July 2019

Red Card

Examining the link between subprime credit cards and problem debt

Contents

StepChange Debt Charity

1. Executive summary

Around four million people in the UK hold a subprime credit card: a credit card with a high interest rate (APR) – between 30% and 70% compared to the average credit card interest rate of 20% – typically offered to those with a low income, who are unemployed or who have an impaired credit file or are new to credit. Four firms account for around 95% of subprime credit cards.

Subprime credit cards are commonly held by people in, or at risk of, financial difficulty. Our national polling indicates that one third (32%) of those who are in serious problem debt have at least one subprime card.[1] We find a similar pattern among StepChange clients, 39% of whom have at least one subprime card.

1. **Poor lending practices lead people in financial difficulty to take on unaffordable subprime credit card debt, often at a point of desperation.**

Our national polling indicates that one quarter of those with a subprime card were behind on at least essential bill (including rent, utilities and debt repayments) when they took out the card. Among clients who responded to our survey, 47% were behind on at least one essential bill and 18% were unemployed when they took out a subprime card. Seventy-nine per cent of clients with a subprime card had more than one credit card, reflecting a pattern in which people no longer able to access mainstream cards move to higher cost options. Many clients felt that they had been inappropriately encouraged to borrow at a time they were under financial pressure by targeted online, postal and on-street marketing.

2. **Borrowing using subprime cards among StepChange clients is driven primarily by living costs.**

This includes buying food and clothes, paying rent and utility bills and meeting unpredictable expenses like repairs. Borrowing is often linked to life transitions like relationship changes, moving home or new children, or factors like redundancy, ill-health and disability or delays to social security payments. Borrowing was sometimes driven by specific vulnerabilities including serious mental health conditions. Some clients also said that they had failed to budget effectively or control impulse spending.

Although subprime credit cards are sometimes referred to as 'low and grow' or credit builder products, we found a minority of clients (9%) had used a card in practice to build their credit rating. A majority of clients reported that the credit limit of their card was higher than they had expected, and many felt drawn into spending more than they had planned by unsolicited credit increases.

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[1] All figures, unless otherwise stated, are from YouGov Plc. Total sample size was 5,326 adults. Fieldwork was undertaken between 29th April - 2nd May 2019. The survey was carried out online. The figures have been weighted and are representative of all GB adults (aged 18+).

3. **Subprime borrowers often encounter repayment difficulty**

In our national polling, 23% of those with a subprime card were in severe problem debt and 42% were showing signs of financial difficulty.[2] Among StepChange clients, 71% said they found it difficult to pay more than the minimum. A majority of clients (67%) had missed payments, with 52% missing three or more monthly repayments each year. More than half of clients reported that the interest rate was increased while they had a subprime card.

4. **Repayment difficulty locks subprime credit card users into expensive long-term credit card debt**

For financially distressed borrowers, costs often become unreasonable and harmful, reaching more than 100% of the amount borrowed. Credit card balances tend to be high – the average subprime card balance among our clients is £1,348 – and the impact of interest charges on stretched household finances is significant.

5. **Subprime credit cards often exacerbate financial precariousness**

A majority of StepChange clients (79%) felt that overall using a subprime credit card had a negative impact on their financial situation. For some clients, a subprime credit card had been a 'lifeline' and a useful source of flexible credit. For most, however, a subprime card had been obtained at a point of severe need and subsequently exacerbated financial difficulty through expensive long-term debt.

Demand for subprime credit cards among people in financial difficulty reflects stretched household finances and speaks of the need for wider action to address poverty, support low- and middle-income households to increase their financial resilience and offer better affordable credit alternatives. In this report, we focus on policy and regulatory action to directly address problems linked to subprime credit cards.

What our clients tell us

> "If you are struggling to pay for food and you use this card you feel like it spirals out of control because when payments arrive you can't afford food on top of the card payment so they add more onto [the balance]"
>
> "The credit card company just keeps feeding the rope to you for you to hang yourself"
>
> "I would have been better off going to a food bank or borrowing money [from] family"

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[2] Repayment difficulty includes one or more of the following: exceeding the card limit, missing at least one repayment or receiving a persistent credit card debt letter. See page 12, footnote 21 for details of 'severe problem debt' and 'signs of financial difficulty' criteria.

Our recommendations

The Financial Conduct Authority should take action to ensure subprime credit cards work safely for people at risk of financial difficulty by:

- Providing an update on supervisory work in the subprime credit card market and setting out actions to address outstanding issues, focusing particularly on the impact of new persistent debt rules.
- Strengthening creditworthiness and affordability assessment rules for revolving credit to ensure the rules work effectively for subprime products.
- Testing and requiring firms to implement new credit card repayment tools that make the cost of borrowing more transparent and encourage prompt repayment among those who can afford to increase monthly payments.
- Requiring firms to use an opt-in system for credit limit increases.
- Examining and acting on consumer harm linked to ‘low and grow’ credit builder products through the recently commenced credit information market study.

This report finds that the design of subprime credit card products leads financially vulnerable people to pay an excessive cost for credit and experience serious debt problems. The government and the FCA should protect financially vulnerable borrowers against products that exploit behavioural bias and lead to unreasonable and harmful costs.

To achieve this, policy makers should take a preventative approach and increase statutory minimum credit card payments for new cards to the level required to clear debt without excessive cost.

Our evidence also shows that there is a role for ‘backstop’ measures to address excessive costs by suspending interest charges for consumers in persistent debt and limiting the cost of credit to 100% of the amount borrowed in line with comparable high cost credit products.

2. Introduction

In this report we look at the subprime or high cost segment of the credit card market. Using the Financial Conduct Authority's definition of the high-risk market segment, we define subprime cards broadly as credit cards with a representative APR of 30% or more.[3] In practice, cards in the sector have representative APRs which range from 34.9% to 69.9% (see figure 1). This compares to an average APR across all credit cards of 20%.[4]

Around four million people in the UK hold a subprime credit card; the principal characteristics of those served by this market include having a thin or adverse credit history, being unemployed and having a low income.[5]

Subprime credit cards are common among those who experience debt problems. Our national polling indicates that 32% of those in severe problem debt hold a subprime card.[6] Based on client data, we estimate that 39 per cent of StepChange clients hold at least one subprime credit card.[7]

The FCA noted in its credit card market study that four firms account for 'virtually all' balances in the high risk market segment.[8] The market is therefore relatively concentrated compared to the mainstream credit card market where 24 firms provide cards.[9] Figure 1 sets out the current representative APR and minimum monthly payment for each of these four firms, drawing on summary box data.

Figure 1: Subprime credit card APR rates and minimum payments[10]

Card	Representative APR	Minimum payment[11]
Card 1	34.9 variable (no range	3% of the outstanding

[3] Financial Conduct Authority (2016) *MS14/6.3 Credit card market study – Final findings report*. London: Financial Conduct Authority, p. 37.
[4] December 2018, Bank of England dataset IUMCCTL (Further information about this statistic is available at www.bankofengland.co.uk/statistics/details/further-details-about-quoted-household-interest-rates-data).
[5] pwc (2018) *Sizing the UK Near Prime Credit Card Market*.
[6] All figures, unless otherwise stated, are from YouGov Plc. Total sample size was 5,326 adults. Fieldwork was undertaken between 29th April - 2nd May 2019. The survey was carried out online. The figures have been weighted and are representative of all GB adults (aged 18+).
[7] See methodology section for more details.
[8] Financial Conduct Authority (2016) *MS14/6.3 Credit card market study – Final findings report*. London: Financial Conduct Authority, p. 8.
[9] In the mainstream market two-thirds of outstanding balances are held by four firms, which the FCA describes as implying a 'moderate' degree of concentration.
[10] APRs may vary across products for cash withdrawals and balance transfers.
[11] This is the standard initial minimum payment offered by the card provider: firms may increase minimum payments during the term of a credit contract. For low balances, the minimum payment is a fixed percentage of the balance or a minimum payment floor of £5 or £10 (depending on the card provider).

	given)	balance plus interest and charges
Card 2	34.9 (no range given)	1% of the outstanding balance plus interest and charges
Card 3	35.9 variable (35.9 to 59.9)	1%-3.25% of the outstanding balance plus interest and charges
Card 4	39.9 variable (39.9 to 69.9)	3% of the outstanding balance plus interest and charges

Revolving credit products like credit cards and overdrafts are the most common form of credit used by households with low incomes.[12] Revolving credit has an important utility for households – allowing them to bring payment forward or spread the cost of useful purchases and providing a cushion for unexpected expenses – but has characteristics that can increase risks of debt problems.

Credit cards allow people to borrow easily with extremely flexible repayment terms. Budgeting pressures and the 'low and grow' structure of cards can lead those with low incomes to accumulate large outstanding balances and steadily increasing monthly minimum payments. Repayment difficult may emerge gradually as spending increases, or a change in circumstances such as unemployment or ill health may also make it difficult for borrowers to continue to make repayments. An increase in the interest rate or minimum repayment required by the card provider can also introduce repayment difficulty.

These risks mean that revolving credit may not always be a better option than fixed-term alternatives, even if the latter have a higher interest rate. Borrowing a small amount for a specific purpose that is linked to a clear short-term repayment plan may be a safer form of borrowing, particularly for those using credit to meet living expenses who are particularly at risk of experiencing debt problems. The

[12] Ellison, A. et al (2011) Credit and low-income consumers. Dorking: Friends Provident Foundation.

flexibility of revolving credit is double-edged and requires careful design to work safely for those at risk of financial difficulty.

Between 2014 and 2016, the FCA undertook a market study of the credit card sector. The FCA concluded that credit cards can offer significant benefits to consumers through flexibility that allows people to defer costs and smooth expenditure.[13] However, the FCA also identified significant concerns about the scale, extent and nature of problem credit card debt.

The FCA noted that there are several reasons credit cards use might be associated with financial difficulty, including:[14]

- optimism bias (the tendency for consumers to over-estimate their ability to repay);
- present-bias (the tendency to value a benefit now over a benefit in future – the FCA reported that 29% of people say they spent more using their credit card than they expected);
- framing effects (credit card repayments are not fixed and are expressed in percentage terms, leading people to under-estimate the cost of repayment); and
- the tendency of the statutory mandatory minimum monthly payment – 1% of the outstanding balance and interest and charges – to anchor repayments.

At the conclusion of its credit card market study, the FCA implemented a package of measures designed to address the concerns it had identified, including:[15]

- Through a voluntary agreement, new customers have been given the ability to opt-out of automatic increases in the card credit limit (and existing customers are given the opportunity to opt-out in future).
- Cardholders will receive notifications when an introductory offer is coming to an end and automatic credit limit alerts (where a threshold between 80% and 95% of the limit is crossed).
- Customers have been given the ability to request a 'later than' payment date in the month to help avoid penalty charges.
- Firms may not increase the credit limit for customers in persistent debt for 12 months.
- Firms must put in place policies and procedures to identify and support customers in financial difficulty.

The FCA identified specific concerns about the extent of persistent credit card debt (defined as where, over a period of 18 months, a customer pays more in interest, fees and charges than they have repaid of the outstanding principal). The FCA found that customers in persistent debt pay on average £2.50 in interest and charges for every £1 that they repay of the outstanding balance. There are a total of four million accounts in persistent debt and firms have few incentives to help these

[13] Financial Conduct Authority (2016) Market Study MS14/6.3: Credit card market study Final findings report. London: Financial Conduct Authority.
[14] Financial Conduct Authority (2016) Market Study MS14/6.3: Credit card market study Final findings report. London: Financial Conduct Authority, p. 31. And Financial Conduct Authority (2015) Market Study MS14/6.2: Credit card market study: interim report. London: Financial Conduct Authority, p. 73.
[15] These are set out in Financial Conduct Authority (2018) Persistent debt PS18/4: Credit card market study: persistent debt and earlier intervention - feedback to CP17/43 and final rules. London: Financial Conduct Authority.

customers because they are profitable.[16] In response to this issue, the FCA has required firms to identify customers in persistent debt, encourage them to repay more quickly and help where they cannot afford repayment within a reasonable period.

The FCA reported that a quarter of cards in the higher risk segment were in severe or serious arrears compared to 8% of all cards.[17] The FCA noted that the extent of arrears in the higher risk segment raises questions about the effectiveness of affordability assessments undertaken by these firms and committed, where appropriate, to undertake supervisory intervention.[18]

In March (2019), the FCA also wrote to credit card firms to set out concerns about fee charging practices and customers in financial difficulty.[19] Having reviewed a sample of firms' practices, the FCA raised concerns about the application of repeated missed payment fees, consecutive over-limit fees and situations where the application of one fee triggers another (like a declined payment fee pushing a customer's balance above their limit and triggering an over-limit fee). The FCA highlighted firms' duties to identify people in financial difficulty, that patterns of fee charges could be indicators of difficulty and firms' responsibilities to provide forbearance where appropriate.

For some StepChange clients, using a subprime card had proved to be helpful, reflecting the value of access to flexible credit. Ultimately, however, the majority of clients who had borrowed using a subprime card felt that using the card had a negative effect on their financial situation. Many cited distressing impacts on the wider situation, including hardship and mental health problems.

Recent analysis suggests that the potential size of the subprime credit card market is between 10.2 and 13.6 million people.[20] It is likely that these products will affect an increasing number of people who are, or are at risk of being, financially or otherwise vulnerable. The conduct and evolution of this market is therefore of crucial importance to the extent to which consumer credit plays a positive role in the lives of stretched households.

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[16] https://www.fca.org.uk/news/press-releases/new-credit-card-rules-introduced-fca
[17] Financial Conduct Authority (2016) Credit card market study: Final findings report. London: Financial Conduct Authority.
[18] Financial Conduct Authority (2016) MS14/6.3 Credit card market study – Final findings report. London: Financial Conduct Authority, p. 25.
[19] Financial Conduct Authority letter to firms 6 March 2019 'Credit card fees and charges – results of our review'
[20] PWC (2018) Sizing the UK Near Prime Credit Card Market.

Methodology

- We reviewed StepChange client data for the charity's telephone advice and online Debt Remedy tool for January 2019 and identified clients with subprime credit cards. This data includes clients who completed the full debt advice process and submitted details of their debts (but not those who began but did not complete an advice session). In January 2019, StepChange advised 22,644 unique clients.

- We were unable to identify clients with one of the four most common subprime card brands (this is because the firm concerned provides a mainstream card using the same brand name and it is not possible to distinguish the two cards separately in our data). We also excluded store cards offered by subprime credit card firms from our analysis on the basis that these cards are marketed and used primarily in a specific retail context.

- A client survey was sent to a sample of StepChange clients who had received advice from the charity during 2018 and had taken out a subprime card in the last two years. The survey was conducted in two waves between January and June 2019. We received a total of 598 complete and 924 partial responses.

- We define subprime credit cards, in line with the FCA's definition of high-risk cards, as credit cards with a representative APR of 30% or more. In our client survey, we asked clients about the initial APR of the subprime cards they used: 13% reported that the initial APR on the card was lower than 30%. Our survey is therefore broadly representative of the subprime card market segment.

- We also commissioned national polling by YouGov to learn more about the circumstances of those in the general population who take out a subprime card and how this group compares to StepChange clients. The total survey sample size was 5,326 adults. The survey was carried out online and fieldwork was undertaken between 29 April and 2 May 2019. The polling figures have been weighted and are representative of all adults in Great Britain aged 18 or over.

3. Subprime credit cards and problem debt

We heard from clients that problem debt linked to subprime credit cards is driven by a number of different factors.

We have organised our analysis into six sections:

- Lending practices
- Reasons for using subprime cards
- Borrowing and repayment
- Distress borrowers
- Multiple cards and credit card ‘snowballs’
- Persistent credit card debt

Lending practices

Responsible lending is crucial in the subprime credit card market segment because poor lending decisions may have serious negative consequences for financially vulnerable people who take on unaffordable debt. Nevertheless, we found clear evidence of problems with lending practices. In the national polling we commissioned, 25% of those who had taken out a subprime card reported they were experiencing some form of financial difficulty when they took out the card.[21] This included being behind on consumer debt repayments, rent or mortgage payments, utility bills or council tax.

Among StepChange clients, 47% of those choosing to take out a subprime card reported that they were already in some degree of financial difficulty at the point they do so (using the same criteria as above). Notably, 18% of clients who took out a subprime card were not in employment when they took out the card (this figure excludes those who do not usually work such as full-time students and retirees).

In our national polling we also asked people with a subprime card if they were currently in financial difficulty: 23% of those with a subprime credit card were in severe problem debt and 42% were showing signs of financial difficulty.[22] Some degree of risk is inevitable in lending decisions and some

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[21] All figures, unless otherwise stated, are from YouGov Plc. Total sample size was 5,326 adults. Fieldwork was undertaken between 29th April - 2nd May 2019. The survey was carried out online. The figures have been weighted and are representative of all GB adults (aged 18+).

[22] Those classified as being in ‘severe problem debt’ selected three or more options (excluding None and Don’t know) and those ‘showing signs of financial difficulty’ selected 1 or 2 options (excluding None and Don’t know) of the following question:

In the last 12 months have you experienced or carried out any of the following activities in regards to your household finances? (Please tick all that apply.)

- Used credit/ loans/ overdraft to make it through to payday
- Made just the minimum repayments on your debts for three or more months
- Got hit by late payment or overdraft charges on a regular basis
- Fell behind on your essential household bills (e.g. rent, mortgage, energy bills, council tax etc.)

of those who are initially creditworthy will subsequently get into financial difficulty that was difficult to foresee. However, the proportion of subprime credit card borrowers who experience financial difficulties strongly suggests lending is both failing to adequately identify financial difficulties at the point of borrowing and predict the risk of borrowers encountering subsequent financial difficulty.

A majority (68%) of the respondents to our client survey had used more credit than they expected. Almost all (89%) reported that they had reached the card limit, and most (81%) reported that they did so frequently. Moreover, 69% of respondents exceeded the card limit, and 25% (of all respondents) reported that this had happened fairly or very often.

Clients also reported difficulty repaying the balance: 66% of respondents most often paid the minimum payment while 31% most often repaid a higher fixed amount or an amount that varied from month to month.

Inertia – being able to pay more but choosing not, or forgetting, to do so – was not the primary factor in low repayments; rather, financial pressures made repayment difficult: 71% of respondents found it difficult to repay more than the minimum amount each month; 27% had cut back on normal day to day spending to make repayments, 21% had used another source of credit and 20% had fallen behind on other bills.

Clients cited a variety of reasons repayment became difficult. One theme was that they had not realised the amount that minimum payments would rise to, particularly following credit limit increases. Borrowing using multiple cards (discussed further below) were also cited as contributing to repayment pressure as payments across cards accumulated. Other reasons included:

- Not having enough income to make repayments once essential living costs were met; unexpected expenses;
- Uncontrolled or careless spending and borrowing beyond means to repay;
- Income shocks linked to illness, unemployment or reduced employment/pay; and
- Relationship changes or other changes in household structure (like an adult child moving out).

Ineffective creditworthiness and affordability assessments may stem from a number of issues. Among the clients surveyed, 16% reported that they were not asked for income or expenditure information. It was significantly more common for clients to recall being asked for evidence of income than of expenditure. While firms are usually collecting *some* information, they may be collecting insufficient evidence to make informed decisions.

Another driver of problems may be that card issuers rely principally on their own data about customers, either in relation to a customer's repayment history on the card or another current account or credit product with the firm. As noted below, most clients with a subprime card had at least one other credit card (and often additional debt). If checked, credit information records should usually provide information about these debts, but it is limited and may not always be sufficient to

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- Used credit to keep up with existing credit commitments
- Used credit to pay essential household bills (e.g. rent, mortgage, energy bills, council tax etc.)
- None of these
- Don't know

identify difficulty. FCA rules also allow firms to lend without requesting certain information where it is ‘obvious’ the amount of credit offered is affordable.[23] If the initial limit on the card for which someone applies is comparably low (i.e., £150-250), less evidence may be requested. Those who have become reliant on a card to meet living expenses may also be reluctant to be forthcoming with firms about difficulties for fear of losing access to credit.

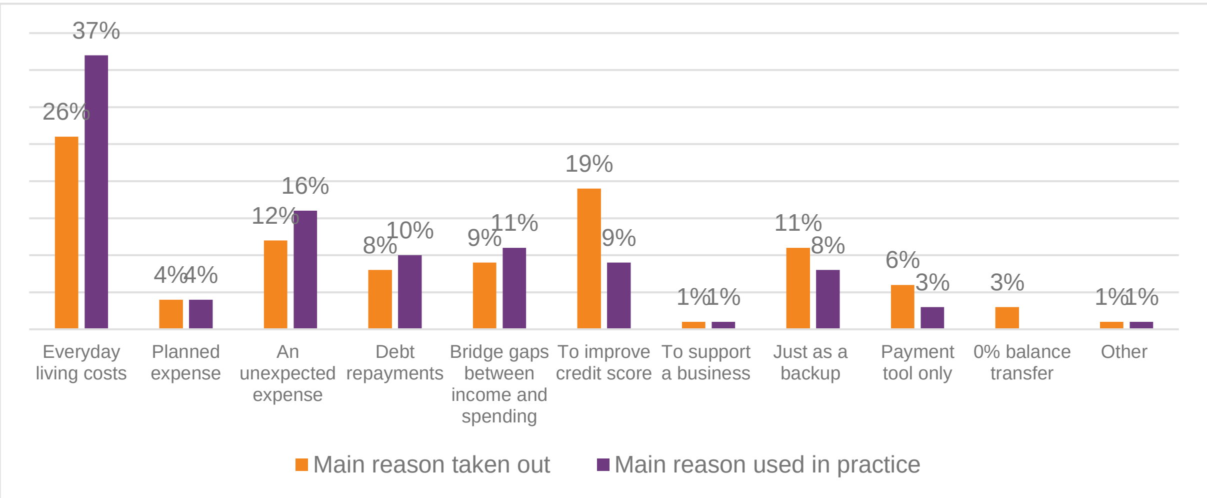
What our clients tell us

> “The card should never have been granted given the amount of existing debt.”
>
> “I should never have got them when my income was based on benefits only.”
>
> “If a person who has low interest cards borrows on one of these high interest ones, it should be a red flag to companies to say no.”
>
> “I take responsibility for spending the money on the card, but more severe checks need to be made when credit is given to customers”
>
> “It boosted my confidence that I could still get credit, but they obviously didn’t check my credit history as if they did, they would [have] seen [the card] shouldn’t have been given to me as it put me into more debt”

Reasons for using subprime cards

People cite a range of reasons for borrowing using a subprime card (figure 2): borrowing was most often driven by everyday living costs. We also asked clients how they used the card in practice and there were notable differences between people’s intended and actual usage patterns with the proportion of people who used the card to meet everyday costs increasing significantly and the proportion who used the card for credit building decreasing significantly.

Figure 2: Main reasons for taking out and using a subprime credit card



[23] FCA Handbook, Consumer Credit sourcebook 5.2A.15

We asked people who had borrowed using multiple cards, including at least one subprime card, why they had taken out the cards. Respondents offered a range of reasons, including:

- Living costs (food, clothes, bills, white goods and unexpected repairs)
- Meeting costs associated with being a carer, long-term illness and disability and end of life care
- Debt consolidation and making repayments on previous credit card borrowing
- Impulse purchasing, often linked to mental health issues
- Building their credit rating following difficulties with debt, or in the hope of accessing more affordable credit to manage existing debt
- Activities with children, social activities and holidays
- Life transitions like moving home, relationship changes and new children
- Delays in benefit payments, including the five-week wait for Universal Credit
- Redundancy and using credit to meet living expenses before finding work (and in some cases making up the difference while hoping to find work at a similar salary level to the past)

Marketing played a significant role in affecting decisions to use a subprime card. The most common form of marketing cited by clients as affecting their decision to take out a card was direct mail marketing like pre-approval letters (33%), followed by an interest-free offer (19%). A significant proportion of clients (14%) also mentioned using a price comparison website. TV advertising, online searches, credit rating intermediaries and being offered a card by their existing bank were also cited by respondents. Although we did not ask specifically about on-street marketing, a number of clients mentioned that they had been signed up for a card this way, including in town centres and at service stations.[24]

Awareness of key product characteristics of subprime cards is mixed. Among our survey respondents, less than half (46%) reported that they had a clear knowledge of the amount of interest charges when they took out the card and 50% a good understanding of late payment fees. A majority of respondents (81%), however, reported fairly or very good understanding of the requirement to make a monthly minimum payment. However, only 31% felt they had a good understanding of how long it would take to repay the balance of the card by making minimum payments.

These findings echo past Which? research that found a widespread lack of understanding of the implication of making minimum payments for the cost and length of time to repay, as well as a common misunderstanding that the minimum payment is the *recommended* payment amount.[25]

What our clients tell us

> "It is so easy to fool yourself that you are ok because they increase your credit without you requesting it unlike a personal loan."
>
> "I was using cards to pay other card payments. Maybe this shouldn't have been allowed as I probably would have asked for help sooner."

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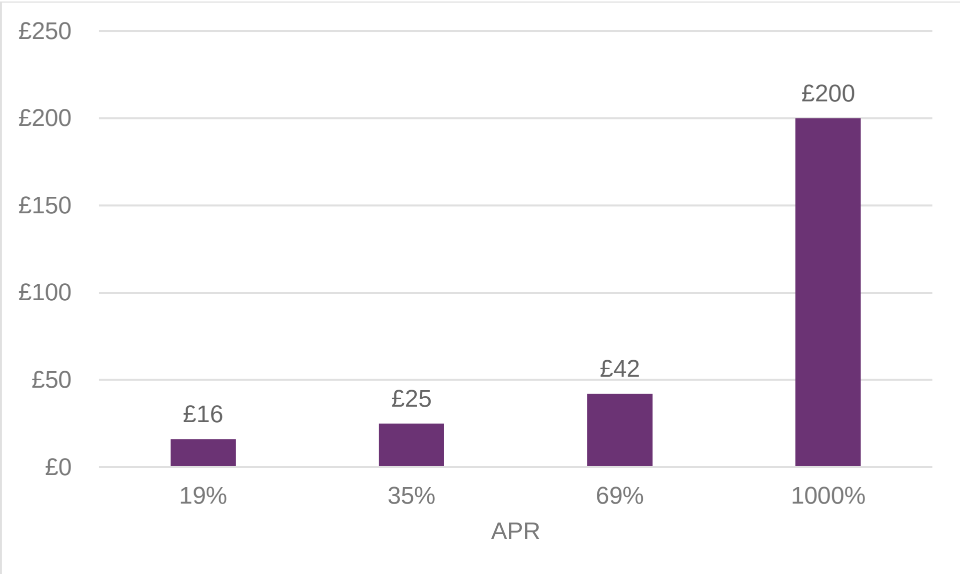
[24] CONC 2.9 prohibits unsolicited credit tokens, which includes credit cards.
[25] Cited in Financial Conduct Authority (2016) Credit Card Market Study Annex 4: Behavioural Trials. London: Financial Conduct Authority, p. 2.

> "Receiving only £60 per week for caring for my terminally ill father and having to try and cover bills and repayments has gotten me into a hole"
>
> "I only had a month to find the full balance of my council tax"
>
> "Being totally bedbound and disabled and I had huge expenses to get equipment and care. I was told I would get this money back from social services but then they changed their minds"

Borrowing and repayment

Subprime credit cards have a comparatively low cost of borrowing if paid off promptly (figure 3); for example, borrowing £500 and repaying over three months at an APR of 35% would cost £25 in interest payments. This compares favourably to the three-month borrowing cost of high cost short term credit alternatives (typically £140-£260).

Figure 3: Costs of borrowing £500 over three months[26]



Short-term borrowing and repayment, however, is not the pattern of borrowing we find among most of our clients. Rather, those using subprime cards most often utilised a high proportion of the balance and made low or minimum repayments, leading to a long-term repayment pattern.

Most clients (89%) reported that they reached the limit of the card (in our survey, we defined this as coming within 10% of the limit). Two-thirds of clients (69%) said that the credit limit had been increased while they had the card. These figures are consistent with a 'low and grow' credit builder product structure, but most clients did not take out or use a card for credit building purposes (in fact,

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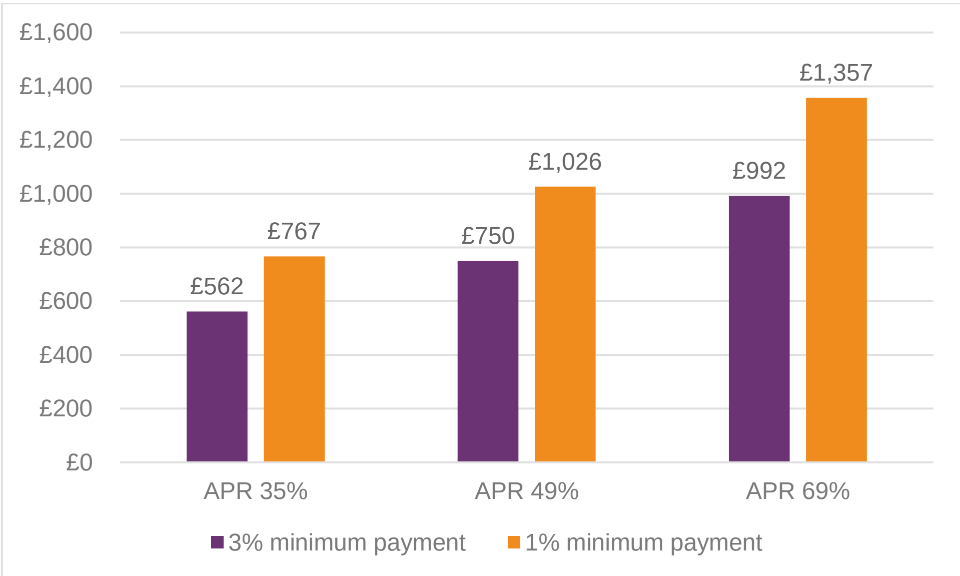
[26] Assuming repayment in equal instalments over three months.

coming within 10% of the card limit can negatively affect a credit score).[27] Moreover, 68% of clients reported that they used more credit than they expected to on the card and 69% that they exceeded the limit of the card at least once: most did so just once or twice, but 25% did so fairly or very often.

A majority of clients (66%) paid only the minimum monthly payment on the card, while 31% repaid an amount that varied from month to month depending on what they could afford or a fixed amount. Seventy-one per cent of clients found it difficult to pay more than the minimum payment and only 10% found it easy to pay more than the minimum. One quarter (27%) of clients had cut back on normal day to day spending to make monthly repayments; a fifth (20%) had fallen behind on bills to make repayments and 21% had used another source of credit.

The FCA's persistent credit card debt rules, implemented from 2018, mean that customers would usually now be directed into a repayment plan after 36 months of persistent debt (defined as if someone has paid more in interest and charges than they have repaid of the amount borrowed). Focusing on this initial 36-month period, figures 4 and 5 illustrate the cost of using a card for a significant one-off expense or using it each month to help meet regular living costs. (We discuss later in the report how firms' decisions about repayment options at 36 months will affect the total cost of borrowing.)

Figure 4: Cost of borrowing £1,000 for 36 months[28]



[27] Indicative figures provided by Experian to Which? via www.which.co.uk/news/2018/10/credit-scoring-are-you-in-the-dark
[28] Assuming £1,000 is spent in the first month and the borrower pays the minimum repayment. The balance remaining after 36 months is £344 if the minimum payment is 3% plus interest or £703 if the minimum payment is 1% plus interest.

Figure 5: Cost of spending £50 a month for 36 months[29]

One notable difference between these two examples is that a decreasing balance leads to a steady decrease in minimum payments while an increasing balance, a common pattern as card limits are increased, leads to a steady increase in minimum payments; in the example in figure 5, the minimum payment rises from £5 in the first month the card is used to between £61 and £83 (depending on the card APR and minimum payment) after 36 months.

In each example, the high cost of long-term borrowing with a subprime card is evident. In a best-case scenario, the cost of long-term debt is comparable to other subprime credit products like guarantor loans (see figure 13 later in this report). However, where the APR is initially higher or is increased – which our survey evidence suggests is commonplace for subprime card borrowers – or minimum payments are lower than 3%, the cost of a subprime card compare unfavourably to other products subprime borrowers may be able to access. In these examples, a significant outstanding balance remains at 36 months to be repaid: from £344 to £703 in figure 4 and £1,109 to £1,516 in figure 5.

What our clients tell us

> "The credit limit increased when I got near to limit and encouraged me to spend money I didn't have"
>
> "Raising the limit without me asking was just fuel to the fire"
>
> "At first it had a positive impact and helped. After one or two months, it went to negative"
>
> "The credit providers should be more open […] by checking the repayment affordability, not increasing the credit limit after few months and providing advice and help when the customer is in financial difficulties"

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[29] Assuming £50 is spent using the card each month (reaching a total over 36 months of £1,800) and the borrower pays the minimum repayment. The balance remaining after 36 months is £1,109 if the minimum payment is 3% plus interest or £1,516 if the minimum payment is 1% plus interest.

> "I don't believe that credit card companies should be able to just up your limit without permission this just encouraged me to spend more money especially when having financial trouble"

> "Why offer to increase my spending [limit] when they don't know my personal circumstances? It's ok saying I have to call to decline the increase, but being offered more money when you have none is, or at least at the time, was a no brainer."

> "The provider should give you an option whether you want a limit increase before they apply it to account."

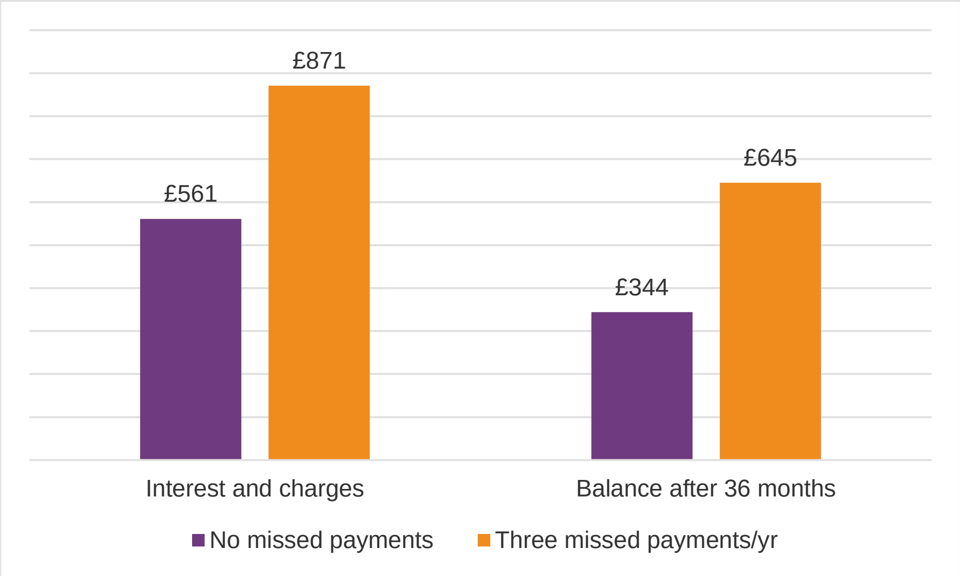
Distressed borrowers

So far, we have looked at relatively straightforward borrowing patterns. Two further borrowing patterns appear common among those in financial difficulty: missed payments and credit card debt 'snowballs' in which borrowers use a sequence of credit products, frequently increasing in cost over time (i.e., borrowers resort to a higher cost product to continue to meet living expenses or debt repayments when they can no longer access lower cost mainstream alternatives).

In our national polling, 24% of those who had taken out a subprime credit card had encountered repayment difficulty, including exceeding the card limit, missing at least one repayment or receiving a persistent credit card debt letter. As noted, StepChange clients had also commonly missed payments.

Missed payments compound the cost of borrowing because a fee is added to the balance (typically £12) and the balance is not reduced in the month in which a payment is missed. In the example set out in figure 6, the additional cost of borrowing £1,000 over three years where three payments are missed each year is £217. There is also a substantial increase of £301 in the outstanding balance remaining at the end of this period, increasing the time and cost of repayment.

Figure 6: Cost of borrowing £1,000, three missed payments a year[30]



What our clients tell us

> "As I was paying all my bills I had virtually no money to get me through the month, I was missing meals as I couldn't afford to eat and was worried sick"
>
> "My debt was really starting to affect my health; I couldn't sleep worrying about what I was going to do"
>
> "[I was] worried, sleepless, depressed"
>
> "I just kept accumulating debt by missed payments"
>
> "They increased the interest by over 20%"
>
> "[The company] didn't understand that I've became a single parent and I'm no longer capable of making such a high payment"

Multiple cards and credit card 'snowballs'

Most clients with a subprime card already had at least one mainstream credit card: seventy-nine per cent with a subprime credit card had more than one credit card, holding an average of 3.1 cards in total (figure 7). Most commonly, clients hold two mainstream cards and one subprime card. This suggests a pattern of 'escalation, where borrowers move from lower cost mainstream cards to higher cost subprime cards, which means borrowing costs and total credit card debt tends to increase with multiple cards. We also found that 17% of clients with one subprime card provider had more than one

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[30] We assume £1,000 is spent in the first month; an APR of 34.9%; that payments are missed in the second, fourth and sixth month of each year; and that a minimum repayment of 3% of the balance plus interest is made in all other months.

card issued by the firm, likely reflecting a pathway between near-prime and subprime products. (A smaller proportion of clients, 3-4%, who held a card offered by the other two other largest subprime card providers held more than one card offered by the same firm.)

Figure 7: Credit cards per client with a subprime card

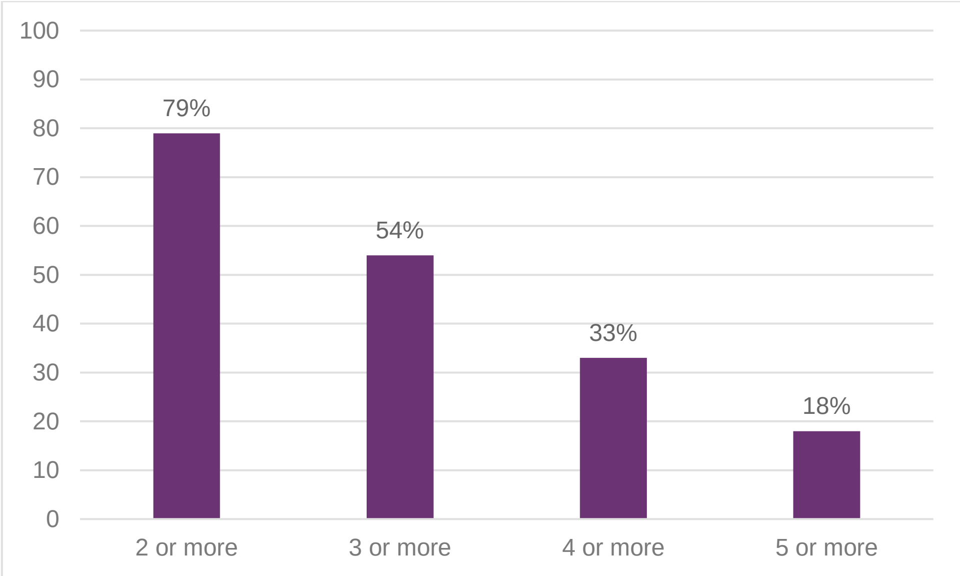
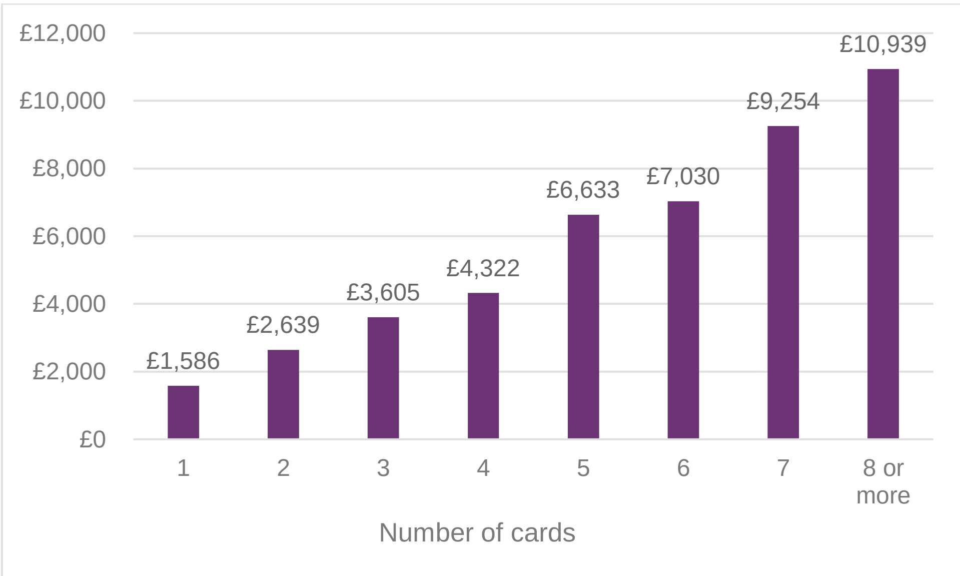


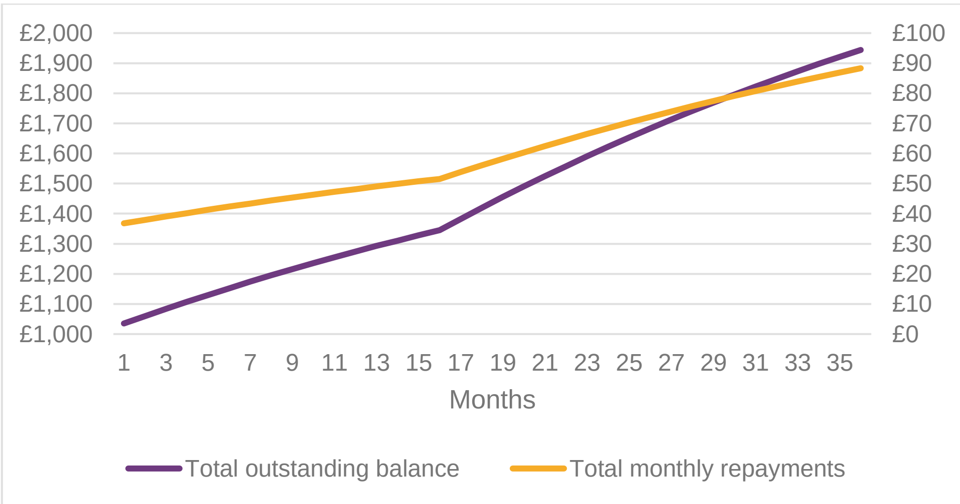
Figure 8: Average outstanding credit card balance by number of cards (clients with a subprime card)



Borrowing using multiple credit cards may create problems for a number of reasons. Initially manageable minimum payments may accumulate, particularly where missed payment fees increase the outstanding balance. Those unable to make any repayment in some months across multiple cards will face a sudden cascade of missed payment fees. Credit card firms have a limited read across of a customer's outstanding debts and are reliant on limited credit reference agency information or direct engagement with a customer; they may therefore make changes to minimum payments that appear rational from a single card account perspective but are unsustainable for a customer.

Using credit to repay debt is a strong risk factor in developing debt problems. The fact of not being able to make regular repayments from income or assets indicates repayments are no longer affordable. Unless a borrower's financial circumstances decisively improve for the better, there is a high likelihood that rising borrowing costs and/or the cost of missed repayments will cause debt to gradually 'snowball' until repayments are unsustainable. Figure 9 sets out a stylised model of this process, taking into account the likelihood that each successive card taken out will have an increased APR. In this scenario, after three years an initial outstanding balance of £1,000 has increased to £1,944, the borrower has paid £1,632 in interest charges, and monthly repayments have increased from £37 to £88. No additional spending has taken place, the original utility of the debt for the borrower has long passed and both the balance and monthly fees have increased dramatically. Once trapped in this kind of debt spiral it is very difficult to get out.

Figure 9: Credit card debt 'snowball'[31]



[31] Assumptions: £1,000 balance on first card with APR of 34.9% and minimum monthly repayments of 1% of the balance and interest; repayments made drawing on second card with an initial zero balance, an APR of 49%, minimum monthly repayments of 1% of the balance and interest and a limit of £500; repayments on both cards switch to third card when £500 limit is reached. Third card has an APR of 69% and minimum monthly repayments of 1% of the balance and interest.

Persistent credit card debt

Following its credit card market study, the FCA set out detailed requirements on firms to identify and help customers in persistent debt (as noted, defined as where, over a period of 18 months, a customer pays more in interest, fees and charges than they have repaid of the outstanding principal). Firms must respond to customers in persistent debt through three phases of intervention:[32]

1. At 18 months, firms must notify customers that they are in persistent debt, explain the benefits of faster repayment, encourage the customer to contact the firm and provide the details of debt advice providers.

2. If a customer remains in persistent debt after 27 months, firms must provide a further reminder with the same information provided as at the 18-month stage.

3. If a customer remains in persistent debt after 36 months, firms must take reasonable steps to assist the customer to repay the balance more quickly in a way that does not adversely affect their financial situation over a maximum of three to four years and apply forbearance where appropriate (in line with the FCA's rules on financial difficulty).

Importantly, where customers in persistent debt increase repayment sufficiently to leave the persistent debt definition but then revert to a pattern of payment that puts them in persistent debt, the interventions return to the first 18-month stage; customers may therefore 'skim' the interventions and continue to experience costly debt over a period in excess of 36 months.

At the representative APR of the four cards we have examined, two have a default minimum payment – 3% plus interest and charges – sufficient to avoid meeting the persistent debt definition, assuming all monthly repayments are made. Figure 10 sets out the minimum payment needed to avoid meeting the persistent debt definition for cards with a range of APRs.

Figure 10: Minimum monthly payment needed to avoid persistent debt threshold

APR	**Minimum payment needed to avoid persistent debt**
34.9%	2.7% plus interest
49.9%	3.6% plus interest
69.9%	4.7% plus interest

[32] The final rules for firms are summarised in Financial Conduct Authority (2018) PS18/4: Credit card market study: persistent debt and earlier intervention - feedback to CP17/43 and final rules. London: Financial Conduct Authority.

The persistent debt rules are designed to encourage a sustainable increase in credit card repayments. One effect of the rules could be to change the structure of products by setting a new minimum payment. Firms have discretion over whether to increase minimum payments; they may also suggest but not require an increase or do nothing beyond explaining the benefit of faster repayment until required to do so by the 36 month intervention.

Our survey suggests that firms routinely change the APR after people have taken out a subprime card: 50% of clients reported that the APR had increased during the time they had the card.[33] Sixty per cent also said that the minimum payment had increased – 75% of those affected by the latter said that an increase in minimum payments had caused them financial difficulties. As noted earlier in this report, many clients experienced hardship or took action that would compound financial difficulties, like missing utility payments or taking on additional debt, to continue to make minimum payments.

FCA rules are clear that firms should not increase payments where increased payments are unaffordable, but our evidence suggests firms are often not aware of, or are unresponsive to, repayment difficulty. Early experience of the persistent debt rules suggests firms may also propose a ‘recommended’ minimum payment, which may cause some confusion and lead people to make unaffordable payments. Firms’ interpretation of the persistent debt rules therefore has the potential to drive negative side effects, particularly in the subprime market segment.

At 36 months, the FCA rules require that firms take reasonable steps to help people repay the balance in a manner that does not cause them financial difficulty.[34] The rules suggest two options: increasing monthly repayments or transferring the outstanding balance to a personal loan with a fixed monthly payment (firms may, of course, also treat customers more favourably). The rules require that firms provide customers with a repayment plan over a ‘reasonable period’ of up to three to four years. Where the customer is unable to repay more quickly, the firm must show forbearance, for example by reducing, waiving or cancelling any interest or charges. (In this situation firms would usually be required to suspend the card.) An extension beyond four years can be allowed in exceptional circumstances but no additional cost can be incurred by a consumer.

Figure 11 illustrates the relative cost of different repayment options. The analysis illustrates the limitations of the persistent credit card debt rules in protecting subprime card borrowers from high costs: unless forbearance is applied, the cost of repayment is likely to exceed 100% of the amount borrowed. At higher APR levels, costs may exceed 200% of the amount borrowed. These repayment scenarios are relatively conservative and assume borrowers do not miss repayments or add to the outstanding balance.

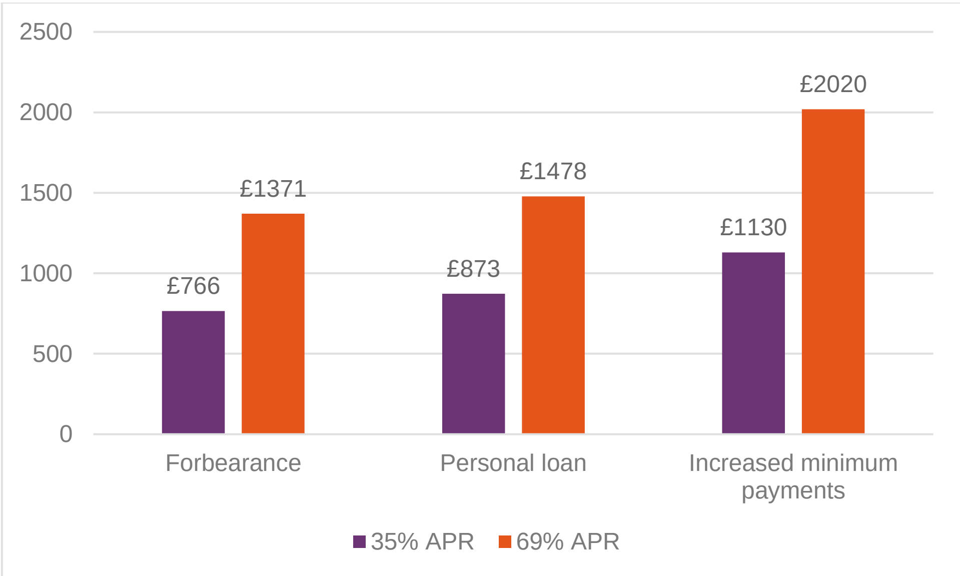
The analysis illustrates that the persistent debt rules will not offer a safe way out of debt for many subprime credit card borrowers. It also shows that, once firms are required to offer customers an affordable repayment plan after 36 months of persistent debt, the repayment option offered will have

[33] Firms are precluded from increasing interest rates where a customer is at risk of financial difficulties under CONC 6.7.10R other than where a promotional interest rate ends.
[34] (CONC 3.7.30)

a significant impact on the total cost of borrowing. Forbearance of interest charges may have negative side-effects through credit reporting but will lead to the most favourable cost for the borrower. Converting the remaining balance to a personal loan is likely to be the next most affordable option, followed by increasing monthly minimum payments to the amount necessary to clear debt within a reasonable period.

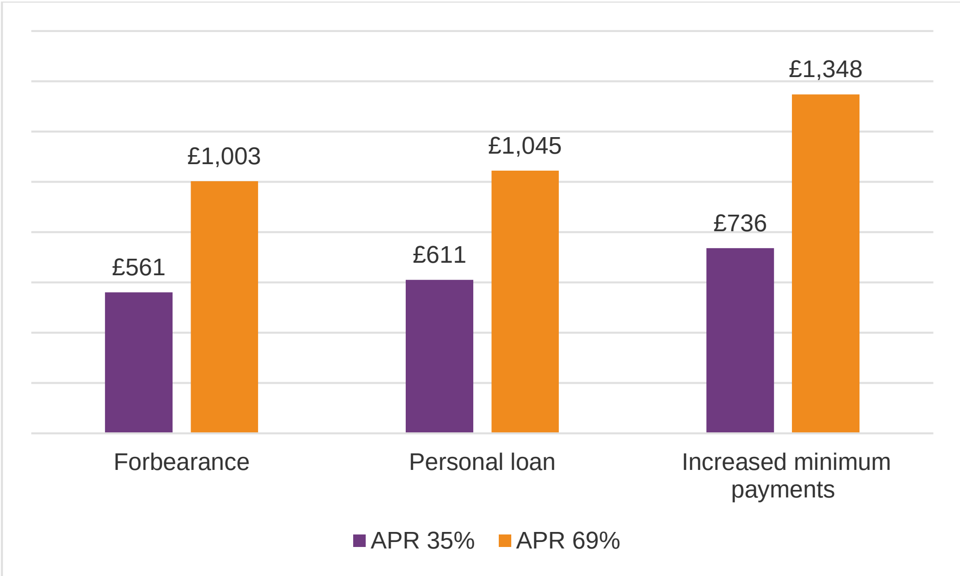
The FCA's rules deliberately do not specify, beyond applying forbearance where appropriate, that firms apply a particular repayment model to provide firms with flexibility. Not all firms will be able to offer options like converting an outstanding balance to a personal loan (because they do not offer personal loans). This limitation as well as a lack of clarity in the rules could lead to inconsistency, with different costs and outcomes for customers in similar circumstances.

Figure 11: Total cost of borrowing £1,000, repayment through persistent debt pathway (1% minimum payment)[35]



[35] We assume a borrower draws down £1,000 immediately and makes the monthly minimum payment for 36 months of 1% of the balance plus interest. We also assume the repayment plan put in place at 36 months is made over the subsequent 36 months (for a total of six years). We assume that forbearance means the waiving of all interest charges and fees and a personal loan APR of 9.9%. To identify a minimum payment necessary to clear the balance in 36 months, we assume the balance must be reduced to £200 (in the final months of a repayment plan, repayment would reach an increasingly small residual level until they reach the £5 minimum: in practice, it is likely all but the most financially constrained people would pay off the balance in larger instalments or in full at this stage).

Figure 12: Total cost of borrowing £1,000, repayment through persistent debt pathway (3% minimum payment)[36]



Those using subprime credit cards are particularly likely to be impacted by changes instigated by the persistent credit card debt rules. The choice of repayment option will matter a lot for the affordability and total cost of credit for people in persistent debt. The level of interest paid by many people with subprime credit cards raises a question about whether the remedies are sufficiently tailored for this product segment. Customers have an incentive to accept whatever a firm proposes to maintain access to the card or to avoid adverse credit record reporting (FCA rules do require that firms should not suspend a card if doing so would have a significant adverse impact on their financial situation). For many customers in the subprime market segment this is likely to result in long-term repayment and excessive costs.

[36] Assumptions as above with a monthly minimum payment for 36 months of 3% of the balance plus interest – at a minimum payment of 3%, the balance falls below £200 within 72 months without an adjustment to minimum payments.

4. Policy recommendations

Overall, 79% of the respondents to our survey who had used a subprime card felt that taking out a card overall had a negative effect on their finances, and only seven per cent felt that it had had a positive impact.

The problems experienced by clients fell broadly under three themes: the first is poor lending practices, with people taking on debt that is unaffordable to them, often while managing substantial existing credit card debts. Second, budgeting pressures and limit increases draw borrowers to use more credit than they can afford, and repayment difficulty is compounded by increases in interest rates and/or minimum payments. Third, due to these issues, subprime card users often have little choice, but long-term repayment and the cumulative cost of borrowing becomes high.

These issues are linked by the experience of financial difficulty; addressing problems in the subprime card market means engaging with the difficult question of whether credit products should be offered to people in, or at significant risk of, financial difficulty and, if so, how such products can work safely.

There is no one measure that will address the detrimental impacts of subprime credit cards. In the first instance, there is an urgent need for safe alternatives for people who need to borrow to meet essential living costs. StepChange has welcomed the government's work to scope a no interest loan scheme and would like to see a scheme piloted as soon as possible; there are many other opportunities to expand and support affordable credit. The government can also help by addressing avoidable drivers of debt problems in Universal Credit, such as the five-week wait and inflexible system of deductions to repay government and third party debts, and ensure the social security system provides sufficient support for those who cannot afford to borrow when they are faced with essential expenses.

Credit cards are likely to remain, however, the most common form of consumer credit and serve a useful function for many people, including many who borrow using subprime credit cards. Policy makers must therefore also focus on a coherent package of measures to ensure credit cards work well and safely for those who use them.

Our recommendations

The FCA should take action to ensure credit cards work safely for people at risk of financial difficulty by:

1. **Providing an update on supervisory work in the subprime credit card market setting out actions to address outstanding issues, focusing particularly on the impact of the persistent debt rules.**

   Following the credit card market study, the FCA required credit card firms to put in place a strategy to identify customers at risk of financial difficulty at an early stage and committed specifically to undertake supervisory intervention to address issues with the effectiveness of affordability assessments in the high risk market segment.[37] Our evidence also indicates that problems with affordability assessments have been extensive in the subprime market segment and that firms have also failed to respond appropriately to customers in financial difficulty, often increasing minimum payments and interest rates in circumstances in which they are unaffordable to borrowers.

These issues raise a fundamental question about expectations in the subprime credit card market where credit cards are targeted at people who are likely to be at significant risk of financial difficulty. In fact, our polling suggests that a high proportion of borrowers are *already in* financial difficulty when they take out a card.

The new persistent credit card debt rules also have the potential to drive unintended negative side-effects for subprime credit card users by prompting unaffordable increases in minimum payments. The FCA has proposed to evaluate the impact of the rules in 2022 or 2023; this is clearly too late to address emerging problems.

Given the impact of subprime cards on those in financial difficulty, the FCA should:

- Provide an update on its supervisory work in the subprime credit card market segment and set out to what extent it believes problems have been addressed, and what further action is necessary to ensure compliance with its rulebook;

- Issue guidance for firms that addresses the practice among firms of increasing minimum payments to ‘lift’ customers above the persistent debt threshold, clarifying that such changes should only be made where they are affordable, and that customers should have sufficient notice and the opportunity to decline such increases if they are not affordable;

- Commit to an interim review of the persistent debt rules in 2020 once the initial impact of the first three phases of intervention (at 18 months, 27 months and 36 months) have become clear; and

- Collect and publish data on the stock of accounts in persistent debt and flow of accounts in and out of persistent debt.

[37] Financial Conduct Authority (2016) MS14/6.3 Credit card market study – Final findings report. London: Financial Conduct Authority, p. 25 and p. 59.

2. **Strengthening creditworthiness and affordability rules to address poor lending practices in subprime revolving credit.**

   We have highlighted a number of issues beyond compliance that contribute to ineffective creditworthiness and affordability assessments, including a focus on affordability only in relation to the firm's own products and a failure to take into account multiple other credit cards (or other debts), and any assumption that lending is obviously affordable (perhaps linked to the low initial limit of many subprime cards).

   The FCA has recently made changes to its creditworthiness and affordability rules, clarifying particularly that creditors must obtain sufficient information and evidence to make effective affordability assessments, with the revised rules and guidance coming into force in November 2018.[38] We recognise that these changes can be expected to have a positive impact. However, these changes were not designed to address specific issues linked to revolving credit products offered to people at significant risk of financial difficulty.

   The FCA's rules require lenders to assess creditworthiness and affordability for running account credit by assuming the credit (whether a new card or a limit increase) is used at the earliest opportunity and repayments are made over a reasonable period.[39] The rules state that a 'reasonable period' should usually be defined with reference to the typical time required to repay a fixed-sum unsecured personal loan for an amount equal to the credit limit. This requirement is too ambiguous to lead to responsible decisions for subprime borrowers because personal loans are not typically available for balances below £1,000; credit options for lower sums, primarily high cost credit products, do not provide a suitable reference point.

   The FCA can usefully strengthen the rules to work well in the subprime segment. In doing so, it should take into account that cautious assumptions should be made when lending through revolving credit to people at significant risk of financial difficulty, particularly where they hold multiple credit products, due to the risk of borrowers under budgeting pressure experiencing repayment difficulty and/or a debt trap. It should also set a clearer definition of a 'reasonable period' for repayment by specifying that this should be no more than one year (but less where appropriate), reflecting the FCA's definition of high cost short-term credit.

   To address problems with subprime credit card creditworthiness and affordability assessments, the FCA should set out that firms in the high-risk revolving credit market segment:

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[38] Financial Conduct Authority (2018) PS18/19: Assessing creditworthiness in consumer credit. London: Financial Conduct Authority.
[39] FCA Handbook, Consumer Credit sourcebook 5.2A

- should make cautious assumptions about affordability and should not assume that lending is obviously affordable;

- must seek out sufficient information to identify those at risk of financial difficulty, particularly where consumers hold multiple revolving credit products; and

- should assess affordability assuming a reasonable repayment period of no more than one year.

3. Testing repayment sliders and, if the results show a positive impact on repayment patterns, require credit card providers to use sliders in a standard format.

Repayment mechanisms should seek to neutralise behavioural bias and make it easier for those using credit cards to make conscious, informed borrowing and repayment decisions. Some approaches, such as providing repayment prompts by text message, have been shown to be relatively ineffective by FCA research. The FCA has announced that it will consult on a 'de-anchoring' measure – where reference to the minimum payment amount is removed from repayment screens, nudging people to make a conscious choice about how much they can afford to repay – which has shown promise in increasing repayments among those who can afford to pay more than the minimum in some circumstances.[40]

Recent experimental work by the Behavioural Insight Unit has also indicated that the use of repayment 'sliders', which allow people to see the time to repay and cost of borrowing depending on the repayment amount they choose, encourage an increase in credit card repayments.[41] Over and above the FCA proposed de-anchoring measure, sliders do more to make the cost of credit cards more transparent and offset the complexity of credit card cost calculations. Crucially, repayment tools with representative examples should be made prominent at the point people make decisions about how to repay each month (i.e., set any direct debit or choose to repay the minimum amount) to encourage informed decisions about the impact of each option.

While many subprime borrowers have difficulty increasing repayments beyond the minimum, this approach is a promising way to help those who can afford to pay more make active, informed repayment decisions. The FCA should therefore work with firms to test this approach in a real-world context and, if shown to be effective, require firms to introduce repayment sliders prominently in repayment screens using a standardised format.

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[40] Ibid.
[41] Money Advice Service (2018) A behavioural approach to managing money: Ideas and results from the Financial Capability Lab. London: Money Advice Service.

4. **Requiring firms to use an opt-in system for all credit limit increases.**

In its credit card market study, the FCA noted (of the whole credit card market) that there was no 'clear causal link between credit limit increases and problem debt or widespread consumer detriment'.[42] Our evidence suggests it is unlikely credit limit increases are not contributing to debt problems in the subprime credit card market segment specifically. The FCA recently negotiated a voluntary agreement with firms to give customers the ability to opt-out of automatic credit limit increases when they take out a new card. Lenders have also agreed that those making minimum payments for eight months will not be offered a limit increase unless the customer specifically agrees to the increase; and those making minimum payments for 14 months will not be offered an unsolicited limit increase. These changes are welcome and we would expect them to have an impact. However, they have limitations in relation to subprime cards, which tend to advertise increasing limits as a card feature making an initial opt-out unattractive for many borrowers. It will also be relatively easy for borrowers to 'skim' above the voluntary thresholds by making one or more payments above the minimum. It is inconsistent to promote measures like de-anchoring that encourage consumers to make active decisions about credit use while failing to take action to give consumers active control over credit limits. The downsides of an opt-in system are very limited – 'low and grow' cards, for example, could still operate within an opt-in system – and its upsides in empowering people to manage credit use actively are significant.

5. **Examining and acting on consumer harm linked to 'credit builder' products.**

Products that are marketed as a means of building credit must be marketed and designed carefully. While there is a diverse 'new to credit' group, these products will inherently appeal to people who have experienced financial difficulty. Half of the respondents to our client survey who took out a subprime card for credit building purposes used it in practice for that purpose, indicating how frequently financial pressure is likely to lead to flexible credit products to be used in unanticipated ways. We have no data on the proportion of those who take out a subprime credit card who see an improvement in their credit score. Given the high proportion of subprime card borrowers who encounter financial difficulty or fall into arrears, it appears likely that as a credit builder product subprime cards are a gamble with potentially serious downsides.

Credit builder products may prompt those experiencing difficulty into behaviour that exacerbates their financial problems. Some respondents to our client survey, for example, had used a subprime card to try to rebuild their credit rating while they had debt problems, hoping that this would allow them to access lower cost credit and reduce their debt burden.

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[42] FCA (2017) Credit card market study: Persistent debt earlier intervention remedies - feedback to CP17/10 and further consultation. London: Financial Conduct Authority, p. 41.

Some clients appeared to erroneously believe they must borrow using a card and repay over time to achieve a positive impact on their credit file (rather than pay the balance in full each month).

In light of the risks of credit building products like subprime credit cards and their impact on financially vulnerable people, the FCA should use its recently commenced credit information market study to examine and act on consumer harm linked to credit builder products. There are a number of options available to the FCA, including proscribing inaccurate marketing of credit builder products, using disclosure requirements to better inform consumers, promoting myth-busting work with partners like the Money and Pensions Service, and addressing wider limitations of the credit information system to ensure those who have experienced financial difficulty do not feel under pressure to use expensive credit to demonstrate financial health.

6. **The government and the Financial Conduct Authority should protect financially vulnerable borrowers against unreasonable and harmful credit card costs.**

A cap on the cost of revolving credit has been proposed and received political and consumer support.[43] However, there is no reason to assume a cap is the best way of addressing excessive costs in the subprime market segment. The outcome policy makers should aim to achieve is to protect financially vulnerable borrowers against unreasonable and harmful costs.

The ideal way to meet this aim is to ensure products are designed in a way that is fair and prevents high costs from emerging. One way to address high costs is to increase the minimum payment to ensure that credit is cleared within a reasonable period. We also recognise there is a balance between increasing minimum payments and preserving the flexibility of credit cards that has a utility for borrowers.

There is no perfect statutory minimum repayment amount: this decision reflects a judgment about balancing timely, affordable repayment and preserving repayment flexibility. The present statutory minimum monthly credit card payment (1% of the outstanding balance plus interest and fees) is currently too low and contributes to the build-up of unaffordable balances and reinforces behavioural bias that leads to expensive long-term borrowing and problem debt.

There is significant scope to pursue different repayment models that strike a better balance. One way of meeting this aim is to ‘fix’ payments as a proportion of the card balance: this means that, instead of declining over time as a credit card balance declines, minimum payments work more like the monthly repayments of a term loan. This approach has a dramatic effect on time to repay and costs: for example, fixing repayments of a card with an APR of 35% at 3% leads to a monthly payment of £55 and prompt paydown within in 24 months. Figure 13 illustrates two further scenarios that demonstrate the benefits of this approach.

This type of model would also help improve affordability judgements as lenders would need to assure themselves minimum payments at this level are affordable for borrowers when offering new cards.

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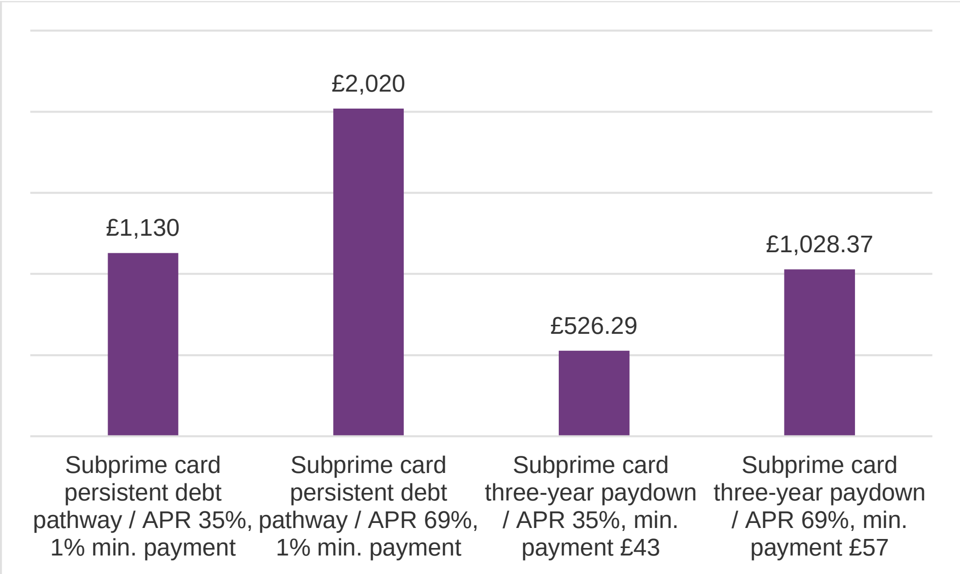
[43] ‘Labour to pledge help for millions trapped by credit card debt’, Rowena Mason, The Guardian, 24 September 2017.

We would expect any increase to apply only to new credit card lending to avoid creating any income shock for existing borrowers.

Following the credit card market study, the FCA chose not to pursue an increase in the statutory minimum credit card payment, citing the potential of its 'de-anchoring' measure (noted above).[44] De-anchoring has potential but has limitations in the subprime sector where it is imperative products are structured in a way that prevents difficulties and people often become constrained in their repayment options. The FCA should continue to conduct behavioural research and work with firms to test different credit card repayment models to inform its regulatory approach; including more effective approaches like the fixed repayment model that is tailored for the high-risk market segment.

Figure 13 illustrates the significant benefits of a fixed minimum payment model. For comparison, the cost of borrowing £1,000 over three years using a credit union at an APR of 42.6% would be £649 and a guarantor loan at an APR of 49.9% £757 – each products potentially available to subprime borrowers. The scenarios (and analysis earlier in this report) also illustrate that the persistent debt rules alone will not effectively end excessive costs in the subprime market segment.

Figure 13: Subprime credit card cost comparisons (£1,000)[45]



Those using subprime credit cards are particularly vulnerable to costs that are excessive relative to a low household income and other credit products that may be available to them. They have limited choice of borrowing options, are motivated to borrow by urgent living costs and are constrained in how quickly they can afford to repay debt. The borrowers we encountered who were conscious of the

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[44] 'FCA publishes outcome of testing behavioural remedies to address under repayment of credit card debt', Financial Conduct Authority notice published 26 July 2018.
[45] Persistent debt assumptions as for figure 11. Three-year repayment assumes minimum payment is fixed at first month at level needed to pay down balance within three years in equal monthly instalments.

high costs they had incurred were not prepared for the scale of costs and did not believe the amount of interest they had paid was fair.

StepChange has argued that firms should not profit from consumer vulnerability, biases or constrained choices.[46] The best way to deal with excessive credit card costs is to prevent them from emerging through effective affordability assessments and good product design – in this case through higher minimum payments. However, there remains a strong case for a 'backstop' total cost cap on revolving credit because even significant increases in minimum payments would not entirely eliminate excessive costs; in the absence of reform of minimum payments, this case is stronger.

Credit cards are fundamentally flexible products, with flexible borrowing and repayment terms: this means that the design of a cap is not straightforward. A cap should seek to balance retaining the flexibility of credit cards that allows households to flex their budget with the need for safe and fair products. A total cost of credit cap would address excessive costs that arise through long-term credit card debt. The high cost short-term credit (HCSTC) and the recent cap on the cost of rent-to-own products, both set at 100% of the loan amount, have established a precedent for assessing whether credit costs are excessive. Credit card balances, including in the subprime market segment, tend to be higher than for these products – in thousands rather than hundreds of pounds – and the impact of interest charges on households proportionately greater. The case for a total cost of credit cap is arguably stronger in the subprime card market segment.

Any cap would create an imperative for matching intervention to protect existing credit card holders against excessive costs given limitations of the persistent debt rules. This aim could be achieved pragmatically by requiring firms to suspend interest for customers in persistent debt for three years, i.e., beyond the 36-month threshold. (The suppression of interest through the persistent debt remedies would not, however, be an effective alternative to a cap because people may move in and out of persistent debt but nevertheless incur high costs; this approach also has the downside of leading to different 'caps' for those with different borrowing interest rates.)

Credit caps may have negative side-effects, such as reduced access to credit that provides a valuable utility for borrowers, prompting firms to recoup costs through alternative means like fees and add-ons, or the displacement of borrowing to more expensive and less safe products.[47] These risks means that a cap requires careful design to balance risks and benefits. However, some of these side-effects may have positive outcomes, for example by reducing unaffordable borrowing and diverting people from subprime products to more affordable alternatives.

The discussion about a total cost of credit cap raises several questions that deserve further attention. The first is that the threshold at which a cost caps are set requires careful thought. Comparisons with other products like credit union or guarantor loans potentially available to subprime borrowers suggest that 100% of the amount borrowed represents a premium over an appropriate long-term borrowing rate, even allowing for the additional flexibility and risk premium of revolving credit products. Credit cards costs could be judged to be excessive below a technical 100% threshold.

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[46] StepChange (2018) Response to FCA DP18/5: a duty of care and potential alternative approaches
[47] Ferrari, A. et al. (2018) Interest Rate Caps: The Theory and The Practice. Policy Research working paper; no. WPS 8398. Washington D.C.: World Bank Group.

The second is that alternative models for restraining credit card costs exist internationally; for example, through the ‘taux d’usure’ in France, which is an APR cap set at one third above the average of APR rates over the most recent quarter, or the interest rate cap in Germany, which is twice the average market rate.[48] These kind of limits have some advantages, such as being preventative and more flexible than a total cost of credit cap. However, interest rate caps in France and Germany sit alongside greater national and local support for social lending models through regional banks and co-operatives. Past research has also highlighted that credit regulation of this kind may be linked to negative side-effects like an increase in illegal lending, although the absence of independent comparative research makes objective analysis of these models difficult.[49]

The international context is worth bearing in mind given that the UK has a comparatively large subprime lending market: understanding affordability relative to a 100% cost cap or other products in the subprime market may lead to a distorted sense of an appropriate cost of credit. A more objective understanding of the impact of costs on households (or the extent to which costs can be justified by responsible commercial lending models) has the potential to prompt a wider discussion about the balance between a commercial credit market, proportionate regulation and social lending alternatives.[50] Policy makers should not underestimate the range of options available to them to provide better alternatives to subprime credit products for households.

[48] www.economie.gouv.fr/particuliers/taux-usure; Faherty, M. et al (2017) Interest Rate Restrictions on Credit for Low-income Borrowers, Centre for Co-operative Studies on behalf of the Social Finance Foundation.
[49] Policis (undated) Economic and Social Risks of Consumer Credit Market Regulation
[50] Faherty, M. et al (2017).

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With thanks to Lu Stanton-Karczewska and Joshua Sidebottom, StepChange Business Information team.

For help and advice with problem debts call (Freephone) 0800 138 1111 Monday to Friday 8am to 8pm and Saturday 8am to 4pm, or use our online debt advice tool.

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