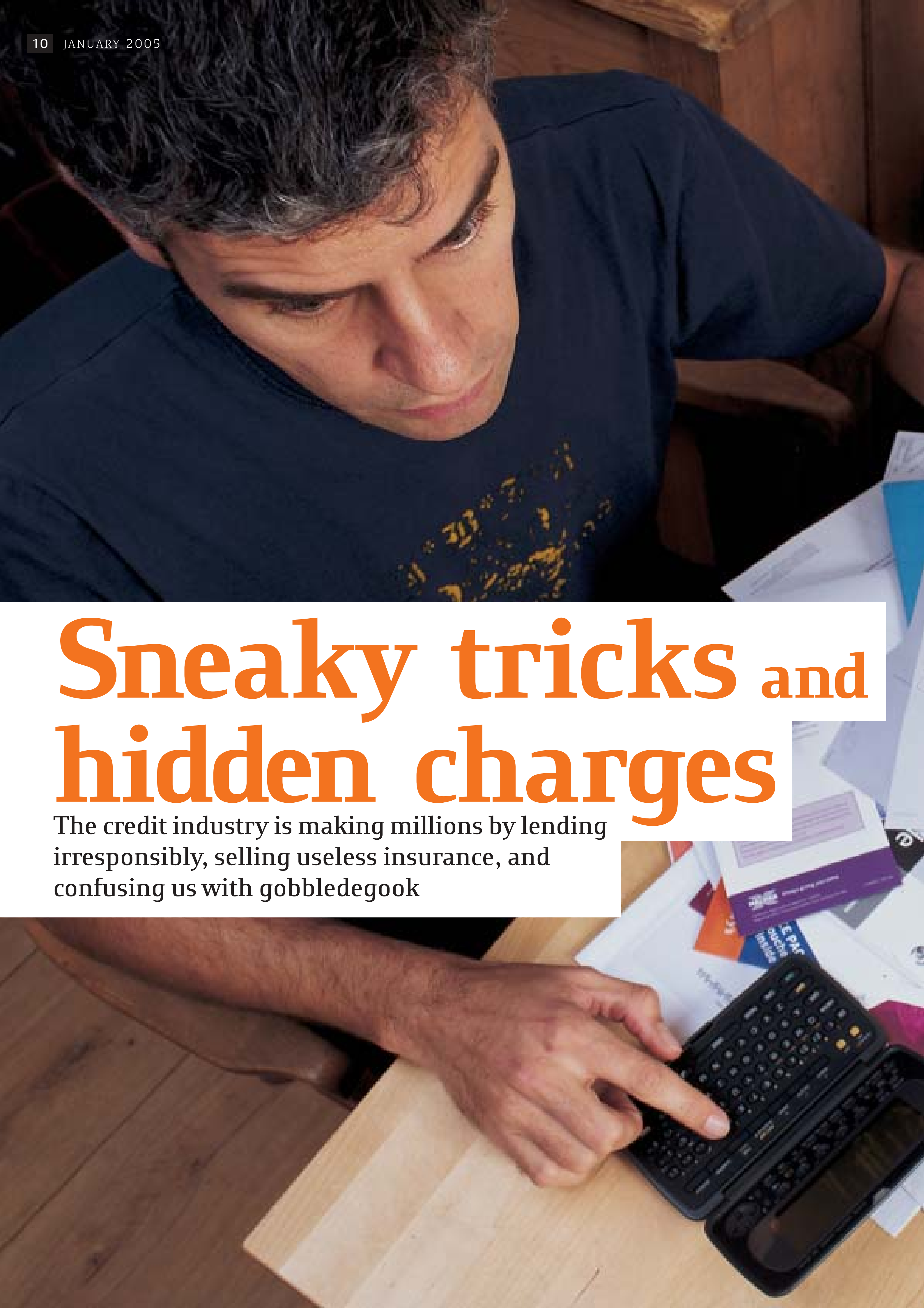
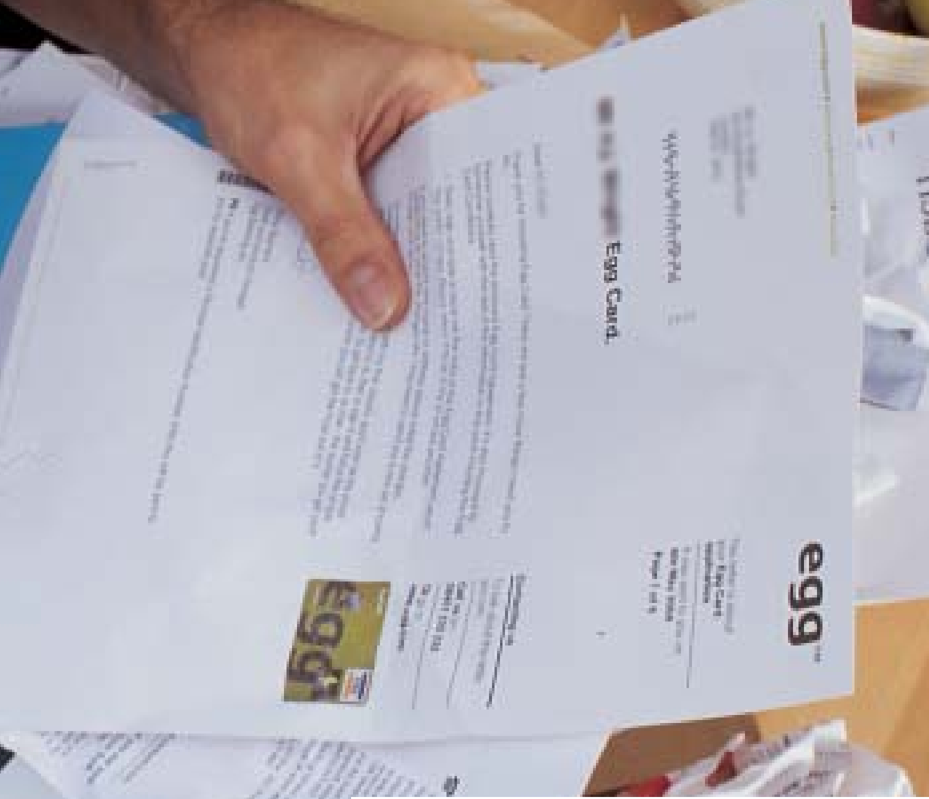


Sneaky tricks and hidden charges

The credit industry is making millions by lending irresponsibly, selling useless insurance, and confusing us with gobbledegook



Credit card and loan companies are raking it in. This huge industry does everything it can to encourage people to borrow more than they planned to, and catches them out with deliberately confusing deals and hidden charges. In the UK we now owe more than £1 trillion – £180 billion on credit cards and personal loans alone.

Loan and credit card companies boost their profits by selling expensive and sometimes inappropriate insurance, which is supposed to cover you if you can't make your payments. We've estimated that loan companies earn at least £1 billion each year from selling this insurance with personal loans. Another way credit card companies make money is by charging customers who pay bills late or exceed credit limits. We've estimated that they make around £400 million a year from these charges.

Because credit card companies calculate interest in different ways, it's impossible for people to compare cards. Two cards with the same interest rate may well cost different amounts, as it depends on when they start and stop charging interest. John McFall MP, Chairman of the Treasury Select Committee (a group of MPs that has been investigating the credit card industry), told us: 'Competitiveness and transparency are the twin objectives of the committee's work in this area. The industry acknowledges that it has some way to go before it becomes fully transparent. There can't be a competitive environment unless consumers can easily understand the information they are presented with.'

HOW CREDIT COMPANIES MAKE MONEY

Credit cards are convenient and popular but, unless you pay off your bill in full every month, you could be paying through the nose for your piece of plastic – and probably not in ways you'd expect. Credit card companies love nothing better than someone who transfers a balance to a new credit card, forgets to switch at the end of the introductory rate, uses credit card cheques, makes late payments or pays only the minimum each month. All of these things boost their massive profits. Barclaycard, for example, made £761million in 2003 just from its 10 million credit card customers in the UK.

You'd expect card companies to make money charging interest – but we've found that they rake in millions of pounds from penalty charges. Most card companies charge £20 to £25 when you don't pay your credit card bill or you go over your credit limits. This doesn't affect just a few absent-minded people. Our survey of 2,000 people found that a staggering one in four people was charged at least once last year for paying late or exceeding their credit limits. We've calculated that this adds up to £427 million each year.

We think these charges are way above the actual costs incurred by companies for dealing with late or missed payments, as letters are generated automatically and penalty charges are simply added on to your next bill. To make matters worse, the charges are the same whether you're a day or a month late, or exceed your credit limit by a pound or a thousand pounds. We hope that the Office of Fair Trading's investigation into these charges will force companies to lower them.

One way to avoid late payment charges is to pay your credit card bills by direct debit (DD). However, not all credit card companies allow you to set up a DD automatically when you

The worst credit practices

- Different methods of charging interest on credit cards, which make it impossible to compare cards
- Unsolicited credit card cheques and unsolicited credit limit increases. to encourage us to spend more
- Credit companies failing to share information with credit reference agencies, resulting in irresponsible lending
- The automatic inclusion in personal loan quotes of payment protection insurance, which is expensive and offers limited cover
- Small print and gobbledegook in marketing and terms and conditions
- Adverts and mailings that encourage us to borrow irresponsibly and fail to give details of charges

Credit is easy to come by but could take years to pay back

take out a new card – instead you have to call them to set it up. We think they do this in the hope we'll pay late. Companies should always give new customers the option of setting up a DD.

To make it even easier for people to miss payments, some companies send statements out up to three days after the statement date and use second-class post, which delays them even further. This can reduce the time you have to pay by five or more days. Some companies also take longer than necessary to process payments.

Another £1 billion from PPI

It's not just the interest that makes loan firms money – it's the extras. Personal loan companies make at least £1 billion in commission by selling payment protection insurance (PPI) with personal loans each year. This is a conservative estimate based on the percentage of loans sold with PPI.

PPI is designed to pay your loan or credit card payments if you are unable to work. However, it's expensive, gives limited cover, and can be useless for the self-employed or those on contracts. We've also found that companies aren't selling it properly.

In 2002 and 2004 we made a total of 230 calls to loan companies, posing as customers, and found them selling PPI badly. Many companies automatically included PPI in quotes, and a significant proportion failed to tell us that the quotes included PPI. On one of the RAC's recent loan leaflets, we found that all the figures included PPI. We made two calls as a customer to get a quote for a loan, and both times we were given quotations that included PPI. In one call, we were given the cost for just the loan only when we asked.

Adding PPI on to a three-year £5,000 HSBC loan would increase the total cost from £6,072 to £7,092, a whopping £1,000 more. The insurance nearly doubles the cost of the loan. Given that the chance of your needing, or being able to, make a claim is fairly low, you'd be better off saving the money or buying an income protection policy, which is better because it gives you money to use for any purpose and may pay out for longer.

It's not surprising that companies try to make money by selling PPI on as many loans as possible. Lots of companies currently offer rates of around 6 per cent on their loans and, at a time when the base rate is only a little lower at 4.75 per cent, this means profit margins are small. Richard Thompson from Price Waterhouse Coopers, a firm of financial consultants that has recently published a report on the credit industry, agrees. 'Personal loan companies are over-reliant on PPI because of low margins, and this is due to low interest rates,' he told us.

Credit card companies also make millions selling PPI. PPI on credit cards is even less useful than PPI on loans as, if you're unable to work, it usually pays off only a small amount of your debt each month. It costs from 60p to 89p per £100 of the balance on your card. Premiums are normally added on to your credit card balance, and interest is charged on them, which means that your debt could increase: for example, if you owe £2,000 on your card, PPI could cost up to £18 a month, which would mount up to £213, plus interest charges, over the year. Even more reason to avoid PPI on credit cards.

Which card is cheaper?

Question You spend £300 on each card and pay £100 when you get your bill. The next month you spend £150 more. When you get your next bill, you pay it off in full. Which card would be the cheaper?

Answer They both cost the same because of the different ways they charge interest

Interest calculation methods

By calculating interest in different ways, credit card companies make it impossible for consumers to compare cards and choose the best one for them. It all hinges on when cards start and stop charging interest, which means that two cards with the same interest rate could charge you different amounts of interest. For example, if you spent and repaid

> **By calculating interest in different ways, credit card companies make it impossible for consumers to compare cards**

exactly the same amount over a year on two credit cards – RBS Platinum and Co-op Advantage, which both have an interest rate of 15.9 per cent – we've calculated that RBS charges significantly more interest (£31) than Co-op (£22). Not surprisingly, when we talked to consumers, most knew nothing about these differences, and card companies rely on this lack of knowledge to increase their profits. We've lobbied the industry to standardise the way interest is calculated, but it's refusing to budge.

Laurence Baxter, Senior Policy Adviser for Which?, says: 'In the 18 months since we called for the standardisation of how credit cards calculate interest, all we've heard from the industry is why it shouldn't happen. It argues that standardisation would stifle competition. In fact the reverse is true: standardisation would allow people to compare cards by looking at interest rates, and this can only be good for competition.'

PHOTOGRAPHY NICK WRIGHT

Tricks of the trade

Along with late payment charges, PPI, and complex interest calculation methods, the credit industry uses lots of other tricks to make money

Partial payments

You may think that, when you pay money off your credit card debt, you'll be charged interest only on what's left. However, you'd actually be charged on the full amount – as if you hadn't made a payment at all. For example, if your credit card bill was £1,000 and you paid off £900, you'd expect, for that month, to be charged interest only on the balance of £100. Most cards, though, would charge interest on £1,000 up to the date you made your payment, and on £100 from then on.

High interest rates

The difference in the cost of credit can be huge, and companies exploit loyal customers who don't bother to switch. For example, Northern Rock's credit card, a Which? Best Buy, has an APR of just 9.1 per cent, less than half of Barclaycard's APR of 18.9 per cent.

Different rates for the same card

Credit card companies normally charge different interest rates for purchases and balance transfers, and may also have low introductory rates. As a result, adverts and application forms can contain lots of different interest rates. This means it can be difficult to know how much you'll be charged. One of the worst examples is Capital One, which gives 160 rates on a credit card mailing – a baffling mixture of APRs and monthly rates.

Order of payments

With a few exceptions, payments on credit cards go towards paying off money you've borrowed at the lowest interest first. This means that, if you have balances on your credit card at two different rates, you'll pay off the cheapest debt first and be left with a balance being charged at a much higher rate (see example, below). Companies do this to make money, and consumers are oblivious to it.

Charges for balance transfers

0 per cent balance transfer deals are now common, but some companies have introduced charges for processing them. For example, Barclaycard charges new customers 2 per cent on balances moved to its 0 per cent introductory rate (with a maximum of £35) – an extra £20 on a £1,000 transfer. It's therefore misleading to advertise these deals as 0 per cent.

Minimum repayments

Over the years, credit card companies have slashed the minimum amount you have to pay each month from 5 per cent to 2 or 3 per cent. Paying only the minimum is never a good idea as it means it could take years to pay off your debt and cost you huge amounts of interest. For example, it would still take more than 14 years to pay off a £1,000 debt on the Halifax One card, which has a low rate of 9.9 per cent, if you paid the minimum 2 per cent. We want the credit card industry to put a personalised illustration on statements showing how long and how much interest you would pay if you carried on paying the minimum. Last year MBNA came up with a new way of calculating minimum repayments on all its cards that means you pay off even less of your debt each month. MBNA takes the lowest of one of three figures as your monthly repayment: 2.25 per cent of the balance; £5 plus the total charges (interest, insurance and handling fees); or the full balance if less than £5. This means that it can take even longer to reduce your debt and MBNA receives interest for longer. It could even mean that a debt is never repaid.

Avoid borrowing on store cards. However, you could play stores at their own game by taking the discount on your first purchase, paying off the debt and then cutting up the card

Store cards

Avoid borrowing money on store cards. Most charge between 26 and 30 per cent, much more than even the most expensive credit cards. And we found last month that some companies are still not selling them properly (see 'Don't put store cards on your Christmas list', Which?, December 2004, p5). Staff weren't able to give basic details about their cards, such as the interest rate or charges. You could play stores at their own game by taking the discount on your first purchase, repaying the debt and then cutting up the card.

Small print

We know from talking to consumers that most people don't read the terms and conditions when they apply for a credit card or personal loan. Companies rely on this and hide important information in the small print, using confusing language to bamboozle us further. For example, we found the following sentence on a Capital One No Hassle Platinum credit card leaflet: 'The monthly interest rates are equal to one twelfth of the sum of the Base Rate as at the seventh day prior to the beginning of the statement period, plus for purchases a margin of 1.98%.'

We think it means that interest rates will go up and down as the Bank of England base rate changes. However, the wording doesn't make it clear.

HOW CREDIT CARD PAYMENTS ARE ALLOCATED

You have a balance of £1,500 on a card, made up of a £1,000 balance transfer at 0 per cent and £500 new purchases at 15.9 per cent (see figure 1). When you get your statement, you pay £500 off your bill. Instead of paying off the new purchases, your payment's used to reduce the balance transfer, so you still owe £500 at 15.9 per cent and the 0 per cent balance has gone down to £500 (figure 2).

Figure 1

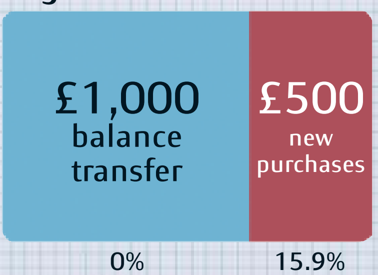
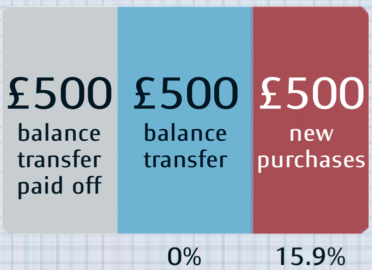


Figure 2



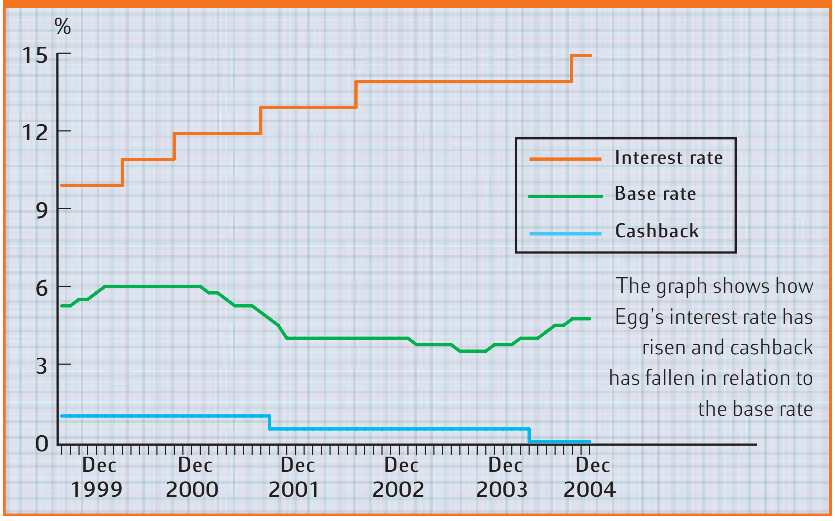
Credit files compared

COMPANY	Type of credit	Credit reference agency: Equifax	Experian	Callcredit
First Direct	Current account	×	×	×
First Direct	Personal loan	×	×	×
Cahoot	Current account	✓	✓	×
Cahoot	Credit card	✓	✓	×
IF	Current account	×	×	×
IF	Credit card	✓	×	×
Virgin	Credit card	✓	✓	×
Ryanair	Credit card	✓	✓	×
Egg	Credit card	✓	✓	✓
American Express Blue	Credit card	✓	✓	✓
Barclaycard	Credit card	✓	✓	✓
Nationwide	Mortgage	×	✓	×
Total debt not shown	excluding mortgage	£7,000	£9,200	£14,200
Total debt not shown	including mortgage	£73,500	£9,200	£80,700

This table shows the credit information held by the three credit reference agencies about one of our researchers. Not one holds full information – Callcredit, for example, doesn't hold any mortgage details and underestimates this person's debt by £80,700.

A bad egg

Egg was a market leader when it launched but has become less competitive over the years (see the graph, below). Egg was launched with a low rate of 9.9 per cent in 1999 – it was also the first card to offer 1 per cent cashback on purchases. Egg's interest rate has risen by 5 per cent, even though the base rate is lower now than when the card was launched. It also slashed its cashback last year from 1 per cent to a paltry 0.1 per cent. Its cashback is now so low that we don't include it in our credit card cashback Best Buys. Despite all this, Egg has almost 3 million credit card customers – more than ever before. Now that it's sucked those people in, it boosts its profits by selling them loans and car insurance. A spokesperson from Egg said: 'Our standard rate of 14.9 per cent APR is still below the market average'.



The graph shows how Egg's interest rate has risen and cashback has fallen in relation to the base rate

HOW CREDIT COMPANIES HOOK YOU IN

Whatever tricks credit companies use, none of them can work unless you take out the card or apply for the loan. So credit companies spend hundreds of millions of pounds advertising their products and are responsible for a quarter of all the junk mail we receive each year. It can cost companies around £100 to find each new credit card customer, once marketing costs are taken into account, so it's not surprising that, once they get a customer, they try to make as much money as they can from them.

The way companies market and design their products often encourages us to borrow more than we should. For example, a Virgin mailing to a new card customer reads 'Go, go, go' beneath a credit limit of £7,500. Virgin told us this was telling people to activate their card, not spend on it. However, it told us it would look at different ways of displaying the information.

Suggestions from American Express on how to use a loan

A Halifax personal loan newspaper advert asks: 'Escape to the sun? Buy a special gift for a loved one? Or just celebrate Christmas in style this year? What would you do with a Halifax loan?'

The credit industry has come under fire for failing to lend responsibly, with tragic cases of people who have racked up huge debts. Consumers obviously have a duty to borrow responsibly, although this can be difficult when the credit industry encourages them to borrow more and more. Peter Tutton, Social Policy Officer from Citizens Advice, told us: 'The number of people coming to us with debt problems has increased by 74 per cent in the last seven years. In a number of cases, people have been lent money they shouldn't have.'

Lenders are supposed to use credit reference agencies (CRAs) to ensure that they're not lending more money to people who have high debts. People can borrow more than they can afford because not all credit companies supply the same information about their customers to the three CRAs – Experian, Equifax and Callcredit. This can mean that not all of your debt will show on your credit file.

Another problem is that some companies pass on details only if you are in financial difficulties – for example, if you are missing payments or not paying at all. This means that good customers may find it difficult to switch credit company because there is nothing on their files, good or bad. Until all credit companies share the same full data about a person's credit commitments, companies simply won't be able to make responsible lending decisions that take into account a person's full financial situation.

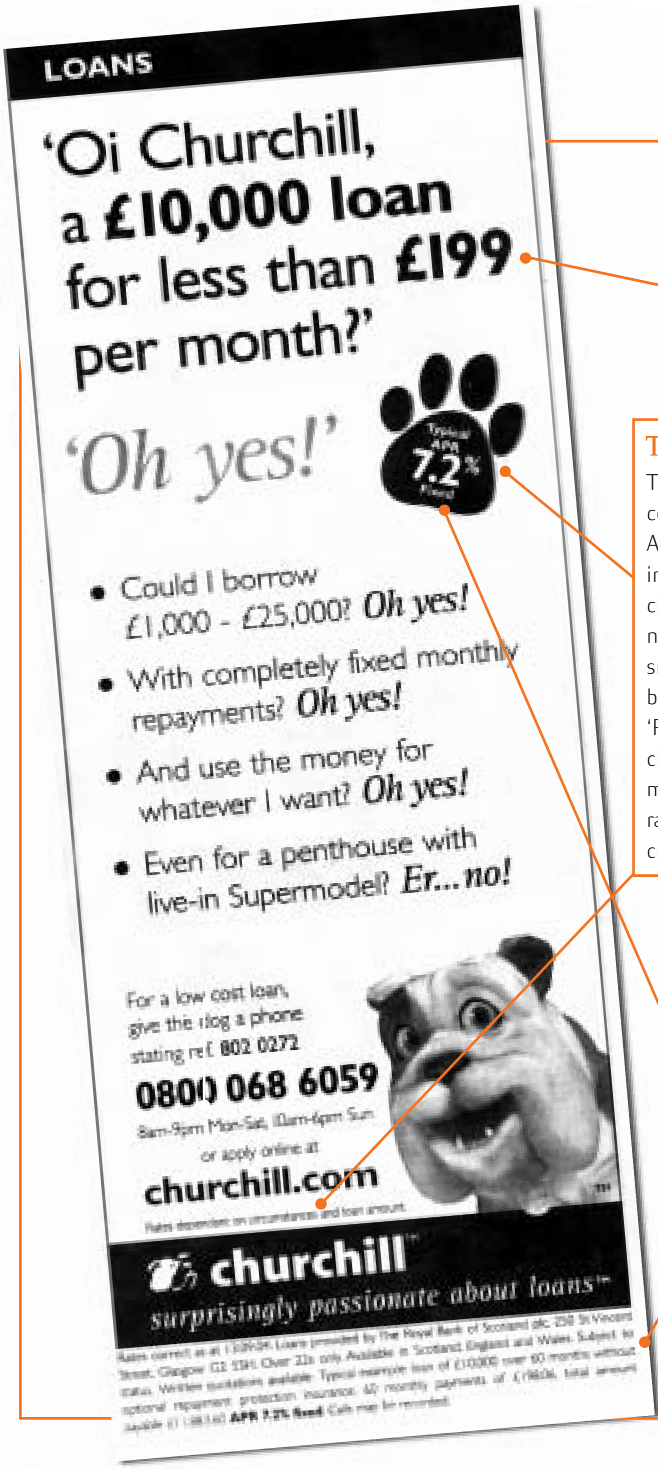
Credit card companies have signed up to an agreement that says they will share as much information with CRAs as they are allowed to by law. This is a step forward and will mean that more

What ads don't say

EARLY REPAYMENT PENALTIES
Churchill's advert doesn't tell you that it will charge up to two months' interest if you pay the loan off early. Companies don't have to include early repayment charges in adverts. Since many people pay loans off early, we think these charges should be scrapped, or at least included in ads.

RANGE OF RATES
Ads show the typical rate, which isn't necessarily the rate you'll get (see 'Risk-based pricing', p16). One of Churchill's customer service staff told us that we could get a rate from 7.2 to 25.4 per cent, which certainly isn't clear from the ad.

DIFFERENT RATES FOR DIFFERENT LOAN AMOUNTS
Some companies have different rates depending on how much you borrow. Churchill's rates are the same no matter how much you borrow, despite what the small print says.



MONTHLY PAYMENT
Loan companies often use the monthly payment to sell their loans – in this case £199 a month for a £10,000 loan. What they don't make so clear is how long the loan is for and the total cost. These facts are normally hidden away in the small print – in this case, 60 months and £11,883.60 respectively.

TYPICAL APR
This is where it gets complicated. Typical APR means that the interest rate you'll be charged may or may not be 7.2 per cent. The small print at the bottom of the ad states 'Rates dependent on circumstances', which means that interest rates depend on your credit scoring.

FIXED RATES
This means that the interest rate will stay the same for the length of the loan. Churchill doesn't have to include this in its adverts – companies are only required to say if rates are variable and could change during the course of the loan. We think it's misleading to put the word fixed next to the interest rate because people may think that's the rate they're guaranteed to get.

OUR RESEARCH
In March 2004 we surveyed 10,000 Which? members by post about their credit cards; 4,574 replied. In September 2004 we held four focus groups with holders of credit cards and loans. In October 2004 we carried out an online survey of 2,000 people to calculate credit card charges.

information will be recorded. However, it still doesn't go far enough as it means that some historic accounts won't show up on people's credit records.

To find out what credit information is held by the CRAs, some Which? researchers obtained their credit files. Not one CRA had full information about their credit commitments. In the worst case, this meant an underestimate of one person's outstanding debt by almost £81,000 – including a mortgage of £66,500 (see table, opposite).

WE WANT TO SEE THE END OF...

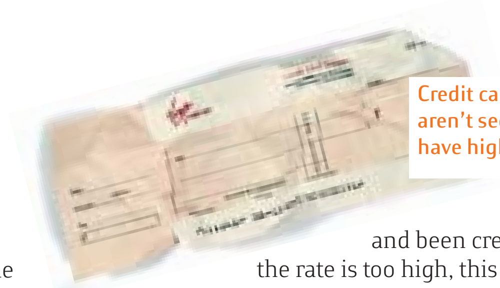
Credit limit increases

Companies increase our credit card limits to encourage us to spend. Our research shows that 42 per cent of Which? members have had their credit card limits increased in the last year without asking. And, the more you owe, the more likely it is that your credit limit will be increased. People who owe more than £10,000 on a credit card are more than twice as likely to have their limit increased than people who owed nothing on credit cards. We don't like this practice and want it banned.

Credit card cheques

Credit card companies use credit card cheques to encourage people to spend more. Again, we've found that you're more likely to receive cheques the more you owe. Almost half of Which? members have received credit card cheques in the last year that they haven't asked for.

Buying goods with a credit card cheque costs more than paying with your card as you're charged interest from when you use the cheque, even if you pay your bill in full, and you also pay a handling charge of around 2 per cent. If the goods are faulty or don't turn up, you can't claim against your card company, which you can do if you'd use your credit card. Customer services staff don't seem to realise this. One of



Credit card cheques aren't secure and have high charges

Shopping around affects your credit rating

Glynn Allcock, from Chipping Norton, Oxfordshire, had his credit rating lowered because he shopped around to get the best rate on a car loan. Glynn has a good credit rating and was annoyed when one of the companies turned him down. It told him that each time he made an application, a search had been registered on his credit file. It declined his application because it looked as if he had been applying for lots of credit and been turned down. 'I couldn't believe that my credit rating could be lowered by trying to get the best deal,' said Glynn. 'People need to be warned of the dangers of shopping around for credit.'

Each time you apply for credit, it's registered on your credit file

our researchers phoned Lloyds TSB twice and asked whether the cheques it had just sent her gave her the same protection as using her card. Each time she was told 'Yes, they are exactly the same as using your card'. We got the same answer from Halifax.

Credit card cheques have been blamed for increasing credit card fraud. Ken Farrow, Detective Chief Superintendent, City of London Police Fraud Squad, told us: 'Criminals are able to use credit card cheques to commit fraud because they aren't secure and are sent out unsolicited'. Despite this, some companies send them out willy nilly. Virgin sent one of our researchers 21 credit card cheques in a year. The researcher had never requested any cheques and had never used one. When we asked Virgin why it sends out so many cheques, it said: 'Credit card cheques are just another way for people to use their card, and customers can opt out of receiving them.'

Companies are good at suggesting ways to use your cheques. MBNA has a leaflet called 'Making the most of your credit card cheques', which says: 'Credit card cheques make perfect gifts for family and friends and are a really clever way to use your MBNA credit card account'. Halifax encourages us to use its cheques to pay for club memberships, holidays, home improvements, school and university fees, gifts and treats'. This is yet another example of the credit industry encouraging us to spend more than we can afford. We want unsolicited credit card cheques to be banned.

Risk-based pricing

If a rate on a credit card or loan is advertised as typical, it means that not everyone will necessarily get that rate – it may depend on your credit rating. This is known as risk-based pricing (RBP). More and more credit card and loan companies are using RBP because it allows them to advertise lower interest rates. Changes to the Consumer Credit Act mean that companies now have to say 'typical' in every advert, even if all applicants get that rate. If it is dependent on your credit rating, it will have to say so, and at least two thirds of accepted applicants will get the advertised rate. However, if, for example, only 40 per cent of applicants are accepted (which is quite possible), it could mean that, out of 100 applicants, only 28 could get the advertised rate.

Charging more or less depending on a person's credit rating is, in principle, not a bad idea, because the rate you get reflects your financial situation and how you've handled credit in the past. However, we've found from talking to consumers that they don't understand RBP – and neither do customer services staff. Posing as loan customers we phoned some of the big names in the personal loan market to see how well staff could explain about charges and interest rates. Few staff were able to tell us what percentage of people would get the typical rate, the range of possible rates or explain how much of a penalty there would be for paying the loan off early.

RBP can make it hard to shop around because you won't know the rate you'll get until you've applied and been credit searched. If you decide the rate is too high, this search, or 'footprint', will affect your ability to get credit elsewhere. We want the industry to use quotation searches, which wouldn't be registered until you'd signed up to a loan or credit card, so your credit rating wouldn't be affected. A spokesperson from Experian told us: 'The quotation search facility is available, but the industry isn't using it.' Sandra Quinn from Apacs, the body that represents the credit card industry, said: 'Credit card companies that use risk-based pricing are already considering the introduction of quotation searches.' We'll monitor their progress – and will continue to lobby for all companies that use risk-based pricing to use quotation searches. ■

FURTHER INFORMATION

Where to get help if you are worried about debt

Consumer Credit Counselling Service www.cccs.co.uk, 0800 138 1111

Citizens Advice www.citizensadvice.org.uk

National Debtline www.nationaldebtline.co.uk, 0808 808 4000

Where to get a copy of your credit file (£2)

Callcredit www.callcredit.plc.uk, 0870 060 1414

Equifax www.equifax.co.uk, 08705 143700

Experian www.experian.co.uk, 0870 241 6212

Which? says

The credit industry continues to make money using sneaky tricks and dubious sales practices. Responsible lending ought to be at the heart of good business, which won't be possible unless the credit industry shares full credit data on everyone. Until it gets rid of some of its dodgy practices, such as unsolicited credit limit increases and expensive PPI, consumers will carry on being exploited.

We want the credit card industry to standardise the way it calculates interest so that consumers can compare cards and choose the right one for them. We hope that the regulation of general insurance (see Inside Story, p8), will improve how PPI is sold. We also want the industry to introduce quotation searches, which won't be registered until a borrower signs up to a loan or credit card.

While the review of the Consumer Credit Act last year tackled some issues, such as extortionate lending, it has failed to tackle others, such as data sharing and interest calculation methods. We will continue to campaign and keep up the pressure on the industry to get its house in order.