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Regulatory Affairs

Need for Consumer Credit Directive questioned by key EU officials

The European Commission's draft Consumer Credit Directive has come under fire after Enterprise and Industry Commissioner Günter Verheugen intervened to hold back the Directive in May, according to an article in the German newspaper *Handelsblatt*.^{*} The action was reportedly motivated by the view that the regulation may be unnecessary, given that the volume of cross-border consumer loans is marginal and any distortions to the internal market arising from different national rules is negligible.

The *Handelsblatt* article holds that Verheugen would favour a cost/benefit analysis to see whether further EU legislation in this area is sufficiently justified. Commission President José Manuel Barroso and Commissioners Joaquin Almunia (Economic and Monetary Affairs) and Charlie McCreevy (Internal Market and Services) purportedly share this line of thinking, coming at a time when the EU is under pressure to simplify and improve EU regulation.

Our sources, however, indicate that DG Markt has not budged from its stance that the current low level of cross-border consumer credit is the result of differences in national rules. On this basis, it continues to strongly support the case for harmonisation.

The draft, which will be the third Consumer Credit Directive proposal issued, is now under discussion within the Commission. We do not expect it to be published before the beginning of September.

^{*} M. Sheerer, "Verheugen stoppt neue Regeln für Verbraucherkredite [Verheugen stops new rules for consumer credits]", *Handelsblatt*, 6 May 2005.

Green Paper sets out priorities for the post-FSAP era

On 3 May, the European Commission issued a Green Paper presenting the EU's post-Financial Services Action Plan (FSAP) priorities for the next five years. Building on the opinions collected during a two-year consultation period, the Green Paper acknowledges the progress achieved so far: most of the rules outlined in the FSAP are being implemented and the EU regulatory procedures have become more efficient in this area as a result of the introduction of the Lamfalussy process in securities, banking and insurance. Thus, during the period 2005-10, the focus will turn to:

- consolidating existing legislation, finishing remaining measures, enhancing supervisory cooperation, removing unjustified barriers to cross-border consolidation and deepening

financial market regulatory dialogues with other countries such as the US, Japan, China and possibly India;

- ensuring the effective transposition of EU rules into national regulations and more rigorous enforcement by supervisory authorities; and
- setting up continuous *ex-post* evaluation processes, whereby the Commission will carefully monitor the application of these rules in practice and their impact on the EU financial sector.

In addition to these objectives, new initiatives are needed to tackle the deep fragmentation of retail financial services. The Commission observes several other factors suggesting that further integration should be encouraged: the single currency, innovations in information technology, increased consumer mobility and the growing need for complementing state welfare provisions.

To facilitate the cross-border provision of retail financial services, the Commission believes that the launch of pan-European passports for businesses would be the most beneficial strategy. Nevertheless, taking account of the views expressed in the consultation, it will launch a feasibility study on the so-called '26th regime', i.e. a programme specifically envisaged for service providers and consumers operating across borders, while the 25 existing sets of national rules would remain untouched. The Commission is also seeking to establish forum groups consisting of experts in the field – each group focusing on a specific kind of retail product – to identify barriers and solutions. In conjunction with these activities, it will undertake sectoral enquiries in the different areas of retail financial services (see the article on "Competition investigation" on this page) and business insurance, with the objective of putting in place selective competition screening. During these enquiries, special attention will be given to the identification of obstacles to the provision of cross-border services and entry barriers, both in the form of regulation as well as 'typical' antitrust issues.

The Green Paper has been well received by the financial services industry, which noted with relief that the Commission has recognised the need for a legislative respite and foreseen a greater role for cost-benefit analysis (part of the 'better regulation' approach) before proposing new legislation in the future.

Public consultation on the Green Paper on Financial Services Policy 2005-2010, COM(2005) 177 is open until 1 August 2005. Responses should be sent to the European Commission at markt-consultfinancialservices@cec.eu.int. The final policy programme will be presented in the form of a White Paper in November 2005.

EU Parliament report on financial services endorses legislative pause

In April, the EU Parliament's Committee on Economic and Monetary Affairs (CEMA) published a report on financial market integration and regulatory issues: *Report on the Current State of Integration of EU Financial Markets*.*

The CEMA report recommends that the EU take a legislative pause in the area of financial markets (as noted in the article above, this stance has also been taken by industry). It holds that this extra time would allow stakeholders to adapt their practices and for FSAP

measures to be implemented. A proper assessment of the process could then be undertaken. The CEMA expresses support for the full application of better regulation principles, in particular the inclusion, in any new measure, of a cost-benefit analysis of the corresponding non-legislative option.

Regarding retail banking services, the report asks the Commission to provide a comprehensive study identifying the major barriers to competition and further integration. It notes that despite the low current demand for cross-border financial services, certain groups of internationally mobile consumers could benefit from the setting up of a uniform '26th regime', and therefore asks the Commission to assess its feasibility.

The report further stresses the importance of improving the availability of personal data for responsible consumer lending (including positive data on current financial commitments, which would be used to prevent consumers from becoming over-indebted).

* For further information, see the *Report on the Current State of Integration of EU Financial Markets, 2005/2026* (INI), CEMA, 7 April 2005.

Competition investigation launched in the financial services sector

On 11 May, Financial Services Commissioner Charlie McCreevy wrote in the *Financial Times* that "In spite of the progress made in integrating financial markets in the EU, there are still obstacles that prohibit competition. This is the most obvious in the retail banking sector."*

In this vein, on 13 June the Commission launched enquiries in the financial services sector. The investigation will examine whether competition is sufficiently potent in the market to deliver full benefits to consumers. The enquiry on financial services will focus on retail banking, particularly payment cards. It will be based on detailed questionnaires aimed at market participants. Depending on the responses collected, the Commission will determine how to pursue its analysis. The first reports are expected to be published in 2006.

The investigation, which was announced in the Green Paper on Financial Services Policy, is part of the follow-up on the FSAP. Sector enquiries will allow the Commission to better understand the functioning of the industry (with the goal of identifying competition distortions) and, at the same time, enhance transparency in price-setting and general industry practices. Besides allowing customers to make better-informed choices, an increased transparency level will contribute to the strengthening of consumers' bargaining power, thereby increasing competitive constraints on the behaviour of banks and insurers.

The inquiry is based, according to the Memorandum on Sector Inquiries in Financial Services by competition Commissioner Neelie Kroes in agreement with Commissioner McCreevy, on the presence of the following indicators of distorted competition:

- considerable variation in prices for similar retail banking products across the EU;
- notable variation in bank profitability; and
- weak cross-border merger activity (together with large variations in the degree of foreign participation in banks' capital) and increased concentration levels in domestic banking markets.

The Commission also noted that the prices of certain retail banking products may be above their competitive levels.

In case the enquiries reveal the existence of anticompetitive practices, the Commission is prepared to take appropriate measures to restore competition, following EC Treaty rules on restrictive business practices and abuse of monopoly power (Arts. 81 and 82). The Commission intends to maintain an open dialogue with representatives from industry and consumer associations throughout the process.

* C. McCreevy, "Europe Must Embrace Market Forces", *Financial Times*, 11 May 2005 (retrieved from <http://www.news.ft.com>).

Consumer Credit Bill progresses through UK Parliament

The final stage in the most significant reform of the UK's consumer credit laws in 30 years began on 18 May with the re-introduction, to the House of Commons, of the Consumer Credit Bill. The Bill, partly aimed at implementing the EU Directive on Consumer Credit in the UK, will amend the Consumer Credit Act of 1974 by sharpening up regulation in order to provide borrowers with better protection and improved rights. In its current state, it would:

- establish an independent ombudsman service for consumers and make it easier for them to challenge unfair loan agreements (bringing a complaint to the ombudsman will be free);
- create a new requirement for lenders to give consumers better information about their credit accounts; and
- improve powers for the Office of Fair Trading to take action against rogue companies, while introducing a more targeted licensing system to limit the burden on reputable businesses.

The Bill would also remove the financial limit below which regulation currently applies, so that all consumer credit could be regulated on the same level. Summarising the Bill, UK Consumer Minister Gerry Sutcliffe said "this Bill is an important step towards achieving our objectives of creating a fair, clear and competitive consumer credit market, and enhancing consumer protection, particularly for the most vulnerable".* The report stage for the Bill is scheduled for 14 July.

* See the DTI Press Notice of 19 May 2005 (retrieved from <http://www.gnn.gov.uk/environment/detail.asp?ReleaseID=156896&NewsAreaID=2&NavigatedFromDepartment=False>).

Market News

Bad loans seen as a good investment opportunity

Several large investment banks and equity groups are in the process of accumulating assets that do not look very valuable at first sight: bad loans portfolios. Important acquisitions have occurred mainly in Germany and Italy,

countries where commercial banks faced new transparency obligations after recent regulatory and accounting changes. To improve their balance sheets while complying with the new rules, many of them were eager to sell a share of their bad loans. In May, Goldman Sachs bought Demora, a spin-off of two German regional banks with more than €2 billion of bad loans, for which Goldman is supposed to have paid between €400 and €500 million. The investment bank is believed to plan more acquisitions of this type in Germany.

It is worth noting that Basel II guidelines on banks' capital will induce some banks (those choosing to use the advanced approaches) to set aside more of their capital for non-performing loans. Some banks seem to anticipate these changes: for instance, on 30 May Intesa sold a majority stake in its bad-loan servicing subsidiary ICG to a Merrill Lynch-Fortress joint venture. This sale was part of a bigger deal in which the joint venture bought a portfolio of loans from Intesa with a face value of €9 billion for just over €2 billion.

When a significant proportion of outstanding bad debt consists of unsecured consumer loans, as seems to be the case for Delmora and ICG, the acquirers of such portfolios will need teams of operators in call centres to chase up defaulters. The process could prove lengthy – for example in Italy, it can take seven years to start the process of foreclosing on a property after the owner has defaulted. Consequently, and because chasing up corporate defaulters is not necessarily any easier, many German and Italian retail bankers do not believe that the current high level of interest in non-performing loans will be sustainable in the long run.

Looking east for profit

Many Western European retail banks are currently expanding in Central Europe, either through existing operations or acquisitions. This new attention eastwards is partly motivated by the strong growth in household borrowing that countries in the region are experiencing. In the Czech Republic and in Slovakia for instance, household debt has recently been increasing at over 30% per year. In Hungary, the same growth rate is about 25% while in Poland it is around 12%.

The May issue of Goldman Sachs' *New European Markets Analyst* listed four main reasons for this strong consumer credit growth in Central Europe: a structural adjustment to higher debt levels (as debt-to-GDP ratios converge on those of Western Europe); greater competition in the banking sector, low/declining real interest rates and relatively high levels of real wage growth and consumer confidence. The report also pointed out potential sources of risk for economic growth in these countries, including a possible overstretching of the household sector in Hungary and Poland, the possibility of a real estate price bubble in the Czech Republic and a high level of household borrowing in foreign currencies, especially in Hungary. So far however, the growth in consumer credit has only translated into high financial-sector profitability and good performance by local financial companies.

Turkey also appears to be seen as a country with considerable growth potential in retail and credit markets. For example, in February BNP Paribas acquired 50% of TEB, a Turkish bank holding that recently declared plans to develop its retail banking activities. Belgian bank Fortis purchased Dişbank, a privately owned, commercial-

oriented entity that has developed a strong platform in Turkish retail banking over the last few years. Rabobank is in talks with Sekerbank about a partnership (with a focus on retail business, mortgage lending, SMEs and the local agribusiness sector), while Unicredit Group, with its local partner Koç Holding, took over Yapi Kredi, the current leader of the Turkish credit card market (handling approximately 25% of the total market volume).

Of course, this trend might be affected negatively by the aftermath of the French and Dutch referendums. Nevertheless, BNP Paribas has already announced that it will not change its plans in Turkey. Solid reasons exist, besides the prospect of EU accession, to believe in the country's potential: economic structural reforms have brought inflationary expectations down; the financial market now shows relative stability; and in contrast to Central Europe a decade ago, Turkey already has an advanced banking sector. GDP per capita is still low, but some Istanbul bankers evaluate the number of 'bankable persons' at a sizeable 25 million.

Consumer indebtedness in the EU: The cases of Spain, the UK and Lithuania

Should European consumers go on a spending spree or on a saving frenzy? At the beginning of June, ECB President Jean-Claude Trichet called on consumers to trust the ECB for maintaining price stability and to not hesitate to increase their consumption. A few days later, however, ECB Chief Economist Otmar Issing reportedly said that "rational consumers and savers should consider expectations of the future" and added "I never in speeches encourage people to consume more". ("ECB chiefs at odds on consumer spending" by R. Atkins in the *Financial Times*, 5 June 2005) Given the demographic changes forecasted for most EU countries, his words could be reasonably interpreted as a call for saving.

What is certain is that current eurozone consumption levels are relatively low. Cuts in ECB interest rates may help, but until now the bank has been reluctant to do so, partly because of the fast growth observed in borrowing and the resulting risk for price stability (according to declarations by ECB staff). Is the growth in credit and consumer indebtedness alarming? Below we briefly examine three EU countries that have shown especially fast credit growth: Spain, the UK and Lithuania.

Spain

In Spain, bank credit to the private sector rose by 17.9% from February 2004 to February 2005, which is more than twice the rate for the euro area as a whole. As widely reported in the press (*The Economist*, *Financial Times*), the biggest contribution to overall credit growth came from mortgage loans, which for the moment, show little sign of slowing down. A prolonged property boom, higher incomes, demographic variables and low interest rates have fuelled increases in mortgage lending (up 24% in the first quarter of 2005). Meanwhile, household debt overtook disposable income for the first time in 2004. Although default rates are still low, the Bank of Spain recently warned that banks had become more vulnerable to adverse disturbances in family incomes or wealth. Households' ability to face debt service costs could be at risk if euro interest rates were to increase significantly. These concerns are balanced, however, by the most recent indicators still showing a high level of economic

activity (in contrast to several EU neighbours) with growth rates holding at 2.5 to 3% and a dynamic labour market.

The United Kingdom

In contrast to the Spanish case, UK households already seem to be facing some difficulties in honouring their financial obligations, as several banks (Royal Bank of Scotland, HSBC, Barclays, HBOS and Lloyds TSB) successively issued warnings about deterioration in consumers' ability to repay their debts. This follows a parallel period of strong growth in household debt and private consumption, which is generally seen as having been encouraged by rapidly rising house prices. Of course, the current slowing down of the housing and consumer credit markets, combined with a record level of household debt (roughly 90% of GDP mid-2004), have suggested for some time now that debt service problems could appear. Nevertheless, as the December 2004 ECFIN Country Focus already concluded, a scenario comparable to the early 1990s recession (stirred by a house price boom and its subsequent bust) does not seem too likely. In a climate of low interest rates, low inflation and low unemployment, UK households seem less vulnerable than 15 years ago. Yet the Bank of England warned in early July that the record levels of debt that households had taken on could be a threat to the economy, especially because the increase in default rates may not have been fully anticipated by banks.

Lithuania

In Lithuania, one of the fastest growing economies in the EU, domestic credit has increased by an average of 30% during the last four years, with household borrowing increasing by close to 100% and 170% in 2003 and 2004 respectively (although from a noticeably low base). The June 2005 ECFIN Country Focus found that despite these high growth rates, financial stability risks still appeared to be fairly contained. The indebtedness-to-GDP ratio is still low compared with other EU countries, bank profitability measures are improving and the credit growth is well spread across economic activities, to list but a few touchstones for unsustainable credit booms. On the other hand, a low level of savings combined with rising levels of indebtedness has increased households' vulnerability to asset prices and income shocks. The report concluded that although most of the typical financial crisis indicators are not observed in Lithuania these days, the situation should be closely monitored.

Strong consumer credit growth, while offering expansion opportunities for banks as noted in the article on "Looking east for profit" (see p. 3), was also seen as a possible risk for economic growth in Hungary and Poland. As a rule, it seems that as long as the macroeconomic environment remains favourable, the current level of consumer indebtedness will not put financial stability in jeopardy, even if in some countries it induces an increase in the number of financially distressed households.

More European bank integration

A new wave of mergers in the past few months has created fresh hopes for European banking consolidation, confirming the forecasts of studies that held that the break in the trend of EU banking consolidation was only a cyclical phenomenon.*

A new European cross-border bank merger has recently taken place between Italy's largest bank, Unicredito and Germany's second-largest bank, HVB Group. The size of operations of both banks in Central and Eastern Europe appears to have played an important role in the negotiations, along with the prospect for the new group to become the market leader in those countries. On 21 June, DNB Nor, the largest financial services group in Norway, and Germany's Norddeutsche Landesbank announced the creation of a joint venture (DNB Nord) for Northern and Eastern Europe. At the same time, two cross-border acquisitions of Italian banks, BNL by BBVA and Antonveneta by ABN Amro, are still under discussion. Both acquirers are challenged by local Italian rivals, in a competition that some judged unfairly arbitrated by national authorities.

The mergers portend renewed activity in banking consolidation; however, regulation constraints and cross-country differences in consumer protection and banking supervision continue to be powerful obstacles. A recent book by French professors Esther Jeffers and Olivier Pastré et al. (*La TGBE. La Très Grande Bagarre Bancaire Européenne*, Paris: Economica, May 2005) claim that the emergence of an EU banking industry is "an absolute necessity". Even if the authors admit that the lack of regulatory harmonisation makes EU mergers difficult, they warn that this obstacle will not, in the medium run, prevent global players from overseas from taking advantage of the undervaluation of European banks.

*See for example, *Banking Consolidation in the EU* by Rym Ayadi and Georges Pujal, CEPS Report No. 34, CEPS, Brussels, May 2004.

Upcoming Issues

Green Paper expected on mortgage credit

Following on the heels of the Green Paper on Financial Services Policy, a separate Green Paper on Mortgage Credit is anticipated from the Commission during this summer. It will address the 48 recommendations of a report by the Forum Group on Mortgage Credit (*The Integration of the EU Mortgage Credit Markets*, DG Internal Market, Brussels, 13 December 2004).

Three other specific areas in retail financial services have also been identified by the Commission for future consideration, which are:

- codification and possibly simplification of existing rules on information requirements;
- financial mediation – especially through allowing cross-border service provision by knowledgeable and reliable intermediaries – while applying full transparency on fees and relationships with providers; and
- bank accounts, involving an assessment of the obstacles to opening accounts cross-border as well as issues regarding their handling, portability, transferability and closure.

Events

ECRI and Visa Europe to co-sponsor workshop on consumer financial capability

The direct exposure of households to financial risk and the use of credit products have noticeably increased during the last few years, as mentioned in recent publications by the ECB and the IMF. These changes may justify policy initiatives in the areas of consumer information, education and protection. A workshop, co-sponsored by ECRI and new ECRI member Visa Europe, aims at contributing to the debate in this subject, which will be held in Brussels on Tuesday, 8 November.

The Consumer Financial Capability Workshop will provide specialists with the opportunity to exchange ideas and perspectives on the relevant economic, social and regulatory issues. The goal of the workshop is to develop a set of guidelines on how to improve the financial capability of consumers.

For further information please contact us at info@ecri.be.

ECRI Roundtable Discussion on the draft Consumer Credit Directive

As discussed on the front page, the new draft Consumer Credit Directive is expected to be publicly accessible in September 2005. Early after the summer break, ECRI will organise a Roundtable Discussion to consider the possible consequences of the new legislation for lenders and consumers. Further information about the event and date will be circulated to ECRI members as soon as it is available.

New CEPS Task Force to tackle issues in retail financial services

Triggered by the recent release of the European Commission's Green Paper on Financial Services Policy (2005-10), CEPS has launched a new Task Force on the Internal Market for Retail Financial Services. Planning to meet for the first time in September, the group aims at tackling unresolved issues in an innovative, pragmatic and consensual manner, with the understanding that in financial services, end-user confidence and system stability are paramount. The ultimate purpose of the group will be to assist policy-makers in striking the right balance between prudential requirements, regulation, competition and consumers' interests. Members of the Task Force are to include financial institutions, supervisors and regulators as well as end-users (consumers and SMEs). Their work will be complemented by relevant academic contributions.

For further information about participating in the Task Force, please contact Rym Ayadi at rym.ayadi@ceps.be