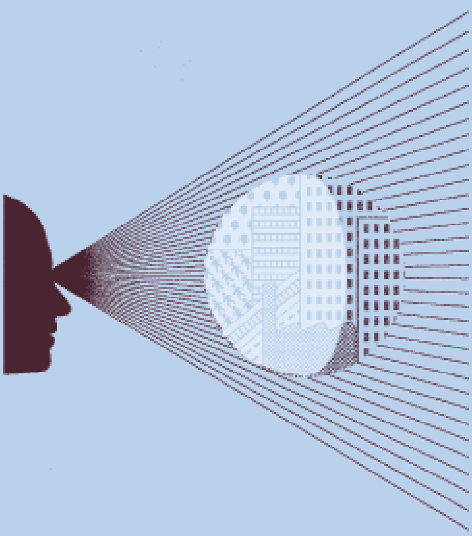
Oxera

What is the impact of the proposed Consumer Credit Directive?

Prepared for APACS/BBA/CCA/FLA

April 2007



Oxera Consulting Ltd is registered in England No. 2589629 and in Belgium No. 0883.432.547. Registered offices at Park Central, 40/41 Park End Street, Oxford, OX1 1JD, UK, and Stephanie Square Centre, Avenue Louise 65, Box 11, 1050 Brussels, Belgium. Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented herein, the Company accepts no liability for any actions taken on the basis of its contents.

Oxera Consulting Ltd is not licensed in the conduct of investment business as defined in the Financial Services and Markets Act 2000. Anyone considering a specific investment should consult their own broker or other investment adviser. The Company accepts no liability for any specific investment decision, which must be at the investor's own risk.

© 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.

Executive summary

Oxera has been commissioned by APACS, the British Bankers' Association (BBA), the Consumer Credit Association (CCA), and the Finance & Leasing Association (FLA) to assess the impact of the revised versions of the proposed Consumer Credit Directive (CCD) on credit for consumers and, more broadly, the UK economy.

The first draft of the CCD was published on September 11th 2002[1] ('the 2002 Text'). The impact of the 2002 Text on the UK economy was assessed by Oxera in a study (commissioned by APACS, BBA, FLA, and the Council of Mortgage Lenders) published in July 2003.[2]

Since the publication of the 2002 Text, further texts have emerged. The European Commission issued a formal revised text on October 7th 2005 ('the 2005 Text').[3] Since then, other, informal texts have emerged from the Council Working Group process. The most widely recognised of these informal texts was that issued on November 11th 2006 under the aegis of the Finnish Presidency ('the Finnish Text').[4] Hereafter, references to the proposed Directive relate to the 2005 and the Finnish Texts.

This study provides an update on the impact assessment conducted by Oxera in 2003, taking into account the changes to the 2002 Text and assessing the impact on the UK economy of a number of specific articles in the 2005 and the Finnish Texts. There are some differences between the 2005 and the Finnish Texts; however, these differences are small. The overall conclusions in this present report are valid in respect of both texts.

Key findings

The Oxera 2003 study identified a number of articles in the 2002 Text that could result in a serious negative impact on users of credit and on the UK economy. In the proposed Directive, some of these articles have been altered or deleted.

The Commission has decided to consider mortgages separately,[5] and has therefore removed the proposals relating to mortgages from the proposed Directive. Examples of alterations and deletions include a partial exemption for overdraft facilities and deletion of the requirement to get customers to re-sign agreements in certain situations. The main changes are summarised in Table 1 below.

Notwithstanding the changes made to the 2002 Text, there are still a number of provisions that are likely to result in costs for credit providers (which would ultimately be passed on to consumers) without providing significant benefits to consumers. Such provisions include, in

[1] Commission of the European Communities (2002), 'Proposal for a Directive of the European Parliament and of the Council of the EU on the harmonisation of the laws, regulations and administrative provisions of the Member States concerning credit for consumers', 2002/0222 (COD).

[2] Oxera (2003), 'Assessment of the economic impact of the proposed EC Consumer Credit Directive', July, available at www.oxera.com.

[3] Commission of the European Communities (2005), 'Amended proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers repealing Council Directive 93/13/EEC', 2002/0222 (COD), October.

[4] Council of the European Union (2006), 'Modified proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers repealing Council Directive 87/102/EEC and amending Council Directive 93/13/EEC', 2002/0222 (COD), December.

[5] European Commission (2007), 'Internal Market: expert groups report on integration of EU mortgage markets', IP/07/54, January 17th.

particular, Article 7a which imposes a statutory duty on the lender to undertake a creditworthiness assessment, and Article 5 which imposes a duty on credit providers 'to provide adequate explanations to the consumer, in order to put the consumer in a position to assess whether the proposed credit agreement is adapted to his needs and to his financial situation'. The impact of these provisions and a number of others is summarised in Table 2 below.

The proposed Directive, if implemented, could result in a serious impact on users of credit and the UK economy. The medium scenario prepared in this study shows the following:

– consumer spending falling by around 0.21% (or around £1.4 billion/€2 billion) within two years of the implementation of the Directive;

– overall GDP falling by around 0.08% (or around £850m/€1.2 billion) within two years of the implementation of the Directive;

– a significant proportion of consumers (estimated at between 1m and 1.7m) could be affected by a reduction in the amount of credit that lenders would be prepared to make available to them. They would either not be able to access legal sources of credit at all, or would be constrained in the amounts they could borrow.

The main causes of these outcomes are likely to be the following.

– A direct increase in the cost of providing credit—in particular, both the enforced duty to explain and the provision on responsible lending/assessing creditworthiness are likely to require lenders to store more information about credit applications and assessments. Furthermore, the duty to explain is likely to 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.

– A reduction in the availability of credit, particularly to those with lower credit ratings—the provisions on responsible lending/assessing creditworthiness would confer a new set of legal rights on consumers. Consumers would be able to activate these through new (free) out-of-court dispute settlement systems (which the CCD requires Member States to set up). The overall effect is likely to be to increase lending risk with the potential to cause lenders to cut back on supply. The effects would be most serious for those with low and/or irregular incomes, and those in the sub-prime market.

– A number of other changes are likely to add indirectly to the cost of providing credit, and may lead to common forms of credit no longer being as widely available. Changes of this type include, in particular, the provision for a cooling-off period for credit contracts concluded on retailers' premises.

Finally, it should be mentioned that the 2005 Text and the Finnish Text both contain exemptions for 'interest-free' credit, hire-purchase (HP) agreements and pawnbroking. BBA, APACS, CCA and FLA believe that it is unlikely that these would be implemented into UK law. In the UK the different types of credit are currently subject to the same regulation. Other Member States might, however, apply these exemptions. This could result in distorted competition across the EU. The lighter regulatory burden would mean that exempt products would be cheaper to supply (and more convenient for consumers to use). Furthermore, it would make it more difficult for lenders (for example, offering personal loans) to enter new markets and compete with local lenders offering exempt credit products such as HP and interest-free credit. The regulated credit provider would face price and customer convenience disadvantages.

Impact on the UK economy

The effects of the proposed 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 in the years following the implementation of the Directive.

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 proposed Directive on consumer spending and GDP in the UK. The medium scenario shows the following:

– consumer spending falling by around 0.21% (or around £1.4 billion/€2 billion);

– overall GDP falling by around 0.08% (or around £850m/€1.2 billion) within two years of the implementation of the Directive.

This is a lesser impact than the 2002 Text, primarily reflecting the fact that mortgages continue to be discussed outside the CCD process, as well as certain other changes that have been made. Nevertheless, the overall impact on consumer spending and GDP is still likely to be negative.

A higher cost of credit and a restriction on the availability of credit resulting from the Directive would also lead to a welfare loss to consumers. All users of credit would end up paying higher charges 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—between 1m and 1.7m consumers in the UK are likely to be affected.

Does the Directive result in effective consumer protection?

One of the implicit objectives of the Directive is to provide a high level of consumer protection and to prevent consumers from getting into financial difficulty and becoming over-indebted. However, the measures proposed are unlikely to be proportionate. From an economics point of view, it is not efficient to use consumer protection regulation to seek to eliminate all cases of over-indebtedness.

Consumer protection regulation (typified by the existing Directive) would normally seek, as far as is reasonably possible, to avoid situations of over-indebtedness by providing consumers with sufficient information and addressing clearly ‘unfair’ business practices. However, in practice, there will always be some borrowers who are not able to meet their financial obligations. The most commonly reported reason for financial difficulty is a collapse in income as a result of an unanticipated event, such as job loss or divorce. In general, such events cannot be anticipated at the time the loan is granted. These cases of over-indebtedness can be dealt with by appropriate insolvency regulation or the purchase of insurance products by borrowers.

Given this, if too stringent, regulation is likely to be counterproductive. The provision of credit inherently involves an element of risk. Placing too great a burden on lenders is likely to have a range of effects (depending on the type of burden)—for example, credit costs may rise, and credit supply may also be restricted.

In terms of the impact on consumers, 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.

This has a policy impact. It means that laws that aim to protect potential defaulters by intervening in the lender's credit-granting process will also exclude customers who would be able to repay.

The aim of a regulatory framework should not be to restrict the provision of customer credit but rather to allow a market that provides cost-reflective credit to those who require it.

Research shows that excluding certain consumers from credit is likely to make them seek it from illegal lenders, and that illegal lending often involves high levels of consumer detriment in the form of generally high costs compared with legal forms of lending, and recovery processes and techniques that would not be tolerated in any legal market.[6]

Will the Directive contribute to the creation of a single European market for credit?

Another objective of the Directive is to contribute to the creation of a single European market for credit by 'establishing conditions for a genuine internal market'. 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.

Lenders indicated that that they would not enter a foreign market in this way. Instead, they would approach this via joint venture, merger or acquisition, or by opening their own local offices. Some stressed the fact that this was (in their view) the only really commercially sensible way to enter a new market. It was also pointed out that having a local presence offered a wide range of extra commercial advantages. These would include aspects such as language skills, and general local knowledge.

Importantly, lenders stressed that complying with local credit laws (which is what the Directive addresses) was likely to be only a minor component of the overall cost of new market entry. There are obvious key differences between the provision of credit on the one hand and non-financial products (such as electronic appliances and cars) on the other. When goods are sold, the supplier will only release them against payment. So the supplier does not require any knowledge about the customer (except, perhaps, a delivery address). In the case of credit, the lender has risk to assess and must understand the profile of the borrower. If the borrower is based in another Member State, this creates two new difficulties in terms of this risk assessment. First, how do consumers in that other Member State behave, and, second, how are debts in that State recovered?

Thus, for all these commercial reasons, merger, acquisition and entering at scale by opening offices in foreign markets are likely to continue to be the main mechanisms through which the European market for consumer credit will develop.

Conclusion

The analysis in this study shows that the Directive is unlikely to achieve its objectives. Furthermore, although a number of amendments have been made to the draft text, the Directive is still likely to result in a negative impact on consumer spending and GDP in the UK.

[6] Policis and PfRC (2006), 'Illegal Lending in the UK', research report prepared for the DTI, November, URN 06/1883.

Table 1 Main differences between the 2005/2006 and 2002 drafts of the Directive

Provision in the 2002 Text but altered/removed in latest draft	Comments
Mortgages	The 2002 Text covered mortgages only in as far as they were used for 'consumption' purposes, rather than mortgages used solely to buy and renovate property. Covering the 'consumption' element raised several issues. For example, the Directive assumed that mortgage lenders would know the purpose of a mortgage, but this is not the case in practice; in general, they do not know or find this out. Owing to the way in which mortgages differ from other forms of credit (amount of credit provided, security against property, etc), there is arguably a case for regulating them separately. This is indeed the approach the European Commission has taken, and is also the approach taken in the UK, where mortgages are regulated by the Financial Services Authority (FSA).
Re-signing the credit agreement	The 2002 Text required a provider to get the customer to re-sign their credit agreement if the terms of the agreement changed. The 2003 Oxera study concluded that this requirement would result in a series of costs since credit providers would have to pay for more correspondence with customers, increase the number of staff handling customer queries and processing re-signed agreements, and make provision for following up customers who did not return their re-signed credit agreements. In the 2005 and 2006 drafts, this requirement has been removed.
Responsible-lending clause	The 2002 Text contained a clause entitled 'responsible lending'. In the latest draft, this has been moved from Article 9 to what is now Article 7a. It has also been significantly reworded and is now headed 'obligation to assess the creditworthiness of the consumer'. This is discussed in Table 2 and section 3 in the main text of this report.
Index-linking clause	The 2002 Text required credit providers to link variable borrowing rates to an agreed base rate, such that the borrowing rate could only be varied in line with that base rate. This has been removed from the latest drafts. The requirement would have made it impossible for credit providers to change margins in response to changes in consumer default risk; therefore they would have had to price the risk 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. Furthermore, it would have made it impossible for lenders to reduce rates on all credit agreements except new ones without getting the agreements re-signed—this would have suppressed competition between credit providers.
Restriction on pricing and unfair contract terms	The obligation to hold charges and fees constant over the life of the credit agreement has been removed from the 2005 and 2006 drafts.
Total lending rate clause	The necessity to calculate for the borrower the total lending rate and the borrowing rate has been removed. Having two different rates could have confused customers.
Central database clause	The 2002 Text would have obliged EU Member States to set up a central database (or a network of databases) to hold details on consumers and guarantors who have defaulted (ie, negative data). This requirement has been removed from the 2005 and 2006 drafts. The UK system of databases may have been affected by Article 8 in the 2002 Text. Whereas, at present, three credit reference agencies (CRAs) hold their own private databases, Article 8 could have been interpreted as obliging the UK to establish a central database or a network of (identical) databases in the UK. Therefore, the 'credit data' held by the CRAs in the UK would have to be similar in terms of the specification of the fields in the databases. Another option would have been to set up one central database with basic functionalities, which could be accessed by private database and credit providers. The private databases could then have offered 'value-added' functionality to compete with each other in providing their services to credit providers.
Restrictions on the use of data	This clause has been removed from the 2005 and 2006 drafts and there is no longer a restriction on the use of private customer data, as stipulated by the 2002 Text. The data protection clause in the 2002 Text placed strict limits on the use of personal data obtained from consumers, guarantors and others in the process of concluding a credit agreement. In particular, data collected for the purpose of assessing the financial situation and ability to pay of those seeking to take out credit would only have been allowed to be used for this purpose. This would have precluded the use of such data for any other purposes, such as marketing, thereby making marketing more expensive and less effective. In the UK, under the Data Protection Act 1998, consumers who do not wish their personal details to be used for marketing purposes are already able to 'opt out' of receiving marketing material. The additional benefit of the data protection provision in the draft CCD would therefore have been relatively small.

Note: The table 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.
Source: Oxera.

Table 2 Specific impact of the latest draft Directive

Provision	Impact
Responsible lending/assessing the creditworthiness of the consumer—Article 5(1) in the 2005 Text states that the creditor shall adhere to the principle of responsible lending, whereas Article 7 in the 2006 draft obliges the creditor to assess the creditworthiness of the consumer	While it is in the interest of the credit provider to assess the creditworthiness of the consumer, Oxera's discussions with providers make clear that there is a distinction between what lenders need to do in practice to run a viable credit business and what a statutory requirement to 'lend responsibly' or to 'assess creditworthiness' would require them to do. Providers interviewed by Oxera have indicated that a statutory requirement would, in their view, increase costs to credit providers, and would also cause them to change their lending practices (although not necessarily in a way that would benefit consumers). They would move to what they termed a 'more defensive' style of lending. Under this, they would have to assess not only credit risk (in the normal way), but also the risk of claims being made against them by debtors. The 'defensive' approach would also require lenders to record and store more information to assist in rebutting claims by debtors. See section 3.2 in the main text of the report.
Duty to advise—Article 5(5) in the 2005 and 2006 drafts require creditors to provide adequate explanations to the consumer, in order to put the consumer in a position to assess whether the proposed credit agreement is adapted to their needs and financial situation	Although the emphasis has shifted from a 'duty to advise' (2002 Text) to a 'duty to explain' (the Finnish Text), the overall impact on lenders is likely to remain more or less the same. The credit provider must provide sufficient information to the consumer so that the consumer can assess whether the credit agreement is appropriate. In practice, this is likely to mean that the credit provider has to provide some kind of advice on the appropriateness of the credit product. The actual provision of advice is an expensive activity for credit providers—consumer credit contracts normally involve much smaller amounts than other types of financial product, such as mortgages or investment products. Since this would be a statutory duty (which debtors could argue had been breached), credit providers would need—as a 'defensive' measure—to have in place internal systems that allowed them to keep a record of any advice given and (possibly) to record officially whether that advice had been followed. This would impose further costs on credit providers. See section 3.3 in the main text of this report.
Definition of credit intermediaries—Article 3e in the 2005 and 2006 drafts gives a broad definition of credit intermediaries, which would also include 'affinity partners'	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. They would therefore incur additional costs in registering themselves as an intermediary. Article 7 does, however, exempt those acting as credit intermediaries in an ancillary capacity. However, this exemption is rather vague and does not clearly indicate whether, for example, affinity partners would be exempted.
Right of withdrawal—as a result of Article 13 in the latest drafts, the existing cooling-off period in the UK would be extended to apply also to credit agreements signed and negotiated on business premises, rather than just to credit agreements signed off the business premises	As a result of this provision, retailers would be 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 would probably 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.
Timing of pre-contract documentation—the 2002 Text required information to be received before the conclusion of the credit agreement. Article 5(2) of the 2005 and 2006 drafts has changed the timing from 'before' to 'in good time'	It is not entirely clear what this means in practice. 'In good time' could mean that much more than a minute or two must be left between consumers being given the information and signing the credit agreement. For example, this requirement might involve them in a one- or two-hour delay. In such a situation, consumers may choose, as a matter of convenience, to use their pre-existing credit facilities, such as credit cards or overdraft facilities. In other words, the words 'in good time' could create a market distortion in favour of existing revolving-credit systems.
Database searches—Article 8(2) in the 2005 and 2006 drafts stipulates that if a credit application has been rejected as a result of the database being consulted, the consumer must be informed immediately and without charge of the result of such consultation and of the particulars of the database consulted	In economics terms, it is difficult to see what benefit accrues from Article 8(2). First, many consumers may simply not want this data, and, second, even if they receive it, in most cases it may not offer them real insight into how the credit rejection has been arrived at. In some clear-cut cases, the rejection will be the result of the credit bureau search—for example, a lender may apply a 'policy reject rule'. In the more usual cases, where the customer application is credit-scored, the results from the credit bureau search will simply be part of the assessment carried out on the customer. Thus, it will be far from obvious whether the bureau search is the main reason for the rejection or not. The provision would result in a cost. Searches of credit scores are now done electronically. The implication of Article 8(2) is that the debtor would probably need to have this material printed out and posted to them. The Data Protection Act 1998 (based on a European Directive) allows the debtor to apply for a copy of their credit report. Thus, debtors interested in obtaining this information can do so at minimal cost. Therefore, the 2005 and 2006 drafts would result in no additional benefits to consumers.

Note: The table 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.
Source: Oxera.

Contents

List of tables

List of figures

1 Introduction

1.1 Remit and objectives

Oxera has been commissioned by APACS, the British Bankers' Association (BBA), the Consumer Credit Association (CCA), and the Finance & Leasing Association (FLA) to assess the impact of the revised versions of the proposed Consumer Credit Directive (CCD) on credit for consumers and, more broadly, the UK economy.

The first draft of the CCD was published on September 11th 2002[7] ('the 2002 Text'). The impact of the 2002 Text on the UK economy was assessed by Oxera in a study (commissioned by APACS, BBA, FLA, and the Council of Mortgage Lenders) published in July 2003.

Since the publication of the 2002 Text, further texts have emerged. The European Commission put out a formal revised text on October 7th 2005 ('the 2005 Text').[8] Since then, other, informal texts have emerged from the Council Working Group process. The most widely recognised of these informal texts was that issued on November 11th 2006 under the aegis of the Finnish Presidency ('the Finnish Text' or the '2006 Text').[9]

The objective of the CCD is to facilitate the emergence of a well-functioning internal market in consumer credit by providing a harmonised regulatory framework for consumer protection:

> In order to facilitate the emergence of a well-functioning internal market in consumer credit, it is necessary to make provision for a harmonised Community framework in a number of core areas. In view of the continuously developing market in consumer credit and the increasing mobility of European citizens, forward-looking Community legislation which is able to adapt to future forms of credit and which allows Member States the appropriate degree of flexibility in their implementation should help to establish a modern body of law on consumer credit.
>
> It is important that the market should offer a sufficient degree of consumer protection to ensure consumer confidence. Thus, the free movement of credit offers can take place under optimum conditions for both those who offer credit and those who require it, with due regard to specific situations in the individual Member States.[10]

The impact of the 2002 Text on the UK economy was assessed by Oxera in a study published in July 2003, commissioned by APACS, the BBA, the Finance & Leasing Association, and the Council of Mortgage Lenders.[11] This Oxera study provides an update on the impact assessment conducted by Oxera in 2003, taking into account the changes to the 2002 draft CCD and assessing the impact on the UK economy of a number of specific articles in the 2005 and 2006 drafts. Furthermore, it assesses the extent to which the

[7] Commission of the European Communities (2002), 'Proposal for a Directive of the European Parliament and of the Council of the EU on the harmonisation of the laws, regulations and administrative provisions of the Member States concerning credit for consumers', 2002/0222.

[8] Commission of the European Communities (2005), 'Amended proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers repealing Council Directive 93/13/EEC', 2002/0222 (COD), October.

[9] Council of the European Union (2006), 'Modified proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers repealing Council Directive 87/102/EEC and amending Council Directive 93/13/EEC', 2002/0222 (COD), December 11th.

[10] Ibid., Recitals 7 and 8, pp. 3–4.

[11] Oxera (2003), 'Assessment of the economic impact of the proposed EC Consumer Credit Directive', July, available at www.oxera.com.

Directive may or may not deliver benefits by providing consumer protection and contributing to the creation of a single market for consumer credit. The impact of some of the new aspects of the most recent version of the draft CCD, such as the exemptions for certain types of credit, is also evaluated.

Table 1.1 provides an overview of the versions of the CCD. The update of the impact assessment focuses on the two most recent ones: the draft CCDs published in 2005 and 2006.

Table 1.1 Draft versions of the EC Consumer Credit Directive

Date of publication	EU Presidency	
September 11th 2002	Denmark	First draft of the CCD. Impact assessment carried out by Oxera on this version
October 28th 2004	Netherlands	Draft Directive
October 7th 2005	UK	Draft Directive
November 23rd 2005	UK	Draft Directive
December 11th 2006	Finland	Draft Directive

Source: Oxera.

1.2 Oxera 2003 impact assessment of the 2002 Text

The Oxera impact assessment published in 2003 comprised three elements:

– a qualitative cost–benefit analysis of the Directive;

– a quantitative assessment of the impact of changes in the usage and costs of credit on the UK economy; and

– a quantification of additional net welfare effects in the UK.

The analysis in the Oxera study showed that the Directive was unlikely to achieve its objectives and that the economic and welfare-related impacts of the Directive could be significantly greater than envisaged by the Commission. By contrast, the benefits were likely to be small. The study concluded that the Directive, if implemented, could result in a serious negative impact on users of credit as a result of three main effects, as follows.

– 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 have the greatest impact on those credit agreements where the amount of credit drawn was the smallest.

– A reduction in the availability of credit, particularly for 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 segment of the market.[12]

– A series of 'hassle factors', which would add indirectly to the cost of providing credit and could even preclude the provision of common forms of credit. These include, in particular, the obligations placed on 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.

1.3 Methodology for assessing the impact of the proposed Directive

This present study provides a qualitative assessment of the costs and benefits of the provisions in the proposed Directive that are likely to have the most impact in the UK. Conceptually, the total costs of regulation can be broken down into three types of cost:

– direct costs—these are the direct costs of regulation incurred by the relevant authorities such as the European Commission and national governments. These include the costs of designing the CCD, transposing it into national legislation and monitoring compliance by credit providers. These costs are relevant as they are ultimately paid for by credit providers (and hence their customers) through taxes and regulatory fees, such as licence fees;

– compliance costs—these include expenses incurred by industry to comply with the CCD, and may include the value of the extra resources, including time that would be used by firms and/or individuals to comply with the CCD;

– opportunity (or indirect) costs—these are the benefits to the economy that are forgone due to resources being invested in complying with financial services regulation, including any distortions in the allocation of resources in the financial system and the wider economy. The CCD contains provisions that are likely to change the behaviour and incentives of credit providers and consumers. These behavioural changes may directly affect the supply and demand for credit, and may also result in higher costs, thereby indirectly affecting the usage of credit.

Economic theory suggests that *incremental* costs should be measured—ie, costs that are in addition to the costs of existing good business practice. These can be considered a deadweight cost for the credit providers, and, through them, for the economy as a whole.

Applying the concept of 'incremental compliance costs' to the CCD means that the elements in the Directive need to be compared with the existing regulatory framework (in particular, the UK Consumer Credit Act 2006) and current business practice. The requirements in the proposed CCD that go beyond what is required in the existing regulatory framework and what is business practice may result in incremental compliance costs.

Consumer credit in the UK is regulated by the Consumer Credit Act 1974, as amended by the Consumer Credit Act 2006. The 2006 Act brings consumer credit within the ambit of the Financial Ombudsman Service (FOS).[13] The FOS was set up under the Financial Services and Markets Act 2000 (FSMA) in order to resolve disputes between consumers and financial service firms quickly and with minimum formality. It is an out-of-court system that deals with complaints from consumers against financial services firms. Compared with the court system, it is free to the consumer and a relatively quick and easy process. This system pre-empts (and will satisfy) the requirement in the CCD for out-of-court redress.

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

[13] Section 59 of the Consumer Credit Act 2006.

This study estimates the impact of the proposed Directive on consumer welfare by modelling a number of scenarios based on estimates of the impact of the CCD on credit providers. The direct costs caused by the CCD would be passed on to consumers in the form of an increase in the cost of credit. In addition, a reduction in the willingness of credit providers to supply credit would lead to a lowering in the overall availability of credit. These changes in the supply of credit would result in a welfare loss, as quantified in section 3. Furthermore, the reduction in the availability of credit would have an impact on the real economy in the years following the implementation of the Directive. This is modelled using the Oxford Economics macroeconomic model of the UK economy.

1.4 Information sources

The impact assessment is supported by a number of information sources. Public domain reports on, for example, specific issues such as over-indebtedness and illegal lending were consulted, and interviews were held with credit providers in the UK and other European countries and national associations in the banking and credit sector in various European countries. The purpose of these interviews was to obtain a better understanding of the impact of certain articles in the proposed Directive on credit providers. Credit providers of different sizes and types of business were contacted to take into account a variety of views on the draft Directive and the functioning of the credit market.

1.5 Structure of the report

The report is structured as follows.

– Section 2 describes the economics of (unsecured) consumer credit, in particular the characteristics of different credit products. The section then examines the market failures that can occur and why some degree of regulation is needed for consumer credit.

– Section 3 examines the changes to the CCD since Oxera's previous impact assessment of the 2002 version of the draft CCD. It analyses the impact with respect to the current situation in the UK, noting that, since the last impact assessment, the Consumer Credit Act 2006 has come into force, changing the baseline reference to some extent. The impact of the Directive on the UK economy in terms of consumer spending and GDP is then considered.

– Section 4 looks at the exemptions allowed for in the proposed CCD and their potential impact.

– Section 5 considers different ways of creating a single European market for consumer credit, identifies barriers to entry into new foreign markets, and assesses the extent to which the Directive would take away some of these barriers.

2 Economics and regulation of consumer credit

This section describes different types of credit and how they are used in various European countries. It also examines the benefits of consumer credit to consumers and the economy in general, and assesses the extent to which consumer credit products require regulation (eg, in the form of consumer protection).

2.1 Usage of consumer credit

The principal benefit of credit to consumers, which has been well documented in the literature,[14] is that it allows consumers to afford a more desirable consumption pattern and/or to finance house purchases. The opportunities to borrow can enhance economic welfare by allowing smoother consumption paths over time.

The Permanent Income Hypothesis, developed by Milton Friedman in 1957, states that an individual's consumption pattern is determined not by current income, but by expectations of future income as well. According to this theory, when a consumer is illiquid, they can borrow by using the facility of credit and paying it back at a later date. In economic terms, an individual's overall utility or measure of satisfaction will be higher due to consumption smoothing.

The current market for consumer credit offers a range of products:

– credit cards;
– store cards;
– overdrafts;
– fixed-term loans;
– 'interest-free' retail credit; and
– hire-purchase (HP) agreements.

These types of credit are described in more detail below. In principle, mortgages can also be considered a form of consumer credit. However, these are not covered by the current CCD and are therefore not discussed in detail in this report (see section 3.1).

2.1.1 Credit cards

Credit cards are a highly flexible form of credit whereby consumers can pay for goods of an unspecified value up to an agreed limit (credit limit). Credit-card debt is billed and can be paid off monthly or allowed to roll over to the next month. However, a minimum monthly payment must be made, otherwise an overdue payment is recorded. Product offerings within the UK credit-card market encompass a wide variety of interest rates, interest-free periods, credit limits, insurance and cash-back offers.

2.1.2 Store cards

Store cards are payment cards that can be used to pay for goods at one particular retailer or group of retailers. There are two types of cards: option and budget. The credit limit of budget cards is typically defined as a multiple of how much the cardholder wishes to pay each month. Option cards work more like credit cards and allow cardholders to spread the cost of

[14] See, for example, Bertola, G., Disney, R. and Grant, C. (2006), *The Economics of Consumer Credit Demand and Supply*, Cambridge, MA: MIT Press, and Friedman, M. (1957), *A Theory of the Consumption Function*, Princeton University Press.

their purchases, which normally includes an interest-free period. In a minority of cases, retailers manage and finance their own store-card scheme. However, it is more common for retailers to contract out the management of their store-card scheme to a bank on a third-party basis.

2.1.3 Overdrafts

An overdraft is a loan made to a customer with a cheque/deposit account at a bank or building society, in which the account is allowed to go into debit, usually up to a specified limit (the overdraft limit), although this limit can be negotiated between the account holder and account provider. This form of credit is highly flexible, as account holders can remain in overdraft, and change the amount of the overdraft at their own discretion within the agreed overdraft limit.

2.1.4 Fixed-term loans

Fixed-term loans are specified sums of money lent by a financial institution, for a specified time, at a specified rate of interest (annual percentage rate, APR). Typically, along with the value of the loan and the APR, a payment schedule is agreed during which instalments are to be repaid. This form of credit is typically used on a purchase-specific basis, for instance to fund the purchase of electrical goods or a car. Due to the agreed payment schedule, it is a less flexible form of credit than an overdraft.

Unsecured loans are provided directly to consumers from a range of lenders through a variety of channels, such as the bank branch, over the telephone and Internet, or by post. Small-value, short-term loans are offered by weekly home-collected credit lenders, cheque converters and pawnbrokers, and short-term is taken to be less than 12 months.

2.1.5 ‘Interest-free’ retail credit

This form of credit is probably most typically associated with ‘agency’ mail-order purchases. With ‘agency’ mail order, consumers can choose to repay usually over a period of 20 or 38 weeks, depending on the product purchased. The price of the goods covers the cost of the instalment credit and so no explicit interest is charged. (The total sum of the instalment repayments is no higher than if one single payment had been made at the time of purchase.)

This differs from 0% credit offers (often on credit cards) which are for a limited time period only and where the rate eventually reverts to a normal interest rate over the remaining lifetime of the product.

2.1.6 Hire-purchase

In HP schemes, a customer agrees with a retailer to pay for the goods they have purchased in a series of instalments. While the customer has a right to take delivery of the goods purchased as soon as they are available/delivered, the retailer retains ownership of the goods purchased until the HP agreement is fully paid off. Effectively, the credit provided to the customer is secured against the value of the goods purchased. Typically, there are three parties involved in HP schemes: the retailer is the primary seller of the goods. If sold for cash, the retailer would contract directly with the customer. When HP arrangements are concluded, the retailer instead sells the goods to a finance company, which in turn supplies them, via the HP agreement, on to the customer. HP agreements are very popular in the new and used car markets.

2.2 Market failures and the need for regulation

Many financial services markets are characterised by risks and market failures, and may require some degree of regulation to function properly. For example, in the market for consumer credit, there are 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 to compare prices across different 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.

There are different ways of regulating markets and market participants. In assessing the need for regulation or alternatives to regulation, it is useful to understand the nature of the harm that these market failures cause to consumers—in other words, what does regulation aim to prevent and what does it aim to deliver?

In the explanatory notes to the Directive, the European Commission places emphasis on responsible lending and the risk of people becoming over-indebted as a result of irresponsible lending practices. Addressing these concerns requires an understanding of why over-indebtedness occurs. This is explored below.

2.2.1 Why does over-indebtedness occur?

When deciding whether to lend money to a particular customer, credit providers use sophisticated risk models to assess the likelihood that the customer will repay. Assessing a customer's creditworthiness is of crucial importance to the credit provider's business—it is not in the credit provider's interest to lend money to people who are at a significant risk of getting into arrears.

Furthermore, before taking out a loan, individuals themselves are also likely to assess their own financial situation. The assessments undertaken by both lenders and borrowers should reduce the risk of over-indebtedness; however, in practice, there will always be some borrowers who are not able to meet their financial obligations and who get into arrears, for the following reasons.

- The borrower always faces uncertainty about future revenues and expenditures, and therefore about the affordability of the credit. This means that future unanticipated events, such as job loss or divorce, may lead to default.
- There is asymmetric information between lender and borrower. A lender can only assess its customer's financial position on the basis of information that is available within the organisation of the lender, and that made available by the borrower and the credit bureau. There is a risk that borrowers may fail to inform the lender about other credit commitments or misinform the lender about their level of income.

This means that credit providers always take a certain risk in providing credit, and interest rates are normally set in accordance with these risks. Minimising the risk of default would require the credit providers to significantly restrict lending, possibly making it difficult for a large proportion of the population to obtain access to credit.

An in-depth empirical analysis of the reasons for over-indebtedness is beyond the scope of this report. Some evidence on the reasons why people in the UK get into financial difficulty or arrears can be found in Kempson (2002).[15] Kempson obtained data on problems with credit

[15] Kempson, E. (2002), 'Over-indebtedness in Britain', commissioned by the Department of Trade and Industry, September. For an assessment of over-indebtedness in the UK, see Oxera (2004), 'Are UK Households Over-indebted?', April.

and with meeting household bills. The overwhelming reason for such financial difficulties or arrears was loss of income (45%). In the sample, 12% also pointed to increased/unexpected expenses and a further 4% indicated debts left by former partner. 8% overlooked or deliberately withheld payment and 5% cited third-party error. A further 10% cited over-commitment[16] and 14% low income.

The question is whether enquiries made before a loan is granted would necessarily show up any of the above to lenders. The first three categories (61% in total) refer to unanticipated events, as are the 8% who overlooked or withheld payment and the 5% who cited third-party error.[17] In other words, this suggests that financial difficulty is mainly driven by unanticipated events.

2.2.2 Different types of regulation and market-based instruments

There are a number of approaches to address market failures in the consumer credit market. They often consist of a mix of market-based instruments (such as sharing data on debtors and the offering of insurance products) and certain types of (self-)regulation, as discussed below.

– *Sharing data between credit providers*—in most EU countries credit providers can share negative and positive data about borrowers.[18] Negative data consists of records pertaining to arrears and bankruptcies; positive data consists of records on the total amount and type of loan, accounts currently open and active, and credit limits. The logic behind sharing negative data is simple: information about the extent to which a customer has been able to repay loans in the past can be used by banks as an indication of that customer's ability to repay loans in the future. In other words, sharing this type of information reduces the information asymmetry between a credit provider and its (potential) customer. Overall, this is likely to result in lower default rates and hence improve market functioning.

  Sharing positive data may reduce the risk of over-commitment by borrowers. It may prevent situations in which a borrower takes credit simultaneously from many credit providers, without any of these banks being aware of the total amount of credit taken on by the borrower. Furthermore, positive data enables credit providers to better assess the probability of default of credit applicants.[19]

– *Insurance*—in a number of European countries, insurance companies offer an insurance against unanticipated events ('Payment Protection Insurance'). The insurance protects a borrower's ability to maintain loan repayments should they be unable to keep up their repayments due to accidents, sickness or unemployment. This type of insurance therefore reduces the risk of becoming over-indebted as a result of unanticipated events.

– *Consumer protection (self-)regulation*—consumer protection focuses on further reducing information asymmetries between credit providers and consumers, and standardising price features, thereby making it easier for consumers to understand the characteristics of different credit products and compare prices across different credit providers.

[16] In relation to the 10% who indicated that they were over-committed, Kempson (2002) points out that these were likely still to be up to date with payments.

[17] Some of the job losses are not necessarily unanticipated—in particular, where these are related to people in short-term employment.

[18] For an explanation of the economics of sharing data, see Oxera (2005), 'Accentuating the Positive: Sharing Financial Data between Banks', *Agenda*, December, available at www.oxera.com.

[19] There is empirical evidence in the economic literature on the impact of using positive data on default rates. See Barron, J.M. and Staten, M., 'The Value of Comprehensive Credit Reports: Lessons from the US Experience', in M. Miller (ed) (2003), *Credit Reporting Systems and International Economy*, Cambridge, MA: MIT Press.

Certain aspects of consumer protection may be put in place through self-regulation while other aspects may be included in law. For example, in the UK the majority of banks have signed the Banking Code and other credit providers the FLA Lending Code. These codes set out how customers should be dealt with, in areas such as: marketing of services, information on interest rates, notification of charges, and handling of financial difficulty. An advantage of self-regulation is that it is easier to change and therefore easier to take into account new developments.

– *Insolvency regulation*—debtors in financial difficulty have a number of options available to them. They can enter into an arrangement with each of their credit providers (a 'debt management plan'), or into an individual voluntary arrangement (IVA). They can apply for bankruptcy through a formal court procedure, or, in some circumstances, refinance their debts. An IVA gives debtors in financial difficulty the option to get a part of their debt written off and to pay back the remainder of what they owe over a set period—it is an agreement with all creditors. The main advantages for debtors of IVAs over bankruptcy are that an IVA allows the debtor to keep some of their assets and avoids a public announcement of the bankruptcy order. For creditors, an IVA may be more attractive than bankruptcy if, for example, the debtor has future revenue streams that can be used to pay off the debt. The time period of repayment for IVAs is usually five years and for bankruptcies up to one year.

Other remedies to the market failures include improving consumers' financial capability by providing them with appropriate education and training, and the provision of advice by, for example, Citizen Advice Bureaux.

2.2.3 Finding the right balance

In designing a regulatory framework for the market for consumer credit, it is crucial to find the right balance of regulation and market-based instruments. This often requires a combination of a number of different remedies that address the market failures—each remedy in itself is unlikely to be sufficient to make the market work properly.

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, as explained above, 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, by definition, not known when the loan was granted. These cases of over-indebtedness are more efficiently dealt with by appropriate insolvency regulation or insurance products (as discussed in section 2.2.2).

Furthermore, excessively stringent regulation may be counterproductive. The provision of credit inherently involves an element of risk. Putting too much of a burden on credit providers may result in a restriction in the supply of credit (or an increase in the costs of credit). Although this may affect consumers who may have become over-indebted anyway (in the absence of the regulation), it may also affect consumers who would not have become over-indebted, thereby excluding certain consumers from the provision of credit. The aim of a regulatory framework should not be to restrict the provision of consumer credit, but rather to create a market that provides cost-reflective credit to those who need it.

Excluding certain consumers from credit may make them seek credit from illegal lenders. A recent study for the DTI shows that people who are refused loans by legitimate lenders often obtain credit from illegal lenders.[20] In the UK, where lenders serve even the highest-risk borrowers, including those in the sub-prime market, the number of consumers financially

[20] Policis and PfRC (2006), 'Illegal Lending in the UK', research report prepared for the DTI, November, URN 06/1883.

excluded is relatively low. This study also shows that illegal lending in the UK is low relative to that in 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. The study also shows that illegal lending often involves high levels of consumer detriment in the form of generally high costs compared with legal forms of lending, and recovery processes and techniques that would not be tolerated in any legal market.

3 Impact of specific articles in the proposed Directive on the UK and other Member States' economies

This section provides an assessment of the impact of the proposed CCD and thereby updates the Oxera impact assessment conducted in 2003.

3.1 Main differences between the 2005/2006 and 2002 drafts

The Oxera 2003 study identified a number of articles in the 2002 draft Directive that could result in a serious negative impact on users of credit. Since 2002, the Directive has been redrafted on numerous occasions and this has altered its impact. This section briefly describes the articles in the 2002 draft that could have caused a negative impact on the industry and economy, but have been altered or removed in the later texts of the Directive.

– **Scope**—the latest texts do not apply to mortgages. The 2002 Directive covered mortgages only in as far as they were used for 'consumption' purposes, rather than mortgages used solely to buy and renovate property.

  Covering the 'consumption' element of mortgages raised a number of issues. For example, the Directive assumed that mortgage lenders would know the purpose of a mortgage, but this was not the case in practice; mortgage lenders generally do not know or find out about the purpose of a mortgage. Furthermore, it could be argued that all mortgages with the potential to be used for consumption purposes would fall under the Directive. However, in the UK, many mortgages have a flexible element, whereby equity can be withdrawn during the course of the mortgage. If the Directive applied to mortgages with flexible provisions for equity withdrawal, whether or not consumers actually use this facility, this could have implied that the Directive would apply to a substantial proportion of the mortgages taken out in the UK. Owing to the way in which mortgages differ from other forms of credit (amount of credit provided, security against property, etc), there is arguably a case for regulating them separately. This is indeed the approach the European Commission has taken, and is also the approach adopted in the UK, where mortgages are regulated by the Financial Services Authority (FSA).

  The latest texts of the draft Directive contain exemptions for 'interest-free' credit, HP agreements and pawnbroking—exemptions that were not included in the original 2002 Text. The impact of the re-introduction of these exemptions is assessed in section 4 below.

– **Re-signing the credit agreement**—Articles 10, 15 and 34 in the 2002 Directive required a provider to get the customer to re-sign their credit agreement if the terms of the agreement changed. The 2003 study concluded that this requirement would result in a series of costs since it would require credit providers to pay for an increased level of correspondence with customers, increase the number of staff handling customer queries and processing re-signed agreements, and make provision for following up customers who did not return their re-signed credit agreements.

  This requirement has been removed from both the 2005 and the 2006 draft Directives. In the 2005 draft Directive, Article 5 (1) obliges the creditor to update the financial information of the consumer, and to assess the consumer's creditworthiness before any significant increase in the total amount of credit is approved. In the 2006 draft Directive, the same requirements as those in the 2005 draft Directive are found in Article 7a. These two activities are already common practice for most providers in the UK and therefore this requirement is unlikely to result in significant costs. However, Articles 5(1) and 7a(2) both refer to 'a significant increase in the total amount of credit',[21] without making clear what this threshold is.

– **Responsible-lending clause**—the 2002 CCD contained a clause entitled 'responsible lending'. In the latest texts, this provision has been moved, from Article 9 to what is now Article 7a. It has also been significantly reworded and is now headed 'obligation to assess the creditworthiness of the consumer'. This is further discussed in section 3.2 below.

– **Index-linking clause**—the 2002 Directive required credit providers to link variable borrowing rates to an agreed base rate, such that the borrowing rate could only be varied in line with that base rate. The latest texts have removed this requirement. Articles 5(2c), 9(2d) and 10 state that the borrowing rate and any reference rate applicable to the initial borrowing rate should be calculated for the borrower. Article 10, in particular, obliges providers to inform consumers of a change in the borrowing rate on paper or another durable medium before the change comes into force, as well as related information such as the new amount owed following the change and any changes to the frequency of payments. If arranged in the credit agreement, providers can inform consumers periodically, rather than immediately, if the change in borrowing rate is caused by a change in the reference rate and the new reference rate is made publicly available. Currently, credit providers in the UK already inform their customers of changes in the borrowing rate and therefore there should be no significant impact resulting from this clause.

– **Restriction on pricing and unfair contract terms**—the obligation to hold charges and fees constant over the life of the credit agreement has been removed from the 2005 and 2006 draft Directives.

– **Total lending rate clause**—the necessity to calculate the total lending rate for the borrower as well as the borrowing rate has been removed. Having two different rates could have confused customers.

– **Central database clause**—the 2002 Directive would have obliged EU Member States to set up a central database (or a network of databases) to hold details on consumers and guarantors who have defaulted (ie, negative data). The 2005 and 2006 draft Directives removed this requirement.

  The UK system of databases could possibly have been affected by Article 8 in the 2002 Directive. Whereas, at present, three credit reference agencies (CRAs) hold their own private databases, Article 8 could have been interpreted as obliging the UK to establish a central database or a network of (identical) databases in the UK. Therefore the 'credit data' held by the CRAs in the UK would have to be similar in terms of the specification of the fields in the databases. Another option would have been to set up one central database with basic functionalities, to which private database and credit providers have access. The private databases could then have offered 'value-added' functionality so as to compete with each other in providing their services to credit providers.

– **Restrictions on the use of data**—this clause has been removed from the 2005 and 2006 draft Directives and there is no longer a restriction on the use of private customer data, as stipulated by the 2002 Directive.

  The data protection clause in the 2002 Directive placed strict limits on the use of personal data obtained from consumers, guarantors and others in the process of concluding a credit agreement. In particular, data collected for the purpose of assessing

[21] CCDs of November 23rd 2005 and December 11th 2006 respectively.

the financial situation and ability to pay of those seeking to take out credit would only have been allowed to be used for this purpose. This would have precluded the use of such data for any other purposes, such as marketing, making marketing more expensive and less effective.

In the UK, under the Data Protection Act 1998, consumers who do not wish their personal details to be used for marketing purposes are already able to 'opt out' of receiving marketing material. The additional benefit of the data protection provision in the draft CCD would therefore have been relatively small.

In addition, the 2002 Text would have required data to be destroyed immediately following conclusion of the credit agreement.

Notwithstanding the amendments made in the latest versions of the CCD, there are still a number of articles that are likely to result in costs for credit providers without providing significant benefits to consumers. These are assessed in detail below.

3.2 Responsible lending

3.2.1 Comparison of the CCD with existing regulation in the UK

'Article 9: Responsible Lending' of the 2002 Directive effectively required the lender to assess whether the consumer (or guarantor) was able to meet their obligations. Whereas the 2005 Directive states in Article 5 (1) that 'the creditor … shall adhere to the principle of responsible lending', the 2006 Directive does not explicitly mention 'responsible lending'; rather, it 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.[22]

Article 7a of the 2006 Directive imposes a statutory duty on the lender to make this creditworthiness assessment based on 'sufficient information obtained from the consumer' and from consultation of the 'relevant database'. In addition, if the amount of credit being provided is subsequently increased, providers are required to update the financial information about the consumer and reassess their creditworthiness.

In the UK, there is no legislation imposing a direct statutory duty on creditors to check the financial situation of consumers or their guarantors. The 2002 Text also indicated that 'responsible lending' rules were only to be found in the Netherlands and Belgium.

3.2.2 Economic impact assessment

It is clearly in the interest of the credit provider to assess the creditworthiness of the consumer. Skill in granting credit is central to the success of any unsecured lending business. In order for their businesses to be viable, lenders need to be able to judge how much to lend, over what term and at what rate. Such decisions will also include assessments of the level of default that the lender is willing to bear (and which will have to be priced into the cost of the credit). However, Oxera's discussions with credit providers make clear that there is a distinction between what lenders need to do in practice to run a viable credit business and what a *statutory requirement* to 'lend responsibly' or to 'assess creditworthiness' would require them to do. Providers interviewed by Oxera have indicated that a statutory requirement would, in their view, increase costs to credit providers, and

[22] CCD of December 11th 2006.

would also cause them to change their lending practices (although not necessarily in a way that would benefit consumers).

If such a duty were to become law in the UK, it is possible that debtors who are unable to repay would seek to rely on this duty. In effect, those debtors would argue that their failure to repay was as a result of the lender advancing credit in breach of the statutory duty.

Lenders interviewed by Oxera described how they would have to move to what they termed a 'more defensive' style of lending. Under this, they would have to assess not only credit risk (in the normal way), but also the risk of claims being made against them by debtors. The 'defensive' approach would also require lenders to record and store more information to assist in rebutting claims by debtors. Lenders were of the view that these were *incremental* costs because they would go beyond good business practice.

As explained in section 2, credit is a risk business. There is asymmetric information between lender and borrower, and there is uncertainty about events that the borrower may face in the future affecting their revenue and expenditure. Assessing the creditworthiness therefore always involves a certain degree of judgement based on the credit providers' expertise and experience.

Furthermore, no matter how detailed the assessment of customers, most customers who fail to pay do so because they have experienced a life event that causes a sudden collapse in income (as explained in section 2).

Credit providers indicated that a statutory duty to assess creditworthiness would increase the risk of debtors litigating against them. They also suggested that, in practice, the burden of proof (particularly under the FOS system) would shift from consumers (having to prove that the lender was 'irresponsible') to lenders (having to prove that they had been 'responsible').

This would mean that a party with much better information about ability to repay (the customer) would bear no responsibility for their decision to take out the loan, while the party with inferior information (the lender) would bear full responsibility for its decision to provide credit.

Moral hazard is a possible consequence of this imbalance between information and responsibility. Consumers could become less careful, in the knowledge that, if they were to fail to repay, lenders would be legally liable for that failure.

In this context, it is significant that, with effect from April 2007, it will become easier for consumers to claim compensation. As explained in section 1, the FOS is now also available for claims in relation to the sale of credit products (whether or not sold by banks, which are already subject to the jurisdiction). With easier access to a dispute resolution service, such as the FOS, the risk of compensation claims is likely to be higher, since this is a system that is free to the consumer and easy to activate.

If a duty to assess creditworthiness were to become part of UK law as a result of CCD then claims based on breach of that duty could be made to the FOS as well as in a court of law.

Although the economic effects of Article 7a[23] are subject to some uncertainty, they could be as follows.

– The availability of consumer credit in general, and especially to consumers with low credit ratings (ie, those in the sub-prime market, those with low and/or irregular income and the self-employed), may be restricted. The shift in burden of proof from borrower to lender may increase the likelihood that, in court cases (or under FOS claims), lenders would be held liable for the financial consequences of credit provided to borrowers who

[23] CCD of December 11th 2006.

ended up in financial difficulty. Alternatively, lenders may increase their level of write-offs rather than risk litigation or an FOS claim. To the extent that lenders would be unable to recover all their costs (because of litigation or an increased level of write-offs), the effective cost of providing credit to customers with low credit ratings would increase. Costs would also rise to the extent that lenders would have to pay case fees to the FOS. In some cases, the expected loss as a result of the risk of irrecoverable costs may outweigh the profit to be made from a loan. In such cases, certain borrowers—in particular, those with low credit ratings—would no longer be able to access credit. This could result in financial exclusion among certain categories of consumer, in particular low-income consumers.

– Throughout the entire credit market, the risk of litigation would increase the cost of providing credit. Additionally, if the moral hazard caused by Article 7a increased default rates then interest rates (at least for certain categories of consumers) would rise further.

– The reduction in the availability of credit to those with low credit ratings is unlikely to lead to any fall in the demand for credit. A consequence of such consumers being unable to draw on credit from legitimate sources could be an increase in the reliance on illegal credit providers. As explained in section 2, research has found a correlation between the availability of legal credit and the prevalence of illegal lending. In other words, once legal lenders withdraw or reduce availability of credit, illegal lending increases.

  Article 7a may result in a degree of distortion of competition between different credit products. Extra costs imposed at the point when an agreement is entered into are likely to cause the market to distort in favour of running-account systems (eg, credit cards and overdrafts). This is because the greater the set-up costs imposed by regulation, the more lenders can achieve cost savings by moving to revolving credit agreements which can last for many more years than fixed-sum products. The shift to revolving credit could occur as a result of supplier pressure (as suppliers seek to reduce costs) and consumer pressure (as consumers seek to minimise the inconvenience of much longer and more intrusive ‘fact-finds’).

3.3 Duty to explain/advise

3.3.1 Comparison of proposed CCD with existing regulation in the UK

The ‘duty to advise’ Article in the 2002 Directive has been amended to become a ‘duty to explain’ clause. Article 5 (5) in both the 2005 and 2006 texts states that:

> Member states shall ensure that creditors …provide adequate explanations to the consumer, in order to put the consumer in a position to assess whether the proposed credit agreement is adapted to his needs and to his financial situation

Therefore, a minimum level of information must be provided in order for the most appropriate form of credit to be advised.

The recitals to the Directive explain that:

> Where appropriate, the relevant pre-contractual information, as well as the essential characteristics associated with the products proposed should be explained to the consumer in a personalised manner so that the consumer could understand the effects they may have on his economic situation.

There is no specific duty in the UK to explain or advise on consumer credit; rather, the approach is that all credit providers are obliged to provide certain information (as specified in the Consumer Credit Act) about the obligations and repayments imposed by a credit agreement (with the exception of overdrafts), in advance of the conclusion of that agreement.[24]

The 2006 Directive, in requiring lenders to provide personalised advice and to put the consumer in a position to assess whether the proposed credit agreement is adapted to their individual needs and financial situation, would impose a new statutory duty on lenders and credit intermediaries in the UK.

3.3.2 Economic impact assessment

Although the emphasis has shifted from a 'duty to advise' (2002) to a 'duty to explain' (2006), the overall impact on lenders is likely to remain more or less the same. The credit provider must provide sufficient information to the consumer so that the consumer can assess whether the credit agreement is appropriate. In practice, this may mean that the credit provider has to provide some kind of advice on the appropriateness of the credit product. Such a requirement may have the following impacts.

– The actual provision of advice is an expensive activity for credit providers—consumer credit contracts normally involve much smaller amounts than other types of financial product such as mortgages or investment products. If Article 5 were interpreted as obliging credit providers to similar advisory processes for all forms and amounts of credit then a flat cost would be imposed on each credit contract. At the smaller end of the scale, the cost of providing any given form of advice would be higher as a proportion of the overall cost of the credit.

– Since this would be a statutory duty (which debtors could argue had been breached) credit providers would need—as a 'defensive' measure - to have in place internal systems that allowed them to keep a record of any advice given and (possibly) to record officially whether that advice had been followed. This would impose further costs on credit providers.

– As with the duty to assess creditworthiness this too is a legal duty. It would allow to claim compensation (either in the courts, or via the FOS system) on the basis that the credit had been 'mis-sold'.

– If (as the Explanatory Memorandum to the 2006 texts suggests) Article 5 means that credit providers must undertake face-to-face interviews with prospective customers (as with 'advised' sales of other financial products, such as pension and life insurance products), this would discriminate between credit providers with branches and those without branches. In particular, this would impose a large burden on Internet, direct mail and telephone-based credit providers, which currently do not incur the costs of operating via retail premises. This would reduce the scope for providers using such technology to apply the maximum competitive pressure in the market in future.

Again, a market distortion may be a move towards revolving credit products. The more regulation imposes cost on agreement set-up, the greater the cost advantage revolving credit systems have over fixed-term products. So overall, the market could shift towards revolving credit as lenders seek to achieve cost efficiencies. This shift could occur both as a result of supplier pressure (as suppliers seek to reduce costs) and as a result of consumer pressure (as consumers seek to minimise the inconvenience of much longer and more intrusive 'fact-finds').

[24] The Consumer Credit Act 1974 amended by the Consumer Credit Act 2006 has provision for the duty to explain or advise and the exchange of information in Sections 60–63.

It is not clear whether the duty to explain prevents consumers from getting into financial difficulty. If most consumers' get into financial difficulty as a result of unexpected life events, it is unlikely that a duty to explain would improve their position.

3.4 Credit intermediaries

3.4.1 Comparison of the CCD with existing regulation in the UK

A concern about the 2002 Directive was that it was also applicable to affinity partners and to the agency mail-order and weekly home-collected credit agents due to the wide definition of credit intermediaries. This has not been changed in the 2005 and 2006 Directives. Article 3e of both these Directives would extend the definition of 'credit intermediary' to include affinity partners and co-branded partners. These are essentially firms that carry out some other trade (commonly football clubs and charities, and, in the case of co-branded partners, mainly retailers), but which offer or endorse consumer credit that is supplied and administered by a separate creditor. The link between the affinity partner and the consumer is minimal, as the actual business of providing the credit is the sole responsibility of the creditor. The most common credit products provided under affinity arrangements are credit cards and personal loans.

The impact of Article 3e should be seen in the context of affinity cards, which have become a fast-growing choice. These are credit cards issued on the basis that the card issuer makes a donation to a particular organisation. Some providers issue cards on behalf of a group of charities, and allow cardholders to nominate a preferred beneficiary. A typical affinity credit card works by the issuer agreeing to donate a specified amount when the credit card account is first set up or when the card is first used, thereafter making a specified payment each time the credit card is used or where a purchase is over a certain figure (eg, £100). At the end of 2005, there were some 5,472,000 affinity cards in the UK, on which over £7,080m was spent, representing almost 8% of all credit cards in the UK and accounting for more than 7% of all credit card spending. In the UK, there were over 40 charity-related credit cards in the market.[25]

At present, typical arrangements in the UK do not require the affinity partner to register as a provider of financial services. Credit providers (ie, credit-card or personal loan providers) make credit facilities available to consumers and look after all of the administration of the credit accounts. In effect, there is no direct link between the consumer and the affinity partner. The link between the credit provider and the affinity partner is limited in scope. In exchange for the use of the affinity partner's brand, the credit provider makes payments to that affinity partner. Consumers do not pay the affinity partner directly. Additionally, the credit provider is provided with access to its affinity partner's customer lists for marketing purposes.

Article 3e requires affinity partners, for the first time, to comply with consumer credit regulations in the UK. Affinity partners would need to be licensed, and credit-card providers would have to provide them with a copy of each credit agreement they entered into in association with the credit-card provider.

Article 7 does, however, exempt those acting as credit intermediaries in an ancillary capacity, and explanatory note 18 describes an ancillary capacity as any:[26]

> activity … [that] is not the main purpose of their trade, business or profession and does not amount to a substantial part of their turnover.

[25] APACS (2006), 'Cards & Charities—How the Cards Industry Supports Charitable Giving'.

[26] CCD of November 23rd 2005 and December 11th 2006.

The above definition of ‘substantial part of turnover’ is rather vague and does not clearly indicate which intermediaries would be exempted from the provisions in the Directive.

Article 7 may also cover self-employed agency mail-order and home-collected credit agents. There are around 2m such mail-order agents and approximately 28,000 home-collected credit agents.[27] As currently drafted, the Directive would impose new legal liabilities on these groups of agents.

Industry representatives have explained to Oxera that, in practice (especially given the requirements of UK credit licensing law), the mail-order and home-collected credit companies that engage these agents accept full responsibility for their actions. This means that consumers are protected against unfair practices. The text in the Directive may be aimed at a form of intermediary that is more commonly found in Continental Europe, for whom lenders do not accept responsibility.

3.4.2 Economic impact assessment

The requirement for affinity partners to be licensed and provided with a copy of each credit agreement entered into in association with credit providers would place significant costs on such organisations. This would be most keenly felt in the charities sector, which undertakes affinity credit arrangements as a way of raising money and encouraging loyalty from donors. Hence, any increase in costs would reduce the amount of money available for charitable purposes.

It is difficult to determine the purpose of including affinity partners within the definition of credit intermediaries. Neither consumer protection nor the scope for competition would be increased by requiring affinity partners to comply with the Directive. Furthermore, the requirements would result in additional costs for agency mail-order and home-collected credit agents.

Both agency mail-order and home-collected credit providers specialise in providing credit for consumers on lower-than-average incomes. It is this consumer group that is most at risk from illegal lending.[28] To the extent that extra costs are imposed on legal suppliers (such as agency mail order and home-collected credit), the more likely it is that customers of those sectors will be refused access. This means that the provisions placing new legal liabilities on intermediaries may in fact contribute to increased levels of illegal lending.

3.5 Right of withdrawal

3.5.1 Comparison of the CCD with existing regulation in the UK

Article 13 of both the 2005 and 2006 drafts deals with the consumer’s right to withdraw from a credit agreement, and has remained much as it was in the 2002 Text.[29] This would primarily affect fixed-term credit products. Although credit cards and store cards would also be affected by this article, once the cooling-off period on such revolving credit agreements had elapsed, the use of such forms of credit would be a way of avoiding the inconvenience of the cooling-off period in connection with purchase-specific credit agreements.

Currently, UK credit law confers a right of cancellation on agreements concluded away from trade premises if there have been face-to-face discussions. The overall effect is that the customer can cancel within a period of about 12 days (7 days for the lender to send notice of

[27] Source: www.ccauk.org.uk.

[28] See Policis and PfRC (2006), ‘Illegal lending in the UK’, research report prepared for the DTI, November, URN 06/1883.

[29] The only change is that Articles 2(3) and 2(3a) do not apply to overdrafts, regardless of whether they have to be paid back on demand or within three months, or if agreed upon on one occasion. Therefore this form of credit agreement is now exempted from this part of the Directive.

rights, plus 5 more days for the customer to exercise their rights). If the customer does cancel, they pay no charges at all (in contrast to Article 13) if they repay the credit within a month of serving notice of cancellation. For other agreements (for example, those concluded in a shop), there are no cancellation rights.

The key effect of the 2006 text on the UK market would therefore be to impose a new right of withdrawal for all credit contracts. The main effect would be on credit concluded in retail outlets. The other difference between the Directive and existing UK regulation is that, under the Article 13 right of withdrawal, the debtor must pay interest at the agreed borrowing rate until they repay the capital they have received (paragraph 4).

Paragraph 3 of Article 13 states that the consumer must inform the creditor using paper or some other durable medium of the consumer's decision to withdraw from the agreement within the cooling-off period.

3.5.2 Economic impact assessment

Article 13 of both the 2005 and 2006 draft Directives would, in particular, affect HP or conditional-sale agreements in Member States that do not apply the new exemptions in Article 2 of the 2006 draft to these products. BBA, APACS, CCA and FLA believe that it is highly unlikely that the UK government would, in general, apply these exemptions under UK law—in the UK, the different types of credit are currently subject to the same regulation. Other Member States may, however, apply the exemptions.

Article 13 of the Directive, by introducing a right of withdrawal on *all* credit agreements for a period of 14 days after conclusion/purchase, introduces a new problem for retailers. Those retailers would now have to consider whether to release goods within the cooling-off period. If they did, they would now face a new risk that goods supplied on HP or conditional sale would be returned in a used state following a withdrawal. This is because, under UK law, there are 'composite', indivisible contracts. Thus, although they are credit contracts, they are also contracts for the sale of goods.

Retailers would therefore have to reassess their policies, to consider a series of factors, such as:

– whether to continue to use HP or conditional sale (with the risk and pricing advantages that these offer);

– the rate of depreciation—brand new cars, for example, depreciate instantly by very large amounts and most suppliers would hesitate to release a new vehicle if they knew it could be returned two weeks later;

– the value of the goods—a retailer might take a business risk with relatively low-value assets such as fridges. The risks change for high-value goods such as cars;

– the level of stock/inventory required—retailers currently running 'lean' inventory systems would be forced to hold onto and insure purchases prior to their release after the cooling-off period had elapsed. Alternatively, they would be required to introduce artificial delays in the order management system so as to allow the cooling-off period to elapse prior to the delivery of the purchased goods to the consumer.

In Ireland, withdrawal rights already exists, but, pragmatically, the debtor is allowed to waive the right (which they will do if they wish to take delivery of goods). However, under Article 21,[30] such a waiver would not be permitted.

[30] CCDs of November 23rd 2005 and December 11th 2006.

The general overall effect of Article 13 could, in the UK, be a distortion to the present pattern of credit use away from HP and conditional-sale agreements to other types of credit, such as personal loans and pre-approved forms of credit held by consumers (eg, overdrafts and credit cards). Overdrafts and credit cards are, however, not necessarily the most appropriate credit product for the purchase of certain types of goods, such as cars, which are much more traditionally sold on HP and conditional-sale agreements.

Compared with unsecured loans, HP and conditional-sale agreements have an important advantage. Because the loan is secured against the value of the goods purchased, HP and conditional-sale agreements generally involve lower risks for lenders than unsecured loans, since, in the case of default, they can recover some of the amount owed by selling the goods involved. They are therefore a cheaper form of financing for consumers than unsecured loans. In other words, a switch to personal loans for the financing of a car, for example, may result in higher costs to consumers—consumers with a higher than average risk profile may not be able to obtain a personal loan and would therefore be excluded.

3.6 Timing of pre-contract documentation

3.6.1 Comparison of the CCD with existing regulation in the UK

Article 5(2) of both the 2005 and 2006 draft Directive details the exact requirements for pre-contract information to be provided to credit applicants, which are similar to the requirements in Article 6(2) in the 2002 Directive. Pre-contractual information includes the duration of the agreement, the total amount of credit, and conditions concerning drawdown and the borrowing rate.

The 2002 Directive stipulated that information should be received before the conclusion of the credit agreement. Article 5(2) of the 2005 and 2006 draft Directives has changed the timing from ‘before’ to ‘in good time’. It is not entirely clear what this means in practice.

3.6.2 Economic impact assessment

‘In good time’ could mean that consumers must leave much more than a minute or two between being given the information and signing the credit agreement. For example, this requirement might involve them in a one- or two-hour delay. In such a situation, consumers may choose—as a matter of convenience—to use their pre-existing credit facilities, such as credit cards or overdraft facilities. In other words, the words ‘in good time’ could create a market distortion in favour of existing revolving credit systems.

3.7 Database access and informing the consumer of database consultation

3.7.1 Comparison of the CCD with existing regulation in the UK

The meaning of Article 7a[31] is unclear in relation to database searches. The implication is that these should be made ‘where appropriate’. This is the more reasonable interpretation, since usage of these systems differs from credit format to credit format. Pawnbrokers, for example, would not make such searches

However, Article 8(2)[32] stipulates that if a credit application has been rejected due to the database being consulted, the consumer must be informed immediately and without charge of the result of such consultation and of the particulars of the database consulted.

[31] CCD of December 11th 2006.

[32] CCDs of November 23rd 2005 and December 11th 2006.

The structure of these suggested new rules underestimates the subtlety and complexity of the referencing systems in the most advanced credit markets.

In some clear-cut cases, the rejection will be the result of the credit bureau search. For example, a lender may apply what is called a ‘policy reject rule’. This would be the case where a lender, as a matter of policy, chose to refuse any customer where the search revealed, say, a county court judgement. Here, there is a clear link between the search and the rejection.

In the more usual cases, where the customer application is credit-scored, the results from the credit bureau search will simply be part of the assessment carried out on the customer. So, it will be far from obvious whether the bureau search is the main reason for the decline or not.

In the UK, there is no legal requirement for credit providers to provide credit applicants with information about the results of consulting a database. However, under Section 7 of the UK Data Protection Act 1998, an individual is allowed access to the personal data of which that individual is the data subject. For a fee of £2, individuals can see a copy of their statutory credit report.[33] This law is, in turn, based on a European Directive.[34]

3.7.2 Economic impact assessment

In economic terms it is difficult to see what benefit accrues from Article 8(2). First, many consumers may simply not want this data, and, second, even if they receive it, in most cases it may not offer them real insight into how the credit rejection has been arrived at.

Against this has to be balanced the cost of compliance. Searches of credit scores are now done electronically. The implication of Article 8(2) is that the debtor would probably need to have this material printed out and posted to them.

Finally, as mentioned, the Data Protection Act 1998 (based on a European Directive) allows the debtor to apply for a copy of their credit report. Thus, debtors who are interested in obtaining this information can do so at minimal cost.

3.8 Impact on the UK economy: quantification of the economic effects of the Directive

The impacts discussed above could give rise to a series of negative effects in the wider economy. As a result of the restriction in the supply of credit and the increase in the cost of credit, the use of consumer credit could be expected to decline. Given the influence that the availability and cost of credit has on consumer expenditure decisions, any reduction in the use of credit would lead, all else assumed equal, to a reduction in consumer expenditure over the medium to long term and a one-off reduction in the level of GDP as the economy adjusted.

In the 2003 Oxera study, the impact of the CCD on the economy (in terms of consumer spending and GDP) was quantified by using a macro-economic model. Furthermore, the impact was quantified in terms of the effect on consumer welfare of the reduction in the availability of credit and the increased price that consumers would pay for credit.

This section forms an update of the analysis undertaken in 2003, taking into account the changes made to the 2002 Directive.

[33] www.experian.co.uk; www.equifax.co.uk; and www.callcredit.co.uk.

[34] Sections 7, 8 and 9 of the Data Protection Act 1998 refer to the provision of the statutory credit report. Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

3.8.1 Modelling inputs

The Oxera 2003 study quantified the impacts of Article 6 (duty to advise; Article 5 in the 2006 Directive), Articles 10, 15 and 34 (re-signing of credit agreements) and Article 9 (responsible lending; Article 7a in the 2006 Directive). The medium scenario comprised:

– 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%—it was assumed that 50% of secured credit would be covered by the Directive.

The analysis showed that this scenario could result in a fall in consumer spending 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.

As explained above, the requirement to get customers to re-sign credit agreements when changes are made to the agreement is removed and some changes are made to the article on the duty to advise and responsible lending. Furthermore, the 2006 Directive does not apply to mortgages. This means that, overall, the impact of the Directive on the UK economy in terms of consumer spending and GDP is likely to be less severe than that estimated in the Oxera 2003 report.

Article 5 may raise the cost of credit to all consumers and increase the risk of litigation, which may translate into a restriction in the supply of credit. Article 7a may also increase the risk of litigation, which may in turn also affect the supply of credit.

In this section these effects are modelled using a series of indicative scenarios, developed using representative cost data—these scenarios update the scenarios used in the 2003 Oxera study. The scenarios involve modelling the effects of the Directive both as an increase in the cost of credit and a reduction in the availability of credit overall. Table 3.1 shows the scenarios used as inputs to the model.

While the remaining provisions outlined above also have economic impacts, these generally arise through harmful effects on competition, 'hassle factors' for both consumers and credit providers, and economically unnecessary or harmful behavioural effects. Such effects are difficult to quantify; hence, in this quantification, only the costs caused by Articles 5 and 7a are included. This will result in an understatement of the overall impact of the Directive.

Table 3.1 Scenarios used in the quantification of the effects of the Directive

Scenario	Low	Medium	High
Increase in the cost of unsecured consumer credit (percentage points)	0.1	0.35	0.50
Restriction in the availability of consumer credit (%)	0.00	2.50	2.50

Source: Oxera.

The low scenario assumes that the Directive would not result in any restriction in the supply of credit, while the medium and high scenarios reflect the assessment that the Directive would increase the risk of litigation and would make credit providers decide to restrict the supply of credit. The increase in costs is a result of the additional costs incurred in providing credit applicants with some kind of advice. The increase in costs in the low scenario reflects the costs of a short meeting with the credit applicant, whereas the medium and high scenarios reflect the costs of a more comprehensive assessment of the fit between the credit applicants' needs and the credit products available (for example, similar to an assessment by independent financial advisers when providing financial services to end-consumers).

The extent of the restriction on the availability of credit was estimated on the basis of the size of the sub-prime market. This may result in an underestimate, as it is likely that, in addition to sub-prime consumers, consumers with low or irregular income would experience a reduction in the amount of credit to which they had access.

A Mintel survey found that sub-prime consumers made up 10% of the market for personal loans, and 5% of the credit-card market.[35] The survey concentrated on the number of consumers rather than the value of credit taken out. Given the likelihood that borrowers with low credit ratings hold, on average, less debt than borrowers in the prime market, the reduction in the availability of credit has been modelled using a conservative estimate which assumes significantly lower average borrowing amounts in the sub-prime/low credit-rating market. In the modelling, it is assumed that unsecured consumer credit is restricted by 2.5%.[36]

The first part of the analysis looks at the broad economic effects in terms of the use of consumer credit, the use of mortgages, GDP and consumption. The results presented in this part of the analysis are derived from the Oxford Economics UK macroeconomic model—part of the Oxford Economics Global macroeconomic model, which is the most widely used large-scale macroeconomic model in the world. The outputs from the Oxford Economics model indicate changes in a series of economic variables compared with their predicted future levels if no changes were to occur. The second part of the analysis presents an estimate of the welfare impact that would be likely to result.

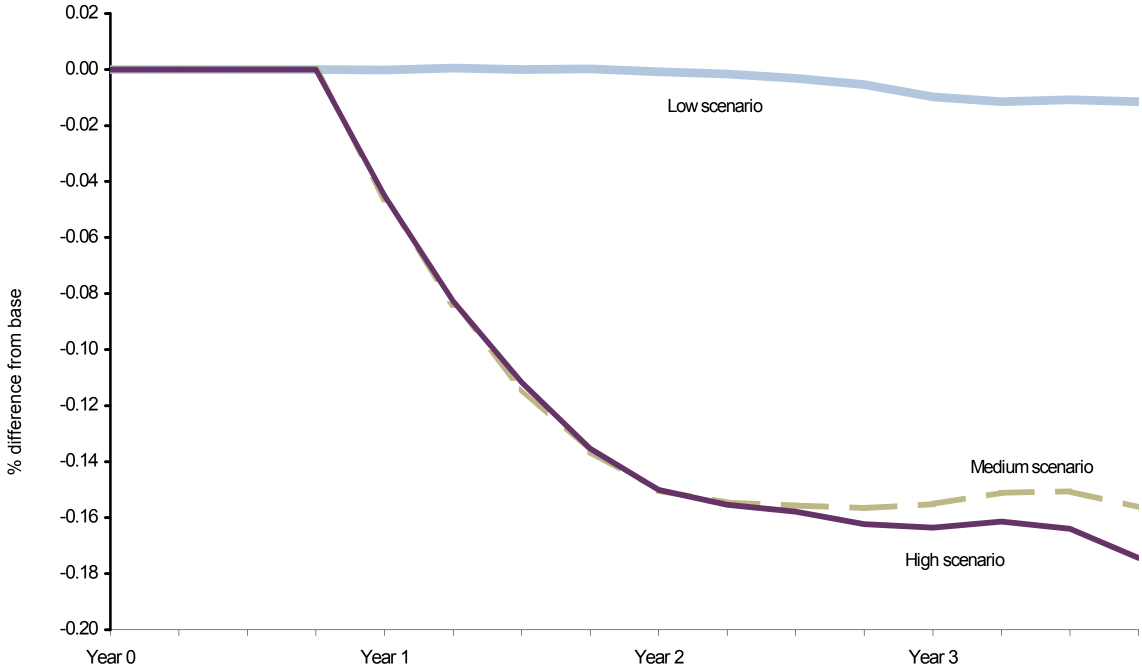
3.8.2 Macroeconomic impact

The immediate effect of both the reduction in the availability of credit and the increase in the cost of credit would be a drop in the usage of credit. This would decrease to a steady level after about three years, as the stock of credit changed to reflect the changes imposed. Figure 3.1 below shows the effect of the three scenarios on the total amount of credit (ie, secured and unsecured).

[35] Mintel (2002), 'Sub-prime Lending: Entering the Mainstream', *Financial Intelligence*, September. The Mintel report defines sub-prime consumers as those who have been refused credit more than once or who cannot obtain credit. This is a conservative definition, as it does not include 'near-prime consumers'—ie, those who have been refused credit only once.

[36] This effect may be offset to some extent by a shift to illegal lending. This shift is not taken into account in the modeling exercise. If a significant proportion of consumers would switch to illegal lending, the effect on consumer spending and GDP would be lower than presented in this section. At the same time, there would be a high cost to consumers—consumers switching to illegal lenders would pay high interest rates and could become subject to unfair business practices.

Figure 3.1 Effect of the Directive on the total use of credit



Source: Oxford Economics.

Figure 3.1 shows that the different scenarios would result in credit providers making available a lower amount of credit than they would otherwise. While the low scenario has a relatively small impact on the total use of credit, with only a small deviation from the base, the effects under the medium and high scenarios are much more significant. In addition to a reduction in the amount of credit used, there would be a change in its composition. As the cost of secured credit would not increase, consumers would to some extent substitute away from unsecured credit towards secured credit, in effect making more use of the flexible elements of their mortgages.

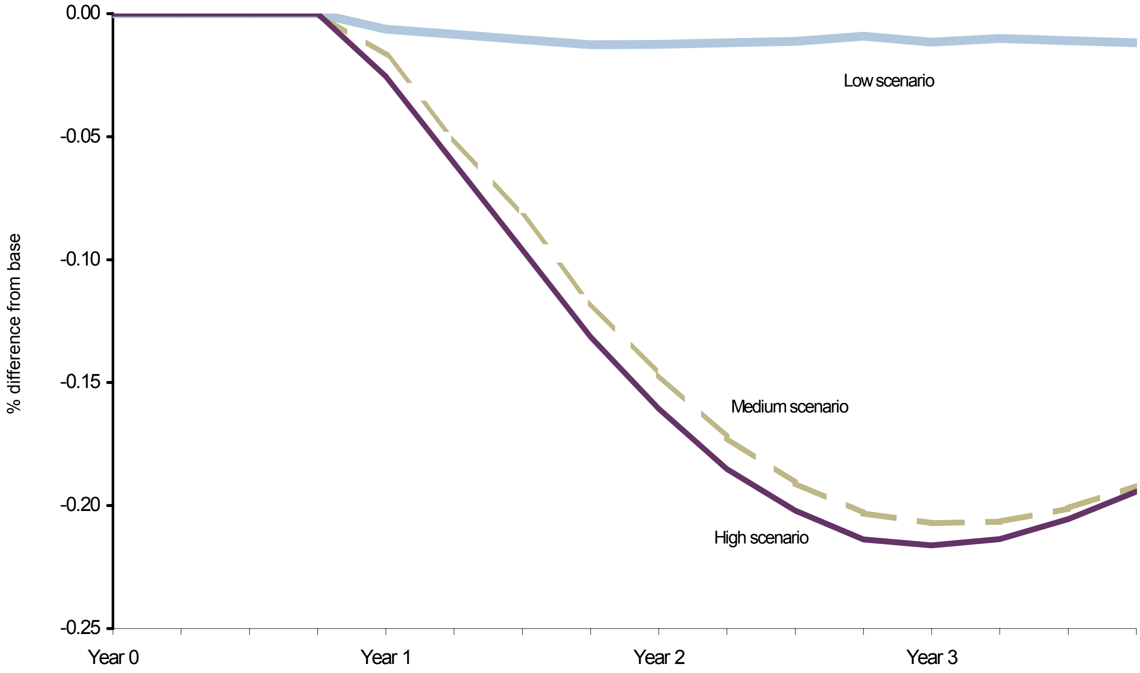
A consequence of using less credit would be that consumers would be unable to smooth consumption as much. Looked at in a different way, in any given period, for the same amount of income earned without the possibility of smoothing consumption, fewer purchases could be afforded. Furthermore, those experiencing a negative shock to their income (eg, through job loss) would be unable to obtain as much access to credit as previously. The credit available to them would also be more expensive.

This implies that consumer expenditure (ie, consumption) falls in the years following the implementation of the Directive. Other consumers who would be forced to cut their level of consumption more than they otherwise would have done include:

– those with a large outstanding stock of debt, who would experience an increase in the cost of servicing that debt and would therefore be forced to reduce consumption now;
– those wishing to fund large one-off purchases by borrowing money, who would not be able to do so if their access to credit was restricted. Such consumers would be forced to postpone such purchases, resulting in a short-term reduction in consumption.

Figure 3.2 below illustrates the effects of this. The low scenario shows a small drop in consumer spending, but, over time, this deviation from the base gradually disappears. The impact under the medium and high scenario is much more significant. The difference from the base increases over a two-year period (from the end of Year 0 to the end of Year 2) to a peak of 0.21% (medium) and 0.22% (high). From this peak in the impact, the difference begins to decrease.

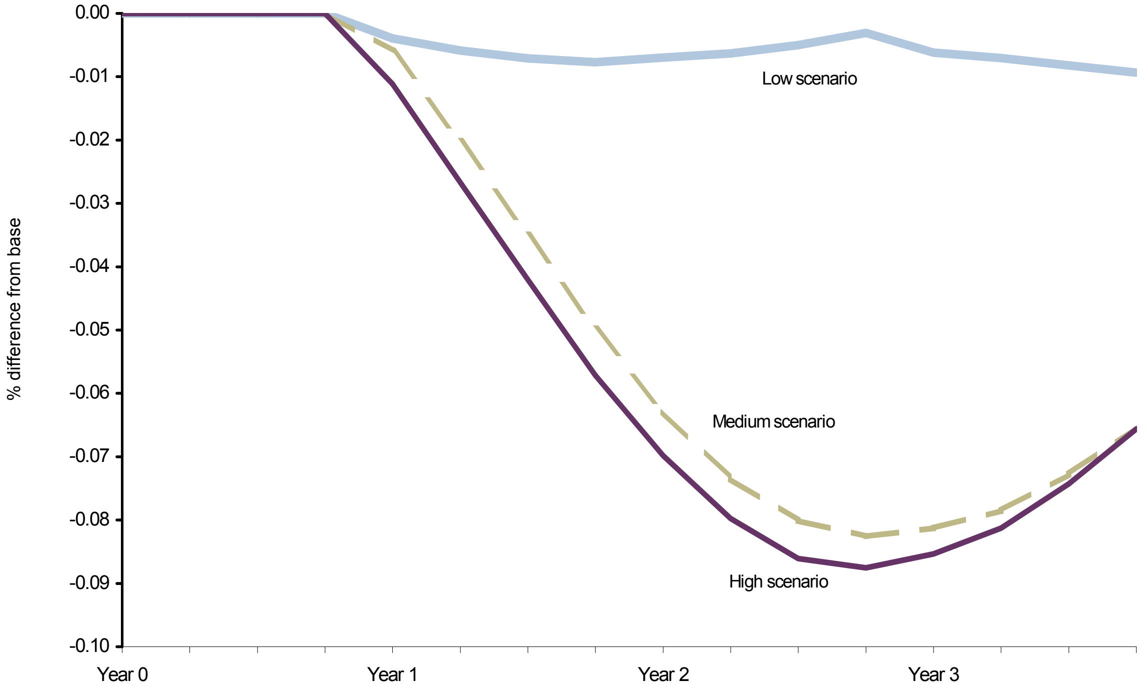
Figure 3.2 Effects of the Directive on consumer spending



Source: Oxford Economics.

The main knock-on effect of the reduction in consumer spending is a fall in demand in the economy, which works through into a lower GDP (see Figure 3.3). It is notable that the drop in GDP is not permanent, although it is significant when it does occur. The low scenario shows a slight impact on GDP, whereby it drops, although this effect decreases over time. The medium and high scenarios both show an increasing drop in GDP until a peak of 0.08% (medium) and 0.09% (high). After this peak, the impact begins to decrease in magnitude.

Figure 3.3 Effects of the Directive on GDP



Source: Oxford Economics.

The drop in GDP is not permanent because it is assumed that the Bank of England would use monetary policy to help compensate for a reduction in the level of demand in the economy. If such a monetary policy response did not occur (ie, due to other economic shocks), the impact on GDP would be likely to be worse than that shown. Over the long term, the reduction on consumer spending would also translate into an increase in savings, which, along with the monetary policy response, would lead to an increase in the level of investment and in the capital stock. Over the long term (at least ten years), consumer expenditure would recover to its original level. However, in the meantime, there would be the real cost of the reduction in GDP and the welfare impact of consumers not being able to use as much credit as they demand at present, and having to pay more than at present for the credit they do use. This is modelled in the following section.

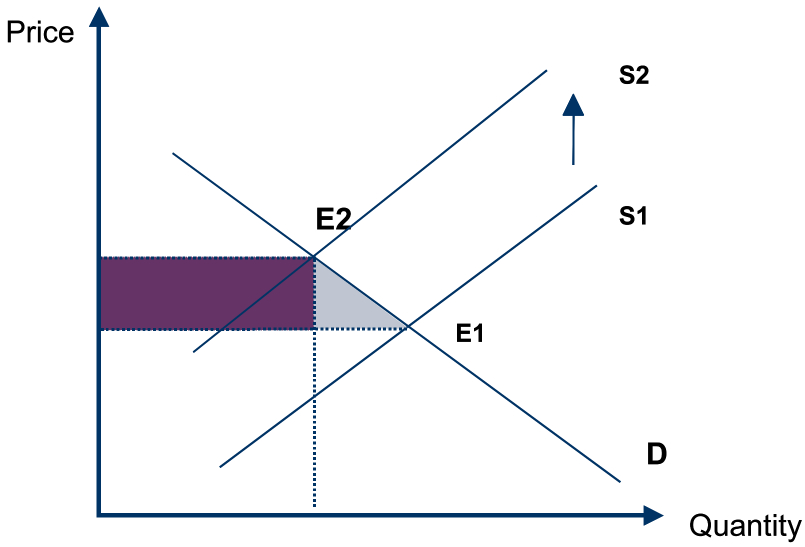
3.9 Impact on consumer welfare

In addition to the effect on consumption and GDP, the reduction in credit may result in a net welfare loss. As is well established by the economic theory of consumption, individuals like to smooth their consumption over their life cycle, and credit markets allow them to do so. By preventing full inter-temporal smoothing of consumption, credit constraints may lead a sizeable proportion of consumers to link consumption decisions to current disposable income flows, rather than permanent income. In other words, the credit constraint introduces a distortion in the market: it restricts choice for consumers and prevents them from smoothing their consumption over time. This means that shocks to current incomes will pass through more fully to consumer spending, thereby reducing welfare for risk-averse consumers.

The welfare effect from restricted smoothing is exacerbated because the credit restrictions would not apply homogeneously to all consumers. The effect of contraction in supply is to exclude the most vulnerable marginal borrowers from the credit market—ie, those with the lowest credit ratings. These consumers are also likely to have the lowest current incomes and would therefore also be those who benefit most from smoothing some of the future consumption to the present.

Figure 3.4 presents a demand and supply curve analysis of the possible reduction in the supply of credit. The consumer credit supply prior to the introduction of the Directive is denoted with demand curve D and supply curve S1. The resulting market equilibrium occurs with the prices and quantities as in E1. The reduction in the supply of credit and the additional unavoidable costs is denoted in Figure 3.4 as a shift in the supply curve up and to the left, to S2. The market settles in new equilibrium E2, where less credit is supplied to consumers at a higher price.

Figure 3.4 Impact of the Directive on the consumer credit market



Source: Oxera.

The reduction in welfare is depicted in Figure 3.4 by the loss in consumer surplus (the shaded area). This loss can be quantified by estimating the price elasticity of demand for consumer credit and undertaking a scenario analysis of a number of price increases of credit. Table 3.2 shows a series of estimates of the impact on welfare according to each scenario.

Table 3.2 Estimated welfare losses arising from the implementation of Articles 5 and 7a

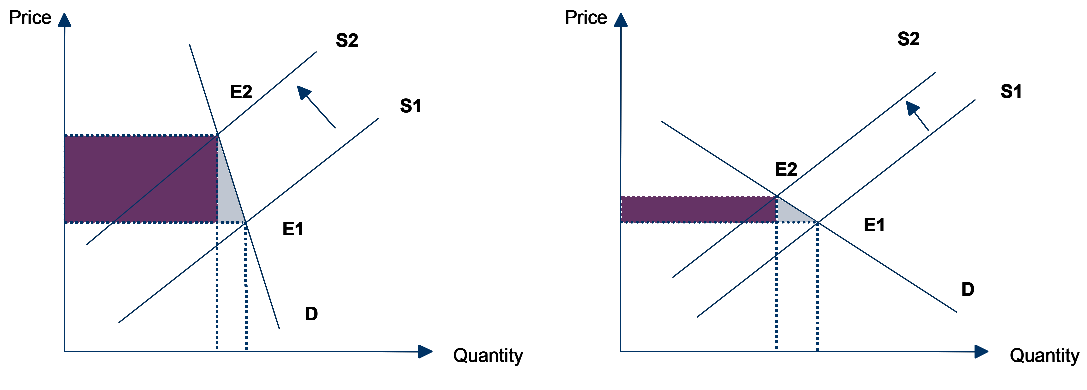
Scenario	Estimated annual welfare loss (€m)
Low	105
Medium	216
High	360

Source: Oxera calculations.

The impact on welfare is shown in Table 3.2 on an aggregated basis. However, this economic impact may not be felt evenly across the population/income distribution. Credit is particularly important for those on low and irregular incomes because it is needed to smooth consumption, as borrowing either to fund seasonal or one-off purchases, or to cover costs while no income is being received.

On this basis, the elasticity of demand for credit would be expected to be lower for those on low or irregular incomes (and those in the sub-prime market) than for those with high incomes. Furthermore, because Article 6 is likely to impose relatively flat costs on a per-agreement basis, the average increase in the cost of credit is likely to be higher for those with the least access to credit. Although insufficient data is available to calculate the relative welfare effects between low/irregular income and sub-prime market consumers and high-income prime market consumers, this can at least be illustrated graphically. Figure 3.5 shows the welfare effects using a linear representation of the supply and demand curves for consumer credit.

Figure 3.5 Relative welfare effects of the Directive



Low/irregular-income and sub-prime borrowers High-income and prime borrowers

Source: Oxera.

In Figure 3.5, the lower elasticity of demand for credit among low earners is represented by a steeper demand curve (D) than the demand curve for high earners. Similarly, as low earners have access to less credit than high earners and the credit-rationing effect will predominantly affect consumers in the sub-prime market, the higher average increase in the cost of credit is shown as a greater shift (reduction) in the demand curve than occurs for high earners.

Despite the fact that low earners experience a greater increase in the cost of credit than high earners, the reduction in the amount of credit they use is shown to be lower than the reduction for high earners. As a result, the welfare loss (shown as the shaded area in Figure 3.5) is likely to be larger for low earners than for high earners.

The reduction in credit would affect a significant number of consumers. The Mintel report indicates that the sub-prime market is made up of 10% of borrowers in the market for personal loans, and 5% in the credit-card market.[37] This could mean that between 0.7m and 1.7m consumers in the UK would be affected. As explained in section 2, there is a risk that some of these consumers would be targeted by illegal lenders.[38]

3.10 Summary of the impact on the UK

This section has shown that the overall economic impact of the Directive is likely to be serious, with reductions in the use of consumer credit, which in turn lower the level of consumer expenditure and GDP over the short to medium term. Furthermore, as a result of the restrictions in the availability of both unsecured and secured credit, and the increase in the cost of both forms of credit, consumers would be worse off in terms of their overall welfare.

Table 3.3 summarises the 'peak' short- to medium-term effects of the Directive under the three scenarios according to its impact on the use of credit on consumer expenditure and GDP—equivalent monetary values are also provided. In addition, the monetary value of the impact on consumer welfare is given, expressed also as a proportion of 'expenditure' on consumer credit.

Table 3.3 Summary of peak to short- to medium-term annual economic impacts of the Directive

		Low scenario	Medium scenario	High scenario
Use of consumer credit	% impact on outstanding debt	–0.01	–0.16	–0.17
	Value of impact (£billion)	–0.08	–1.35	–1.43
	Value of impact (€billion)	–0.12	–1.98	–2.11
Consumer expenditure	% impact	–0.01	–0.21	–0.22
	Value of impact (£billion)	–0.07	–1.39	–1.45
	Value of impact (€billion)	–0.10	–2.04	–2.14
GDP	% impact	–0.01	–0.08	–0.09
	Value of impact (£billion)	–0.11	–0.85	–0.95
	Value of impact (€billion)	–0.16	–1.25	–1.40
Consumer welfare	Value of impact (£billion)	–0.11	–0.22	–0.36
	Value of impact (€billion)	–0.16	–0.32	–0.53
	Proportion of total credit usage (%)	–0.20	–0.41	–0.69

Note: Figures shown are in comparison to the Oxford Economics base scenario.
Source: Oxford Economics and Oxera.

[37] Mintel (2002), op. cit.

[38] See Policis and PfRC (2006), 'Illegal lending in the UK', research report prepared for the DTI, November, URN 06/1883.

3.11 Impact on other Member States' economies

There are two ways in which the proposed CCD may have an impact on other Member States' economies.

– **Direct impact**—where the CCD is more stringent than current domestic legislation, it might make the provision of credit more costly and result in a restriction in the provision of credit (as in the UK). If existing domestic regulation is sub-optimal, the CCD may have a positive effect on the local credit market.

– **Indirect impact**—since the Directive would affect the UK economy, it could also indirectly affect economies in other EU Member States. For example, a significant proportion of consumer credit in the UK is used for the purchase of cars, while a significant number of cars sold in the UK are manufactured in Continental Europe. Thus, a restriction in the supply of credit could also affect economies in Continental Europe.

An assessment of these two effects was beyond the scope of this study. This study focuses on the impact of the Directive on the UK economy.

4 The impact of exemptions in the Directive

The texts of the 2005 and 2006 Directives include exemptions for 'interest-free' credit, HP agreements and pawnbroking, and have new limits for the scope of credit regulated.[39]

Overdrafts have partial exemptions in the 2005 and 2006 texts, which are intended to address the practical problems of regulating such a flexible credit product without destroying its functionality. This section assesses the impact of exemptions based on the counterfactual of a Directive without exemptions.

4.1 The impact of exemptions

4.1.1 Comparison of the CCD with existing regulation in the UK

Currently in the UK, all forms of credit are subject to the same broad set of rules.

This approach was a matter of deliberate policy. Prior to the 1974 Consumer Credit Act, UK credit laws had differentiated between different credit formats. For example, HP credit had its own specific set of laws,[40] as did pawnbroking[41] and money lending.[42] Credit granted by some types of organisation (such as banks) was largely unregulated.

The Consumer Credit Act 1974 took the approach that, in essence, all credit was performing the same function and required (broadly) the same type of regulation. The major exception to this was overdraft credit, which received a 'lighter touch' regime to preserve its different functionality.

Section 2 of the 2006 Consumer Credit Act also removed the £25,000 upper financial limit for the regulation of consumer credit. The rationale for this was that credit agreements have increasingly become unregulated due to higher borrowing on second-charge mortgages and unsecured loans.

4.1.2 Impact on competition

It is the responsibility of national governments to decide whether to transpose the exemptions into national law. Apart from the special exemptions for overdrafts, BBA, APACS, CCA and FLA believe that it is highly unlikely that the UK government would, in general, apply the exemptions under UK law—in the UK the different types of credit are currently subject to the same regulation. Other Member States may, however, apply the exemptions.

Currently, UK consumers have a wide range of credit products available to them. These have different functionalities, with some better suited to certain purposes than others. For example, an overdraft facility is not generally seen as the best product for car purchase. Instead, cars are most often purchased using HP, conditional sales or fixed-term loans.

If the exemptions were transposed into UK law, the overall effect might be a shift towards exempted credit products.

[39] These exemptions are similar to the current 1987 Consumer Credit Directive (87/102/EEC).

[40] Hire-Purchase Acts 1938, 1954, 1964, 1965; and Advertisements (Hire-Purchase) Act 1967.

[41] Pawnbrokers Acts, 1872 and 1960.

[42] Moneylenders Acts 1900 and 1927.

First, on the supply side, credit providers would seek to use exempt products wherever they can because this would offer clear cost advantages. As explained in section 3 above, the CCD is likely to increase the costs of providing regulated credit. This cost burden will be driven mainly by the provisions of Article 7a (obligation to assess creditworthiness) and Article 5.5 (duty to explain).

Second, new demand-side pressures would contribute to a shift to exempt products. Two factors—price and convenience—would be at play here. The pricing impact is clear: if suppliers sell exempt products more cheaply than regulated formats, consumers are more likely to buy exempt products. Just as importantly, customers place a premium on convenience. Articles 7a and 5.5 are likely to make credit application processes (for regulated products) slower, more unwieldy and more intrusive.

Exempt products will be able to achieve a convenience 'win' and are thus likely to be more attractive to consumers. Indeed, exempt product providers would be able to advertise these advantages as part of their marketing strategy.

The overall effect is that exempted products will be a more popular proposition, for both suppliers and consumers. Hence, one could expect to see a market movement towards these formats. This would amount to a market distortion created purely by differing regulatory regimes, an outcome that is not in line with the principles of good regulation.

Since the UK government is not expected to apply the exemptions in the UK, there is no direct harm from these exemptions to the UK economy. However, they may be applied in other EU Member States and distort competition in these local markets.

There is extensive historical evidence showing that differing regulatory regimes for consumer credit products can indeed result in a distortion of competition. In the UK, before the Consumer Credit Act came into force in 1973, different types of credit and different types of credit provider were subject to different regulatory regimes. For example, one key characteristic was that credit providers with a banking licence were not subject to stringent regulation on money-lenders. This resulted in a large number of credit providers applying for a banking licence and thereby avoiding regulation. The effects of the differing regulatory regimes were assessed in detail by the Crowther Committee and led to the Consumer Credit Act 1973, which treats all types of credit equally.[43]

4.2 The impact of exemptions on entry and the creation of a single market

The exemptions for zero-interest credit and HP agreements may also affect the ease with which foreign credit providers can enter local markets where the exemptions apply.

The two key exemptions (interest-free retail credit and HP) relate to credit products that necessarily involve a fairly close relationship between the seller of the goods and the supplier of the credit. Proximity factors mean that such relationships are much more likely to be formed between retailers and creditors from the same Member State. In certain industries (especially the motor industry) the trend is for manufacturers also to own finance companies. These finance companies fund purchases of vehicles by the dealers' customers.

This means that the exemptions for interest-free credit and HP may work to the disadvantage of a creditor from another Member State seeking to enter into a new market. For example, a motor manufacturer based in State A may own a finance company that enters into HP arrangements with customers of that manufacturer's dealers in State A. A lender from Member State B wanting to enter into Member State A could best to do so by offering fixed-term loans directly to customers wanting to buy that manufacturer's cars. However, if HP is

[43] Crowther Committee (1971), 'Consumer Credit—Report of the Committee', March.

exempt in State A, this is likely to give the Member State A manufacturer's finance company a competitive advantage over the lender from Member State B. The non-regulated HP agreement can be sold more cheaply and more conveniently to the car buyer. The cash loan, however, has to be priced to include the cost of the increased regulatory burden and will be a less attractive proposition to customers because the application processes may be more intrusive and time-consuming.

In other words, the exemptions may in practice prevent certain credit providers from entering markets in other Member States.

5 Impact of the Directive on the creation of a single market for credit

One of the main objectives of the Directive is to contribute to the creation of a single European market for credit by 'establishing the conditions for a genuine internal market'.[44] 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.

This section assesses the extent to which the Directive may contribute to a further integration of credit markets in the EU. There are a number of ways in which credit may be offered across border 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.

This section examines the extent to which these mechanisms are likely to be used. To inform Oxera's understanding, a number of conference calls with credit providers were conducted.

5.1 Cross-border credit

5.1.1 Barriers to entry

The majority of credit providers interviewed indicated that offering credit across borders is unlikely to be a realistic option to 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.

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 as follows.

– **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 have to be tailored to suit local consumer habits, attitudes and

[44] Explanatory memorandum to CCD, November 23rd 2005, Section 2, p. 3.

needs. To market their credit products successfully, credit providers often have to hire staff locally and serve consumers in their own language.

– **Distribution channels**—the availability of distribution channels will affect the ease with which credit providers can enter new markets. For example, they may find it more difficult to enter countries where most credit providers 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 good 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 upon 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 amount is taken directly from their salary. This differs from other countries where wage assignment is not available or where a court order is needed first. Furthermore, the optimal strategy towards debt recovery often depends on consumer attitude and is therefore likely to differ across countries.[45]

– **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.

5.1.2 Assessment of entry barriers

As barriers to entry are often a matter of degree, they do not necessarily preclude entry, but may affect the way 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, such as Cetelem and GE Consumer Finance, 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 EU Member States.

Some of the barriers highlighted 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 CRAs to assess the creditworthiness of applicants in combination with their internal credit score models. To build such models, sufficient

[45] A European Commission Green Paper on Debt Recovery is currently being consulted upon. Commission of the European Communities (2006), 'Annex to the Green Paper on improving the efficiency of the enforcement of judgments in the European Union: the attachment of bank accounts', SEC(2006)1341. It is not clear, however, whether the proposed measures would make offering credit across border commercially feasible. An assessment of this Green Paper is beyond the scope of this report.

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 is therefore normally only worth doing if the new market segment is entered into at a certain scale. Similarly, developing a business strategy to recover debt from defaulting customers is costly and is often only commercially viable if done at a certain scale.[46]

Furthermore, offering cross-border credit to consumers who shop around in different countries is likely to be risky and therefore often not an option. Interviews with credit providers themselves 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. In the main, there is little demand for cross-border credit, although some providers have cited anecdotal evidence that some consumers do search for credit across borders; however, this is often because they have been rejected for credit by domestic credit providers (ie, it may result in adverse selection).

5.1.3 Impact of the CCD on entry barriers

To what extent does the CCD remove these aforementioned barriers? As the Directive only removes some of the differences in regulation of consumer credit across countries, its impact may be limited. First, in contrast to the 2002 Directive, which proposed maximum harmonisation of regulation across EU 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 worthwhile to have 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, acquisition 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.

[46] Certain elements of debt recovery activities may be outsourced to specialised debt collection companies.

www.oxera.com

Park Central
40/41 Park End Street
Oxford OX1 1JD
United Kingdom

Tel: +44 (0) 1865 253 000
Fax: +44 (0) 1865 251 172

Stephanie Square Centre
Avenue Louise 65, Box 11
1050 Brussels
Belgium

Tel: +32 (0) 2 535 7878
Fax: +32 (0) 2 535 7770