

RESPONSIBLE LENDING AND FINANCIAL INCLUSION

Summary: Responsible lending involves a combination of compliance with legal requirements and business practices developed to regulate access to credit for private customers. There is no agreed definition of the concept but the following are examples of best practice many lenders today fulfil:

- Using unambiguous language to complying with regulations on misleading advertising and, actively seeking to remove small print and jargon.
- When assessing credit applications, examining the overall likelihood of the applicant being (or close to being) over-committed.
- Looking at ways to work with industry colleagues, Government, Regulators and Consumer Groups to promote consumer education and financial awareness – also by helping consumers to understand the reasons for a credit application being declined.
- Together with credit bureaux¹, where appropriate, considering ways of identifying possible over-commitment at the earliest opportunity. This is in the interest both of the lender and the customer.
- Actively supporting and promoting awareness of free money advice organisations² that can support customers in difficulty.
- Regularly reviewing their end-to-end processes, making changes to practices where necessary and preparing internal guidance to promote staff education
- Going beyond simple compliance and seeking ways to promote tangible benefits from adopting/extending responsible lending practices
- Examining ways to increase data sharing, including positive data, within the existing data protection provisions - “enabling fully informed decisions”
- Within the tradition of the market place developing robust and meaningful Codes of Practice.

In their own interest most mainstream lenders in the EU, and particularly credit institutions, lend ‘responsibly’. But how do we recognise responsible, or indeed irresponsible lending when we see it? This paper gives a description of **responsible lending**, the various **stages** in the credit process, and some examples of **best practice**.

Myths and reality

Unlike irresponsible lending, which can be characterised by misleading or exploitative practices, (such as knowingly lending to customers who are over-committed), responsible lending is not easy to define.

Customers vary enormously in terms of their attitude to risk, financial sophistication, income and commitments. For a financially sophisticated customer, responsible lending might simply mean ensuring that a loan goes through quickly and smoothly. Less risk averse customers may need more guidance from their lender to understand the various options available to them, whereas more confident customers may see this as an irritation.

Lenders may not know the full picture at the time of making the loan and cannot predict all future eventualities. For example the borrower may not provide the full picture of his commitments and may *borrow* irresponsibly. Or the borrowers who later lose their job, or suffer

¹ Third party collators and provider of credit data

² Third party providers of free advice to consumers

bereavement may find themselves in a very different position from when they took on the loan. Yet on the day the loan was made, the transaction was made ‘responsibly’ and in good faith.

We would argue that three criteria are key – **transparency, support for consumer education and efforts on financial inclusion** when it comes to judging responsible lending in its entirety.

Promotion and Advertising of Credit

Consumers across the EU enjoy access to a healthy and competitive credit market, thanks to the promotion and advertising of credit – the first stage in the overall credit process. **General advertising**, whilst not precise, gives customers the initial information needed to shop around.

Not all advertising is general – some is targeted at particular customers. Credit risk screening aims to ensure that potential customers with signs of financial stress are not approached. Irresponsible targeting benefits nobody. It is expensive for industry (in terms of marketing costs and ultimately a declined application) and raises expectations for the consumer, by giving them the false impression that they are considered a good “risk”.

In terms of our key criteria for responsible lending

- **Transparency** - It is important that lenders ensure that the promotion and advertising of credit is not misleading, and that terms and conditions are clear at the outset.
- **Consumer education** - Lenders should seek to ensure that consumers fully understand the nature of the transaction. In particular, customers need to understand that failure to make payments on a loan secured on their property may result in them losing their home.
- **Financial inclusivity** is less easy to address in this area, as it would not be responsible to promote credit to desperate or vulnerable customers. That said, lenders have a role to play in finding solutions to issues such as access to credit for those on low incomes, or those customers who narrowly fail the credit scoring process.

A responsible lender will ensure that their advertising/targeting techniques are appropriate and that all related marketing/product materials are transparent, without any attempt to mislead the consumer.

BEST PRACTICE RECOMMENDATION: Lenders complying with regulations on misleading advertising and seeking to remove small print and jargon.

Assessing Applications for Credit Products

Credit scoring is widely used to assess affordability and is an integral part of the application process. It involves taking data from a number of sources such as: direct from the customer; the lenders' records of past transactions with the customer; and credit bureaux.

Computerised scoring has proved more reliable than human intervention, with research indicating that levels of early arrears are generally seen to be four times higher where there has been manual discretion.

The objective of any credit scoring system is to provide a robust mechanism to assess the applicant's **ability to repay**. Many systems have become highly sophisticated over the years, going beyond the simple "yes/no" decision to determining the amount and terms of the credit offered.

Where a borrower is known to the lender (for example through their current account record or other existing borrowing) this information will be fed into the lending decision. Where this "in-house" information is not available, the role played by the **credit bureau** becomes ever more important. There are differences in the *type and accessibility* of data, which is available across the EU, but the fundamental purpose – checking ability to repay – is consistent.

As they review data from a credit bureau, lenders will be assessing whether credit facilities are being paid and whether there are any arrears. A responsible lender will also act with due caution, e.g. by keeping initial credit card/overdraft limits prudently low, until such time that the consumer has demonstrated an ability to manage the repayments, i.e. a "track record".

In terms of our key criteria for responsible lending

- **Transparency** – Lenders should be clear and upfront throughout the applications process whilst thoroughly checking ability to repay. Greater transparency in the *declines* process would help **educate** customers to understand why they have been refused credit – could they consider borrowing a smaller amount, or are they simply 'over-committed' already?
- **Consumer education** – Experience suggests that around two-thirds of the loan customers who are refused a loan subsequently take out credit elsewhere. Many of these customers lack the financial sophistication to shop around, and end up with more expensive credit; many should not be borrowing high amounts at all. Starting customers on an initial low credit limit can help those using cards or overdrafts for the first time to become familiar with the operation of the facility, without the fear of getting into too much debt.
- **Financial inclusion** – Good credit scoring processes inevitably mean that some customers, including desperate customers, will be refused credit. Lenders and policy makers need to think imaginatively about solutions for these customers, who might otherwise turn to **loan sharks**.

A responsible lender will ensure that they use the best credit scoring tools available and that they pay close attention to internal and external information to check ability to repay.

BEST PRACTICE RECOMMENDATION: Lenders should examine the overall likelihood of the applicant being (or close to being) over-committed and seek to educate customers by helping them understand the reasons for a credit application being declined.

Management of Existing Customer Accounts

The lender's obligation to lend responsibly should not cease once an applicant has become a borrower. Many lenders are increasing their expertise in the management of existing customers, including the use of a combination of internal information, such as "**behaviour scoring**" and external data provided by a credit bureau to pre-empt repayment difficulties.

The use of both internal and external data provides a sound basis on which lenders can manage the account, for example in terms of credit limits (increases and decreases), transaction authorisations and collections strategy (e.g. to identify a deteriorating arrears position early via the bureau data). Using a *combination* of data supports responsible lending principles by providing as full a picture as possible to make assessments on an ongoing basis.

- **Transparency** – Customers should expect regular statements outlining their borrowing, repayment terms and other relevant information such as interest rates applied. Any variation in these terms should be notified to the customer in advance.
- **Consumer education** should not stop after the initial lending decision. Lenders need to find ways of regularly *informing* customers (e.g. details in customer statements of estimated interest, should the customer choose not to repay their balance in full).
- **Financial inclusion** – Several lenders have worked with credit bureaux to develop an **early warning** system that can alert lenders to a potentially deteriorating credit situation. Lenders must also exercise care in dealing with customers who get into difficulty – see below.

A responsible lender will ensure that customers have access to the necessary information throughout the course of the credit agreement.

BEST PRACTICE RECOMMENDATION: Lenders, together with credit bureaux where appropriate, should consider ways of identifying possible over-commitment at the earliest opportunity. This is in the interest both of the lender and the customer.

Dealing with those in Financial Difficulty

Research indicates that the main reasons customers experience financial difficulties are loss of income and relationship breakdown, rather than irresponsible lending/borrowing.³

If a customer is experiencing financial difficulties, it is imperative that they are in dialogue with the lender at the **earliest opportunity**. This is particularly important for those who are experiencing difficulties and are trying to resolve such issues, as opposed to those who simply have no intention to repay.

Early recognition of a problem will allow the lender to ensure that, wherever possible, the situation is contained. According to the individual circumstances Lenders should deal with customers fairly and **sympathetically**, e.g.:

- Allowing extra time for customers to bring their account(s) back into order;
- A temporary reduction, or possibly suspension, of credit repayments;
- Extending the term of the facility, or agreeing a short/long term repayment plan; and
- Arrangements around the reduction, or possibly suspension, of interest charges.

³ Amparo San Jose Riestra, *Credit Bureaus in Today's Credit Markets*, ECRI, September 2002

The best outcome is for the borrower to preserve their credit record and for the lender to be repaid.

In terms of our key criteria for responsible lending:

- **Transparency** – Lenders should be clear about any new terms agreed.
- **Consumer education** – Lenders should work with external organisations to educate customers by promoting awareness of FREE money advice.
- **Financial inclusion** – Lenders should continue to work closely with local **community based** organisations (such as Credit Unions, Citizens' Advice Bureaux and the Consumer Credit Counselling Service in the UK). Many customers prefer to discuss financial difficulties with a third party rather than their creditor – a preferable approach to the customer ignoring the debt altogether.

A responsible lender will treat all customers fairly and sympathetically if they experience difficulties.

BEST PRACTICE RECOMMENDATION: Lenders should actively support and promote awareness of FREE money advice organisations who can support customers in difficulty.

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.

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