New EU rules for consumer credit markets

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Explainer

Consumer credit is more prevalent in European countries than is often assumed. While many households have a long-term mortgage loan, they also use short-term consumer credit, to different degrees and in different forms across countries. In its most basic iteration, it is used by consumers without their noticing on an almost daily basis in the form of payments, overdraft facilities, and increasingly, in international payments with credit cards or even new forms of payments such as buy-now-pay-later schemes.

In some countries, consumer credit is very widespread for the purchase or use of basic household items, such as a car or household appliances, as well as for more luxury purchases, such as holidays or excursions. The EU legislation applicable to such financial services covers issues such as how the applicable interest rate and costs are calculated, the know-your-customer rules and the standard information requirements. These rules are split between the EU and the national level, with a growing importance of the EU regulatory system, notwithstanding very diverse national markets and consumer protection rules.

The updated EU Consumer Credit Directive is a sign of the EU's growing importance in financial regulation, also on the retail side. The proposal was published by the European Commission in 2021 and the EU legislators have now almost agreed on its final version. The directive considerably extends and clarifies the scope and terms of the directive. Other new EU legislative acts have also had an increasing impact on consumer credit, such as rules on non-performing loans, on data and privacy protection. Moreover, judicial interpretations play a major role in shaping the consumer credit landscape.

This ECRI Explainer will start with a review of consumer credit markets in the EU, their evolution across countries and the recent dynamics to the radically changing credit environment. It will then analyse the approach taken in the latest update to the Consumer Credit Directive and assess the implications for the credit markets. It further discusses the approach to the topical issue of over-indebtedness, and the interaction with other aspects of EU rulemaking. It ends with some considerations on the activity of the EU in this domain, an area where Member States' rules are still dominant.

Consumer credit markets in the context of raising rates and changing markets

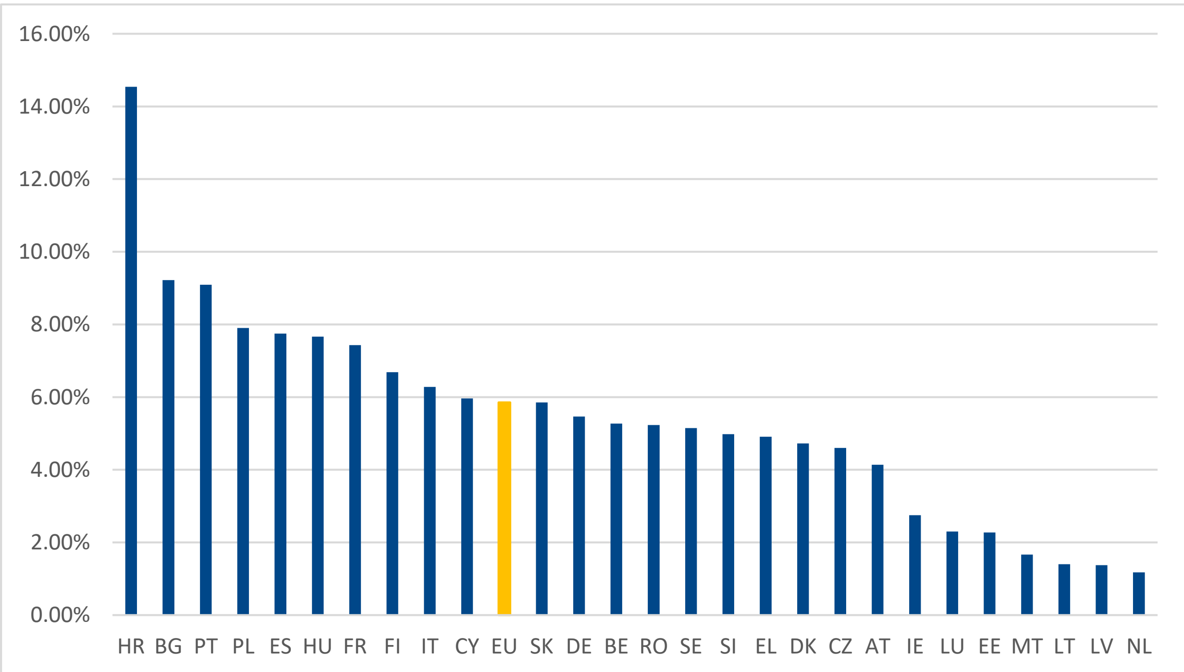
As with other aspects of retail financial markets, consumer credit markets in the EU are very different in their role and how they have developed. Available products and consumer habits hugely differ. Notwithstanding 30 years of the single market, and the EU's harmonising efforts in the Consumer Credit Directive (CCD), markets nonetheless remain very diverse. The cross-border provision of credit is very limited, which is reflected in the diversity of rates. In a truly single market, consumer credit rates of a similar duration and the clients who use consumer credit should be much more comparable. But consumer protection, redress and personal bankruptcy procedures differ considerably. Monetary policy rate changes are transmitted differently in EU countries.

The share of cross-border loans and deposits by households remains negligible at around 1 %, according to the ECB. They are conditioned by where consumers live. Exploiting differences in interest rates on savings accounts is mostly forbidden by banks, even within the same banking group.

Multiple barriers are hampering consumers willing to look beyond their home borders for taking out a loan. Know your customer (KYC) in combination with anti-money laundering requirements limit banks' will and capacity to offer credits to individuals living in another Member State. On top of legislative barriers there is also the language barrier – hence a single market as we know it in other domains barely exists for consumer credit.

As can be seen in Table 1, the share of consumer credit as a share of GDP differs widely between Member States. It ranges from 14.5 % in Croatia to 1.2 % in the Netherlands, and at EU level averages out at 5.9 %. When broadly generalising, higher consumer credit levels as a share of GDP were observed in eastern and central European countries.

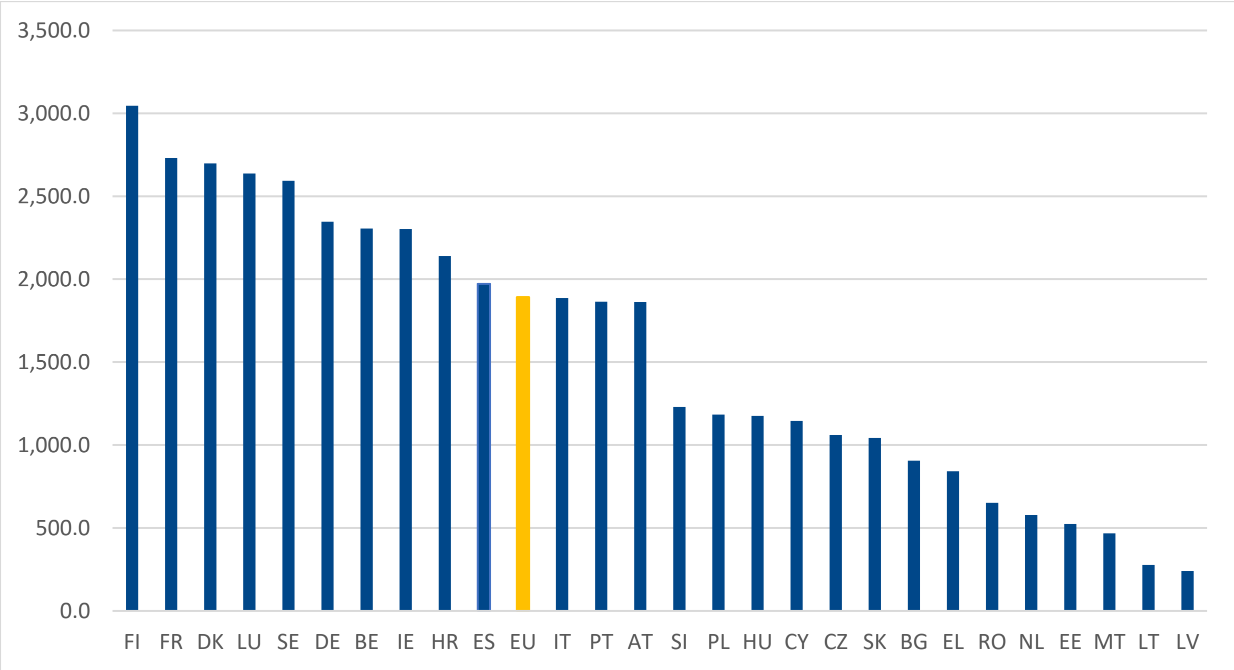
Table 1. Consumer Credit as share of GDP (2021)



Source: ECRI Statistical Package 2022

Moving on to the level of consumer credit per capita, we observe greatly varying amounts across Member States. The EU average of EUR 1 890 includes levels ranging from as high as EUR 3 050 per capita in Finland, down to EUR 240 and EUR 280 in Latvia and Lithuania. Generally speaking, countries with a higher level of credit per capita in absolute numbers tend to be northern and western European Member States, with lower levels being recorded for the central and eastern European Member States.

Table 2. Consumer credit per capita (EUR, 2021)



Source: ECRI Statistical Package 2022

In short, countries with higher absolute values of consumer credit per capita are countries in which credit as a share of GDP is lower, indicating higher GDP overall. Multiple factors influence the level of take-up and the size of a short-term loans. One of these factors is interest rate levels and is discussed further down.

Digitalisation continues to change markets. Several factors are at work that create greater competition and easier customer access: (i) smartphone technology, the internet and application programming interfaces (APIs); (ii) Artificial Intelligence (AI) and Big Data technology; and (iii) distributed ledger technology (DLT). Areas where digital technology has made the biggest inroads in financial services are consumer credit and payments (EBA, 2021). Traditional providers are under pressure from newcomers that cooperate with them or go into direct competition. The outcome of this process is difficult to predict, but has been ongoing for some time now, and the role of incumbent banks has not diminished. Newcomers have not been able to unseat European banks, due to a variety of factors, including the core distribution networks operated by the banks, consumer wariness to trust new players, and the massive investments needed for the technology at play. However, fintechs have been successful in taking market share from the established banks in the digitalisation of payments, for both retail and e-commerce. They have successfully managed to take a big share of payments for web-based purchases – above all during the pandemic – which traditional banks would have otherwise attracted. A further challenge is the Central Bank Digital Currency (CBDC) or the digital euro directly issued by the ECB. This will impact the future disintermediation role of banks, but this remains to be seen how it will be filled in by the ECB.

Raising interest rates have bought important changes to credit markets, with the current high levels of eurozone rates unseen for many years. The impact on consumer credit has not been widely discussed, but it also differs across countries, as caps on rate increases are often applied at national level. This is clear from Table 3, which shows how increases in short-term interest rates vary across Member States. It compares the euro average interest rate for households for consumer credit, excluding mortgages, for periods of under one year for seven eurozone Member States, covering the period June 2018 - March 2023. The consumer credit interest rates in the eurozone, even though all are related to the interest rate set by the ECB, are different and not necessarily synchronised.

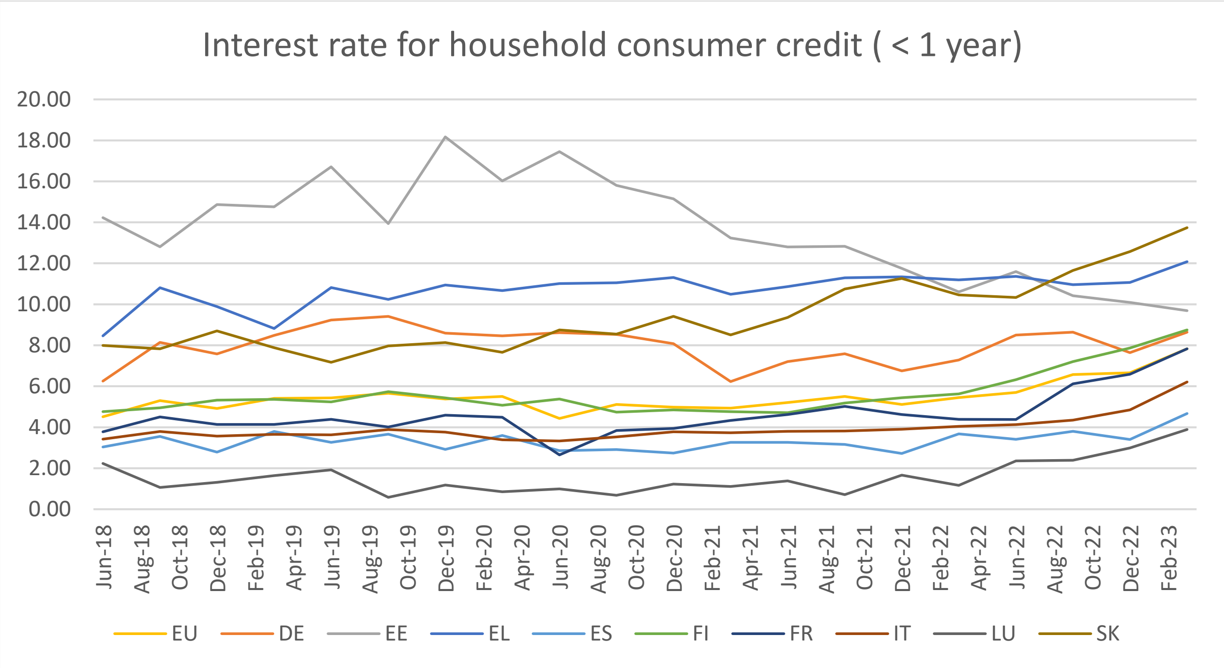
Since the strong rise in inflation in 2022, and the ensuing increase in monetary rates, rates for short-term consumption credit have increased for almost every country in the eurozone. A trend break can be observed in Q4 2021/Q1 2022, with interest rates rising in almost all countries observed.

Luxembourg started at a comparatively low interest rate level, where consumers could, before the rise in interest rates, take out short-term loans at a rate of 1.16 % in early 2022. By early 2023, consumers were facing interest rates of 3.89 %, more than three times the level from 12 months earlier.

At the other end of the scale is Estonia's interest rate evolution. Starting from a peak of 18.17 % in December 2019, Estonia has gone against the tide with a persistent decline in consumer credit interest rates over the last three years, down to 9.69 % in March 2023.

All other euro zone countries demonstrated relatively stable interest rates for short-term credit up until Q4 2021/Q1 2022. In this instance interest rates started to increase in all the observed countries. The actual interest rate increase across the EU has ranged from 1.89 to 3.57 percentage points, creating a situation where consumers are faced with considerably increased costs, regardless of where they live. Interest rates on deposits, however, have only started to increase very slowly.

Table 3. Interest rate for household consumer credit (< 1 year)



Source: [Euroarea Statistics: Bank interest rates - Loans]

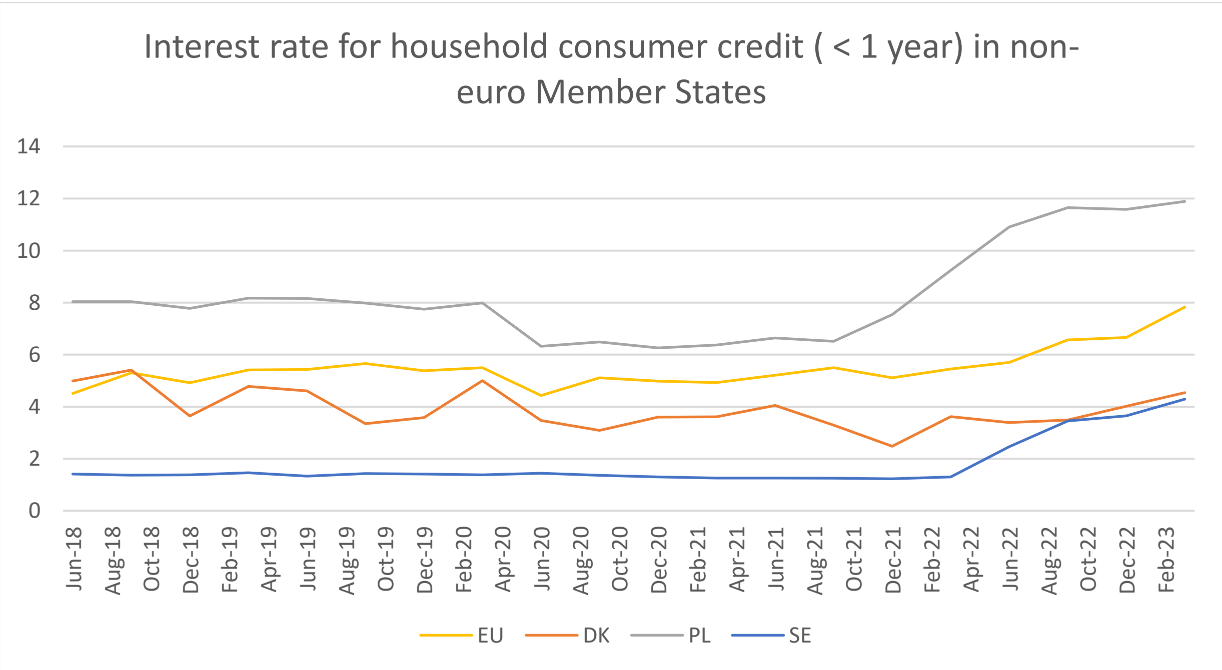
Table 4 below shows the evolution of the interest rate for household credit in three countries – Denmark, Poland[1] and Sweden, compared to the euro average. Consumers in these three Member States have experienced different interest rates evolutions over the last few years.

Interest rates for short term consumer credit in Denmark evolved at a slow but steady negative pace throughout the Covid-19 pandemic, with increases starting to be observed from the end of 2021. Since then, interest rates have steadily increased, moving from the lowest point of 2.48 % in December 2021 to today's value of 4.54 %.

Polish consumers have faced much higher interest rates. Starting from 7.99 % in Q1 2020, they decreased to 6.51 % in September 2021. Recently an upturn has been taking place, with the average interest rate for consumer credit in Poland reaching 11.88 % at the time of writing.

Consumers in Sweden have over the last five years experienced the lowest interest rates in our sample. From our first observation, starting mid-June 2018, interest rates for short-term consumer credit have steadily remained below 1.5 %. In Q1 2022 market conditions drastically changed, with interest rates rising rapidly. Consumers are today (as of March 2023) facing an interest rate of 4.29 %, a value that is expected to continue rising, with repercussions on the market already visible with strong declines in the uptake of consumer credit.

Table 4. Interest rate for household consumer credit (< 1 year) in non-euro Member States



Sources: Danmarks Nationalbank's Statbank; Narodowy Bank Polski ; Statistics Sweden

The data analysed in the four previous tables display a general increase in interest rates over the last 18 months. The increase is likely to lower consumer demand for credit. The reduction in credit uptake might decrease individuals' short-term indebtedness and a lower level of short-term credit as a share of national GDP. This effect is likely though to be dampened by the additional costs being endured by

[1] Interest rates in Poland are for all forms of consumer credit, not only limited to more than three months and less than one year, as is the case for the EU average, Denmark, and Sweden. It is therefore conceivable that interest rates for short term credit are actually higher than indicated in the graph.

households' where credit is used for essential consumption. The impact on household consumption and on GDP remains to be seen but a decrease in overall household spending can be expected.

The Consumer Credit Directive

As with other product harmonisation efforts at the time, harmonised rules for consumer credit (directive 87/102/EEC) were already adopted in 1986 by the then-EEC. The directive harmonised the calculation of the APRC (Annual Percentage Rate of Charge), to make all the costs of short-term consumer credit comparable across the EEC (at that time consisting of 12 Member States). The CCD has since then undergone revisions and has been complemented by a 2014 directive covering mortgage credit. The harmonisation of mortgage credit rules was initially considered to be unfeasible, as other factors, such as the call on underlying assets and tax deductibility made it very difficult to grow the levels of cross-border credit. This started to change with digitalisation and the facilitation of credit comparison.

The CCD has been reviewed twice, the first in 2008, and now, with the latest amendments almost finalised. It remains a directive, unlike many other pieces of EU financial law that took the form of regulations. This means, as with the MCD, that the rules are to be transposed into national law by national legislatures, which can lead to big differences in transposition. The draft directive has grown considerably in length, due to market developments in payments and credit, and to the enormous growth of EU regulatory activity in general. Some clauses in the CCD have gone for 'maximum' harmonisation or fully identical provisions, where rules need to be transposed in exactly the same way (as specified in Art. 42). Other elements of credit agreements fall outside its scope and leave it up to Member States to apply national law. The Commission did consider turning the directive into a regulation but this was seen to be against the principles of subsidiarity and proportionality.

The CCD remains narrow in scope, as consumer protection has been left to national law. Also, other elements related to consumer credit have been legislated on in the meantime, such as the standardisation of lending to tackle non-performing loans. This directive (2021/2167) was enacted to allow for the restructuring of banks' non-performing loan portfolios. But it also sets the basic rules for credit servicers, that is commercial entities that repurchase bad loans, and for the cross-border provision of such services.

Transposition of the CCD will be ongoing until the end of 2025, with the European Banking Authority (EBA) developing guidelines and standards for data templates. Another directive that applies laterally is the directive concerning the distance marketing of consumer financial services (2002/65/EC) that ensures consumers can access comprehensive information on the marketing of credits at a distance or remotely. This directive was amended in 2011 (Directive 2011/83/EU) and will be replaced in 2023 with a new text streamlining and modernising the previous one. It focuses on pre-contractual information, the right of withdrawal and protection against online interface, thus these are *lex specialis* provisions, as in the CCD, that prevail over general rules.

The Consumer Credit Directive thus far

The 2008 CCD (2008/48/EC) covers consumer credit amounts ranging from EUR 200 to EUR 75 000, such as loans granted for personal consumption, including cars, household goods, travel, as well as some overdrafts and credit cards. It permitted a right of withdrawal, early repayment (without penalties) and linked agreements. However, it excludes other important credit agreements such as those exceeding EUR 75 000, financial leasing agreements and short-term credit below three months.

Commission reports on the CCD show great differences between the laws of the various Member States regarding credit for natural persons in general and consumer credit in particular. One of the reasons for the revisions is Member States' diverging implementation, with imprecise wording during transposition being one key reason for this. Other reasons include technological developments and increasing digitalisation, which have brought 'significant changes to the consumer credit market' (Recitals 3-4 CCD III), and the development of new market actors offering forms of consumer credit that will be included in the new directive. This leads to competition distortions in the internal market (Recital 6 CCD III).

A Commission report from 2020 gives an overview of the achievements and shortcomings of the 2008 directive. The Commission concluded that its objectives were achieved, i.e. high levels of consumer protection and the consolidation of a single market, but also concluding that certain adaptations must be made on the scope and disclosure standards. The consultation that led to the CCD review only got very limited feedback, however, with a mere 25 responses. This is related to the broader question of the European market for consumer credit and its development, which is hardly analysed in the different reports and impact assessments. They rather focus on legal analysis and methodology.

The new Consumer Credit Directive

The new proposal considerably extends the CCD's scope, and for the first time allows the European Commission to adopt delegated acts[2]. Compared to earlier versions, the current draft directive has also become much longer.

Scope

- The CCD includes additional types of loans: buy-now-pay-later schemes, short-term overdraft facilities, interest-free credit and loans offered through crowdfunding. Deferred payment loans, credit card payments (on the condition that payment remains free of interest), pawnshop and doorstep loans are left out of the scope together with certain suppliers of goods and services. Due to the advantages deferred debit cards offers to households in adjusting their finances, Member States can exempt these if they fulfil specific conditions. Mortgages are excluded from the CCD's scope.
- Loans also below EUR 200 are included, but loans above EUR 100 000 are excluded.
- Leasing agreements which include the option to eventually buy the leased item (i.e. the French '*Location avec Option d'Achat*' (LOA)) is included[3]. Leasing agreements without a purchase option are expected to be excluded.
- Crowdfunding credit services are included when the provider functions as a credit intermediary.
- Green consumer loans based upon standards set by the EBA are included.

[2] See Art. 45 of the draft CCD, April 2023. This will most likely be prepared by the European Banking Authority but seems to be a point of contention. The 2008 CCD only mentioned that 'The European Commission shall be assisted by a Committee' in its Art. 25, Committee Procedure.

[3] Guittard-Losay, Isabelle (2023), Les enjeux des acteurs français du crédit à la consommation à l'heure de la révision de la directive européenne, conference, 4 April.

The broadening of the scope raises questions over the application of the APRC, which was originally defined for traditional consumer credit and not for leasing agreements, where the residual value is used to calculate the term of the agreement.

Pre-contractual information

All necessary information should be provided to the consumer before they sign a credit contract, and this should be free of charge (Art. 5, and repeated throughout the directive, and Art. 10). It requires lenders to focus on the key information, such as borrowing rates and costs, the APRC, and the total amount of credit. This information must be summarised through a Standard European Consumer Credit Information overview and form.

The consumer is given the right of withdrawal starting from the day of the credit agreement or from the day when the consumer is handed the terms and conditions. In the case that the consumer did not receive the contractual terms, the withdrawal period will in any case expire 12 months and 14 days after the conclusion of the agreement (Art. 26). If the consumer is buying an item with a linked credit agreement where the purchase includes a return policy, then the right of withdrawal should equal the amount of days included in the return policy (Art. 26).

The Annual Percentage Rate of Charge (APRC)

The APRC is the hallmark of the first CCD. Its calculation of the APRC should include all costs to accurately represent the credit agreement setup. Member States are allowed to cap increases in the cost of credit and this should be publicly available. Intermediaries' remuneration based on the cost of credit is forbidden, and commissions based on the number of credit agreements sold will be banned (Art. 32).

Credit worthiness assessment

The directive requires lenders for all loans within the scope of the proposal to perform creditworthiness assessments (CWA). If the assessment is negative, lending will be banned to avoid irresponsible lending and over-indebtedness. Information on the applicant shall be obtained from a variety of sources and – whenever necessary – by consulting a credit register (consumer arrears in the repayment of previous credit agreements, the type of credit and the identity of the creditor), that can be either public or private. Cross-border access to credit databases shall be guaranteed. Only objective criteria can be used for CWA, never personal data obtained from social media (Art 19.3). When automated profiling is used, the consumer has the right to request and obtain human intervention from the creditor, consisting of an explanation of the assessment and of the review (Art. 18.6).

Credit institutions could use AI to facilitate and complement some of their lending processes. For the creditworthiness assessment, AI could help the creditor gain access to a faster and more accurate overview of their potential customers. It could give the customer access to more personalised conditions, which could benefit them and simultaneously make it safer for the lender, with more risks being accounted for.

These benefits also come with certain risks, as highlighted in the Commission's AI Act proposal. The AI Act tries to ensure consumer protection by addressing loopholes that generate economic or financial harm. The AI system would have influence over individuals' access to financial services, with the potential for certain groups to completely lose their access to finance. Enhanced discrimination against already exposed groups or the creation of newly excluded groups could be a very unwelcome outcome.

The EBA recommended that the '*creditworthiness assessment of the borrower is robust, accurate and relies on adequate information and that credit providers' practices are compliant with consumer protection requirements*'. Using AI in the CWA and credit decision-making processes should be appropriate to the size, nature and complexity of the credit facility and the types of borrowers concerned. The risk, however, is that CWAs for lower amounts are automated, which may lead to higher levels of indebtedness for poorer households.

Automated profiling is however forbidden due to the General Data Protection Regulation (GDPR), and more specifically under its articles 21 and 22. In an opinion on the matter, the Advocate General of the European Court of Justice judged that automated credit risk scoring is indeed profiling under GDPR, and that the storage of data is unlawful if it has considerable negative consequences on a person[4]. A consumer has right to see their data, and their negative credit assessments, under GDPR, have 'the right to be forgotten'.

Conduct of business

The bundling of products is allowed but tying is prohibited (Art. 14). Creditors are required to manage conflicts of interests in the best interests of the consumer (Recital 67). The directive bans tying practices and sales of ancillary services as a default option. Only ancillary services that are compulsory for credit, such as a credit insurance policy, which are not mandatory in all Member States, are permitted. Unsolicited granting of credit without the consumer's explicit agreement is forbidden. The remuneration of staff should not be related to the sale of credit.

Overdraft facilities and over-indebtedness

Where the proposed credit contains an overdraft facility, the consumer should be kept informed by the creditor, throughout the duration of the credit agreement, of the amounts, the new balance and the APRC. The same applies for an overdraft facility on a current account. Consumers should have the possibility to repay their overdraft at no additional cost.

Creditors have a role in preventing over-indebtedness (Recital 72 and Art. 18), and they should allow a period of forbearance before enforcement procedures are started (Art. 35). This includes the possibility for the consumer to refinance, for a modification of the agreement's terms, with reasonable extra charges, and eventually a cap on these charges.

Member States shall ensure independent debt advisory services exist for consumers in distress (Art. 36). The directive requires the Commission to conduct a study within three years giving an overview of the availability of debt advisory services across Member States and identifying best practices for the further development of such services.

A recent European Commission (2021) study found that only about half of EU countries offer advanced debt advice, while in 13 other countries debt advice is only provided sporadically or is non-existent. There are large differences in the services provided. The study found that 90 % of over-indebted households – or about 16 million households in the EU27 and UK – currently do not receive debt advice, even though the benefits of debt advice are estimated to be much larger than the costs.

[4] Advocate General's Opinion in Case C-634/21 | SCHUFA Holding and Others (Scoring) and in Joint Cases C-26/22 and C-64/22 SCHUFA Holding and Others (Discharge from remaining debts).

Implementation

There will be a 24-month deadline for the transposition of the new directive and one additional year before its entry into force. The Commission is obliged to report every four years on the scope, the evolution of the market and the effectiveness of penalties to combat imprecise implementation, with the EBA publishing a report on the measures to prevent abuse, including the methodologies to establish caps where relevant, and of their effectiveness in limiting excessively high interest rates or APRCs.

A European Standard Consumer credit information sheet containing all necessary information should be provided to the consumer before the conclusion of any contract.

Two years after the directive's entry into force, the Commission will assess the necessity of protecting consumer borrowing and investing via crowdfunding platforms.

Conclusion

Consumer credit markets continue to vary largely across EU Member States. Their evolution remains mostly determined by national circumstances. More than 30 years of regulatory efforts have not brought European markets closer as we can see in other retail financial services markets. Local, cultural, regulatory, and structural matters determine market developments, and the cross-border provision of consumer credit remains very limited.

These large differences across countries were apparent in the latest amendments to the Consumer Credit Directive. This review was broadly prepared and assessed, but it did not create a lot of controversy. Consumer credit is a widely debated issue, but this happens primarily at national level. The current proposal widens the scope of the directive and tightens its provisions, even if they impact national markets differently.

For the new proposal to be successful it will be necessary for other regulations to be aligned with it, ensuring the creation of a level playing field. Such an alignment must also be incorporated into new legislative proposals. The latest draft directive on payment services (PSD3) allows for payment institutions to offer credit. Even though they would be regulated under strict conditions, this development runs the risk of distorting the market.

The EBA is given the task to assess the directive's implementation, four years after its transposition, with the European Commission being given the power to adopt delegated acts. In other domains of financial services, implementing standards and guidelines have become widespread, but not for consumer credit. Almost 20 years ago, we argued that technical details should be left to level 2 legislation, that is implementing secondary legislation, allowing the Commission, together with consultative bodies, to update technical details. This is however still not the case in the domain of consumer credit. This negatively impacts proper accountability to the European Parliament on these matters, for a domain where this is certainly required.

European Credit Research Institute

The European Credit Research Institute (ECRI) is an independent, non-profit research institute that develops its expertise from an interdisciplinary team and networks of academic cooperation partners. It was founded in 1999 by a consortium of European banking and financial institutions. ECRI's operations and staff are managed by the Centre for European Policy Studies. ECRI provides in-depth analysis and insight into the structure, evolution, and regulation of retail financial services markets in Europe. Through its research activities, publications and conferences, ECRI keeps its members up to date on a variety of topics in the area of retail financial services at the European level, such as consumer credit and housing loans, credit reporting, consumer protection and electronic payments. ECRI also provides a venue for its members to participate in the EU level policy discussion.

For further information, visit the website: www.ecri.eu.

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