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OXFORD ECONOMIC RESEARCH ASSOCIATES

REPORT PREPARED BY OXERA FOR

APACS/BBA/FLA/CML

ASSESSMENT OF THE ECONOMIC IMPACT OF THE PROPOSED EC CONSUMER CREDIT DIRECTIVE

JULY 2003

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Executive Summary

OXERA has been commissioned by the Association for Payment Clearing Services, the British Bankers' Association, the Finance & Leasing Association, and the Council of Mortgage Lenders to assess the impact of the new (draft) EC Consumer Credit Directive (CCD) on credit for consumers and, more broadly, the UK economy. The study consists of three elements:

- a qualitative cost–benefit analysis of the Directive;
- a quantitative impact assessment of changes in the usage and costs of credit on the UK economy;
- a quantification of additional net welfare effects.

The second element was subcontracted to Oxford Economic Forecasting.

Key findings

A number of scenarios of increases in the costs of credit and reduction in the availability of credit were designed in order to model the impact of the Directive on consumer spending and GDP in the UK. The scenarios show that within two years of the implementation of the Directive:

- consumer spending could fall by around 0.6% (or around £4 billion/€5.8 billion);
- overall GDP could fall by around 0.2% (or around £2 billion/€2.9 billion);
- the welfare loss to consumers could be as high as £950m/€1,400m, with at least 2m consumers finding it difficult or impossible to obtain credit.

Background

The study was commissioned in light of the omission on the part of the European Commission to undertake a rigorous impact assessment of the Directive. In the time available it has only been possible to model the impact on the UK economy. However, the market for consumer credit in the UK is the largest in the EU, accounting for around one-third of the total European market for consumer credit. The consumer credit market in the UK is well developed, with a wide range of credit products, a high proportion of revolving credit, constant product innovation and a large number of credit providers.

Impact on credit users

The Directive, if implemented, would result in a serious impact on users of credit. This would arise through three main effects:

- a direct increase in the cost of providing credit. In particular, the enforced duty to advise and the requirement for credit providers to ensure that their customers re-sign their credit agreements would add directly to the costs of providing credit. Overall, there would be similar impacts across the product range. For example, by abolishing the present exemption of overdrafts from the scope of the Directive, the draft Directive would pose a real threat to the current flexibility enjoyed by users of overdraft arrangements. The costs imposed by the Directive would tend to be fixed per agreement, and so would impact most significantly on those credit agreements where the amount of credit drawn was smallest;

- a reduction in the availability of credit, particularly to those with low credit ratings. The responsible lending provisions are likely to increase the risk to credit providers of lending to this group of consumers. This would have the most serious impact on those with low and irregular incomes and those in the sub-prime market;[1]

- a series of 'hassle factors', which would add indirectly to the cost of providing credit and may even preclude the provision of common forms of credit. These include, in particular, the obligations placed upon providers of overdrafts and the provision for a cooling-off period for credit arrangements agreed on retailers' premises. Other measures could reduce competition, potentially leading to higher prices for consumers in the long term.

Impact on the UK economy

The effects of the Directive would not be limited to the users or potential users of consumer credit, but would affect the whole UK economy. An increase in the cost of credit faced by consumers, and a reduction in the availability of credit to those with low credit ratings, would reduce the use of consumer credit, leading to lower consumer spending and a reduction in GDP.

A number of scenarios of increases in the costs of credit and a reduction in the availability of credit were designed in order to model the impact of the Directive on consumer spending and GDP in the UK. The scenarios show that consumer spending could fall by around 0.6% (or around £4 billion/€5.8 billion) and overall GDP by around 0.2% (or around £2 billion/€2.9 billion) within two years of the implementation of the Directive.[2]

Because the Directive would result in a higher cost of credit and a restriction in the availability of credit, there would be a significant welfare loss to consumers. All users of credit would end up paying a higher rate of interest in order to cover the costs that would result from the Directive. Also, a significant proportion of consumers could be affected by a reduction in the amount of credit that lenders would be prepared to make available to them—a conservative estimate indicates that at least 2 million UK consumers could be affected. This welfare loss could be as high as £900m/€1.3 billion.

Meeting its objectives

One of the objectives of the Directive is to increase consumer protection and to address the problem of overindebtedness. The effect of these provisions is likely to be a reduction in the availability of consumer credit to those with low credit ratings. However, studies show that the main causes of overindebtedness are unforeseeable and would not be avoided systematically by provisions such as responsible lending and duty to advise. The blunt measures in the Directive are unlikely to have an impact on the rate of

[1] Defined as the part of the market made up of those borrowers who have been refused credit more than once.

[2] This is based on the medium scenario consisting of an increase in the cost of unsecured consumer credit of 0.7 percentage points; a restriction in availability of unsecured consumer credit of 2.5%; an increase in the cost of secured credit that would be covered by the Directive, of 0.05 percentage points; and a restriction in the availability of secured credit that would be covered by the Directive, of 3%. In this scenario, it is assumed that 50% of secured credit would be covered by the Directive.

overindebtedness, but would have a significant impact on the ability of those with low or irregular income and consumers in the sub-prime market to obtain access to credit. The end result could be to exacerbate the existing problems of financial exclusion.

Moreover, a reduction in the availability of credit to consumers in the sub-prime market may lead to an increase in the use of credit from sources willing to operate outside of legal and regulatory regimes.

Conclusion

The analysis in this study shows that the Directive is unlikely to achieve its objectives. The economic and welfare-related effects of the Directive may be significantly larger than envisaged by the Commission; by contrast, its benefits are likely to be small.

Summary table

The table below presents a summary of the qualitative assessment of the impact of each relevant provision of the Directive. It is intended primarily as a guide to the main points in this report, and should be used in conjunction with the full analysis in the report.

Costs and benefits per provision

Provision of the CCD	Benefits	Costs
Data protection (Article 7): credit providers only permitted to use private customer data for the purpose of assessing ability to meet credit obligations	Consumers who do not wish their personal details to be used for marketing purposes already have the option to 'opt out' of receiving marketing material. The additional benefit of this provision is therefore likely to be small	Direct—more expensive and less effective marketing Indirect—less well-targeted marketing material may increase the chance that the recipients of such material do not value it, and some consumers will not be informed of certain new credit products, special offers or credit products from new firms
Central database (Article 8): Member States must set up a central credit-risk database(s) (or networks of databases) populated with, at minimum, negative data. Credit-risk data will be available on a cross-border basis	Cross-border access to credit reference data Entire EU market for consumer credit opened up Easier for foreign credit providers to enter local markets Increased competition	Direct—cost of setting up central database(s), or networks of databases, to access data from databases in other Member States
Responsible lending (Article 9). Credit providers must adhere to the principles of responsible lending when making lending decisions, basing such decisions on an assessment of a customer's ability to pay	May protect consumers from overcommitting due to unscrupulous management of personal finances. However, it is already not in the interest of credit providers to lend to consumers in this manner. Thus, the beneficial impact is likely to be small	Direct—system costs to record lending decision process; increased risk of litigation and irrecoverable legal costs (even if legal defence is successful) Behavioural—credit providers are likely to become less willing to lend to consumers in the sub-prime market or with lower credit rating
Exchange of information and duty to advise on the most appropriate credit product (Article 6). Credit providers must make a certain minimum set of information available to consumers during the course of negotiating and concluding a credit agreement. They must also advise on the most appropriate form of credit prior to the conclusion of a credit agreement	Some consumers may benefit from the compulsory advice. They may opt for a more appropriate form of credit to that which they originally intended to use, on the basis of advice received	Direct—depending on interpretation, the cost of staff and premises in order to carry out interviews with customers (especially for distance sales); inconvenience for consumers, not all of whom necessarily want advice from credit providers Behavioural—credit providers may restrict the range of credit products available; some may reorganise into separate monoline (or similar) businesses Competition—credit providers may only be willing to provide quotes after customer interviews; this makes getting quotes more difficult, increasing search costs and reducing competition

Costs and benefits per provision (cont'd)

Provision of the CCD	Benefits	Costs
Index-linking of interest rates (Article 14). Variable borrowing rates must be linked to an agreed base rate and can only be varied in line with that base rate	Lenders will be forced to change interest rates immediately in line with changes in the chosen reference rate	Direct—credit providers are unable to change margins in response to changes in consumer default risk; therefore this risk will be priced into borrowing rates up front, leading to a higher cost of borrowing, especially for consumers who during the course of a credit agreement prove to be low-risk Inability to change margin in accordance with customer default risk conflicts with the new Basel Accord Competition—the inability to reduce rates on all credit agreements except new ones without getting the agreements re-signed suppresses competition between credit providers
Restrictions on pricing/unfair contract terms (Article 15). Charges and fees must be held constant throughout the life of a credit agreement	Similar to 'index-linking' above	Direct—credit providers are forced to hold charges and fees constant in nominal terms. Therefore they are unable to raise charges to reflect increases in their own costs or reduce them to reflect efficiency increases. Expected future cost increases would be factored into the level of charges and fees up front, increasing the cost of credit Competition—the inability to pass on cost reductions that reflect efficiency improvements, except new ones, without getting the agreements re-signed suppresses competition between credit providers.
Re-signing of credit agreements (Articles 10, 15 and 34). Changes to credit limits and interest rates cannot be made without customers re-signing the credit agreement	Possible small benefit from increased customer awareness of terms of credit agreements—may increase competition marginally	Direct—one-off costs of setting up large temporary operations to handle postage and processing of all re-signed agreements within two years of implementation of the CCD Ongoing costs of postage and processing to deal with re-signed agreements whenever terms and conditions of credit agreements changed Inconvenience of additional paperwork for consumers, especially where changes in conditions of credit agreement are either legally sanctioned or in the best interests of the consumer (ie, introduction of Chip/PIN technology on credit cards)

Costs and benefits per provision (cont'd)

Provision of the CCD	Benefits	Costs
Re-signing of credit agreements (Articles 10,15, and 34)	–	Behaviour—increased cost of changes to interest rates and credit limits means that changes would be made less often. Credit providers using prudent 'start low and then grow' approach to lending would be likely to provide higher initial credit limits to customers in order to reduce need for future increases. This conflicts with responsible lending provisions
Joint and several liability (Article 19). The present joint and several liability provisions of Section 75 of the Consumer Credit Act 1974 would no longer hold for credit-card transactions	Removes joint and several liability for credit-card issuers. The cost savings for issuers are likely to be small. Furthermore, any benefit for issuers is a direct cost to the credit-card holder. They will no longer benefit from the joint and several liability protection for credit cards	Direct—no significant effects. Behaviour—credit-card issuers may 'voluntarily' provide joint and several liability-type cover (minus cover for contingent losses) to consumers in order to differentiate their credit card from credit cards offered by other issuers
Definition of credit intermediaries to include affinity partners (Article 2). Affinity partners, such as charities, universities and football clubs, would be considered credit intermediaries and be required to hold a copy of each credit agreement with which they were affiliated	–	Direct—costs for affinity partners to be registered and to receive and store copies of all credit agreements made with credit provider (typically credit-card or personal-loan provider). Extra costs involved would lead to a reduction in the amount of money available for charitable purposes.
Right to withdrawal and cooling-off (Article 11). The cooling-off period is extended and will now also apply to credit agreements signed and negotiated on business premises rather than just to credit agreements signed off business premises	Marginal reduction in default if some consumers during the course of cooling-off period decide to withdraw from credit agreements that would have caused them to default	Direct—no direct compliance costs to credit providers, except unfavourable reaction from consumers Behaviour—retailers unwilling to release goods purchased under credit agreements until the cooling-off period has elapsed. This is likely to lead to the elimination of the provision of credit by retailers at the point of sale Consumers likely to use other forms of credit (ie, overdrafts, credit cards and mortgages) so that they will not have to wait until the cooling-off period expires before they can take delivery of the goods
Early repayment provisions (Article 16). Indemnities to be paid by the consumer in case of early repayment must be calculated according to 'actuarial principles'	Increase in early repayment rebates for customers using credit providers that calculate rebates with the 'Rule of 78' where this is used on high-value longer-term loans	Direct—-systems changes (eg, accounting systems) for credit providers that currently use the 'Rule of 78' to calculate repayment penalties on the basis of actual cost and as a method for accounting

Provision of the CCD	Benefits	Costs
Introduction of borrowing rate and total lending rate (Articles 13 and 14). Credit providers must present the borrowing rate and the total lending rate to potential customers in the course of negotiating and concluding a credit agreement	Increase in the amount of price information available to consumers	Direct—systems changes in order to calculate the new rates; changes to marketing and contract information in order to display the new rates Indirect—confusion among consumers who already often have difficulty in understanding the present annual percentage rate (APR). This could reduce competitive pressure to the extent that consumers are unable to understand the information presented to them sufficiently well to be able to make comparisons.
Ban on unsolicited negotiation of agreements outside of business premises	Assuming that the existing definition of 'business premises' is maintained, this is unlikely to represent any significant change to current rules	There are unlikely to be any significant effects