Harmonising credit: a rocky road ahead?

The EU Council of Ministers and European Parliament will soon be discussing a revised proposal for a Directive on Consumer Credit. The first draft of the Consumer Credit Directive was published in 2002, but was rejected by the European Parliament because the costs for credit providers resulting from the Directive (ultimately affecting consumers) were considered too high. This article provides an economic perspective on the costs and benefits of the revised drafts of the Directive.

The Consumer Credit Directive has had a rough ride over recent years. The European Commission recognises that the current version, which dates back to 1987, is out of date, given the increase in volume of credit provision, the emergence of new credit products, and the convergence of European markets. However, the creation of a revised version has been problematic.

The EU Council of Ministers is soon to discuss a modified proposal. The overarching benefits cited by the Commission are that the new Directive will enhance European consumer protection while enabling a pan-European market for credit, thereby fostering competition. However, the revised draft does involve potential costs and factors that may limit the extent to which some of the cited benefits might be realised. This article takes a closer look at these potential limitations, focusing on consumer protection and competition. The analysis is based on recent research conducted by Oxera for the industry associations representing the credit sector in the UK.

Effective consumer protection?

One of the objectives of the Consumer Credit Directive is to enhance consumer protection. Like many other markets in the financial services sector, the market for consumer credit is characterised by particular risks, and relating to these, market failures. There are information asymmetries in both directions between the credit provider and debtor—it is not straightforward for credit providers to assess consumers’ creditworthiness and future ability to pay off a loan. Furthermore, in an unregulated market, due to the complexity of credit products, the offering of such products may lack transparency—for example, credit providers could present the costs of borrowing in different ways, making it difficult for consumers to understand the real costs of borrowing and compare prices across credit providers.

These characteristics mean that, in the absence of any regulation, the market for consumer credit may not work properly, which explains why, in most countries, the provision of consumer credit is regulated.

The Directive introduces provisions that improve transparency and make it easier for consumers to understand credit products. In addition, it attempts to address concerns about irresponsible lending practices and the likelihood that households could become overindebted, by introducing two specific provisions:

- the creditor must adhere to the principle of responsible lending (and/or assess the creditworthiness of the consumer);2
- the creditor must provide adequate explanations to the consumer such that the consumer can assess whether the proposed credit agreement is adapted to their needs and financial situation.

At first sight, the introduction of the principle of responsible lending and the duty to explain can be considered a positive contribution to consumer protection. The ultimate effects on the industry and consumers will depend on how these provisions are transposed into national law and interpreted by the courts and/or out-of-court dispute settlement systems (eg, a financial ombudsman service, which the Consumer Credit Directive requires Member States to set up).

However, the effects of these provisions could be counterproductive, incurring two types of cost.
Increased costs. The provisions could require lenders to retain more information about credit applications and assessments in order to defend their decisions in disputes. Furthermore, they may result in a more costly and time-consuming sales process. Given that the same process would be applicable to all amounts of credit, a flat cost would be imposed on each credit contract. At the smaller end of the scale, the cost of providing credit will become relatively expensive, possibly making the provision of smaller loans unattractive to lenders.

Increased risk. The supply of credit inherently involves an element of risk. The provisions of the proposed Directive introduce an additional lending risk (the risk of compensation claims) and may result in lenders cutting back on the supply of credit, particularly to more risky consumers such as those with low income and/or poor credit ratings.

Lenders’ decisioning systems can only identify degrees of likelihood that a customer will repay. This means that a lender can usually gauge what percentage of a group of its customers will default. However, the lender cannot identify precisely which individuals those defaulters will be. Although the restrictions may affect consumers who would have become over-indebted anyway (in the absence of the regulation), they are also likely to affect consumers who would not have become over-indebted, thereby excluding certain consumers from the provision of credit.

Excluding certain consumers from credit may make them seek credit from illegal lenders. Research shows that people who are refused loans by legitimate lenders often obtain credit from illegal lenders. In the UK, where lenders serve even the highest-risk borrowers, including those in the sub-prime market, the number of consumers financially excluded is relatively low. Levels of illegal lending in the UK are low compared with other major European countries such as France and Germany, where, partly due to tighter regulatory environments, consumers with high risk are less likely to be able to obtain credit from legitimate lenders. The incidence of illegal lending in Germany is two and a half times higher than in the UK, and that in France is three times higher than in the UK. Illegal lending often involves high levels of consumer detriment in the form of very high costs compared with legal forms of lending, and recovery processes and techniques that would not be tolerated in any legal market.

To enhance a market’s effectiveness, a combination of different types of regulation and market-based instruments is often required. A piecemeal approach may not be sufficient. For example, from an economics point of view, it would not be efficient to seek to use consumer protection regulation to eliminate all cases of over-indebtedness. Such regulation is aimed at avoiding situations of over-indebtedness by providing consumers with sufficient information and addressing unfair business practices. However, in practice there are always likely to be some borrowers who are not able to meet their financial obligations. For example, they may get into financial difficulty as a result of unanticipated events, such as unemployment or divorce, which were not known when the loan was granted. These cases of over-indebtedness are more efficiently dealt with by appropriate insolvency regulation or the purchase of insurance products by borrowers. Thus provisions that put the responsibility for the lending decision at the feet of the lenders may have the unintended consequence of restricting access to credit for higher-risk customers. This may result in an overall detriment to welfare, especially if this leads those customers to use forms of illegal lending.

Cross-border credit and entry barriers

As noted above, another objective of the Directive is to contribute to the creation of a single European market for consumer credit by ‘establishing the conditions for a genuine internal market’. The logic behind this is that creating such a market may result in increased competition, lower prices and a greater variety of credit products, thereby enhancing consumer welfare.

The theoretical concept underpinning the Directive is that, by harmonising credit regulation across EU Member States, providers would find it easier to offer credit across borders—and at the same time, consumers shopping around could be assured that they benefit from the same degree of protection, irrespective of the origin of the credit product.

There are a number of ways in which cross-border credit may be offered and in which a single European market for consumer credit could develop. For example, credit providers in one Member State may:

- start offering credit in another Member State by opening an office or setting up a network of branches in that Member State;
- enter into a joint venture with an existing local credit provider, or acquire, or merge with, a local credit provider; or
- start offering credit in another Member State by using their offices in their own Member State. The credit provider would then typically offer credit over the Internet and/or by phone.

As part of Oxera’s research, interviews were conducted with a number of credit providers. The majority of credit providers expressed concern that cross-border credit would be subject to high risk and that the cost of compliance would be high.
Barriers to offering cross-border credit

- **Lack of brand or reputation**—consumers may not be familiar with the brand and reputation of the foreign credit provider. This may impair consumer trust and confidence in credit providers from abroad.

- **Natural barriers**—when entering a foreign market, the credit products and marketing activities will normally need to be tailored to suit local consumer habits, attitudes and needs. To market their credit products successfully, credit providers often have to hire staff locally and serve consumers in their native language.

- **Distribution channels**—the availability of distribution channels will affect the ease with which credit providers can enter new markets. For example, credit providers may find it more difficult to enter countries where most others have their own distribution networks.

- **Risk assessment**—to make the provision of credit in foreign countries or any other new market segment commercially viable, credit providers need to have a clear understanding of the risk profiles of their potential credit applicants, and these are likely to differ across countries. For a credit provider entering a foreign market, there is no existing pool of customers against which to assess risk. Although credit providers can obtain access to a domestic credit bureau, they often need more information to build their own credit score models in order to develop a competitive business offering in a new market.

- **Debt recovery**—the way in which debt can be recovered varies from one Member State to another due to differences in regulation and legal systems. For example, some countries have provision for wage assignment whereby if a consumer misses a certain number of repayments, the balance is taken directly from their salary. This differs from other countries where wage assignment is not available or where a court order is required. Furthermore, the optimal strategy towards debt recovery often depends on consumer attitudes, and is therefore likely to differ across countries.¹

- **Differences in regulation of consumer credit**—as credit legislation varies from country to country, a provider wishing to enter a new market would need to understand the legislation on consumer credit as well as that governing contracts and agreements.


Source: Oxera.

providers interviewed indicated that offering credit across borders is unlikely to be a realistic option for them. Their preferred method for entering foreign markets is in the form of a joint venture, through mergers and acquisitions, or by opening their own local offices or setting up their own network of local branches. This is because of the range of entry barriers that must be overcome in order to offer a credit service.

There are a number of barriers to offering cross-border credit. Some of them are generic to a wide variety of products, while others are more specific to credit products. The most important are summarised in the box above.

As barriers to entry are often a matter of degree, they do not necessarily preclude entry, but may affect the ways in which credit providers enter foreign markets. For example, lack of brand and reputation is one of the reasons why credit providers often enter foreign markets in the form of a joint venture, or through acquisition of a local credit provider with an established brand and reputation. Furthermore, although the lack of brand and reputation may make entry by a credit provider on its own more difficult, there are examples where credit providers have successfully built up a brand and reputation in foreign markets. There are currently pan-European credit providers with a presence in a growing number of EU Member States.

Similarly, although the availability of distribution channels is likely to facilitate entry, there are banks that have managed to enter foreign markets by offering their products over the Internet rather than using the traditional distribution channels. One such example is the Dutch bank, ING, which has recently started offering mortgages in addition to savings accounts in a number of Member States.

Some of the barriers highlighted in the box above relate to the core business expertise of credit providers—for example, the ability to assess the risk profile of credit applicants and to recover debt from defaulting customers. Credit providers often use scores from credit reference agencies to assess the creditworthiness of applicants in combination with their internal credit score models. To build such models, sufficient information is required about the risk profiles of credit applicants in the foreign markets. An alternative is to purchase a loan portfolio of existing credit providers. Assessing the risk profiles of credit applicants and building credit score models is costly and are therefore normally only worth doing if the new market segment is entered into on a certain scale. Similarly, developing a business strategy to
recover debt from defaulting customers is costly and is often only commercially viable if undertaken on a certain scale.8

Furthermore, offering cross-border credit to consumers who shop around in different countries is likely to be risky and therefore often not an option. In the main, there is little demand for cross-border credit, although some providers have cited anecdotal evidence that when consumers do search for credit across borders, this is often because they have been rejected by domestic credit providers. Interviews with credit providers have indicated that they would not lend directly to individuals in foreign countries where they had no commercial activity because of the difficulties of assessing risk and recovering debt, which are integral parts of the lending process.

**Does the Directive lower entry barriers?**

To what extent does the Consumer Credit Directive remove these barriers? As it removes only some of the differences in regulation of consumer credit across countries, its impact may be limited. First, in contrast to the 2002 draft of the Directive, which proposed maximum harmonisation of regulation across Member States, the 2006 Directive provides de facto minimum harmonisation, since it allows Member States to impose additional requirements on credit providers. Second, and more importantly, although harmonisation of credit regulation may reduce some of the costs incurred by credit providers when entering foreign markets, in terms of order of magnitude, these costs are likely to be small compared with the costs resulting from the other remaining barriers. For example, as explained above, once a credit provider has decided to enter a foreign market, it incurs significant costs in developing credit score models and a strategy on debt recovery. This often means that it is worth having a local presence, which would also make it easier to hire local staff. The additional costs incurred by the credit provider in making sure that its business practices comply with local credit regulation are then likely to be small.

This reflects a key difference between the provision of credit products and other—in particular, non-financial—products that are bought and sold over the Internet across borders, such as electronic appliances and other consumer products. For these products, the supplier does not need to know anything about its customers other than the delivery address. By contrast, in the case of the provision of credit products, in order to make its business commercially viable, it is crucial for credit providers to understand the risk profile of credit applicants in the new markets and the way in which debt can be recovered if they default.

Mergers, acquisitions and entering at scale by opening offices in foreign markets are therefore likely to continue to be the main mechanisms through which the European market for consumer credit will develop. The Directive’s contribution to the creation of a single European market for credit may therefore be limited.

**Retail financial services**

**Green Paper**

The preparation of the Consumer Credit Directive has resulted in a lively debate about how to create a single European credit market. This debate should be considered in the broader context of the Commission’s current review of the single market to ensure that its policies are fit for the 21st century. The recent Green Paper on retail financial services in a single market seeks to strengthen and deepen the Commission’s understanding of the problems faced by consumers and industry in the field of retail financial services, as well as to establish the scope for, and impediments to, further initiatives in this area.7 The consultation is open until July 16th and a hearing will be held on September 19th 2007.

---

2 Article 5 (1) of the 2005 Directive states that ‘the creditor … shall adhere to the principle of responsible lending’, while the 2006 Directive does not explicitly mention ‘responsible lending’, but refers to an ‘obligation to assess the creditworthiness of the consumer’. In addition, according to explanatory note 19: ‘Member States should take the appropriate measures to promote responsible practices during all phases of the credit relationship.’
4 Ibid.
5 Explanatory memorandum to Consumer Credit Directive, November 23rd 2005, Section 2, p. 3.
6 Certain elements of debt recovery activities may be outsourced to specialised debt collection companies.

© Oxera, 2007. 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.
Harmonising credit: a rocky road ahead?

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 May issue of Agenda include:

- 25 years on: markets transformed and the European ethos  
  Professor Dieter Helm
- coup de grâce? private actions for damages in Europe
- taming the beast? regulating German electricity networks

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

www.oxera.com