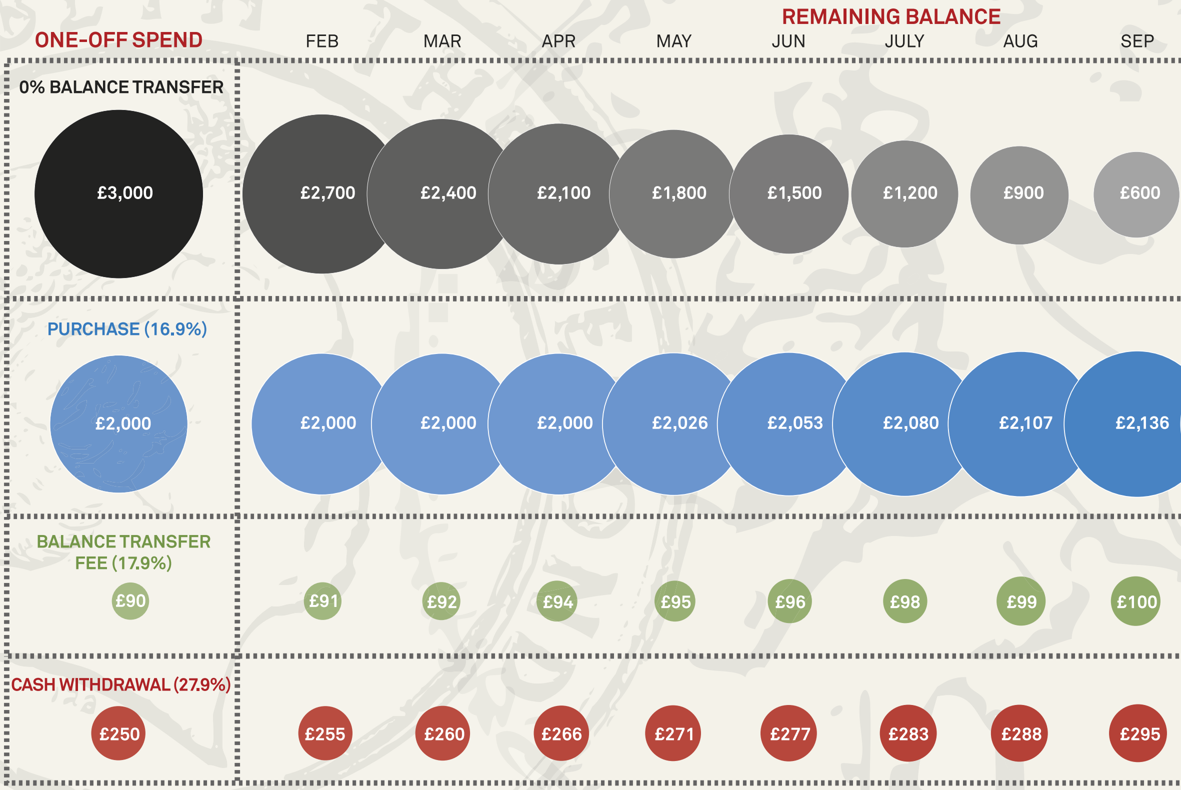
How credit card providers force you to pay off 'cheap' credit first

This shows the effect of a negative order of payments. Monthly repayments of £300 are allocated to the debt attracting the lowest interest rate first. The card shown offers 12 months at 0% on balance transfers and three months at 0% on purchases. On the first day, £3,000 is transferred from another credit card, with an uncapped balance transfer fee of 3%. A one-off purchase of £2,000 and a single cash withdrawal of £250 are also made. No further transactions are made through the year.



THE GREAT BRITISH credit card rip-off

The UK credit card market is structurally biased against consumers – we show you how to avoid the pitfalls and cut the cost of using your card

At a time when interest rates on savings have plummeted, many credit card companies have maintained or even put up their rates and charges. In a tough year, this has further squeezed the finances of hard-pressed consumers.

Inflated interest rates

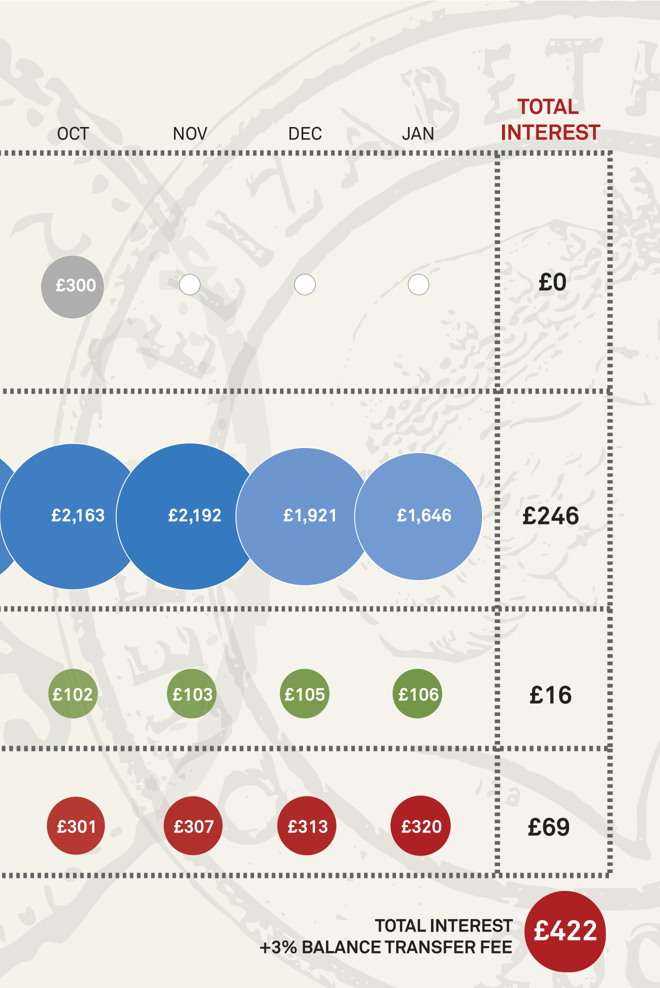
In late January 2007, the Bank of England base rate was 5.25% and the rate at which banks lend to each other, known as Libor, was 5.59%. Nearly three years on, the landscape is strikingly different – by October 2009, base rates had plummeted to 0.5% and Libor to 0.55%. Yet the average credit card interest rate had risen from 16.7% to 16.8% (see graph, p20).

Interest rates for savings dropped, while credit card APRs rose

When the base rate dropped in late 2008, the banking industry blamed Libor for keeping credit card rates high. When Libor dropped too, it changed tack. In a recent statement about mortgage costs, the British Bankers' Association claimed: 'Banks largely fund themselves using a mix of wholesale money and customer deposits. Savings rates for customers are a full 2% to 3% higher than base rate, so deposits are therefore a costlier way to finance mortgages.'

Transfer this logic to credit cards and, even allowing for higher-risk unsecured debt, there is a glaring difference between the rates paid to savers and the APR charged to credit card customers. The average rate paid on £5,000 in an instant-access savings account is less than 1%, while the average credit card interest rate is nearly 17%.

ILLUSTRATION DAVID MCCANDLESS



All figures correct at 22 October 2009

In the past year, Northern Bank hiked its APR by 5% to 22.9%, while Amex Platinum Cashback's APR hit 19.9% – an increase of 4% in two years. Egg, meanwhile, withdrew its Egg Money MasterCard with an APR of 7.9% and launched the Egg Money World MasterCard, with a monthly £1 fee and an APR of 17.8%. And yet, Saga was able to slash its credit card APR by 4% to 11.9%.

Out of order

Very high headline rates are bad enough, but they risk overshadowing deep-seated faults in the very structure of the UK credit card market. One of these is the order of payments (OOP) system.

When you use the same credit card for a balance transfer, buying your shopping and withdrawing cash, the interest rate you pay on each varies. When you repay part of your balance, your card provider decides which element of your debt to allocate the payment to, so two otherwise identical cards could cost you significantly different amounts of interest.

You'd want to pay off your most expensive debt first. Unfortunately, most card providers don't see it that way. On a credit card, cash withdrawals and credit card cheques are by far the most expensive debts. If you use these services, many lenders prevent you from paying off that debt until you've paid off everything else on your card.

Among the big banks that penalise customers in this way are Barclays (whose Barclaycard brand is the most widely held among Which? members), Lloyds TSB, NatWest and HSBC. Even some providers with excellent customer satisfaction scores have poor OOPs, including John Lewis Partnership, First Direct and Marks & Spencer.

WHICH.CO.UK

See how much you could save by switching credit cards

www.which.co.uk/switchcreditcards

Double whammy

Which? member Robin Kenward was hit twice by the order of payments. Mr Kenward had taken advantage of a 0% offer on his Alliance and Leicester (A&L) credit card. However, when he mistakenly used the card for a further £47 purchase, he was surprised to be charged interest on this despite making a payment in the month.

A&L explained to Mr Kenward that, as he had an existing balance on his credit card (the 0% balance), he would not receive the interest-free period of up to 56 days on new purchases. And, because of A&L's negative order of payments, any repayment Mr Kenward made would be allocated against the 0% balance first, leaving the £47 to attract interest until every penny of the 0% balance was paid off.

Mr Kenward said: 'As a result, I immediately sent the total statement balance by BACS and closed the account, together with a suitably tart letter. I wonder how many other Which? members have lost out in this way.'

A recent survey by comparison site Confused.com revealed that consumers found credit card interest rates the fifth most confusing thing in the world, ahead of Stephen Hawking's theories and only narrowly pipped by algebra.

Avoid the extra interest

The easy answer to being charged different rates of interest is to have a different credit card for each purpose. However, if you want to use only one card for everything, two names stand out from the pack – Nationwide and Saga. Both providers use a positive order of payments, minimising the interest you pay.

Andrew Goodsell of Saga says: 'When it comes to credit, over-50s want to know they are being treated fairly. After interest

Rates compared

CREDIT CARD INTEREST RATES AND BALANCE TRANSFER FEES

	APR 08 (%)	APR 09 (%)	BT FEE 08 (%)	BT FEE 09 (%)
ABBEY / SANTANDER Zero MasterCard	18.9	18.9	0.00	3.00
AMERICAN EXPRESS Platinum Cashback	18.9	19.9	n/a	n/a
AMERICAN EXPRESS Red	16.9	18.9	n/a	n/a
EGG MONEY MasterCard [a]	7.9	17.9	3.00	none
MARKS & SPENCER MONEY MasterCard	15.9	15.9	2.00	2.9
NATIONWIDE Classic Visa	17.9	19.9	3.00	3.00
NORTHERN BANK (NI) Visa	17.9	22.9	0.00	0.00
THOMAS COOK Visa	17.9	19.9	2.99	2.99
VIRGIN Money MasterCard	15.9	16.6	2.98	2.98

Rates highlighted in red have risen since 2008. a Egg Money MasterCard replaced with Egg Money World MasterCard, both paying 1% cashback. **Using the table** The table shows the difference between nine credit cards' interest rates (APRs) and balance transfer fees (BT fee) in September 2008 and 2009.

Checklist

Cut the cost of using your credit card with our tips

- Check your £2 credit file with Callcredit, Equifax and Experian before applying for a credit card. Mistakes on your file may have a detrimental effect on your application and result in you being offered a higher rate.
- Think about how you're planning to use the card before you apply. If you pay off your bill every month, choose a cashback card. If you're planning a large purchase, a 0%-on-purchases card may be best.

- Have a different credit card for each purpose. If you transfer a balance at 0%, don't spend on that card.
- Never use credit card cheques – they usually come with no interest-free period, an inflated interest rate and reduced consumer protection.
- Never withdraw cash with your credit card – an APR of 27.9% is common.
- Set up a direct debit for at least the minimum payment to avoid late payment fees.
- Regularly check the APR you're paying and switch to a different card if it's too high. See our credit card tables on p72 to find the best rates.

All figures correct at 22 October 2009

and fees, repayments on the Saga platinum card clear the most expensive debt first, unlike most credit cards available in the UK.'

A spokeswoman from Nationwide added: 'Nationwide has always operated a positive order of payments, as we recognise that a negative order penalises the most vulnerable consumers who may be relying more heavily on their credit cards, particularly in the current economic climate.'

0% balance transfer deals could leave you paying more interest overall

0% deals with a sting

If you're transferring an existing credit card balance to another card, you'll generally look for the longest 0% deal, which is currently an impressive 16 months from Virgin.

Several cards, including the Virgin card, also offer 0% on purchases for the first three months. Sounds great. But it's not – you'll end up paying more interest in the long run if you spend on the card as well.

Virgin's negative order of payments means that the most expensive debts are paid off last, so any repayments you make will be allocated against the 0% balance transfer. Once the three-month introductory period has expired, your purchases are left attracting interest at the card's standard APR of 16.6% until the balance transfer is paid off in full (ie for up to 13 months).

Other providers offering cards with an excellent 0% balance transfer deal coupled with a poor 0%-on-purchases hook include Santander, MBNA, Halifax and Bank of Scotland. And, unsurprisingly, all of them have a negative order of payments, allowing them to claw back some of the interest they're losing on the 0% balance-transfer deal.

Lloyds TSB is a particularly bad example, as its Platinum credit card offers a 0% balance transfer period of 14 months, but only if you spend at least £100 on purchases in the first three months. With Lloyds' negative order of payments, you'll be paying interest on any purchases until the balance transfer is paid off in full. If you don't spend at least £100, the 0% balance-transfer period drops to a paltry three months.

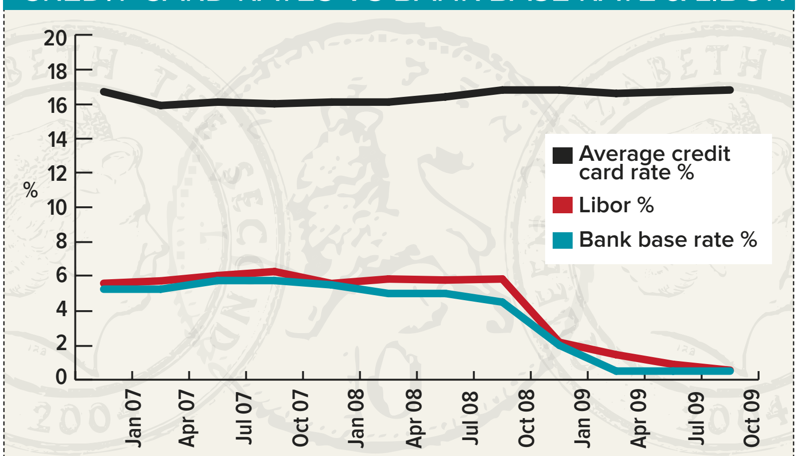
Sainsbury's Finance, on the positive side, has recently changed the offer on its MasterCard so that you get 10 months interest free on both purchases and balance transfers. This means that, as long as you pay off both balances before the deal runs out, you won't pay any interest and won't be hit by Sainsbury's negative order of payments.

Cashback tricks

Cashback cards can be a good way of making your credit card work for you. But most impose minimum and maximum cashback levels, making them less attractive than at first sight.

Which? member Phil Owen has an Egg Money MasterCard and earned £8.64 cashback last year. However, he did not receive this as it was below Egg's minimum cashback level of £10. To make matters worse, the cashback he had earned was not carried forward to the following year. Phil commented: 'I do not know why lower values cannot be automatically credited. Needless to say, my account is to be cancelled.'

CREDIT CARD RATES VS BANK BASE RATE & LIBOR



HOW £1 CAN COST YOU £13

Ian Jones, *49, IT specialist*

Ian Jones of London usually clears his credit card bill every month and enjoys up to 50 days interest free on new purchases, so was shocked to be charged £48 interest when one month he paid off all but £117 of his MBNA credit card bill.

If you don't pay off your bill in full, even by a matter of pence, you lose the interest-free period on all purchases. When Ian paid only part of his credit card bill, the interest on the whole purchase was backdated. Had he paid the extra £117, Ian would have paid no interest at all.

Ian told Which?: 'MBNA offered to halve the interest charge because I am a good customer, but said that the charge was correct. I also have a Halifax MasterCard and they told me they would charge interest exactly as MBNA does. I suppose this is how all credit card companies operate.'

So, if you spend £1,000 on your card and repay £999 when your statement arrives, don't be surprised if you're charged backdated interest on the whole £1,000 up to the date of partial repayment. Based on an APR of 16.9%, underpaying by just £1 on a £1,000 spend could cost you £13 in interest over just one month. And you'll lose the interest-free period on next month's purchases, too.

Peter Woolf had the same problem with his Halifax card. Having earned £6 cashback last year, Peter explained: 'I lost my cashback as I was not allowed to roll it over for another year. This really angered me as they don't have to send out loads of cheques, just deduct it from our bill. I have not used the card since.'

Even the best cashback deals are now worse value than they were two years ago. The Amex Platinum cashback card reduced the maximum you can earn on its introductory deal over the first three months from £200 to £100, and increased the APR from 15.9% to 19.9%. You have to spend at least £3,000 a year to earn any cashback, and if you cancel the card before the card 'anniversary' you'll lose any cashback earned. If you don't use the card at all for a whole year, Amex will charge you a £20 dormancy fee.

The Egg Money credit card – relaunched as Egg Money World Cashback card – used to charge a 7.9% APR with 1% cashback on all spending. The current card still pays 1%, but has a purchase APR of 16.9% and a £1 monthly fee, so you have to spend £100 a month just to break even.

In 2007, Smile paid 0.5% cashback and had an APR of 16.9%. Since then the cashback level has halved, while the standard APR for customers without a Smile current account has risen to 20.9%. Other providers have withdrawn their cashback cards altogether, including Capital One, Halifax and Abbey.

Which? says

The government announced plans in October to reform the order of payments system, ban unauthorised credit limit increases and raise minimum monthly repayments. The sooner these practices are stamped out, the better.

Credit card customers are sick of paying through the nose just to bolster banks' depleted profit margins. With average credit card interest rates currently 33 times the Bank of England base rate, banks must re-enter the real world: charging sensible APRs and putting an end to charges hidden in the small print would be a good start.

PHOTOGRAPHY ALAMY, MALCOLM CASE-GREEN

WHAT OOPS MEAN FOR YOU

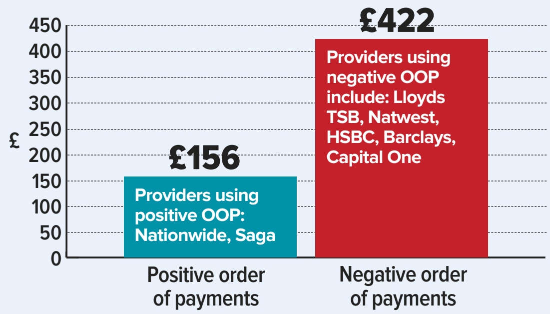


Chart shows total interest paid on two typical cards with positive and negative OOPs over 12 months and includes balance transfer fee. For scenario details, see illustration on p68.

MEMBER BENEFIT

Our *Money Saving Handbook* separates the bargains from the cons, with more on credit cards and other ways to save. To order your copy for £9.99 (normal price £10.99) including free p&p, call 01903 828557 quoting code MSHW1209 and ISBN 978 1 84490 048 0. Offer closes 8 January 2010.