Oxera

Agenda

Advancing economics in business

The Consumer Credit Directive: cross-border trade at all costs?

The European Commission has recently presented a revised proposal for the Consumer Credit Directive, which will seek to develop cross-border credit among Member States. Yet will the proposal really work in the interests of consumers and lead to transparent competitive markets? Eric Leenders, Director, British Bankers' Association, and David Rees, Chairman of the Consumer Credit Association Law Committee, suggest that the outcome is far from certain

Whenever asked to consider the UK credit market in its widest sense, but equally in terms of retail banking, the first thought that springs to mind is that the industry is without doubt in the midst of a period of unprecedented scrutiny of what is unequivocally one of its core competencies.

In considering the Consumer Credit Directive, the starting point for this article is the context within which it must be made to fit. The 'democratisation' of credit has created a vibrant market in the UK, second only to the USA in scale. It is an enabler, often referred to as the oil in the engine of commerce. And there is a lot of it; the cost of money has been relatively cheap in the past ten years, and when coupled with low unemployment and pay rises that have at least matched inflation, the climate has been good for lenders and borrowers alike.

Crowther and the democratisation of UK credit markets

The 1971 Crowther Committee was asked to review the UK's outdated and cumbersome credit laws. The Committee knew what it had to do. It saw that 'antiquated provisions' and 'official restrictions' were holding back the credit industry. By removing these it could:

> make an increasing contribution to the efficiency of the national economy and to the standard of living of the public.[1]

The Crowther report was a huge success, becoming the blueprint for the UK's 1974 Consumer Credit Act. Largely as a result of this timeless piece of law, the UK market has grown to become the most dynamic and vibrant in the world after the USA.

The statistics tell the story. The UK now has over 11m mortgages, 65m credit cards, 55m current accounts, 15m mail-order users, and around 3m home credit users.[2] Consumers have shown themselves able to handle these products and most UK households use credit 'modestly', according to research commissioned for the UK Department of Trade and Industry (DTI).[3]

This massive democratisation of credit has been good for UK consumers and has helped support and grow the UK economy. The memories of the UK's once old-fashioned and uncompetitive credit market have faded. Today's consumers would be astonished to learn how hard it once was to get credit.

However, success has brought high visibility and a high profile which, in turn, have attracted a great deal of critical scrutiny. In some ways this is not new: credit has had a 'bad press' for millennia.

'Europe could end up with a badly designed credit law'

The recent media and consumer group criticism carries a serious risk. UK credit markets offer huge choice and are highly competitive. Ill-considered policy changes could just as easily reverse all this. Credit supply could fall and competition could weaken. This would be bad news for UK consumers and the UK economy.

There will always be individual cases where consumers have got into difficulties with credit. The industry recognises these and is keen to put in place systems to help these users. However, the industry also insists that, in the main, credit is a force for good, giving consumers purchasing power and allowing them to smooth consumption. In fact, EU-commissioned research shows that the more underdeveloped a state's credit market, the more severe its consumers' debt problems.[4] These citizens have no tool to cope with unexpected expenditures.

This is part of the dilemma facing the EU as it considers the proposal for a new Consumer Credit Directive (the proposal). The EU recognises that credit is the oil in the engine of commerce, but it also hears the hostile media and consumer group comment. Furthermore, it worries that credit is not being purchased 'cross-border', as was envisaged when the 1987 Directive (87/102/EEC) became law.

The UK industry recognises these concerns, and understands the commercial importance of credit to the EU economy. Most UK lenders would also welcome any chance to deploy their know-how in opening up new market opportunities (especially given the intensity of competition in the UK).

Where the industry differs from the EU is in its vision of such a market opportunity. Just how will 'a genuine internal market in consumer credit' look?

Can credit ever be sold cross-border?

The proposal's broad premise is that a harmonised contract form and process will encourage lenders to lend cross-border, which, in turn, will create 'a genuine internal market in consumer credit'. Cross-border, according to the Commission, involves a lender in state A granting credit to a consumer in state B. At first glance this seems to make perfect sense. After all, many other products (including some financial services products, such as insurance) are sold in just this way.

However, the UK industry sees this analysis as flawed.

Credit, unlike most other products, involves a special form of 'residual risk'. Lenders have to judge whether a debtor will make repayments that stretch into the future. They do this based on experience and knowledge. So lenders need a good 'feel' or statistical view of how debtors behave. They must also have a good knowledge of debt-recovery processes and how effective they are.

A lender in state A will be able to make these judgements in its own state. But it may not know how a state B consumer will behave, or how that state's recovery processes work.

'Consumer credit laws must be proportionate and can best be delivered at Member State level'

These are simple, but important realities. They mean that ad hoc cross-border lending (in the Commission's sense) is a hazardous prospect. Given current arrangements, few lenders would risk their funds in such a way, and this is probably the main reason why cross-border lending is so limited.

Nothing in this proposal really addresses these problems. Debt-recovery processes differ widely across Member States and are embedded in national legal systems. Wage assignment, for example, is commonplace in some Member States, but is an unknown concept in the UK. Predicting debtor behaviour in another country is also next to impossible unless the lender has a large 'pool' of customers in that country. Database access may be some help, but has its limitations.

So how will lenders go cross-border?

UK creditors have a highly pragmatic approach to all this. They are hungry for new markets, but have to be efficient in attacking them. 'Scale entry' is the most sensible, commercial way to enter a new market.

'Scale entry' means total commitment to a credit market in another state. The lender aims to win not 100 customers, but 100,000. It will set up a branch, a subsidiary, or perhaps a joint venture in the new market, and employ local staff who speak the language and understand the culture. It will spend what it takes to learn about lending risks and recovery processes in that market, and can justify that spend because it is going to issue 100,000 loans.

Scale entry is cross-border trade, but not as the Commission recognises it.

UK firms have taken to scale entry into other credit markets with gusto. Some have succeeded; some have failed. The proposal would not increase the scale of this activity (but could decrease it, see below). UK suppliers that have entered new markets confirm that contract formation processes are easy to handle; the differences from state to state are not a barrier to scale entry.

A brief overview of the macroeconomics

The EU rightly sees bigger markets as more competitive and thus better for consumers. This is why the Commission wants to promote cross-border credit; it sees lenders based in one state offering credit to citizens in a range of other states.

As noted above, the Commission's version of cross-border lending is unlikely to work, but scale entry (which is working) offers the same eventual economic benefits that the Commission seeks. More players in any national market means greater choice and more intense competition.

Across Europe generally, the scale entry process has developed rapidly over the past 15 or so years, and

there has been no required change to EU credit law for this to happen.

Protecting the consumer

Consumer protection elements are important to any new law. UK consumer groups have expressed concern about the 'levelling down' of protections as part of the trade-off in generating more cross-border trade. The credit industry shares these concerns, especially as we fail to see how the proposal will generate extra trade in credit.

The DTI is in the closing stages of a major review of UK credit laws. The focus of this work has been on improving all aspects of transparency, both at the contract stage and afterwards. Many of these improvements could possibly be swept away by a maximum-harmonisation proposal.

New exemptions in the proposal are of concern as regards consumer protection. In effect, they take hire purchase, short-term '0%' retail credit, and pawnbroking completely outside of legal control. The UK industry does not support these exemptions. Nor would it expect the DTI to implement them into UK law.

There may, however, be unwelcome effects for consumers in the rest of Europe. We could see markets in continental Europe quickly distorting in favour of these exempt products, narrowing consumer choice and reducing competitive forces. Where the exemptions are applied, they will protect domestic incumbent suppliers. Any such national market will be 'ring-fenced', blocking off potential new entrants.

These problems may not stop at the UK border. It is conceivable (depending on the eventual text of the proposal) that continental European providers may be able to 'import' these unregulated formats into the UK market. If this were to happen, it would not only distort the UK market, but also undermine the past 30 years of UK credit law development.

There are other aspects of the proposal where the desire to 'protect' consumers may in fact damage their interests. Take, for example, the 14-day cooling-off period. If this leads to suppliers holding back goods for 14 days, customers may use their credit cards instead. This distortion, purely the result of a legal measure, could reduce competitive forces.

Most damaging are the proposals on responsible lending and duty to explain. At first glance, these sound helpful for consumers. However, they could lead to significant reductions in credit availability, increased financial exclusion and declining economic growth. A much more sensible model is that contained in the Consumer Credit Act 2006, which empowers the regulator (the Office of Fair Trading) to investigate if a lender is considered to be 'lending irresponsibly'.

Impact assessment and the Lisbon Strategy

The Lisbon Strategy is the centrepiece of the EU's plan to become a competitive player on the global stage. At the heart of this strategy is 'Better Regulation', a policy that President Barroso has embraced whole-heartedly. Commissioner McCreevy, the Internal Market Commissioner, has pledged to withdraw any draft law unless a proper economic analysis has been undertaken.[5] This approach is to be welcomed, but only if the EU acts on it in practice.

In the case of this proposal, the Commission has not delivered on its Better Regulation promises. Admittedly, the first draft of the proposal pre-dated the latest Commission approach, but the disappointing reality is that at no stage in the past four years has the Commission carried out any sort of valid impact analysis.

In 2002, a group of UK lenders commissioned an in-depth study of the original 2002 Commission proposal (COM 2002/443). The report concluded that the proposal could have depressed UK GDP by around 0.2% and caused UK consumer spending to fall by 0.6%. In addition, it could have financially excluded 2m UK consumers.[6]

Key drivers of these economic outcomes were the responsible lending and duty to advise provisions in the 2002 text, and these provisions remain in the current text (albeit in slightly altered form). The UK industry believes that the conclusions of the independent study still apply and that the current text could damage the UK economy and the interests of UK consumers.

What level of harmonisation?

Officials are expending a great deal of intellectual energy in seeking to devise complex 'multi-layered' harmonisation and mutual recognition systems. The aim seems to be to preserve national systems as much as possible, while creating an environment in which 'cross-border' trade (as the Commission understands it) can flourish.

At first glance, some simple harmonisation seems possible in a number of areas. For example, it might be feasible in relation to pre-contract information, right of withdrawal, and over-running of accounts. It could also be sensibly considered in the context of contractual information, standardised APRs and credit bureau

access. However, even these straightforward areas reveal hidden complexities.

The problem is that two overriding questions remain. First, will these harmonisation/recognition systems change lender behaviour, moving them away from the scale entry model? Second, will this all undermine consumer protection? The UK industry sees the answer to the first question as 'no', and to the second question as 'yes'.

Overall, the UK industry agrees with the DTI, which argues that consumer credit laws must be proportionate and can best be delivered at Member State level.

Next steps

The latest proposal has moved a long way since the 2002 text, perhaps even to the extent that one might question the need for any change at all. Yet even this heavily revised text continues to generate serious concerns.

The UK industry would fully support any proposal that did not damage the functioning of the UK credit market and the interests of UK consumers. The problem is that, in seeking to create a cross-border market, this is what the current text will do. A further irony is that a damaged UK industry will not have the funds to enable it to expand abroad.

The proposal is currently being considered by a working party that reports into the Council of Ministers. The Council will ultimately agree the shape of the Directive that is returned to the European Parliament for a second reading. Where these negotiations will lead is pivotal: there are opportunities to make improvements in discrete areas of credit law that will truly raise, rather than lower the bar.

On the other hand, Europe could end up with a badly designed credit law. This would claim to 'protect' consumers but could, in reality, damage their interests by harming the most successful credit markets and by reinforcing protectionist tendencies in others. This would all stunt, rather than promote, EU growth.

An in-depth, independent impact assessment would quickly confirm these outcomes, but this is a step that Commission officials do not seem prepared to take.

Eric Leenders and David Rees

---

[1] Committee on Consumer Credit (1971), 'Report of the Committee on Consumer Credit', under the presidency of Lord Crowther, Cmnd 4596, March.
[2] Source: banking and credit trade associations.
[3] Kempson, E. (2002), 'Over-indebtedness in Britain', commissioned by the DTI, September.
[4] ORC Macro (2001), 'Study of the Problem of Consumer Indebtedness: Statistical Aspects Contract n°: B5-1000/00/000197—Final Report', prepared for DG Health and Consumer Protection, October.
[5] In a speech to the European Parliament's Legal Affairs Committee on February 2nd 2005, Commissioner McCreevy stated that:

> Secondly, we must ensure that our rules are effective and cause the minimum burden for business … The Barroso Commission wants to lead by example. No proposal leaves the house without having been subject to thorough impact assessment. There is wide consultation. A major simplification and codification exercise is under way. Ex-post evaluation is becoming the norm.

[6] Oxera (2003), 'Assessment of the Economic Impact of the Proposed EC Consumer Credit Directive', July. Available at www.oxera.com.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

Other articles in the July issue of *Agenda* include:

- **essential or nice to have? a competition-based framework for 'rail-related services'**
- **in search of a lasting solution: the 2006 Energy Review**
- **regulation on tap: looking ahead to PR09** ***Melinda Acutt, Ofwat***
- **the cost of raising capital: an international comparison**

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com

© Oxera, 2006. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.