SUPER-COMPLAINT

INTEREST CALCULATION METHODS

Executive Summary:

At present, the easiest way for consumers to compare credit cards is to use the Annual Percentage Rate (APR) advertised by credit card issuers. As the Office of Fair Trading (OFT) found, "APR is certainly the key item [consumers] look at when making comparisons. Even though they may not fully understand what this means, they know to look for a low figure".[1] As our survey found, 51% of consumers believe that comparing APR that credit cards charge is the best way of telling which card is cheapest.[2]

However, the advertised APR does not reflect the way in which interest charges are actually applied. The existence of different interest calculation methods means that when two consumers use two different credit cards with the same APR in exactly the same way, they can end up paying very different levels of interest. For instance, the HSBC MasterCard and Sainsbury's Bank MasterCard both charge an APR of 15.9%, however consumers who use the two cards in the same way may end up paying up to £25 more a year with the Sainsbury's Bank MasterCard than the HSBC MasterCard.[3]

We note that 81% of consumers are unaware that differences between interest calculation methods even exist.[4] We conclude that while a large proportion of consumers believe that they can make a meaningful comparison on the basis of APR, in practice they cannot.

[1] Credit Card Survey, OFT, March 2004, para 1.11.
[2] A Which? March 2007 online omnibus survey of 958 adults aged 18+ found that 51% of credit cardholders agree (strongly or slightly) that comparing APRs that credit card charge is the best way of telling which card is cheapest. Only 27% of credit cardholders disagree. 16% percent were undecided and 6% did not know.
[3] This estimate has been based on our Part & Full Payer scenario which assumes that consumers repay £180 off their first two bills and then repay the next two bills in full. Consumers spend £500 on the 15th of each month and make repayments on the 10th of the following month. This pattern is repeated over the year. This scenario is underpinned by Which? November 2006 telephone omnibus survey of 1,908 adults aged 18+.
[4] *Good rate hunting*, Egg, February 2004, p 8.

We are currently aware of 12 different interest calculation methods used by the top 20 credit card issuers[5]. These methods are difficult to appreciate without lengthy and complicated financial analysis and they are therefore likely to be impenetrable for consumers. We have identified six features other than APR that determine the cost of credit:

1) **Interest free periods**[6], i.e. whether an interest free period is offered or not, and if so, whether it is conditional on the balance from the previous month being paid off in full.
2) **End of interest charge**, i.e. whether interest is charged until the date of repayment in full or until the statement date before the cardholder repays the balance in full.
3) **Interest calculation**, i.e. whether interest is calculated by multiplying the average daily balance in the month by the monthly rate or as a sum of the daily balances in the month multiplied by the daily rate.
4) **Start of interest charge**, i.e. whether interest starts being charged from the date a purchase is made or the date it is posted to the account.
5) **Statement day**, i.e. whether interest is charged until the day before a statement is produced, or until the day on which the statement is produced.
6) **Interest on interest**, i.e. whether the interest bearing balance in the current statement period includes interest charged on the previous month's statement.

We are convinced that the existence of a variety of these methods prevents consumers from making an informed choice on the basis of price. We estimated that these methods cause a consumer detriment of £0.4bn a year.[7]

We conclude that interest calculation methods need to be standardized. We have a clear view as to how the first three features of interest calculation methods should be standardised while keeping our mind open on the other three.

[5] Top 20 providers correspond to approximately 90% of the market.
[6] Not to be confused with 0% introductory deals.
[7] We estimated consumer detriment on the basis of different user scenarios established by our market research. Our analysis benchmarked issuers' interest calculation methods against the cheapest method offered by one of the top 20 credit card issuers.

We believe that all credit cards should have an unconditional interest free period on new purchases. We also believe that daily interest calculation is more transparent and easier to understand. Finally, we are convinced that consumers should be allowed to clear their balance following the receipt of their statement without incurring any additional interest between the statement date and the date of repayment.

We keep our mind open as to when issuers start to charge interest, whether they charge interest up until the statement date and whether they charge interest on interest. While we have a preferred option for each of these features - we prefer interest to be charged from the date purchase is posted to the cardholder's account until the day before the statement date with no interest charged on interest - we are not prescriptive as to which method is chosen. However, we urge the OFT to take a pro-active approach when discussing standardisation to prevent a "race to the bottom".

PART 1: The Problem

1.1. Interest Calculation Methods

(1) The role of APR in the credit card market is to indicate the level of charges consumers will pay when using their credit card as a means of borrowing. However, in practice the charge consumers pay depends not only on the advertised APR, but also on the interest calculation method that an issuer uses to establish the interest charged. The top 20 market providers currently use 12 different methods to calculate interest on credit cards used for purchases leading to widely differing interest charges for consumers.

(2) For instance, the HSBC MasterCard and Sainsbury's Bank MasterCard both charge an APR of 15.9%, however consumers who use the two cards in the same way may end up paying up to £25 more a year with the Sainsbury's Bank MasterCard than with the HSBC MasterCard.[8]

(3) We conclude that these methods distort the outcomes of consumers' search behaviour and prevent them from comparing credit cards effectively on the basis of APR.

1.1.1. Establishing a method

(4) Interest calculation methods are very difficult to establish. In theory, it should be possible to establish issuers' methods on the basis of their Summary Boxes and Terms and Conditions. Summary Boxes in general provide "headline" information about the credit card, while Terms and Conditions are meant to supplement them with detailed information.

(5) However, Summary Boxes and Terms and Conditions on their own hardly ever provide sufficient information to ascertain beyond doubt the issuers' interest calculation method. We also note that the quality of Terms and Conditions supplied by issuers was

[8] This estimate has been based on our Part & Full Payer scenario which assumes that consumers repay £180 off their first two bills and then repay the next two bills in full. Consumers spend £500 on the 15th of each month and make repayments on the 10th of the following month. This pattern is repeated over the year. This scenario is underpinned by Which? November 2006 telephone omnibus survey of 1,908 adults aged 18+.

far from ideal. We found the language complicated, information incomplete and display not prominent.[9] Consumers in general have to show resilience and determination to find them and possess financial skills to understand them.

(6) We therefore devised a questionnaire with clear questions and illustrative examples which we then sent to issuers (questionnaire attached in Annex 1).[10] We sent the questionnaires to the issuers in July 2006. Issuers had two weeks to respond. Responses from the questionnaire were in general very useful, although in some cases we needed to follow questions further with the issuers or analyze their Terms and Conditions. However, not all issuers agreed to collaborate. We therefore had to establish their method solely on the basis of their Terms and Conditions, and our previous survey results.

1.1.2. Features of the methods

(7) There are several factors other then APR that will influence the level of credit card charges consumers are subject to. These factors are as follows:

i. **Interest free periods**, i.e. whether an interest free period is offered or not, and if so, whether it is conditional on the balance from the previous month being paid off in full.
ii. **End of interest charge**, i.e. whether interest is charged until the date of repayment in full or until the statement date before the cardholder repays the balance in full.
iii. **Interest calculation**, i.e. whether interest is calculated by multiplying the average daily balance in the month by the monthly rate or as a sum of the daily balances in the month multiplied by the daily rate.
iv. **Start of interest charge**, i.e. whether interest starts being charged from the date a purchase is made or the date it is posted to the account.
v. **Statement day**, i.e. whether interest is charged until the day before a statement is produced, or until the day on which the statement is produced.
vi. **Interest on interest**, i.e. whether the interest bearing balance in the current statement period includes interest charged on the previous month's statement.

[9] When searching issuers' websites, in many cases, we needed to fill in a credit card application form before we could access issuers' Terms and Conditions. In some other cases, we were unable to locate the Terms and Conditions at all.

(8) We analyzed the impact of the above factors on consumers' credit card interest charges. We used typical usage scenarios developed on the basis of our market research to simulate the impact of each method on interest charges. We established that there were 13 methods which top 20 issuers used to apply interest to purchases. However, since we carried out our analysis in late 2006, one card – Halifax Flat Rate Online - was withdrawn from the market. To our knowledge, the top 20 issuers currently use 12 methods. In addition to the 12 methods used by the top 20 issuers, there are other methods used by issuers in the market fringe that we are aware of. (For information on methods see Annex 2.)

(9) Interest free periods proved to be one of the main factors affecting the final interest charge followed by the end of interest charge and interest calculation. The exact impact of all six features depended on the repayment behaviour of consumers with some groups being more affected than others.

(10) We established that out of the 13 methods used by the top 20 providers, the method used by HSBC was the cheapest for consumers. Conversely, Halifax Flat Rate Online was the most expensive method. Table 1 below shows the ranking of the methods from the least detrimental to the most detrimental.

Table 1: Interest Calculation methods and their ranking

Top 20 card issuers	Method number
HSBC	1
Lloyds TSB	2
Egg	3
Nationwide	4
Barclaycard	5
Tesco	6
Co-op, Goldfish	7
Marks & Spencer	8
Lloyds TSB (Advance)	9
American Express, Capital One, NatWest, Royal Bank of Scotland	10
Abbey, Alliance & Leicester, MBNA	11
Bank of Scotland, Halifax, Sainsbury's Bank	12
*Halifax Online**	*13*

Source: Which? issuer survey, issuers' Terms & Conditions and Summary Boxes
** Halifax Online credit card is not currently available*

[10] The Which? magazine has used similar questionnaire in the past to produce their Best Buys tables.

1.2. Consumer Detriment

1.2.1. Approach

(11) We based our consumer detriment analysis on our key finding that issuers' advertised APR does not accurately reflect the costs of credit to consumers because of the presence of different interest calculation methods. Our consumer detriment analysis benchmarks the 13 methods we found among the top 20 credit card issuers in late 2006[11] against the best method used by one them.

(12) We reasoned that the method that currently leads to the lowest cost of credit, advertises its APR in the most favourable way to consumers. We concluded that every other method is more expensive and therefore underestimates the advertised APR as opposed to the market best practice. In practice, an issuer can lower its APR while keeping the cost of credit to consumers unchanged just by rendering its calculation method more expensive. Such manipulations are hidden to consumers and prevent them from making informed purchasing decision.

(13) The cost of credit will not only depend on the advertised monthly rate[12] and the calculation method, but also on consumers' spending and repayment behaviour. We carried out market research to ascertain the impact of this behaviour and established typical consumer behaviour scenarios. Our consumer detriment analysis calculates the cost of credit in these scenarios.

(14) It is noteworthy that we chose the cheapest method used by one of the top 20 issuers, the HSBC method, as a benchmark for the detriment analysis. We did not opt for the cheapest conceivable method as this would render our calculation hypothetical and would require making a value judgement about which method is best for the market. However, we could have chosen the cheapest available method in the market as a whole, the Northern Bank method. Given that this method is substantially cheaper than the HSBC method, the overall detriment would have been significantly higher. The lack

[11] According to GFK NOP market share data, the top 20 credit card issuers correspond to approximately 90% of the market (see Annex 3g).

of detailed market share data on the market fringe prevented us from carrying out such analysis.

1.2.2. Calculation

(15) Our November 2006 market research[13] uncovered three types of behaviour: 1) consumers who always pay their balance off in full ("Full Payers"), 2) consumers who sometimes pay their balance off in full and sometimes in part ("Part & Full Payers"), and 3) consumers who never pay their balance off in full (Never Payers).

(16) We realized that Full Payers will always try to repay their balance off in full and therefore will not be likely to be subject to most of the features of the interest calculation methods. The only feature that they fall victim of is the interest free period. If their credit card does not have an interest free period, they will not be able to discharge their balance without incurring any interest. Part & Full Payers and Never Payers, on the other hand will be subject to all features of the methods.

(17) We therefore had to devise two separate detriment analyses, one for Full Payers and another for Part & Full and Never Payers. In both cases, we used spending scenarios with data based either on our own research or the British Bankers Association's (BBA) figures.

(18) Once we established the three scenarios, we estimated the revenues each of the top 20 issuers generates in each scenario using information about consumers' purchases, repayments and outstanding balances from our November 2006 market research and information about issuers' monthly rates collected on 13 November 2006 from MoneyFacts. We then established which of the top 20 credit card issuers used the cheapest method of calculating interest. Finally, we calculated the increases in the monthly rates that would need to occur should all top 20 issuers use the cheapest method while keeping their revenue unchanged.

[12] Our analysis of the impact of consumers' spending and repayment behaviour on the cost of credit uses monthly rates rather than APR because consumer behaviour needs to be analysed in monthly cycles. This is possible since APR is an annualized expression of the monthly rate used to simplify consumer comparisons.

(19) Given the differences in consumer spending, outstanding balances and levels of repayments in the three scenarios, it was crucial to find an appropriate basis on which to apply the calculated increases in monthly rates. We also needed give the scenarios appropriate weighting in order to represent the scale of the detriment correctly.

(20) In the case of the Part & Full Payers and Never Payers, we decided to use the outstanding credit card debt as a basis, as only consumers under these two scenarios accumulate an outstanding balance. We used the volume-based proportions of Part & Full Payers and Never Payers as established by our November 2006 market research to assign an appropriate weight to each scenario.

(21) In the case of Full Payers, we decided to use the value of purchases as a basis for the consumer detriment analysis. This is because consumers under this scenario do not accumulate any outstanding balance and can therefore only incur any interest charge on the value of their monthly purchases. We used the volume-based proportion of Full Payers among all cardholders as established by our November 2006 as a weight to this scenario.

1.2.3. Full Payer Detriment

(22) The Full Payer Detriment analysis takes as its basis the fact that consumers in this scenario use their credit cards for purchases which they repay at the end of each statement period. These consumers do not intend to use credit cards to borrow money for more than a month and they normally do not incur any interest charges unless they have a card with no interest free period. Only Full Payers with credit cards with no interest free period will incur detriment.

(23) There is currently only one card on the market with no interest free periods, Lloyds TSB Advance. Until recently, there was another card with similar features, Halifax Flat Rate Online. Since our detriment analysis was based on market data from November 2006, we kept Halifax Flat Rate Online in our analysis. Our detriment analysis therefore calculates the amount of interest Full Payers incur each month as a result of using these two cards.

[13] Which? carried out a telephone omnibus survey of 1,908 adults aged 18+ in November 2006. 1,046 of these (weighted to a representative total of 1,027) had at least one credit card and were asked more detailed questions about their credit card usage.

(24) We took as a basis for our analysis the average value of monthly purchases over the last year ($\overline{P}$). We reduced this basis to reflect the value of these purchases repaid in full each month (s_f). We then multiplied this basis by the share of the Full Payer detriment attributable to each of the two issuers (I_i).

(25) The issuers' share was calculated as a multiple of their market share, their daily interest rate and the number of days during which consumers incurred interest. The final detriment figure is a sum of the detriment caused by each issuer over a year (i.e. 12 months). It is noteworthy that our final detriment is a simple multiplication of the monthly interest charge and is not compounded. This is because Full Payers clear their balance in full every month and do not accumulate any balance.

(26) The detriment analysis can be written as follows:

$D_F = 12\overline{P}s_f \sum_i I_i$, where $I_i = m_i b_i t_i$ and therefore $D_F = 12\overline{P}s_f \sum_i m_i b_i t_i$

where:

i. **Full Payer consumer detriment (D_F)**, i.e. the consumer detriment under the Full Payer user scenario.

ii. **Average monthly Purchases ($\overline{P}$),** i.e. the average monthly value of purchases calculated over the last year (as derived from BBA statistics from December 2005 to November 2006).

iii. **Share of purchases repaid in full (s_f),** i.e. the share of the value of purchases that is paid off in full every month (as derived by our market research in November 2006).

iv. **Issuers (i),** i.e. credit card issuers (in our case Lloyds TSB Advance and Halifax Flat Rate Online).

v. **Issuer detriment share (I_i)**, i.e. the share of the detriment caused by each credit card issuer.

vi. **Issuer's market share (m_i)**, i.e. issuers' volume-based market shares (as found in the GFK report, December 2006).

vii. **Issuer's daily rate (b_i),** i.e. the part of the outstanding credit card debt that attracts interest (as calculated on the basis of issuer's monthly rates as found in November 2006 MoneyFacts).

viii. **Interest attracting days (t_i)**, i.e. the number of days during which consumer's purchases will attract interest (as established by our interest calculation methods' analysis).

1.2.4. Part & Full Payer and Never Payer Detriment

(27) The Part & Full Payer scenario and Never Payer scenarios allow for all features of interest calculation methods to take their full effect. The calculation of the detriment was therefore more complex than in the Full Payer scenario.

(28) Our detriment analysis proceeded in five steps.

i. We established how consumers use their credit cards and constructed typical usage scenarios.
ii. We calculated the revenue that each provider generates from its credit cards in each scenario given its advertised monthly rate and its calculation method.
iii. We calculated by how much would each advertised monthly rate need to increase if the issuer adopted the cheapest available method on the market while maintaining the same revenue as it currently generates.
iv. We applied the estimated increase in monthly rate on an appropriate basis to establish the scale of detriment. The basis was weighted to reflect each scenario.

v. We calculated the overall consumer detriment figure as a sum of the detriment created by each issuer under both scenarios.

(29) Given that consumers under these two scenarios do not always repay their balance in full, we used the UK outstanding credit card debt as basis for our detriment analysis. We reasoned that since these consumers use their credit cards as a means of borrowing for a period longer than a month, their unpaid balance will be reflected in the UK outstanding credit card debt.

(30) We apportioned the adjusted UK outstanding debt between the two scenarios. We used the value of outstanding balances from our market research to reflect that the Never Payer scenario is likely to constitute a higher proportion of the final detriment given that on average consumers in this scenario kept a larger outstanding balance than Part & Full Payers.

(31) As a result of these adjustments we obtained a part of the UK outstanding debt that could be used as a basis for our analysis. We multiplied this basis by the share of the detriment caused by each credit card issuer under each scenario.

(32) The issuers' scenario specific share was calculated as a multiple of their market share, the compounded increase in their monthly rate that would be necessary if the issuers were to maintain the same level of revenue while using the cheapest available method on the market. As the two scenarios had a different impact on the revenue, the monthly rate increases needed to be scenario specific.

(33) Consumer detriment is calculated according to the following formula:

$$D = Ocpd \sum_{j} \sum_{i} s_j m_i [(1 + \frac{\overline{r_{ij}} - r_i}{100})^{12} - 1]$$

The above equation was arrived at in the following way:

$D = \sum_j D_j$: The total consumer detriment is a sum of the detriments arising from each scenario (D_j).

$D_j = O_j \sum_i I_{ij}$: The detriment arising from a scenario was calculated as a multiple of the part of the outstanding debt that can be apportioned to that scenario (O_j) and the sum of the share of the detriment caused by each credit card issuer under each scenario (I_{ij}).

$O_j = Ocpds_j$: The part of the outstanding debt that can be apportioned to a scenario (O_j) was based on the general outstanding debt figure (O) diminished by the proportion of the outstanding debt that represents credit cards (c), further decreased by the proportion of the outstanding debt that represents purchases (p), reduced by the proportion of the outstanding debt that is bearing interest (d) and finally adjusted by the share of the outstanding debt assigned to of each scenarios (s_j).

$I_{ij} = m_i[(1+\frac{\overline{r_{ij}} - r_i}{100})^{12} - 1]$: The share of detriment caused by each provider in the market under a given scenario was calculated as a multiple of an issuer's volume-based market share (m_i) and the difference between its adjusted monthly rate in the given scenario ($\overline{r_{ij}}$) and its current monthly rate (r_i). This formula is based on the OFT standard APR calculation formula.

Finally, the core of our analysis – adjusted monthly rates in the given scenario ($\overline{r_{ij}}$) – were calculated by assuming that if the issuers were to maintain the same revenue as they generate at the moment while adopting the cheapest method on the market, they would need to increase their monthly rates (details on who we obtained these rates can be found in Annex 3).

The equations $D_j = O_j \sum_i I_{ij}$ can be rewritten as $D_j = Ocpds_j \sum_i m_i[(1+\frac{\overline{r_{ij}} - r_i}{100})^{12} - 1]$.

Subsequently, $D = \sum_j D_j$ can be rewritten as $D = \sum_j \{Ocpds_j \sum_i m_i [(1 + \frac{\overline{r_{ij}} - r_i}{100})^{12} - 1]\}$ or

$D = Ocpd \sum_j \sum_i s_j m_i [(1 + \frac{\overline{r_{ij}} - r_i}{100})^{12} - 1]$, where:

i. **Consumer detriment (D)**, i.e. the consumer detriment resulting from the use of different interest calculation methods under both scenarios.

ii. **Scenarios (j)**, i.e. the Part & Full Payer and Never Payer scenarios (as established by our market research, November 2006).

iii. **Issuers (i)**, i.e. credit card issuers (as found in the GFK report, December 2006).

iv. **Issuer's market share (m_i)**, i.e. issuers' volume-based market shares (as found in the GFK report, December 2006).

v. **Issuer's monthly rate (r_i)**, i.e. issuers' monthly rates (as derived from MoneyFacts' data on 13 November 2006).

vi. **Issuer's adjusted scenario-based monthly rate ($\overline{r_{ij}}$)**, i.e. issuers' monthly rates adjusted to reflect the use of the cheapest interest calculation method used by one of the top 20 credit card issuers while assuming that the issuers' revenue remains the same.

vii. **Issuer detriment share (I_{ij})**, i.e. the share of the detriment caused by each credit card issuer under each scenario.

viii. **Outstanding debt (O)**, i.e. outstanding credit card debt (as stated by BBA in September 2006).

ix. **Adjusted outstanding debt (O_j)**, i.e. the share of outstanding credit card debt attributable to each scenario.

x. **Credit card share (c),** i.e. the part of the outstanding credit card debt that corresponds to credit cards (as derived from the Competition Commission's Store Card Market Inquiry).

xi. **Outstanding Purchases (p),** i.e. the part of the outstanding credit card debt that is caused by purchases (as stated by BBA in November 2006).

xii. **Debt attracting interest (d),** i.e. the part of the outstanding credit card debt that attracts interest (as stated by BBA in November 2006).

xiii. **Detriment scenario share (s_j),** i.e. the proportion of the detriment that can be attributed to each scenario (as derived from our market research, November 2006).

1.2.5. Detriment calculated

(34) Using data from our market research, BBA statistics, Competition Commission Reports, MoneyFacts and GFK, we obtained an overall detriment of £414,624,831 (See table 3).

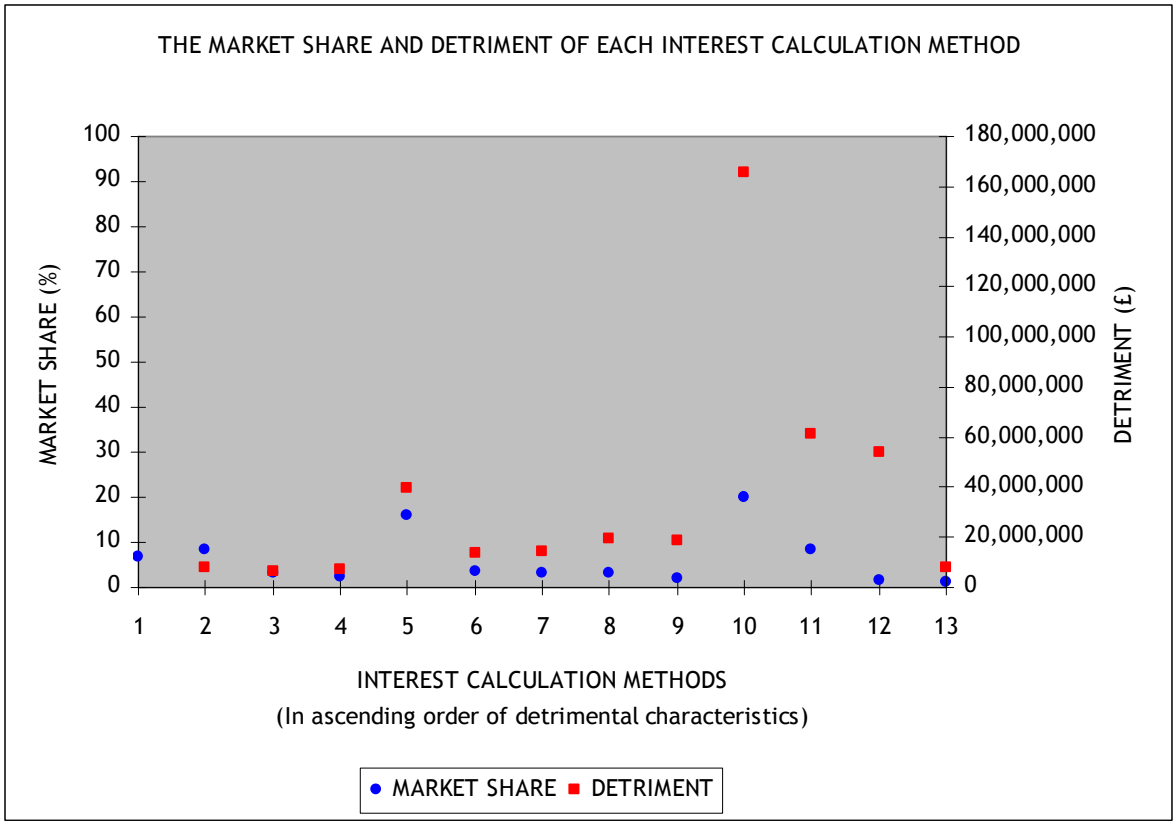
Table 3 Detriment Calculated

Scenarios	Consumer Detriment (£)
Full Payer	11,496,128
Part & Full Payer	344,715,434
Never Payer	58,413,269
Overall	**414,624,831**

Source: Which? calculations

(35) We were also interested to see how important the detriment generated by the top 20 issuers was in relation to their market share. It seems that the largest part of detriment is being generated by issuers using method 10 (American Express, Capital One, NatWest, Royal Bank of Scotland) who together account for approximately 20% of the market. Similarly, issuers using method 12 (Bank of Scotland, Halifax, Sainsbury's Bank) also generate a significant part of the detriment although their market share is negligible. Unsurprisingly, the more detrimental a method is, the more detriment it tends to generate as opposed to its market share.

Graph 1: Markets share, detriment and interest calculation methods



Source: Which? calculations, GFK NOP data[14]
Key: For names of companies belonging to each method see Table 1

1.2.6. Assumptions and caveats

(36) We had to make a number of assumptions in order to complete our analysis. However, we made a conscious effort to make logical assumptions and conservative estimates to ensure that our analysis remains valid. We can therefore be confident in our analysis. The technical annex (Annex 3) describes in detail the type of decisions we had to make with suggestions on how the OFT could improve our analysis in particular should it have access to more detailed data.

(37) It is noteworthy that our analysis of consumer detriment provides a static ball park estimate. Indeed, since we carried out the thrust of our analysis, one method has disappeared from the market and we are aware of issuers who will change their method

[14] Since GFK NOP requested that their December 2006 volume based data be kept confidential and since we intend to make the main supercomplaint document available to public, we could not label market share data in the graph. The graph therefore only provides an indication of the proportions.

in the future. We do not believe that this in any way invalidates our analysis. On the contrary, we believe that these constant and unpredictable changes make it impossible for consumers to make an informed judgement when choosing their credit card.

PART 2: Which?'s Campaigning Genesis

(38) Over the past eleven years, Which? has repeatedly tried to raise consumer awareness of the existence of different interest calculation methods. During this time, we also brought this issue to the attention of the relevant policy makers and the industry. We consistently lobbied for standardisation of the interest calculation method. We have engaged on this issue in variety of platforms:

i. Which? Magazine
ii. Treasury Select Committee
iii. Banking Code Review
iv. Consumer Credit Act Review
v. APACS

2.1. Which? Magazine

1995 – to date

(39) We first uncovered the existence of various interest calculation methods for credit card interest charges in 1995. We first reported on it to consumers in Which? Magazine in 1996. The Magazine covered the issue almost every year since 1996. (For a selection of Which? reports, see Annex 4.)

2.2. Treasury Select Committee

July 2002

(40) In July 2002 the Treasury Select Committee published a report entitled "Banking and the Consumer" in which it expressed dissatisfaction amongst other areas with the lack of transparency in the credit card market. As a result, the Committee decided to dedicate a full inquiry to the transparency of credit card charges. Which? (under the name of Consumers' Association) provided the Committee with a wealth of research into the different aspects of the credit card market, focusing on issues such as complexity of credit agreements, variety and complexity of charging methods, and opaque Terms and Conditions. (For copies of Which?'s written submissions, see Annex 5.)

December 2003

(41) In December 2003, the Treasury Select Committee published a report into credit cards entitled "Transparency of Credit Card Charges". Following our and other expert evidence, one of the Committee's recommendations focused on how credit card issuers calculate interest. The Committee concluded that the existing situation was unsatisfactory and that onus will be on industry to prove that standardisation would not be beneficial.

First Treasury Select Committee report: Transparency of Credit Card Charges, 10th December 2003, Conclusions and recommendations, p 56 & p 58:

Recommendation 6:

Whilst the UK credit card industry considers itself competitive, we feel that while consumers cannot properly compare products the level of competition is inadequate. We want to make it more competitive, by giving consumers clear information to choose between cards. The industry and regulatory frameworks need to provide consumers with clear and understandable information. This is clearly not happening currently…. The true cost of cards to the consumer is concealed behind complex interest calculation methods not taken account of in the APR…. While some of these failings reflect a regulatory framework that is comprehensively out of date, there have been no significant initiatives from much of the industry aimed at improving matters. Our inquiry has been a wake-up call to the industry—as some in the industry have already conceded—and we hope that providing customers with clear and transparent information about what are necessarily complex products will now become a priority."

Recommendation 18:

[…] We welcome the DTI's intention to discuss with the industry ways in which interest calculation methods can be standardised and made more transparent without inhibiting competition. The DTI aims to conclude discussions by February 2004 and will be looking for prompt action after that date has passed. The onus will be on the industry to prove that a measure of standardisation will not be beneficial.

March 2004 – June 2004

(42) In its response to the First Treasury Select Committee report, in March 2004, the Government expressed concern that consumers did not know how interest was applied to their credit cards but suggested that any enforced standardisation would stifle competition and product innovation.

Government Response to the First Report of the Treasury Committee: Transparency of Credit Card Charges, 9th March 2004, p 7:

Government response to Recommendation 18:

2.10 The Government is concerned about consumers not knowing how interest is applied to their credit card account when this can have a great impact on the amount of interest that they pay. However, we also have concerns that any enforced standardisation of applying interest would stifle competition and product innovation. We are discussing how far the improved transparency for consumers – brought about by the APACS Summary Box and the Government's Form and Content proposals – deals with this interest application issue. Consideration is being given to setting down in regulations a requirement that the information which currently appears in Summary Boxes concerning how each lender calculates its interest charge must be clearly explained in the pre-contract information and also in agreements.

(43) In June 2004, the Government produced a supplementary response to the First Treasury Select Committee report. In this response, the Government further reiterated its position against standardisation. According to the Government, standardisation would have a negative impact on innovation, flexibility, competitiveness and consumer choice.

Supplementary Government Response to the First Report of the Treasury Committee: Transparency of Credit Card Charges, 23rd June 2004, pp 3-4:

2.8 Following our discussions in this area, we have concluded that consumers would benefit from clear information about how the interest charges on credit card accounts are calculated. The Consumer Credit (Disclosure of Information) Regulations 2004 and the Consumer Credit (Agreements)(Amendment) Regulations 2004 therefore require both the pre-contract information and credit agreements to include, in a similar way to the new credit card Summary Box initiative, an explanation of how and when interest charges are calculated and applied under the contract.

2.9 It is hoped that this new information about an important feature of credit cards will and (sic: aid) consumers to select the product that best suits their needs. These details will no longer be

hidden in the small print.

2.10 We have concluded, however, that imposing standardisation in the way that interest is calculated and applied would not result in overall benefits for consumers. One consequence of an absence of standardisation is that consumers are free to choose a product that complements the way that they organise their finances. For example, some will want a lower APR, but will be prepared to pay interest from the date of a purchase; some will prefer a slightly higher APR, but will only want to pay interest on the amount left outstanding if they do not settle the whole balance. As long as these aspects of the product are clearly highlighted, we think this can assist consumers.

2.11 We are also aware that there have been calls for a CAT type standard covering, for example, when interest accrues and what percentage of the original amount it is charged on. We note that this would be a complex exercise and that it could have unintended consequences with issuers migrating to that standard at the expense of flexibility, innovation and, ultimately, competitiveness and consumer choice.

2.12 We have therefore concluded that a CAT type standard might not be necessary, so long as the improved transparency objectives of our new legislation are fulfilled. However, if we find that the changes have not proved effective, then we will consider this option further. In the meantime, APACS have told us that steps are underway to improve the Summary Box initiative to address the interest methodology issue in September 2004.

Oct 2004 – Feb 2005

(44) The Committee revisited interest calculation methods again in October 2004. It published its second report in February 2005. The report noted that even industry leaders conceded that the variety of interest calculation methods in use could be unfair for the consumers. The report also suggested that the Committee did not believe that standardisation would be detrimental to competition in the credit card market.

Second Treasury Select Committee report: Credit card charges and marketing, 25th January 2005, Conclusions and recommendations, pp 36-37:

Recommendation 10:

We note that even many industry leaders largely conceded that the variety of interest calculation methods presently in use can be unfair for the consumer. The consumer may often be unaware that the differences exist and unable to understand the effects the differences can have. As one issuer has noted, an "illusion" can be created that a deal is better than it really is.

Recommendation 11:

Lack of clarity about interest calculation methods and their effects continues to be a major problem for consumers. The industry sees a solution in clearer explanations and descriptions of methods in the summary box, rather than standardisation of method. They argue that standardising methods will restrict competitive freedoms, to the detriment of the consumer. We appreciate the importance of a competitive market in stimulating innovation and creating more sophisticated products to serve varying needs. But we remain to be convinced that standardising methods will restrict competition in this way, since—with the exception of short interest-free periods—there is little evidence that the consumer has any awareness or understanding of the differences involved. As the Chairman of the OFT has previously told us "if a product characteristic is invisible to consumers then it cannot be a dimension of competition". We recommend that the industry, working with the consumer bodies, give further consideration to whether some elements of standardisation of charging methods could be introduced and bring forward proposals to achieve it. This could be through the establishment of one or two well publicised (and therefore more widely understood) standards, from which individual issuers would be free to diverge so long as clear indications were given of the effect on consumers.

April 2005

(45) The Government responded to the Committee's second report reiterating that standardisation would 'come at the expense of flexibility, innovation and, ultimately, competitiveness and consumer choice'. The Government used only a sketchy example to illustrate how this restriction in 'competitiveness and consumer choice' would come about. The Government also disregarded the view of the then Chairman of the OFT, John Vickers that 'if a product characteristic is invisible to consumers then it cannot be a dimension of competition'.

Government Response to the Second Treasury Select Committee report: Credit card charges and marketing, 5th April 2005, pp 4-5

Government response to Recommendations 10 & 11:

2.6 In our formal response to the Committee in February last year, we argued that the key to consumer empowerment in this area was ensuring that borrowers were given clear information, before they commit themselves, about how the interest charges under an agreement would be calculated.

2.7 The new transparency regime that we introduced last year fulfils this function. In particular, the new rules requiring consumers to be given pre-contract information and on the form and content of credit agreements will require clear explanations of how and when interest charges are calculated and applied under the contract.

2.8 The Regulations come into force on 31st May this year. The Government believes that, in promoting this important information about the costs of credit from the small print to a prominent position in the agreement, they will help consumers to select the product that best suits their needs before they commit themselves.

2.9 Beyond this, the Government has consistently said that it has reservations about whether requiring standardisation in the way that interest is calculated and applied would actually be beneficial to consumers.

2.10 While the Government shares the Committee's concerns about consumers not knowing how interest is applied to their loan account, and acknowledges that this can have an impact on the amount of interest that they pay, we are also concerned that standardisation would restrict or even eliminate consumer choice.

2.11 Not all borrowers want to use credit in the same way, and they benefit from being able to choose a product that complements the way that they organise their finances. A standardised approach that suits one consumer might prove an expensive or inconvenient option for another. For example, some credit card users will want a lower APR, but will be prepared to pay interest from the date of a purchase; some will prefer a slightly higher APR, but will only want to pay interest on the amount left outstanding if they do not settle the whole balance. As long as these aspects of the product are clearly highlighted—as the new transparency provisions will require—we believe that it is better to gives consumers a choice of different products. Standardisation would bring certainty, but it would come at the expense of flexibility, innovation and, ultimately, competitiveness and consumer choice.

2.3. Review of the Banking Code

(46) In February 2004 and May 2004, Which? (then Consumers' Association) made submissions to the independent reviewer of the Banking Code. One of the recommendations we made was to standardise interest calculation methods (see Annex 6). During the review process, we met the independent reviewer several times and attended a roundtable meeting with all involved parties. The independent reviewer highlighted the issue in her final report and indicated her sympathies, but felt the review was not the right place to address the problems.[15]

2.4. Review of the Consumer Credit Act

(47) Which? welcomed the Government's revision of the 1974 consumer credit bill. While we supported some advances of the new Act, in particular with respect to the regulation of loan sharks, we felt that the Government missed a golden opportunity to tackle the problems in the mainstream credit market, in particular the need for consumers to be able to more accurately compare credit cards.

(48) Which? campaigned both at the White Paper stage and during the Bill process for standardisation of interest calculation methods applied to credit cards. During the reading of the bill, MPs from opposition parties tabled amendments to introduce standardisation. The amendments gained opposition party support, but were rejected by the Government.

(49) After the bill had reached the end of its parliamentary process, a parliamentary question was tabled on the government's position on standardisation. Once again, the Government argued that standardisation would restrict consumer choice.

[15] Elaine Kempson, Independent Review of the Banking Code, para 3.1.3., p 26.

House of Lords Parliamentary Question: 21 Jul 2005 : Column WA283

Interest Charges: Credit Cards

Lord Taylor of Warwick asked Her Majesty's Government whether they have any plans to require lenders to standardise the way in which they charge interest on credit cards. [HL1318]

Lord Sainsbury of Turville responded on behalf of the Government: The key to consumer empowerment in this area is ensuring that borrowers are given clear information about how the interest charges under an agreement will be calculated, before they commit themselves.

The new transparency regime that we have introduced fulfils this function. The new rules require consumers to be given information both pre-contract and in the credit agreement. Since 31 of May this year a statement of when and how interest charges are calculated and applied under the agreement has to be included up-front in the agreement.

Beyond this, I have reservations about whether standardising interest rate calculations would be beneficial to consumers. Not all borrowers want to use credit in the same way, and they benefit from being able to choose a product that complements the way that they organise their finances. I am concerned that standardisation would restrict or even eliminate this consumer choice.

2.5. APACS

(50) Which? had been in discussions with the credit card issuers' trade association, APACS, for a number of years on the issue of standardisation. Most notably, Which? met with APACS on 10 June 2005 to discuss the issue. During the meeting, APACS asked Which? if we could put forward a standardised method of calculating interest on credit cards that they could discuss with their members.

(51) On 1 November 2005 we wrote to APACS setting out the method we thought the industry could use. On 3 March 2006 APACS wrote back arguing that standardisation would restrict competition, innovation and consumer choice expressly referring to the position adopted by the Government. (For copies of correspondence between Which? and APACS, see Annex 7.)

PART 3: The Solution

3.1. Benefits of standardisation

(52) Which? has consistently advocated standardisation as the best solution for the problem of interest calculation methods. We are of course aware of the criticisms of this approach, in particular the argument that standardisation will stifle innovation in the credit card industry and restrict competition. We remain unconvinced by this argument.

(53) *Firstly*, we believe that standardisation would increase competition in the credit card market, not diminish it. At the moment, although we observe a variety of APR on offer, consumers cannot truly compare credit cards on the basis of APR. Price competition therefore does not function properly. We cannot see how competition could be distorted by a measure which aims precisely at introducing the possibility for consumers to make meaningful price comparisons. On the contrary, standardisation will enable competition on price.

(54) *Secondly*, we do not believe that standardisation would stifle innovation. As the industry research determined, 81% of consumers are unaware that differences in interest calculation methods exist. In this case, the possibility for issuers to introduce new interest calculation methods can hardly be of any benefit to consumers. We fully endorse the view of the previous Chairman of the OFT, John Vickers, that 'if a product characteristic is invisible to consumers then it cannot be a dimension of competition'[16].

(55) The obvious solution, and the solution that the Government and competition authorities invariably prefer in situations such as these, are informational remedies. In the context of interest calculation methods several such remedies have been suggested, benchmarking and improved Summary Boxes in particular.

(56) It is noteworthy that the industry has already placed some information about interest calculation methods in the Summary Box. Our own analysis showed that this information is insufficient to ascertain issuer's calculation method. In some cases, Terms and

[16] Transparency of Credit Card Charges, First Treasury Select Committee Report, 10th December 2003.

Conditions provided some additional information. However, we needed a detailed questionnaire with illustrative examples to understand how interest calculation methods work.

(57) However, even if full information were available in plain and unambiguous language, it would be exceptionally difficult for individual consumers to use this information to compute the impact of a particular calculation method on their overall cost of credit card use. In addition, any cross-method comparison for a number of cards would become extremely time-consuming. Our focus group research concluded that consumers had little appetite for reading summary boxes and Terms and Conditions of their credit cards.[17]

(58) We hope that our report of the analysis we needed to undertake to assess the impact of the different interest calculation methods on consumers will be in itself sufficient to convince the OFT of the complexities that we would be asking consumers to deal with should we require them to assess the impact of different interest calculation methods when choosing their credit card. Moreover, the fact that interest calculation methods are difficult to define and subject to change, makes it very hard even for a professional body such as Which? to ascertain at any given point in time what methods different credit card issuers are using and advise consumers accordingly. We therefore conclude that relying on informational remedies in a situation where many consumers do not even fully understand what APR means would be naïve.

(59) We understand that standardisation of interest calculation methods would lead to immediate changes to income that issuers generate from their cards. We expect that issuers might consequently need to reset their APR to reflect these changes.

(60) We also expect issuers to argue that such changes would be difficult and costly to implement. We are not convinced by such arguments. Indeed, issuers often change their

[17] Focus Group Research conducted for Which? by IFF Research Ltd. In September 2004 found that only few consumers claimed that they would read a Summary Box and if so, only for the key points. None of the consumers in the focus group read the Terms and Conditions of their most recent credit card. (See Annex 8b). In addition, a separate piece of quantitative research by Which? found that only 21% of consumers with an unsecured loan or a credit card read the entire Terms and Conditions in detail. 13% claim to have read a part of them in detail. 36% of consumers skim read a part or a section of the terms and conditions. 28% of consumers either do not read these documents at all or claim not to have received them. (See Annex 8c.)

methods from one year to another without this causing a major upheaval for their business[18].

(61) It is possible that as a result of standardisation, some issuers may no longer be able to maintain the same level of revenue as they currently have. This will be the result of informed consumer switching and in our eyes a sign of healthy competition.

(62) Finally, this supercomplaint focuses on purchases made on credit cards. However, the problem of interest calculation methods applies in the same way to purchases made on store cards. Any solution that the OFT may devise should therefore also include store cards. Similarly, interest calculation methods also apply to balance transfers and cash withdrawals. Although these appear to be dealt with consistently across the industry, we believe that it would be useful if the OFT stated that in the future, consistency of interest calculation methods should be a basic principle in the credit card industry as a whole.

3.2. Finding the best method

(63) Our detriment analysis took as its benchmark the cheapest interest calculation used by the top 20 credit card issuers – the HSBC method. If all top 20 issuers adopted this method, the detriment we identified would disappear. While the HSBC method may not be the cheapest conceivable method, indeed, it is not even the cheapest method available in the market (this is the Northern Bank method), our detriment analysis established that consumers would save around 400 million pounds a year if all of the top 20 issuers adopted this method.

(64) We understand that the issuers may not wish to adopt the HSBC method and may instead prefer to develop a different industry standard. The section below discusses which features we believe are crucial or desirable for such a method to have and which features are to be avoided.

[18] For instance, Barclaycard, Capital One, Marks & Spencer's, Natwest, Royal Bank of Scotland, Mint, Lloyds TSB appeared to have changed their method since 2005. We were also told that Liverpool Victoria, Goldfish, Saga and Morgan Stanley are set to change their calculation method this year.

3.2.1. Interest free periods

(65) We believe that all credit cards should have an interest free period on new purchases.[19] The main reason for this is that given the significant impact of interest free periods on the effective interest charge consumers incur, the absence of standardisation will invalidate any cross-card comparison on the basis of APR. An interest free period will also allow consumers to clear their balances should they not wish to use their credit cards for borrowing (Full Payers).

(66) We also believe that consumers should keep their interest free period whether they cleared their previous balance or not. Conditionality of interest free periods means that those consumers who previously did not pay their balance in full, but may wish to do so by the next statement period (Part & Full Payers) will not be able to do so without incurring an additional interest charge. Moreover, when a conditional interest free period is combined with charging interest until the date of repayment in full (see section "End of interest charge" below), consumers will automatically lose their interest free period because of an outstanding interest charge, even if they repaid their statement if full. Most importantly, the interest these consumers are charged will depend on their repayment behaviour. This will invalidate any meaningful initial price search.

(67) While we want all credit cards to have an interest free period, we believe that the length of the period should remain subject to competition. This is for the following two reasons: Firstly, consumers incur detriment as a result of non-existence or conditionality of interest free periods, not their length. Secondly, we believe that it is possible to communicate to consumers the length of interest free periods as a competitive feature of credit cards in a sufficiently clear manner for them to understand it and make an informed purchasing decision accordingly.

(68) We are of course aware that some credit cards offer a very low APR in exchange for no interest free period such as Lloyds TSB Advance (11.9% APR). It has been argued that these cards deliver some benefits to consumers who always carry a balance from one period to another (Never Payers) who will therefore benefit from a lower APR.

(69) However, there are a number of reasons why these cards too should have an interest free period. First and foremost, as we have argued in some detail above, the absence of interest free period will make these cards impossible to compare with cards offering interest free periods. Secondly, when consumers change their repayment behaviour and start paying off their balance in full, they will be penalized by an increased interest charge.

(70) There are other more beneficial products in market for those consumers who have accumulated a large outstanding balance and wish to minimize the APR they are paying. For instance, consumers can benefit from balance transfer deals offering typically 0% APR on the repayment of the balance subject to a fee (2% to 3% of the balance) or other advantageous deals such as the fee free Marks & Spencer's balance transfer deal with 4.9% APR for the lifetime of the balance.

(71) We recognize that the majority of credit cards do already grant interest free periods; they only differ in the length of such period. We believe that it is key that consumers have a reasonable minimum repayment period which will allow them clear their balance. At the moment, interest free periods vary from 45 to 59 days leaving a minimum of 14 to 28 days for consumers to pay off their balance.[20] We believe that standardisation should not go below 45 days, i.e. consumer should have at least 14 days to clear their balance.

(72) It is also important that consumers are well informed about the due date. While interest free periods are important as such, consumers can be easily confused by their application. It would be beneficial if consumers were clearly informed of the "payment date", i.e. the day by which they need to repay their bills in order to benefit from their interest free period. We believe that such information could be easily incorporated on statements.

[19] Not to be confused with 0% introductory offers.
[20] Assuming that a statement is issued on the first day of each month, when a credit card has an interest free period of 45 days, it will grant consumers a minimum of 14 days to repay their balance. Indeed, when a consumer makes a purchase on the first day of a month with 31 calendar days, it will have 14 days left in the next month to clear the balance. If the consumer makes a purchase later in the month, the interest free period will increase accordingly.

(73) Finally, we have noticed that some companies reserve the right to shorten the interest free period when consumers always repay their balance in full (Full Payers). We found such an example in the Terms and Conditions of Lloyds TSB credit cards. The Terms and Conditions state that "we may reduce the number of days between the statement date and the payment date if you always pay off your balance in full".[21] We believe that such practice is aiming at catching out the full paying customer and should be prohibited. Should the issuer find that providing credit cards with interest free periods to Full Payers is not profitable, it should introduce a more transparent way of charging them for the use of their credit card, for example a fixed fee.

3.2.2. End of interest charge

(74) Issuers differ in whether they charge interest until the statement date before the cardholder repays the balance in full or until the date of repayment in full. If the latter is the case, consumers will incur small interest charge from the period between the statement date and the payment date. This charge may be difficult to pay off as consumers will rely on their statement to tell them how much they need to pay.

(75) It is noteworthy that some issuers write such interest off if the consumer pays two consecutive statements in full. However, in other cases unless consumers overpay their statement, they will continue to incur an ever decreasing interest charge. It is clear that any standard method should avoid this situation and stop charging interest on the statement date.

3.2.3. Interest calculation

(76) Some issuers calculate interest daily, while others use the average daily balance calculated over a month. In addition, some of the issues using the latter method define the statement period as a calendar month, while others use a fixed number of days. We believe that daily calculation of interest is more transparent and easier for consumers to understand. The standard method should therefore use this approach.

[21] "Your credit card Terms and Conditions", Lloyds TSB, section 17.1, p 5.

3.2.4. Start of interest charge

(77) Some issuers start charging interest from the date the credit card holder makes a purchase, while others only start charging interest from the date the purchase was posted to the cardholder's account.

(78) However, we found one issuer, Northern Bank, who starts charging interest only from the statement due date. This has a significant implication on the calculation of interest in particular on the interest free period. This means that if consumers do not make a full repayment by the statement due date, they will only start being charged interest on their purchases from the statement due date onwards rather than from the date when their purchases were made. It is clear that this calculation method is very beneficial to consumers.

(79) We believe that the Northern Bank approach would be most beneficial to consumers. This is the only approach that effectively makes interest free periods unconditionally interest free. This is why our ideal calculation method would follow the Northern Bank approach.

(80) We believe that as a bare minimum a standard method should start charging interest from the date the purchase was posted to cardholder's account as this is the day on which the issuer effectively starts lending money.

3.2.5. Statement day

(81) Some issuers charge interest until the day before a statement is produced, while others charge interest until the day on which the statement is produced. Of course, as it is more advantageous for consumers if the interest charge stops the day before the statement date, we would in principle favour this method to be used as standard. However, we are flexible as to which method should be adopted by the industry providing that all issuers use the same methods.

3.2.6. Interest on interest

(82) Some issuers include interest charged in the previous statement period in the balance on which interest in the current statement period is applied, while others do not. We do not have a strong view as to whether interest on interest should be charged, but again we in principle prefer to exclude previous interest from the current balance as this will result in lower charges for consumers.

3.2.7. Conclusion

(83) Credit card calculation methods have a large number of features that influence to more or less significant degree the interest consumers will be charged for the use of their card. Differences in these methods prevent consumers from making meaningful comparison between credit cards on the basis of APR. We therefore believe that standardisation in necessary to enable real price competition in this market. We hold a strong view as to how some of these features should be standardized, while keeping our mind open on others.

(84) We believe that all credit cards should have an unconditional interest free period on new purchases. We also believe that daily interest calculation is more transparent and easier to understand. Finally, we are convinced that consumers should be allowed to clear their balance following the receipt of their statement without incurring any additional interest between the statement and repayment days.

(85) We keep our mind open as to when issuers start to charge interest, whether they charge interest up until the statement date and whether they charge interest on interest. While we have a preferred option for each of these features, we are not prescriptive as to which method is chosen. However, we urge the OFT to take a pro-active approach when discussing standardisation to prevent a “race to the bottom”.