

# Consumer Credit Newsletter

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### REGULATORY ISSUES

#### **State of play in the Consumer Credit Directive saga:**

#### **The Commission's amended proposal of 28 October 2004**

The Commission's amended proposal for a Consumer Credit Directive (CCD) released on 28 October 2004 exposed the differences that remain between the Commission and European Parliament (EP) when it comes to the regulatory requirements for consumer credit in the EU.

In its first reading of the co-decision procedure – which took two years of heated discussion to achieve – Parliament had adopted a whopping 152 amendments to the 30 articles of the draft CCD. Some of these amendments modified the very essence of the Commission's proposal, revealing a rather different take on regulating consumer credit in Europe.

In its amended version, the Commission took into account Parliament's views, by introducing changes to its proposal (108 amendments), but it stuck to its guns in several key areas.

- *Return of full harmonisation*

The Commission had opted for *maximum* harmonisation among member states in its original proposal for a new CCD in 2002. In this approach, member states will have to transpose the Directive in its exact terms. Further, they will not be able to increase the level of consumer protection in their state. The EP, however, agreed in its first reading to move forward through *minimum* harmonisation, which allows member states to legislate beyond the limits set in the Directive.

Nevertheless, in its amended version, the Commission has reinstated the full harmonisation approach of its original proposal, which has a profound affect on the tenor of the Directive.

- *Scope of application*

The scope of the draft CCD has been severely cut back compared with the original proposal. Yet it is still greater than that approved by the EP. For instance, mortgages continue to be included. As Dirk Staudenmayer (Head of Unit at DG SANCO) explained at a recent ECRI meeting, the Commission holds that mortgages are an important part of consumer credit and therefore need to be covered by the new CCD.

**New exclusions.** Now totally excluded from the scope of the Directive are credits above €100,000, credit agreements concluded with pawn shops and those where the consumer is required to repay within three months free of charge (they no longer need to be repayable in one single payment) as well as agreements certified by a court.

The amended version also won't apply to those surety agreements that guarantee business loans (instead of *all* surety agreements – those in which the surety or guarantor is a consumer will be covered, as in the original version). Nor will the draft CCD apply to rental agreements (except where these provide for the title to eventually pass to the renter) or to leasing agreements that do not create any obligation to purchase the object of the agreement.

**New 'light regimes'.** For other kinds of agreements that the EP had agreed to exclude from the scope of the Directive, the Commission has created so-called 'light regimes' (new Arts. 6 and 7).

The light regime proposed by Art. 6 applies to overdrafts as defined in para. 1. Before an overdraft is agreed, the consumer shall be informed of:

- the total amount of credit;
- the borrowing rate;

- the annual percentage rate (APR) by means of a representative example mentioning all the financial data and assumptions used for calculating the said rate;
- the charges applicable from the time the agreement is concluded and the conditions under which those charges may be amended; and
- the conditions and procedure for terminating the agreement.

While some information must be provided prior to contract conclusion, the requirements are less rigorous for certain kinds of agreements, according to Art. 7. The light regime it sets out will apply to four kinds of credit contracts:

- small loans of less than €300;
- loans granted to a restricted public, at no interest or at a rate that is lower than the rate usually offered on the market, and when the creditor is fulfilling a statutory duty with a general interest purpose;
- loans granted by certain non-profit associations such as genuine credit unions; and
- credit agreements aiming at refinancing the existing debts of a consumer in order to avoid legal proceedings and where the terms do not have the consequence of putting the consumer in a worse situation than prior to the new agreement.

The information that will be required for such agreements (either on paper or another durable medium) is:

- the total amount of credit;
- the borrowing rate;
- the APR, by means of an example mentioning all the financial data and assumptions used to calculate the said rate;
- the duration of the agreement; and
- the amount, number and frequency of payments to be made. The information must be provided "in good time" before a consumer is bound by a credit

agreement or any offer concerning a credit agreement within the meaning of Art. 3(4). The interpretation of the vague phrase "in good time" is left to the discretion of the national courts.

- *No ban on doorstep consumer credit*

The controversial Art. 5, through which the negotiation of credit outside business premises was banned, has been removed.

- *Right of withdrawal*

The right of withdrawal has been kept at 14 calendar days. Despite some support within the EP for reducing this requirement to 7 days, the final vote agreed to keep it at 14. This provision is strongly endorsed by consumer representatives on the one hand and heavily criticised by industry groups on the other (see the summary of interventions of the ECRI Seminar 2004 and ECRI Roundtable 2004 at [www.ecri.be/events](http://www.ecri.be/events)).

- *Data protection: Central databases not required*

The duty of the member states to create national databases has been substituted by the right to request information from any existing database on a non-discriminatory basis (Art. 8). The provision on the processing of data for lending purposes has been deleted.

- *Linked contracts*

With regard to linked transactions, consumers that withdraw from a purchase contract are allowed to withdraw from the credit contract as well. Withdrawal from the credit contract does not, however, allow withdrawing from the purchase agreement.

If the supplier of goods or services has acted as a credit intermediary, the creditor and the supplier shall be jointly and severally liable for indemnifying the consumer if there is a default on the underlying agreement.

- *Responsible lending and the duty to advise*

The principle of responsible lending has been retained. Accordingly, lenders must:

- **assess creditworthiness** (on the basis of the information provided by the consumer, and where appropriate, consultation of the relevant database);
- provide substantive **pre-contractual information** (more than before; see Art. 5 (2)); and
- establish the most appropriate type and amount of credit for the consumer (**duty to advise**). The wording of this provision lacks clarity.

The principle of **responsible borrowing** as such and as approved by the EP has not been introduced. Yet the ability of the creditor to assess the consumer's creditworthiness is partially conditional on the quality and accuracy of the information the consumer provides. Further, in the case of early repayment, the consumer is entitled to an equitable reduction of the cost of credit. The creditor is, however, entitled to claim "fair and objective" indemnities.

The Commission has made a valiant effort to reconcile its original proposal with the flow of recommendations coming from different actors over the last two years. Some of the articles that were thought to increase bureaucracy and put additional strains on the lending business have been amended. The text has also been improved to avoid inconsistencies with other applicable EU legislation.

Nevertheless, the political debate surrounding consumer credit reform reduces the likelihood that the draft CCD will be adopted before the end of 2005.

Art. 251 of the Amsterdam Treaty makes it clear that after the first reading by Parliament it is up to the EU Council to further the development of the legislative procedure. Meetings of the Council working group will restart in 2005.

## **New expert report on cross-border mortgages**

Despite the Commission's determination to include certain aspects of mortgage lending in the CCD, in March 2003 it organised a Forum Group to study the integration of EU mortgage markets, with representatives from industry and consumer groups. Their report on mortgage credit was published by the EU Commission in December 2004.

To foster the integration of mortgage markets, the report proposes both legislative and non-legislative intervention. The markets are still highly fragmented in terms of mortgage products and mortgage-funding instruments. Borrowers do not have a choice among a full range of mortgage products in any of the national markets.

A recent Eurobarometer study found that only 1% of Europeans (mainly those who own second homes or live in border regions) take mortgage loans from other member states. The main reasons for the lack of cross-border mortgages include difficulties in comparing complex products along with language and legal barriers.

The Forum Group has noted that consumer confidence is a prerequisite for an integrated mortgage market. It concludes that EU legislation should bring national rules on early repayment fees and the calculation of real interest rates in line. It further asks the EU Commission to encourage information sharing between member states and underlines the potential of new distribution channels such as the Internet. With regard to mortgage-funding instruments, it calls for a deeper and more liquid secondary market for mortgage funding.

The report will be followed by an EU Commission communication in mid-2005, on how the recommendations could be transformed into EU policy. In addition, the EU Commission has also launched a research project on the economic costs and benefits of further integrating the mortgage markets.

## **New UK Consumer Credit Bill**

The UK government will reform consumer credit rules for the first time in 30 years to give individuals better protection from unfair lending, as announced on 23 November 2004 in the Queen's annual Speech to Parliament.

According to the Department of Trade and Industry (DTI), the new regulation will help consumers and create a fairer, more competitive credit market through

- enhancing consumer rights and redress by empowering consumers to challenge unfair lending and by providing more effective options for resolving disputes;
- improving the regulation of consumer credit businesses by ensuring fair practices and targeted action to drive out rogues; and
- making regulation more appropriate for different types of consumer credit transactions by extending protection to all consumer credit and creating a fairer regime for businesses.

The licensing of credit providers will be tightened up in the new legislation and companies will be forced to provide more information to consumers as well as annual statements.

The UK has one of the highest levels of consumer borrowing among EU countries (£1 trillion or \$1.9 trillion), while the UK's annual GDP is about £1.1 trillion (source: Bloomberg). The major banks in the UK are HSBC Holdings, Royal Bank of Scotland Group, Barclays, HBOS and Lloyds TSB Group. Abbey National, the country's second-largest mortgage lender, was bought in December 2004 by Santander. Cattles and Provident Financial are the major providers of small credit in the UK.

### *MARKET ISSUES*

## **US Federal Reserve confirms rise in consumer credit**

Outstanding consumer credit rose above the forecast by \$7.7 billion in October to

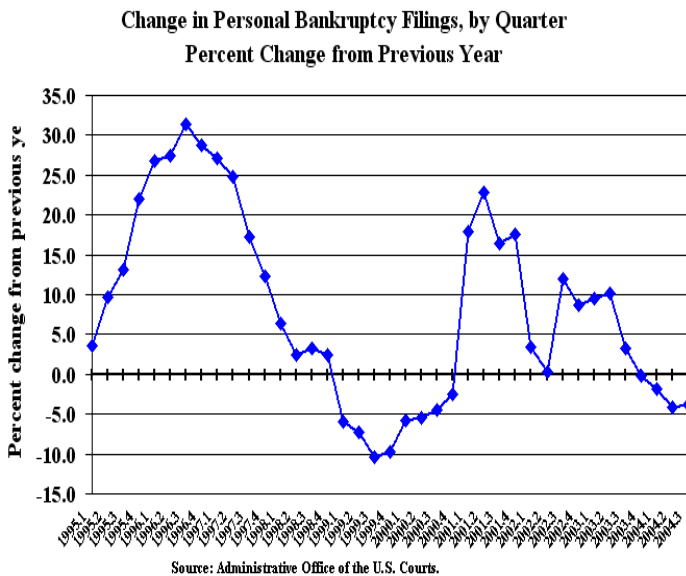
nearly \$2.09 trillion. That follows a revised \$13.6 billion rise in September to nearly \$2.08 trillion, originally reported up by \$9.8 billion.

The October consumer credit increase was led by non-revolving credit (for vacations, training or education, automobiles, trailers, etc.), which escalated by \$6.5 billion in October, the largest increase since January. Revolving credit also rose by \$1.2 billion in October.

According to the Federal Reserve, consumer credit increased in annual terms at a rate of 4.4% in October, after growing at an annual rate of 7.9% in September.

**US Bankruptcy filings down**

The number of personal bankruptcies filed in the US was down by 2.6% for the year ending September 2004 compared with the previous year. Based on the latest statistics of the Administrative Office of the US Courts, the total number of personal bankruptcies in the US stands at 1,584,170. The economic upturn seems to have moderated household financial stress, even if only a little. The chart below shows the yearly change (by quarter) in personal bankruptcy filing rates.



ECRI NEWS

**ECRI Seminar: Integration of EU retail financial markets – A challenge for Europe?**

Bringing together key policy-makers, members of consumer and industry groups and national representatives to the EU Council, an ECRI seminar on integration of EU retail financial markets was held at CEPS on **28 October 2004**.

Two main issues were discussed:

- 1) The absence of retail financial market integration, the related obstacles and the strategies in order to achieve higher integration.
- 2) The draft consumer Credit Directive (Draft CCD)

*1. Integrating the retail financial markets*

The current market situation in the field of EU retail finance was analysed during the morning session. The speakers discussed on the level of integration of the EU retail financial market and the need for integration, obstacles and prospects.

**Nick Page** (PricewaterhouseCoopers) remarked that retail financial markets are less integrated than wholesale financial markets and that the first ones are still very localized. Cross-border trade is nearly non-existent and the evidence shows that banks prefer to enter foreign markets through mergers and acquisitions rather than on a cross-border basis. In fact, major banks such as Barclays and JP Morgan state that cross-border deals are still very difficult and they do not see the value added.

Mr Page previewed gradual integration over the next five years and a very slow start to cross-border service activity only after domestic consolidation has progressed.

Referring to Santander Consumer's recent expansion in several European countries, **Pierantonio Rumignani** (Santander Consumer) discussed the favourable

outlook for consumer banking and the positive development of activity. At present their assets are tenfold their holdings at the beginning of 1998.

On retail financial market integration, Mr Rumignani attributed the lack of integration to obstacles such as taxation, regulations, different economic frameworks and structures. He argued, however, that such obstacles are not a major problem, since consumer business is and will remain a local business for economic reasons. In his view, the lack of a level playing field in Europe is an issue of greater importance, as it is the basis of fair competition.

**Eric Spielrein** (RCI Banque) confirmed the previous views, by restating that there is lack of financial market integration and that there are and will be limited cross-border synergies and cross-border service provision. The reason lies in poor economic incentives for banks to engage in such operations, unless total legal and tax harmonization occurs. Thus, the approach pursued by RCI bank is local, based on local operations and optimization.

Mr. Spielrein expressed more concerns in relation to the lack of a level playing field than in relation to the low degree of retail financial market integration. Finally, he also questioned the worthiness of retail financial market integration which in his view depends strongly on consumer benefits, degree of consumer confidence and adequate security for credit institutions.

The second morning session was devoted to the regulatory needs in order to achieve market integration in the field of retail finance.

**Eric Ducoulombier** (DG Internal Market) pointed to language barriers, culture, divergence in consumer protection rules and policy-induced obstacles such as taxation as reasons for lack of integration. In contrast to arguments that financial market integration is not worthwhile, he underlined the need for a coherent strategy, based on four major principles:

- the existing *acquis*;
- identification of areas where obstacles remain and where integration is realistic and needed;
- proof that there are economic benefits for consumers and businesses; and
- internal market fundamentals, thus home country control and mutual recognition.

Finally, to achieve an integrated financial market Mr Ducoulombier argued that further harmonisation should be pursued where a high level of protection is necessary. Soft law can be considered as an alternative, but it must prove to be effective in terms of timing, scope, enforcement and geographical coverage.

The benefits of integration in terms of efficiency (cost reductions and lower rates of interest for consumers) were highlighted by **Rosa-Maria Gelpi** (Cetelem). Along with the natural and legal obstacles to integration, she identified legal hurdles such as consumer protection regulations, which could be removed by political will.

She argued that excessive consumer protection rules – such as those implied by the Commission's full harmonisation approach in the draft CCD – penalise industry and impose unworkable legislation and consequently higher costs upon consumers. In this respect, Mrs Gelpi advocated targeted harmonisation. Once common core principles have been adopted, mutual recognition should follow as a solution. As common core rules are not possible for all areas, host country principles should apply to any not otherwise covered, which would also prevent confusion among consumers.

The positive effects that an integrated retail financial market would have on consumers were voiced by **Donal Walshe** (Euro Coop). He sustained maximum harmonization of consumer protection and also argued that mortgage credits should benefit from the same level of consumer protection as consumer credit. Mr Walshe

also underlined the need for clear, concise and standardised consumer information, by pointing out that a recent Eurobarometer study on financial services found that 58% of consumers disagreed that information from financial institutions is clear and understandable.

He continued by attributing the lack of retail financial market integration to the minimum harmonization principle, to the reticence of consumers about cross border transactions, to their lack of confidence in dealing with financial services and to different language and banking traditions. Thus, in order to overcome these barriers maximum harmonization should be the primary approach.

Finally, he argued that the implementation of the CCD could lead to the eventual problem of cross border over indebtedness in the future. In this regard, he stressed the importance of an EU wide action against over indebtedness.

## *2. The draft CCD*

The afternoon session on the draft CCD continued the debate on harmonisation with national representatives to the EU Council from the UK and Germany.

British panellist **Hergen Hays** (DTI, UK) found the total harmonisation approach taken by the Commission to be inadequate, as it does not take into account the differences among national credit markets in Europe.

Using the example of the UK consumer credit market – which is the most vibrant in the EU – he pointed out that it has its own characteristics. At present the UK is undergoing a national review of consumer credit, aimed at tackling related issues at the national level. Mr Hays underlined the importance of respecting the need for different lending practices as well as different consumer protection rules in relation to the features of specific credit markets. Full harmonisation, in his judgement, should only apply to areas such as data sharing, the licensing of

operations, the right of withdrawal and defining the APR.

With regard to mortgages, he argued for their exclusion from the CCD, on the rationale that mortgages cannot be compared to other forms of consumer credit because they imply different risks.

Expressing a view from Germany, **Peter Horne** (Ministry of Justice, Germany) said that Germany fears losing its current high level of consumer protection and supports full harmonisation only in relation to minor technicalities, e.g. defining the APR.

Seeking an overall reduction in the scope of the CCD, Germany welcomes the exclusion of settlements reached in court, agreements with pawnbrokers, overdrafts and small loans.

He argued, however, for the inclusion of mortgage-backed loans in the draft Directive, stating that there should not be a distinction made in the purpose of the loan as the Commission proposes. He held that in the interest of consumer protection, mortgage-backed loans should be included in the draft CCD regardless of their purpose.

Concerning responsible lending, he stated that the German government recognises its importance, but believes that consumers need to be free to choose the most appropriate loan. A similar view was expressed by **Stephan Huber** (Assistant to MEP Wuermeling), who stressed that responsible lending should apply to both lending and borrowing.

Mr Huber also called for targeted harmonisation, expressing the concern that full harmonisation restricts the freedom of member states to legislate on consumer protection. He said that full harmonisation is desirable, however, on access to databases and information systems, the right of withdrawal and the exclusion of mortgages.

An alternative way forward was presented by **Karel Lannoo** (CEO, CEPS), in the form of the application of comitology to

the field of consumer credit. Drawing from a recently published working document (see p. 10), he argued that full harmonisation would create numerous difficulties for regulating consumer credit. First, it implies working through slow and inflexible legislative procedures at the EU level. Further, it is clear that member states want to retain regulatory power on the different economic, financial and social aspects that affect their consumer credit markets. Thus, the use of comitology would improve the regulatory process and allow greater participation from the member states.

### **ECRI Roundtable: The Commission's amended proposal for a new CCD – A new step in the legislative procedure**

The EU Commission's latest version of the draft CCD was presented by Dirk Staudenmayer (DG SANCO) at ECRI's meeting on **8 December 2004**. The presentation was followed by an animated discussion with key representatives from the Parliament and Council. Also members of the industry and consumer associations actively participated to the discussion.



**Dirk Staudenmayer** (DG SANCO) explained that the Commission accepted 108 of the 152 amendments adopted by EU Parliament in the first reading. The reasoning beyond the Commission's acceptance of several

amendments was the increasing awareness of the need to reduce the scope of the draft Directive. Along these lines the amended proposal endorsed some amendments in full and others under the new 'light regime'.

The 44 amendments that were rejected mainly concerned information, defining the APR and consumer protection.

With regard to pre contractual and contractual information, he referred to the bank's duty to advise borrowers as crucial. Consumers will only be in a

position to make a reasonable decision if they have been carefully advised.



On consumer protection, Mr Staudenmayer underlined that the Commission did not change the right of withdrawal and only tightened up the wording in order to make it more coherent with distance selling. Moreover, he stressed that with regard to linked transactions the right of withdrawal can be exercised only in one direction: the consumer who withdraws from the purchase contract can also withdraw from the credit contract, but not the other way round.

Regarding early repayments, he said that the Commission intends to take both the interests of banks and consumers into account; thus while early repayment is possible, the lender is to be compensated in a fair and objective way.

Finally, on the controversial approach to harmonisation, Mr Staudenmayer stressed that full harmonisation is of primary importance, since minimum harmonisation would allow member states to go beyond the minimum standards. Consequently, obstacles to the cross-border provision of credit would rise and hinder the creation of an internal market.

While recognising that the Commission has made major progress in limiting the scope of the CCD, **Stephan Huber** (Assistant to MEP Wuermeling) held that it is still too wide. In his opinion, small loans and mortgages should be excluded. He also criticised the Commission's 'one-

way' approach to credit-linked agreements, stating that consumers should not only be able to withdraw from purchase then credit agreements but also the other way around.

Mr Huber reconfirmed the Parliament's support for targeted harmonization. Full harmonisation deprives the member states of the ability to regulate their consumer credit markets. He said that there is no internal market for consumer credit owing to natural obstacles such as language and traditions, and that the Commission is unable to take into account the large differences between credit markets. Thus, it should not regulate a European consumer credit market that does not exist – it should be left to the member states.



Adding to criticism of the Commission's approach, **Aidan Liddle** (Permanent Representation of the UK to the EU) raised the concern that the creation of an internal market in the field of consumer credit represents a "real danger". He explained that consumer confidence – one of the milestones of financial markets – would be "wiped away" by changing the rules. Advocating targeted harmonisation, he stressed that this is the only way to deal with the differences that characterise credit markets in EU member states.

He also supported excluding mortgages from the draft CCD, which in his judgement would allow them to be dealt with in a more coherent way. He felt the duty to advise, as conceived by the Commission, would give larger companies an advantage, as the process is very

burdensome for smaller firms. On the right of withdrawal, he felt that 14 days is far too long, explaining that it is problematic for companies to accept goods such as cars two weeks after they have been used.



The French panellist **Emmanuel Lacroix** (Permanent Representation of France to the EU) also favoured limiting the scope of the draft CCD, welcoming the Commission's acceptance of a large number of the Parliament's amendments. He underlined that there is a trade-off between scope and harmonisation: full harmonisation requires a restricted scope, while a wider scope is more compatible with minimum harmonisation. Thus, he supported targeted harmonisation as the solution for the adoption of the CCD.

The aim of the draft CCD is to create a single internal market, argued **Kari Hafkenscheid** (Finance Ministry, The Netherlands). But minimum harmonisation would never achieve this in her opinion. She recognised, however, that full harmonisation is not politically feasible. Thus, she proposed home country control accompanied by as much as harmonisation as possible and endorsed the use of comitology.

In the active discussion session with the audience, **Rosa Maria Gelpi** (Cetelem) expressed the concern that the creditors' duty to advise is unclear and the definition of a credit agreement is still too wide and thus problematic to understand. The definition of linked consumer credit operations was found to be ambiguous by **Michel Van Lierde** (Eurofinas), who also

felt that the 14-day right of withdrawal is too long. He further added to criticism of the Commission's "one-way approach" to withdrawing from linked contracts.

**Donal Walsche** (Euro Coop) held that the exclusion of small loans under €300 is fair and that this ceiling could even be reduced. He underlined the need of including all mortgages in the proposal, as they are such an important form of consumer credit. With regard to the duty of advise he stressed its role in helping consumers to avoid over-indebtedness. In favour of highest consumer protection, Mr Walsche strongly supported full harmonization.

### **Proposal for a More Efficient Regulatory Model – New publication**

Setting out their strategy for a more flexible and responsive EU regulatory model, Karel Lannoo and Almudena de la Mata Munoz contribute to the much-debated issue of harmonisation in CEPS Working Document No. 213.

Since the Consumer Credit Directive was adopted in 1986, the EU consumer credit market has changed significantly in terms of size and structure. Although amendments were introduced in 1990 and 1999, it no longer addresses the market's needs. Cross-border lending in the EU has been estimated to be only 2 to 5% of total EU lending – partly owing to the differences in legislation on consumer protection across member states.

To bring consistency to the regulatory process, the Commission is seeking full harmonisation in the new CCD. Yet this method presents several difficulties, starting with an EU legislative process that is too long and rigid for a fast-changing market. Member states do not wish to lose regulatory powers on issues that may need rapid adaptations to meet social or economic needs.

The paper, entitled *Integration of the EU Consumer Credit Market – A Proposal for a More Efficient Regulatory Model*, argues that one way forward is to draw from the experience of work towards the integration of EU financial markets and adapt it to consumer credit. A variation of the Lamfalussy approach, in which comitology procedures are used in the legislative process, would radically improve the regulatory process for consumer credit. By involving the member states to a greater extent and allowing for quick adaptations, such an approach would ultimately lead to a greater level of market integration.

### **ECRI News**

The Review of the Spanish Ministry of Consumption published in the last number (December 2004) an article on ECRI's new statistical package. For more information see <http://www.consumo-inc.es/revista/diciembre/principal.htm>.