TACKLING PERSISTENT CREDIT CARD DEBT

RESPONSE TO THE FCA CONSULTATION CP17/10

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CONTENTS

INTRODUCTION

This paper is the response of the New Economics Foundation (NEF) and Centre for Responsible Credit (CfRC) to the Financial Conduct Authority (FCA) consultation on the new rules and guidance proposed to address persistent credit card debt. Below we set out three concerns with the FCA's proposed approach, and recommendations for addressing these.

Specifically, we recommend that the FCA:

1. **Bring forward the intervention points for addressing persistent debt from 18 and 36 months to 12 and 24 months.**
2. **Extend the total cost of credit cap of 100%, which is currently in place in respect of High Cost Short Term Credit products, to the credit card market.**
    a. Credit card lenders should conduct an immediate exercise to determine which borrowers have already paid in excess of 100% of the principal advanced in interest and other charges and, where this is the case, be required to write off any outstanding amounts.
    b. Moving forwards, lenders should be required to put in place adequate systems for the monitoring of the level of interest and other charges levied on accounts relative to amounts of principal drawn down (including where refinancing has occurred through the use of balance transfers). Extending the total cost for credit cap of 100% to this market would ensure that people do not get trapped in persistent debt, and would be the single most effective measure that the FCA could take to deliver this outcome.
3. **Require lenders, at the second intervention point, to ensure that the repayment plan is affordable by either reducing the interest rate or reducing the balance on the principal.** The FCA should strengthen the forbearance rules to require lenders to consider the borrower's Debt Servicing to Income (DSI) ratio, including what they are spending on other loans, as part of ensuring affordability.

NEF and CfRC welcome the FCA's focus on credit card debts and its concern for borrowers who have high or persistent debts and face expensive charges and interest rates, with little prospect of paying off their debts within a reasonable timeframe. The consultation paper demonstrates how seriously the FCA takes the issue of personal debt and its commitment to protecting borrowers from unjust or damaging treatment.

We share the FCA's concern about the scale, persistence and cost of credit card debts in the UK economy, having witnessed these debts accumulating at the fastest rate in a decade. Our analysis[1] shows that:

- Consumer credit debt reached £236. 5 billion at the end of 2016, exceeding its pre-crisis peak of 2008 by 4.6%.
- Although consumer credit debt makes up around 15% of total household sector indebtedness, it accounts for around half of the total interest payments that households are making and currently stands at £28.3 billion per year.
- Credit card debt now accounts for 41% of all consumer credit debt, compared to 33% in 2008.

Action is vital to reduce the scale of credit card debts and prevent their accumulation in the future for three reasons:

1. High levels of costly personal debt risk suffocating the economy at a time when, with Brexit on the horizon, maximum economic strength is vital. Sustainable economic growth will not be possible until personal debt levels are reduced.
2. Debts are harming individuals' and families' ability to make ends meet with negative consequences for their health, mental health, relationships and working life.
3. Some lenders are taking advantage of the financial struggles of some households; a society that upholds justice should seek to prevent lenders from providing debt for borrowers who will struggle to pay it off.

DEFINING THE PROBLEM

The definition of persistent debt proposed by the FCA is where the amount paid on interest and charges compared to the amount of the principal repaid exceeds a ratio of 1:1 over an 18 month period.

In our view this definition of persistent debt is a good indicator of the problem but it is not a definition of the problem itself. The problem borrowers currently face with long-standing credit card debts is threefold:

1. Inability to get free from debt within a reasonable time period
2. Payment of an unfairly high total cost for credit
3. Inability to repay the debt without reducing spending on basic needs, resulting in deprivation

As the proposed definition focuses only on the relative amounts of interest and principal paid, it is not sufficient for addressing this threefold problem. Specifically, it overlooks:

1. **Reasonable timeframes.** Beyond 12 months most credit card products become an expensive way to borrow. If a borrower has paid more interest than principal over one year, then logically they are already experiencing persistent debt. Waiting for 18 months until the first intervention and 36 months for the second intervention, then scheduling repayment over a further 3-4 years will not help people to get free of debt within reasonable timeframes.
2. **Cumulative cost.** The total cost of credit to the borrower is not a factor in the proposed remedies. Our modelling suggests that many customers will already have paid more than 100% in interest payments by the time they have been in persistent debt (according to the definition) for two consecutive periods of 18 months. At this point they will have exceeded the cost of credit cap applied to other forms of high-cost short-term credit (but not currently applicable to credit cards).
3. **Affordability.** Ability to repay debt without causing further financial difficulties or resulting in household deprivation depends on the ratio of Debt Servicing to Income (DSI). This is not made explicit in the proposed interventions, meaning that repayment renegotiations could result in payment schedules that cause borrower detriment through inability to afford essentials.

In the following sections we consider each of these elements in turn and make recommendations for addressing them through adjustments to the proposed remedies.

REASONABLE TIMEFRAMES

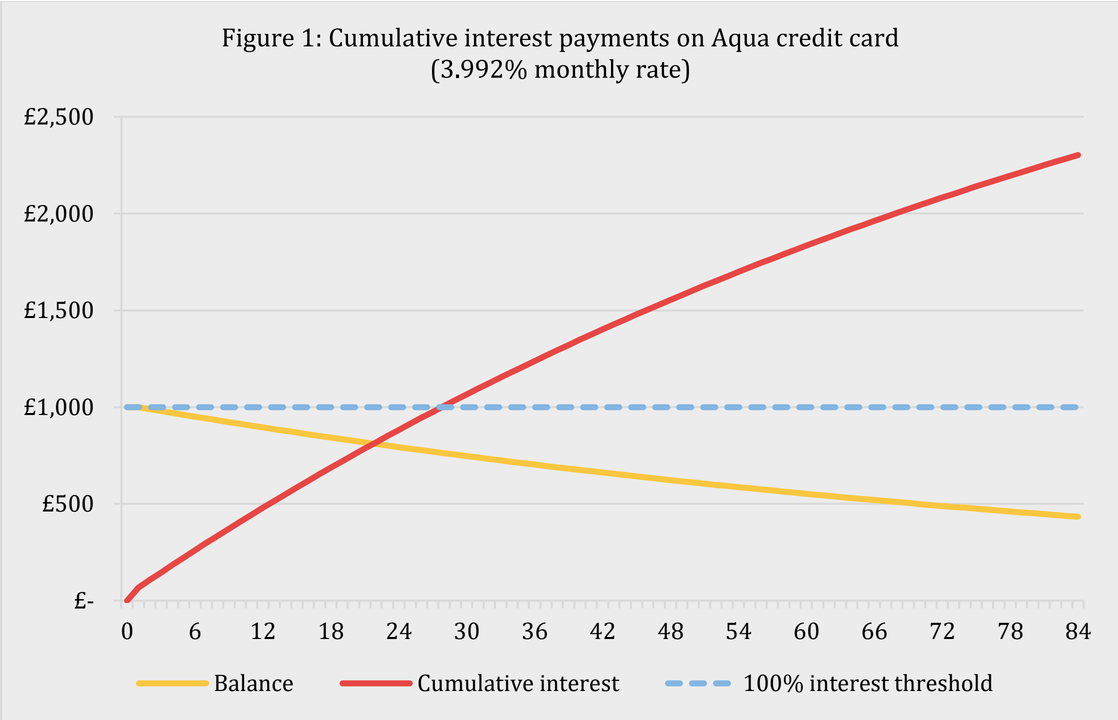
Credit cards are suited to short-term borrowing and are – as the FCA state in the consulation paper – an expensive way to borrow over a long period. Addressing persistent debts which are not being cleared within a reasonable timeframe is therefore an important policy goal.

Our concern is that the 18 month period for the definition will mean that borrowers will have already paid a high cost for their credit before the the lender has any duty even to contact them. Likewise, waiting until 36 months to offer any substantive help to borrowers will result in further costly interest payments, and many borrowers who are struggling financially are also likely to have incurred additional charges for missed payments in that timeframe.

For example, our analysis – depicted in Figure 1 – shows that someone who borrowed £1,000 from an Aqua credit card with a monthly interest rate of 3.992% and making minimum monthly payments will already have paid:

- £480.57 interest by 12 months
- £687.64 interest by 18 months
- £882.59 interest by 24 months
- £1006.17 interest by 28 months
- £1238.93 interest by 36 months

This analysis is a conservative estimate which overlooks the fact that many borrowers will incur additional charges for missed payments, and that some will have taken cash advances at higher rates of interest when in persistent debt. Factoring in these additional charges would mean that the point at which these borrowers have paid a total cost of credit of 100% of the principal is moved forwards.



Repayment in 12 months is the basis on which the FCA requires creditors to calculate the APR when advertising and illustrating the cost of credit cards and reflects an appropriate use of this credit product. Yet products are not structured in a way to deliver this, and the APR calculation and illustrations given to borrowers are therefore misleading. Just as payday loans extended beyond 30 days became an expensive problem for borrowers and was addressed by the regulator, credit cards being extended beyond 12 months should be treated as persistent debt.

On this basis, we recommend that the interventions be brought forward to 12 months and 24 months respectively.

CUMULATIVE COST

The FCA's analysis finds that people falling into its definition of persistent debt are typically paying approximately £2.50 in interest and charges for every £1 of their balance they repay.[2] This is considered to be too high a cost, but otherwise no mention is made of an appropriate total cost for credit.

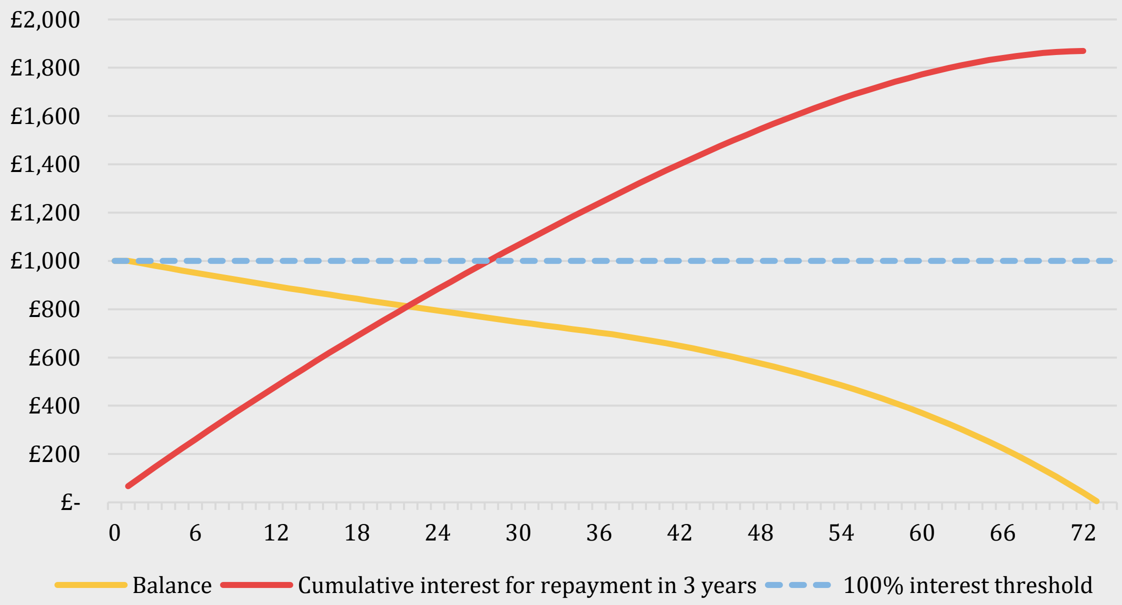
Given that the total cost to the borrower of high-cost short-term credit has been capped at 100%, it is unfair that credit card products can end up costing as much as 250% in interest and other charges.

Returning to the indicative example above, under the current proposals, by the time the borrower is contacted at 18 months they will have paid 68.8% interest; and they will only be contacted again at 28 months, by which time they will have paid over 100% interest (100.6%).

Remedies to help such a borrower to repay more quickly would only be triggered at 36 months, by which time they will have paid 123.9% interest. This is assuming no missed payments or cash advances which would have further increased the cost of credit through additional charges.

If the creditor then proposes a new repayment plan to pay off the debt within the period considered 'reasonable' by the FCA – a period of three to four years – then a borrower in the above situation, assuming they agree a fixed repayment schedule of the kind proposed by the FCA (in this case set at £33.05 per month) will ultimately pay a total of £2,096.03 interest in four years, or 209.6% of the principal amount borrowed. If they were able to agree a payment plan to repay in three years (at fixed monthly payments of £36.73, modelled below in Figure 2), they would still pay £1869.47 interest; 186.9% of what was borrowed.

Figure 2: Cumulative interest payments on Aqua credit card (3.992% monthly): Repayment plan over three years following FCA-proposed second intervention



The FCA has a duty under Section 137C of the Financial Services (Banking Reform) Act 2013, "to make general rules with a view to securing an appropriate degree of protection for borrowers against excessive charges".

In order to protect credit card users from excessive charges and to ensure that it is not possible to charge unfairly high costs for borrowing on any credit product, **we recommend that the FCA extend the total cost of credit cap of 100% to credit cards**.

Credit card lenders should conduct an immediate exercise to determine which borrowers have already paid in excess of 100% of the principal advanced in interest and other charges and, where this is the case, be required to write off any outstanding amounts.

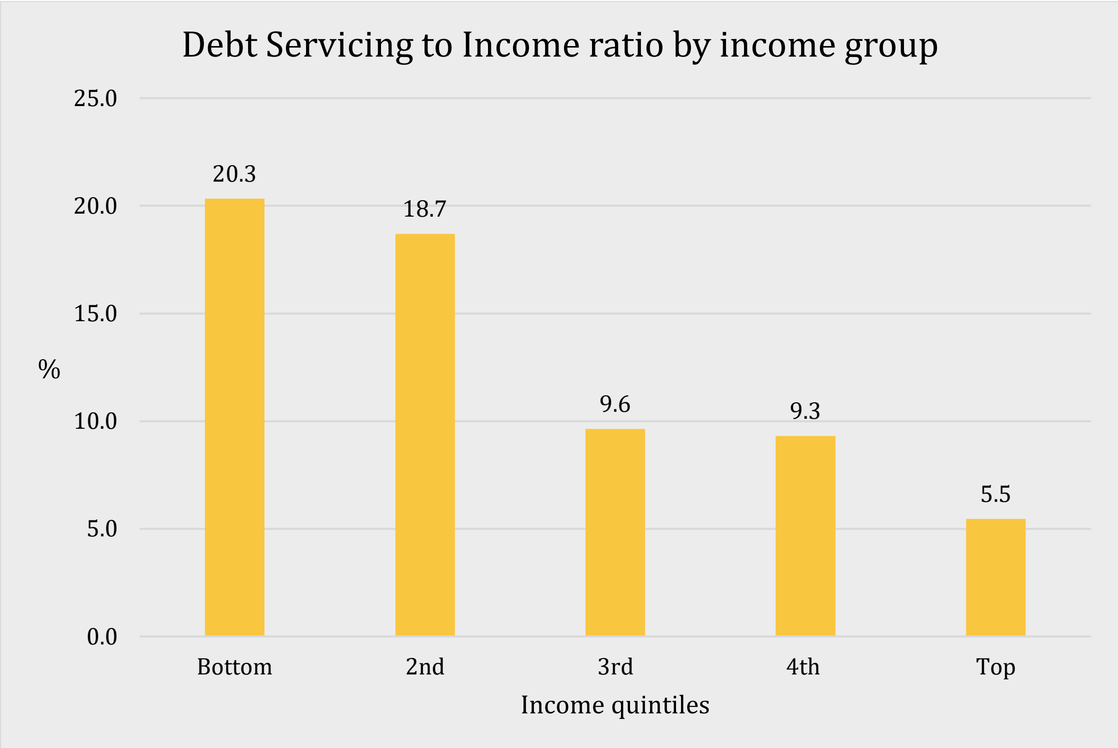
Moving forwards, lenders should be required to put in place adequate systems for the monitoring of the level of interest and other charges levied on accounts relative to amounts of principal drawn down (including where refinancing has occurred through the use of balance transfers). In the case of borrowers at the first or second intervention point this would mean that interest payments would stop once the 100% threshold had been reached.

Extending the total cost for credit cap of 100% to this market would ensure that people do not get trapped in persistent debt, and would be the single most effective measure that the FCA could take to deliver this outcome.

AFFORDABILITY

Under the current proposals there is no guarantee that repayment schedules agreed at the second intervention point will be affordable to borrowers. This presents a significant risk that the intervention could lead to borrowers feeling pressured into agreeing to monthly repayments which are more than what they are currently paying and are not affordable unless they cut back on other essential spending, for example on food and household bills. This is a well-known phenomenon, often occurring when creditors approach borrowers to offer them settlement deals, and one which the debt advice sector has worked hard to prevent with its clients on the basis that unaffordable repayment plans cause further detriment, either through deprivation or by triggering other debts used to cover the costs of repayment.

We consider the risks regarding affordability to be especially high given the current context, in which debt servicing already represents a large cost in household budgets. Our analysis shows that around 4.8 million households containing 11.4 million people with a pre-tax income of £25,000 or less are already spending on average one fifth of their pre-tax monthly income on payments for consumer debts.[3]



Given that rent is typically 30% of incomes, we expect that these debt payments are already impacting on people's ability to pay for essentials. If the proposed interventions go ahead without consideration of DSI levels our concern is that the proposed remedies will in fact worsen the situation for low income households.

Therefore, we recommend that at the second intervention point **lenders should be required to either reduce the interest rate or reduce the balance on the principal** in order to reduce the DSI to an appropriate level. We recommend the FCA strengthen the forbearance rules to require lenders to consider the borrower's Debt Servicing to Income (DSI) ratio, including what they are spending on other loans, as part of ensuring affordability.

ENDNOTES

[1] CfRC analysis of the latest data from the UK Economic Accounts released by the Office for National Statistics on 31st March 2017 (covering the period up to December 2016) and from the Bank of England's NMG Consulting survey.
[2] Paragraph 2.12 of consultation paper CP17/10.
[3] CfRC analysis of the Bank of England's NMG Consulting survey, conducted in August and September 2016, covering 6,011 UK households. The survey data was released by the Bank of England in December 2016.