice, with just under a quarter citing it as the primary cause of their problem debt.⁷⁶ 45% of Christians Against Poverty's clients reported the primary reason for their debt as relationship breakdown, unemployment or long-term illness.⁷⁷

Consumer decision-making and behavioural biases

- 6.17** Consumer harm may arise from consumers making poor borrowing or repayment decisions, potentially caused by a lack of information and understanding or deep-rooted behavioural issues (for example, being overly optimistic). This harm might take the form of higher costs, sacrificed consumption, the stress of meeting repayments, or the consequences of default.⁷⁸
- 6.18** If these higher costs are incurred because of behavioural biases, such as over-optimism, then this could lead to consumers taking longer to repay their debt than would be optimal. This type of consumer harm is less likely with other debt products where repayments are less flexible (e.g. fixed at the point of borrowing).
- 6.19** UK Cards' recent Credit Card market report⁷⁹ found evidence of behavioural biases, including anchoring to minimum payments and being overly optimistic about the future availability of funds.
- 6.20** The academic literature also points to a range of consumer behavioural biases in relation to credit cards.⁸⁰ This includes:
- **Present bias** (when a decision is unduly influenced by the present at the expense of the future and can lead to regretful purchases). Evidence of this includes consumers making initial borrowing decisions that are inconsistent with their subsequent borrowing behaviour and consumers exhibiting higher levels of present bias borrowing larger amounts.
 - **Optimism bias** (where consumers may be overconfident when assessing the likelihood of future events). Consumers with more moderate levels of optimism have been shown to be more likely to pay off their credit card balances while extreme optimists have been shown to have preferences for credit card features that are inconsistent with their subsequent borrowing behaviour.
 - **Presentation and framing of information about repayment.** One particular area of focus has been on how repayment behaviour may be influenced by the presentation and framing of information about repayment, particularly the minimum repayment level. One study showed that most repayments are either in full or the minimum. A group of studies

⁷⁶ Step Change, *Personal Debt 2014; Statistics Yearbook Findings* (2014)

⁷⁷ Christians Against Poverty official response to the FCA's credit card market study terms of reference.

⁷⁸ These issues were considered when the mortgage market was reviewed. In that case, borrowing was deemed to be affordable (i.e. not problematic) if repayments could be met with disposable income.

⁷⁹ Research submitted to the FCA from UK Cards, March 2015.

⁸⁰ See Annex 6 for summary of relevant academic literature.

have then shown that removing minimum payment information or accompanying it with additional information (e.g. regarding alternative courses of action) has increased levels of repayment.

- 6.21** Our consumer survey also found that 29% of respondents claimed to spend more than they had budgeted for on their main credit card and that around half of consumers with outstanding balances were very or slightly concerned about it.

Drivers of lending by firms that may be unaffordable for consumers

- 6.22** Firms' lending decisions and criteria are key to mitigating the risk of unaffordable borrowing. These decisions include which consumers to lend to, how much to lend, and how to manage open accounts, including when consumers get into difficulty.

- 6.23** From the perspective of the firm, the incentives to lend will be driven in large part by profitability. This means that:

- Incentives of the firm may well be aligned with the consumer, as both have an incentive to avoid default ('credit risk').
- There may be instances when incentives may be less well aligned, as the firm is concerned to get its money back, with interest, but may be less concerned with whether the consumer can do so only by suffering an adverse impact on their financial situation for example by not being able to meet other reasonable financial commitments ('affordability').

Creditworthiness and forbearance

- 6.24** In this section we consider how firms are making key decisions in the following areas:

- firms' credit risk assessments
- firms' affordability assessments
- firms' forbearance policies

- 6.25** The first two of these issues relate to lending decisions. FCA rules⁸¹ require an assessment of creditworthiness before a credit agreement is entered into and before any significant increase in the amount of credit or the credit limit. This must include an assessment of the potential for the commitments under the agreement to adversely impact the customer's financial situation, and the customer's ability to make repayments as they fall due or (in the case of an open-end agreement) within a reasonable period. This is usually referred to as 'affordability' (in contrast to an assessment of credit risk, i.e. the probability of default).

- 6.26** The third issue relates to how firms' treat customer's that are failing to meet repayments. FCA rules⁸² require firms to treat customers in default or arrears difficulties with forbearance and due consideration. They also⁸³ require firms to monitor repayments and take appropriate action where there are signs of actual or possible repayment difficulties.

- 6.27** Our review of these issues draws primarily on firms' submissions.

⁸¹ CONC 5.2.1R and 6.2.1R

⁸² CONC 7.3.4R

⁸³ CONC 6.7.2R

Firms' credit risk assessments

- 6.28** Firms assess credit risk using empirical, data-driven models that predict the probability of default. The assessment process is at the core of firms' credit card business and they invest in it heavily.
- 6.29** For the assessment, firms tend to use a combination of data which can include data from credit reference agencies, application form data, such as employment status and income, and, for existing customers⁸⁴ or once an account becomes active, transaction data from firms' own records.
- 6.30** Each firm has its own scorecard and policy rules. A scorecard is a set of weights that are attached to the pieces of information held on each consumer and form part of the calculation of the consumer's credit score. Higher weights are associated with information that is a stronger predictor of default. Each firm designs and reviews its own scorecards to try and improve the predictive power of the model. Policy rules in contrast are 'hard stops' or 'cut offs' which may lead applications to be rejected irrespective of credit score or before a scorecard is applied.
- 6.31** Once an account is active, firms routinely update their credit score estimates for each consumer and review how consumers have managed their accounts. The frequency of these updates varies between firms but is typically between monthly and quarterly. Updated credit scores are monitored and feed into decisions over changes to consumers' credit limits (which can be increased or decreased as a result) and potentially changes in interest rates. These updates can also affect the promotional offerings and, in extreme cases, lead to the suspension of credit facilities.
- 6.32** For all credit card firms these processes are largely automated with very little role for manual processes. Even in cases where firms told us that there was a role for human intervention this was said to very rarely lead to a change in outcome.

Firms' affordability assessments

- 6.33** Firms are required, in assessing creditworthiness, to consider affordability, that is, making an assessment of the potential for commitments to adversely impact a customer's financial situation and the customer's ability to make repayments as they fall due within a reasonable period.
- 6.34** Depending on the particular firm, affordability assessments might influence a credit card application in different ways. In some cases it is part of an integrated assessment alongside credit risk, while in others it is a separate assessment, typically applied only if the applicant first passes a credit risk assessment. In either case it can directly influence on the credit limit that is granted.
- 6.35** The practical steps involved in an affordability assessment are broadly similar across firms, and typically involve a comparison between a consumer's income, expenditure and prospective debt repayments. This may use actual information from the consumer, or (in the case of expenditure) proxy information such as data from the Office of National Statistics (ONS) on average household expenditure. Some firms also rely quite heavily on affordability or indebtedness indices provided by credit reference agencies.
- 6.36** Income data plays a key role in affordability assessments yet it is rarely verified. In most cases it is information that is self-reported by the applicant or obtained from credit reference agency

⁸⁴ This covers existing credit card customers, as well as customers who use other types of products with the provider, such as current accounts, mortgages, savings accounts, and personal loans.

data. Income data from the latter is often based on historic credit applications (self-reported) or estimated.⁸⁵ We also noted that the definition of 'income' used by firms can vary significantly.

6.37 Firms do not typically conduct regular affordability assessments once an account is active. The firms that do undertake some form of later review request updated income data, though again this is usually not verified.

6.38 We are currently wider on our expectations as regards creditworthiness across consumer credit markets and we will take forward our thinking through that process.⁸⁶

Firms' forbearance policies

6.39 Forbearance can be short-term or long-term and come in the form of, among other things, freezing interest and/or charges or offering a different payment arrangement.

6.40 Each firm has its own forbearance policy, with one or more of the following options available to its customers:

- A period without any collections activity ('breathing space') that usually lasts for 30 to 60 days. This does not necessarily involve suspending or reducing interest and charges, thus interest may continue to accrue during this period.
- A reduction or suspension of interest and charges during the forbearance period.
- Refinancing, when monthly payments or the rate of interest are reduced on a permanent basis. Some firms also offer temporary payment arrangements that allow for reduced payments for a short period.
- Re-aging of an account. This involves writing off arrears following a number (usually three) of consecutive missed payments by the consumer.
- Part-settlements may occasionally be negotiated, where less than 100% of the outstanding debt is accepted by the firm.
- Write-off of debts in response to major unsettling life events of their consumers, such as terminal illness.

6.41 Debt is normally charged-off after an account has been in arrears for a certain period of time. When this occurs varies by firm, but several firms charge off debt after between 120 to 180 days of arrears. This may be followed by internal recoveries, placing the debt with debt collection agencies, or the sale to debt purchasers.

6.42 Overall, it appears that firms are generally proactive in contacting consumers to initiate these forbearance procedures when consumers begin to miss payments. However, there is limited evidence of any significant efforts by firms to initiate these types of procedures for consumers currently meeting repayments but exhibiting other signs of potentially problematic debt (e.g. maintaining a high credit limit utilisation). We believe there is more that could be done to intervene earlier with consumers exhibiting signs of potentially problematic debt.

⁸⁵ Some firms told us that they do make some efforts to verify data where possible. For example, one firm told us that it will check an applicant's stated income against current account turnover data. Another firm told us that they verify an applicant's stated income where there is a mismatch between salary, age and employment type. Validation may require the customer to send in proof of income.

⁸⁶ FCA Business Plan (2015/16): www.fca.org.uk/news/our-business-plan-2015-16

6.43 At the end of this chapter we turn to the issue of firm incentives. Firm decisions are likely to be made largely on the basis of profit incentives and we have therefore analysed the relationship between profitability and our indicators of potential problem credit card debt.

Scale and nature of problem credit card debt

6.44 In this section we set out a series of indicators that we have used to assess the scale and nature of potentially problematic credit card debt.

Context

6.45 Identifying problem credit card debt can be challenging. For example, levels of debt that appear affordable one period may become unaffordable the next and, similarly, what is affordable for one person may not be for another.

6.46 Past work has emphasised these challenges and there is no general consensus on what constitutes problem debt. Most studies rely on one or more indicators based on subjective thresholds.

6.47 In the context of credit cards, this can be particularly difficult. The flexible drawdown and repayment options of these products make it difficult to distinguish between consumers actively choosing to use these features to their advantage and those struggling with problem credit card debt. This distinction is clearly important as the welfare implications are opposed for these groups, with the flexibility offered by credit cards being a key feature that is likely to be valued by many consumers.

6.48 Our approach to these issues has been as follows. We first identified our high-level concerns regarding affordability for credit card products. Using these as a guide, we then specified a number of quantitative indicators that map to these concerns.

6.49 At a conceptual level, we identified three main areas of concern:

- The first and most clear concern is when consumers default or miss payments. The financial and non-financial implications in these cases are likely to be significant.
- The second concern is persistent and long-term debt. Consumers in these cases may be able to meet repayments but have reached a level of debt that they are unlikely to be able to recover from, even over a sustained period of time. This cycle may begin with relatively minor incidents, but the cumulative welfare implications that follow may be large.
- The third concern is when consumers are making minimum repayments while incurring interest charges. The low minimum repayment requirement of credit cards means that these consumers may not be struggling to meet the repayments but, over time, may be incurring high interest costs as a result of their repayment profile.

6.50 The indicators we chose cover a range of measures that map to these concerns. These include these three areas of concern as well as the cost that consumers pay for credit and the length of time it will take them to repay their debt. Each of these measures is described in more detail below.

6.51 To implement each indicator it was necessary to specify a number of thresholds. For presentational purposes, we focus on certain baseline thresholds to present our results. However, we also tested a number of alternative thresholds and definitions, which are presented as sensitivity

checks. The choice of thresholds necessarily involves subjective judgement and, for this reason, the indicators are best interpreted collectively.

6.52 There are also a number of limitations to each indicator.

- In some cases they will capture some consumers that do not have problem credit card debt issues (for example, some consumers making minimum repayments will be doing so only for a temporary period before resuming higher repayments).
- In other cases, individual indicators will neglect aspects of unaffordable credit card debt (for example some consumers making above minimum repayments are doing so with difficulty).

6.53 The tension between these two possibilities motivated our approach of using several indicators and again highlights the importance of interpreting the results together.

6.54 More generally, it is important to recognise that some degree of problem debt will always be present in this market. With any risk-based product, by definition there must be some losses. It is unfortunate but inevitable that some consumers will, for example, fall into financial difficulty because of major adverse life events (e.g. job losses, divorce). Many of the outcomes captured by our indicators may be due to these unavoidable causes. However, at least some of the outcomes will be due to other factors, for example because some consumers may make uninformed or poor borrowing decisions and firms find it profitable to lend to these consumers.

6.55 The indicators are grouped into three areas as follows:

- indicators of potential problem credit card debt
- balance transfers and future problem credit card debt
- cost of credit and repayment term

6.56 We discuss each set of indicators in turn.

Potentially problem credit card debt

6.57 We use quantitative indicators to provide an indication of the likely scale and nature of problem credit card debt.

6.58 We have used four indicators, each based on 12 months of data to December 2014. The indicators are defined as follows:

- 1. Severe arrears:** consumers that have been charged-off⁸⁷ or have been at least six months in arrears.⁸⁸

87 Charged-off refers to debt that issuers have deemed unlikely to be collected and that they have written off on their balance sheet. Consumers whose accounts have been charged-off have not been relieved of their repayment requirement, and charged-off accounts are often pursued via collection processes.

88 We noted that the distinction between this category and the serious arrears category is partially driven by firm practices and their decision of when to charge-off a consumer. Some firms will do this sooner than others. This will mean that there is a degree of overlap between these two categories that the data does not reflect.

2. **Serious arrears:** consumers who having missed three or more repayments, and are either in or have been in arrears.⁸⁹
3. **Persistent debt:** consumers that have an average credit limit utilisation of 90% or more while also incurring interest charges.⁹⁰
4. **Systematic minimum repayments:** consumers that have made nine or more minimum repayments, while also incurring interest charges.

6.59 We chose these indicators based on a review of the academic literature, existing research and consumer surveys, and our own analysis and understanding of the market.

6.60 As explained above, there is necessarily an element of subjectivity in defining the indicators and their thresholds. In recognition of this we have conducted a number of sensitivity checks to assess the impact of our choices on the results, for example by considering alternative thresholds (e.g. 75% rather than 90% for persistent debt, or six months instead of nine for systematic minimum repayment) or alternative definitions (e.g. using an absolute level of debt rather than credit limit utilisation for persistent debt). We describe these sensitivity checks in more detail in Annex 6.

6.61 For each consumer, we checked which indicators applied to the accounts they held. In some cases, more than one indicator applied to a single account or to multiple accounts held by the same consumer. We assigned each consumer a single indicator by selecting the 'worst' arrears status across all of their accounts, with indicator 1 being the most severe and indicator 4 being the least severe.⁹¹

6.62 We estimate (see Figure 18 below) that most credit card consumers do not appear to have problem credit card debt. The results of the baseline indicators show that:

- Approximately 1.9% of consumers (600,000 consumers) were in severe arrears. These consumers were either charged-off or were at least six months in arrears. In addition, approximately 4.9% of consumers (1.5 million consumers) were in serious arrears. These consumers missed three or more repayments and were in arrears at some point. These are more prevalent amongst consumers with higher credit risk and in the more deprived demographic segments.
- Approximately 6.6% of consumers (2.1 million consumers) were in persistent debt. These consumers were maintaining a credit limit utilisation of 90% or more over one year while incurring interest.
- Approximately 5.2% of consumers (1.6 million consumers) made systematic minimum repayments. These consumers are repeatedly making minimum payments while incurring interest.
- For both persistent debt and systematic minimum repayments, the repayment behaviour appears across all credit risk groups and demographic segments. This, in part, suggests

⁸⁹ We chose three repayments as the threshold rather than one or two repayments as we considered that the latter two thresholds may capture a number of consumers that simply missed repayments due to inattention.

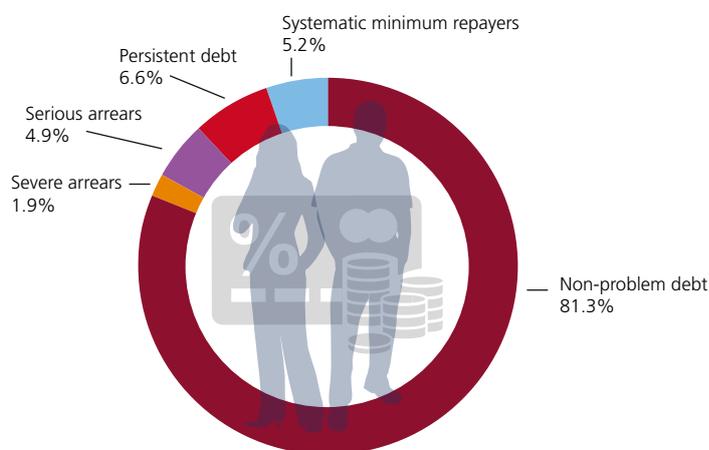
⁹⁰ This was calculated by finding the credit limit utilisation each month and then taking a simple average across months. We also considered an alternative measure of persistent debt which was based on the actual value of debt over time rather than credit limit utilisation. In particular, we were interested to see how sustained levels of credit card debt are, and whether there was issue with consumers being unable pay-down their outstanding balance once it had reached a particular level. This is discussed in more detail in Annex 6.

⁹¹ This ordering is supported by analysis presented later in this chapter regarding cost of credit and estimated length of repayment.

that a number of low risk individuals may be struggling with credit card debt or not paying down their debt for other reasons. For example, they may be unaware that they are making low repayments or that this leads to higher costs. It may also reflect that our indicators are capturing some consumers that may not be struggling.

- 6.63** We conducted sensitivity checks on the thresholds used in the definitions of persistent debt and systematic minimum repayments. This increased the proportion of consumers identified by each indicator, to 12.0% for persistent debt and 6.2% for systematic minimum repayments.

Figure 18: Indicators of potential problem credit card debt



Source: FCA analysis of account-level data

Balance transfers and future problem credit card debt

- 6.64** We have also considered whether balance transfer products may be masking future unaffordable credit card debt, in that consumers who are currently able to shift balances around without incurring interest for long periods may in future be unable to do so. These problems might only be realised once consumers' existing promotional balance transfer period ends and they are unable to transfer their outstanding balance to a new 0% deal.
- 6.65** We estimate that 22% of consumers who acquired a new card in 2014 chose a balance transfer card, and such transfers account for about £14 billion (out of £60 billion) of outstanding balances. Most of those taking out balance transfer cards were low risk consumers. Around one in five of those who acquired a new card in 2014 and chose a balance transfer card had previously taken out a balance transfer between 2012 and 2013, that is, appeared to be shifting balances repeatedly.
- 6.66** The repeated use of balance transfers was most prevalent amongst lower risk consumers with only around 2% of those cards taken up by higher risk consumers, and the evidence suggests that consumers struggling to pay any of their debts are unlikely to be offered repeated balance transfer deals. Balance transfers do not currently appear to be materially contributing to problem credit card debt. However, if wider economic conditions were to change significantly then, as with any credit product, the proportion of consumers unable to pay is likely to increase.
- Cost of credit and repayment term**
- 6.67** To provide further insight into levels of problem credit card debt, and to assess some of the consequences of problem debt, we computed estimates of the cost of credit and repayment term. The former provides an indication of the direct financial impact of credit card debt while the latter may be related to the non-financial impacts (e.g. because consumers experience the debt for longer).

6.68 We have defined the two indicators as follows:

- **Estimated cost of credit:** the total interest and charges on an account divided by the total value of transactions. The rationale behind this measure is that it provides a simple estimate of the actual costs incurred by the account holder as a proportion of each £1 of transactions.⁹² We calculated this measure for all accounts opened after January 2010 with total transactions above £50.
- **Estimated repayment term:** the length of time taken for a consumer to repay their outstanding credit card debts as of January 2015 – i.e. the last observation in our sample – with a rate of repayment equal to their average over the last six months.⁹³ It was assumed that no future transactions are made and all future interest charges are applied to the outstanding balance at the current purchase rate.⁹⁴

6.69 While the two measures are clearly linked – lower repayments will lead to a longer repayment term and more interest charges – the cost of credit measure also takes into account any charges that the consumer may have incurred. The cost measure also takes into account actual payments while the repayment term measure is an estimate based on recent behaviour.

6.70 We examine these indicators for accounts identified by the previous four indicators and the remainder of accounts. The results for consumers not identified as potentially having problem debt provides not only a useful comparison, but also an alternative view of whether some of these consumers may be struggling despite not being picked up by our earlier four indicators.

6.71 We found that consumers identified by our potential problem credit card debt indicators pay a significantly higher cost of credit and will take significantly longer to repay their debt than those without problem credit card debt:

- We estimate that 1% of credit cards opened after January 2010 (360,000 accounts) paid debt service costs over five years exceeding the amount borrowed. Those in arrears or with persistent debt incurred the highest cost.
- We estimate that 8.9% of credit cards active in January 2015 (5.1 million accounts) will – on current repayment patterns and assuming no further borrowing – take more than 10 years to pay off their balance. Again those in arrears or with persistent debt take the longest to repay.

6.72 Figure 19 shows that for those consumers not identified by our problem credit card debt indicators, around three-quarters pay an estimated cost of credit that is below 5% and around 94% paid an estimated cost of 20% or less.⁹⁵ For those in arrears or with persistent debt, over 15% of consumers paid an effective cost of 50% or more. A non-negligible proportion of consumers in each category also paid an effective cost of 100% or more—10% of those in

⁹² An alternative measure of cost would be to calculate the Annual Percentage Rate (APR). This measure is usually applied when there is a fixed repayment schedule, which does not apply in the case of credit cards. As a result, applying the APR measure to credit cards raises a number of methodological challenges. An APR can be calculated each month, but then it must be decided how best to weight the monthly APR to give a single number. One solution would be to introduce a weighting scheme based on closing balance. However, such a solution creates new challenges, such as the treatment of fees and charges for consumers who are characterised by transacting behaviour, where this important component of costs would be ignored. Given these difficulties, we opted for the simple measure described above.

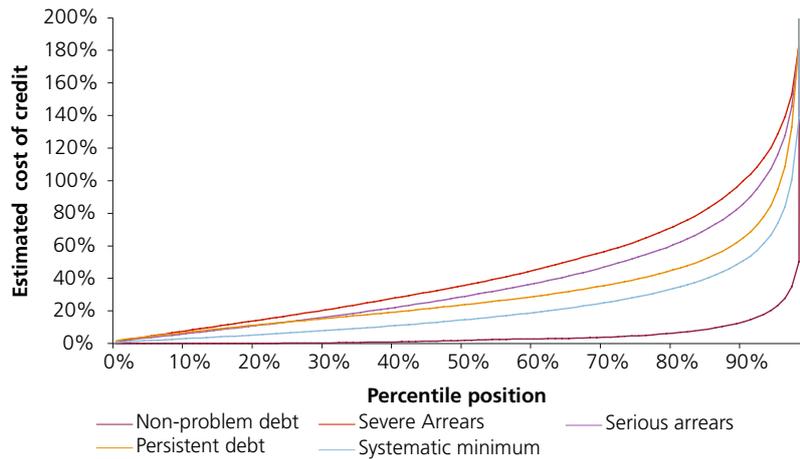
⁹³ As an indication of how representative average repayments over the last six months are as predictor of future repayments, we estimated the average repayments made on accounts over the six months prior December 2012 and measured how well they forecasted repayments in 2013. We found that the actual level of repayments predicted by this measure were within 30% of the average actual repayments for 52% of accounts.

⁹⁴ This analysis has been conducted at the account-level as undertaking it at the consumer-level would be more complex and require making additional assumptions in order to capture the repayment behaviour of consumers across multiple cards.

⁹⁵ Many of these consumers will be transactors, paying little or no interest and charges.

severe arrears, 7% of those in serious arrears, 4% of those in persistent debt and 3% of those making systematic minimum repayments.

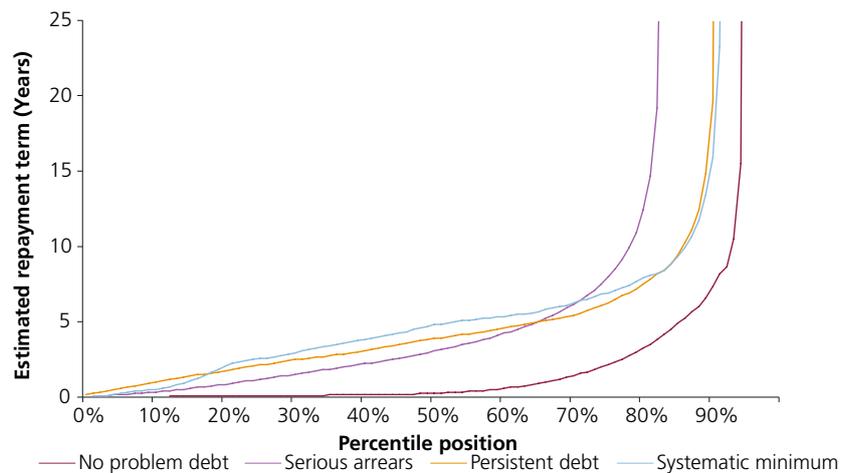
Figure 19: Distribution of the estimated cost of credit over five years, by problem credit card debt indicator⁹⁶



Source: FCA analysis of account-level data

6.73 Figure 20 shows that around 86% of accounts not identified by our problem credit card debt indicators are estimated to repay their credit card debt within five years. The comparable proportion for accounts identified as being in serious arrears, persistent debt or making minimum repayments is much lower at 55% to 65%.

Figure 20: Distribution of the estimated repayment term, by problem credit card debt indicator



Source: FCA analysis of account-level data

⁹⁶ The cost of credit estimates reported reflect the observed costs that have accrued on accounts to date. No allowance is taken for the size of the outstanding balance at the end of the sample or the length of time it is expected to pay off this balance. See Annex 6.

- 6.74** The sensitivity tests show that these results are robust to minor changes in the methodology for calculating effective cost and repayment term.
- 6.75** We believe that the picture our three sets of indicators show comprises a mixture of:
- People struggling under a debt burden that is or has become problematic.
 - People paying more in debt service cost and taking longer to pay off debt than they need to. While these people may not regard their debt as problematic, it is more expensive than it needs to be and there is some risk that it becomes problematic in the future.

Firms' lending incentives

- 6.76** As mentioned earlier in the chapter, firms' decisions are likely to be made primarily on the basis of profit incentives and therefore in order to determine firms' incentives to lend we need to look at profitability.
- 6.77** In Chapter 5 we showed that firms' financial forecasts focus on the average profitability of different cohorts. This is a useful model for understanding products' competitive dynamics but to understand firms' profitability incentives requires an analysis of individual account-level profitability.
- 6.78** The focus of our analysis has been on where firms' and consumers' interests may not fully align. In some instances, firms' and consumers' incentives align, for example, firms generally wish to minimise the likelihood and cost of default, as do consumers. In other instances there may be a misalignment of incentives. We identified three areas to investigate:
- **Distribution of profitability:** The first area relates to the distribution of profitability, and whether this is heavily influenced by a small number of very profitable consumers. To explore this issue we calculated the profitability of each account in a cohort of new accounts and examined their contribution to overall profits made by each account. Our concern was that if profits were heavily skewed to a small number of accounts, firms could be incentivised to target, and possibly exploit, these consumers.
 - **Expected profitability:** The second area we investigated is the profitability of consumer risk segments. In principle, firm and consumer incentives should be aligned from a risk and default perspective, simply because both firms and consumers wish to avoid this outcome. However, since firms cannot distinguish at the point of lending between consumers that will default and those that will not, firms may find it profitable to lend to some risk groups that contain a very high proportion of consumers that will go on to default. This might happen if the positive profit contributions of some consumers (e.g. those that do not default, or those that default but are highly profitable prior to default) are sufficient to outweigh the negative contributions of default. To investigate this possibility, we have examined the distribution of profits across risk segments.
 - **Profitability and problem credit card debt:** The third area we investigated is how the profitability of consumers relates to the problem debt outcomes defined in paragraph 6.58. If consumers with problem debt are profitable for firms, then this will not create incentives for firms to assist these consumers, even if a firm can identify the consumers that are struggling by their ongoing borrowing and repayment behaviour (e.g. after an initial lending decision). To evaluate this issue, we computed profitability for consumers that were identified, after 12 months of borrowing, by our problem credit card debt indicators.

6.79 In the following three subsections, we describe each of these pieces of analysis in more detail and present our findings.

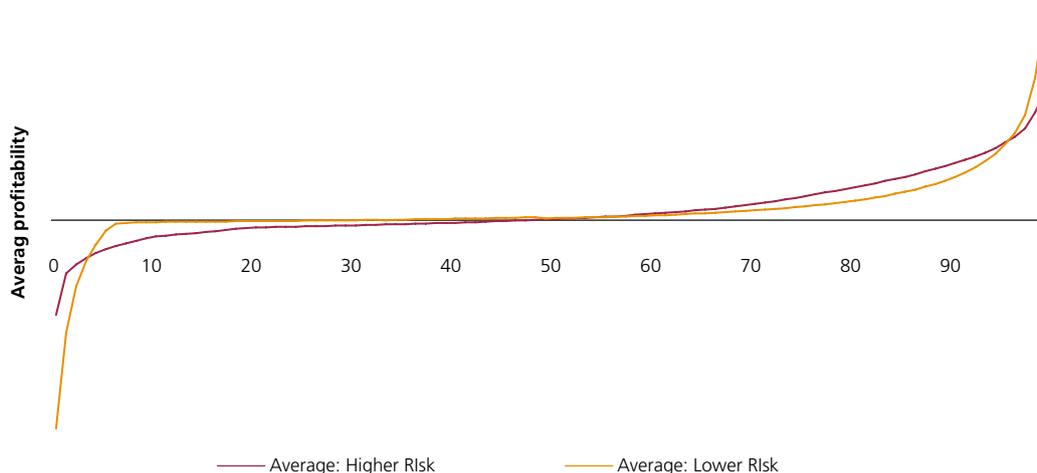
Distribution of profitability

6.80 We begin our analysis of firms' profitability incentives by considering the actual marginal profits on a sample of accounts. Some firms' accounting systems were unable to provide details of variable operational costs at the account-level and so we use a sample cohort of consumers each coming on book in January 2010 across six credit card products, three products targeted at lower risk segment and three from the higher risk segment. This sample represents approximately 10% of accounts opened in January 2010. See Annex 6 for further details on our sampling methodology and sensitivity analysis.

6.81 In order to look at the profitability distribution, we order the five year profitability of accounts for each of the six products in our sample. We then split the data into one hundred groups based on their profitability and take averages for each percentile to give a distribution of profit and loss for each product. Figure 21 shows an average of these distributions with each product's distribution split into two groups based on whether the product under examination is targeted at a higher or lower risk segment of the market.

6.82 This allows us to look at the five year profitability for all accounts in our sample from those making the highest losses through accounts that are breaking-even to accounts making the highest profits. The steeper the slope of the right hand side of the distribution, the smaller the proportion of accounts on which firms are making profits. The smaller the group making profits, the greater firms' incentives to target this group and the greater the possibility that firms' incentives could be misaligned with consumer welfare.

Figure 21: Distribution of five year profitability in the high and low risk segments



6.83 The lower risk products tend to produce more extreme tails. We find that a small proportion of accounts, approximately 30% of accounts, are responsible for 90% of profits but another small group of consumers, around 5%, are responsible for almost 90% of losses.

6.84 The large flat section of the low risk segment distribution curve is caused by a higher number of consumers in the lower risk sample using their account as purely a payment card. We know that the majority of transactors are typically close to break-even for the firm. We find that transactors can make a positive contribution to profits due to interchange fees but do not

typically generate large profits, since they do not make interest payments. Firms can also have other financial or strategic reasons for attracting and retaining these accounts.

- 6.85** The tails of the distribution are more extreme for the lower risk segment because these accounts have higher average credit limits. Consumers taking out a lower risk card are typically less likely to default and tend to have higher credit limits. As a result, when compared with the higher risk segment, lower risk consumers can borrow more using these cards. This makes profitability higher but leads to larger losses when an account defaults, though this happens less frequently than in the higher risk segment.
- 6.86** Higher risk accounts tend to exhibit more borrowing behaviour, and although lower credit limits mean lower levels of profitability on individual accounts, a higher proportion of accounts are profitable as a result. It can also be seen that the rate of default is higher leading to more loss-making accounts. This is consistent with our understanding of firms' product design.
- 6.87** A tension exists between firms' incentive to maximise consumer borrowing versus its incentives to avoid default and hence losses, because those who borrow and earn profits are the same consumers who are more likely to default.

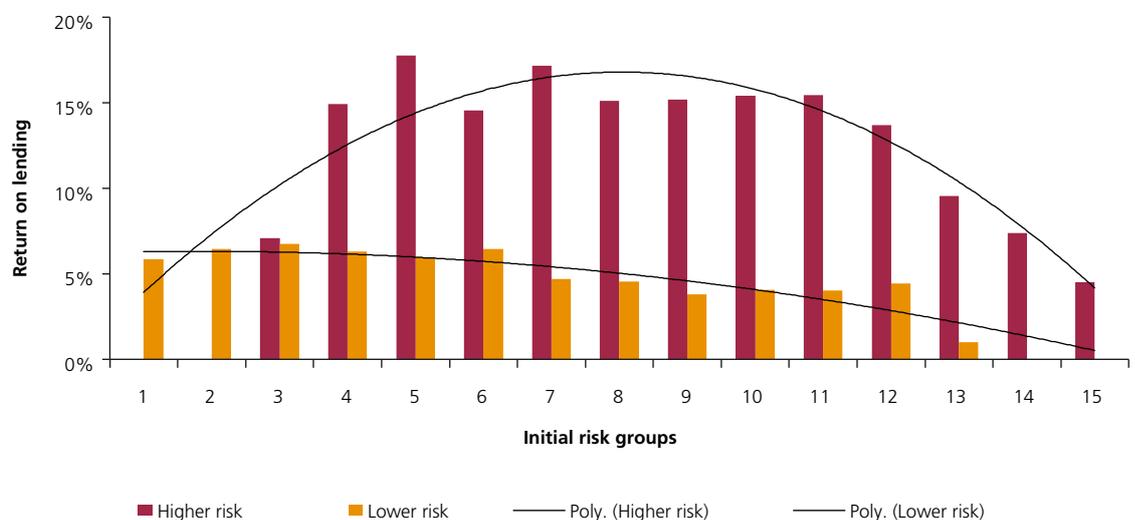
Expected profitability distribution

- 6.88** It appears that firms and consumer incentives are aligned to some extent, in so far as firms are incentivised to lower the instance of default as much as possible. Firms that can do so reduce the cost of default and improve their products' financial performance.
- 6.89** Firms are not able to identify perfectly which accounts will default and which will be profitable. Firms are able to calculate a default rate and hence forecast default costs for groups of accounts. Firms then make their decisions based on the group as a whole. This means that, for the highest risk group, although by definition more accounts will default, if firms think that the profit generated from the other consumers in the group will outweigh these losses, they will be inclined to lend to this group.
- 6.90** Therefore, to fully investigate firms' incentives we also need to consider the 'in-expectation' profitability of different risk groups. If the expected profitability of a very risky group was disproportionately high, firms would be incentivised to lend to that group, even though it would tend to inflate the occurrence of default in the short run. This could lead to the kind of misalignment of incentives that we are concerned about.
- 6.91** To conduct this analysis we used the same sample as before and report our findings based on the average results of the three products in the lower risk segment and the three products in the higher risk segment. However, where before we looked purely at five year profitability, here we used rates of return on lending as a further measure of financial performance for products offered by different credit card firms. This allowed us to take into account not just profits but the amount of money being lent to generate that profit, allowing us to better assess firms' incentives.
- 6.92** We calculated the return on lending by dividing the total profits made by all accounts with the same product (the same five year profitability measure used in the profit distribution analysis above) by the average outstanding balances of that cohort. We then annualised this monthly return estimate.⁹⁷

⁹⁷ The cohort's average monthly balance is the average of all accounts' average outstanding balance over five years (see Annex 6 for further details).

- 6.93** Figure 21 shows that products targeted at the higher risk segment tend to generate higher returns on lending than in the lower risk segment. However, Figure 22 allows us to look at how rates change as risk increases, with risk category 1 being the lowest harmonised risk category (see Annex 6) and risk category 15 being the highest.
- 6.94** This approach to analysing the data allows us to look at how average annualised return changes based on firms' initial assessment of risk. If the data shows that very high risk groups generate the greatest returns, firms would tend to be incentivised to target these groups, even if default was more probable, potentially leading to a misalignment of incentives.

Figure 22: Return on lending rates by initial risk category



- 6.95** Our analysis demonstrates that, as expected, lower risk individuals do not take out higher risk cards and higher risk individuals do not have access to lower risk cards. By targeting a specific range of risk, firms are able to forecast default cost and match product characteristics (such as interest rate, fees, credit limit) to deliver profits in line with internal targets.
- 6.96** Typically, as risk increases firms compensate for increasing default costs by offering terms that are less generous; credit limits fall and the interest rate increases. Despite lower credit limits, utilisation and revolve rates tend to rise as risk increases. Higher risk groups can therefore generate higher revenue, though default costs and other organisational costs such as capital requirement costs will also rise. Firm's incentives will be to target the point where profitability and returns are maximised.
- 6.97** Figure 22 shows for the lower risk segment the optimal profitability point tends to occur at relatively low levels of risk. Whereas the higher risk segment tends to maximise returns in the mid-to-high groups. At very high levels of risk, profits decrease on higher risk products because default rates increase faster than revenue. At lower levels of risk the reduced cost of bad debt is not enough to compensate for loss of revenue caused by improved terms.
- 6.98** Based on this analysis, we conclude that higher risk, and potentially more vulnerable, consumers are not the most profitable group of consumers and that firms do not seem to be incentivised to target these groups. Rather, firms make greatest returns from consumers for whom the product was designed. Consumers at the edge of products' risk appetite are typically less profitable.

Profitability and problem credit card debt

- 6.99** Consumer behaviour may be unknown when an account is first created. However after a period of time, firms can determine with reasonable accuracy what behaviour an account is exhibiting.
- 6.100** If accounts exhibiting behaviour that could lead to problem debt are highly profitable this could indicate firms have incentives to target these consumers once they are identified, or to encourage existing consumers to engage in behaviour that could lead to problem credit card debt.
- 6.101** To assess the relationship between profitability and the problem credit card debt groups detailed above we split the account-level data into five groups based on our problem credit card debt indicators.⁹⁸
- 6.102** To assess the financial performance of these groups we used both average profitability figures and the return on lending measure from the previous section. We also looked at these performance metrics in conjunction with the numbers of accounts in each category, credit limits and other account data stratified by the groups defined above.

Figure 23: Return on lending rates for problem debt groups in the lower and higher risk segments



Severe arrears

- 6.103** Our analysis shows that accounts initially classified as being in severe arrears are, on average, heavily loss-making.
- 6.104** Losses are driven by lower credit limits (indicating firms had already identified these accounts as higher risk) which leads to lower interest income. These accounts typically have a much shorter period than other accounts before default occurs which would further reduce revenue. Lower credit limits and short active durations also lower costs on these accounts. However default costs are higher than in any other category to such a degree that accounts are loss-making on average.

⁹⁸ See paragraph 6.58.

6.105 Firms' credit risk models are designed to screen out accounts that would default within 12 months. Given our definition of severe arrears identifies accounts that have either already defaulted or are close to default within 12 months it seems likely that the majority of accounts in this category are attributable to the error margin of firms' models. With respect to these accounts, the incentives of the firm seem to be largely aligned with the consumer, as both have an incentive to avoid default.

Serious arrears

6.106 Firms have less incentive to eliminate accounts in the serious arrears category. Taken as a whole this group tends to be in expectation profitable in both the higher and lower risk segments, though the low risk segment is very close to break-even.⁹⁹ Profitability in the higher risk segment is driven by the fact that interest income in the serious arrears category is far higher than for those in severe arrears whilst charge-off cost is, on average, far lower. The serious arrears category typically has lower credit limits, lower interest income and higher default rates, than the persistent debt, minimum payers or accounts with no problem debt categories. This makes this category less profitable than all categories except for the severe debt. However, the longer duration before default in the serious debt category makes it a profitable proposition.

6.107 We note that while firms are unlikely to prefer serious arrears accounts, since the rate of return is lower than for all groups other than severe arrears, firms have limited incentives to screen out this type of account, assuming this were possible.

6.108 We acknowledge that accounts falling into severe and serious arrears groups could be similar types of consumer separated only by the timing of their default. If these two groups are linked to the extent that firms could only exclude accounts in the severe debt category at the expense of excluding serious debt accounts, they may be incentivised not to do so. Firms' incentives would depend on the number of serious and severe accounts excluded by the new scorecard, as well as the relative profitability to the firm of each group.

Systematic minimum repayments

6.109 Systematic minimum payers have slightly higher credit limits than the serious arrears category but pay much higher levels of interest income on their accounts. This drives higher levels of profitability and return.

6.110 Systematic minimum payers and those not identified by our problem credit card debt indicators tend to have similar credit limits on average. Figure 23 shows that in the higher risk segment, the rate of return on lending is higher for the no problem category than for minimum payers. However, in the higher risk segment the average profit for a systematic minimum payer is higher than for the no problem category but a higher active balance tends to reduce the return on lending ratio. In other words, generating slightly lower profits on no problem accounts requires proportionally far less lending by firms. In the lower risk segment returns from minimum payers are, on average, the same as returns from the no problem category.

Persistent debt

6.111 Similarly, the persistent debt group returns, on average, a higher rate of return than all other groups in the higher risk segment. In the lower risk segment returns are comparable with the minimum payment and no problem categories. This might indicate that there is some incentive to encourage high utilisation behaviour in the high risk segment. This is in line with the incentives discussed in Chapter 5 especially around the standard products typically offered in the higher risk segment.

⁹⁹ We discuss in both chapters 3 and 5 firms' wider strategic incentives regarding account which are close to break-even.

Summary

- 6.112** Our analysis shows that accounts that in their first year are in serious arrears, systematically minimum paying or having a very high persistent level of debt on average all generate positive returns over the product life-cycle.
- 6.113** We conclude that firms in the lower risk segment have no particular incentives regarding accounts in the no problem, systematic minimum payer or persistent debt groups, though they have clear incentives to minimise default across their portfolio.
- 6.114** For firms in the higher risk segment firms would also prefer accounts that are in the no problem, minimum payer or persistent debt groups. However they may also be incentivised to push up utilisation. Depending on the profitability and number of accounts in serious and severe arrears firms may also find that adopting score cards designed to minimise these groups may not be profit-maximising.
- 6.115** Based on this, our view at this stage is that firms make losses on consumers that default so they have a strong incentive not to lend to these consumers. However, firms have fewer incentives to avoid lending to consumers who have persistent debt or make systematic minimum repayments because they are profitable to the firm.

7. Interim conclusions

- 7.1** This chapter summarises our interim conclusions on how well competition is working in the interests of consumers in the credit card market, based on our analysis to date.

Interim findings

The extent to which consumers drive effective competition through shopping around and switching

- 7.2** We found that in most of the market, competition is working fairly well for consumers.
- 7.3** **Consumers value the flexibility offered by credit cards and use them in different ways**, for example making secure payments and collecting rewards, as an emergency credit facility, for debt consolidation, or for building credit history. There are a number of firms offering a range of products to meet these varied consumer preferences and competing strongly for their custom.
- 7.4** As set out in Chapter 4, **consumers are engaged and willing to switch**, with around 6 million new accounts opened in 2014. Evidence suggests half of those taking out a credit card shopped around first and that around 14% of existing credit card consumers took out a new card in 2014. According to our consumer survey, a further 8% compared at least two credit cards but did not take one out. Most consumers do not perceive material barriers to switching, and firms do not consider a lack of switching to be a significant barrier to entry or expansion.
- 7.5** **Price comparison websites (PCWs) play an important role in this market.** For consumers they can help navigate complex products and reduce search costs by comparing products in one place and for firms they can help attract consumers. We found that of those consumers who shopped around, 66% used one or more PCW and found them useful.
- 7.6** We found some limitations to the effectiveness of PCWs in helping consumers navigate product complexity, for example ranking criteria may be based on assumptions that may not reflect their credit card usage pattern. We also found that PCWs on the whole did not make clear how they were funded and whether they compared the whole of the market. **We find that consumers do not always manage to choose the best credit card for their circumstances.** This may be because:
- they have not been able to effectively compare the different cards available to them
 - they have given insufficient weight to certain product features when making their decision
 - their actual card usage differed from what they expected when they took out the card

- 7.7** Based on our analysis of the consumer survey (Chapter 4) and firms' business models and strategies (Chapter 5) we find that **competition is focused primarily on certain product features such as introductory promotional offers and rewards**. There is less competitive pressure on interest rates outside of promotional offers and on other fees and charges. Our analysis of firms' financial submissions (Chapter 5) shows that most firms do not rely on these conditional charges to generate significant revenue, with income from default, cash withdrawal and foreign exchange fees accounting for around 5% to 12% of overall firm income.
- 7.8** While the market is only moderately concentrated overall, we found that **higher credit risk consumers have a more limited choice of products and providers** than lower risk consumers. The main barriers to serving this segment, other than commercial viability, appear to be the reputational and regulatory risks associated with higher risk and higher cost lending. We also found higher credit risk consumers have concerns about whether other firms would offer them a credit card and the impact of multiple applications on their credit score, which discourages some from shopping around.

Balance transfer products

Balance transfer products are a significant feature of the market. We found that 22% of new accounts in 2014 involved a balance transfer, with £14bn held in balance transfers at the end of 2014. They are popular with consumers and provide a valuable role in facilitating competition for existing consumers with outstanding balances.

Balance transfer products make money from the up-front balance transfer fee, from interest on new spend on the card, and from interest on the balance at the end of the promotional period.

Balance transfer lengths have been getting longer over the past few years. Over the course of 2015, there has been an increasing prevalence of shorter balance transfers with lower fees and headline balance transfer fees on a number of long length balance transfer products have reduced.

Consumer understanding of balance transfers is mixed and there is some instances where late payment or going over-limit can result in consumers losing their 0% deal. Our consumer survey found that some consumers with balance transfers may not fully understand how they work with only 59% of respondents who had made a balance transfer to or from their main card in the last 12 months correctly answering three true or false questions about 0% balance transfer deals. Recent work by Which? found that consumers often struggle to understand the true cost of balance transfer deals.

We looked at whether BTs were storing up future problem credit card debt problems but were re-assured that:

- Almost half of accounts repaid the full amount of the balance transferred by the end of their promotional period. This increases to 60% three months later and to 71% six months later.
- Only around 20% of consumers that carried out a balance transfer in 2014 had previously taken out a balance transfer in either 2012 or 2013.

- Consumers with a perceived lower credit risk were typically offered the most favourable terms, such as a longer 0% introductory offer period. Consumers with a perceived higher credit risk tended not to be accepted for balance transfer deals so they are unlikely to comprise a significant proportion of outstanding balances.

However, if wider economic conditions were to change significantly then, as with any credit product, the proportion of consumers unable to pay is likely to increase.

How firms recover their costs across different cardholder groups and the impact of this on the market

- 7.9** As set out in Chapter 5, we find that while different types of products may have a similar profitability over a five year lifecycle, the profile of that profit over time varies significantly between product types and the consumer behaviour underlying products' profitability also differs by product.
- 7.10** Based on our analysis, **we do not consider that cross-subsidisation in the credit card market materially restricts entry or expansion in the market.**
- 7.11** **We did not find firms targeting particular groups of consumers or behavioural types with a view to cross-subsidising others** – depending on the design of the product any consumer behavioural type can be profitable, except those accounts that default. Within a given product, we do not consider that groups of consumers whose behaviour is profitable for the firm are significantly less restricted in their ability to switch than those whose behaviour is loss-making.
- 7.12** As discussed in Chapter 5, we also considered the potential impact of the cap on interchange fees. Firms' estimates of the reduction in income from the cap averaged 5% to 10%. Firms with higher levels of transacting consumers will face proportionally bigger losses in income. Firms say they will respond by offering more products with a small annual fee or increasing an existing annual fee and diluting rewards schemes.

The extent of unaffordable credit card debt

- 7.13** There is no standard definition of problem debt in the credit card market. As set out in Chapter 6, we used a series of indicators to assess the scale and nature of debt that is potentially problematic. We found that of the 31 million active consumers in the last year, **1.9% (600,000 people) charged-off or were at least six months in arrears, and 4.9% (1.5mn people) missed three or more repayments and were in arrears at some point.** Defaults and arrears are more prevalent amongst consumers with higher credit risk and in the more deprived demographic segments.
- 7.14** We also looked at credit limit utilisation, since persistent high utilisation can be an indicator of debt problems. We found that **6.6% (2.1 million people) have maintained an average credit limit utilisation of 90% or more for over one year while incurring interest.** This behaviour was present across all credit risk groups and demographic segments but was more prevalent amongst consumers with higher credit risk and in the more deprived demographic segments.

- 7.15** We also looked at systematic minimum payment. We recognise that this may be a weaker indicator of potential credit card debt and that this group includes consumers who are not struggling. Nevertheless, it indicates that consumers are taking longer to repay their credit card debt (with associated costs) than perhaps they need to. We found that **5.2% (1.6 million people) are repeatedly making minimum payments while incurring interest**. This repayment behaviour appears across all credit risk groups and demographic segments.
- 7.16** Lastly, we looked at the total costs consumers pay in debt servicing per account relative to the amount borrowed, and at the length of time they take to pay off credit card debt on these accounts. We found:
- **1% of credit cards opened after January 2010 (360,000 accounts) paid debt service costs over five years exceeding the amount borrowed**. Those in arrears or with persistent levels of debt incurred the highest cost.
 - **8.9% of credit cards active in January 2015 (5.1 million accounts) will – on current repayment patterns and assuming no further borrowing – take more than 10 years to pay off their balance**. Again, those in arrears or with persistent levels of debt take the longest to repay.
- 7.17** We therefore consider that we have identified a mixture of:
- People struggling under a debt burden that is or has become problematic.
 - People paying more in debt service cost and taking longer to pay off debt than they need to. While these people may not regard their debt as problematic, it is more expensive than it needs to be and there is some risk that it becomes problematic in the future.
- 7.18** We recognise that some bad debt is a feature of all credit activity – borrowing is never risk-free, as ability to repay is affected by major negative life events (such as divorce, redundancy or long term illness). Both borrowers and lenders take a degree of risk entering into any kind of credit agreement, but particularly for open-end running-account credit such as credit cards.
- 7.19** However, there are known patterns of consumer behaviour ('behavioural biases') that will tend to lead to over-borrowing and under-repayment. These include optimism bias (consumers typically over-estimate their ability to repay), framing effects (consumers perceive costs expressed in % terms as being smaller than the same costs expressed in £), and the anchoring effect of minimum repayment amounts (consumers will tend to pay what their lender suggests).
- 7.20** As set out in Chapter 6, **firms tend to make losses on defaulting consumers, so have strong incentives to avoid lending that has this outcome** – firms' credit risk assessments are built around predicting the likelihood of default. Firms also have a range of forbearance procedures to help consumers clearly struggling to repay.
- 7.21** We find that consumers with high levels of credit utilisation or systematic minimum payment behaviour are profitable, suggesting that firms have little incentive to screen these consumers out or to intervene when they identify such behaviour.

8. Potential remedies

- 8.1** As a result of our interim findings, we are considering remedies in a number of areas in order to make the market work better.
- 8.2** In this chapter, we set out our early thinking on remedies to help make the market work better for consumers and address the problems we have found. We would like stakeholders' views at an early stage to help us develop these remedies. We welcome your views on the options we have identified and the most effective ways of addressing them.
- 8.3** Our initial thoughts on possible remedies focus on two main areas:
- Shopping around and switching
 - Affordability and problem debt

Key principles for considering remedies

- 8.4** We want to identify proportionate and effective measures which address these concerns without having a negative impact on a market that, overall, provides benefits for the majority of consumers.
- 8.5** When we propose remedies we will consider:
- how the remedy addresses the interim findings and resulting consumer detriment
 - the tools we can use, including our powers and our ability to make further rules, as well as constraints from relevant EU and domestic legislation
 - how effective and proportionate the remedy (or package of remedies) will be
 - how the different remedies interact and work as a package to make the market work better for those consumers for whom it is not working well
 - how the remedy (or package of remedies) fits in with the FCA's other policies and actions relevant to credit cards
- 8.6** At this point, we are presenting early thinking on remedies for discussion. Our final report will set out the final package of remedies with supporting analysis.
- 8.7** As set out in our market study guidance, we have a range of options which we could explore when developing the remedies. These include using rule-making powers and publishing guidance, supervision and enforcement action as well as proposals for enhanced industry self-

regulation. Any proposed rule-making remedies would require formal consultation and cost benefit analysis.

- 8.8** We have not yet assessed how effective and proportionate the potential remedies could be and we recognise that our approach may be constrained by EU and domestic legislation in some areas. We welcome stakeholder feedback on the most effective way to seek the outcomes identified.
- 8.9** We summarise below the aim of the potential remedies and how they can address the issues we have identified.

Our initial thinking on potential remedies

Shopping around and switching

- 8.10** The inherent flexibility of credit cards can make it complex for consumers to decide which card to choose. This is because their decision depends on how they will use the card, and consumers do not always use the card in the way they originally anticipated. Potential remedies in this section aim to help consumers who do shop around to cut through the complexity and make better decisions which more closely reflect their behaviour. We believe there is scope to boost the role of third party intermediaries to simplify the choice for consumers seeking the best deal. In particular, we consider that the market could be improved in the following ways:

- **Allow consumers to open access to their credit card usage data to other market participants:** We could consider how to build on the Government Midata initiative¹⁰⁰ for personal current accounts, and the development of Application Programming Interfaces (APIs¹⁰¹) which will make the process simpler. Consumers may make more informed comparisons if they consented to third parties, such as price comparison websites and other, credit card providers, having access to their transaction history data. We are interested in views on the potential cost and benefits of developing comparable solutions for the credit card sector.
- **Clearer standards for price comparison websites (PCWs):** We recently consulted on introducing additional standards for PCWs which compare high-cost short-term credit products to address practices which result in consumers making poor decisions and not choosing the cheapest loan for their needs.¹⁰² These measures cover commercial relationships, rankings, advertising, input functionality and market coverage. We will use the responses to this consultation when we consider if similar standards are needed to address the issues we have found in the credit card market and so enable consumers to make more informed choices.

- 8.11** We found promotional offers were common in this market, and were an important spur for switching. However, our findings suggest that some consumers would be helped by being reminded of the benefits of repaying their debt or shopping around at the end of their promotional period. We consider that the market could be improved by:

- **Providing timely information to remind consumers to repay their credit card debt or shop around before promotional offers expire:** There may be benefits in firms giving consumers proactive warnings through text alerts, mobile applications, and/or emails to remind them that their promotional offer is due to expire and the rates they will pay on

¹⁰⁰ Gov.uk/government/news/government-to-make-it-easier-to-check-that-you've-got-the-right-bank-deal.

¹⁰¹ APIs – Application Programming Interfaces – are rules that allow pieces of software to interact with each other and exchange data. They have become the de facto standard for sharing data, and have enabled organisations that hold large amounts of data to become platforms for third party innovation.

¹⁰² CP15/33

any outstanding balances when it does so. The industry's Lending Code already includes provisions which recognise the value that information about the end of promotional periods can bring to consumers. We see further benefit in exploring how effective these provisions are and how providing information in this area can be improved. This builds on our work on consumer banking behaviour¹⁰³ and smarter disclosure.¹⁰⁴

- **Promoting and facilitating the use of quotation searches:** We found that some consumers with higher credit risk are dissuaded from shopping around because they are worried about the impact of multiple application searches on their credit score. We are currently considering measures to promote and facilitate the use of quotation searches across all credit sectors¹⁰⁵ and the evidence from this market study will feed into this work.

8.12 Other concerns around conditional charges and other aspects of terms and conditions were firm-specific rather than market wide. We are pursuing these concerns with the firms in question.

Affordability and problem debt

8.13 We found evidence that some consumers borrow more than they intended when they originally intended, and repay less than they could, causing them to pay additional fees and interest. Our review of the academic evidence shows that behavioural biases play an important role and we will need to take these into account when identifying potential remedies.

8.14 There is scope for the market to work better for consumers struggling with credit card debt or paying more than they could in fees and interest. We are reviewing our rules on creditworthiness (including affordability) across consumer credit, and our findings in credit cards will feed into this.¹⁰⁶

8.15 Below, we outline possible steps that could (i) reduce over-borrowing and encourage earlier repayment, so reducing the amount of interest and charges that consumers pay because of the way they use their credit cards; and (ii) encourage earlier intervention by firms to identify and help consumers with potentially problematic debt.

8.16 In relation to under-repayment:

- **Disclosures to encourage faster repayment:** Firms could disclose in each monthly statement (i) how long it will take the consumer to repay the current balance and/or (ii) the saving in total cost from repaying more than the minimum and/or (iii) the repayment amount needed to pay off the balance within, say, one year. We are keen to hear from firms that have already trialled or are interested in trialling such an approach.
- **Provide a wider range of pre-set repayment options:** Firms could offer different pre-set payment options for regular automated payments, for example, reflecting target time to repay. This would help influence consumer choice on how much to repay (framing effects) and counteract the potential 'anchoring' effect of making the minimum repayment.¹⁰⁷ For online payment mechanisms, firms could remove the minimum amount from the range of pre-set payment options but with a default setting to ensure that at least the minimum is repaid.

¹⁰³ www.fca.org.uk/news/occasional-paper-no-10

¹⁰⁴ www.fca.org.uk/static/channel-page/dp-smarter-comms/dp-smarter-comms.html?utm_source=smarter-comms&utm_medium=smarter-comms&utm_campaign=smarter-comms#sc2

¹⁰⁵ www.fca.org.uk/your-fca/documents/consultation-papers/cp15-06

¹⁰⁶ www.fca.org.uk/static/channel-page/business-plan/business-plan-2015-16.html

¹⁰⁷ Please refer to the Literature Reviews published alongside this report.

8.17 Some stakeholders have suggested simply increasing the minimum repayment across the board, i.e. mandating that consumers pay a much higher amount than our rules currently require. This has the obvious disadvantage of reducing the repayment flexibility from which many consumers benefit. However, we would be interested to hear further views from stakeholders.

8.18 For over-borrowing, the following measures could make the market work better for consumers:

- **Providing timely information to remind consumers to consider how much they are borrowing:** We found some consumers spent more on their credit cards than they expected to when they took out their credit card. Some credit card firms already provide proactive warnings to consumers using through text alerts, mobile applications, and/or email to remind them how much credit they have used at certain trigger points, e.g. half their credit limit. We want to better understand how effective these warnings are, and explore the scope for encouraging this practice across the market.
- **Giving consumers more control during the lifetime of the credit card on variations, such as an opt-in for credit limit increases:** Firms must already let consumers opt out of proposed increases in the credit limit. There may also be benefits in requiring consumers to actively opt in to an increase and to permit 'over the limit' transactions. Consumers could also benefit from being able to choose the same payment due date each month, to align with the time they receive their regular income where this is not currently an option.

8.19 In relation to potentially problematic debt, we consider the following measure could make the market work better for consumers:

- **Earlier forbearance:** We think firms could identify and address potentially problematic debt (e.g. persistent debt or systematic minimum repayment) sooner, before consumers miss payments and accumulate interest and avoidable charges. Firms are already required to monitor for signs that consumers may be struggling to repay, but could do more to respond, for example by contacting the consumer to find out if they are in financial difficulties and, if so, whether to exercise forbearance. In particular we want to explore how to rebalance the incentives for firms in the credit card market to ensure that lower cost alternative credit is offered as a matter of course to those who appear to be building up problem debt after a standard period, for example 12 months.

We recognise the challenges firms face when dealing with consumers in financial difficulties. We also acknowledge that when firms identify consumers experiencing difficulty they may have to use a stepped approach which reflects consumers' responses and how their situation changes. This could include reminders or signposting to debt advice or potentially re-structuring the repayment arrangements. We invite views on (i) how consumers struggling with debt could be identified earlier and (ii) how interaction at that stage could best be managed.

8.20 There are more radical possible approaches to tackling problem debt. Consumer groups have suggested a cap on the costs of credit cards, similar to that in the high-cost-short-term credit ('payday') market, where we have capped the total cost at twice the amount borrowed. At this stage we do not intend to pursue this approach, which is hard to reconcile with the flexibility of credit cards. We want to retain the flexibility credit cards offer for those who need credit, while encouraging better borrowing/repayment habits. We consider that the package of remedies outlined above is the best way for us to strike this balance. But we would be interested to hear further views from stakeholders on this point.

9. Next steps

9.1 During the next phase of the study, we will:

- continue to engage with firms, trade bodies and consumer groups
- consider in more detail the different forms of remedy that could be adopted, having regard to responses to our interim report
- publish the final report, setting out our findings
- consult on any proposed remedies.

Further work planned

9.2 We will continue to develop our thinking on whether the FCA should intervene in this market, and what interventions would be most effective in improving competition to the benefit of consumers, having regard to the further evidence we collect and views from stakeholders including in response to this interim report.

Final report

9.3 We expect to publish the final report in Spring 2016. The final report will set out our findings and conclusions. If appropriate, we will consult at the same time, or subsequently, on any proposed remedies.

Stakeholder views

9.4 We would like to hear your views on this report, including on the need for intervention and, if so, your views on what form it should take. Please send us written comments by 8 January 2016.

9.5 If you would like to email feedback, please contact us at creditcardmarketstudy@fca.org.uk.

Glossary of terms used in this document

0% purchase offer	A promotional offer that allows consumers to spend on their card without incurring interest for a specific period of time.
0% balance transfer offer	A promotional offer that allows consumers to transfer an outstanding balance from one credit card to another and not incur interest on the transferred balance for a specific period of time, usually in return for a fee that is added to their balance.
Account balance	The amount of borrowing attributed to an account, at a point in time, which is owed to a credit card provider. It includes any fees, charges and interest incurred as well as the principal borrowed.
Account-level data	Account level data, unless otherwise specified, refers to the data we collected from eleven credit card issuers. Here we collected information on over 1 January 2010 to 31 January 2015, on consumer details at the point of origination, monthly account activity and product features.
Acquisition or distribution channel	The medium used by a credit card provider to get their customers. For example, customers may make applications online, such as price comparison websites, online marketing, internet search and credit card provider websites, or offline through direct mail, telephone, branches or face-to-face marketing.
Affinity or co-brand partners	Typically charities, membership groups or commercial businesses who are not directly involved in issuing credit cards or processing transactions but lend their brands and give access to their customers or members to card issuers in return for a share of revenues or profits.
Affordability	Borrower-focused elements of creditworthiness, and in particular the customer's ability to make repayments as they fall due (or in the case of open-end credit such as a credit card, within a reasonable period) without an adverse impact on their financial situation.
Annual or monthly fee	A flat fee charged to customers for holding a credit card account which are unrelated to their use of the product.
Application Programming Interfaces (APIs)	Rules that allow pieces of software to interact with each other and exchange data.
Arrears	A consumer is considered to be in arrears if they have failed to make the required minimum payment on their account in one or more statement cycles and have yet to rectify this.
Balance transfer	A balance transfer is when a customer transfers all or part of the balance outstanding on one credit card product to another credit card product. A fee is typically charged and added to the transferred balance.

Base curves	A collection of graphs depicting estimates of each aspect of the 'average' consumer's behaviour over the lifecycle of their card (for example, active balance, revolve rate, profit). These are typically based on a group, or cohort, of consumers who have all taken out the same credit card during the same month.
Cashback	A reward offered on some credit card products which provide consumers with a percentage of their card spend back as cash. This is typically credited to their statement either the following month or on an annual basis.
Charged-off	Charged-off refers to debt that issuers have deemed unlikely to be collected and that they have written off on their balance sheet. Consumers whose accounts have been charged-off have not been relieved of their repayment requirement, and charged-off accounts are often pursued via collection processes.
Consumer re-pricing	This refers to the changing of an interest rate on the account after it has been opened. This may be to reflect changes in the consumer's behaviour (risk-based re-pricing) or in the economic, regulatory or competitive environment (portfolio-based re-pricing) or to induce the consumer not to switch away from the product (retention-based re-pricing).
Credit builder products	Credit builder products are offered to higher risk consumers who are looking to build or improve their credit history.
Credit limit	The maximum amount of credit that can be drawn down by the customer.
Credit limit increase	Where a credit card firm raises the credit limit associated with a credit card account.
Credit reference agencies	Collects information about consumers' financial standing to inform the decisions of consumer credit firms.
Credit limit utilisation rate	The amount which a consumer borrows on account as a percentage of the maximum amount of credit the card provider has agreed to lend (i.e. the credit limit).
Credit risk	The likelihood of a consumer defaulting on their credit card account.
Creditworthiness	The assessment required by CONC 5.2 (before entry into a credit agreement) and CONC 6.2 (before any significant increase in the amount of credit).
Cross-subsidisation	For the purposes of the credit card market study we define cross subsidisation as the sale of one set of goods or services at a loss enabling or increasing the sale of another good or service, or where profits from one group of consumers are used to cover the losses from another.
Default	When the customer is past the contractual due date by more than 90 days and the lender reasonably considers that they are unlikely to pay.
Default fees	Typically fees charged for late payment, over limit or default.
Differential pricing	Where some firms offer consumers applying for the same card different prices or promotional terms based on their risk profile.
Dormant	An account with no balance and no transactions or fees over a period (typically the last three months).

Framing effects	As people have limited attention, framing can determine what and how information is processed. Even when the economic benefits of particular choices are identical in two situations, consumers may make different choices depending on how the decision problem is framed.
Interchange fee	These fees are paid from the merchant acquirer (the merchant's bank) to the card issuer (the cardholder's bank), as a percentage of each transaction made by the card-holder and form part of the package of fees that merchant acquirers charge to merchants.
Interest grace-period	The interval between the date of a purchase and the payment due date. No interest is charged during this interval if the customer pays the entire balance in full by the payment due date and is not carrying a balance from a previous period.
Low-rate products	A credit card product that offers consumers an on-going lower interest rate, typically without any promotional offers on either balance transfers or purchases.
Market questionnaire	This refers to an industry questionnaire which 24 firms responded providing us with extensive information about the supply-side of the market, including their business models and product details.
MiData	A government initiative under which customers are able to upload their usage data for analysis and get an instant answer to whether or not they would be able to save money by moving to a different account.
Minimum payment	The minimum amount a consumer is required to repay on their account for a statement cycle.
Monolines	Firms which only provide credit cards.
Net interest income	The revenue earned by credit card firms from interest paid by card holders on their accounts balance, less the cost of funding borrowing by consumers. The term can also refer to the difference between interest earned and interest paid on borrowing by consumers.
Open-end running accounts	Accounts which enable the consumer to draw down money from time to time, up to a credit limit, with subsequent repayments refreshing the amount available, and with no fixed or maximum duration.
Over-optimism bias	Refers to an overly positive general outlook towards future matters for individual economic decision-making that a person has, particularly for credit card use in this context.
Present bias	Refers to the situation where decision-maker's preferences change over time, in such a way that they place significantly more emphasis on the present than in the future.
Purchase products	Purchase products typically have an introductory 0% interest offer on new purchases for a defined period of time.
Quotation searches	Where borrowers are able, before submitting a full application and when shopping around, to get an indication of the price and terms which they will be offered (but not necessarily an indication of eligibility) without a footprint being left on their credit files which could impair their credit rating.
Repayment term	The time taken for a consumer to fully repay a credit card balance.
Revolve rate	The proportion of outstanding balance that attracts interest income.

Revolvers	Consumers who maintain an outstanding balance from one period to the next, often paying less than the full repayment amount on their credit card. As a result they are charged interest on the borrowing.
Rewards products	Reward products offer consumers benefits, discounts or other rewards based on their credit card usage.
Scorecard	A scorecard is a set of weights that are attached to the pieces of information held on each consumer and form part of the calculation of the consumer's credit score. Higher weights are associated with information that is a stronger predictor of default.
Standard products	Standard products are those that tend not to have long promotional offers on either balance transfers or purchases. Their main feature is the annual interest rate charged.
Statement cycle	The period in respect of which a monthly or other periodic statement is provided.
Total cost of credit	The total cost paid by a consumer, including fees, interest and charges accruing to an account, over a specified period of time.
Transactors	Consumers who use credit cards mainly as a payment mechanism usually paying off their balance in full at the end of the month thus incurring little or no interest on balances.

Annex 1

Feedback on Terms of Reference

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-1

Annex 2

How credit card products are regulated

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-2

Annex 3

Results from the consumer survey

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-3

Annex 3

Appendix 1 to consumer survey – Note on questionnaire design

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-3-1

Annex 3

Appendix 2 to consumer survey – Technical Report

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-3-2

Annex 4

Switching Analysis

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-4

Annex 5

Firm business model analysis

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-5

Annex 6

Affordability analysis

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-6

Annex 7

A Review of Price Comparison Websites (PCWs)

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-7

Annex 8

Understanding credit card contracts, the consumer journey

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-8

Annex 9

A review of a sample of financial promotions

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-9

Annex 10

Account-level data

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-10

Annex 11

International comparisons

www.fca.org.uk/your-fca/documents/market-studies/ms14-6-2-ccms-interim-report-annex-11

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