

UK credit cards – an industry in decline?

April 2007

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Publisher

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Peter's other publications include *Rethinking Banking Efficiency*, an important study that challenges established approaches to the measurement of bank efficiency.

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Abbreviations and conventions

| | |
|----------------------|---|
| Balances outstanding | The stock of credit outstanding (which may include interest-free balances) on cards at a given date |
| Billion | 1,000 million |
| bn | Billion (eg £25bn) |
| m | Million (eg £132m) |
| na | Not available |
| nya | Not yet available |
| Nominal | Change in value unadjusted for inflation |
| Turnover | The value purchases and cash advances on cards during a given period |
| , (comma) | thousands (eg 1,000) |
| . (dot) | decimal point (eg 100.5) |

Acknowledgements

Peter Welch would like to thank David Dooks, director of statistics at the British Bankers' Association for his help clarifying various aspects of credit card statistics.

Peter would also like to thank ECR editor Richard Rolfe and industry consultant Steve Round for their comments on a draft of the report.

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Introduction

40th birthdays are often traumatic events. Celebrations are generally muted as youth gives way to middle age. For the UK credit card industry, its 40th birthday in 2006 proved to be no exception.

Back in 1966, Barclays had introduced the credit card to the UK with its iconic Barclaycard. In doing so, it launched a multi-billion pound industry. The credit card became a consistent provider of growth and profits to UK banks and other card issuers. No other country in Europe achieved anything on a comparable scale.

Yet 40 years on, the industry was in no mood to celebrate. After years of uninterrupted growth, credit card issuers found themselves struggling with declining volumes, rising bad debts and a host of regulatory pressures.

During 2006, the overall size of the market actually shrank. Spending and borrowing on credit cards fell in nominal as well as real terms.

In addition to the unaccustomed experience of market contraction, the industry faced further specific pressures on its profitability. Important revenue streams such as interchange income, late payment fees and payment protection insurance commissions are subject to extensive regulatory scrutiny. Further, deteriorating loan quality has forced issuers to increase their bad debt provisions.

The experience of 2006 raises important questions for the industry's long-term future. Do the changes represent little more than a cyclical adjustment as consumers' take-up of credit inevitably slows? Or do they represent a more substantial change, signalling the start of a sustained period of market contraction. And with the pressure on income and costs, how can issuers sustain their profitability? The report offers a timely analysis of these questions.

Structure

The report is divided into five main sections:

1. The first section examines trends in spending and borrowing on credit cards in the UK.

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2. The second section examines the competitive structure of the market, looking at market segments and (to the extent that available data allows) the market shares of individual issuers.
3. The third section examines recent regulatory developments – focusing on those related to credit card default charges, payment protection insurance and interchange – which are having a significant impact on industry profitability.
4. The fourth section examines industry economics, analysing the impact of market trends, competitive and regulatory developments on the industry's main revenue and cost streams.
5. The final section looks at the industry's prospects and considers future developments in light of the tougher market conditions now facing the industry.
6. An appendix provides further details on the main statistical series used in the report.

Coverage

The credit card business comprises card issuing and merchant acquisition. The report focuses on the card issuing business, the issuing of credit cards to personal customers as a means of payment and source of revolving borrowing. The report does not cover the merchant acquisition business (the acquisition and processing of card payments for merchants).

1. Trends in credit card use

1.1 Structure of card use

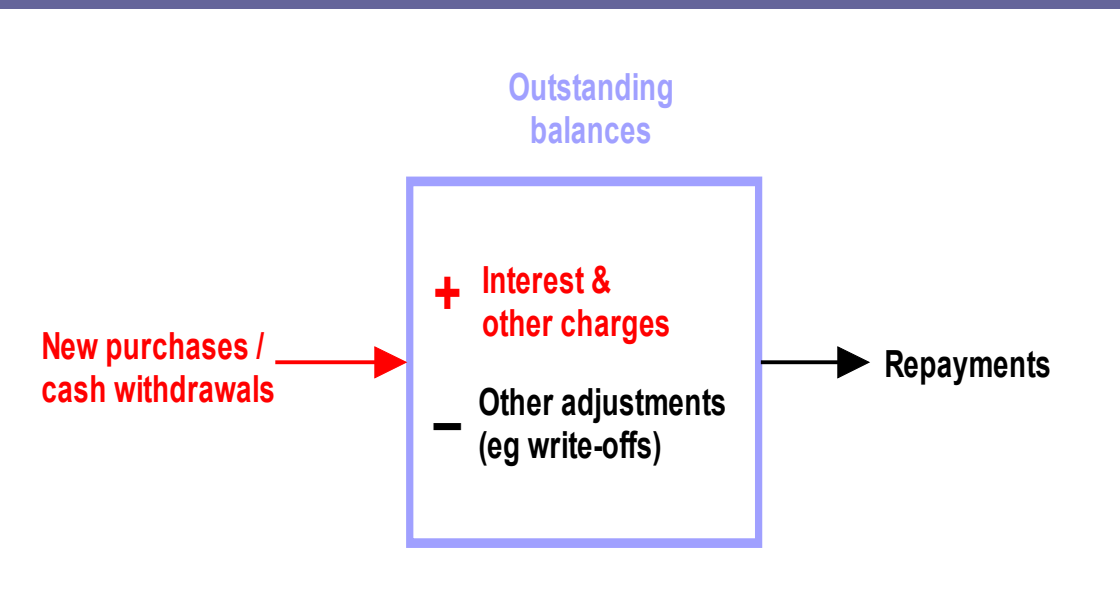
Analyses of overall credit card trends usually focus on three core measures:

- The number of credit cards and accounts
- Credit card turnover – ie the value and number of card transactions (purchases and cash withdrawals)
- Credit card borrowing – the value of credit outstanding on card accounts

Before looking at the latest trends in each, it is worth noting that the relationship between card turnover and card borrowing is particularly important in analysing trends in card use.

Technically, each purchase and cash withdrawal on a credit card is a new loan, even if the account is repaid in full each month. The value of card turnover measures the flow of new card lending during a period. The value of card borrowing measures the stock of credit outstanding at the end of a period (chart 1).

1. Relationship between card turnover and borrowing



Source: Author

Broadly, during a given period, the **change in the stock of credit outstanding** equals the value of **new card turnover + interest**

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and other charges minus the value of **repayments + write-offs and other adjustments**.

The relationship between the flow of new lending and the stock of credit outstanding – ie the rate at which debt is turned over – varies significantly between loan types.

Credit cards have high flows relative to outstanding credit because of the use of cards as a means of payment (and this is accentuated if charge cards are included in the credit card data – as is the case with the British Bankers' Association data on UK credit card use which is drawn on in the report).

In contrast, instalment loans for high value items such as cars repayable over several years have much lower new lending flows relative to outstanding credit.

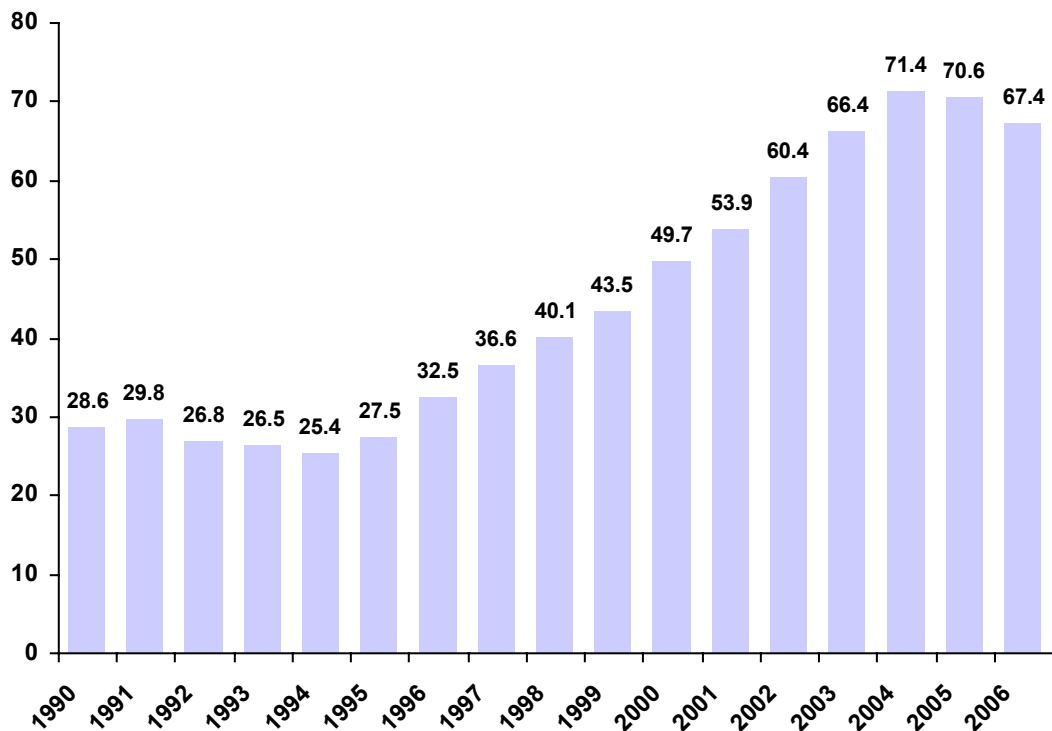
In the case of credit cards, changes in this relationship between the flow of transactions and stock of outstanding credit are significant because they indicate the extent to which cards are being used simply as a means of payment and the extent to which they are being used as a means of borrowing.

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1.2 Number of cards and accounts

The number of credit cards in issue fell during the early 1990s following the short-lived introduction of annual fees by the main issuers. Since then, the number of cards in issue has risen almost threefold, peaking at more than 70 million in 2004.

2. Credit cards in issue (millions)



Notes:

1. Chart covers Visa and MasterCard credit and charge cards in issue only.
2. The number of cards is as at December each year.
3. The coverage of the APACS statistics referred to in the commentary is marginally different from the BBA statistics. APACS reports 69.9 million credit cards and 4.7 million charge cards for 2005, though its coverage includes cards other than Visa and MasterCard cards.

Source: British Bankers' Association

However, as the chart shows, card numbers have since started to fall. This indicates the change in market environment discussed more fully below in the analysis of turnover and borrowing statistics. The introduction of chip and PIN is also likely to have reduced card numbers.

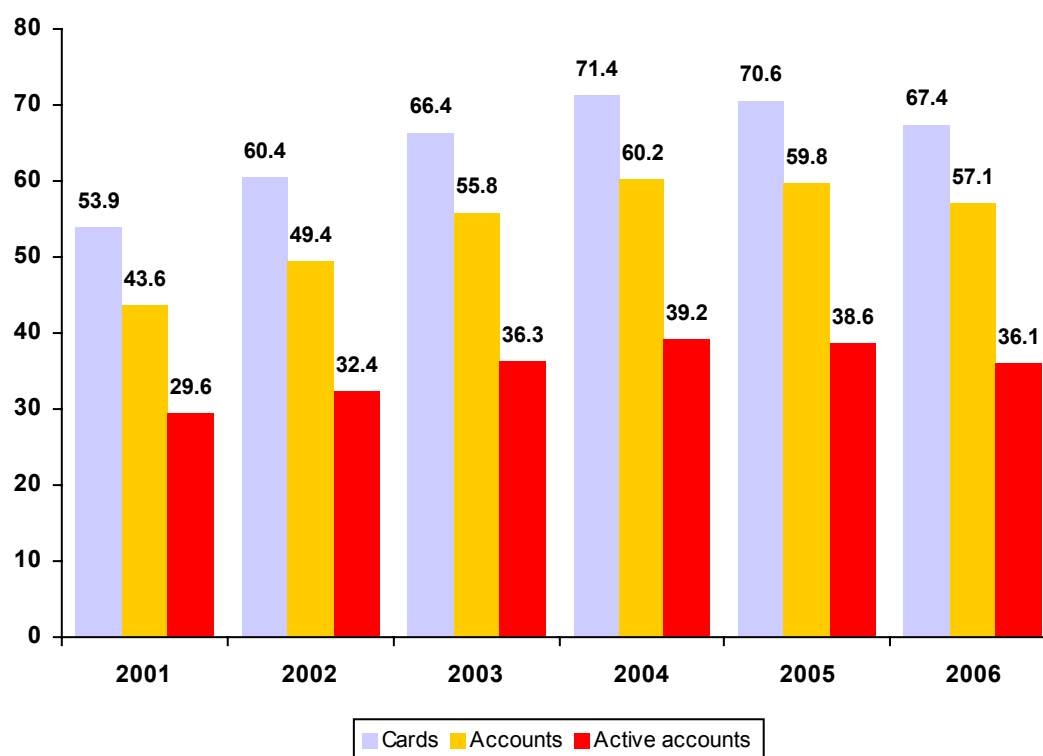
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The rise in the number of cards in issue in the years to 2004 was due both to an increase in the number of cardholders and the growth in multiple cardholding.

According to statistics from APACS, the number of personal credit and charge cardholders reached 31.6 million in 2005, just over two-thirds of the over-18 population. It has grown by 14 million over the past ten years.

As of 2005 according to APACS, the average number of credit cards per person was 2.4. This compares with approximately 1.5 credit cards per person a decade earlier.

3. Credit cards and accounts (millions)



Notes:

1. Chart covers Visa and MasterCard credit and charge cards in issue only.
2. The number of cards and accounts is as at December each year.
3. Active accounts are defined as those with a balance outstanding as at the end of December.

Source: British Bankers' Association

However, even adjusting for multiple cardholding, the number of cards in issue is of only limited value as an indicator. There will be more cards than accounts (reflecting multiple cards on a single

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account). And, particularly during a period when multiple cardholding grows, many accounts may become inactive as cardholders switch from old to new cards.

Though data on accounts is only available from 2001, it shows that there were 36.1 million active accounts at end 2006. This compares with more than 57 million accounts in total and more than 67 million cards.

The number of active accounts has fallen during the last two years, from a peak of 39.2 million at end 2004 to 38.6 million at end 2005 and then 36.1 million at end 2006 (chart 3). In only two years, the number of active accounts has fallen by 8%.

Active accounts represented 63.3% of total accounts at end 2006, a ratio that has fallen during the last five years from 68.0% at end 2001.

Looking more closely at the last full year - between end 2005 and end 2006, the ratio of active accounts to total accounts fell from 64.6% to 63.2%. The fall of 2.5 million in the number of active accounts between end 2005 and end 2006 was almost as high as the overall fall of 2.7 million in the number of accounts. The decline in the number of active accounts indicates that a significant number of cardholders have stopped using their credit cards.

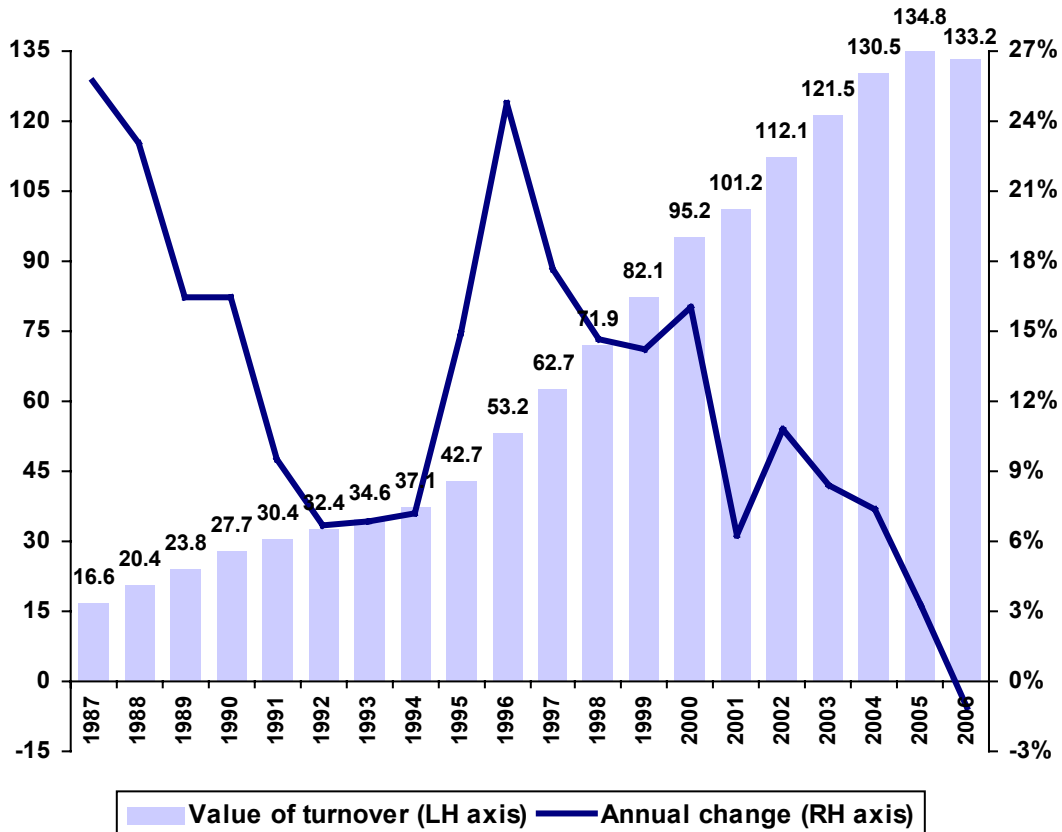
There are signs that issuers are now responding to the decline in activity through clearing out their portfolios. For example, Barclays reported that Barclaycard's UK customer numbers declined 1.4 million during 2006 to 9.8 million. Barclays said this reflected the closure of 1.5 million inactive accounts.

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1.3 Trends in credit card turnover

Credit card turnover covers purchases and cash advances on cards. Chart 4 shows the value of turnover on UK-issued Visa and MasterCard credit cards during the last two decades.

4. Value of credit card turnover (£ billion)



Notes:

1. Chart covers Visa and MasterCard credit and charge cards in issue only.
2. Turnover covers both purchases and cash advances.

Source: British Bankers' Association

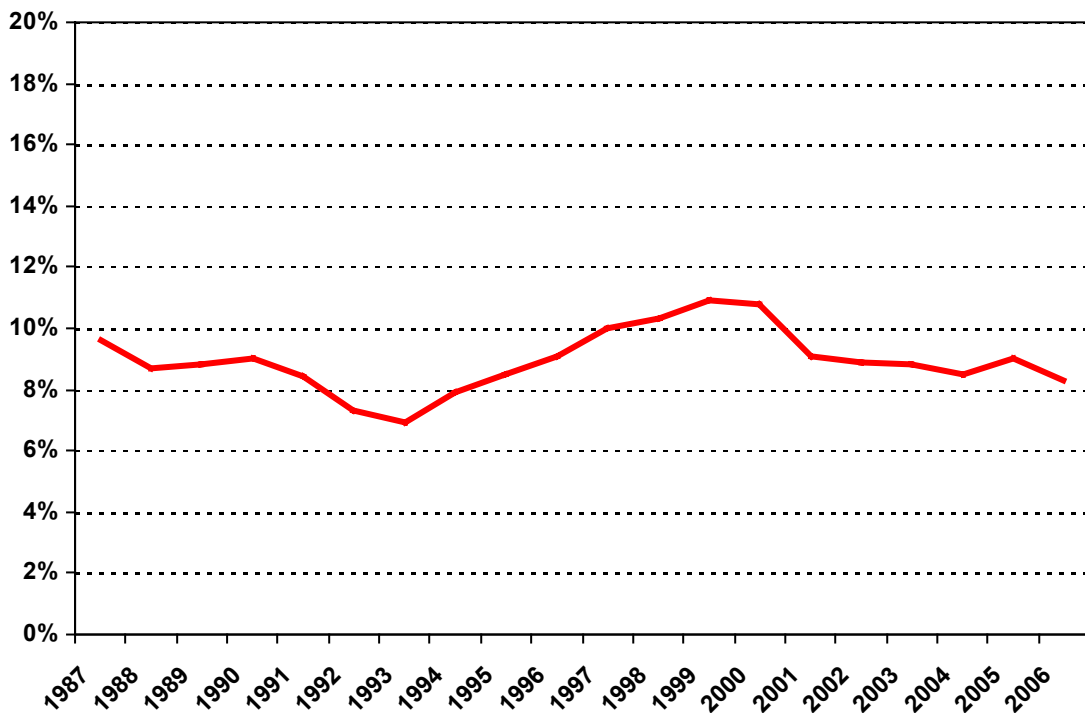
Credit card turnover increased more than threefold in nominal terms between 1995 and 2005, from £42.7 billion to £134.8 billion.

However, as the chart shows, the annual rate of growth has showed sharply during recent years. The rate of growth in fell below 10% in 2003. By 2005, it had fallen to 3.3%, little more than the rate of inflation. And, for the first time in at least two decades, nominal turnover on credit cards fell during 2006. Turnover of £133.2 billion in 2006 was 1.1% lower than the previous year.

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It is worth noting that cash advances on credit cards have not changed significantly as a proportion of card turnover by value. They accounted for 8.3% of card turnover in 2006, within the 8-9% range of recent years. Cash advances remain a secondary use of cards, though a lucrative source of income for issuers given the fees charged on credit card cash withdrawals.

5. Cash advances as a proportion of card turnover



Note:

Chart covers Visa and MasterCard credit and charge cards in issue only.

Source: British Bankers' Association

Looking at the use of credit cards as a means of payment, they have been diminishing in importance relative to debit cards in the UK for many years.

Debit cards were introduced later than credit cards in the UK and positioned by banks as a complimentary, cheque replacement product. However, despite the cash-flow benefit offered by credit cards, debit cards have become the payment instrument of choice for many UK consumers.

The value of payments on UK-issued debit cards has long since passed the value of payments on credit cards. According to

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statistics from APACS (which are not an exact match for the BBA statistics), debit cards accounted for more than 60% of the combined £320.7 billion of credit and debit card payments in 2006.

By number, debit cards account for an even higher proportion of card payments, reflecting the lower average transaction value on debit cards. According to APACS, debit cards accounted for over 70% of the 6.43 billion card payments in 2006.

However, the rapid growth in debit card payments is well established and pre-dates the recent deceleration of growth in credit card turnover. The striking feature of the credit card market is the sudden transition during the last two years from rapid expansion to contraction (in nominal as well as real terms) in the value of turnover.

The recent contraction in the value of card turnover needs to be seen in the context of recent trends in credit card borrowing and consumer indebtedness.

A second factor is the emergence of surcharging in high growth sectors where card payments dominate (or may in practice be the only option). In particular, the budget airlines such as easyJet and Ryanair charge more for paying by credit than debit card. At the time of writing:

- With easyJet, credit cards incur a percentage charge of 1.95% of the total amount payable, with a minimum charge of £4.95, while debit cards (except Visa Electron or Carte Blue in France) are subject to a fixed £1 charge.
- With Ryanair, the fee per passenger per one-way flight is £1.75 for payment by credit card compared with £0.70 for payment by debit card.

Though data on the extent of the impact is not available, these fees will have pushed payment traffic from credit to debit cards in one of the fastest growing segments for payment card use.

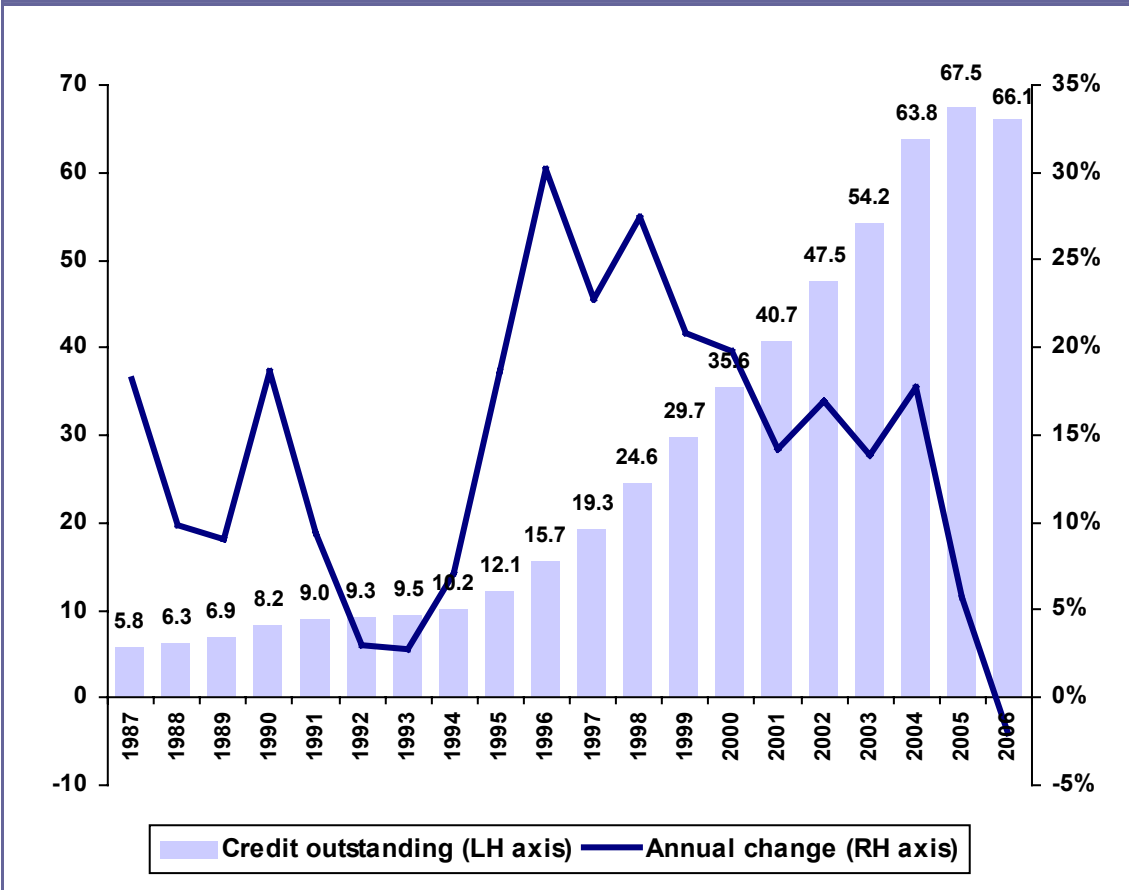
The growing use of PayPal may also have had an impact, though its operation depends on use of the underlying bank or credit card accounts of buyers and sellers.

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1.4 Trends in credit card borrowing

As with card turnover, the trend during the last decade has been a rapid rise in credit card outstandings, followed by deceleration in the rate of growth during 2005 and a fall in outstanding balances during 2006.

6. Credit outstanding on credit cards (£ billion)



Notes:

1. Chart covers Visa and MasterCard credit and charge cards in issue only.
2. Credit outstanding includes interest-free balances.

Source: British Bankers' Association

Between 1995 and 2004, the value of credit outstanding on UK-issued MasterCard and Visa credit cards increased at an annual (nominal) rate of 14% or higher. The amount owed on credit cards rose six fold from £10.2 billion at the end of 1994 to £63.8 billion at the end of 2004, according to British Bankers Association statistics.

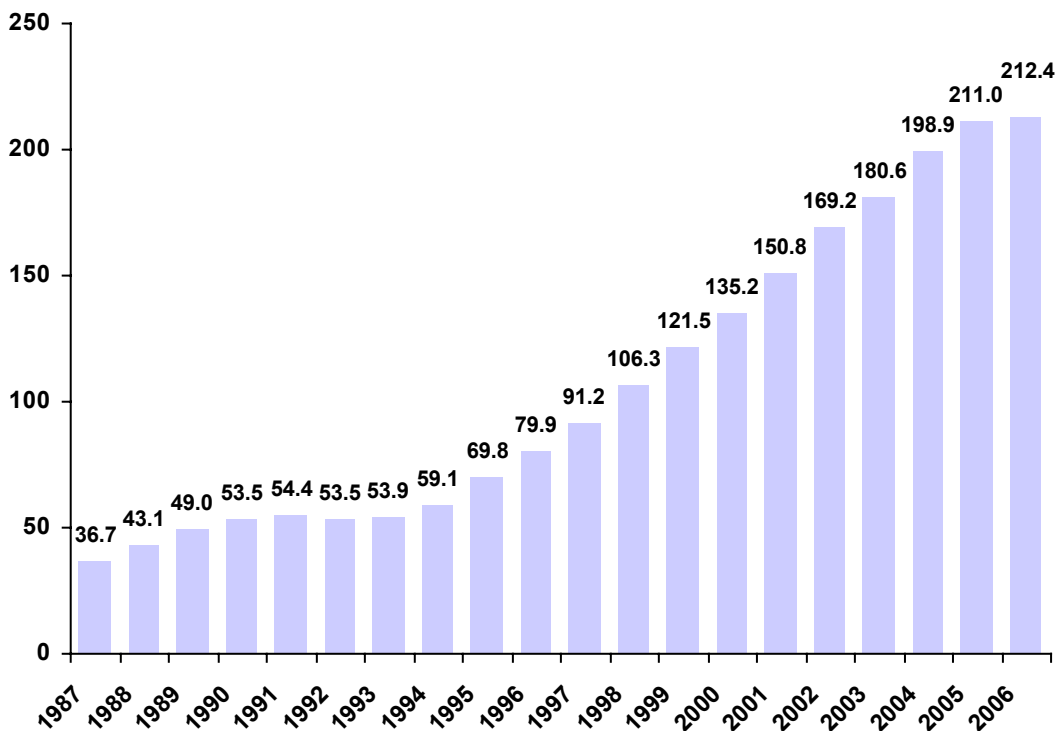
However, outstanding balances rose by a much smaller 5.7% in 2005 and fell by 2% in 2006 to £66.1 billion at year-end.

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The rise in outstanding balances on credit cards needs to be seen in the context of the sharp growth in overall unsecured consumer borrowing in the UK during the last decade.

Total consumer credit outstanding rose threefold in nominal terms from £69.8 billion at the end of 1995 to £211 billion at the end of 2005.

7. Total consumer credit outstanding (£ billion)



Note:

1. Figures are at year-end.
2. Figures are not seasonally adjusted.
3. See discussion in Statistical Appendix.

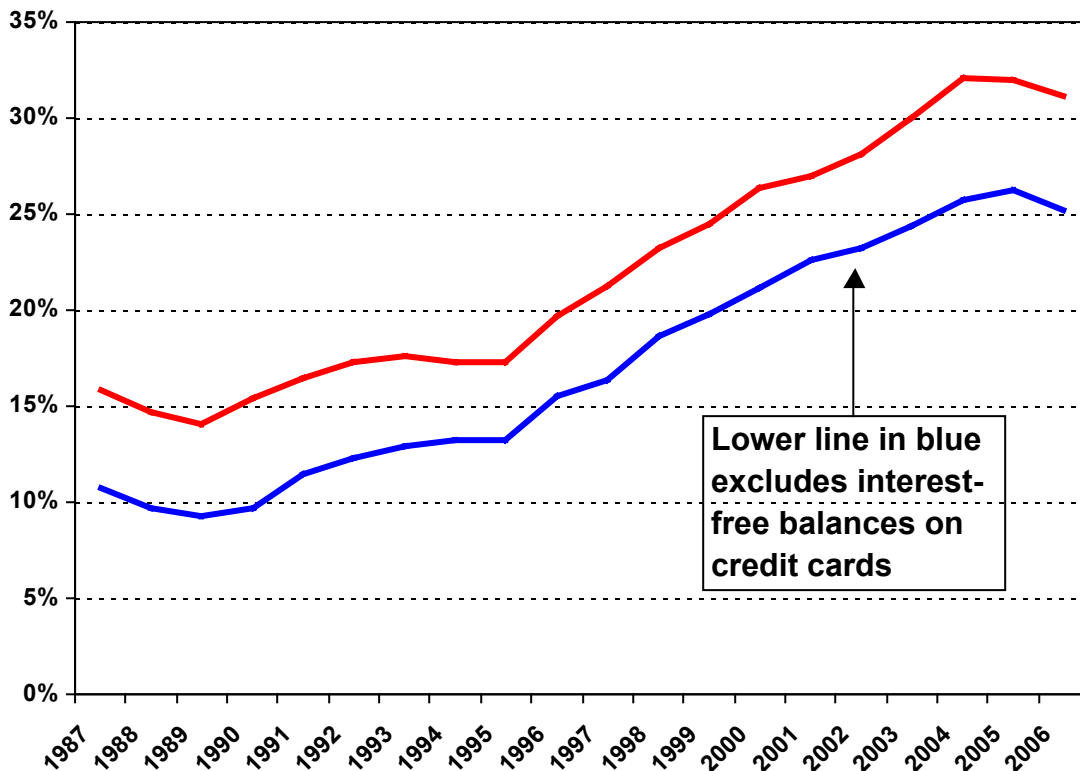
Sources: Bank of England, Office for National Statistics

However, it is important to note that credit card borrowing has done more than simply track the overall growth in unsecured consumer borrowing. Within the total consumer credit market, borrowing on credit cards has grown more quickly than other forms of borrowing.

Looking at chart 8, credit card borrowing increased from just over 17% of total consumer credit in the mid-1990s to over 30% a decade later. However, the proportion fell in 2006, the first fall in almost two decades.

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8. Credit cards as a proportion of total consumer credit



Notes:

1. Figures are at year-end.
2. Figures are not seasonally adjusted.
3. Credit card series covers MasterCard and Visa issued credit and charge cards.
4. For lower line in blue – interest-free credit card borrowing excluded from both credit card and total consumer credit data.
5. The chart should be treated as indicative only. Because of the treatment of balances securitised through non-resident SPVs in the ONS/Bank of England statistics (see discussion in Statistical Appendix), the chart may overstate the proportion of total consumer credit accounted for by credit cards (particularly during recent years). This is because such balances are included in the numerator (BBA statistics for credit card balances) but excluded from the denominator (ONS/Bank of England statistics for total consumer credit outstanding).

Sources: Office for National Statistics (total consumer credit), BBA (credit cards)

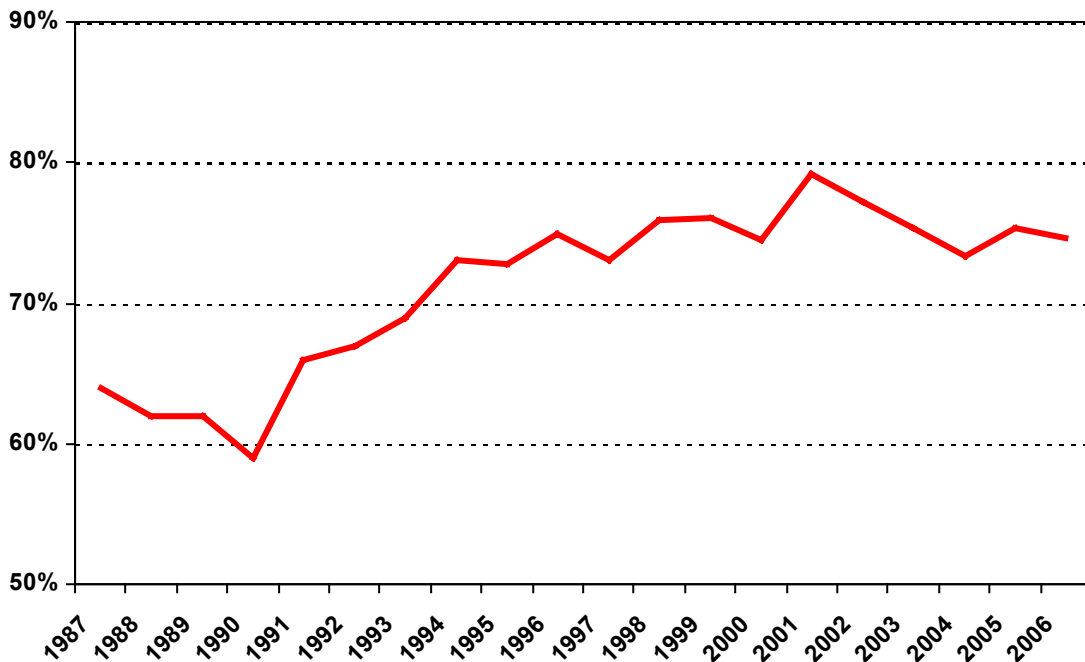
As noted above, a proportion of the credit outstanding on credit cards simply represents the float of cardholders who use their cards as a means of payment. A rough calculation has been made to excluding this deferred payment from credit card and total consumer credit borrowing.

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Excluding interest-free balances, credit card borrowing rose from approximately 13% of total consumer credit in 1995 to approximately 25% a decade later (see blue line in chart 8).

During this period, it is important to note that the proportion of credit card balances earning interest remained largely constant, varying around 75% of total balances. The industry therefore saw interest-earning balances grow in a decade from just under £7.5 billion at the end of 1994 to more than £46.5 billion at the end of 2004.

9. Proportion of credit card balances bearing interest



Notes:

1. Figures are at year-end.
2. Series covers MasterCard and Visa issued credit and charge cards.
3. Weighted average based on data from all issuers.
4. Inclusion of charge cards should be borne in mind when considering the interest-bearing ratio.

Source: British Bankers' Association

1.5 Comments

In commenting on the main trends in the credit card market since the early to mid 1990s, there are perhaps three main features that stand out:

- The astonishing growth in card use from the early 1990s to the end of 2004
- The higher growth in credit outstanding compared with credit card turnover during this period
- The sudden transition from rapid expansion to contraction since 2004

Market growth

One way of setting the growth in credit card use in context is to compare it against the growth in cardholder numbers and UK consumer expenditure over the same period.

As noted above, APACS reports that the number of personal credit and charge cardholders reached 31.6 million in 2005, just over two-thirds of the over-18 population, and has grown by 14 million over the past ten years. This implies approximately 17.6 million cardholders in 1995, and an increase in just under 80% in cardholder numbers during the following decade.

According to the Office for National Statistics' analysis of the household sector's use of its disposable income, individual consumption expenditure rose from £457.5 billion in 1995 to £791.3 billion in 2005. This is an increase of approximately 73%.


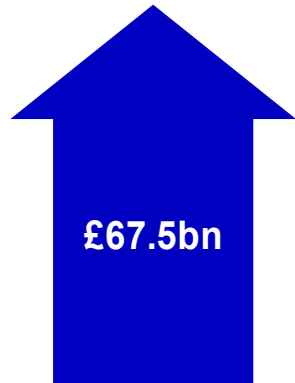






Credit card turnover was (purchases and cash advances) £42.7bn in 1995 while outstanding balances on credit cards were £12.1 billion at the end of 1995.

Assume 31.6 million rather than 17.6 million cardholders during 1995 (with the additional cardholders in aggregate using their cards on an equivalent basis to the actual 17.6 million). Card turnover would have been £76.7bn in 1995, with outstanding balances at year-end of £21.7bn.

Now assume that turnover and outstanding balances, as adjusted for 31.6 million cardholders at period end, rose between 1995 and 2005 in line with the overall growth in households' consumption expenditure. This would take card turnover to approximately £132.5bn in 2005 and outstanding balances to approximately £37.5bn by end 2005.

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10. Growth in card use – 1995 to 2005

| | | |
|------------------------------------|---|---|
| Actual outcome 2005 |  |  |
| Growth in consumer spending |  |  |
| Growth in cardholders |  |  |
| Position in 1995 |  |  |
| | Card turnover | Outstanding balances |

Note:
These calculations should be treated as indicative only.

Source: ONS, APACS, BBA, authors' analysis

These calculations are crude, and should be treated as indicative only.

It is striking nonetheless that actual card turnover in 2005 was £134.8bn, not far removed from the figure projected by the combined growth in cardholder numbers and consumer expenditure.

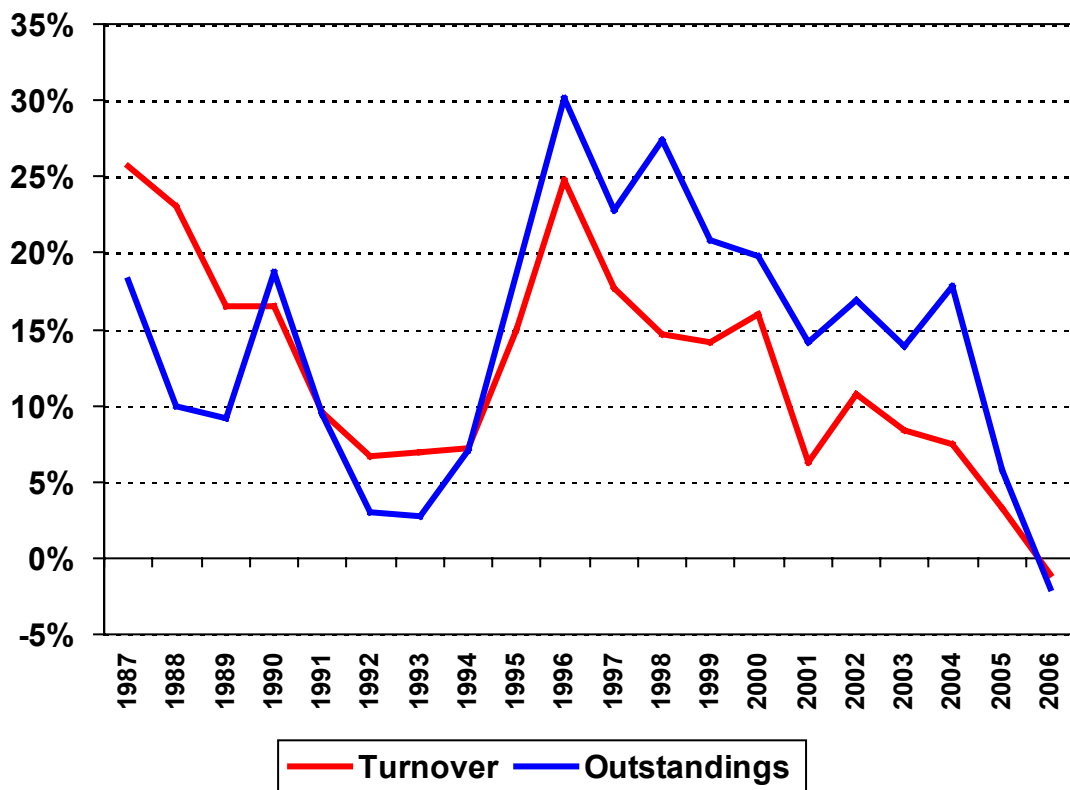
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However, actual outstanding balances at end 2005 were £67.5bn, far greater than the crude projection based on the combined effect of growth in cardholder and consumer spending.

Higher growth in borrowing

While the value of turnover (in nominal terms) rose just over threefold between 1995 and 2005, there was a rise of approximately 5.5x in credit outstanding. The much stronger growth in credit outstanding is evident in chart 11.

11. Annual rates of growth in turnover & outstandings



Notes:

1. Figures are based on the percentage change in the annual total for a given year compared with the previous year (turnover) and the percentage change in the year-end figure compared with the figure at preceding year-end (outstanding balances). No adjustments have been made to the series.
2. Figures are not seasonally adjusted.
3. Credit card series covers MasterCard and Visa issued credit and charge cards.

Source: British Bankers' Association

This represents a reversal in trends that few in the industry back in the early 1990s could have foreseen.

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It is worth recalling that during the late 1980s and early 1990s, the main concern in the credit card industry was the rising proportion of cardholders using their cards simply as a means of payment. This is evident in the lower growth rate in card balances compared with turnover during that period (chart 11) and the fall in interest-bearing balances (as a proportion of total balances) to a low of 59% at end 1990 (chart 9).

The fear during this period was of credit card borrowing in structural decline. Concerns at the declining proportion of balances earning interest – the main source of industry revenues – led to the short-lived introduction of annual fees on cards by major issuers and the switch to charging interest from transaction as opposed to statement date.

However, from the early 1990s onwards, borrowing trends on credit cards reversed sharply. While it is difficult to be precise on the weight assigned to particular factors, this reflected various favourable factors coming together:

- Economic recovery from the recession of the early 1990s
- Significant falls in nominal interest rates
- Rising house prices, giving consumers the confidence to borrow for consumption
- Intense competition stimulated by new entrants, with teaser rate and balance transfer offers

It is also worth noting that this rapid growth in credit card borrowing has occurred during a period of comparatively low nominal interest rates. During periods of higher rates, the contribution of interest charges to the growth in (nominal) balances will be greater. The fact that balances have risen so sharply during a period of comparatively low rates underscores the contribution of new borrowing to balance growth.

In contrast, there was a significant factor working against rapid growth in the use of cards as a means of payment – namely the emergence of the debit card as a major payment instrument. The rapidly growing use of debit cards during the last decade must at least partly explain the much slower growth in card turnover compared with outstanding balances.

Recent market contraction

After the rapid market's growth since the mid-1990s, the surprise is the speed with which conditions have changed.

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A slowdown in the rate of growth, particularly of outstanding balances, was only to be expected at some point. Compound annual growth rates in the mid-teens or higher are clearly unsustainable indefinitely. However, growth in both turnover and borrowing did not simply slow down; card turnover and borrowing fell sharply during 2005 and contracted (in nominal as well as real terms) during 2006.

Looking at the macro-economic conditions that supported the growth in credit card borrowing from the early/mid 1990s – consistent economic growth, rising house prices, low nominal interest rates – it is noteworthy that there were no significant changes during 2005 and 2006 to trigger a fall in card use.

The Bank of England's base rate, the main central bank reference rate, was increased in three steps from 4% to 4.75% between February and August 2004, but then reduced to 4.5% in August 2005 (see interest rate charts in Section 4 on industry economics). And the increases during 2004 were modest in an historical context. The UK economy has continued to grow, with house prices remaining high. The contraction in card use despite no fundamental change in economic conditions suggests that some cardholders had become significantly over-borrowed.

Unfortunately, data on the concentration of credit card borrowing is not publicly available. However, it appears that a significant minority of cardholders holding multiple cards had borrowed (and been allowed to borrow) on their cards to levels that simply proved unsustainable (see for example, the findings of the recent CCCS Research on credit card borrowing among its clients, *More silver threads among the gold cards*, cited in Section 4 on industry economics).

These over-borrowed cardholders have in effect been leaving the market by means of one of the various debt-management avenues available – debt consolidation, Individual Voluntary Arrangements (IVAs), bankruptcy or other debt management arrangements. This is corroborated by the rapid rise in credit card write-offs during recent years (see Section 4 on industry economics).

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2. Competitive developments

The analysis of competitive developments is broken down into three parts:

- The relative positions of MasterCard and Visa, the main card payment networks, in the UK market
- Segmentation in the UK market, including developments such as expansion of the sub-prime segment and contraction of the store card segment
- Developments among the main credit card issuers

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2.1 MasterCard and Visa

Until the early 1990s, the main UK retail banks dominated the UK credit card market. And the main banks were either Visa or MasterCard issuers.

Barclays, through its market-leading Barclaycard brand, was historically a Visa issuer. TSB, before its merger with Lloyds in 1995, was the other large Visa issuer through its Trustcard brand. Other Visa issuers included Bank of Scotland (before its merger with Halifax in 2001) and Co-operative Bank.

In contrast, the other major retail banking groups were, through their shared interest in the Access consortium, MasterCard issuers. Lloyds (30%), Midland (30%), NatWest (30%) and Royal Bank of Scotland (10%) owned the Access credit card brand affiliated to MasterCard. HSBC acquired Midland in 1992, while Royal Bank of Scotland (RBS) acquired NatWest in 2000.

Since 1989, following the break-up of the Access consortium, the main UK banks have issued both Visa and MasterCard cards.

Visa initially gained market share because many of the new entrants chose to issue only, or mainly Visa cards. MasterCard meanwhile faced the challenge of establishing itself as a domestic brand in the UK. Historically, Access had functioned as the domestic brand, with MasterCard only used for international transactions.

By 2000, Visa's share of UK credit and charge cards had reached 64-68% of the market (excluding non-MasterCard and Visa cards) on the main measures of card issuance and use (chart 12).

However, since 2000 MasterCard has gained significant share and is now approaching parity with Visa. By 2006, its share had reached 44-46% of the total market (again excluding non-MasterCard and Visa cards) on the main measures.

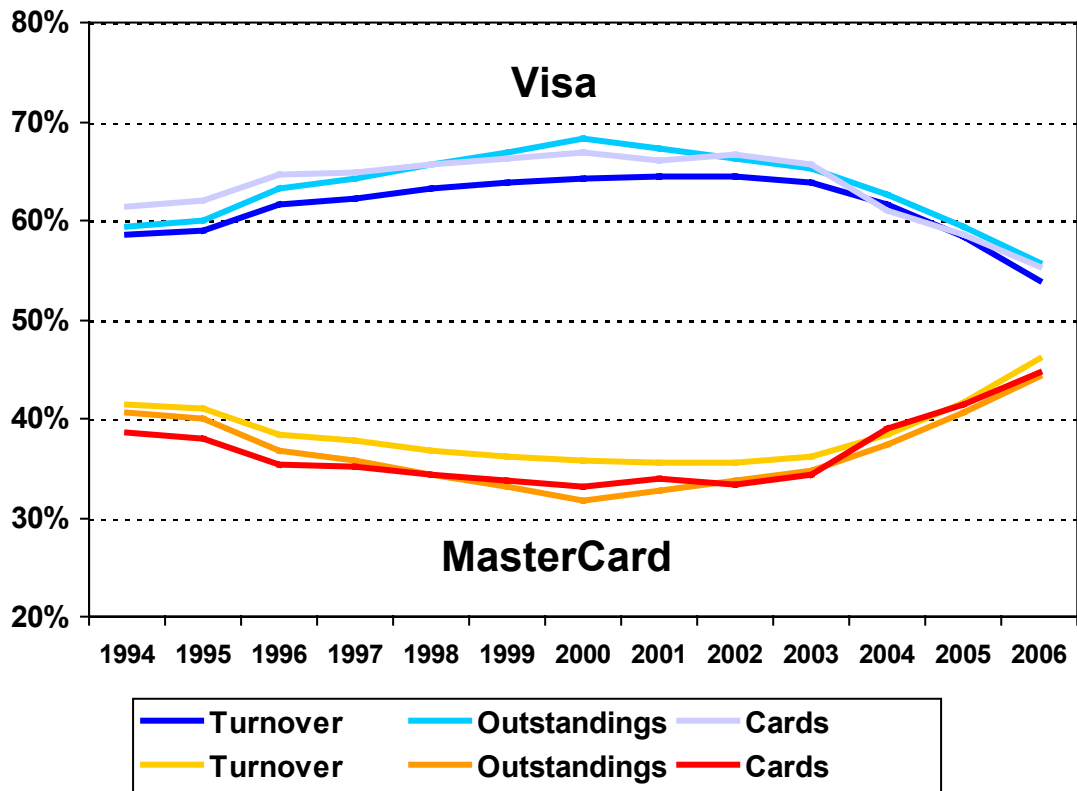
The increase in MasterCard's UK share during recent years is noteworthy in the context of the structural changes at the organisation – namely the merger with Europay International in 2002, and subsequent developments leading to the initial public offering in 2006. It may reflect a more commercial approach to business development in the UK.

Certainly, MasterCard now has a strong base among the main UK issuers. Several of the largest issuers, including HSBC, RBS and

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MBNA, are mainly MasterCard issuers. Morgan Stanley is also a MasterCard issuer in the UK. And anecdotal reports indicate that Barclays may now issue more MasterCard than Visa cards following the success of its Barclaycard Premiership football-linked card.

12. Market share of MasterCard and Visa



Notes:

1. Figures are not seasonally adjusted.
2. Series covers MasterCard and Visa issued credit and charge cards.
3. Outstandings and Cards as at December.

Source: British Bankers' Association

2.2 Market structure & segments

Issuer segments

The main UK banks started to lose their grip on the credit card market more than a decade ago.

At the end of 1990, the Main British Banking Groups (MBBG) accounted for over 90% of credit outstanding. By the late 1990s, this had fallen to below 75% of credit outstanding.

More recent shares are more difficult to calculate, because of the impact of developments such as balance securitisations. However, as of 2006, the five large UK retail banking groups on a rough calculation collectively accounted for approximately 60% of total outstanding balances (see following section on individual issuers).

The large UK banks lost market share to two main groups of competitors:

- US issuers entering the UK market
- Smaller UK banks expanding their credit card activities

During the 1990s, most of the main US issuers began issuing credit cards in the UK (table 13). In addition, several of the smaller UK banks started or expanded their credit card activities. These included RBS (before its acquisition of NatWest), Co-operative Bank and several of the former building societies (Halifax before its merger with Bank of Scotland, Alliance & Leicester, Abbey).

Several major non-bank issuers also entered the market, though through partnerships with established banks and card issuers. Notably, the supermarkets Tesco and Sainsbury began issuing credit cards in the late 1990s through their banking joint ventures with RBS and Bank of Scotland (now HBOS) respectively. Virgin issued a card with MBNA.

However, through a mixture of acquisition and withdrawal, issuers have come and gone. Several of the US issuers have been acquired (see table 13). While Egg, the internet banking subsidiary, emerged as a major card issuer, Alliance & Leicester and Abbey subsequently outsourced their credit card activities to MBNA (though Abbey has since announced plans to bring its credit card back in-house). In 1998, MBNA also acquired the credit card operations of Robert Fleming, the pioneering issuer of low interest rate cards under the Save & Prosper brand.

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| 13. US issuers operating in the UK market | | |
|---|----------------------------|--|
| US issuer | Began issuing in UK | Subsequent developments |
| Providian | 1999 | UK card business acquired by Barclaycard in April 2002 (1) |
| Morgan Stanley | 1999 | |
| Banc One (First USA) | 1998 | UK card business acquired by Halifax (now HBOS) in 2000 |
| People's Bank | 1996 | UK card business acquired by Citigroup in April 2001 |
| Capital One Bank | 1996 | |
| GE Capital Bank (2) | 1995 | |
| Citibank International (Citigroup) (3) | 1995 | |
| Associates Capital Corporation | 1994 | Acquired by Citigroup in 2000 |
| HFC Bank | 1994 | Acquired by HSBC in 2005 (4) |
| MBNA | 1993 | Acquired by Bank of America in 2005 (5) |
| Beneficial Bank | 1987 | Acquired by HFC in 1999 |
| Notes: | | |
| <ol style="list-style-type: none"> 1. Barclays announced sale of part of its Monument portfolio to US credit card issuer CompuCredit just as this report was being finalised (see section on sub-prime market below). 2. Year when GE Capital Bank began issuing Visa/MasterCard. 3. Citigroup announced acquisition of Egg from Prudential in January 2007. 4. HSBC acquired Household International (now HSBC Finance Corporation), HFC Bank's then parent, in 2003. HFC Bank's credit card business was sold internally to HSBC Bank in December 2005. 5. Merger completed on January 1 2006. | | |
| Source: British Bankers' Association, author's research | | |

The net outcome of both the initial influx of issuers and the subsequent consolidation is a market structured around the main UK retail banking groups and the large US issuers that remain (with and a second tier of smaller issuers). This market structure is outlined in more detail in Section 2.3 below.

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Cardholder recruitment

Though hard data is not publicly available, the influx of new issuers during the 1990s pushed the balance of cardholder recruitment away from existing bank customers and towards direct solicitation. Historically, Barclays had promoted Barclaycard to non-Barclays customers. However, the other large UK banks mainly focused on issuing cards to their existing customer bases.

For the US issuers without an existing banking business, the only recruitment option was direct solicitation through advertising, direct marketing and public relations (or through affinity & co-branding relationships). However, the effect has been to push cardholder recruitment activity more generally in this direction.

This process detached the credit card from cardholders' current account banking arrangements and re-positioned it as a stand-alone product open to a variety of suppliers. One consequence has been the increase in multiple cardholding. As already noted, according to APACS, by 2005 the average number of cards per person was 2.4 credit cards.

With market conditions now worsening, there are already signs that some of the main retail banks are returning to a strategy of mainly recruiting new cardholders from their existing banking business (see Section 2.3). This is one of the strategic issues facing the UK retail banks as the credit card market moves from a period of growth to one of retrenchment (see Section 5).

Issuing strategies

In the more open market for cardholders, issuers have pursued a variety of different strategies to attract and retain customers. Though the strategies can be classified in various ways and there is inevitably overlap between them, the main approaches pursued by issuers can be grouped into three main categories:

- Price
- Loyalty
- Added Value

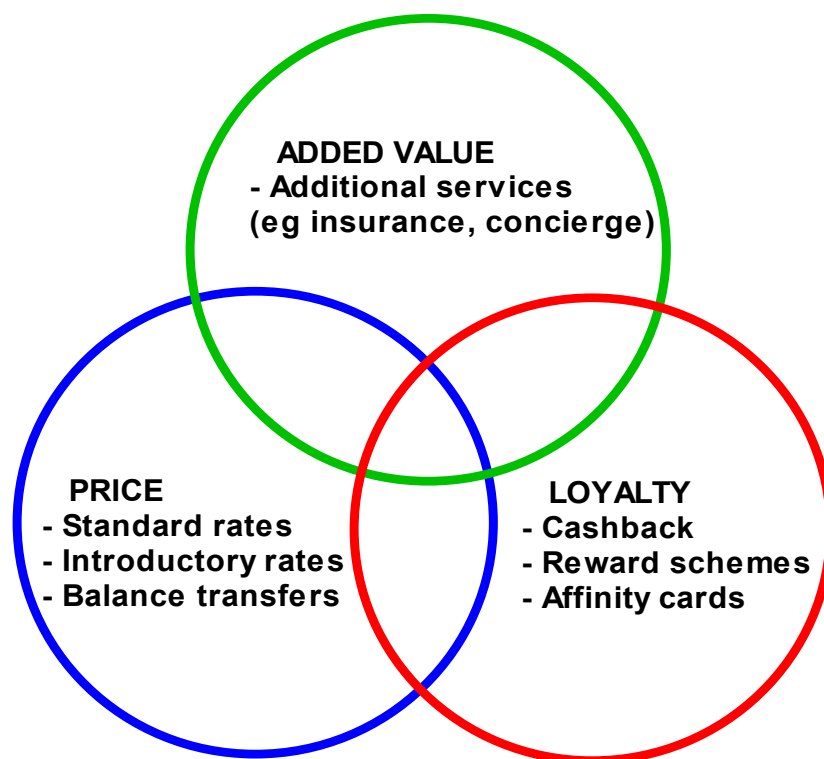
Though there has been aggressive competition on price, much of it has focused on balance transfer and introductory offers rather than the standard rate of interest. Balance transfer rates are applied to existing card balances that are transferred from one issuer to another (or to a consolidation of other debts). Introductory rates are lower than the standard interest rate for an initial period.

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Though data is only available from 2001, the significance of balance transfers to the market is evident from chart 15. The value of transfers peaked at £12.5 billion of transfers to Visa cards and £8.8 billion to MasterCard cards in 2004, though it has declined during 2005 and 2006.

Despite the welcome growth in price competition, it is arguable that the proliferation of balance transfer and introductory offers has reduced rather than improved price transparency in the market.

14. Issuing strategies



Source: Author's analysis

The second strategy is one based around generating and maintaining customer loyalty. Success comes from linking benefits to card use. The benefits fall into three broad categories:

- Cashback, where a cash reward is calculated as a percentage of spending.
- Cards that offer reward schemes such as Air Miles, where points accumulated on the basis of spending can be converted into some kind of reward.

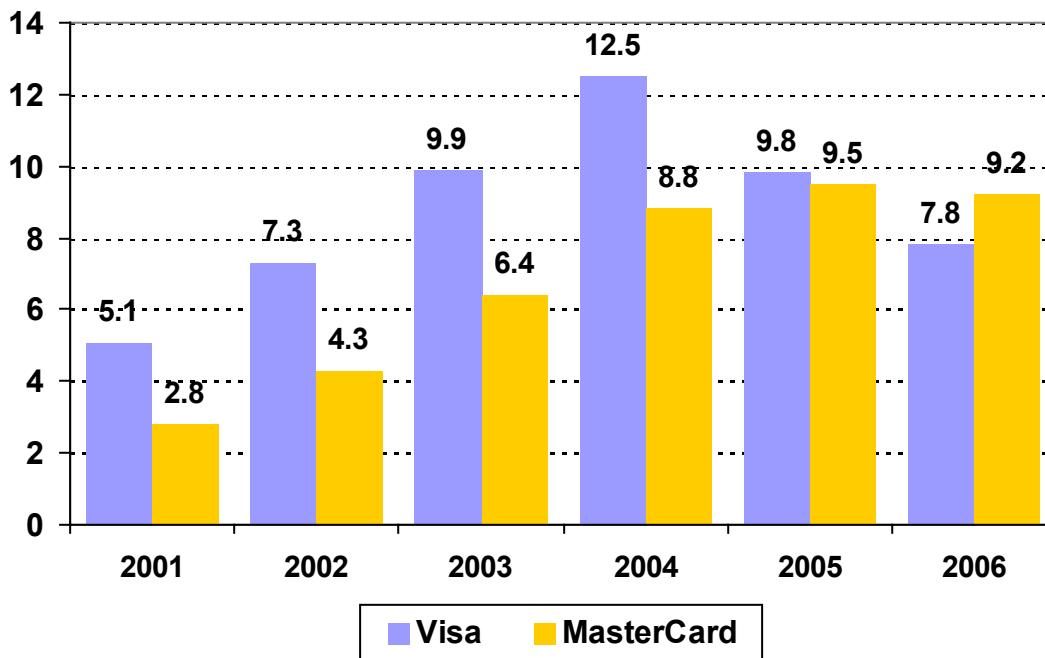
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- Affinity or donation cards, where a percentage of purchases made via card usage is donated to a charitable beneficiary by the issuer.

The economics of such a strategy depend on generating levels of card use sufficient to compensate for the additional costs of the rewards to cardholders. Their long-term sustainability is likely to depend on the card industry's success in protecting interchange as a revenue stream.

The third strategy is one based around adding value to the core payment and borrowing facility. Additional benefits may include free travel insurance, free purchase protection insurance, concierge schemes, savings on services such as travel and hotels. The added value approach is most developed in the premium (gold and platinum) card segment.

15. Value of balance transfers (£ billion)



Notes:

1. Figures are not seasonally adjusted.
2. Series covers MasterCard and Visa issued credit and charge cards.

Source: British Bankers' Association

Again, in an environment characterised by retrenchment rather than growth, there is likely to be a scaling back and tightening of conditions attached to cardholder offers and benefits. This is

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already evident in the conditions attached to balance transfer offers and the reduction in volumes evident since 2004 (chart 15).

Sub-prime market

These issuing strategies are focused on the mainstream market. In addition, it is worth noting that several issuers have issued credit cards targeted at the 'sub-prime' market of consumers who do not meet the underwriting criteria of mainstream issuers and card products. Cards targeted at the sub-prime market are characterised by higher interest rates and lower credit limits than the mainstream market.

Card issuers targeting the sub-prime market include established mainstream banks, specialists in the sub-prime credit market, and dedicated new entrants.

Barclays has been present in the sub-prime market through Monument, formerly the UK business of US sub-prime lender Provident, which Barclays acquired in April 2002. However, just as this report was being completed, Barclays announced the sale of part of the Monument credit card portfolio to the US credit card issuer CompuCredit. Barclays said the sale portfolio includes approximately £490 million of gross receivables, including a tranche of accounts in collections.

Barclays says Barclaycard will retain a proportion of the Monument portfolio, representing approximately £130 million of receivables, which are "primarily higher quality accounts". These will be integrated into the main Barclaycard branded book.

CompuCredit describes itself as a provider of branded credit cards and related financial services to consumers who are underserved by traditional financial institutions. The purchase from Barclays marks CompuCredit's first international portfolio purchase.

Provident Financial, the UK home credit specialist, also has a presence in the sub-prime segment through Vanquis Bank, the credit card business it established in 2004.

Other players include the private-equity backed SAV Credit, which has launched the aqua card focused on the sub-prime market (the actual card is issued by Halifax).

The potential market is large (though with accompanying risks). SAV Credit estimates that consumers who fail the standard underwriting rules of mainstream credit card issuers represent

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almost 20% of the UK adult population. However, though definitive public data is not available, the sub-prime credit card segment appears to remain very small compared with the mainstream market.

For example, Provident Financial's Vanquis Bank ended 2006, its second full year of operation, with 251,000 customers. Vanquis Bank's average customer receivables in 2006 were £77.3 million. Though these represent strong growth over two years for Provident, they remain tiny in relation to the overall credit card market.

The CompuCredit sale is small in the context of Barclaycard's total portfolio. Barclays commented that the CompuCredit sales portfolio represents about 2% of Barclaycard's loans and advances to customers as at year-end 2006. It represents approximately 5% of Barclaycard's 2006 average outstanding balances on UK credit cards.

As the Barclays sale indicates, the decline in overall market conditions will reduce the appetite of mainstream issuers for expanding into areas such as sub-prime. This is likely to leave specialists such as Provident Financial as the main drivers of further development in the sub-prime credit card segment.

Changes in the store card market

The store card is an essential ancillary service for many retailers. The card is a means both of strengthening customer loyalty and of providing credit to support sales.

However, the store card market appears to be in long-term decline. The recent Competition Commission investigation into store cards (see below) imposed remedies that will reduce the profitability of store card programmes. Even before the Competition Commission investigation, the market had contracted significantly with major retailers such as Marks & Spencer and John Lewis Partnership replacing cards that can only be used in their stores with co-branded credit cards. Ironically, these co-branded cards are providing one of the few sources of growth for the wider credit card market.

Market developments

According to the Competition Commission (CC), which reported in March 2006, there are more than 11 million store cardholders with outstanding balances of well over £2 billion. However, this compares with balances of over £65 billion in the wider credit card market (the CC investigation did not include store-branded credit cards).

The number of active store card accounts has declined significantly, largely due to retailers switching to co-branded credit cards. According to the CC, there were 11.4 million active store card accounts at the end of 2005 compared with 17.5 million at the end of 2002). However, the CC considers that store cards will continue to be important for some time to come.

The CC identified some 70 retailers operating store card services, most of which were department stores and clothing retailers.

In 2004 according to the Commission, the four largest store card programmes by number of active accounts were (in alphabetical order) Arcadia, Argos, Debenhams, and Marks & Spencer. These groups between them accounted for about 50% of all active store card accounts and balances.

General Electric Consumer Finance (GECF, now known as GE Money) is much the largest provider of store card services to retailers. On the indicators looked at by the CC, GECF as of 2004 had a 50-60% share of retail sales and year-end credit balances, and a 60-70% share of

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cardholder revenue and year-end active accounts.

The other major providers of store cards for retailers are:

- Arg Card Services (part of the Argos Retail Group)
- Creation Financial Services (owned by the French consumer finance company LaSer-Cofinoga)
- HSBC Group
- Ikano Financial Services, and
- Style Financial Services.

In-house provision of store cards has almost disappeared in the UK. Historically, the two main in-house providers were Marks & Spencer (M&S) and John Lewis Partnership (JLP). However, HSBC has taken over the running of both card operations – JLP in 2003 and M&S in 2004 (and indeed, prior to the HSBC acquisition, M&S had outsourced much of the processing to Experian when it launched its 'more' credit and loyalty card).

The CC commented in its report that the "recent contracting-out of their previous in-house operations by JLP and Marks & Spencer leaves only Argos among the larger retailers that now provides its own store card services in-house". (Competition Commission, Store cards market investigation, March 2006)

And in August 2006, Argos and Barclays announced an agreement to form a 50/50 joint venture to provide a new Argos credit card and loan product, and a new Homebase loan product. Barclays had previously announced a joint venture with House of Fraser in September 2004, though this was terminated in early 2007.

More significantly, both M&S and JLP have moved from pure own-brand cards to co-badged credit cards (though M&S continues to offer its 'Chargecard' store card alongside its credit card).

Retailers' branded credit cards are now a major segment of the credit card market. In addition to M&S and JLP, the three largest UK supermarkets all offer a co-branded card. The banking ventures of both Tesco and Sainsbury's offer credit cards, while Asda offers a branded card that is provided by GEFCF.

Given that the banking ventures of Tesco and Sainsbury's are joint ventures with RBS and HBOS respectively, four of the five large UK retail banks are involved in the issuance of store-branded cards.

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16: Recent store card developments

| | | |
|-------------|------------------|---|
| 2007 | January | Barclaycard and House of Fraser terminate their planned joint venture |
| 2006 | August | Barclays and Argos Retail Group announce joint venture |
| | March | Competition Commission publishes final report on Store Card Credit Services Inquiry |
| 2004 | November | M&S announces sale of M&S Money to HSBC |
| | September | Barclaycard announces joint venture with House of Fraser |
| | March | The OFT refers the supply of store card services (both to retailers and consumers) to the UK Competition Commission for investigation |
| 2003 | October | M&S '&more' credit card is launched, with Marks & Spencer Financial Services rebranded as 'Marks & Spencer Money' |
| | June | HSBC and John Lewis Partnership announce agreement for the joint management and operation of the John Lewis, Peter Jones and Waitrose store card business |
| 2002 | September | M&S starts trial in South Wales of '&more' credit and loyalty card |
| 2000 | April | M&S starts accepting MasterCard and Visa credit cards |

Sources: Relevant banks & agencies, author's research

For the providers, commission may be payable and profits may be shared with the partner retailer depending on the structure of the agreement. But the advantages of cards co-branded with major retailers are lower costs of acquisition and the ability to drive usage through the partner retailer.

On acquisition costs, Marks & Spencer quoted a typical credit card recruitment cost of £50-£100 in September 2003 at the time of its credit card launch. It compared this with the £8-10 M&S in-store recruitment cost.

As highlighted below, HSBC was the only one of the five large UK retail

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banks to report an increase in UK credit card balances. It reported a 5% rise in average UK credit card balances to US\$13.7 billion.

It is noteworthy that growth was strongest in M&S branded cards. According to HSBC, M&S cards represented 4 percentage points of the increase, driven by “an increased sales focus which included extensive media advertising”. It added that this was partly offset by declining balances within the store cards business and the cards business of HFC Bank Ltd (the business it inherited with the acquisition of Household).

Competition Commission

The changes imposed by the Competition Commission (CC) reduce further the appeal of store cards.

The Commission published its final report on the store card market in March 2006. The report confirmed its provisional conclusions reached in September 2005 that there is “an adverse effect on competition in connection with the supply of consumer credit through store cards and associated insurance in the UK”.

The CC estimated that for the period 1999 to 2003, APRs were some 10 to 20% above what they would have been had they reflected providers’ costs across the sector as a whole, including a reasonable return on capital. According to the CC, average sector APRs have averaged some 26.5% compared with its calculation for cost reflective APRs of some 22 to 24%. (The ‘excess’ of 10 to 20% reduces slightly the period is extended to include less comprehensive data for 2004 and 2005.)

The CC estimated that the excess prices paid for credit and insurance on store cards has been at least £55 million a year and possibly significantly more.

The Commission imposed a number of remedial measures. Store card credit providers must:

- Where APRs are 25% or above, warn cardholders on monthly statements that cheaper credit may be available elsewhere
- Give more and better information on all monthly statements
- Offer option to pay by direct debit, and
- Offer payment protection insurance separately from other elements of store card insurance.

French parallels

Interestingly, France may well follow the UK with the market gravitating from store cards to store-branded credit cards. Groupement des Cartes Bancaires, the French interbank card payments organisation, recently decided to drop its long objection to co-branding, and will allow non-bank brands to appear on French “CB” cards.

France has arguably the most sophisticated store card market in Europe. Two of the main French private label card issuers, Cetelem and Sofinco, are owned by major French banks (BNP Paribas and Crédit Agricole respectively), while the third, Cofinoga, is a 50:50 partnership between Cetelem and Galeries Lafayette. Between them, these three have issued about 30 million private label cards in France. The major supermarket groups, particularly Carrefour and Auchan, currently issue Visa- and MasterCard-branded cards through their in-house banks.

The end of the co-branding ban will potentially simplify the task of issuing and converting existing store cards to store-branded credit cards.

2.3 Individual issuers

Looking specifically at individual issuers, publicly available data is limited. However, based on the snippets of data available, it is possible to piece together an overview of the leading issuers.

Large UK retail banks

Looking first at the five largest UK retail banks, their outstanding credit card balances for 2005 and 2006 are shown in chart 17.

Though the figures may not be directly consistent between banks/issuers (see the notes to the chart), they provide some indication of the market shares of the main UK retail banks.

Collectively, despite the strong competition from US and smaller UK issuers, the figures imply that the five banks accounted for approximately 60% of the market as measured by outstanding balances during 2006.

Perhaps the most noteworthy feature of the chart is the fact that outstanding balances fell for four of the five banks between 2005 and 2006. **Barclays** also discloses separate figures for average extended credit balances on its UK credit cards, and this also showed a fall.

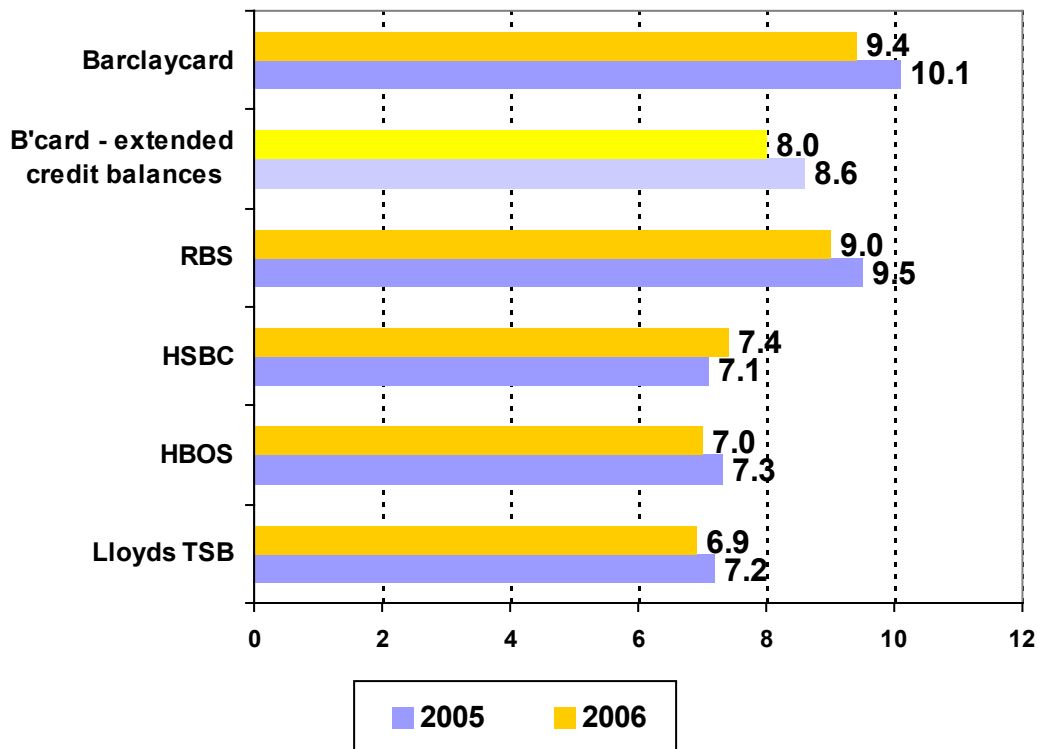
According to Barclays in its 2006 results release, the 7% fall in UK average extended credit card balances reflected the impact of “tighter lending criteria”. (The sale of part of Barclaycard’s Monument credit card portfolio to CompuCredit, announced in early April 2007 as this report was being finalised (see above), will further reduced Barclaycard’s balances. According to Barclays, the sale includes approximately £490 million of gross receivables.)

Similarly, **Lloyds TSB** commented in its 2006 results release that “tightening of credit criteria over the last two years, together with the slowdown in consumer demand, has led to unsecured consumer credit balances remaining at broadly the same level as last year end”. However, while Lloyds TSB’s personal loan balances outstanding at end 2006 rose 1% to £11.1 billion, its credit card balances fell 5% to £6.9 billion.

HBOS reported a 4% fall in credit card balances from £7.3 billion in 2005 to £7.0 billion in 2006, reflecting its “reduced appetite” in the unsecured lending market, certain parts of which it currently views as uneconomic (2006 results release). HBOS’s unsecured personal loan balances also fell by 4% to £6.6 billion.

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17. Leading issuers – outstanding balances (£ billion)



Notes:

1. Barclays: Average outstanding balances and average extended credit balances for UK credit cards.
2. RBS: Figures for cards for 'Retail' component of RBS's Retail Markets business. Gross loans and advances to customers. Not clear whether year-end or average for year. May include balances from RBS's Comfort Card business in continental Europe. Ulster Bank responsible for RBS's operations in Northern Ireland.
3. HBOS: Loans and advances to customers at year-end before impairment provisions.
4. HSBC: Average UK credit card balances. HSBC reports in US dollars. HSBC figure for 2006 (US\$13.7 billion) converted from dollars to sterling at the average \$/£ rate of 1.843 (Source: US Federal Reserve) for 2006. 2005 figure based on reported growth in 2006 compared with 2005.
5. Lloyds TSB: Outstanding balances at year-end. 2005 credit card balances, adjusted to exclude the effect of the Goldfish disposal.

Source: Company reports

HSBC was the only one of the five largest UK retail banks to report a growth in card balances during 2006. It reported in its 2006 Annual Report a rise of 5% in average UK credit card balances to US\$13.7 billion (HSBC reports in US dollars). As noted in the discussion of preceding store cards, HSBC commented that growth was strongest in M&S branded cards. HSBC acquired M&S Money, Marks & Spencer's financial services business, in late 2004 (see box on store cards).

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US credit card issuers

Alongside the five major UK retail banks in the top tier of issuers by size are the three large US issuers – Citigroup, Capital One and MBNA/Bank of America. MBNA was acquired by Bank of America in 2005, with the merger completed on January 1 2006. However, for the moment, MBNA retains its identity in the UK credit card market (in response to the question of when MBNA will change its name to Bank of America, the Bank of America response is that changes will occur gradually throughout 2006 and 2007).

MBNA and **Capital One** have both built substantial businesses in the UK since their arrival in 1993 and 1996 respectively. According to a recent Capital One presentation, MBNA ranked as the third largest UK credit card issuer by outstanding balances in 2005, behind Barclaycard and RBS but ahead of the other major retail banks. Capital One ranked itself seventh after the UK retail banks and MBNA, with UK credit card outstandings expressed in US dollars of \$7.7 billion in 2005.

Citigroup's membership of this top tier follows its recent acquisition of Egg, the internet-based bank, from the Prudential insurance group. Citigroup announced in late January it was acquiring Egg. The quirky internet issuer, which Prudential had been looking to sell for some time, has emerged as a major player. As of the end of September 2005 (the quarter before Prudential bought out Egg's minority shareholders), Egg reported UK card balances of just under £3.6 billion. According to Citigroup, the addition of Egg's approximately 2.9 million credit card customers more than quadruples its 800,000 UK credit card base.

Other major credit card issuers

Below this top tier is a second tier of issuers, which includes Nationwide Building Society, Co-operative Bank and Morgan Stanley/Discover.

Abbey should also be added to the list, having brought its credit card portfolio, previously outsourced to MBNA, back in-house following its acquisition by Banco Santander. Abbey plans to launch its new credit card range in the UK in the first half of 2007.

Publicly available data on individual issuers in this second tier is limited. However, **Discover** disclosed in an SEC filing as part of the planned spin-off from **Morgan Stanley** that for the year ended November 30 2006, managed credit card loans in its International Card segment the UK grew \$2.0 billion, or 74%, to \$4.6 billion primarily due to the addition of the Goldfish business.

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Morgan Stanley significantly expanded its UK card business in December 2005 when it acquired the credit card business of Goldfish from Lloyds TSB (transaction completed in February 2006). As at 30 November 2005, Goldfish's total net credit card receivables amounted to approximately £800 million. In 2006, Morgan Stanley/Discover also acquired several card portfolios from Liverpool Victoria. In the March 2007 SEC filing, Discover says it plans to migrate customers away from the Morgan Stanley brand over a transition period of up to three years and expects its primary brand going forward to be Goldfish as well as other affinity brands.

Nationwide Building Society has focused on differentiating its credit card thought features such as not charging for international use. Nationwide has an April 4 financial year-end. In its most recent interim results to September 30 2006, Nationwide reported 1,067,000 credit card accounts at end September (April 4 2006: 974,000) with the total number of cards in issue up 10% to 1,346,000 (April 4 2006: 1,222,000). Balances outstanding on credit cards at the end of the half-year amounted to £741m (April 4 2006: £670m).

American Express also needs to be included as a major UK issuer, though there is little publicly available data on the number of customers and value of outstanding balances on its UK-issued credit cards.

As at year-end 2006, American Express had 29.9 million cards-in-force outside the United States, of which 25.4 million were basic cards-in-force (basic cards are those issued and outstanding to the primary account owners excluding additional supplemental cards issued on such accounts). Cards-in-force include proprietary cards and cards issued under network partnership agreements. Unfortunately however, American Express does not publish a breakdown its non-US cards by country.

Several UK banks have withdrawn from direct provision of credit cards.

In August 2002, **Alliance & Leicester** announced a partnership with MBNA for the marketing and management of new and existing credit card balances. As part of the partnership, MBNA purchased Alliance & Leicester's existing credit card accounts.

In May 2003, **Northern Rock** sold its credit card portfolio to The Co-operative Bank. The portfolio comprised approximately 90,000 accounts with outstanding balances of £217 million. As part of the

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agreement Northern Rock will offer credit cards, issued by The Co-operative Bank but under the Northern Rock brand.

3. Regulatory developments

The credit card industry has been subject to a series of major regulatory investigations and decisions during recent years. Several of the investigations remain ongoing.

| 18. Regulatory overview | | |
|--|-------------------|---------------------------------------|
| Development | Regulators | Status |
| Credit card default charges | OFT | Decision – April 2006, Implementation |
| Payment Protection Insurance | OFT, CC, FSA | Investigations ongoing |
| Interchange | OFT, EC | Investigations ongoing |
| New Consumer Credit Act | DTI, OFT | Implementation |
| New Consumer Credit Directive | EC, DTI | Negotiations ongoing |
| Basel II | EC, FSA | Implementation from 2007 |
| Notes: OFT = Office of Fair Trading, CC = Competition Commission, FSA = Financial Services Authority, EC = European Commission. | | |
| Sources: Author's research | | |

The following analysis of regulatory developments is broken down into four parts:

- The Office of Fair Trading's decision on credit card default charges
- The investigations by the Office of Fair Trading and Financial Services Authority into the sale of payment protection insurance
- The investigations by the Office of Fair Trading and European Commission into interchange on payment card transactions
- A brief review of other regulatory developments, including the new UK Consumer Credit Act, discussions about a new European Consumer Credit Directive and the implications of Basel II for credit card lending

The implications of these regulatory developments for issuers' income and costs are explored as part of Section 4 on the industry's economics.

3.1 Credit card default charges

In April 2006, the Office of Fair Trading, the UK competition and consumer protection body, announced its view that credit card default charges have “generally been set at a significantly higher level than is legally fair”.

Coverage

The OFT’s statement covers charges that have become an important source of non-interest income for issuers – charges in standard credit card contracts for:

- A failure to pay a minimum payment on the due date
- Exceeding a credit limit
- A failure to honour a payment made.

Reasoning

The OFT statement represents its view of the law. The relevant law is the test of fairness set out in the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs). The UTCCRs implement EU Council Directive 93/13/EEC on unfair terms in consumer contracts. They came into force on July 1 1995 and were re-issued in 1999 (coming into force on October 1 1999).

According to the OFT, a default charge should only be used to recover certain limited administrative costs. Otherwise, the OFT argues, they are open to challenge on grounds of unfairness. The costs may include postage and stationery costs and staff costs and also a proportionate share of the costs of maintaining premises and IT systems necessary to deal with defaults.

The OFT said it had considered the legitimately recoverable costs incurred by eight leading credit card issuers, which it assumed to be largely representative of the industry as a whole.

The OFT concluded that, generally, credit card default fees have been set at “a significantly higher level than is fair for the purposes of the UTCCRs”.

It added that the level of a fair fee will depend on the precise business circumstances. It cited the example of a card issuer requiring (not merely allowing) customers to give it direct debit authority to ensure a minimum payment is made (and so reduce defaults). According to the OFT, a card issuer operating a policy of this kind may be able to justify a higher level of default fee because

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its relevant business costs are being recovered from a proportionately smaller number of defaults.

However, even in these circumstances, the OFT emphasised that the card issuer may only recover the relevant limited administrative costs arising from the defaults.

Consequences

The OFT said it expected all credit card issuers to recalculate their default charges in line with the principles set out in its statement and to take urgent action where needed to reduce the level of credit card default fees.

To encourage what it called “a swift change in market practice”, the OFT included in the statement a simple monetary threshold of £12 for intervention on default charges. Where credit card default charges are set at more than £12, the OFT said it will presume that they are unfair, and are likely to be challenged unless there are exceptional factors.

The OFT added that a default charge is not to be deemed fair simply because it is below £12. However, it will judge fees below £12 “as either not unfair or insufficiently detrimental to the economic interests of consumers in all the circumstances to warrant regulatory intervention at this time”. The OFT described the threshold as “a provisional practical measure to move the whole market towards compliance”.

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3.2 Payment protection insurance

The OFT is also involved in the investigations into the sale of payment protection insurance (PPI), along with the Financial Services Authority (FSA), the main UK financial regulator.

Payment protection insurance is designed to protect borrower repayments in the event of accidents, sickness and unemployment. Its sale provides a lucrative source of commission income for credit card issuers and other consumer lenders.

| 19: Recent regulatory developments: PPI | | |
|---|------------------|--|
| 2007 | March | FSA announces refunds agreement on single premium PPI policies. |
| | February | OFT refers UK PPI market to the Competition Commission (CC) for further investigation. |
| | February | FSA fines Capital One for PPI sales failures. |
| | January | FSA fines GE Capital Bank for PPI and other insurance failures. |
| | January | FSA launches Phase 3 of its PPI work, to be completed by June 2007, and designed to test industry progress on various aspects of the sale of PPI. |
| 2006 | October | FSA publishes Phase 2 work on PPI. |
| | October | OFT proposes to refer the PPI market to the Competition Commission. |
| | April | OFT launches market study of the payment protection insurance (PPI) sector. |
| 2005 | December | The OFT announces plans for a market study of the PPI sector. |
| | November | The UK Financial Services Authority (FSA) raises concerns about the selling practices for payment protection insurance (PPI), publishing its report <i>The sale of Payment Protection Insurance – results of thematic work</i> . |
| | September | Citizens Advice (CitA) submits super-complaint to the Office of Fair Trading (OFT), the UK competition and consumer protection body, about PPI. |
| Sources: Relevant banks & agencies, author's research | | |

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According to the OFT, over 6.5 million PPI policies are purchased every year (across all personal borrowing), worth over £5.5 billion in 2005. Sale of PPI is a valuable source of commission for lenders, including credit card issuers (see Section 4 on Industry economics).

The regulators are concerned at the lack of competition in its provision (OFT) and industry sales practices (FSA).

OFT investigation

In February 2007, the OFT announced under the two-tier UK competition framework that it was referring the PPI market to the UK Competition Commission (CC) for more detailed investigation. This confirmed the OFT's Proposed Decision, published in October 2006 following a market study, and on which the OFT publicly consulted.

According to the OFT, structural features of the PPI market, the behaviour of firms and the behaviour of consumers all adversely affect competition.

Among the **structural features** adversely affecting competition, the OFT notes that PPI is a secondary purchase bought only as a result of taking out the primary credit. The point of sale (POS) advantage experienced by distributors means there is little competitive pressure at the key point at which the consumer buys insurance. Stand-alone providers have difficulty accessing consumers and face substantial start-up and marketing costs to attract custom.

With regard to the **conduct of firms**, the OFT notes that competition is centred on the sale of credit and not PPI. Further, it says PPI is often automatically included in the quote for credit without a customer's knowledge. And it adds that consumers in some cases either assume, or are told, or given the impression by the distributor that taking out the PPI will help the application for credit.

With regard to the **conduct of consumers**, the OFT comments that consumers do not shop around for PPI (with the POS advantage enjoyed by distributors a major contributor). Further, the OFT says consumers display a poor understanding of PPI, its price and the detail of their cover, with suppliers initially doing little to remedy this.

Among the **performance information** that indicates competition is adversely affected, the OFT notes that PPI has low claims ratios

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when compared to other insurance products. It also comments that commission rates paid by insurers to downstream intermediaries look high compared with other general insurance products (see Section 4 on industry economics).

With little demand or supply-side substitution, the OFT believes that separate markets exist for:

- First charge mortgage PPI (MPPI)
- Secured loan PPI
- Unsecured loan PPI
- Credit card PPI, and
- Store card PPI

The OFT's reference includes mortgage PPI, though it notes that some of the market features that distort competition may be less marked in this segment. However, the reference excludes store cards (which were covered by the recent CC store cards inquiry, with remedial measures due to come into force in 2007) but includes credit cards.

Among the OFT findings on PPI specific to credit cards, its consumer survey found that 83% of PPI holders took out PPI at the same time as their credit card (compared with 88% for credit products overall).

Of those who did not take out their PPI at the same time as the credit, overall 73% took out the PPI product offered by the credit provider at a later date. However, for credit cards the figure was 94%.

While 40% of respondents to the OFT's consumer survey claimed to have shopped around for their credit product, just 12% shopped around for the PPI. In the case of credit cards, the proportion of cardholders who claimed to have shopped around for PPI was only 5%.

The OFT comments that consumer access is particularly important in the case of credit card and store card PPI, for which the card issuer may be the only party in possession of information on the outstanding balance on the card, which is critical to setting the premium and calculating the claim payments. The OFT says it only came across one stand alone provider who sold stand alone credit card PPI cover, and they indicated that the number of policies sold was small.

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On claims ratios (defined as claims paid as a percentage of gross written premium or GWP), the OFT business survey of insurers found a mean claims ratio of 20% for all PPI policies. In the case of credit card PPI, the mean claims ratio in 2005 was lower at 14%.

The OFT compares the PPI claims ratios with comprehensive motor insurance (82% of GWP), household insurance (54% of GWP), pet insurance (72% of GWP) and medical insurance (80% of GWP).

FSA investigation

While the OFT is responsible for regulating consumer credit in the UK, the Financial Services Authority (FSA) is responsible for regulating insurance - hence its interest in the sale of PPI. The FSA's concerns relate to the sales standards in the PPI market.

In January 2007, the FSA announced details of a third phase of its work designed to improve PPI sales standards. The new work builds on two earlier phases in 2005 and 2006. The FSA says this is one of the largest programmes of thematic work the authority has undertaken. By the end of June 2007, the FSA says it will have visited over 200 PPI firms in two years.

Results of the FSA's Phase 2 thematic work on the sale of PPI were published in October 2006 (*The Sale of Payment Protection Insurance – results of follow-up thematic work*). The FSA found that some firms selling PPI were still failing to treat their customers fairly. According to the FSA, findings showed that:

- Many firms were still not giving customers clear information during the sales conversation. According to the FSA, it is not being made clear that PPI is optional and customers are not getting full information about how much the insurance will cost.
- Customers were still not being made fully aware that there may be parts of the policy under which they cannot claim. Further, the FSA found some firms are still failing to establish that the PPI policies they recommend are suitable because they are not collecting sufficient information from the customer – for example, about any existing cover they possess.
- Where customers are sold single premium policies, this was not always done with the best interests of the customer in mind.

The Phase 2 work was based on supervision visits to 40 firms selling PPI conducted between April and June 2006.

THE FSA's Phase 2 report followed the work undertaken by the FSA during 2005 and published in November 2005 *The sale of Payment*

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Protection Insurance – results of thematic work. The FSA also issued in November 2005 a “Dear CEO” letter to medium and large firms and a fact sheet for small firms.

The Phase 3 work includes mystery shopping, an extensive programme of both follow-up work with firms whose practices were earlier identified as deficient and visits to a sample of firms not previously visited. The FSA says a particular focus is on firms for whom the sale of PPI is a minor activity relative to their main business.

The FSA is also considering whether some of its current rules relating to PPI need changing or whether new rules need to be introduced.

The outcome of this latest phase of work will be published during the third quarter of 2007.

In late March 2007, just as this report was being finalised, the FSA announced an agreement with the PPI industry, secured in collaboration with a number of industry trade associations, on so called 'nil refund terms'. These are contract terms that prevent consumers from receiving a partial refund if they cancel a single premium PPI policy for any reason.

Single premium policies involve the consumer paying for the cover for the duration of the loan by a lump sum at the start of the contract. According to the FSA, the premium is usually added to the total value of the loan with interest charged on top. This is in contrast to regular monthly premium payments that incur no further cost to the consumer if cancelled.

FSA actions against individual companies

In addition to its ongoing thematic work, the FSA has already taken regulatory action against several major companies for PPI-related failures. These include two of the major credit card issuers – Capital One and GE Capital. They are worth summarising because they exemplify the kinds of sales failings that the FSA is seeking to eliminate.

Capital One

In February 2007, the FSA announced a £175,000 fine for Capital One Bank (Europe) Plc (Capital One) for failing to have adequate systems and controls for selling PPI insurance and for failing to treat its customers fairly. The fine included a 30% discount for agreeing to settle at an early stage.

According to the FSA, from January 2005 to April 2006, Capital One failed to ensure that 50,000 customers received important information about the policy including all exclusions, although they did receive a policy summary. The FSA says affected customers were unable to check what they were covered for or if the policy was right for them.

Though Capital One also offers loans, the FSA investigation focussed purely on credit card PPI sales. During 2005, Capital One sold approximately 335,000 UK credit card PPI policies according to the FSA (giving some sense of the scale of PPI sales in the credit card sector).

The FSA noted that Capital One has proactively engaged in a substantial programme of remedy and appropriate redress. Without this, the regulator says the financial penalty would have been substantially higher. According to the FSA, one part of the remedial programme ensured that those customers who did not receive the policy document had the opportunity to be compensated. The regulator says the cost of this part of the programme, including potential premium refunds and settled claims, is estimated at around £3m, of which £1.1m related to customers after general insurance regulation started in January 2005.

Capital One has been regulated by the FSA since December 1 2001, but only since January 14 2005 in relation to its insurance mediation activities. According to the FSA, Capital One's failings came to light during a thematic visit by the FSA to the firm in 2005 after which it was referred to Enforcement.

GE Capital Bank

The Capital One fine followed the announcement in January of a £610,000 fine for GE Capital Bank (GECB), again for failing to have adequate systems and controls for selling insurance, including PPI, and for failing to treat its customers fairly. The fine included a 30% discount for agreeing to settle at an early stage.

GECB's failings related to its store card business, where it is the largest player in the UK market. GECB sells general insurance policies, which include PPI, mainly on store cards offered by leading high street retailers.

Retail assistants usually offer the insurance to customers at the till when they are applying for a store card. According to the FSA, these in-store sales make up 95% of the firm's sales, with the remainder concluded over the telephone. In 2005 alone, over 850,000 policies that included PPI were sold on its behalf.

Both the in-store and telephone sales are 'non-advised' which means that GECB does not recommend the insurance policy as suitable for particular customers. For a non-advised sale, the FSA says firms are obliged to provide the appropriate information to customers in good time before the sale to enable the customer to make an informed decision as to whether the insurance is necessary or suitable.

In the GECB case, the FSA comments that important information about the insurance was not provided to all customers in good time before the conclusion of the contract. It adds that in some instances telephone customers were provided with inaccurate or misleading information about the insurance.

The FSA found that GECB failed to review and amend its procedures for selling insurance in light of its own evidence, emerging from Q2 2005, of widespread non-compliant selling practices.

According to the FSA, GECB is continuing to carry out a remedial action programme to review and improve its systems and controls.

The FSA noted that GECB is carrying out a comprehensive customer contact exercise and will pay compensation where appropriate (though the FSA adds that in this case the financial impact on most customers was likely to have been modest). Without this, the regulator says the financial penalty would have been substantially higher.

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According to the FSA, GECB's failings came to light during a thematic visit by the FSA to the firm in 2005 after which it was referred to Enforcement.

Other FSA action

Prior to the Capital One and GE Capital Bank announcements, the FSA has previously fined three firms over poor PPI selling practices - Regency, Loans.co.uk, and Redcats – and imposed a public censure on Eastern Western Motor Group.

The FSA adds that two other cases have recently been concluded where problems relating to PPI also featured - Capital Mortgage Connections and Home and County Mortgages – with other PPI enforcement investigations underway.

3.3 Interchange

Background

The battles between card issuers and merchants over interchange date back many years. They also have an international dimension, with the European Commission's investigations of cross-border interchange in the EU (see box following) and the impact of investigations in other markets.

In the UK, the OFT has been investigating MasterCard's domestic interchange arrangements for credit and charge card transactions since 2000. The investigations – which continue and have since been extended to Visa and most recently to debit cards – have taken so long because of various legal, structural and organisational changes and because of the increasing relevance of the EU dimension. Even now, the outcome and implications remain unclear.

Legal framework

The legal bases for the OFT investigations are the EC Treaty and the UK Competition Act 1998. Both the EC Treaty and the Competition Act 1998 prohibit anti-competitive agreements. Article 81 of the EC Treaty and the Chapter I prohibition of the Competition Act apply to agreements which prevent, restrict or distort competition.

EC Regulation 1/2003, which entered into force on May 1 2004, requires the OFT (as a national competition authority of an EU Member State) to apply Article 81, as well as the Chapter I prohibition, when the Chapter I prohibition is applied to agreements which may affect trade between Member States.

The UK Competition Act was amended, with effect from May 1 2004, to provide the OFT with the necessary investigation and enforcement powers for the application of Article 81.

Background

The long and convoluted history of the OFT investigations into MasterCard's (and subsequently Visa's) UK interchange rules is summarised in table 20.

The investigations go back to MasterCard's decision in March 2000 to notify its UK Domestic Rules to the OFT for consideration as to whether they infringed the Competition Act and, if so, whether an individual exemption could be granted.

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| 20: OFT investigation into interchange | | |
|--|------------------|--|
| 2007 | February | OFT announces expansion of the scope of its investigation into interchange fees to include immediate debit cards. |
| 2006 | June | OFT consents to Competition Appeals Tribunal setting aside of its decision on MasterCard's historic interchange fee arrangements and announces new focus on MasterCard's and Visa's current UK interchange fee arrangements. |
| | February | OFT launches investigation into MasterCard's new arrangements for setting the fallback interchange fees that apply to all UK domestic transactions made using UK-issued MasterCard credit and charge cards, introduced by MasterCard on November 18 2004. |
| 2005 | November | MasterCard appeals OFT's September 2005 Decision. |
| | October | OFT issues a statement of objections against Visa and its members regarding an agreement on its domestic multilateral interchange fee (MIF) applicable to consumer credit card, charge card and deferred debit card transactions in the UK. |
| | September | OFT finds collective agreement between members of MasterCard UK Members Forum setting the multi-lateral interchange fee paid on virtually all purchases in the UK made using UK-issued MasterCard credit and charge cards between March 1 2000 and November 18 2004 restricted competition and infringed Article 81 of the EC Treaty and the Chapter I prohibition of the Competition Act. |
| 2004 | November | OFT issues further statement of objections on MasterCard agreement. MasterCard introduces new domestic interchange arrangements. |
| | May | MasterCard notification lapses as a result of changes to the UK Competition Act. |
| 2003 | February | OFT announces it proposes to find that MasterCard agreement does not comply with competition law |
| 2001 | September | OFT issues statement of objections against MasterCard agreement. |
| 2000 | March | MasterCard UK Members Forum notifies its UK Domestic Rules, including its rules on interchange fees, to the OFT for consideration as to whether they infringe the Competition Act. |
| Sources: Office of Fair Trading, author's research | | |

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The then MasterCard UK Members Forum Ltd – previously known as MasterCard/Europay UK Ltd and comprising the major UK MasterCard issuing banks – was responsible for the adoption of rules specific to the UK (the UK Domestic Rules). On **March 1 2000**, it notified its Memorandum and Articles of Association and the UK Domestic Rules, including its rules on interchange fees, to the OFT.

As of **May 2004**, as a result of changes to the Competition Act (see legal framework above), the MasterCard UK Members Forum notification lapsed.

However, the OFT's investigation continued. In **November 2004**, the OFT issued a further statement of objections (following those of September 2001 and February 2003 under the initial notification) against MasterCard UK Members Forum's (MMF) rules on domestic interchange fees.

In **September 2005**, the OFT announced it found that a collective agreement between MMF members setting the multi-lateral interchange fee paid on virtually all purchases in the UK made using UK-issued MasterCard credit and charge cards between March 1 2000 and November 18 2004 restricted competition and infringed Article 81 of the EC Treaty and the Chapter I prohibition of the Competition Act.

This was followed in **October 2005** by a statement of objections against Visa and its members regarding an agreement on its domestic multilateral interchange fee (MIF) applicable to consumer credit card, charge card and deferred debit card transactions in the UK. The OFT again argued that this agreement infringed Article 81 of the EC Treaty and the Chapter I prohibition of the Competition Act.

MMF, along with MasterCard International Incorporated and MasterCard Europe Spri, and the Royal Bank of Scotland Group, appealed to the Competition Appeal Tribunal against the OFT's September 2005 Decision. Subsequently Visa and the British Retail Consortium were granted permission by the Competition Appeal Tribunal to intervene in the appeal against the OFT's decision on MasterCard.

The OFT extended the time by which Visa could respond to the October 2005 statement of objections until after the publication of the Competition Appeal Tribunal's judgment in the MasterCard appeal.

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Competition Appeal Tribunal

On November 18 2004, MasterCard introduced new arrangements for setting the fallback interchange fees that apply to all UK domestic transactions made using UK-issued MasterCard credit and charge cards.

In **February 2006**, the OFT announced an investigation into the new MasterCard interchange arrangements. The OFT again expressed concern that the new arrangements may continue to be set with reference to 'extraneous costs' and used to recover such costs, so infringing Article 81 and/or the Chapter I prohibition of the Competition Act.

In **June 2006**, the Competition Appeal Tribunal set aside the OFT's decision of September 2005 concerning MasterCard's historic interchange fee arrangements.

The OFT consented to the setting aside of its September 2005 decision. The OFT announced it would now focus on tackling both MasterCard's and Visa's current UK interchange fee arrangements.

According to the OFT, the proceedings in the CAT raised serious procedural problems which led it to consent to the setting aside of its original decision. The OFT reiterated its belief that the interchange fee arrangements now in place could infringe competition law.

According to the OFT, in appeal proceedings, MasterCard advanced for the first time a new approach to calculating those elements of the interchange fee allowable in terms of the reasoning of the original decision. If accepted by the CAT, the OFT argues this new approach would have allowed much higher interchange fees than the OFT had previously been led to understand.

The OFT added that it wished to rely in the CAT on arguments not contained in its original decision, and this raised very serious procedural problems.

Most recent developments

In **February 2007**, the OFT announced an expansion of the scope of its investigation into interchange fees to include immediate debit cards. It described the expansion of the investigation as consistent with the scope of the European Commission's current investigation into MasterCard's European intra-regional interchange fees.

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Current position

The net result is that interchange on credit and charge card transactions has been under the regulatory microscope in the UK for an astonishing seven years.

The OFT continues to question the basis on which interchange is set. OFT Chief Executive John Fingleton said at the time of the June 2006 CAT ruling: “We still believe that the interchange fee arrangements that are now in place could infringe competition law and are harmful to consumers, who pay higher prices as a result of these fees.”

Interchange remains a valuable income stream to card issuers (see Section 4). A significant reduction (as has happened in Australia) would have serious implications. However, seven years on from the MMF submission of its domestic rules to the OFT, interchange continues to be paid on domestic MasterCard and Visa credit card transactions.

The European Commission’s ongoing investigations (see following box), along with regulatory interventions and litigation in many other jurisdictions (with Australia and the United States particularly important), mean that interchange is likely to remain under investigation in the UK. However, the complex interplay with the European Commission investigations also suggests that any final resolution remains some way off.

Interchange: the European dimension

The European Commission (EC, the European Union's executive which is responsible for competition policy and enforcement) has taken an increasing interest in payment card interchange across Europe during recent years.

The Commission's interest covers two areas:

- First, the interchange rates applied to cross-border transactions on Visa and MasterCard payment cards in Europe.
- Second, a more recent interest in the wider arguments for or against interchange as part of its sector inquiry into retail banking.

Cross-border interchange investigations

The Commission has been investigating the multilateral interchange fee rates for European cross-border payments (MIFs) of Visa and MasterCard under EU competition law for several years.

The Commission's **Visa** Decision of 2002 (Case no. Comp/29.373 – Visa International – Multilateral Interchange Fee, decision of 24 July 2002; OJ L 318/17, 22.11.2002.) fixed the underlying cost components for consumer card interchange fees and obliged Visa to conduct an in-depth cost study to justify the level of each of the costs. Moreover, the Decision set an annual ceiling on the interchange fee rates for each subsequent year up to 2007.

The European Commission's investigation into **MasterCard** remains open.

In June 2006, the Commission sent a supplementary Statement of Objections (SO) to MasterCard. The SO supplements a preceding SO of 24 September 2003 and concerns MasterCard's cross-border interchange fees.

In its SO, the Commission took the preliminary view that MasterCard restricts competition between member banks by pre-determining a minimum price retailers must pay for accepting MasterCard and Maestro branded payment cards. The Commission's preliminary view was that such behaviour is contrary to the EC Treaty's ban on restrictive business practices (Article 81).

Though the Commission's Visa Decision of 2002 exempted under EU

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competition rules MIFs for cross-border Visa card payments, it is important to note that the exemption is valid only until the end of this year. After December 31 2007 the Commission will be free to re-examine the Visa MIF system in the light of the effects of the revised MIF on the market.

Sector inquiry into retail banking

On June 13 2005 the European Commission initiated an inquiry into retail banking. The final report was published at the end of January 2007. Payment cards, including interchange arrangements, have been a major focus of the inquiry.

Though led by the Commission's Competition Directorate-General, the Commission's influential Internal Market and Services DG has supported the inquiry.

The Commission published two interim reports during the sector inquiry, one of which was on the payment cards sector. In the preliminary report of April 2006, the Commission raised concerns about interchange. According to the report: "Overall, the inquiry has not confirmed the possible justifications for interchange fees which rely on economic efficiency arguments."

The final report of the inquiry reiterated concerns over interchange and doubts about the justifications put forward by the card associations:

"The identified *multilateral interchange fees* raise competition concerns, particularly in some countries. Card payment networks argue that, given the typical set-up of card payment mechanisms, the card issuers typically bear the main costs of the payment system, while most of the revenues are collected on the acquiring side as merchant fees. Therefore, the card payment networks claim that there is a need to redressing cost imbalances by an interchange fee mechanism, i.e. a fee paid by the acquirers to the issuers. However, the evidence shows that most domestic debit card networks set significantly lower (or even zero) interchange fees than international networks on debit card transactions, resulting in generally lower merchant fees." (Paragraph 15)

The Commission added that analysis of the inquiry's market data suggests that card issuing alone (ie without interchange fee) generates positive profits in twenty EU Member States.

Among possible next steps, the Commission commented that

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competition law enforcement action might be appropriate in relation to “high interchange fees and merchant fees in some payment card networks”. However, no further details are provided.

The “frequently asked questions” document accompanying publication of the final report includes the question: “Are you proposing to abolish interchange fees?”

The Commission’s answer is similarly open: “No, we do not propose to abolish the interchange fee. We are trying to make sure that the interchange fee is set at a fair level as a result of a competitive outcome and the cost of this fee is sufficiently transparent for market participants.”

Relationship between EC sector inquiry and case work

The “frequently asked questions” document accompanying publication of the final report also included the question on the relationship between the retail banking sector inquiry and the Commission’s case work (such as the Visa and MasterCard cases):

The reply notes that the MasterCard case remains open:

“Prior to the opening of the sector inquiry, the Commission had done substantial case work in the field of payment cards systems. Some of these cases, such as those addressing interchange fee (inter-bank fee paid by acquiring banks to issuing banks) in the MasterCard network and other types of fee arrangement, such as the 'MERFA' in the French card network 'Groupement de Cartes Bancaires', are still open. Experience and knowledge gained by the Commission in these and other cases has enabled more effective scrutiny of specific aspects of the payment card markets. However, it needs to be noted that no evidence collected in the framework of these cases, was ever used for the purpose of the sector inquiry and, of course, vice versa.”

Relationship between EC and OFT investigations

In the OFT’s document of February 2003 setting out its preliminary conclusions on MasterCard interchange fees, it commented on the relevance of the Commission’s Visa decision of 2002.

While noting similarities between the Visa case and its own MasterCard investigation, the OFT commented that the EC decision relates solely to cross-border and not to domestic transactions. “Consequently, much of the analysis and reasoning that led the Commission to grant an

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exemption is not relevant when examining a MIF for domestic transactions, such as the MasterCard MIF. In addition, Visa International made a number of changes to its MIF agreement which ensured that it qualifies for exemption.”

However, the OFT added that there are many points where its preliminary conclusions are similar to the Commission’s: “For example, both have concluded that MIF agreements create an appreciable restriction of competition, that competition from other payment methods (such as cheques) will not prevent the MIF from being set at an excessive level, and that these agreements can qualify for exemption only if the level of the MIF can be justified.”

Most recently, in its February 2007 statement announcing the expansion of its investigation into interchange fees to include immediate debit cards, the OFT described the expansion as “consistent with the scope of the European Commission's current investigation into MasterCard's European intra-regional interchange fees”. Based on this comment, the future of the UK and wider European investigations appear to be closely linked.

3.4 Other regulatory developments

The analysis of regulatory developments has focused on those specific to the credit card industry (default charges and interchange) and those likely to have the greatest impact on industry revenue and costs (which, though not specific to credit cards, adds PPI to the list).

However, it is important to note that various other regulatory developments that will affect the industry are either being implemented or under consideration.

Even excluding card default charges, PPI and interchange, the summary in table 21 captures the extent of recent regulatory activity across the wider consumer credit sector during recent years. And in addition, there are important European and international developments affecting the sector.

The following section summarises briefly developments related to:

- The new UK Consumer Credit Act
- Proposals for a new European Consumer Credit Directive, and
- The impact of Basel II on revolving credit balances

Consumer Credit Act 2006

The new consumer credit legislation, the UK Consumer Credit Act 2006, was enacted at the end of March, supplementing the existing 1974 Act. The purpose of the 2006 Act is to reform the 1974 Act in order to:

- Provide for the regulation of all consumer credit and consumer hire agreements subject to certain exemptions
- Make provision in relation to the licensing of providers of consumer credit and consumer hire and ancillary credit services and the functions and powers of OFT in relation to licensing
- Enable debtors to challenge unfair relationships with creditors, and
- Provide for an Ombudsman scheme to hear complaints in relation to businesses licensed under the 1974 Act, as amended.

In late May 2006, the DTI set out how and when the changes under the new legislation will come into force. Provisions within the Act will be rolled out over the next two years.

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| 21: Other recent regulatory developments | | |
|---|------------------|---|
| 2007 | March | Consumer group Which? submits super-complaint to the OFT about the way credit card companies calculate interest charges |
| | March | OFT announces in-depth study of retail bank pricing to sit alongside formal investigation into the fairness of bank current account charges |
| | March | European Finance Ministers agree EU Payment Services Directive |
| | February | OFT announces it will not undertake further work on access and governance arrangements of UK card schemes at the present time (though this does not affect the on-going investigations into MasterCard's and Visa's interchange fee arrangements) |
| 2006 | September | OFT announces study of bank current account default charges |
| | May | Department of Trade and Industry (DTI) sets out plans for implementing new consumer credit law |
| | April | Competition Commission (CC) announces its provisional findings into competition in the home credit market |
| | March | Consumer Credit Bill receives Royal Assent (becomes law) in March 2006 |
| | March | Competition Commission publishes final report on Store Card Credit Services Inquiry |
| 2005 | May | The Consumer Credit Bill is introduced into the House of Commons (the lower house of the UK Parliament) |
| 2004 | December | OFT refers the home credit market to the Competition Commission for investigation |
| | March | The OFT refers the supply of store card services (both to retailers and consumers) to the UK Competition Commission for investigation |
| 2003 | December | UK Government issues proposals for a comprehensive overhaul of the 1974 Consumer Credit Act |
| Sources: Relevant banks & agencies, author's research | | |

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European Consumer Credit Directive

There has been European Union consumer credit legislation for almost two decades. The first Consumer Credit Directive was introduced in 1987 to approximate “laws, regulations and administrative provisions of the Member States concerning consumer credit”.

However, the European Commission (the EU’s executive) argues that existing European legislation has become an obstacle to the development of a cross-border provision of consumer credit across the EU and is pushing for new legislation.

First, the Commission describes the existing legislation as out-of-date, reflecting a time when in many EU countries consumer credit was used less, and mainly in the form of cash loans or hire-purchase agreements.

Secondly, the existing legislation lays down only basic standards for regulation. EU Member States have added to these basic standards in different ways, resulting in diverse and opaque regulatory systems. As a consequence, the Commission says there is no Single Market in consumer credit, with providers having to adapt to the existing diversity of regulation.

Given these concerns, the European Commission has pushed during recent years for a new directive on consumer credit. Its first proposal of September 2002 met with strong opposition from lenders and in the European Parliament. In October 2004, the Commission adopted a new proposal, the first modified proposal. This was followed in October 2005 by a second revised proposal. The second revised proposal is based on the first, but includes changes following Commission discussions with concerned stakeholders during 2005.

The second proposal remains the current focus of discussions. It was discussed by Ministers from EU Member States at the Competitiveness Council meeting in Brussels in December 2006. And, as part of its EU Consumer Policy strategy 2007-2013 announced in March 2007, the European Commission has said work will continue to ensure the adoption of the proposal for a new Directive on consumer credit.

However, progress on negotiating a new Consumer Credit Directive appears to be limited. One of the main problems is striking an acceptable balance across EU countries between those rules that

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are uniform and those based on minimum standards (leaving EU countries free to introduce additional provisions).

Basel II

Amid the regulatory pressure on other fronts, the introduction of Basel II offers the prospect of potential benefits to credit card issuers. In general, retail lending – which encompasses residential mortgages and small business lending as well as unsecured consumer credit – benefits from lower capital adequacy requirements than under the existing Basel capital adequacy accord.

Basel II is a highly complex topic. What follows is nothing more than a brief overview of the new accord as it applies to credit card loans.

The main innovation of the original Basel capital adequacy framework was the concept of risk-weighting bank loans and other assets. However, despite introducing the concept of risk-weighting, Basel I divided banks' assets and lending into only three or so core risk categories. Based on a minimum capital to risk-assets ratio of 8%, the accord gave:

- A zero, or very low risk weighing for low-risk investments such as government bonds.
- A 50% risk weightings for residential mortgages secured on property.
- A full 100% risk weighting for other bank loans, including unsecured consumer lending.

Basel II is designed to be a more sophisticated framework. The minimum capital (for credit, market and operational risk) to risk-assets ratio of 8% has been retained, but with a more granular array of risk-weightings. And, under Basel II's more sophisticated "internal ratings-based" (IRB) approach, banks with sufficient capability are able to calculate their own risk weightings using internal loan data rather than the standardised weightings specified in the framework.

Under Basel II's **standardised approach**, unsecured retail lending such as credit cards qualifies, subject to certain conditions, for a lower 75% risk-weighting (other than past due loans). This compares with the 100% risk weighting at present.

However, it is worth noting that Basel II gives significant discretion to national banking supervisory authorities. It says national

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supervisory authorities should evaluate whether the 75% risk weight is too low based on the default experience for these types of exposures in their jurisdictions. Supervisors may require banks to increase these risk weights as appropriate.

At the heart of the Basel II **internal ratings-based (IRB) approach** is the idea that banks themselves provide the data inputs for each category of asset. These inputs are fed into risk-weight functions (mathematical equations) specified in the new accord for each asset category. Based on inputting relevant bank data, the functions generate the risk-weights for the relevant asset category.

Under the Basel II IRB approach, banks provide their own estimates of three core sets of data:

- The Probability of default (PD), the probability in percentage terms that an exposure will fall into default.
- The Loss given default (LGD), the magnitude of likely loss on the exposure expressed as a percentage of the exposure.
- The Exposure at default (EAD), the amount expressed in relevant currency to which the bank is exposed at the time of default.

Maturity – the remaining economic maturity of an exposure – is also an input for some categories of exposure under the IRB approach. However, none of the IRB risk-weight functions contain an explicit maturity adjustment.

Unlike under Basel I and the Basel II standardised approach, the risk-weights generated under the IRB approach increase with the potential default exposure. Broadly speaking, for a given EAD (expressed in the relevant currency), the higher the PD and the higher the LGD (both expressed as a percentage), the higher the risk-weighting.

There are three separate risk-weight functions for retail exposures under Basel II's IRB approach:

- Residential mortgage exposures
- Qualifying revolving retail exposures (QRRE)
- Other retail exposures (ORE)

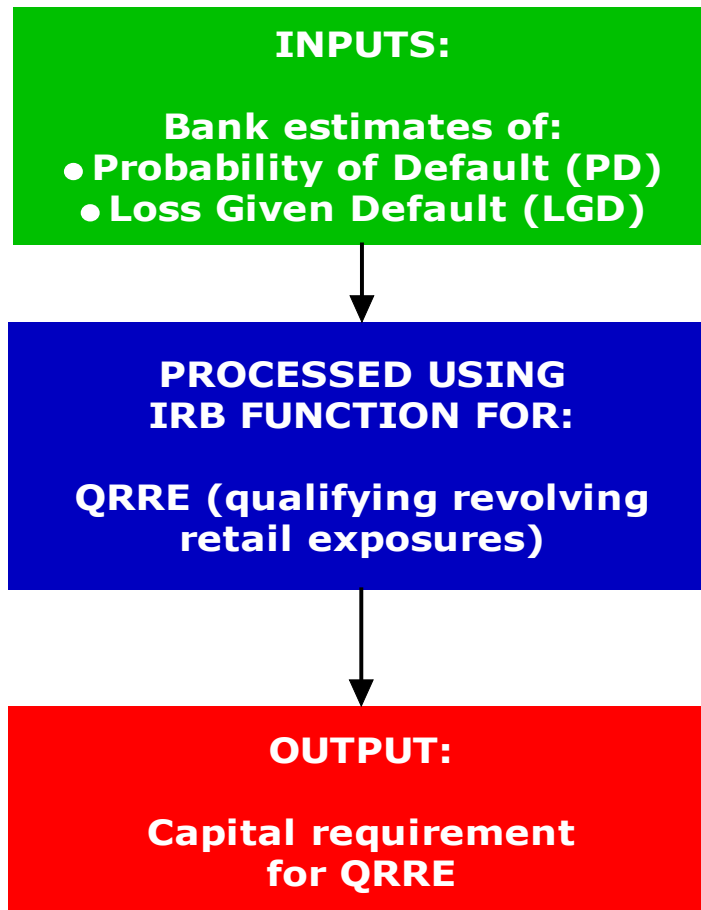
Revolving consumer credit lending such as that on credit cards is captured under QRRE. The treatment of QRRE was one of the last issues to be finalised by the Basel Committee on Banking Supervision, which is responsible for the new accord.

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Other consumer credit lending such as unsecured instalment loans is captured under ORE.

For retail exposures with uncertain future drawdown such as credit card balances, it is important to note that Basel II requires banks to take into account their history and/or expectation of additional drawings prior to default in their overall calibration of loss estimates. Banks must incorporate the likelihood of additional drawings on credit card accounts into either their LGD or EAD estimates.

22. IRB approach for QRRE under Basel II



Note:

Risk-weighted assets = capital requirement ('K' in accord) x 12.5 (ie the reciprocal of the minimum capital ratio of 8%) x EAD (Exposure at Default)

Source: Basel Committee on Banking Supervision (author's presentation)

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Within this broad relationship between PDs, LGDs and risk-weights, actual relationships depend on the specifics of the mathematical formulae that convert the bank-supplied inputs into risk weights. Central to each Basel II formula is the asset correlation – the correlation of the asset values between borrowers. This can either be fixed irrespective of PD, or vary with PD.

The formula for calculating the capital requirement is common to each function. The differences relate to the correlation value for each function. There are differences in the correlation for each. The effect is that the actual relationship between PDs, LGDs and risk-weights vary between QRRE such as credit cards and ORE such as instalment loans.

The treatment of asset correlation in the Basel II function for qualifying revolving retail exposures was subject to intense debate between the Committee and banking industry.

In the final accord, the Basel Committee fixed the asset correlation for QRRE at 4%. This compared with previous drafts in which the asset correlation for QRREs varied inversely with the probability of default. The change in the final accord reduces capital requirements for QRREs under the IRB approach at low probabilities of default.

While typically having high absolute levels of losses, QRREs are assumed on this basis to have relatively low variation in that level of loss. While expected losses on QRREs (which should be covered by loan loss provisions) are high, unexpected losses (which regulatory capital is intended to protect against) are relatively low. In recognition of this, the FSA says that using the QRRE risk-weight function is limited to portfolios where firms can demonstrate that the volatility of loss rates is low.

Risk weights under the IRB approach depend on two variables – probability of default (PD) and loss given default (LGD). The actual impact by credit card issuer under the IRB approach will therefore depend on the specific values for PD and LGD, as well as the application of the capital framework to any securitised QRRE portfolios (the treatment of which is beyond this brief outline).

Given that risk weights depend on both PD and LGD, it is difficult to display the IRB approach in a two-dimensional chart. To give some kind of indication of risk weights under the IRB approach, chart 23 assumes a LGD of 85% and shows the variation in risk weighting for

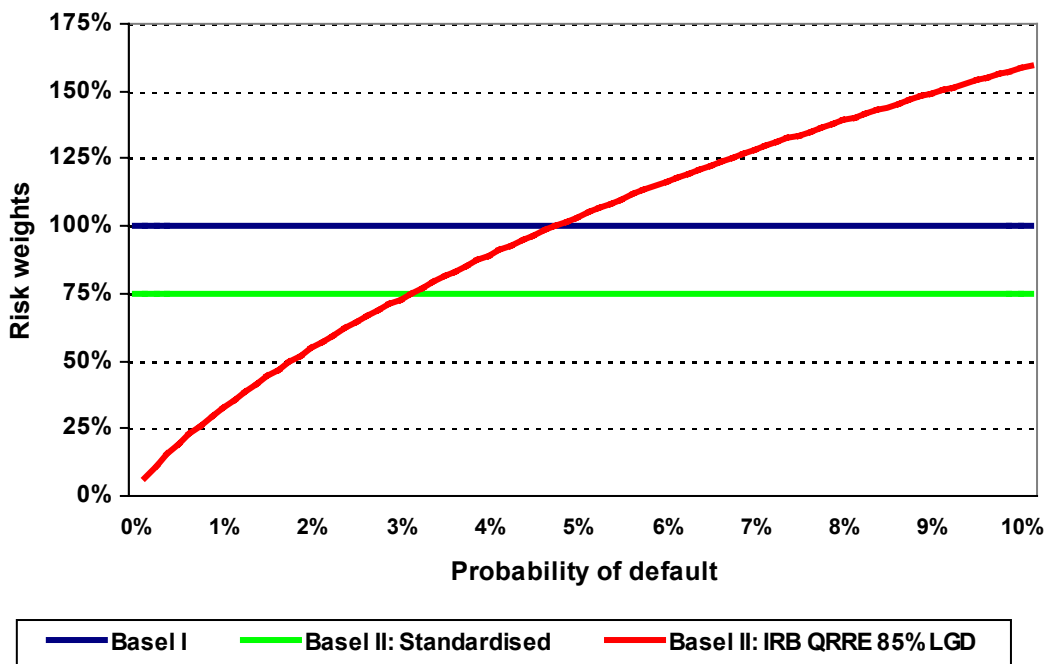
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QRREs depending on PD. These are compared with the risk weights under Basel I and the Basel II standardised approach.

Based on a LGD of 85%, the IRB approach requires less capital than under the current accord up to a PD of approximately 5% and the Basel II standardised approach up to a PD of approximately 3%.

Basel II is being implemented in European Union countries by means of the EU Capital Requirements Directive (CRD). The CRD came into force on January 1 2007. This is the earliest implementation date for a firm wishing to adopt the simpler or intermediate approaches (including Retail IRB) to credit risk under Pillar 1 of the Basel II accord. Firms can apply the advanced approaches (AIRB) only from January 1 2008.

23. Risk weights for QRRE under Basel II



Notes:

1. Chart shows risk weights for qualifying revolving retail exposures (QRRE) under Basel II IRB approach compared with Basel I & Basel II standardised approach.
2. Risk weights under Basel II IRB approach also vary with Loss Given Default (LGD), which is fixed at 85% in the above chart.

Source: Basel Committee on Banking Supervision

4. Industry economics

The following section draws on the analysis of market, competitive and regulatory trends to examine the changing economics of the credit card industry.

Given that credit card businesses generally form part of wider banking groups, the income, costs and profits are absorbed into the wider divisional and group figures. For US issuers, the numbers on their UK operations are rarely broken out in any detail. As a result, robust numbers specific to credit cards on income, costs and profits are not readily available.

Of the large UK banks, Barclays reveals the most detailed data on its credit card operations. Barclaycard is structured as a separate business in the group. However, even with Barclaycard, care needs to be taken with the numbers because they also encompass Barclays' international credit card issuing operations, its merchant acquiring operations and its UK consumer loans operations.

For the record, Barclaycard's profit before tax fell by 40% to £382 million in 2006 from £640 million the previous year. Though it is not specifically isolated in Barclays' reporting, the performance of UK credit card issuing was clearly a key driver of the fall in Barclaycard's profits.

Though not comprehensive, piecing together data from various sources such as Barclays and other banks' reporting, industry statistics and regulatory reports, it is possible to develop a general picture of industry economics.

The following analysis focuses on those income and costs most relevant to the industry's change in fortunes during the last two years and its prospects over the next few years. It analyses:

- The overall income and cost structure of the credit card business
- Developments in interest income
- Developments in non-interest income, both that received directly from cardholders and that received from merchants/acquirers in the form of interchange
- And finally developments in key cost items.

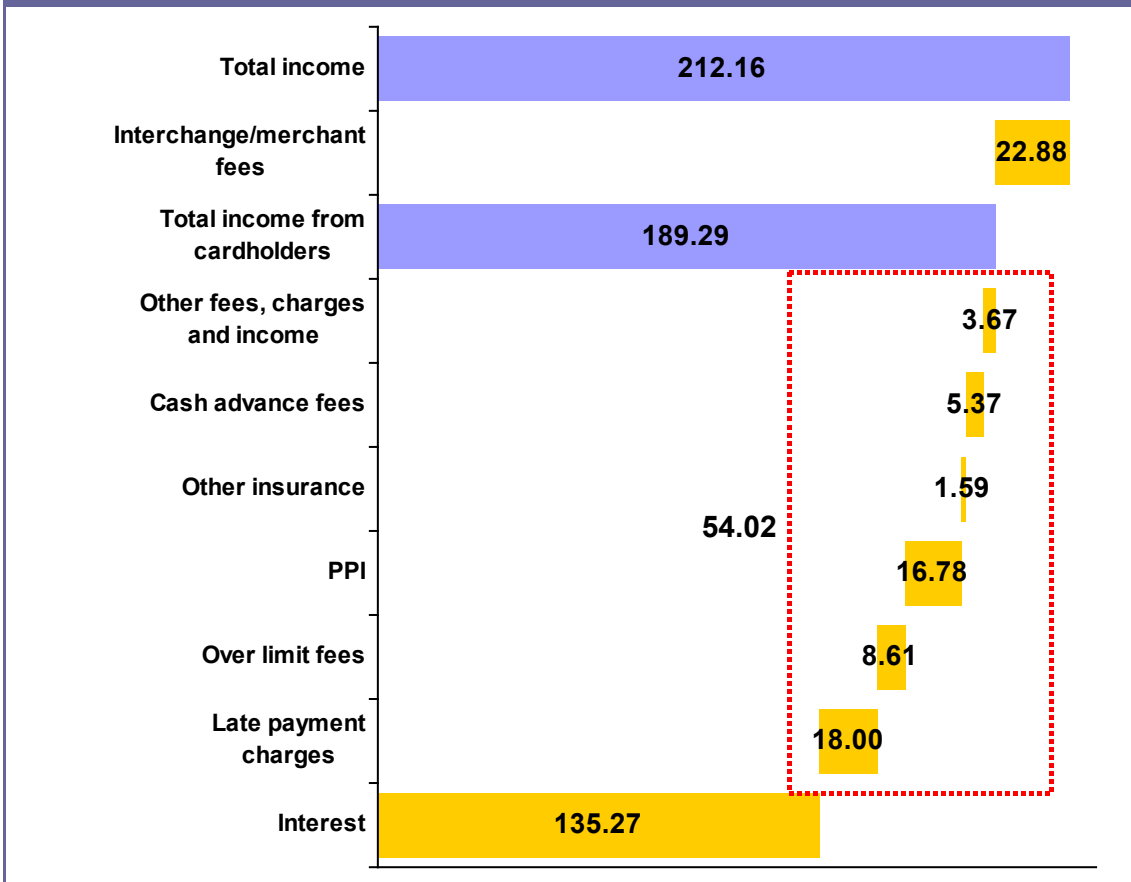
Given the importance of rising credit losses to the industry's profitability during recent years, a box at the end of the section looks in more detail at the measurement of credit losses.

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4.1 Overview of income and cost structure

Chart 24 gives an overview of credit card income per active account. It is based on data in the Competition Commission's 2006 report into the store card market. However, the data used to construct the chart below applies to credit cards and not store cards. The Competition Commission's report contains separate data for the latter.

24. Credit card income - 2003 (£ per active account)



Notes:

1. Data based on information from store card and credit card providers.
2. Figures in the chart are for credit cards and not store cards.

Source: UK Competition Commission, Store cards market investigation report, March 2006 (presentation of data by author)

Although these results relate to 2003, the Competition Commission says in the report that it received no suggestion (for example in response to its provisional findings) that the situation had changed since then. And even if the data may now be a little dated, it provides a useful introduction to the analysis of industry economics.

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The chart highlights a number of features of credit card industry economics that are relevant to the following analysis.

- Non-interest income accounts for almost 30% of income received directly from cardholders. Though there is no hard data publicly available to document this, non-interest income has grown as a proportion of total industry income during the last decade.
- Within non-interest income, the largest contributors are late payment charges, over limit fees and PPI – the revenue streams subject to recent regulatory intervention.
- Adding interchange income, non-interest income accounts on the Competition Commission figures for approximately 36% of total income.

Of course, this kind of analysis aggregates the wide variety of cardholder behaviour found in the credit card market. Cardholders range from those who only use their cards as a means of payment to those who borrow occasionally to those who maintain a large outstanding balance (with many individual cardholders moving between these categories over time). The revenue and cost profiles of these different types of cardholder vary significantly.

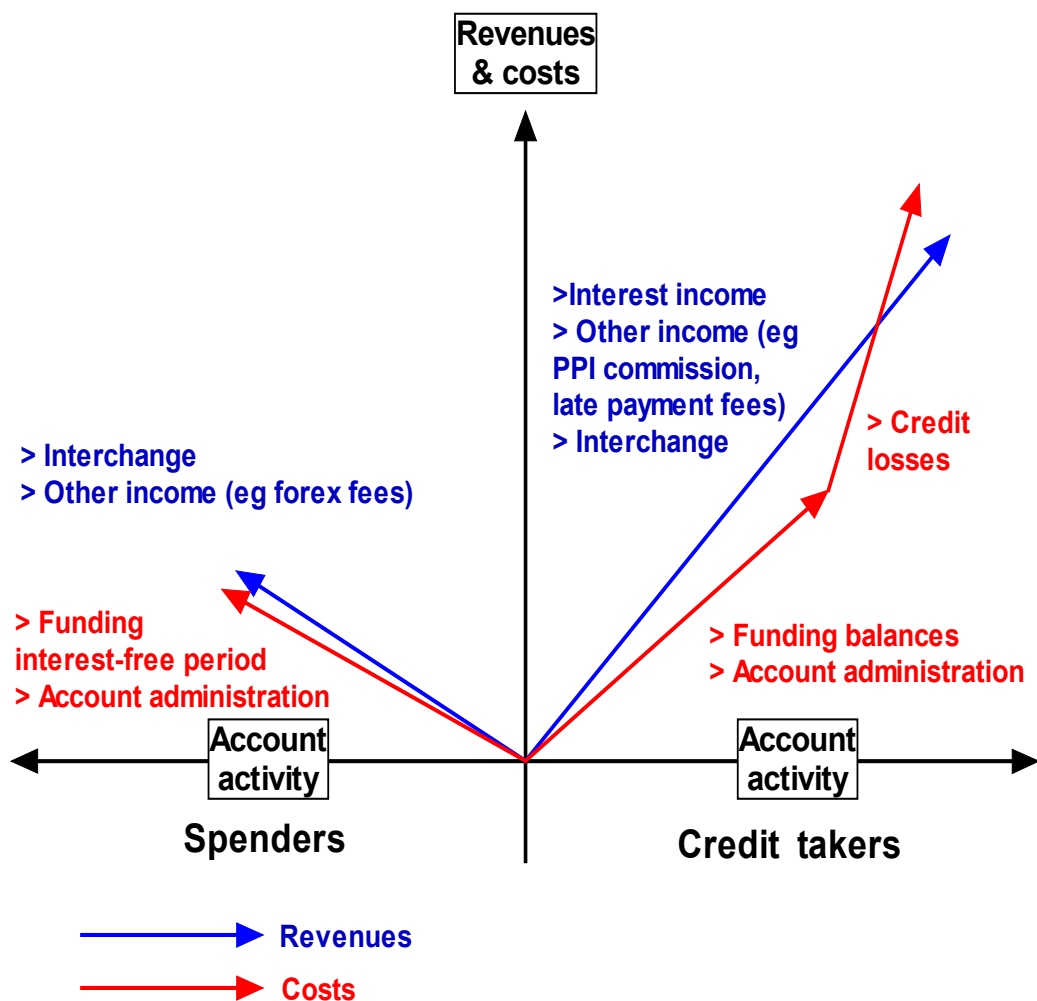
Among active cardholders, borrowers generate interest income and most cardholder non-interest income (PPI commissions, over limit and late payment fees) for issuers.

Those cardholders who only use their cards as a means of payment generate most interchange income. The main costs involved in running the accounts of 'full payers' are funding the interest-free period and administering the account (processing transactions, preparing statements, processing repayments, etc).

Chart 25 sketches the differing income and cost profiles of spenders (often called 'transactors') and borrowers or credit takers (often called 'revolvers'). The chart is only indicative, with actual income and costs per account depending on the specific level and structure of activity, and actual interest rates, fees and costs.

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25. Overview of credit card revenue and cost streams



Notes:

1. Chart is indicative only.
2. Fraud losses (not shown on chart) may apply to both spenders and borrowers.

Source: Author's analysis

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4.2 Interest income

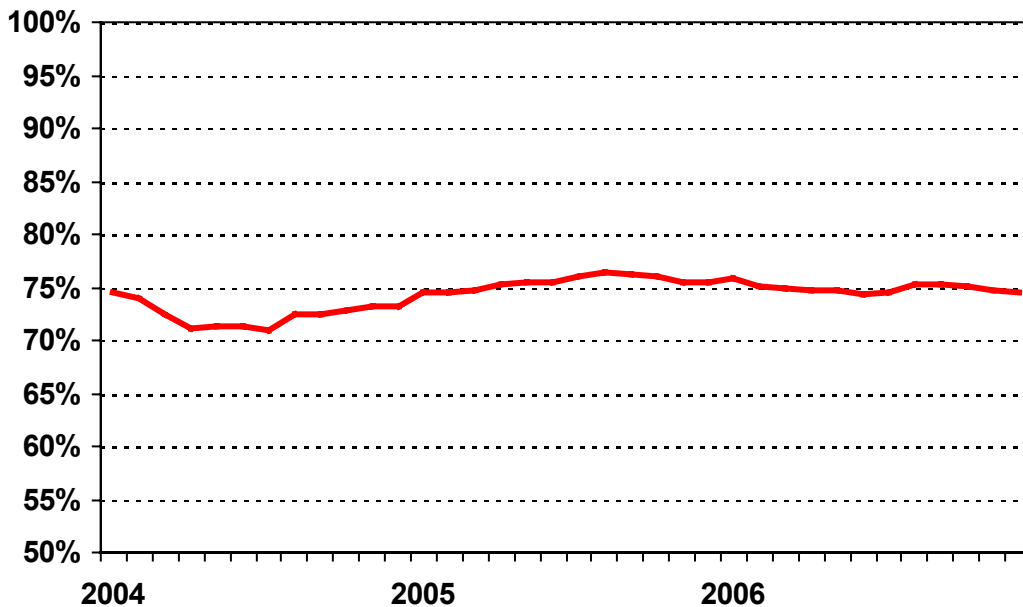
Interest income remains the most important revenue stream for the industry.

Interest income on outstanding balances is primarily determined by:

- The proportion of balances bearing interest, and
- The interest rate charged on those balances.

Looking first at interest-bearing (IB) balances, since 2004 they have shown only modest variation at around 75% of total balances.

26. Percentage of balances bearing interest

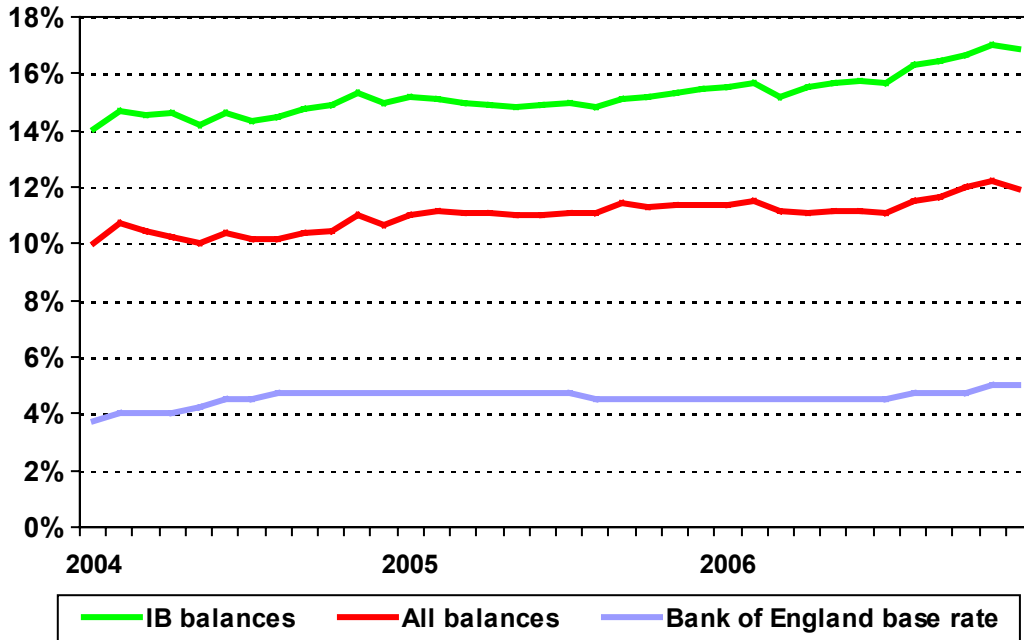


Source: British Bankers' Association

However, in aggregate, credit card interest rates appear to have risen. Chart 27 shows effective credit card interest rate on all balances and on interest bearing balances from 2004 to 2006. It indicates an upward drift in credit card rates, particularly during 2006.

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27. Credit cards – effective interest rates



Notes:

1. Effective rates are calculated as a function of average loan/deposit balances and interest payable/receivable on those balances. More details on the Bank of England's 'Effective interest rates' series are available in the Explanatory Notes to its *Monetary & Financial Statistics* publication.
2. IB balances: Where interest has been charged (ie balances have not been paid off in the interest free period).
3. Bank of England base rate – when the rate has changed during a month, the rate in place for the majority of the month has been used for the whole of the month in the preparation of the chart. The impact of this on the repo rate line is marginal.
4. Note that calculating an interest-bearing ratio from the Bank of England data on effective interest rates on IB credit card balances and all credit card balances (based on the rate for all balances as a percentage of the rate for IB balances) gives a slightly lower figure than the BBA figure for percentage of balances bearing interest as shown in chart 26.

Source: Bank of England (author's presentation of data)

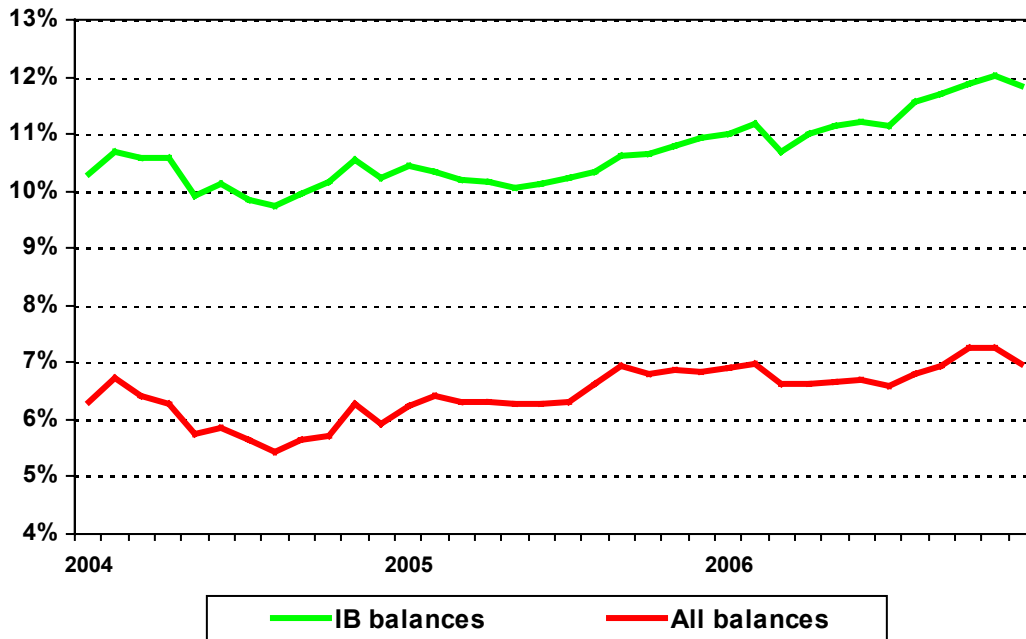
This is more clearly evident in chart 28, which shows the credit card rates minus base rate for the period 2004 to 2006. This serves as a proxy for credit card interest margins.

The margin over base rate on interest-bearing (IB) balances has risen from around 10% during 2004 to close to 12% by the second half of 2006. This has pulled up the overall margin (allowing for

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interest-free balances) from approximately 6% in 2004 and first half 2005 to approximately 7% by late 2006.

28. Credit card interest margins



Notes:

1. Chart uses date presented in chart 27.
2. Y-axis scale range set at low of 4% and high of 13% to display changes in margins more clearly.

Source: Bank of England (author's presentation of data)

The overall trend in card interest rates and margins evident from the Bank of England data corroborates comments from banks in their 2006 earnings releases. Barclays reported that Barclaycard's credit cards margins improved to 8.73% in 2006 from 7.96% in 2005 due to the impact of increased card rates and a reduced proportion of promotional rate balances in the UK. Lloyds TSB and HBOS also reported spread improvements in credit cards during 2006.

It is perhaps no coincidence that the rise in margins on IB balances has risen in the second half of 2006, following the OFT announcement on credit card default fees in April. It indicates that issuers are trying to replace lost non-interest income with higher interest income.

4.3 Non-interest income

The overall squeeze on non-interest revenues is evident from banks' 2006 results. For example, HBOS reported that its non-interest income from credit cards fell from £321 million in 2005 to £286 million in 2006.

Credit card default charges

The OFT's ruling on credit card default fees was made in April 2006, so the impact of issuer reductions in default charges only took effect during the 2006 financial year. However, the impact on industry revenues is already evident.

The fact that the OFT has ruled on default charges during a time of rising credit card arrears and write-offs (see below) will have amplified its impact on industry revenues.

HBOS disclosed that the OFT's decision on credit card penalty fees cost it £25 million in 2006 (it implemented lower fees in August 2006). HBOS added that the decision would cost it an estimated £60 million in 2007.

Some indication of the extent to which penalty fees may apply on accounts is given in HBOS's own credit statistics (see table 31 below), which showed close to 7% of its credit card accounts in excess of their credit limit at end 2005 and end 2006.

The OFT estimates that the level of default charges across the industry has led to unlawful penalty charges currently in excess of £300 million a year. However, grossing up HBOS's £60 million projection for 2007 for the whole industry (based on HBOS's share of outstanding balances at end 2006) gives an even higher figure. It implies an industry wide impact of more than £500 million.

PPI commission

Credit card issuers and other lenders earn significant commission on the sale of payment protection insurance. This is evident from chart 24, which shows PPI accounting for almost 9% of income from cardholders (excluding interchange), and over 30% of non-interest income.

In its report accompanying the reference to the Competition Commission, the OFT commented that evidence from its survey of insurers suggests that commission rates paid by insurers to downstream intermediaries (distributors and non-lending

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intermediaries, including profit sharing deals) look to be high by comparison with other general insurance products.

It quotes anecdotal evidence to suggest that commissions paid by motor insurers can be as low as 10%. By contrast, the OFT says its business survey suggests that average commission rates for single premium PPI policies vary from 50% of GWP (gross written premiums) for first charge mortgage PPI to 67% of GWP for those selling motor finance PPI.

The OFT says the average commission rate for all single premium PPI policies was 59%. It adds that rates for single premium PPI were:

- 66% for second charge mortgage,
- 59% for unsecured loan and
- 61% for retail credit.

The OFT comments that average commission rates were typically lower for regular premiums than single premiums, other than for retail credit PPI.

The average rate for all regular PPI policies was 53% (from the OFT's business survey), while average commission rates for regular premium PPI policies varied from 35% for first charge mortgages to 70% for retail credit.

Though the OFT does not disclose an average commission rate for credit card PPI, the overall averages, ranges and figures for other loan types give a strong indication of the levels of commission earned.

The regulatory scrutiny of PPI is still at the investigative stage (see Section 5 on Prospects for details on the likely timetable). Unlike in the case of credit card default fees, there is as yet no regulatory with a direct impact on lenders' PPI revenues (though there are press reports of a growing number of claims to the Financial Ombudsman Service for PPI mis-selling). However, PPI-related revenues are likely to have fallen during the last two years anyway because of the decline in lending volumes.

For example, HBOS, which is a major insurance provider as well as mortgage and consumer lender, reported that in 2006 sales of repayment insurance fell by 10% to £948 million GWP (2005 £1,048 million), primarily as a result of lower unsecured personal lending volumes. It added that sales to Group customers fell by 7% from

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£565 million in 2005 to £528 million in 2006. Though sales of mortgage repayment insurance rose by 4%, HBOS commented that volumes of unsecured personal loan and credit card repayment insurance fell.

Interchange

With revenues equivalent to approximately 1% of purchase values, interchange is the largest source of non-interest income for credit card issuers.

It is particularly important to card issuers in offsetting the costs of cardholders who simply use their cards as a means of payment. Such cardholders generate no interest income but do benefit from the interest-free period between purchase date and repayment date that comes with credit and charge cards. Interchange is the primary, and in some cases the only source of revenue from such cardholders.

Despite the seven years of regulatory scrutiny from the OFT (as documented in the previous section of the report), the regulatory scrutiny of interchange also remains at the investigative stage. As with PPI, there is as yet no direct impact on industry revenues.

However, again as with PPI, the decline in volumes will have started to affect interchange income. Assuming 1% of purchase value as a proxy for current credit and charge card interchange, current annual credit card purchase volumes of approximately £122 billion imply annual interchange of approximately £1.2 billion.

Based on spending volumes, this will have changed little between 2005 and 2006 in nominal terms and fallen in real terms. Even without regulatory intervention, interchange income may have peaked if recent spending trends on credit cards continue.

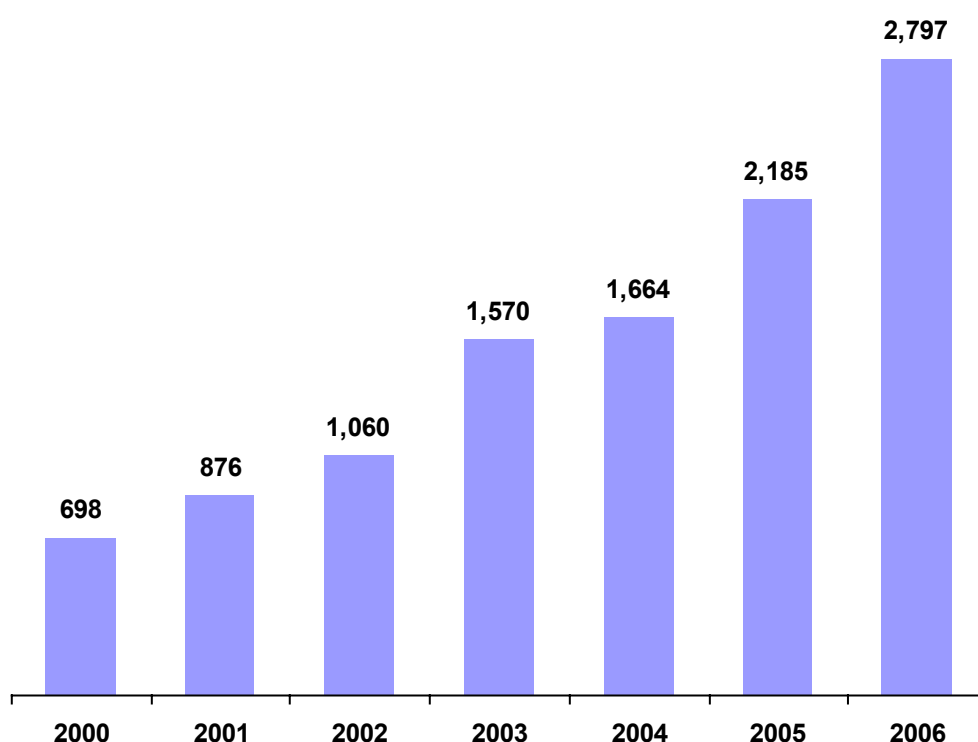
4.4 Credit risk and fraud costs

Growth in credit card write-offs

The most pressing problem for credit card issuers has been the rapid growth in credit losses.

Credit card write-offs and other revaluations by banks rose from less than £1 billion in 2001 to £2.8 billion in 2006 according to Bank of England data.

29. Credit card write-offs & other revaluations (£ million)



Notes:

1. Series covers write-offs & other revaluations of loans by banks.
2. Covers sterling loans.
3. Series can be affected by one-off write-offs, for various reasons. More information about one-off write-offs that affect the data can be found on the Bank of England's Statistical Interactive Database.

Source: Bank of England

The growth in credit card write-offs is corroborated by data from other sources. The Consumer Credit Counselling Service (CCCS), the leading debt advice charity, reports that in 2003, 88% of clients it counselled were credit card holders, with an average of two credit

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cards each and an average total balance of £8,251. By 2006, 91% of clients were credit card holders, with an average of three cards each. However, the average outstanding credit card balance rose to £12,422, a 50% increase on 2003.

CCCS reports that the growth in clients' credit card debt was particularly strong between 2004 and 2005, largely mirroring the Bank of England data on credit card write-offs. (Source: *More silver threads among the gold cards*, CCCS Research, August 2006)

For full year 2006, CCCS reported that credit cards accounted for 45.2% of clients' debt. Personal loans (45.3%) accounted for most of the balance. (Source: *CCCS Statistical Yearbook 2006*, March 2007)

In contrast to the early 1990s, when the credit card industry last experienced a downturn, it is noteworthy that write offs have this time risen without an economic recession. Despite high employment levels, strong growth and low inflation in the UK, credit card write-offs have grown spectacularly during recent years. This indicates that at least some of the rapid growth in card balances reflected poor lending decisions.

In addition to the direct cost of credit losses (in terms of unpaid loan principal and interest written-off), it is worth noting that the growth in credit losses will have adversely affected card issuers' operating costs. The full cost of credit losses includes the costs of handling accounts in arrears – staff engaged in recovery work and the accompanying investment in hardware, systems and technology.

Impact of IVAs and bankruptcies

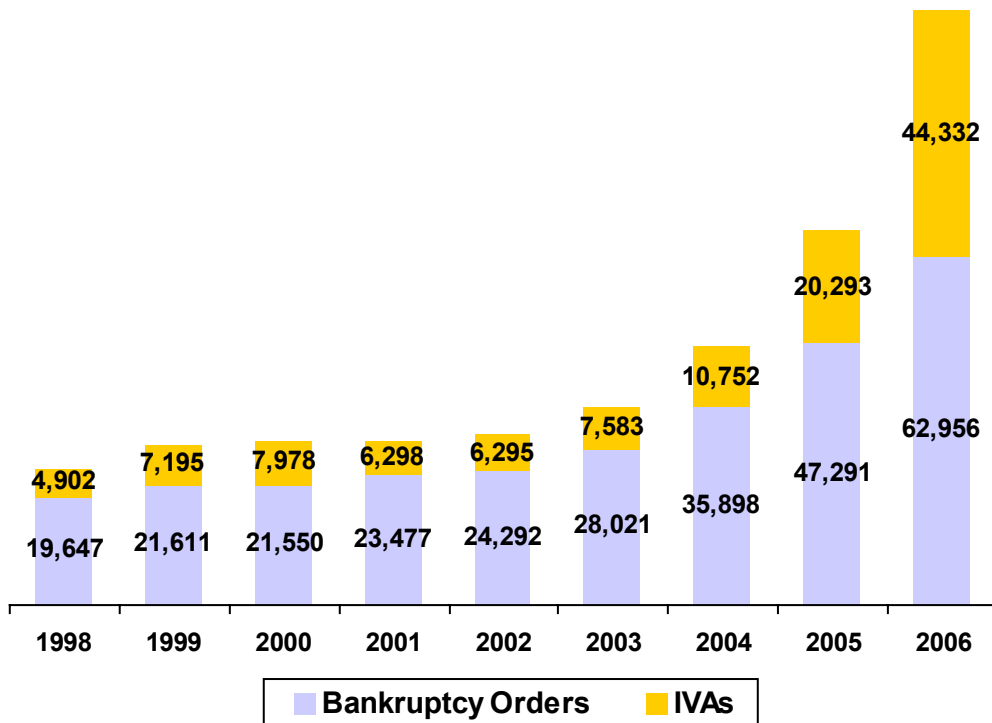
The rapid and much publicised growth in consumer bankruptcies and Individual Voluntary Arrangements (IVAs) has contributed to the growth in write-offs on credit card and other consumer loans.

Individual insolvencies in England and Wales have risen from less than 50,000 in 2004 to more than 100,000 in 2006 (see Statistical Appendix for data on Scotland and Northern Ireland). The growth in IVAs in particular has created a whole sub-industry of providers, several of whom are now listed.

The impact of the growth in bankruptcies and IVAs on the growth in impairment charges for credit card and other unsecured lending during 2006 is evident in comments from the large banks in their 2006 earnings releases.

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30. Individual insolvencies in England and Wales - annual



Notes:

1. Figures not seasonally adjusted.
2. 2006 figure is provisional.
3. IVA series includes Deeds of Arrangement (see Statistical Appendix).

Source: Insolvency Service

Barclaycard's impairment charges increased 36% to £1,493 million in 2006 from £1,098 million in 2005 (these figures cover all Barclaycard's activities and not just UK cards). Barclays reports that the increase was driven by a rise in delinquent balances and increased numbers of bankruptcies and IVAs.

Lloyds TSB described the rate of growth in the number of customers filing for bankruptcy and IVAs as a key factor in the outlook for retail impairment.

Lloyds TSB reported that impairment losses on loans and advances in its retail division rose 16% in 2006 to £1,238 million. Within the total impairment losses of £1,238 million, losses on credit cards rose from £396 million in 2005 to £490 million in 2006 (excluding losses attributable to the Goldfish business, which was sold in December 2005). Losses on personal loans and overdrafts

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accounted for most of the remainder. For credit cards, the impairment charge as a percentage of average lending rose from 5.80% in 2005 to 6.99% in 2006 (see box on asset quality metrics).

Discover, in a March SEC filing as part of the planned spin-off from Morgan Stanley reported that the provision for loan losses in its International Card segment (its UK business) increased \$111.7 million in the year to end November 2006 to \$238.2 million (on a managed basis). This was as a result of “the weakened credit environment in the United Kingdom, the Goldfish acquisition and increased bankruptcy charge-offs”.

It added that credit quality continued to deteriorate as the net charge-off rate rose 135 basis points to 5.45%, and the over 30 and over 90 day delinquency rates increased to 4.58% and 2.22%, respectively.

Overall, Discover’s International Card segment reported a pretax loss of \$87.1 million for the year ended November 30 2006, an increase of \$55.4 million over the loss for the year ended November 30, 2005.

Most recent trends

Are there signs that the growth in credit losses has peaked?

The Bank of England statistics show write offs and other revaluations on credit cards of £1,485 million in the second half of 2006 (with little change between the third and fourth quarters) compared with £1,312 million in the first half of the year.

However, write offs is to some extent a lagging measure of credit quality problems. It represents the point at which existing problem loans are assumed to be beyond recovery.

Based on trends in the second half of 2006, the issuers themselves report signs that the decline in credit quality has stabilised.

Barclays reports that for **Barclaycard** the flows of new delinquencies reduced, and levels of arrears balances declined in the second half of 2006 in UK cards and unsecured loans.

HBOS reports that credit card impairments increased to 15.4% (2005 10.8%) and provisions to 11.4% (2005 8.4%) of closing advances, though the rate of growth slowed in the second half of the year.

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It adds that the main driver of impairment growth in its credit card book continues to be the residual seasoning of pre 2004 business, with delinquency and loss experience from business written since 2004 performing to expectation.

HBOS releases additional data on its credit card business, providing a valuable window on underlying trends. While volumes of accounts new to arrears reduced, HBOS notes a slight hardening in arrears roll rates (see table for definition) between end 2005 and end 2006, with an increase in average loss per case. It also reports a small increase in both credit utilisation and overdrawn limits as a result of selectively tightening credit availability to accounts showing signs of stress.

31. HBOS credit card loan quality statistics

| | End 2005 | End 2006 |
|---|----------|----------|
| Credit utilisation (1) | 27.8% | 28.1% |
| Overdrawn limits (2) | 6.7% | 6.9% |
| Arrears roll rates (3) | 57.0% | 58.1% |
| Notes: 1. Percentage of total available credit lines that are drawn down (restated to exclude unutilised expired cards). 2. Percentage of accounts in excess of credit limit. 3. Percentage of credit card balances in arrears that have worsened in the period. | | |
| Source: HBOS 2006 earnings release | | |

Lloyds TSB reported that its retail impairment charge was lower in the second half of 2006, compared to the first half. It noted towards the end of 2006 “some signs of stabilisation in the rate of our customers filing for bankruptcy and a slowdown in the rate of growth in IVAs”. It expects the rate of growth in the unsecured retail lending impairment charge in 2007 to be significantly lower than that experienced in 2006.

RBS reports that arrears on its unsecured card and personal loan book in the second half were flat compared with the first. RBS adds that credit card arrears have stabilised, while the rate of increase in arrears on unsecured personal loans continued to slow.

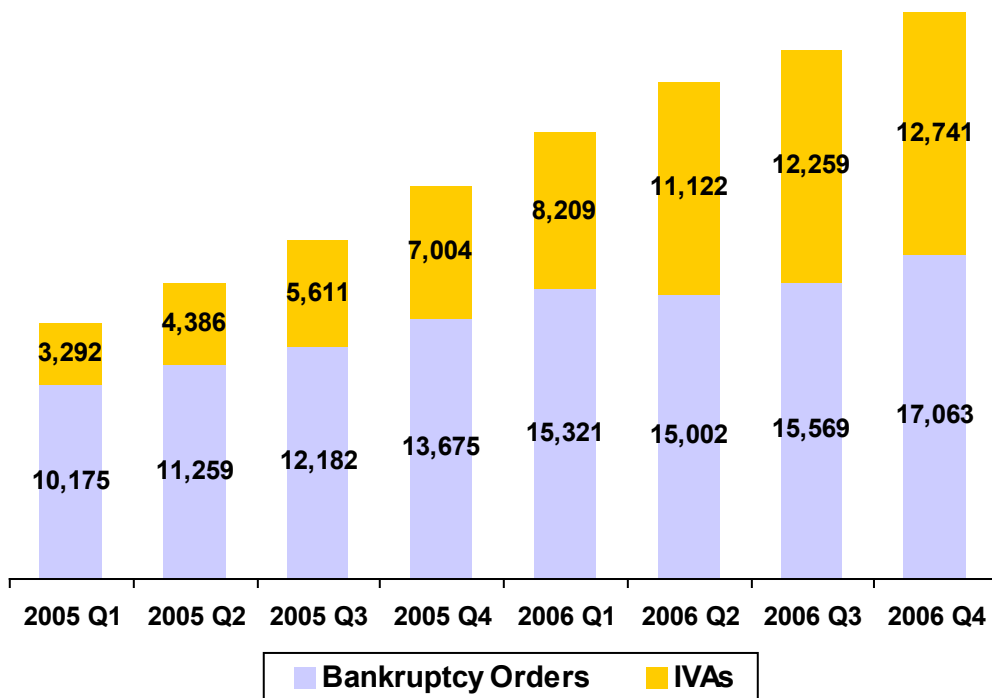
However, **Discover**, in a March SEC filing as part of the spin-off from Morgan Stanley commented that it expects the adverse credit

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environment to continue in 2007 and affect its International Card segment's results.

The most recent insolvency statistics show some signs that the growth in IVAs has slowed down. There were 29,804 individual insolvencies in England and Wales in the fourth quarter of 2006 on a seasonally adjusted basis. This was an increase of 7.1% on the previous quarter and an increase of 44.1% on the same period a year ago.

32. Individual insolvencies in England and Wales – quarterly



Notes:

1. Figures seasonally adjusted.
2. 2006 Q4 figure is provisional.
3. IVA series includes Deeds of Arrangement (see Statistical Appendix).

Source: Insolvency Service

Bankruptcies rose 9.6% on the previous quarter and 24.8% on fourth quarter 2005. However IVAs rose by only 3.9% compared with the previous quarter, though they were 81.9% higher than in fourth quarter 2005.

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In summary, the message from the most recent data and from banks' comments in their 2006 earnings releases appears to be that credit quality has stopped deteriorating, or is close to doing so.

Information sharing

One significant effect of the decline in credit quality is that it has encouraged banks and card issuers to extend data sharing on customer accounts through the three UK credit reference agencies (Experian, Equifax and Callcredit).

Historically banks have been more cautious than non-bank consumer lenders about sharing data through the credit reference agencies because of concerns about banking confidentiality, competitive disadvantage and the uses to which the data might be put.

However, according to a Department of Trade and Industry (DTI) consultation document on data sharing released in October 2006, by September 2005, all credit card lenders were sharing all credit card data, where legally able to do so. This brings the percentage of credit card accounts on which full data is shared to 84%.

Several additional information sharing initiatives have also been announced as banks and card issuers seek to improve their knowledge and understanding of borrower behaviour.

At the end of November 2005, Barclaycard, initially in partnership with The Co-operative Bank, Egg and Abbey, announced an initiative on the sharing of behavioural data via the three agencies. This behavioural data applies to credit card data only and will include information such as:

- How much is being spent on the card each month
- How much is being repaid each month
- How much cash has been taken out
- Any recent increases or changes to the credit limit
- Any cheques sent for payment which bounce
- How many people use the card

The aim is to identify specific behavioural patterns that may indicate consumers at risk of taking on too much personal debt or a change in circumstances, leading to repayment difficulties.

In March 2006, four of the five large banks (RBS, HBOS, HSBC and Lloyds TSB) announced they were piloting a scheme to determine the benefits of sharing income data with Callcredit. Depending on

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the information available to the lenders, this would be in the form of either turnover data on a current account, or income data as specified on an application form, together with a date to indicate how recent the information was. The aim is to improve the assessment of consumers' borrowing to earnings ratios.

As with the behavioural initiative, given its sensitive nature, the data is shared in the form of indices, ratios and movements rather than in the form of raw data.

The extent of the change in attitude on data sharing is evident from the DTI's recent consultation on whether data sharing should be permitted for so-called "non-consensual" accounts. These are accounts that were opened before lenders routinely asked for a consumer's consent to share the data.

The Government is considering to what extent the legal barrier to the sharing of credit data on "non-consensual" accounts could be adjusted to enable the sharing of this data (beyond instance of default, where sharing is currently permitted). The sharing of data on "non-consensual" accounts would add approximately 40 million further credit accounts to the approximately 350 million accounts on which lenders currently share data.

Of the 40 million, approximately 33 million are estimated to be current accounts. However, many of the remainder will be credit cards given that credit card accounts may remain open for decades.

Lloyds TSB commented in its 2006 results release that the increased sharing of industry-wide customer data, particularly with regard to credit card use, had improved its customer understanding and led to a reduction in some credit limits.

Fraud costs

The better news for the industry is continued, if slow progress, in reducing fraud losses. According to APACS, total card fraud losses (on debit as well as credit cards) fell by 3% in 2006 to £428 million.

The main factor behind the fall in 2006 was a 13% decrease in UK domestic fraud and the combined reduction of more than £45 million in mail non-receipt and lost and stolen fraud.

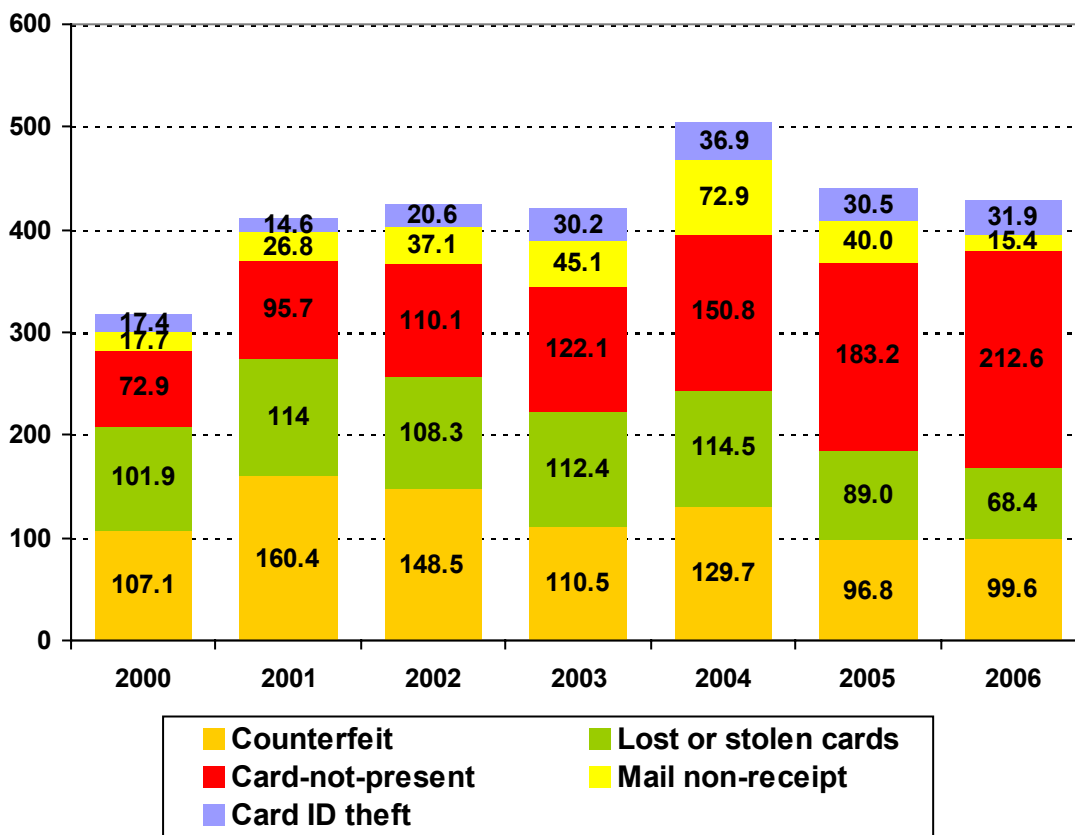
The introduction of chip and PIN has reduced card fraud in the UK, with losses at UK retailers falling by £146.7 million over the past two years to £72.1 million in 2006.

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However, APACS comments that criminals are still copying the magnetic stripe data to create counterfeit magnetic stripe cards that can potentially be used in countries that have not upgraded to chip and PIN. This lies behind the increase in fraud abroad losses over the last 12 months (chart 34).

While other categories are either flat or falling, card-not-present fraud losses continue to increase. They rose by 16% during 2006 and now account for just under 50% of all card fraud losses.

33. Plastic card fraud losses (£ million)



Notes:

1. On UK-issued cards.
2. Counterfeit: skimmed/cloned cards.
3. Card-not-present: phone/internet/mail.

Source: APACS

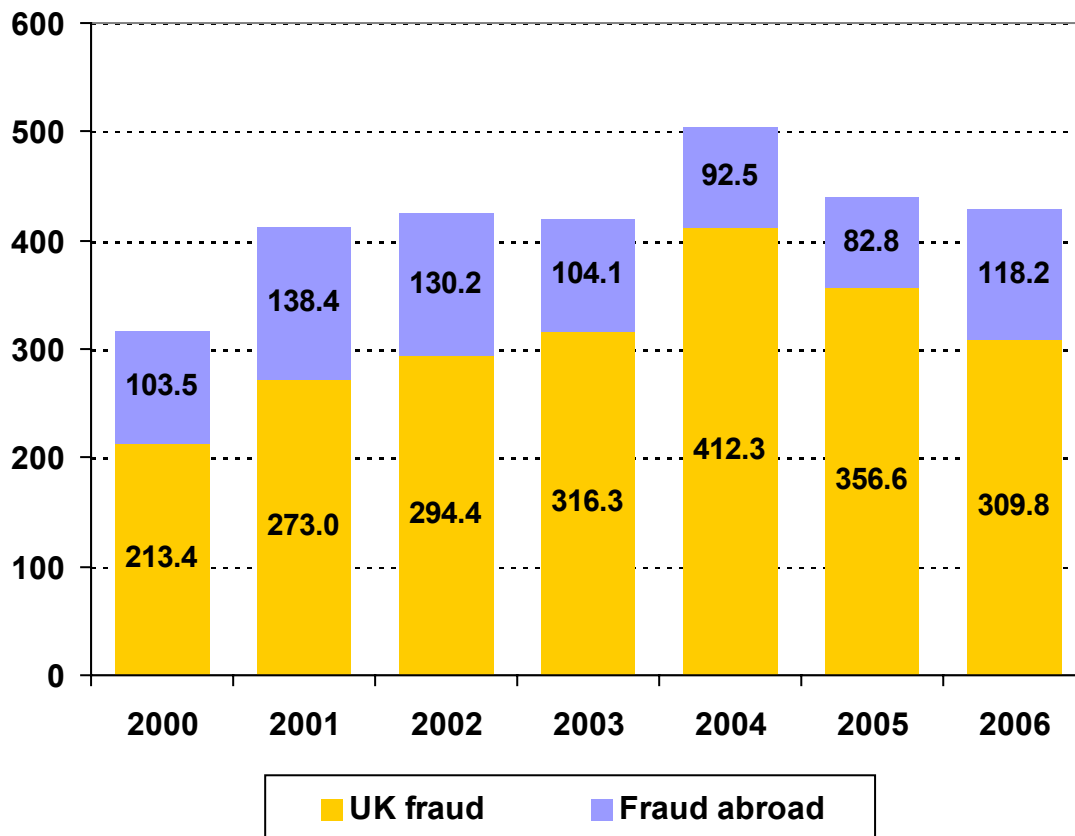
Putting the losses in the context of rising card turnover (driven of course by debit cards during the last two years), losses as a percentage of plastic card turnover fell to 0.095% in 2006 according to APACS. This compares with 0.141% of turnover in 2004 and 0.11% in 2005.

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However (as with credit losses), in addition to the direct cost of fraudulent transactions, the full cost of fraud includes the costs of fraud prevention – staff engaged in fraud prevention work, investment in hardware, systems and technology.

These figures are not publicly disclosed in a systematic way. And the difficulty inherent to calculating the payback on investments in fraud prevention is estimating the counterfactuals. With the investment in chip and PIN, losses at UK retailers (face-to-face transactions) have fallen from £218.8m in 2004 to £72.1m in 2006. However, what might they have reached in 2006 without chip and PIN?

34. Location of plastic card fraud losses (£ million)



Source: APACS

The fact that the industry invested £1.1 billion in the rollout of chip and PIN according to APACS gives some sense of the resources involved in fraud prevention. And the continued rise in card-not-present fraud losses indicates that significant further investment in fraud prevention will be required.

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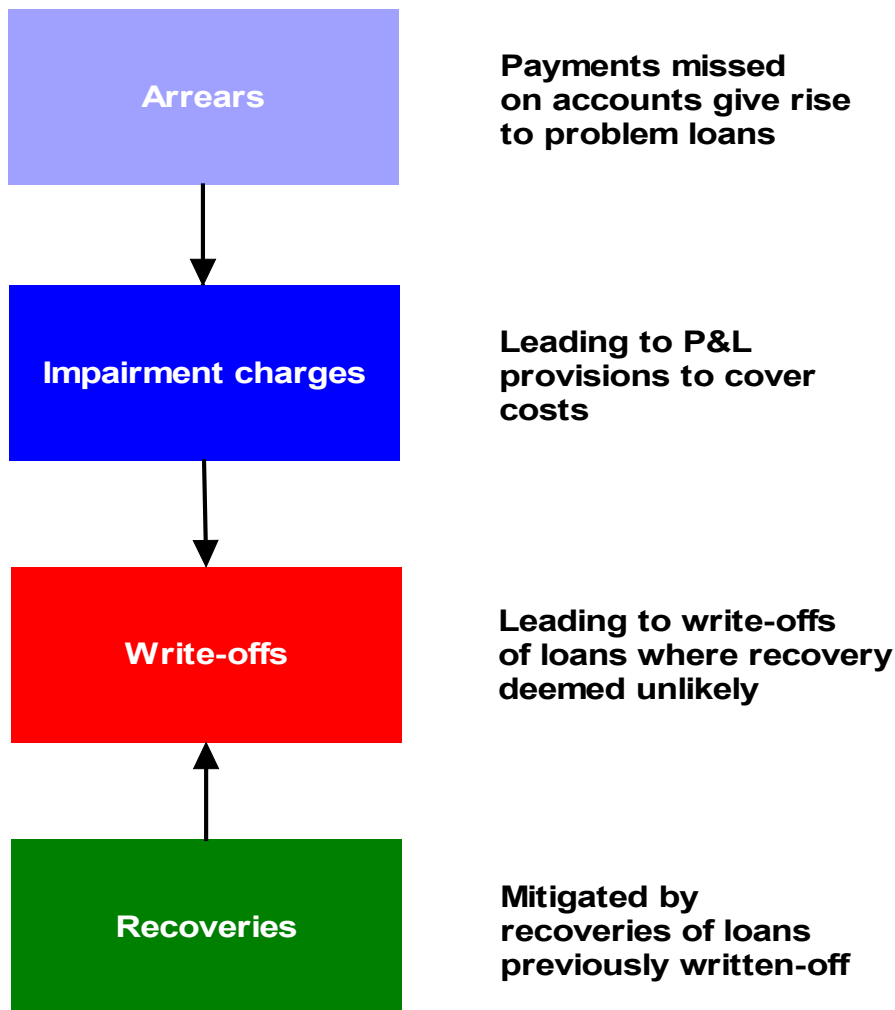
The APACS card fraud statistics cover plastic card fraud in total. A further, speculative point is that fraud specifically on credit cards (compared with card fraud overall) may be flat or even rising, given that debit cards have historically experienced less fraud than credit cards.

Credit quality reporting and metrics

In commentaries on credit quality, various measures are used relating to arrears, delinquencies, impaired loans, problem loans and problem loan coverage. Given the significant rise in credit quality problems in the UK credit card sector during recent years, this box examines the commonly used measures and their relationship to each other.

Table 35 summarises the process of loan impairment over time, from initial arrears through impairment charges to write-offs and finally perhaps the possibility of recoveries.

35. Loan impairment process



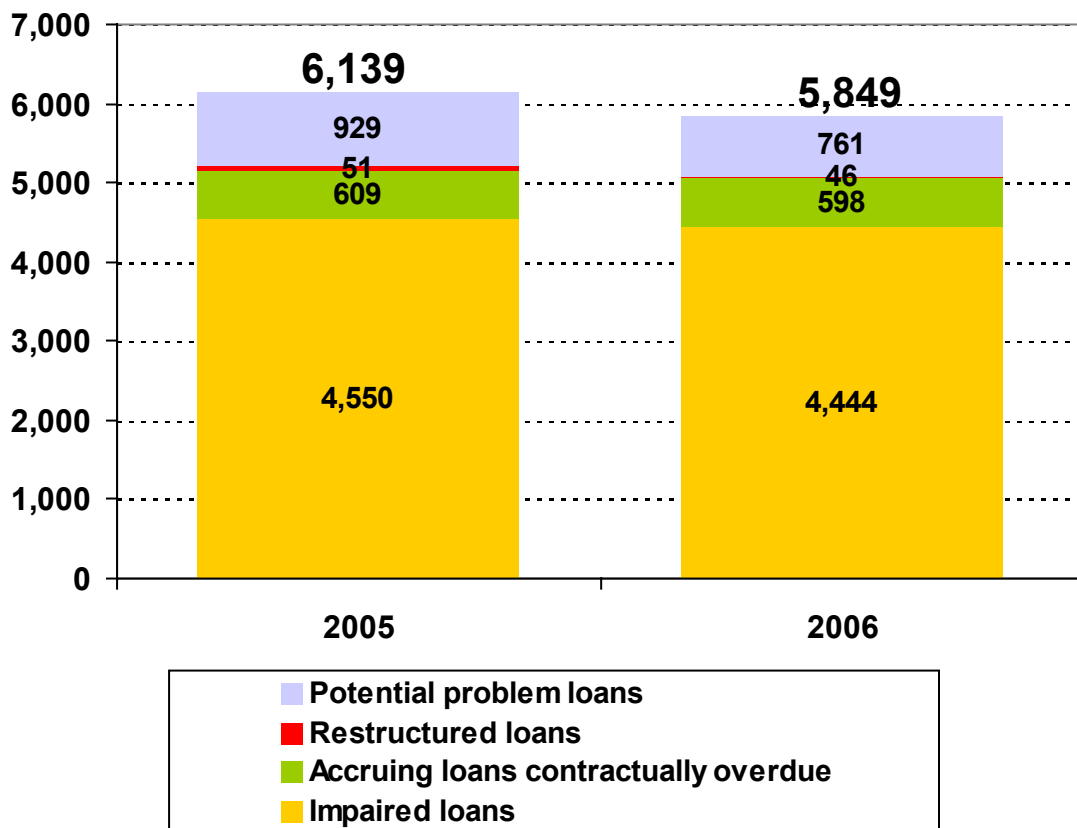
Source: Author's analysis

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Problem loans

Problem loans, on the widest definition, are loans experiencing repayment problems. However, within this broad category, banks often specify tiers or levels of problem loans depending on specific characteristics.

36. Barclays – potential credit risk loans (£ million)



Notes:

1. Figures for Barclays Group.
2. Impaired loans are non-performing loans where, in general, an impairment allowance has been raised. This classification may also include non-performing loans which are fully collateralised or where the indebtedness has already been written down to the expected realisable value.
3. Accruing loans contractually overdue = Accruing loans which are contractually overdue 90 days or more as to principal or interest.
4. Impaired loans + Accruing loans contractually overdue + Restructured loans = **Total non-performing loans** (£5,210 million in 2005 and £5,088 million in 2006).
5. Total non-performing loans + Potential problem loans = **Total potential credit risk loans** (£6,139 million in 2005 and £5,849 million in 2006).

Source: Barclays 2006 preliminary results release (Author's presentation)

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For example, chart 36 shows the breakdown given by Barclays of its potential credit risk loans – that is non-performing and potential problem loans – in its latest earnings release. The table covers the Barclays Group as a whole.

Providing for problem loans

Essentially, banks set aside part of their income from lending during each reporting period to cover the costs of interest and principal that may not be recovered from problem loans. The money set aside appears in the bank's income statement for the period as an impairment charge or provision.

The charge to the income statement is often what makes the headlines. However, it needs to be seen in the context of the overall movement in balance sheet provisions during the reporting period.

On the balance sheet, the accumulated allowance for loan impairment is deducted from gross loans and advances at the balance sheet date. The relationship between the opening allowance at the start of the reporting period compared with the closing allowance at the end of the period will largely depend on the relationship between:

- The amount charged to the income statement during the period, which will increase the allowance.
- Recoveries of previous write-offs, which will increase the allowance.
- The amounts written-off (sometimes called charge-offs), which will reduce the allowance.

In reality, in complex banking groups, the change in the value of the allowance during the reporting period depends on various other movements and adjustments as well.

Continuing to use Barclays as an example, the movement in Barclays' impairment allowance during 2006 (for the Group as a whole) is set out in table 37. Running through the main changes during 2006:

- Barclays made new impairment charges on loans and advances of £2,074 million for the 2006 financial year.
- This added to the opening 2006 allowance of £3,450 million.
- Amounts written-off during the year were £2,174 million, with other adjustment (including recoveries) of -£15 million.
- Therefore, the net movement during the year was -£115 million, leaving a closing allowance of £3,335 million.

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37. Barclays – impairment provisions (2006)

| Balance sheet: Dec 31 2005 (£m) | | Movement in provisions 2006 (£m) | | | |
|--|---------------|---|--------------|------------------------------|---------------|
| Gross loans & advances | 303,451 | | | | |
| Impairment allowances | -3,450 | Opening allowance | 3,450 | | |
| Loans & advances | 300,001 | 2006 P&L charge | 2,074 | | |
| | | Amounts written off | -2,174 | | |
| | | Recoveries | 259 | | |
| | | Unwind of discount | -98 | | |
| | | Exchange and other adjustments | -153 | | |
| | | Acquisitions and disposals | -23 | | |
| | | Closing allowance | 3,335 | Impairment allowances | -3,335 |
| | | | | Loans & advances | 316,561 |
| | | | | | |
| | | | | Loans & advances | 313,226 |

Notes:

1. Figures for Barclays Group.
2. Loans and advances covers both to customers and to banks. This is because the Barclays' preliminary results release does not break down the movement in provisions between customers and banks. Of the £3,335 million allowance at end 2006, £3,331 million covered loans and advances to customers and £4 million covered loans and advances to banks.
3. Including other credit provisions and impairment on available for sale assets the total impairment charge to the Group profit & loss account for 2006 was £2,154 million.

Source: Barclays 2006 preliminary results release (presentation by author)

Credit quality metrics

Credit quality metrics are used to analyse the scale of, and trends in problem loans. Broadly, the metrics used can be grouped into two broad categories:

First, there are metrics that measure the **extent of loan impairment**.

Common indicators are the number and/or value of loans/accounts in arrears over a given period – for example 30+, 60+ or 90+ days.

Accounting based metrics compare impairment charges and allowances with the loan book. Probably the most widely used is some comparison of the income statement impairment charge for a period against loan balances during or at the end of the period (income statement against balance sheet). Others include the end period allowance compared against end period loan balances (balance sheet against balance sheet).

Second, there are metrics that measure the **extent of problem loan coverage**. These generally compare the end period allowance with the overall level of impaired or problem loans (again, balance sheet against balance sheet).

Barclays' 2006 results again provide a useful illustration.

38: Barclays – extent of loan impairment

| | 2005 | 2006 |
|--|--------------|--------------|
| Impairment charges on loans and advances and other credit provisions (£ million) | 1,567 | 2,068 |
| Year-end total loans and advances (£ million) | 303,451 | 316,561 |
| Impairment charges / total loans and advances | 0.52% | 0.65% |

Notes:

1. Figures for Barclays Group.
2. Impairment charges on loans and advances include other credit provisions (-£6 million in 2006 and -£7 million in 2005), which explain the difference with the figures for impairment charges in table 37 above.
3. As in table 37 on impairment provisions, the figures for year-end loans and advances are for loans to both customers and to banks. Loans and advances are expressed before provisions.

Source: Barclays 2006 preliminary results release

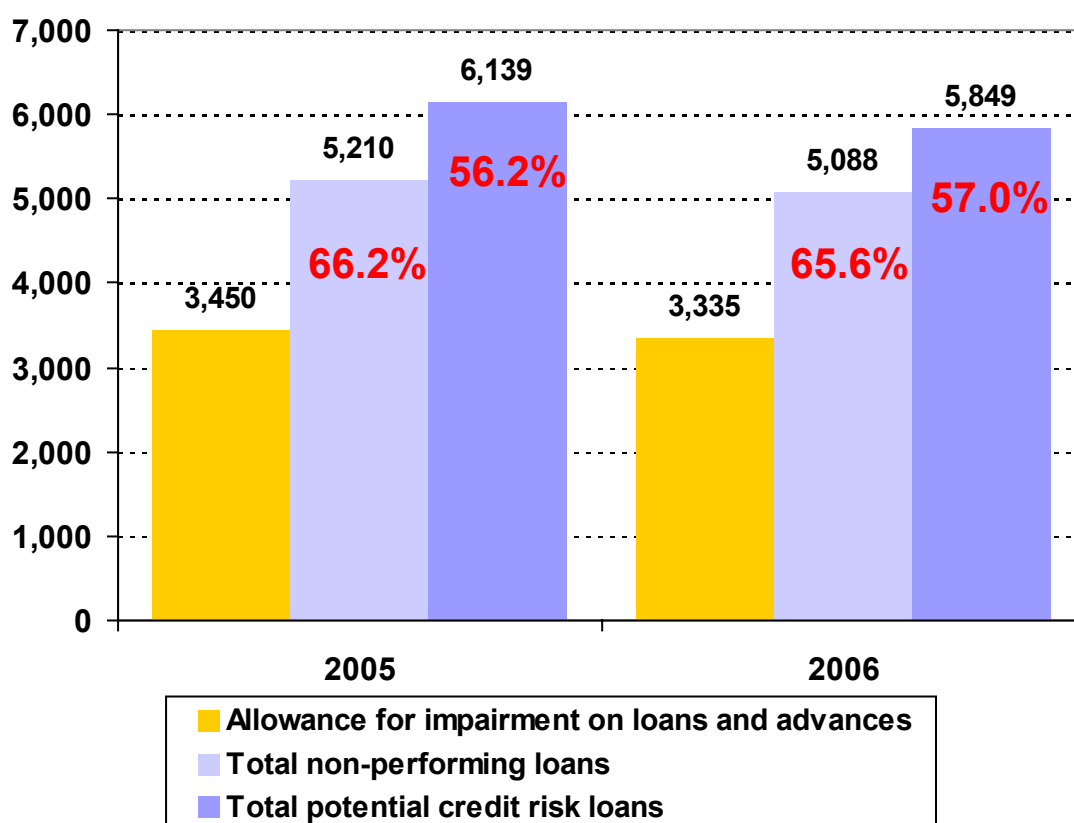
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Looking first at the extent of loan impairment, Barclays reports that the group impairment charges on loans and advances and other credit provisions as a percentage of year-end total loans and advances increased to 0.65% in 2006 from 0.52% in 2005.

The following chart shows Barclays' **coverage ratios** at end 2006. These are based on the closing 2006 allowance for impairment as a proportion of total non-performing loans and total potential credit risk loans (as set out in chart 39).

The allowance coverage of non-performing loans was 66.2% in 2005 and 65.6% in 2006. The allowance coverage of total potential credit risk loans was 56.2% in 2005 and 57.0% in 2006.

39: Barclays – coverage of problem loans



Notes:

1. Figures for Barclays Group.
2. Allowance for impairment on loans and advances as set out in table 37.
3. Total non-performing loans and Total potential credit risk loans as set out in chart 36.

Source: Barclays 2006 preliminary results release (Author's presentation)

Loan impairment under IFRS

One point to note is that accounting for loan impairment has been affected by the move to international accounting standards.

From 2005 listed companies in all European Union countries have been preparing their financial statements under International Accounting Standards / International Financial Reporting Standards (IAS / IFRS). Previously, UK banks had reported under UK Generally Accepted Accounting Principles (UK GAAP). There are important differences between UK GAAP and IAS / IFRS in accounting for impaired loans.

This is a highly technical area, and what follows is no more than an introductory overview. It is based on Barclays' *IFRS Transition Report 2004/2005*.

UK GAAP distinguished between:

- Specific provisions
- General provisions, and
- Allowance for suspended interest.

Specific provisions are raised when the recovery of the whole or part of an outstanding advance is in serious doubt. Specific provisions are made against individual advances or on a portfolio basis for smaller balance homogeneous assets and where statistical techniques are appropriate.

General provisions are raised to cover losses judged to be present in loans and advances at the balance sheet date, but which had not been specifically identified as such.

If collection of interest is doubtful, it is credited to a suspense account and excluded from interest income in the profit and loss account. The suspense account in the balance sheet is netted against the relevant loan.

Under **International Financial Reporting Standards** (IFRS), impairment losses are recognised where there is evidence of impairment as a result of one or more loss events that have occurred after initial recognition, and where these events have had an impact on the estimated future cash flows of the financial asset or portfolio of financial assets.

Impairment of loans and receivables is measured as the difference

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between:

- The carrying amount and
- The present value of estimated future cash flows discounted at the financial asset's original effective interest rate.

Impairment is measured individually for significant assets and on a collective basis for portfolios with similar risk characteristics.

Under IFRS, there is no distinction between general and specific provisions.

Interest on impaired loans is recognised using the original effective interest rate (the rate used to discount the estimated future cash flows for the purpose of calculating impairment).

In practice, Barclays commented in its *IFRS Transition Report 2004/2005* that the overall change in the total level of credit impairment "is not material". It said that the application of IFRS had resulted in "re-analysis of UK GAAP general and specific provisions into IFRS impairment allowances and the reallocation of impairment allowances within the businesses".

Recent credit card examples

The preceding analysis has used Group-wide data for Barclays as illustration, largely because it allows a comprehensive presentation of problem loan accounting and metrics. However, it is interesting to re-consider in light of the preceding analysis recent comments from UK banks specifically about the credit quality of their credit card and unsecured lending businesses.

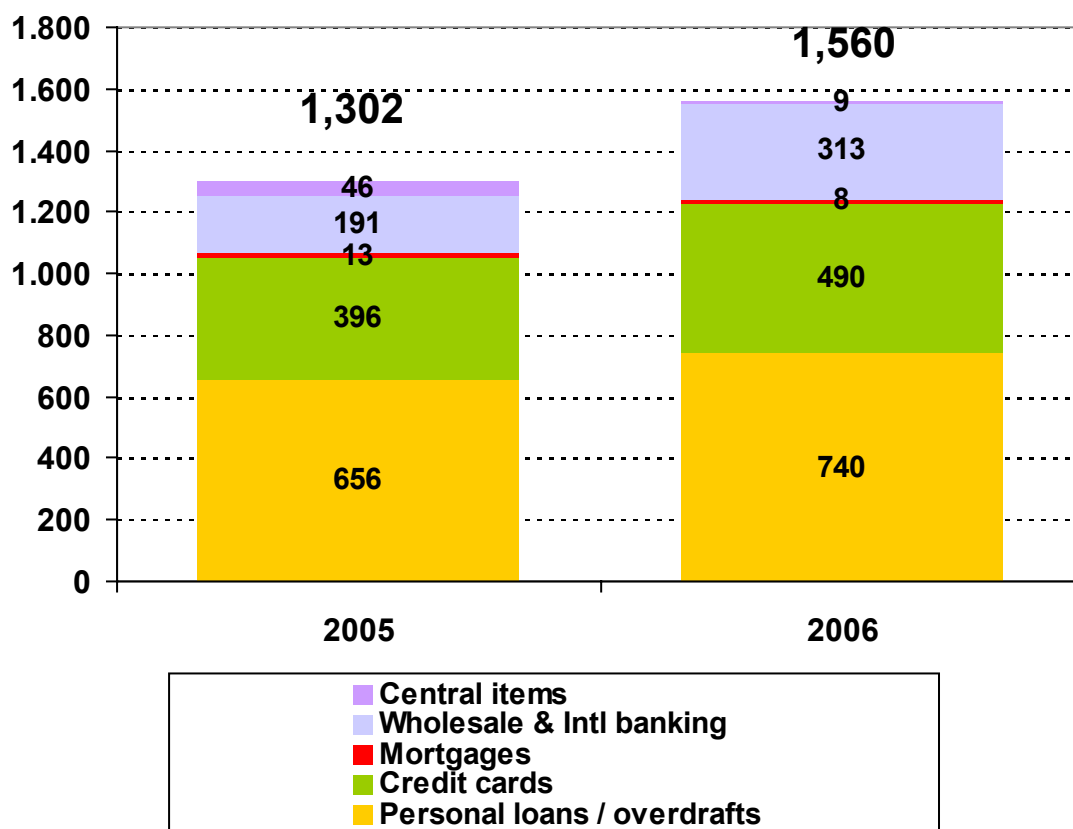
For example, **HBOS** reported that unsecured impairments as a percentage of closing advances increased to 13.2% in 2006 from 11.5% in 2005. This reflected the residual seasoning of the pre 2004 credit card book and a reduction in balances said HBOS. It added that the bank continued to see an improvement in arrears emergence on business written more recently. The coverage of HBOS's impaired unsecured loans reduced slightly to 71% from 73% in 2005.

HBOS reported that credit card impairments increased to 15.4% of closing advances in 2006 from 10.8% in 2005, and provisions increased to 11.4% from 8.4% in 2005, with the rate of growth slowing in the second half of the year.

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Lloyds TSB breaks out the impairment charge for credit cards, allowing it to be placed in a wider Retail Banking and Group context.

40. Lloyds TSB – impairment charge (£ million)



Notes:

1. UK Retail Banking = Personal loans / overdrafts, Credit cards and Mortgages.
2. In the analysis of impairment losses set out above, the losses attributable to the Goldfish business, which was sold in December 2005, have been transferred into Central group items in order to allow a meaningful comparison of the results of UK Retail Banking.
3. Lloyds TSB Group's P&L shows a total impairment charge of £1,555 million for 2006 (2005: £1,299 million). This represents the sum of the impairment charges on loans and advances shown in the chart minus a positive £5 million (2005: £3 million) for other credit risk provisions.

Source: Lloyds TSB 2006 results release (Author's presentation)

Lloyds TSB reported that impairment losses on loans and advances (the charge to the P&L) in its UK Retail Banking division increased by 16% in 2006 to £1,238 million. The charge for UK Retail Banking covers personal loans/overdrafts, credit cards and mortgages.

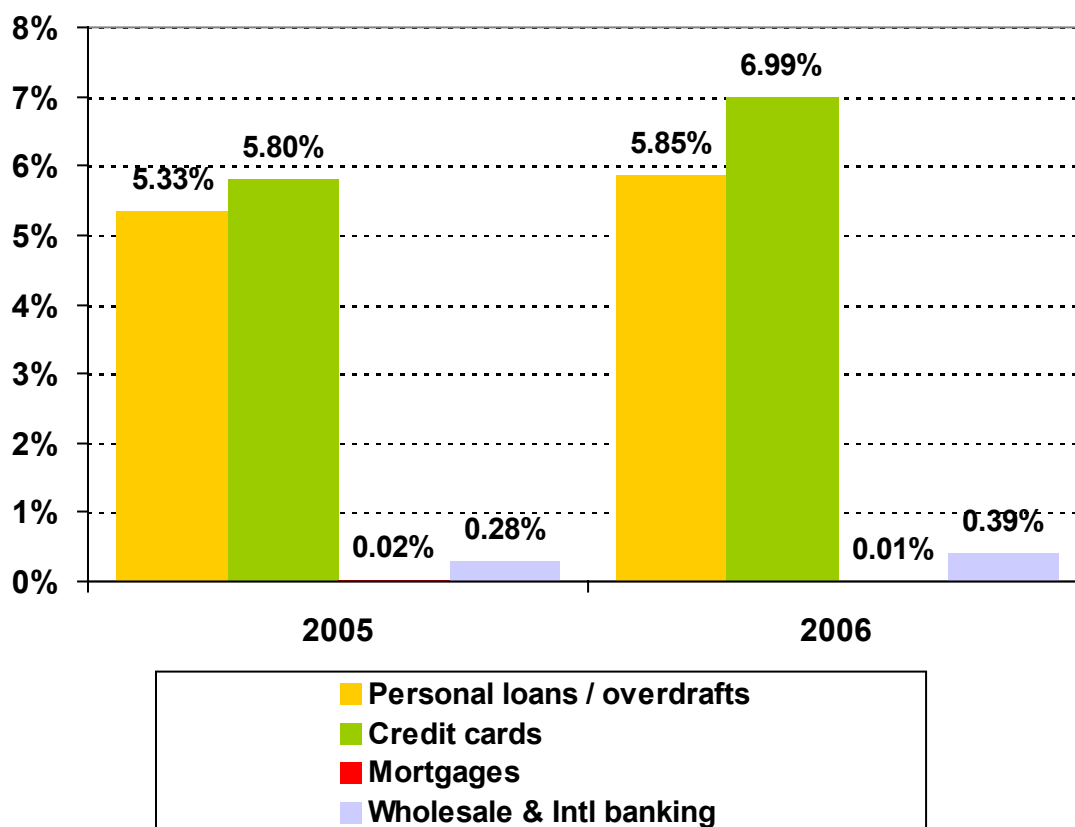
Within the total UK Retail Banking charge for 2006, credit cards

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accounted for £490 million and personal loans/overdrafts £740 million.

The total charge to the P&L, which also includes Wholesale & International Banking and Central Group Items, was £1,560 million in 2006 (£1,555 million allowing for a positive £5 million for other credit risk provisions).

41. Lloyds TSB – impairment charge as a proportion of average lending (%)



Source: Lloyds TSB 2006 results release (Author's presentation)

The two charts capture how significant impairment losses on unsecured loans and credit cards have been for Lloyds TSB (and for UK retail banks more generally) during the last two years. Credit cards accounted for 31.4% and personal loans/overdrafts accounted for 47.4% of the total P&L impairment charge in 2006.

Expressed as a proportion of average lending, the impairment charge in 2006 was 6.99% for credit cards and 5.85% for personal loans/overdrafts, much higher than for other loan types.

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5. Prospects

Given the sharp change in market conditions, where next for the UK credit card industry? What are the likely changes as issuers seek to cope with a much tougher market?

Market size

Forecasting is a dangerous game (who in the early 1990s would have predicted accurately the market's development over the following decade). However, at best, borrowing on credit cards seems likely to grow at or below the rate of inflation during the next 2-3 years.

In Section 1.5, it was estimated that if credit card turnover and outstanding balances had grown between 1995 and 2005 in line with the overall growth in cardholder numbers and household expenditure, card turnover would have reached approximately £132.5bn in 2005 and outstanding balances approximately £37.5bn by end 2005.

In fact, while actual card turnover in 2005 was not far removed from the figure projected, actual outstanding balances at end 2005 were far higher at £67.5bn. While the value of turnover (in nominal terms) rose approximately threefold between 1995 and 2005, there was a 5.5x rise in credit outstanding.

The projections from 1995 based on cardholder numbers and household expenditure were designed to be no more than indicative. But they serve to capture the step change in card borrowing since 1995. Overall, borrowing may have risen in response to expectations of rising house prices and sustained lower interest rates. But the recent credit problems indicate that a significant minority of cardholders increased their borrowing at a faster than sustainable rate.

The recent fall in credit card borrowing, despite any external economic trigger, indicates that some cardholders are consciously seeking to reduce their card borrowing. Issuers have already tightened credit criteria as they seek to improve asset quality, adding to the constraints on future borrowing.

It seems best the industry can hope for is a period of readjustment in borrowing levels as the liabilities of those overcommitted borrowers are reduced to manageable levels. The larger risk is a UK economic downturn triggered by, or leading to a substantial fall

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in house prices. Even allowing for the adjustments that have already taken place, this would add greatly to the downward pressure on credit card borrowing.

Despite its slower growth compared with borrowing during the preceding years, **spending** on cards has also fallen since 2005. The debit card has clearly replaced it as the dominant card payment instrument in the UK. For those who use their cards primarily as a payment rather than a borrowing instrument, future use is likely to depend on its economic attractiveness – in particular, whether:

- Annual fees on cards become commonplace
- Interest-free periods on repayments are maintained, and
- Surcharging in key acceptance segments continues to grow

Market structure

After a period of de-consolidation during the 1990s, this report has noted the emergence of a top tier of issuers comprising the five large UK retail banking groups and the three large US issuers – Citi, Capital One and MBNA/Bank of America. Is this top tier likely to consolidate further?

In the US, the market has seen considerable consolidation during the last decade. According to a recent Capital One presentation, the top five US issuers' share of credit card outstandings rose from 37% in 1994 to 57% in 1999 and an estimated 76% by 2006.

The analysis in Section 2 estimated that the five largest retail banks had a share of approximately 60% of outstandings as of 2006, lower than the 76% estimated by Capital One for the US (though Capital One ranked MBNA in 2005 as the third largest UK issuer by outstanding balances, ahead of three of the large UK banks). On the basis that, in the case of credit cards at least, the UK market often follows the US market, does this point to further consolidation in the UK?

In reality, there is only limited scope for further consolidation in the UK market. Mergers between any of the five large retail banks are highly unlikely for competition reasons.

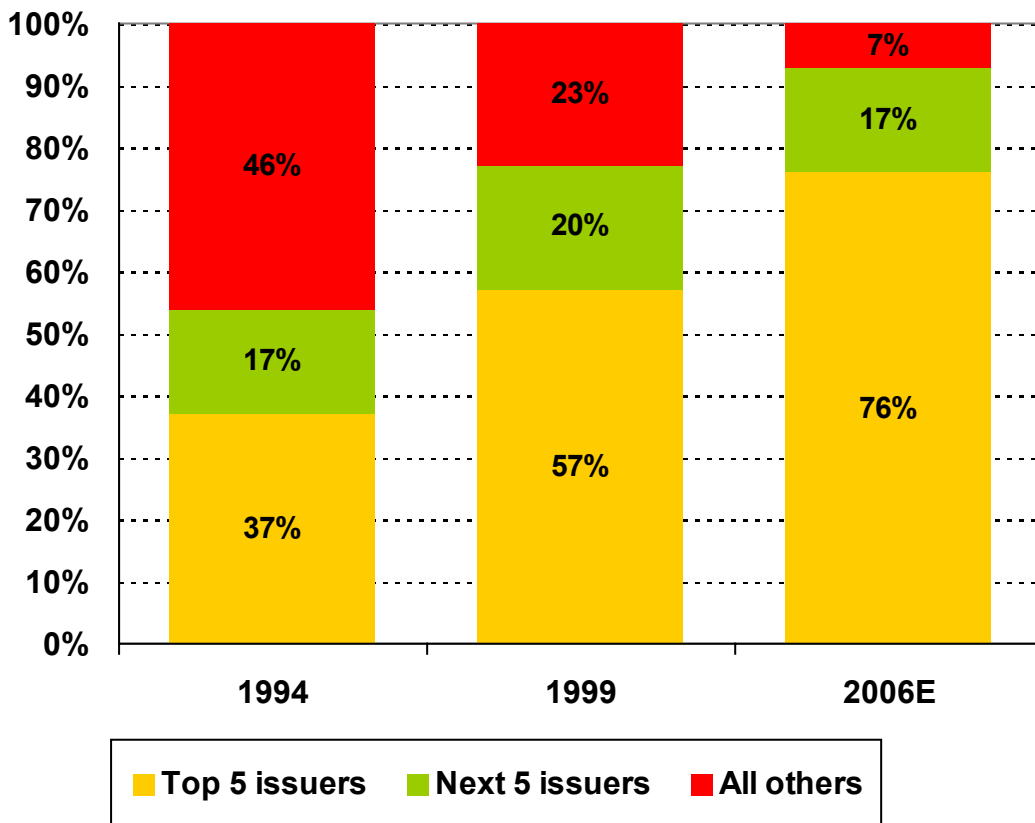
There are however signs in a polarisation of issuer strategies across the top tier and below. This concerns the extent to which the credit card is marketed to existing bank customers and the extent to which it is offered to 'new-to-bank' customers.

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Though hard data is not publicly available, the influx of new issuers during the 1990s pushed the balance of cardholder recruitment away from existing bank customers and towards direct solicitation.

For the US issuers without an existing UK banking business, the only recruitment option was direct solicitation through advertising, direct marketing and public relations (or through affinity partners).

42. US market (% of credit card outstandings)



Note:

Sources cited by Capital One: VISA, MasterCard, American Express, Discover. 2006 estimated based on Q4 2006 reporting companies.

Source: Capital One investor presentation, March 1 2007

However, the effect was to push cardholder recruitment activity more generally in this direction, so positioning the credit card more strongly as a stand-alone product rather than part of a suite of personal banking services.

For the US issuers without an existing retail banking base in the UK (with the partial exception of Citigroup), the question of where to

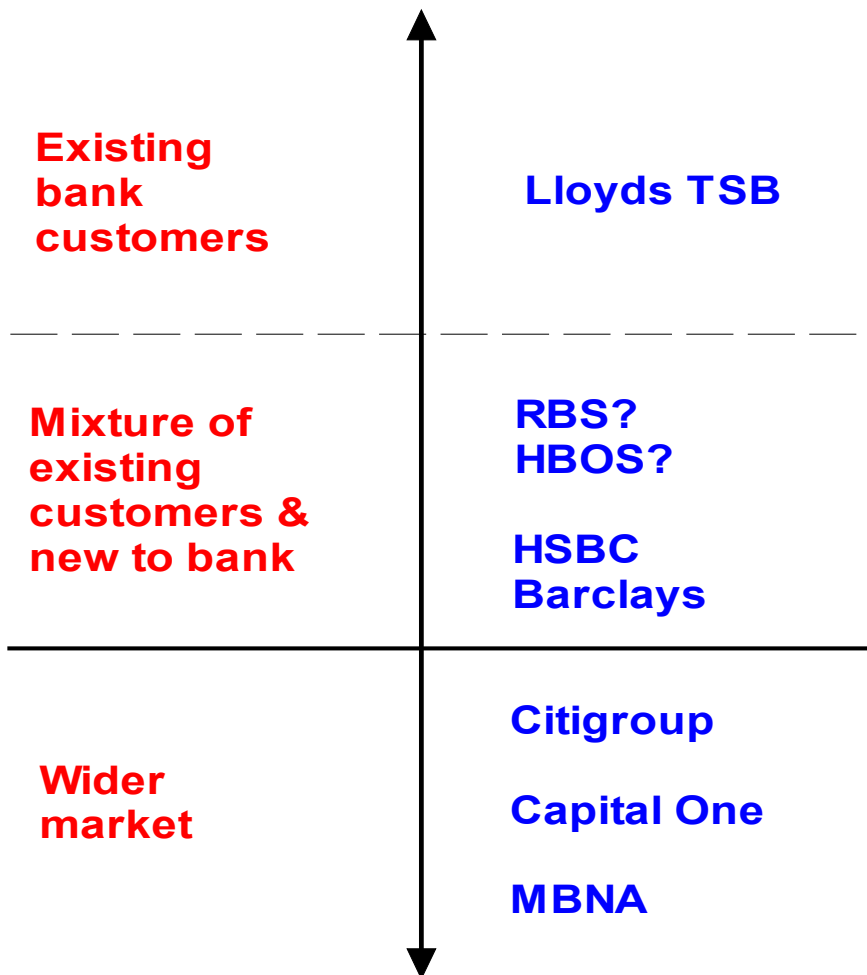
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focus their marketing efforts does not arise. But are the UK banks now likely to refocus their marketing on existing customers?

Historically, Barclays has positioned Barclaycard as a national brand with the card offered beyond the Barclays current account base. Barclaycard is a card and consumer finance division separate from retail banking in the Barclays Group.

Similarly, and particularly following its acquisition of Household (now HSBC Finance Corporation) in 2003, HSBC has moved in this direction. As noted earlier, HSBC commented that growth during 2006 was strongest in M&S branded cards. This follows HSBC's acquisition of M&S Money in 2004.

43. Marketing focus?



Source: Author's analysis

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However, Lloyds TSB does seem to be refocusing on existing customers. It commented in its 2006 results release that over 99% of new personal loans and 84% of new credit cards sold during 2006 were to existing customers.

Lloyds TSB had already signalled its intent with the sale of the Goldfish credit card business to Morgan Stanley at the end of 2005. RBS also appears to be at least partially retrenching from the wider market. It commented in its 2006 results release: "Credit card recruitment and unsecured personal lending continues to be focused on lower risk segments, with reduced emphasis on acquisition through direct marketing."

RBS added: "For the year as a whole, average personal unsecured and credit card lending was flat, reflecting the slower UK consumer demand and our concentration on quality business with existing customers."

The HBOS positioning is among the most complex, given its two major retail brands (Halifax and Bank of Scotland), historic strength in the affinity card sector (through Bank of Scotland) and its joint venture with Sainsbury's, the supermarket group. In its 2006 earnings release, HBOS commented that it acquired 743,000 new accounts (961,000 including those acquired through its joint venture partners) despite the background of lower consumer spending and borrowing.

One factor likely to push the banks back towards their existing customer bases is the cost of acquisition. Hard numbers on the cost of acquisition are not available (though Marks & Spencer quoted a typical credit card recruitment cost of £50-£100 in September 2003 at the time of its credit card launch). But spending £50-£100 to acquire a 'new-to-bank' customer through advertising and direct mail (with the cost of recruitment incentives such as balance transfer rates or introductory rates) becomes much harder to justify in a market which is flat/contracting rather than growing strongly.

Industry economics

The industry's economics will continue to be challenging for the foreseeable future.

Looking first at revenues, both interest and non-interest income streams remain under significant pressure.

The full impact of the OFT ruling on credit card default charges will be felt for the first time during 2007. HBOS commented in its 2006

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results release that the implementation of lower default and late payment fees in August 2006 following the OFT ruling resulted in a reduction in fee income of circa £25 million in 2006. It estimated a full year impact of £60 million in 2007.

Grossing this figure up for the industry based on HBOS's share of outstanding balances at end 2006 (admittedly a crude estimate) implies an industry wide impact of more than £500 million.

As noted in the previous section, there are indications that issuers are trying to replace lost non-interest income with higher interest income. However, competition, media pressure and web-based price comparison sites such as Moneyfacts will limit the scope for raising interest rates.

The industry will have to look for other non-interest revenue streams. Longer-term, the return of annual fees for holding a card seems highly likely, even if individual issuers will seek competitive advantage though not charging fees or offering fee rebates.

In practice, this has already started to happen. According to a BBC news report from February (Lloyds introduces credit card fee, BBC News, February 23 2007), Lloyds TSB is to impose a £35 annual charge on credit card account holders who do not use their cards. The report says annual charge will apply to "low-usage" customers; including people who do not use their cards at all.

Lloyds was famously the first issuer to introduce an annual fee back in the early 1990s when it started levying a £12 fee for its Access card in February 1990.

But even assuming that the introduction of fees does not lead to a wave of account closures, its revenue potential may be limited. For example, an average £10 fee on the 36 million active accounts at end 2006 would only raise £360 million a year. In reality, as happened in the early 1990s, many cardholders will close accounts that charge fees.

The longer-term threats come from the regulatory investigations into interchange and payment protection insurance. However, the timing and impact of these are difficult to foresee at present.

In the case of interchange in particular, the moment of final resolution never seems to arrive. However, the stakes for the industry remain substantial. On current levels of credit card spending (and assuming 1% of purchase value as a rough proxy for

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current interchange) a halving of interchange along Australian lines would remove approximately £600 million of annual income from issuers. The effects of a more drastic restructuring of interchange along the lines proposed by merchants would effectively undermine existing business models.

In the case of PPI, the Competition Commission's current timetable envisages a Provisional Decision on remedies (if required) by June 2008, and publication of its report in August/September 2008. This indicates an inquiry of approximately 18 months, though the statutory deadline for completion is February 6 2009. However, its impact on card issuers will depend on what remedies, if any, the Commission decides upon.

Significant reductions in interchange and PPI-related income may not happen for the foreseeable future. But the fact that two important revenue streams remain under the regulatory spotlight leaves the industry with a great sense of uncertainty hanging over it. And it emphasises how dependent issuers may become on interest income.

With interchange in particular, the longer-term fear among UK issuers is that reductions and restrictions in other major markets will eventually affect interchange in the UK. There was what may prove to be a telling comment in MasterCard's Form 10-K Annual Report for 2005 filed with the US Securities and Exchange Commission in March 2006:

"We believe that regulators are increasingly adopting a coordinated approach to interchange matters and, as a result, developments in any one jurisdiction may influence regulators' approach to interchange in other jurisdictions." (MasterCard Inc, Form 10-K 2005, p25)

In the case of costs, issuers are tightening credit criteria and extending information sharing as they seek to improve asset quality. As noted in the preceding section of the report, the most recent data and bank comments appear to indicate that credit quality has stopped deteriorating, or is close to doing so.

However, the recovery in credit quality is likely to be slow. Carefully worded comments such as "Rate of growth in unsecured retail lending impairment charge in 2007 expected to be significantly lower than in 2006" (Lloyds TSB: 2006 results statement) imply that the charge may increase further in 2007, if more slowly than in 2006.

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And the recovery in credit quality presumes that the broadly benign economic environment continues. The principal risk, as noted above, is a UK economic downturn triggered by, or leading to a substantial fall in house prices. If that happens, credit card asset quality is almost bound to deteriorate further.

Transparency

The OFT ruling on credit card default charges is likely to have wider implications on the way in which card issuers (and banks more generally) charge for services.

In September 2006, the OFT announced it was now considering the application of unfair contract terms legislation to the calculation of bank current account charges in agreements with consumers (and, as this report was being finalised, the OFT announced an in-depth study of retail bank pricing to sit alongside a formal investigation into the fairness of bank current account charges).

In a related development, the FSA has set out its views on mortgage exit administration fees in a Statement of Good Practice issued under its powers as a qualifying body under the Unfair Terms in Consumer Contracts Regulations.

The implication is that card charges will need to be transparent and justifiable under unfair contract terms legislation.

The regulatory investigations are in turn encouraging a new internet-based consumer activism, which adds to pressure on credit card and bank charges.

The OFT investigation into current account charges has led to the various campaigns designed to help customers reclaim charges, with online advice from sources such as consumer group Which?, including downloadable template letters.

And, as this report was being finalised, Which? announced it has submitted a super-complaint to the Office of Fair Trading about the way credit card companies calculate interest charges. According to Which?, the top 20 credit card providers use 12 different methods to apply interest charges to their customers' accounts. Which? has legal powers enabling it to file super-complaints with the OFT.

The credit card industry can point to various recent developments designed to improve transparency. APACS launched its most recent report into transparency and responsibility in the industry in October 2006. It noted new initiatives such as extending the

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Summary Box, first introduced in 2003, to include a version for credit card cheques.

However, facing intense media and political scrutiny, much of the industry's work on improving transparency has appeared reactive.

Product design

The pressures on the industry's economics suggest that the credit card's long-term future will depend on its viability as a borrowing product.

While much will depend on the scale of any future reductions in interchange, those cardholders who simply use their cards as a means of payment are likely to find themselves pushed towards a more explicit charge card product, with annual fees to match.

For cards targeted at borrowers, the challenge facing issuers will be to sustain outstanding balances at viable levels while giving cardholders a greater sense of control over their borrowing. The industry faces large numbers of cardholders scarred by their recent experience of over-indebtedness. And it also faces challenging demographic changes that may affect consumers' propensity to borrow (see below).

Rather than allowing cardholder balances to drift towards their credit limits, issuers may need to help cardholders sustain their borrowing at manageable levels.

The use of technology-based account management tools – tools designed to help cardholders avoid exceeding credit limits or missing payment deadlines – is one means by which issuers can give cardholders a greater sense of control over their borrowing.

It is noteworthy in the United States that issuers are moving in this direction. For example, in January 2007, Chase Card Services, the credit card division of JPMorgan Chase, announced various changes designed to help cardholders manage their accounts and avoid fees. The changes included encouraging Chase's customers to utilise its Free Alerts service to help manage their accounts. Customers may choose an alert – sent as an e-mail, voicemail or text message – that reminds them when a payment is due and when a payment has been posted to their account, or when they have reached any credit limit they choose.

The use of such tools is likely to grow in the UK (Lloyds for example is already using such tools for fraud alerts). They may reduce

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issuers' income in the short-term, as cardholders are helped to avoid late payment and overlimit fees. But this may be the price issuers have to pay for putting borrowing and account charges on a more sustainable long-term basis.

Final thoughts – changing demographics

A final thought on industry prospects concerns the implications of the UK's changing demographics for the credit card market.

According to the life cycle model of income and expenditure, borrowing allows individuals and households to match variations in their income and expenditure over time.

Expenditure rises more steeply than income during the period from youth to middle age. Younger individuals and households therefore take out mortgages and other consumer loans to buy homes, cars and consumer durables.

In later years, income may continue to rise, but expenditure moderates and may fall as children leave home, etc. Individuals and households then switch from borrowing to saving.

In practice, there is no fixed relationship between age bracket and consumer borrowing. Other factors contribute to actual borrowing behaviour. An important feature of the recent consumer credit boom has been the growth in cases of indebtedness among older age groups. For example, the Consumer Credit Counselling Service reports a 2.4 percentage point increase in those clients aged 60 or over (as a proportion of total clients) between 2005 and 2006.

However, even with the increase, it is worth noting that clients aged 60 or over accounted for only 7.8% of the CCCS client base in 2006. This compared with 42.3% for those aged 25-39 and 41.3% for those aged 40-59.

The life cycle model remains valuable in highlighting when, and in what circumstances, individuals and households are most likely to borrow. With the UK facing an ageing population, the model may help to inform the likely development of the UK credit card market.

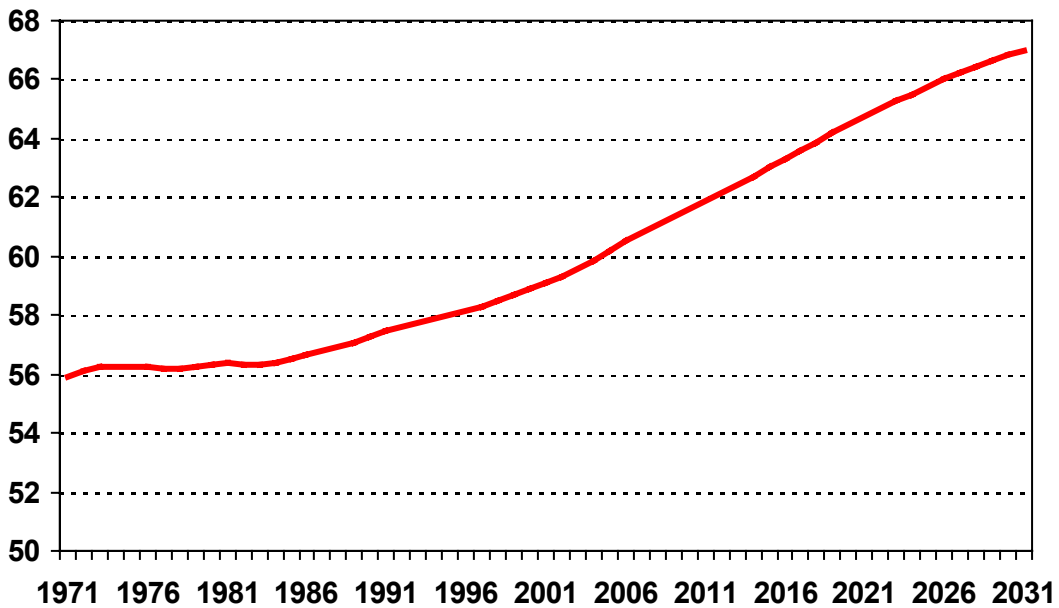
According to data from the Office for National Statistics (ONS), the UK population has grown significantly over the last three decades.

In mid-2005, the UK population was 60.2 million according to the ONS, of which 50.4 million lived in England. The UK population has increased by 7.7% since 1971, from 55.9 million. Growth has been

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faster in more recent years. Between mid-1991 and mid-2004 the population grew by an annual rate of 0.3% and the average growth per year since mid-2001 has been 0.5%.

44. UK population, including projections (millions)



Note:
Figures from 2006 onwards are projections.

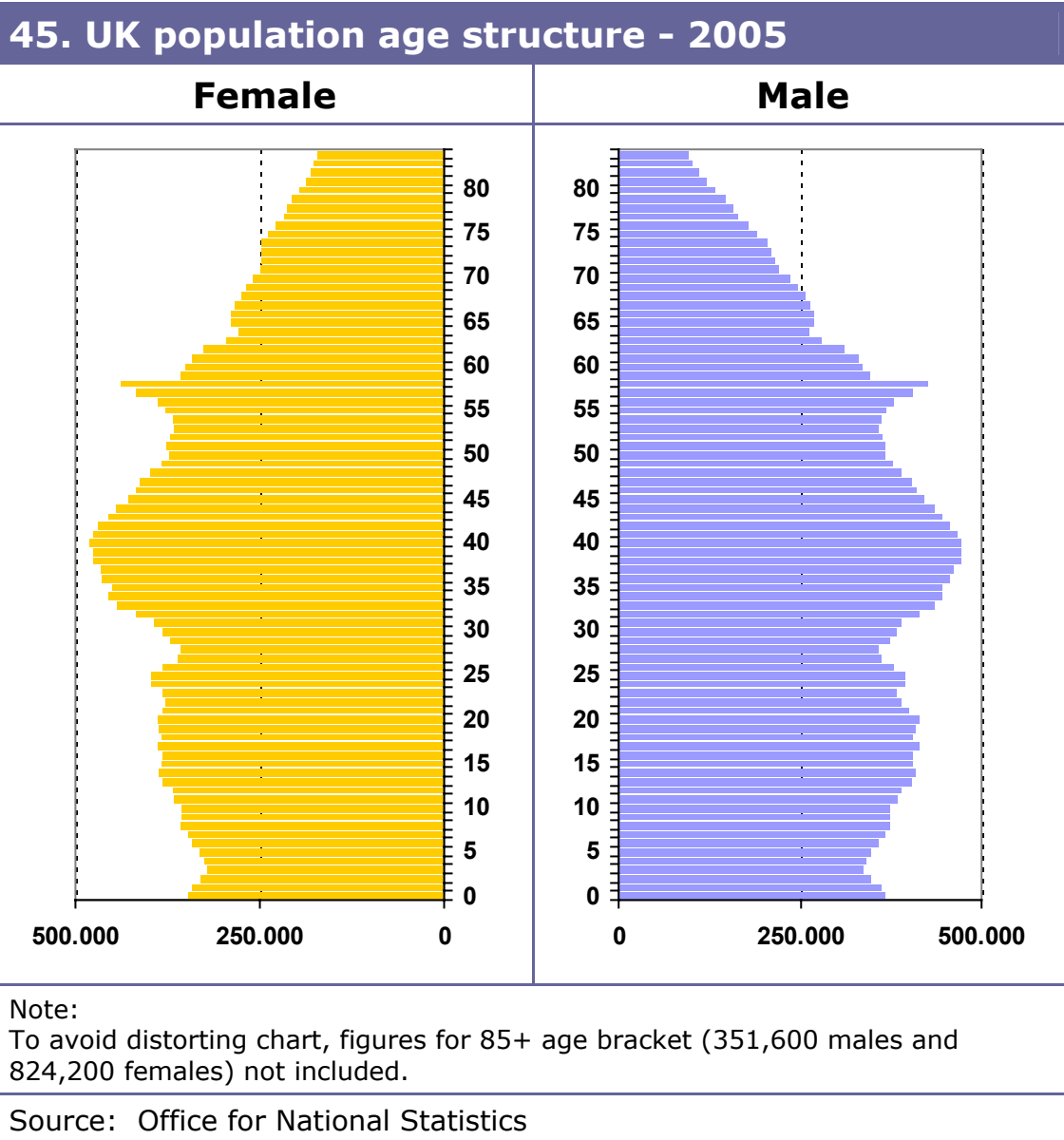
Source: Office for National Statistics

According to ONS projections, the UK population will continue to grow. The UK population is projected to increase by 7.2 million over the period 2004 to 2031 (though, as the ONS notes, long-term population projections are subject to a high degree of uncertainty). This increase is equivalent to an average annual rate of growth of 0.42%, or 12% over the 27 year period. The population growth reflects both a natural increase (more births than deaths) and a net inward flow of migrants (more immigrants than emigrants).

A rising population is, other things being equal, good news for the credit card industry, offering the prospecting of an expanding potential market. However, this is likely to be tempered by the effects of an ageing population.

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The average age in mid-2005 was 38.8 years according to the ONS. This already represents an increase on 1971 when it was 34.1 years.



According to the ONS, the proportion of people aged over 65 is projected to increase from 16% in 2004 to 23% by 2031.

This reflects in particular the ageing of the large numbers of people born after the Second World War and during the 1960s baby boom. The current age profile of the UK population shows peaks in those aged 55 to 58 and those in their early 30s to mid 40s, representing the respective baby booms in the years immediately after the Second World War and during the 1960s.

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Mapping these changing demographics on to future demand for credit cards (and in particular the use of cards as a source of credit) is a complex exercise, and any results will be subject to a high degree of uncertainty.

However, as the industry peers beyond the shock of the market's sudden contraction during the last two years, it may do well to reflect on the implications of the UK's changing age profile. In particular, those born during 1960s baby boom have provided card issuers during the last ten years with a rapidly expanding customer base. What are the implications as this generation moves into age brackets when saving rather than borrowing is likely to become more important?

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6. Statistical appendix

This appendix provides clarification and additional information on some of the key statistical sources used in the report.

The appendix provides details on the British Bankers' Association (BBA) credit card statistics, the main source of data on the overall UK credit card market used in the report. This includes an examination of the relationship between the BBA statistics and the credit card data in the national consumer credit statistics published by the Bank of England and Office for National Statistics.

The appendix also provides further detail on the statistics on insolvency published by the Insolvency Service.

6.1 BBA and Bank of England credit card statistics

British Bankers' Association credit card statistics

The report makes extensive use of statistics collected and published by the British Bankers' Association on UK-issued MasterCard and Visa credit cards:

<http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=470>

The statistics cover the worldwide transactions of UK resident holders of cards issued in the UK by all financial institutions affiliated to either the Visa or MasterCard organisations.

The statistics do not cover cards issued by American Express or cards issued by retailers (though they do include store-branded Visa or MasterCard credit cards). They cover both Visa and MasterCard credit and charge cards. They include business cards.

The BBA statistics are not seasonally adjusted.

The BBA stats for credit outstanding are for gross outstandings, ie customer exposure, with no allowance for balances in arrears.

There are a few breaks in the series to be noted:

January 1996: Data from this month onwards include all bank and building society issuers.

June 2004: Significant break in series reflecting the inclusion of new card issuer.

Differences between BBA statistics and Bank of England/ONS statistics

The Bank of England and the Office for National Statistics publish data on consumer credit.

The key Bank of England publication is *Monetary & Financial Statistics*, particularly the tables in Section A5: Lending to individuals:

<http://213.225.136.206/statistics/ms/current/index.htm>

The Bank of England and ONS data includes a breakdown of consumer credit by type of credit between:

- 'Credit card' and

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- 'Other'

The Bank of England and ONS data includes a breakdown of consumer credit by type of lender between:

- Banks
- Building societies, and
- Other consumer credit lenders

(See Table A5.6: Monthly Consumer Credit, from the Bank of England publication *Monetary & Financial Statistics*).

The credit card series covers sterling credit card lending by UK banks, building societies and other specialist lenders to the UK household sector. Prior to January 1999, credit card lending by other specialist lenders had not been separately identifiable and was included within the 'other' consumer credit component. The Bank of England adds that charge card lending can sometimes be indistinguishable from credit card lending. In these cases, is included in data for credit cards.

Consumer credit data for the banking sector are collected directly by the Bank of England from a sample of banks. According to the Bank of England, banks' credit card data are reported by a sample representing about 98% of total bank credit card lending and the 'other' lending data are reported by a sample representing about 97% of total bank 'other' lending.

The Financial Services Authority collects data for building societies. The Office for National Statistics collects data for other consumer credit lenders. Student lending data are based on information provided by the Student Loans Company.

It is noteworthy that the figures reported by the Bank of England/ONS for outstanding balances on credit cards are lower than those reported by the BBA. Chart 47 shows the respective figures at end December 2006.

According to helpful clarification from the BBA and Bank of England, the main reason why the Bank of England figures are lower is because they exclude some securitised credit card balances.

Specifically, the Bank of England credit card figures include balances securitised through UK-resident special purpose vehicles. In such cases, the balances are transferred from 'Banks' to 'Other consumer credit lenders' in the Bank of England's breakdown by type of

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lender. This transfer in the statistics reflects the underlying sale of the balances from one consumer credit sector to another. They remain under 'Credit cards' in the Bank of England's breakdown by type of consumer credit between 'Credit card' and 'Other'.

46. Coverage of statistics on credit card outstanding

| | BBA statistics | Bank of England statistics |
|---|-----------------------|-----------------------------------|
| Card balances securitised through resident SPVs | Included | Included |
| Card balances securitised through non-resident SPVs | Included | Excluded |
| Non-Visa and MasterCard credit cards | Excluded | Included (2), (3) |
| Business cards | Included | Excluded |

Notes:

1. Bank of England data is in *Monetary & Financial Statistics*, Table A5.6: Monthly Consumer Credit.
2. Prior to January 1999, credit card lending by other specialist lenders (as opposed to banks and building societies) had not been separately identifiable and was included within the 'other' consumer credit component in the Bank of England statistics.
3. Non Visa and MasterCard credit card balances included in the Bank of England data to the extent that the cards are issued by lenders included in the Bank of England/FSA/ONS population.
4. The BBA statistics cover ordinary, Gold, Premier and Affinity Visa and MasterCard credit and charge cards issued to individuals and companies. They exclude in-store or other credit card schemes, and also exclude personal loan schemes processed and operated by the credit card companies.

Sources: British Bankers' Association, Bank of England

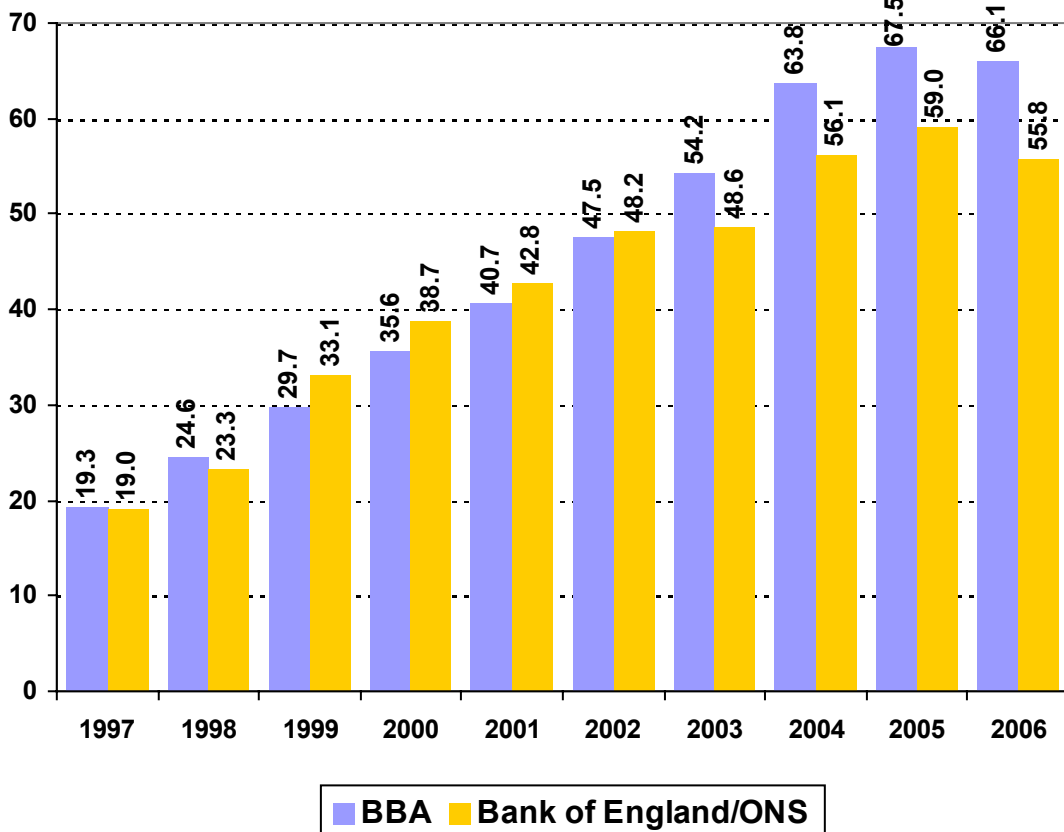
However, the Bank of England figures exclude balances securitised through non-resident special purpose vehicles. This is because all non-resident financial institutions (and therefore all non-resident SPVs) fall outside its remit (the debt is not, in effect, owed to UK lenders any more). Note that in January 1998, 'Other specialist lenders were re-defined to exclude lending by institutions in the Channel Islands and Isle of Man, as these are now classified as non-residents.

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The BBA makes adjustments to 'add back' any securitised balances. The BBA data is therefore a more comprehensive measure of the value of credit card borrowing from the perspective of money owed by cardholders. The Bank of England data is a purer measure of debt owed by UK-resident individuals to UK resident lenders.

However, it is worth noting that the BBA data includes business cards and does not include borrowing on American Express cards (the Bank of England data include borrowing on American Express cards to the extent that they are issued by lenders included in the Bank of England/FSA/ONS population).

47. Credit card outstanding – 1997-2006 (£ billion)



Notes:

1. Year-end data.
2. Data not seasonally adjusted.
3. Prior to January 1999, credit card lending by other specialist lenders had not been separately identifiable and was included within the 'other' consumer credit component in the Bank of England/ONS statistics.

Sources: British Bankers' Association, Bank of England, Office for National Statistics

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For tax reasons, some of the entities involved in UK credit card securitisations have been located offshore. The details of securitisation structures are beyond the scope of this report. The important point in terms of market data, as evident from chart 47, is that those credit card balances excluded from the Bank of England data are significant when compared with the BBA measure.

6.2 Insolvency statistics

Insolvency statistics are available at:

<http://www.insolvency.gov.uk/otherinformation/statistics/200702/index.htm>

Differences in insolvency regimes across the UK

The following information is drawn from the notes to the insolvency statistics published by the Insolvency Service.

The individual insolvency (bankruptcy and IVA) statistics cited in Section 4 of the report are for England and Wales. Data is also published for Scotland and Northern Ireland, but is shown separately in the published statistics according to the Insolvency Service because:

- They are covered by separate legislation
- There are some differences in definition, and
- Policy responsibility for them lies within the devolved administrations.

The data series covering Scotland and Northern Ireland do not demonstrate consistent seasonality and only the raw (unadjusted) series are presented.

Individual insolvencies in both England and Wales and in Northern Ireland comprise bankruptcy orders and individual voluntary arrangements (IVAs).

Insolvent individuals in **England and Wales** are dealt with mainly under the Insolvency Act 1986. A bankruptcy order is made on the petition of the debtor or one or more of his creditors when the court is satisfied that there is no prospect of the debt being paid. (Figures for bankruptcy orders include orders relating to the estates of deceased debtors).

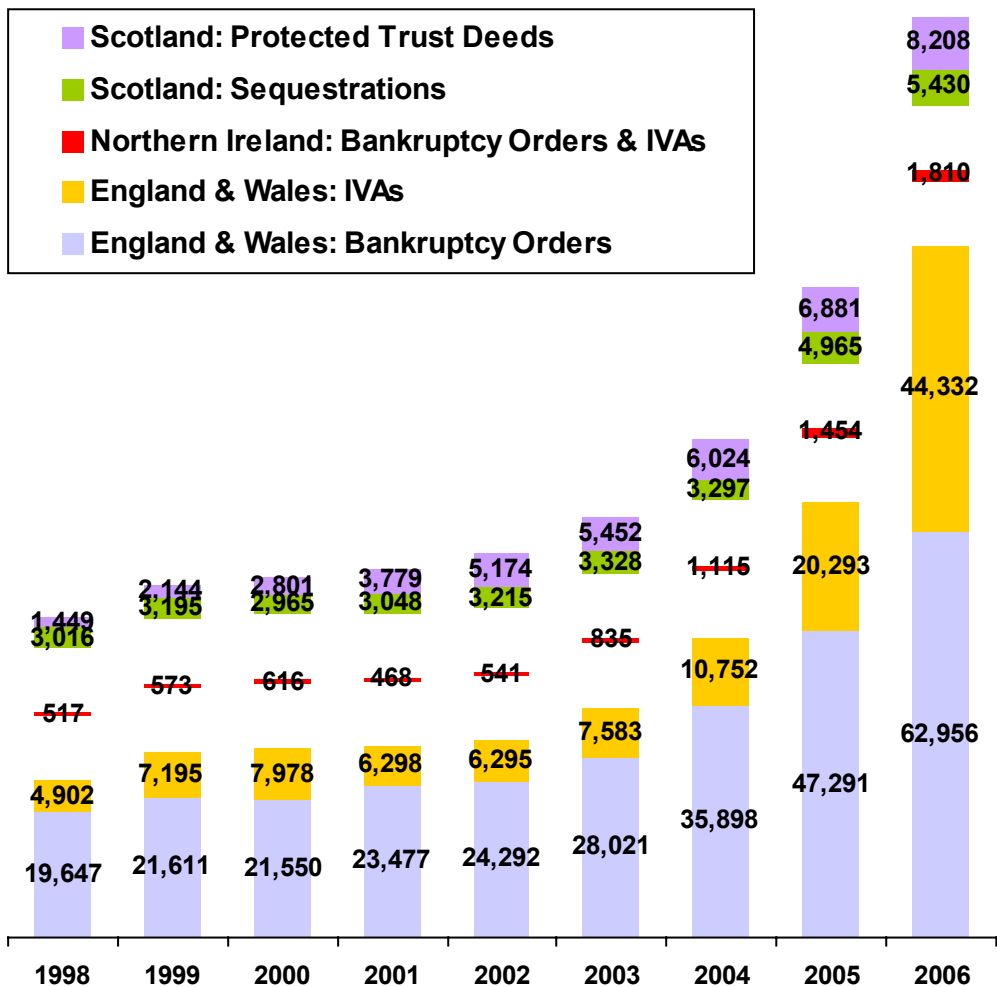
There are also IVAs and deeds of arrangement (the latter under the Deeds of Arrangement Act 1914), which enable debtors to come to an agreement with their creditors.

Changes to bankruptcy law introduced by the Enterprise Act 2002 came into force on April 1 2004. The Act made no changes to the existing individual voluntary arrangement regime (see comments below on the growth in bankruptcies and IVAs).

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Insolvent individuals in **Northern Ireland** are dealt with under the Insolvency (Northern Ireland) Order 1989. On March 27 2006 the Insolvency (Northern Ireland) Order 2005 came into operation and implemented similar changes to bankruptcy procedures as the Enterprise Act 2002 introduced in England and Wales.

48. Individual insolvencies across the UK - annual



Notes:

1. Figures not seasonally adjusted.
2. 2006 figures for all jurisdictions are provisional.
3. IVA series includes Deeds of Arrangement.
4. Figures for Bankruptcy Orders and IVAs in Northern Ireland too small to show separately on the chart.

Source: Insolvency Service

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Insolvent individuals in **Scotland** are subject to sequestration (bankruptcy) or protected trust deeds under the Bankruptcy (Scotland) Act 1985 (as amended). This Act was amended by the Bankruptcy (Scotland) Act 1993. Protected trust deeds are voluntary arrangements in Scotland. Though they fulfill much the same role as individual voluntary arrangements, the Insolvency Service comments that there are important differences in the way they are set up and administered.

Growth in bankruptcies and IVAs

The impact of the legal changes on the growth in bankruptcies and IVAs has been the subject of much debate. As noted above, changes to bankruptcy law came into force on April 1 (with similar changes in Northern Ireland from March 2006). The changes reduced the period of automatic discharge from bankruptcy to one year from three years (while stiffening the penalties for debtors going bankrupt through wilful or reckless behaviour).

The Bank of England has commented in its *Inflation Report* of May 2006:

“Legislative changes may also be behind the most recent spate of insolvencies. The insolvency rate in England and Wales has doubled over the past two years — coinciding with the introduction of the new bankruptcy regime there. One possibility is that the new regime is perceived as more debtor friendly, and that has led to an increase in debtors (rather than creditors) petitioning for bankruptcy. The data for England and Wales confirm that the bulk of the rise in bankruptcies reflects higher debtor petitions.

“But the impact of the legal changes should not be overstated. The number of new IVAs in England and Wales (which accounted for about 30% of all new insolvencies in 2005) has more than trebled since the beginning of 2004, even though the Enterprise Act left the regime governing those insolvencies unchanged.” (Bank of England, *Inflation Report*, May 2006, Box on personal insolvency, page 8)

The Bank of England also notes that insolvencies accelerated in Scotland and Northern Ireland over the same period despite no change in regime.

Bankruptcy orders in England and Wales grew significantly in 2005 and 2006, but by much less than the growth in IVAs. The growth in IVAs appears to reflect a number of factors:

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- The growth in consumer indebtedness, increasing the pool of potential IVA users
- The emergence of a sub-sector of companies marketing the service
- Less stigma for debtors attached to IVAs compared with bankruptcies

The bankruptcy and IVA figures for 2007 will be eagerly anticipated. It is noteworthy that trends were reversed during fourth quarter 2006, when bankruptcy orders in England and Wales grew more quickly than IVAs (see chart 32). This supports anecdotal evidence that banks and other creditors are now taking a tougher line on IVA negotiations.

Further, in December 2006, the British Bankers' Association and representatives of the IVA industry agreed to create industry standards - similar to the Banking Code - to regulate how responsible debt practitioners market and advertise their services. The BBA and registered IVA providers have also agreed to set up a register of responsible insolvency practitioners who subscribe to the Code. The Code will also cover the quality of advice customers receive from IVA providers on the register and the transparency of the charges and fees that will be made.