

CONSUMER CREDIT: WHAT FUTURE FOR A CROSS-BORDER MARKET?

Summary: Consumer credit (mortgage/loans for the purchase or transformation of private property excluded) is a fundamental component of economic growth. Not only does it provide individuals with access to goods and services and enable manufacturers and service providers to sell their products but it also contributes to the operating results of many financial and non-financial organisations. Within the EU, legal rules, as well as market structures, products and cultures vary greatly from one country to another and there is no single market in consumer credit. Steps towards a single market will need to encompass varied areas such as APR calculation, advertising and marketing techniques and lender liability. A move towards an internal market for consumer credit whether by loan, overdraft or credit card could be achieved via a new directive enabling consumers to compare offers coming from different Member States. It will be important to safeguard free competition, consumer protection and data protection in order to increase transparency and comparability within the EU.

THE ECONOMIC IMPORTANCE OF CONSUMER FINANCE

Consumer finance in the form of outstanding balances on installment loans or credit cards represented around 616bn Euro in the EU in 2000. The following figures show that outstanding credit in Germany and the UK is far greater than in the rest of the EU member states. The structures of the market, the actors and the distribution channels are also quite different. Compared to the American market, US consumers spend 7 times as much as European consumers via their credit cards and have more cards. There are 187 credit cards for 1 000 people in Europe and 1 986 for 1 000 people in the US.

Bn Euro	Outstanding (retail consumer credit since 1993 country by country)						
	Germany	Belgium	Spain	France	UK	Italy	Total
Dec 1993	176,9	10,0	30,8	58,7	83,5	16,8	376,7
Dec 2000	222,6	12,2	58,6	97,8	186,2	38,5	615,9
Growth 00/93	+25,8%	+22,0%	+90,3%	+66,6%	+123,0%	+129,2%	+63,5%
Annual growth	+3,3%	+2,9%	+9,6%	+7,6%	+12,1%	+12,6%	+7,3%

Taking a loan or deferred payment on their credit card helps consumers to buy goods or services which they could not afford immediately when paying cash, whether it is electronic goods, furniture, cars or holidays. Loans have a gearing effect globally in the sense that they enable individuals to gain access to new goods or services and manufacturers and service providers to sell more so boosting economic activity. The following figures show that from one country to another the use of credit per inhabitant varies greatly. Nevertheless the common trend is an increase in the use of this type of financial service.

Euro	Average outstanding credit per inhabitant country by country					
	Germany	Belgium	Spain	France	UK	Italy
Inhabitants 31/12/2000	82 163 475	10 239 085	39 441 679	59 225 683	59 623 406	57 679 895
Outstanding per Inhabitant in 2000	2 709	1 192	1 486	1 651	3 123	667
Outstanding per inhabitant in 1993	2 185	1 000	788	1 020	1 438	295
Growth 00/93	+24,0%	+19,2%	+88,5%	+61,9%	+117,2%	+126,3%
Annual growth	+3,1%	+2,5%	+9,5%	+7,1%	+11,7%	+12,4%

15 MEMBER STATES, 15 VISIONS OF CONSUMER CREDIT

EU Directive 87/102/EEC did not succeed in creating an internal market for consumer credit where lenders would be able to offer their loans across-borders to consumers located in an other Member State. The reason for this is that not only are legal rules different from one country to another but so too are the practices, the products and the markets.

The legal rules: one needs just to look at the Annual Percentage Rate (APR) which means the total cost of the credit granted as an annual percentage of the total amount of credit. From the point of view of the consumer, who is considering offers from lenders coming from different Member States, these APRs are not comparable. The Directive 87/102/EEC enabled Member States to adopt their own rules at the time where most of them did not have legislation on consumer credit. Different countries therefore include different elements, for example, insurance costs, in the total cost of credit. An opportunity to achieve an internal market quicker was therefore missed some years ago.

Practices: it is easy to see that using credit in the UK is part of daily life when buying goods or services. On the contrary, consumers in Member States such as Belgium and Italy still remain very cautious when using loans and credit cards. This is particularly obvious when looking at the national figures in the table above. [The Belgian average is lower than the Spanish one]

The structures of loans and the markets: it is interesting to compare the structures of the retail market. In Germany for example, most consumer credit is provided on current account overdraft, while in France around 54% of outstanding credit is granted through independent specialised financial establishments and 46% through banks mainly in the form of personal loans. In UK there are around 45 million credit cards, whereas there are just 1,2 million credit cards in France.

At the moment the only sense in which there is a European market for consumer credit is that institutions use the principle of freedom of establishment to set up operations in Member States other than their home country and offer consumer credit on a domestic basis there.

THE KEY PRINCIPLES IN CONSUMER CREDIT

Consumer credit as well as many other financial services is characterised by the fact that it is firstly quite sophisticated and complicated and secondly that it is not a 'once and for all' transaction but one that endures, often for years.

The key principle in consumer credit is the assessment of risk. Each lender will be comfortable with a different level of anticipated losses from their portfolio. They will price their product accordingly.

It is not so much the absolute level of losses in a portfolio which is crucial rather the level of unexpected losses. That is to say losses beyond those anticipated for the portfolio as a whole.

Where actual losses exceed those anticipated, then the lender will face falling profitability. They can react in a number of ways. At a basic level they can continue with the same methodology for granting loans but increase the price to the borrowers. So accepting that they will now run a portfolio where they anticipate a higher level of loss but are remunerated accordingly.

Or, they can stiffen their criteria for granting credit so aiming to bring actual losses back into line with those originally anticipated but keeping pricing the same.

The most important aspect in consumer credit is that the lender will earn money if his clients repay their loans as expected and he will make profits only if this is the case. This means of course that the lender cannot expect to make profits where an unexpected number of clients fail to repay their loans.[Consumer credit is a portfolio business].

At the time of the granting of the consumer credit the lender will have to look very closely at the financial situation of his client. He will have at his disposal some tools that will help him to evaluate the risk level. These tools are from three categories as follows:

1. In almost all of the Member States a National central credit reference database consulted by every lender will register according to the country all consumers who have had a default of payment or consumers having contracted a loan or a credit agreement. One is called a negative database, the other a positive database. The database is a record of fact from which lenders can draw their own conclusions. Around 70% of all defaults are associated with divorce, unemployment, accident and death which cannot be taken into account in the contract before they happen. To help create a single market with a level playing field what is needed is equal and open access to the various databases that exist.
2. The second type of tool is Credit scoring. This is based on statistical analysis of the history of the customer's account and other information such as personal, socio-professional, behavioural, characteristics of the consumer or it can be bought from external credit agencies. Thus, the scoring system is not an *a priori* tool but a practical one based on past experience. It helps to determine how great the risk is that a client having a certain profile may not repay his loan perfectly.

- Through “expert systems”, the lender will decide that some rules will apply in certain circumstances according to the personal or financial situation of the customer. Expert systems may be considered as a help for the decision making process, particularly to identify fraud. For example by being used to tackle incoherence in the customer’s profile and provide an alert (e.g. individual saying he has got no children and buying pieces of furniture for a child’s room...).

After the loan has been granted, in the vast majority of cases it lasts until the end of the original contract without any difficulties arising. In those very few cases where the client experiences difficulties, whether these are very simple or technical problems (such as they have provided the wrong bank account number, they change address...) or more important (such as financial difficulties, urgent new needs...) most issues can be solved in a quick, simple and cheap way where the lender pays close attention to his client. The lender may suggest that the client reduces instalments or reduces the length of the loan or even the renegotiating of the contract under more favourable conditions. Thus, it is also very important for the lender to have an efficient after-sales service in order to maintain a normal commercial relationship with the client. The aim of the collection department in a financial organisation is to encourage customers to pay whilst making sure the customer stays as a client.

Where problems are more serious than temporary difficulties, where the client does not want to or cannot repay his loan anymore because of an accident, a divorce or unemployment and after the lender has tried to find solutions, it is possible that the lender might be obliged to recover the sums from the customer. At this stage, there are rules in Member States (for example, forbidding harassment), although the lender has the contractual right to recover his claim as long as the client is not insolvent.

Of course, payment protection insurance has an important role to play here in reducing difficulties with repayment.

WHAT AIM FOR A FORTHCOMING DIRECTIVE?

A new proposal for a Directive on consumer credit will be published this year by the European Commission. Its aim should be to create an internal market allowing lenders to offer their loans or cards across borders and providing consumers with a wide choice. The forthcoming Directive should help European consumers to compare offers from lenders coming from different member States. Where possible harmonisation should be maximal in order to facilitate comparisons. Because of the complexity of consumer credit, harmonisation will probably not be full in all its aspects, even not in its legal aspects. In this case key but precise principles should be given and the consumers should be aware that differences between different laws exist. The future directive by helping consumers to compare offers should facilitate consumer choice. The aim should not be to restrain consumers from being granted a loan nor to prevent lenders from offering new services or to make the granting more expensive. In all of these cases consumers would suffer from a lack of ways of financing their purchases, from more restrictive conditions before granting or from more expensive loans.

THE KEY PRINCIPLES FOR AN INTERNAL MARKET IN CONSUMER CREDIT

The key aspect of an internal market for consumer credit is free competition based on a level playing field with clear rules on calculation of APR, advertising and the liabilities of lenders. In

most of the Member States, there are many domestic providers of consumer credit. One can consider that, generally speaking, real competition exists at each national level. This should be maintained at the European level in order to allow consumers to get the best and the most convenient offers. Free competition is also needed to develop new forms of loans. Therefore national markets should not be compartmentalised nor the development of the current and new forms of consumer credit be frozen because of too strict measures. Harmonisation of rules does not have to mean homogenisation of products and processes. The second key aspect within the internal market is to consider an appropriately high level of consumer protection. This protection concerns the terms of the contract, the distribution and the information given to the client. A new directive cannot just aggregate in a single document aspects from different national legislation that seems to be the most protective. As seen before, practices and national approaches to consumer credit should be taken into account. Moreover, the future Directive should not jeopardise the operation of voluntary initiatives such as the European Mortgage Code. This initiative, signed by five European consumers associations and six European credit associations in March 2001 and subscribed by almost 3,000 banks, aims at facilitating pre-contractual information for consumers' home loans. Data protection is also an important aspect of consumer credit. In order to grant a credit, much personal data has to be gathered by the lender to decide whether or not the client should be granted the loan. The 1995 Data Protection Directive already establishes the conditions under which such data is protected.

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Advisory Committee.

Steering Committee

Robert Goebbels, MEP
Chris Huhne, MEP
Giorgos Katiforis, MEP
Piia-Noora Kauppi, MEP
Alexander Radwan, MEP
Peter Skinner, MEP
Theresa Villiers, MEP

Chairman Advisory Committee

Paul Arlman
Federation of European Securities Exchanges
Rue du Lombard 41
B – 1000 Brussels
Tel: 0032 2 551 01 80
Fax: 0032 2 512 49 05
E-mail: arlman@fese.be

Secretary

John Houston
Houston Consulting Europe
Av. Joyeuse Entrée 1
B – 1040 Brussels
Tel: 0032 2 504 80 40
Fax: 0032 2 504 80 50
E-mail: info@houston-consulting.com

Founding Members

Richard Balfe MEP	C.A. Gasoliba I Bohm MEP
Robert Goebbels MEP	Chris Huhne MEP
Othmar Karas MEP	Giorgos Katiforis MEP
Piia-Noora Kauppi MEP	Astrid Lulling MEP
Ria Oomen-Ruitjen MEP	Karla Peijs MEP
John Purvis MEP	Alexander Radwan MEP
Karin Riis-Jorgensen MEP	Olle Schmidt MEP
Peter Skinner MEP	Charles Tannock MEP
Theresa Villiers MEP	

Advisory Committee

ABN AMRO Bank
Banco Bilbao Vizcaya Argentaria
Barclays
Deutsche Bank AG
European Banking Federation (FBE)
Federation of European Securities Exchanges
Futures and Options Association
Goldman Sachs
International Swaps and Derivatives Association
San Paolo IMI Bank
Société Générale
Svenska Handelsbanken
UBS