APRs for Credit Cards – Briefing by The UK Cards Association

Introduction

The APR, or *annual percentage rate*, is a figure that is supposed to represent the total cost for credit. It is, however, a mathematical construct, which conveys little information about actual cost. APRs can be used to *compare* the cost of borrowing, but only when the borrowing is for the same amount and has an *identical* repayment schedule.

This is not the case with credit cards where consumers have very varied patterns of borrowing and repayment, so some simplifying assumptions are imposed by regulation before a credit card APR is calculated i.e. that £1,200 (or the full credit limit if it is less than £1,200) is borrowed on day one of having the card and that this is paid back in twelve equal monthly instalments with no further transactions. Any compulsory fees and charges are also taken into account.

However, these are a set of highly unlikely and grossly over-simplified assumptions compared to the actual ways that customers spend and make repayments on their credit

What is an APR and what is it meant to achieve?

The APR is an expression of the total cost of credit and stands for the Annual Percentage Rate of Charge. It is **NOT** an interest rate. It is intended to do two things (i) to provide consumers with a comparison between credit products e.g. a personal loan vs a credit card vs a mortgage; and (ii) to provide consumers with a means of comparing products of the same type e.g. credit card A vs credit card B. For the 62% of cardholders who pay off their credit card in full each month both the interest rate and the APR are irrelevant.

The range of costs to the cardholder can be highly variable

The APR is a poor indicator of cost for revolving credit products such as credit cards. This is true whether it is used to measure one person's costs on a card or to allow them to compare. While APRs and costs are – very – broadly related, in the sense that a higher APR may often lead to higher cost, we see wide ranges of costs, even among apparently homogenous groups of cardholders (in terms of the amount and type of their borrowing and their headline APR).

Our analysis of groups of similar cardholders shows that costs – in pounds and pence – are highly variable even when cards have similar APRs and a similar amount of borrowing. For example, we looked at a sample of borrowers' accounts which had APRs of around 18% and found that the actual cost varied from around £200 to almost £500. In other cases we found that the ratio of cost between those paying the lowest and highest amounts on the same APR was commonly in the range of three to five times as much and in one extreme case 295 times as much. This range tends to be greater the more intermittently the cardholder borrows.

These huge variations arise because the actual cost to the consumer of using their credit card is dependent on how much they borrow; over how long; when they make purchases; how large those purchases are; when they take cash advances; and when they make repayments (whether in full or in part). None of these factors are reflected in the APR calculation.

So there is often a misalignment between the advertised APR and the ultimate cost to the consumer.

The same pounds and pence cost to the consumer can result in a wildly different APR

For example, if a loan of £1,000 were to be repaid in one lump sum of £1,200 after twelve months, the APR would be 20%. If the loan was repaid in twelve equal monthly instalments of £100, again amounting to a total repayment of £1,200, the APR would be 41.3%. This is because the calculation would be based upon the average amount outstanding during the year. So, despite the amount paid back being the same, the APR is more than double.

Some of the credit cards with the lowest monthly interest rates have among the highest APRs

Using examples of real credit cards available in the UK, a card with a monthly interest rate of **1.16%** and an annual fee of **£250** (for which the cardholder receives a range of additional benefits such as rewards schemes; access to airport lounges; travel insurance; roadside assistance etc.) has an APR of **54.2%**. However, a card with a higher monthly interest rate of **2.21%** (nearly double the previous example) but no annual fee and no add-on benefits has an APR of **29.9%**. This is because of the way in which compulsory fees and charges are included in the calculation and the way in which this distorts the end result.

Conclusion

Not only do we think that the APR is a poor measure that doesn't help consumers, we think it is actually detrimental to their interests. Consumers have been taught to look out for the APR and are led to believe that it is a reliable indicator regarding future costs on which to base their financial decisions. That is simply not the case, so it doesn't help consumers to manage their money better.

Because the law requires lending products to have an APR, the APR also acts as a strait-jacket that deters innovation that might otherwise result in simpler or more transparent pricing. The APR also inhibits lenders' willingness to apply annual fees on credit cards, which would arguably result in a more equitable pricing across the industry, with all cardholders paying a fair share within a more consumer-friendly fee structure. In effect, the APR legislation imposes a consumer-unfriendly fee structure on lenders.

What Are We Doing About It?

The UK Cards Association has commissioned the Personal Finance Research Centre at Bristol University to develop ideas for an alternative, or complement, to the APR which would better help consumers in making product comparisons and understand the likely cost to them of using their credit card. This work is planned to take place during the rest of 2011.

There is no immediate prospect of replacing the APR for credit cards – that would require amending the Consumer Credit Directive, which might take many years – but our work will hopefully find something more useful for consumers that can sit alongside the APR and provoke a review by Government and regulators at home and in the EU about how consumers can be better informed on the costs of revolving credit.