

Consumer Credit Newsletter

Mark your agenda: ECRI Seminar on *The Role of Credit Bureaus in Today's Credit Markets*
12 June 2002, 9:00-13:30, Venue: CEPS, For info, see ECRI website

TABLE OF CONTENTS

NEWS 1

Data protection: Standard contractual clauses

Competition decision on Crédit Mutuel and Livret Bleu

The business of non-performing credits

Internal Market Council

Final report on consumer credit conference in Charleroi

Consumer survey released by Eurobarometer

ARTICLES AND STUDIES 3

Statistical aspects overindebtedness

Financial assets of households

Insurance in the single market

The benefits of integrated retail financial markets

THE LEGAL OBSERVATORY .. 6

Directive on VAT and e-commerce

SPECIAL REPORT 7

EUI workshop on "Evolving credit markets and business cycle dynamics": Review of main articles

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NEWS

Data protection: Standard contractual clauses

The European Commission has adopted a Decision setting out standard contractual clauses for the transfer of personal data to processors (subcontractors) established in non-EU countries that are not recognised as providing an adequate level of data protection.

The Decision offers companies a straightforward means of complying with their obligation to ensure "adequate protection" for personal data transferred to countries outside the EU.

The standard contractual clauses are not compulsory for businesses. However, the advantage of using them is that member states' data protection authorities are obliged to recognise that these transfers enjoy adequate protection.

More information at:
www.europa.eu.int/comm/privacy

Competition decision on Crédit Mutuel and Livret Bleu

The European Commission has decided that the French savings bank Crédit Mutuel, benefited from overcompensation by the French state for costs associated with operating the Livret Bleu system. The latter is a partially defiscalised savings product whose distribution is exclusive to Crédit Mutuel.

Overcompensation is incompatible with the State Aid rules of the EC Treaty. According to EC Treaty rules, the state may compensate a party for undertaking a public

service mission that is entrusted to it by the state, but this compensation may not exceed the sum of the net costs of accomplishing this mission. This decision does not affect the Livret Bleu itself.

The total amount to be recovered will be higher than €164 million. Crédit Mutuel and the French government have stated that they will contest the penalty.

The business of non-performing credits

According to McKinsey research, there are some \$900 billion of non-performing credits in Europe. A few banks and debt recovery organisations see a new business in the management of their own and others' portfolios of retail and corporate default loans. In 2000, the cost of bad debts of European banks reached almost 50% of their total profits. (The percentage varies widely, however, from one country to another.)

Improving debt recovery procedures through outsourcing to specialised organisations might reduce the cost of non-performing credits by more than 10%.

At present, debt collectors are small houses operating on a local basis, but competition is likely to increase in the future. In the household sector, McKinsey sees specialised lenders such as consumer credit and mortgage credit institutions as the most likely competitors in the market of large-scale debt recovery.

http://www.mckinseyquarterly.com/article_abstract.asp?tk=295385:1160:10&ar=1160&L2=10&L3=51

Internal Market Council, 1st March

The Internal Market, Consumer Affairs and Tourism Council, which took place the 1st of March, was largely dedicated to the discussion of economic reforms and the Barcelona European Council.

In the field of consumers, Commissioner David Byrne presented an overview of the results of the consultation on the Green Paper on fair trading practices, adopted in October 2001. It involved a wide consultation with all stakeholders.

The Green Paper has elicited a very large response. Nearly 180 comments have been received from over 70 business organisations and 30 consumer organisations, among others. The paper argues that the EU needs to strengthen economic reform to help European and world markets cope with external shocks and withstand the threat of recession. It points to the benefits that consumers and businesses have already gained from the EU's Internal Market, but warns against standing still.

Final report of the consumer credit conference in Charleroi, 13-14 November 2001

The Belgian ministry of economy has published the final report of the conference it organised late last year (see ECRI Newsletter No. 3 for an analysis of the main topics). The report provides summaries of all the presentations that took place.

The first session included presentations on “the prevention of default payments and bankruptcies” with speakers from France, the UK, Finland, Belgium and Hungary. This workshop highlighted the absence of a uniform definition of over-indebtedness and therefore the lack of comparable statistics at EU level. Participants identified three levels at which overindebtedness can be addressed, namely, adequate information and marketing practices prior to the signature of the contract; adequate risk and budget management on the part of credit institutions and

households for responsible lending and borrowing; and finally, the establishment of an adequate mechanism that ensures the balance between borrower and lender rights once default or bankruptcy has occurred.

The second session on “overindebtedness settlement procedures” reflected the different systems in Europe.

It is essential to deepen our study of the impact of the different settlement systems on overindebtedness, especially in the framework of the single market. The EU has to reflect on the responsibilities of settlement actors, the objectives of procedures, and the financing of the mediation processes. Moreover, the development of cross-border credit demands the approximation of national systems.

Full report at:

http://www.mineco.fgov.be/Presidency/index_fr.htm

Consumer survey released by Eurobarometer

A new Eurobarometer survey confirms that consumers are still less confident about shopping cross-border than in their own countries, and also that they feel less protected in disputes with suppliers based in other member states (except consumers in Greece, Italy and Portugal). Only 31% of consumers think they are well protected when they shop cross-border, against 56% who feel well protected in their own country.

The survey also points out that consumer associations play a central role in providing independent information for consumers and representing their interests. Consumers find consumer associations more trustworthy than their national authorities (72% consider consumer associations to be an effective means of defending their interests, against only 40% who feel the same about their national authorities).

To consult full report:

http://europa.eu.int/comm/dgs/health_consumer/events/event42_en.html



ARTICLES AND STUDIES

Study of the problem of consumer indebtedness: Statistical aspects

This study, commissioned by the Director General SANCO and carried out by ORC Macro, aims at defining and measuring consumer indebtedness and overindebtedness. Once more, it points out the lack of a common definition or measure for overindebtedness and the lack of complete or comparable statistical information.

Contrary to conventional wisdom, the study claims that the rate of personal bankruptcy does not decline when GDP rises, but the two phenomena move together in the same direction. There is neither an obvious connection between the number of personal bankruptcies and the unemployment rate. On the other hand, the study observed that the number of bankruptcies correlates closely with consumer debt and debt to disposable income ratios. This correlation, however, might only be the result of a common positive relation between two economic variables.

Approaches to the task quantifying overindebtedness vary from one country to another. Some measure overindebtedness based on legal procedures. These systems only consider recorded bankruptcies or default payments, and are therefore not able to measure potential overindebtedness situations. The different legal procedures across the EU also hamper any form of country-by-country comparison.

The consideration of other variables such as household disposable income and household assets can give a picture of the relevance of the debt burden to households. However, they overlook the different attitudes to budget management, and do not explain why all households in a certain financial situation are not overindebted (defined as being bankrupt or having defaulted on a loan). A further approach is to classify those consumers as overindebted who consider themselves as such. The authors also apply the “life-cycle” model, used in economics to explain consumer behaviour at different stages of life, to present the relationship between indebtedness and income and between indebtedness and age.

As a result, ORC Macro reports that in those countries where the consumer loan market is more developed, the incidence of loan problems is lower. The group of countries that have a lower proportion of indebted households in overindebtedness situations comprises Denmark, Finland France, Luxembourg and the UK. According to the study

there is a different group of countries with low levels of consumer borrowing and a high proportion of households with debt problems (Austria, Germany, Spain, Italy and Portugal).

Therefore, there is no evidence that increasing the availability of consumer loans increases the percentage of overindebted households. For instance, Greece, where the study finds a high percentage of overindebted population, this is clearly linked to mortgage debt, since the level of other borrowing is very low.

Another conclusion of the study is the lack of an obvious relationship between age and borrowing problems, hence, there is no evidence for instance that young people are more likely to face debt problems than older groups. The authors claim that the percentage of households in Europe facing difficulties in repaying loans is high across all countries and all age groups. Authors quantified overindebtedness at 18% of households.

Finally, the study recognises that negative income shocks affecting households cause a large part of overindebtedness, which is not due to mismanagement of resources but to unpredictable or uncertain circumstances. It makes overindebtedness a phenomenon difficult to predict and therefore to insure against, either contractually or socially.

http://europa.eu.int/comm/consumers/policy/developments/fina_serv/fina_serv06_en.pdf

Financial assets of households

We have considered before in previous issues of this newsletter the relevance of the wealth effect on the analysis of changes in savings and indebtedness ratios of households. Eurostat has recently published figures collected by Ricardo Massaro on household financial assets, which bring the financial portfolio of households in the EU to more than €13,000 billion, about twice the GDP of the area, although national levels vary widely.

Households financial assets in 2000

	Financial assets (billion €)	% GDP
Germany	3642	180
France	3320	236
Italy	2649	227
Spain	1157	190
Netherlands	1191	297
Belgium	781	314
Austria	277	135
Portugal	229	199
Finland	197	150

Source: Eurostat, *Statistics in Focus*, 4/2002.

Excluding liquid assets, shares and other equity represent the more widespread financial instruments – above 40% in all countries, except Austria (where the most common assets are deposits, such as savings deposits and certificates) and the Netherlands (where assets linked to insurance activities represent 55.6% of the total financial assets) (see table below). Data reveal not only differences in the aggregate, but also in the composition of wealth.

Households' main financial assets excluding liquid assets (% shares of total financial assets, 2000)

	Other deposits	Securities other than shares	Securities other than equity	Insurance technical reserves
Germany	24.6	10.2	26.9	27.8
France	17.6	2.3	45.8	23.0
Italy	9.9	17.0	42.9	12.5
Spain	26.5	1.9	45.9	13.1
Netherlands	13.2	2.3	23.3	55.6
Belgium	18.4	20.4	73.8	12.1
Austria	44.5	7.4	17.2	20.7
Portugal	32.2	4.3	32.4	16.5
Finland	5.2	0.9	65.2	10.2
EMU area	18.8	8.5	37.5	23.4

Source: Eurostat, Statistics in Focus, 4/2002.

According to this research, European households will progressively tend in the future to a more similar distribution of assets as regards size and allocation.

Full article at:

www.europa.eu.int/comm/eurostat/Public/datashop/print-product/EN?catalogue=Eurostat&product=KS-NJ-02-004--N-EN&mode=download or

www.ecri.be/Publications/insurancesinglemarket.pdg

Insurance in the Single Market by Rainer Beckmann, Carsten Eppendorfer and Markus Neimke

In this working paper published in January 2002 by ZEW in Mannheim, the authors suggests that in spite of large cross-border linkages through a wave of mergers and acquisitions, the current degree of openness is insufficient, especially for the insurance of private (mass) risks. Furthermore, it should not be expected that this segment of business will reach the degree of integration in the reinsurance and industrial insurance business.

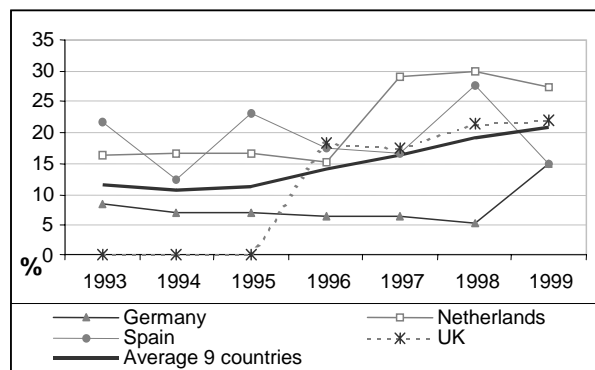
The single insurance market offers advantages to suppliers and consumers. The latter benefit from a larger choice of companies and products and a higher degree of competition, which ensures better

prices. Also the economy as a whole benefits from the single insurance market through increases in growth and employment.

The third generation of insurance directives was intended to completely liberalise the market, but insurance companies still face uncertainties created by the exact scope of the freedom to provide services and the exceptions to the general good principle.

The study demonstrates that the life and non-life sectors differ in their degree of openness, with the life sector being the less integrated. The authors divide the obstacles into policy-induced and natural obstacles and pay special attention to the former, amongst which are included the tax treatment of insurance, regulation and supervision e.g. consumer protection, contract law, and marketing and accounting rules.

These obstacles are only modestly responsible, however, for the low density of cross-border transactions. Moreover consumers' shopping attitudes, whose price sensitivity is low for insurance products, are one of the most important obstacles



that hinder insurance markets integration.

Life insurance, foreign controlled companies in total domestic business (gross premium basis in %)

Source: Working paper cited above, p. 13.

The main integration indicator used is the market share (premium-based) of foreign companies in domestic markets. For the calculation of this indicator, three different kinds of foreign presence are taken into account: foreign presence through merger and acquisitions, through branches and agencies and direct cross-border sales without physical presence.

Full article: www.ecri.be

The benefits of a working European retail market for financial services

A report prepared for the European Financial Services Round Table by Friedrich Heinemann and Mathias Jopp finds that despite remarkable progress at wholesale level, retail financial markets are still operating at a national scale. Participation of European consumers in direct cross-border business is still the exception.

The activities of the banking and insurance sector in new markets are mostly taking place through

mergers and acquisition of national brands. The on-line financial services have not lived up to the expectations created, even in the most successful case of on-line brokerages, and only fund markets show signs of a more significant degree of integration.

Therefore, the potential benefits of financial integration in terms of wider choice of products, lower prices and higher economic growth have not been realised for consumers. Important and relevant obstacles still remain.

Obstacles to full integration of EU financial retail markets

	“Natural”	“Policy-induced”
Demand side	<ul style="list-style-type: none"> • Differences in language and culture • Consumer trust in established national suppliers • Distance and the desire for “handshake” (personal contacts) 	<ul style="list-style-type: none"> • Discriminatory tax treatment of foreign financial services/products • Existence of a national currency (Denmark, Sweden and the UK) • Insufficient knowledge about cross-border redress procedures
Supply side	<ul style="list-style-type: none"> • Information costs caused by natural factors (e.g. cultural differences in legal tradition) • Sunk costs of market incumbents • Bias for home products in established distribution channels • Some smaller national EU markets not commercially attractive 	<ul style="list-style-type: none"> • Information and adjustment costs caused by national differences in regulation (e.g. supervision, consumer protection and accounting standards) • Obstacles to cross-border information flows (e.g. due to limited access to foreign credit registers) • Competitive privileges of domestic suppliers (e.g. through government ownership) • Shortcomings of Internal Market rules (e.g. through slow EU legislative adjustments to new developments) • Particular costs of cross-border operations (e.g. money transfers, identification procedures)

Apart from traditionally different consumer protection regulation at national levels, potential cross-border credit providers have to cope with problems associated with asymmetry of information. To overcome this constraint, private credit bureaus and public credit registers exist to allow for information sharing on the creditworthiness of individual borrowers and groups.

Analysis by the authors demonstrates that the political option of “doing nothing” and leaving further developments to market forces is neither acceptable nor affordable. In the context of the EU’s FSAP, certain problems have been identified and treated, as exemplified by the regulation of cross-border payments. However, more work needs to be done in the area of retail financial services to deliver the potential of integration. The need for political action also derives from the cost of “non-Europe”, which is higher in smaller and poorer member states.

Proposals for reforms often refer to discriminatory tax practices, where progress is very slow. The authors also point out the need to reduce national differences in consumer protection and to limit the scope of application of the general good principle, as has often been reflected in ECRI’s work. If further progress is to be achieved in the integration of retail financial services and on-line finance, much work remains to be done to foster consumer confidence, together with constructing adequate mechanisms of redress for cross-border business. Last but not least, supervisory mechanisms have to be put in place in the light of an enlarged Europe, ensuring a more level playing field.

This report is the result of research carried out by several reputed researchers in the field of financial services at the ZEW and EIP institutes, coordinated by the above two authors.

THE LEGAL OBSERVATORY

Directive on VAT and e-commerce transactions

On 12 February 2002, the ECOFIN Council reached political agreement on the Commission's proposal for a Directive regarding VAT arrangements applicable to certain services supplied by electronic means. After some difficulties, the directive has reached a final stage of the decision-making process. We assess below the likely impact of this proposal on the banking industry.

Internet and the globalisation of the economy contribute to international tax competition. In this context, the EU taxation system could not be a barrier to the growth of e-commerce. The proposal on VAT and e-commerce therefore presents two major modifications in relation to the current regime:

- **Non-EU operators** will be obliged to charge VAT to private EU customers.
- **EU operators** will not be obliged to levy VAT on invoices to non-EU customers.

This modification eliminates the competitive distortion by subjecting non-EU providers to the same rules that EU suppliers apply to their European and non-EU customers.

VAT provisions for on-line services could be summarised as follows:

1. Whenever a **non-EU operator** provides services to:
 - an EU customer, taxation is within the EU and therefore is subject to VAT.
 - a non-EU customer, the operation is outside the EU jurisdiction.
2. Whenever an **EU operator** provide services to:
 - an EU customer, another distinction has to be drawn,
 - if the customer is a taxable person established in another member state (B2B transactions), the place of supply is the member state where the customer is established.
 - if the customer is a private individual in the EU (B2C), or a taxable person established in the same member state (B2B), the place of the supply is that of the location of the supplier.
 - a non-EU customer, the place of taxation is where the customer is located and therefore, the operation is not subject to VAT.

Non-EU companies operating in the B2C segment will have to register in one member state. This provision applies to companies whose annual sales on the B2C European market exceed €100,000. The solution clearly shows that the aim of this proposal is not to increase the revenue of EU VAT administrations, but truly to remove a competitive distortion faced by the EU suppliers.

As we will see in the following, some concerns were expressed by the industry on certain practical aspects of the proposal.

The banking industry is concerned with the **potential use of means of payment for verifying, for VAT purposes, the place of the consumption** of on-line transactions. B2B transactions will be taxed under the reverse charge procedure, and therefore suppliers need to be able to distinguish between business customers (taxable person) and final consumers (non-taxable person). For the European Banking Federation (EBF), this situation could undermine the neutrality required between digital and tangible goods, and could also influence consumers in their choice of payment method, leading to a distortion of the market.

Rules of privacy and confidentiality are also of concern to banks, since they could be obliged to disclose details about their clients. Furthermore, the use of payment methods to locate the place of consumption creates administrative burdens for which the banking industry would need to be compensated. The EBF argues that the authentication process should be based on databases developed and maintained by tax authorities.

Other concerns refer to the **differences of VAT rates between member states**. Since non-EU suppliers are submitted to a single registration, multinationals will obviously shift to the member state with lowest VAT rates and attractive measures for non-resident, to the detriment of EU-based firms.

An issue of concern for the accounting profession is the **degree of compliance in the payment** of VAT. In traditional markets, VAT has a high degree of compliance, but in the on-line market, risks of non-compliance increase significantly. Additional mechanisms need to be established to enforce the VAT system that cannot depend solely on voluntary compliance.

Alfredo Sousa

SPECIAL REPORT

The Finance & Consumption programme of the EUI workshop on “Evolving credit markets and business cycle dynamics”

The Finance and Consumption programme of the European University Institute (EUI) aims to provide theoretical and empirical findings that allow for the explanation of developments in financial markets that affect consumer behaviour and to review the impact of competitive, institutional, and contractual issues on the credit provision.

On 8-9 February 2002, the EUI organised a workshop in Florence on credit markets. Summaries of selected papers are presented below.

“Boom and bust in household savings and debts in the Nordic countries: Causes and remedies”, by Lennart Berg

This article attempts to shed light on changes in savings and indebtedness patterns in recent years, with special attention to the role of new developments in the banking sector in these changes.

The changes in household behaviour have had a great impact on aggregate demand and the business cycle in the Nordic countries. Private consumption expenditures are the largest single component of aggregate demand and account for more than 50% of GDP.

Savings ratios dropped considerably for Denmark and Norway in the middle of the 1980s, whereas the evolution of rates lagged behind a couple of years.

As a consequence of negative net financial savings, the indebtedness of households also increased. In the last half of the 1980s the debt-income ratio rocketed in the four countries. Several other factors influenced this growth, such as the rise in house prices and very low interest rates.

Debt increased in parallel with the rise in asset prices, which means that the debt-gross wealth ratio did not necessarily imply an increased indebtedness.

The situation changed in the 1990s, when net financial savings were greater than household savings. It meant that people stopped investing in houses and started to put more money into financial assets, and in particular, paying off debts. At the same time, house prices declined and so did the debt-income ratio.

The author states the importance of changes in credit markets for the negative figures of net financial savings in the 1990s. New markets and non-banking

financial institutions emerged that did not fall under regulations in practice and the strains imposed by the need to finance increasingly large public sector deficits. The deregulation of credit markets eased the borrowing constraints of households and many people adjusted their financial portfolios and increased debt.

“Judicial costs and household debt”, by Daniela Fabbri and Mario Padula

Empirical research has provided strong evidence that both the content of laws and the quality of legal enforcement of investors’ rights heavily affect the development of financial markets, but only a few papers have treated the impact on household credit markets.

This paper investigates the effect of judicial costs on households’ debt and analyses whether borrowing by those who are not constrained in the credit market is also sensitive to judicial costs. They find that the working of the judicial system impacts on the probability of being credit-constrained and that the amount of debt held by non-constrained households decreases when the quality of the judicial enforcement declines.

A bad judicial system might cause households to be credit-constrained because banks will shelter their revenues by asking a minimum of collateral to grant credit. This collateral will increase for scenarios where the cost of repossessing collateral is higher (lengthy and cumbersome judicial procedures). The study finds that households located in more efficient judicial districts tend to have a lower probability of being turned down in the loan application.

The authors also find welfare implications of the quality of judicial enforcement for those who are not credit-constrained and imply that household’s debt capacity is higher the lower the judicial costs. Therefore, other things being equal, the cost of debt is lower where justice works better. According to this logic, badly functioning institutions can have relevant welfare costs.

“Consumer Credit: Evidence from Italian micro data”, by Robert Alessie, Stefan Hochguertel and Guglielmo Weber

The authors investigate ways in which the usury law adopted in 1996 may have affected the consumer credit market and show how the pool of applicants has changed over time in comparison to a representative sample of the Italian population.

They argue that these changes can be given a structural interpretation. The main finding is that demand for credit correlates with interest rates, the more competition in the consumer credit market, the more elastic is the demand.

The 1997 law set a ceiling on interest rates charged to consumers. Corresponding limits apply to five different types of credit. No credit contract can charge a rate higher than 1.5 times the published benchmark rate.

If these limits had been binding for all types of credit, one might expect to have seen after 1997 a decrease in interest rates charged to successful applicants as well as an increase in rejection rates. If instead, they only affected some market segments (such as medium-sized instalment contracts), substitution across credit types can be found.

The authors find little evidence that the usury law brought widespread credit rationing, and also rejection rates stayed roughly constant over the period. However, they found evidence that substitution took place across credit types, with a large proportion of medium-sized credit applicants moving away from instalment credit towards revolving credit.

“Constrained consumer lending: Methods using the survey of consumer finances”, by Giovanni Ferri and Peter Simon

This paper attempts to assess the implications of the existence of credit constraints on intermediaries’ lending decisions. (Households are credit-constrained if conventional bank lenders offer less than the household wishes to borrow.)

For the purpose of the study, the authors consider that households that carry month-to-month balances on their credit cards must not have full access to conventional intermediated loans. Otherwise, they would not be relying on such an expensive form of credit.

The authors also claim that traditional models of firm borrowing, based on balance sheet elements such as liquidity and leverage, are applicable to household borrowing.

The main findings of this study are consistent with those of previous studies in the field:

- Higher current incomes reduce the possibility of being turned down, although this is ambiguous.
- Households that have lower leverage, are homeowners and have not been delinquent on previous debts are less likely to be turned down.
- Households with larger proportions of stocks and bonds are less likely to be turned down for credit.
- Working with several banks decreases the possibility of borrowing on credit cards, and therefore signals that the probability of being turned down is smaller.
- Being older decreases the probability that an individual is turned down, and the possibility decreases also for individuals with higher levels of education.
- High permanent income seems to demonstrate repayment potential and therefore reduces the possibility of being credit-constrained.

In all, the authors state that using credit card borrowing to measure households’ borrowing constraints has pros and cons, but is useful in explaining the incidence in consumer loan borrowing of asymmetry of information and several aspects of creditworthiness assessment.

The full text of the papers summarised above at: www.IUE.IT/finconsEU/February02.html

Other papers presented at the conference:

“The Real effects of local financial development”, by Luigi Guiso, Paolo Sapienza and Luigi Zingales

“Optimal debt contracts and moral hazard along the business cycle”, by Pietro Reichlin and Paolo Siconolfi