TOWARDS A BALANCED CONTRIBUTION OF HOUSEHOLD CREDIT TO THE ECONOMY

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CEPS-ECRI TASK FORCE REPORT

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The European Credit Research Institute (ECRI) is an independent think tank that carries out research and contributes to the policy debate on financial services in Europe. It is managed by the Centre for European Policy Studies (CEPS), a leading think tank covering a broad range of policies in EU affairs.

This report is based on discussions in the CEPS-ECRI Task Force "Towards a Balanced Contribution of Household Credit to the Economy". The group met four times over a concentrated period from May 2014 to April 2015. The policy recommendations offered at the beginning of this report reflect a general consensus reached by Task Force members, although not every member agrees with every aspect of each recommendation. A list of members, observers and invited guests of the Task Force can be found in Appendix 2. The members were given the opportunity to comment on the draft final report, but its contents may only be attributed to the rapporteur and do not necessarily represent the views of the institutions to which the members belong.

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PREFACE

Throughout Europe, the financial crisis of 2008 and the implementation of new regulations have contributed to a reversal in the continuous growth in outstanding consumer credit registered in the preceding decade, thereby resulting in a cumulative contraction of more than 10% over the last five years in the euro area. The prospect of the American subprime crisis contaminating Europe, the banking fragilities it revealed, and the resulting loss of household confidence in the economy led to the double phenomenon of persistent contraction in the demand for loans and reinforced banking regulation, prompting banks to reduce their balance sheets. In combination with growing ecological concerns, resulting in the need for more responsible consumer behaviour, this major crisis may have been a good opportunity to initiate a broad movement calling into question our growth model, in order to tend to the '*sobriété heureuse*' defended by the French writer, farmer and environmentalist Pierre Rabhi.

Nevertheless, GDP growth remains the main benchmark for assessing the overall success of an economy. Furthermore, the European banking system has been forced to adjust its internal models in order, on the one hand, to adapt to increasingly constraining regulation and, on the other hand, to meet the request from the European Central Bank and governments to support European economic growth by increasing the supply of credit. Nevertheless, the amounts of consumer credit granted remain far below pre-2008 levels. Yet the outstanding sum of consumer credit is not likely to pose the systemic risk that is much feared at the macroeconomic level. On the other hand, rising household over-indebtedness throughout Europe reveals that strengthening regulation does not reduce the risk of household insolvency and that new approaches need to be defined to contain the unacceptable social risk which, to a certain extent, contributes to the dangerous increase of political extremism observed in all EU-28 member states.

Current economic, technological and social developments seem to justify reviving the consumer credit market so it can play an active role in achieving the ambitious Europe 2020 agenda: promoting responsible and

sustainable growth, respecting the environment and human welfare, and implementing the transition to renewable energy sources. Public investment alone will not be sufficient to achieve these ambitious and necessary objectives. Europeans themselves have to be encouraged to take part in this project, by adjusting their consumption habits. From that perspective, credit, in combination with appropriate tax policies, can provide a powerful leverage to fund new forms of consumption in line with responsible growth.

The stance of this report therefore consists of identifying the channels through which regulators can revive consumer credit markets – which are, undeniably, tools for European growth – and, in the meantime, in ensuring sufficient consumer protection, as it remains one of the founding principles of every public policy.

While the transposition of the 2008 Consumer Credit Directive (CCD) has not decreased the heterogeneity in domestic rules across member states – it has in fact done the opposite – today it remains difficult, although necessary, to assess good practices and the impact of stricter regulation on the evolution and dynamics of this market. Indeed, national practices in terms of regulation depend significantly on domestic cultural behaviour and socio-economic conditions, thereby resulting in few possibilities to make pertinent comparisons between countries. How can European regulation on credit be harmonised without harmonising the definition of the different credit products available in each country and establishing a common classification of the diverse technical features of credit, all against the economic backdrop of debt ratios ranging from 1 to 3, depending on the country? How can we regulate effectively when we cannot precisely define what we are supposed to regulate?

On the other hand, the stricter regulation observed in several countries, including France and Italy, has triggered a public debate over and tarnished the image of consumer credit, thereby heightening the sector's poor performance.

In addition, the difficulty of harmonising European regulation also results from the difficulty of integrating the domestic markets within a European single market. The main reason behind this challenge can be found in the fact that consumer credit is usually related to the purchase of a physical good, which remains an essentially local decision from a geographical point of view, except when e-commerce is involved. By incorporating the cultural dimension of borrowers' relationship to money (which differs greatly across countries) and the risk -management challenges facing lenders (assessing their borrowers' creditworthiness and their own

capacity to cover costs in case of default), we can understand why cross-border lending remains marginal, excluding Luxembourg.

As a result, stimulating consumer credit markets in Europe is probably best achieved by finding ways to simplify local rules and implement a new type of regulation, taking into consideration the complexities of the market and the development of e-commerce, the new risks related to digital development and new business models. The legal complexity of consumer credit contracts are obvious proof of the consequences of regulation, which ends up being counterproductive for both the lender (rising administrative costs) and the borrower (incomprehensible, and often unread, contractual clauses). Digitising contracts should contribute to the simplification and gradual harmonisation of both pre-contractual and contractual documents.

Therefore, the recovery of consumer credit markets will be intimately linked to the ability of banks and financial organisations to build a customer relationship based on a better balance of responsibilities, and to take advantage of new information technologies and uses of digital tools. Success will also depend on the ability of regulators, especially those at the EU level, to favour the emergence of regulations that both accompany the development of credit and guarantee the protection of consumers. The recovery would rely on dynamic processes (such as 'trial & error'), favouring the emergence of good practices in each country and then testing and assessing the impact of a new policy before implementing it at the national level. Finally, it may be feasible for the existing regulator to supervise agencies of social and environmental ratings, whose objectives would be to certify the quality of the credit and the behaviour of stakeholders in each country.

In this respect, this report defends the emergence of a new type of European regulation – meaning better, not more, regulation – that fuels growth, protects consumers and enhances the balance of responsibility between borrowers and lenders.

Eric Delannoy
Chairman of the Task Force
Former Vice President, Weave

EXECUTIVE SUMMARY AND KEY RECOMMENDATIONS

While policy-makers are creating conditions to strengthen recovery, the debate on the role that retail finance should play in this respect focuses on corporate loans rather than on household credit. The improvement of financing conditions for firms in order to support further investment spending is certainly essential to ensuring sustainable growth. However, a significant part of EU growth will depend on the behaviour of households and on their ability to secure funding for their consumption and investment. It is therefore essential to place further emphasis on the different options available to stimulate household credit, in particular consumer loans.[1]

Nevertheless, in order to avoid past mistakes, regulators should continue to develop a framework where consumer loans (and by extension household credit) contributes to the economy in a balanced way. To achieve this, five main issues need to be further addressed.[2] Firstly, more harmonisation in statistics is required to support the policy process. Secondly, the macroeconomic models used to boost consumer loans should be refined, both in a quantitative and qualitative way. Thirdly and in parallel, innovative tools should be developed to try to deal with persistent and new market dysfunctions for household credit, especially in the areas of

[1] Although the core of the report places the focus on consumer credit (loans granted to households for personal use in the consumption of goods and services), most of the recommendations could concern the other types of household loans (including residential loans and other loans). In addition, several analytical frameworks may be partially or totally replicated in all the segments of household credit, especially in Chapters 4, 5 and 6.

[2] The intention of the report is to adopt a multidisciplinary approach by using methodological tools from different disciplines: macroeconomics, microeconomics, behavioural economics, statistics, finance and consumer protection/competition laws. In that context, as shown in the table at the end of this executive summary, recommendations can be of use to policy-makers and senior executives, as well as to researchers, statisticians and economists.

information disclosure requirements and responsible lending practices. Fourthly, at a more European level, better understanding of the integration process of household credit is required. Finally, regulators need to create conditions aimed at supporting the financial sector throughout its digital transition process.

1. Greater harmonisation in statistical methodologies

At the beginning of all policy initiatives, regulators need accurate, consistent and verifiable data which help define the scope covered by the enacted rules. Furthermore, the consistency of statistics is imperative to conduct effective impact assessment of existing and future European policies.

In the current state of play, we find that more harmonisation is necessary in statistical methodologies across countries and over time for consumer loans. Special attention should be drawn to the classification of certain types of products included in consumer loan markets (notably the overdraft).

2. A balanced contribution to economic growth

Between 2010 and 2013, the average annual real GDP growth in the EU reached +0.4%, namely 2.2 percentage points (pp) below its long-term average (see 1996-2007 in the table below), while it stood at +2.0% in the US (1.2 pp below its long-term average). This significant transatlantic output gap in 2010-13 was primarily the result of differentiated contributions from private consumption of households: only -0.1 pp in the EU-28 (vs. +1.4 pp in 1996-07) and +1.9 pp in the US (vs. +2.4 pp in 1996-07).[3]

This very poor performance of private consumption in the EU-28 (resulting in subdued economic growth) is likely to be partly explained by the collapse observed in outstanding consumer loans (a cumulative -17.6% in 2010-13 vs. +15.2% in 2004-07, while US cumulative figures stood at +6.8% and +12.4%, respectively). In that context, further research needs to be conducted at European level to better understand, on the one hand, the interactions between consumer credit markets and economic growth and, on

[3] Considering the evolution of disposable income, the average private consumption to household disposable income ratio (DPCI) observed in 2010-13 was below its long-term annual average (1995-07) in the majority of EU-15 countries for which data are available. These figures confirm the poor performance of private consumption in 2010-13.

the other hand, the drivers behind the dynamics in consumer credit markets. Such studies should concentrate on the main factors shaping lending standards and the demand for consumer loans. As shown in this report, the former has been determined to a large extent by bank balance sheet constraints, costs of funds and risk perception of banks, whereas the latter has been markedly influenced by consumer confidence levels and household preference for saving.[4]

Developments in consumer loan markets and key macroeconomic variables

	EU-28			US		
Period	1996-07	2004-07	2010-13	1996-07	2004-07	2010-13
Outstanding consumer loans (yearly average real growth)	+7.9%	+4.8%	-6.2%	+4.2%	+2.2%	+4.0%
Real private consumption (yearly average contribution to real GDP growth)	+1.4 pp.	+1.3 pp.	-0.1 pp.	2.4 pp.	+2.0 pp.	+1.5 pp.
Real GDP (average yearly growth)	+2.6%	+2.8%	+0.4%	+3.2%	+2.6%	+2.0%

Source: ECRI Statistical Package and Eurostat.

On the policy side, quantitative easing in monetary policy aimed at strengthening the very recent economic recovery through the 'credit channel' should be pursued in the EU (quantitative approach). However, the policy framework used for quantitative easing needs to be refined in order to better control for the possible harmful effects of abundant liquidity on long-term financial stability. One option to consider for this purpose is to integrate and emphasise constraints mirroring "socially acceptable levels of macroeconomic risk" in macroeconomic models designed to conduct the monetary and macro-prudential policies.[5]

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[4] The high preference for saving recorded in 2010-13 is reflected by the low levels of PCDI, as many households needed to rebuild their balance sheets notably by substituting saving for private consumption.

[5] For microfounded macroeconomic models, policy-makers should keep in mind that it is necessary to maintain a satisfactory level of standard deviation of microeconomic risks, in order to ensure sufficient diversity in the conduct of retail financial businesses.

Finally, the role of private consumption in the 'energy transition' process should be studied more in depth (qualitative approach). The purchase of ecologically designed final products on a large scale is likely to contribute appreciably to achieving some of the objectives of the Europe 2020 strategy, especially in terms of carbon reduction targets. Further research is necessary to assess which role consumer loans might play in that context. Should well-founded studies confirm the positive role of consumer loans in the 'energy transition' process, regulators could develop some tools to encourage households to fund these purchases through loans (such as via tax breaks).

3. A reinforced policy framework for information disclosure requirements

Regulators should ensure better enforcement of existing European rules for information disclosure requirements. Regarding future policies, information disclosure requirements at the advertising stage, pre-contractual stage and contractual stage need to be reasonable in quantity, easily understood by consumers and targeted primarily towards the main needs of consumers.

On the research side, some analyses need to be conducted on the optimal amount of information that consumers are prepared to take into consideration. Researchers should also continue to study the impact of different types of information on the ability of consumers to make optimal choices. More specifically, some studies should consider types of information that are easier to understand than the annual percentage rate (APR). The use of the latest findings in behavioural insights literature should help in that respect, particularly by considering the most relevant behavioural biases for policy design.

4. Some reflections on the promotion of responsible lending practices

In order to help alleviate the harmful effects of over-indebtedness for both borrowers and lenders, further emphasis should be placed on the prevention of this phenomenon, notably by encouraging the set-up of early-stage detection of potential financial difficulties of the borrower to reimburse his loan. The enhancement of such practices should be made through the use of regulatory incentives (such as tax deductibility or some easing in the implementation of CRD4 price-based ratios). This would avoid the significant risk of binding regulation leading to negative outcomes that could easily outweigh any positive effects.

Responsible lending practices might also be promoted through the use of external assessments performed by independent bodies. However, if not adequately calibrated, these assessments might result in regulatory overlaps, given that supervisory controls have already been reinforced in the context of the new regulatory packages. Therefore, more studies and surveys will be needed before deciding if the use of independent external assessments would become a viable option.

5. Further research on integration processes of retail financial markets

Further research needs to be conducted, firstly, on the impact of rising financial integration on consumer protection and credit/economic growth and, secondly, on the determination of an optimal level of integration, especially to assess the implied costs of further integration. More specifically, some in-depth studies should be conducted on the different channels for integration and the two main types of drivers behind them (macroeconomic developments and domestic rules).

Regarding specific methodologies, analytical frameworks should be developed to help compare the level of harmonisation in domestic rules between 'before domestic implementation of a European regulation' and 'after domestic implementation of this regulation'. Such frameworks should be flexible enough to be applied to the whole scope of financial services. Finally, some indexes based on microeconomic tools (such as surveys) should be put in place to mirror the level of financial market integration.

6. Accompanying the financial sector throughout its digital transition process

Regarding the use of new digital tools in the sector of household credit, regulators should consider digital processing as a channel for reinforcing European integration of retail financial services. In particular, some European regulations such as the Electronic Identification and Trust Services (eIDAS) Regulation need to be adequately enforced at member state level. Also, the interoperability of such rules across the different organisations, financial institutions (FIs)[6] and public authorities, both within and between

[6] The scope covered by financial institutions is provided in a footnote in the Glossary of Abbreviations in Appendix 1.

countries, is necessary for the effective set-up of an integrated digital market of retail financial services.[7]

Finally, rapid development of new business models such as crowdfunding platforms requires the production of adequate data on their volume of activities and types of services. The development of consistent data across countries and over time is essential, if EU regulators decide to design a European regulation tailored to these new entrants on the market.

Summary of the Task Force's policy recommendations

Code	Recommendations	Of use to:
	Chapter 2. Scope and market assessment	
2.2.1	Define an optimal benefit to cost ratio of a regulation, corresponding to a specific segmentation of the regulated products	-Researchers -Economists
2.2.2	Promote the harmonisation of the legal and statistical approaches in the determination of the scope for consumer credit, in order to have consistent data that can adequately reflect the scope of products of the CCD	-Statisticians
2.3.1	Promote the analysis of macroeconomic drivers behind the dynamics and trends in consumer loan markets	-Researchers -Economists
2.3.2	Promote the harmonisation of statistical breakdowns of consumer loans by products across the EU-28 + EEA	-Statisticians
2.3.3	Enhance the development of strong methodologies to study the impact of specific regulations on the dynamism of household credit markets	-Researchers -Economists -Statisticians
	Chapter 3. Growth approach	
3.1.1	Promote consumer credit as a tool to boost macroeconomic private consumption and, as a consequence, real GDP growth. Consumer credit can play a noticeable role in the economic recovery in the EU-28 + EEA	-Policy-makers -Senior Executives

[7] Interoperability describes a situation where the different organisations involved are able to exchange and make use of information.

Code	Recommendations	Of use to:
3.1.2	Promote research on the interactions between the dynamics in consumer credit markets and economic growth	-Researchers -Economists
3.1.3	Promote research on the effect of the regulations of price-based ratios on the dynamics in household retail financial products such as consumer loans	-Researchers -Economists
3.1.4	Integrate and emphasise constraints reflecting 'socially acceptable levels of macroeconomic risk' in macroeconomic models designed to conduct the monetary and macro-prudential policies[8]	-Policy-makers -Senior Executives -Economists -Researchers
3.1.5	Reinforce the consistency in the statistical measurement of over-indebtedness across the EU-28 member states + EEA	-Statisticians
3.1.6	Develop practical tools to evaluate possible over-indebtedness (for example, by considering four key aspects of over-indebtedness: cost of servicing debt, being in arrears, number of loans/heavy use of credit and subjective perception of burden)	-Statisticians -Researchers -Economists
3.2.1	Study the role of private consumption in the 'energy transition' process upheld by the Europe 2020 strategy and assess which role consumer loans could play in that context	-Policy-makers -Senior Executives
Chapter 4. Consumer protection approach		
4.1.1	Promote further enforcement of the CCD, especially regarding advertised cost information with a representative example	-Policy-makers -Business Decision-makers
4.1.2	Enhance the design and implementation of future policies where the information disclosure requirements at the advertising stage, pre-contractual stage and contractual stage should be reasonable in quantity, easily understood by most consumers and targeted primarily towards the main needs of consumers	-Policy-makers -Senior Executives

[8] For microfounded macroeconomic models, policy-makers should keep in mind that it is necessary to maintain a satisfactory level of standard deviation of microeconomic risk.

Code	Recommendations	Of use to:
4.1.3	Overall, promote further research into the optimum amount and structure of informational material that consumers are prepared to take into consideration when deciding on financial products, particularly consumer loans	-Researchers -Economists
4.1.4	Enhance the use by regulators and FIs of a specific ranking for each type of customer need in terms of information, in order to reinforce the efficiency of policies based on information disclosure	-Researchers -Policy-makers -Senior Executives
4.1.5	Promote the use of more simple tools than APR to help customers compare the different financial services available	-Researchers -Economists -Policy-makers -Senior Executives
4.1.6	Promote the use of relevant warnings in the disclosed information	-Policy-makers -Senior Executives
4.2.1	Place further emphasis on the prevention of over-indebtedness, notably by encouraging the set-up of early-stage detection of potential over-indebtedness in order to alleviate collection/juridical costs of FIs and arrears and perhaps bankruptcy costs of households	-Statisticians -Researchers -Economists -Policy-makers -Senior Executives
4.2.2	Use regulatory incentives (such as tax deductibility and some easing in the implementation of CRD4 price-based ratios). This would avoid the significant risk that binding regulation would lead to negative outcomes that could easily outweigh any positive effects.	-Policy-makers -Senior Executives
4.3.1	Assess the possibility of conducting a survey on the different practices in terms of external assessment of responsible lending practices of FIs in the different European member states	-Policy-makers -Senior Executives -Researchers

Chapter 5. Integration, consumer protection and growth		
5.1.1	Promote research on the impact of further financial integration on consumer protection and growth and on the determination of an optimal level of integration, thereby assessing in particular the implied costs of further integration	-Researchers -Economists
5.1.2	Develop different channels to enhance integration of retail financial markets and assess which ones are the most effective	-Policy-makers -Senior Executives
5.1.3	Develop impact assessments whose main purpose is to compare the level of European harmonisation in household credit rules between 'before the domestic implementation of the regulation' and 'after the implementation of the regulation'. Such methodologies need to be sufficiently flexible to be applied to other segments of retail finance and even beyond.	-Researchers -Economists -Policy-makers -Senior Executives
5.1.4	Highlight the limits of the indicators of cross-border standard deviation of FIs interest rates on retail loans (CBSD) in the measurement of the intensity of integration in household credits	-Statisticians -Researchers -Economists
5.1.5	Promote a microeconomic approach, notably based on surveys with FIs or households, to give a better estimate on the evolution of integration across domestic household credit markets	-Statisticians
5.2.1	Promote the idea that the development of cross-border lending would make sense as a policy objective only if a certain degree of regulatory and tax harmonisation is achieved	-Policy-makers -Senior Executives
5.3.1	Promote the idea that the prerequisite for further integration through cross-border M&A is economic growth	-Policy-makers - Senior Executives
5.3.2	Promote research on the main regulatory drivers behind cross-border M&As	-Researchers -Economists

Chapter 6. Digital banking and new/related business models		
6.1.1	Consider digital processing as a channel to reinforce European integration of retail financial services	-Policy-makers -Senior Executives
6.1.2	Strengthen the enforcement of the eIDAS at member state level	-Policy-makers -Senior Executives
6.1.3	Enhance the interoperability of the eIDAS across the different organisations, FIs and public authorities, both within and between member states	-Policy-makers -Senior Executives
6.1.4	Avoid overly prescriptive new legislation particularly in the field of electronic banking in order to not stifle the development of innovative new products. Promote research on how regulation can achieve the optimal balance between trust and innovation.	-Policy-makers -Researchers
6.2.1	Enhance the production of consistent data across the EU-28 on the aggregate activities of new banking business models	-Statisticians
6.2.2	Promote the enactment of a European regulation tailored to crowdfunding business models, once the market using these new business models has reached a critical mass, likely to spark noticeable systemic risks	-Policy-makers -Senior Executives

CHAPTER 1. SETTING THE SCENE: DIFFERENT APPROACHES TOWARDS CONSUMER LOANS

Background

While a significant part of current domestic and European economic policies aim at improving the conditions for a sustained recovery, the debate on the role that retail finance should play in this respect focuses on loans to non-financial corporations[9] rather than on credit to households. The improvement of financing conditions for firms in order to support further investment spending is certainly essential to ensuring sustainable growth; however, a significant part of EU growth will depend on the behaviour of households and on their ability to find funding for their consumption and investment. As a result, this Task Force has decided to focus on the latter element of retail credit.

The credit channel through which retail finance can fund private consumption is principally consumer credit. This specific lending segment is often underestimated, partly owing to the value of its stocks which are generally significantly below the outstanding value of residential loans. Nevertheless, due to rather low maturities and very flexible products, the yearly flows of new businesses in consumer credit markets are high in comparison with many other segments of household retail finance.[10]

Consumer credit markets include many diversified retail products, are relatively flexible and volatile and remain the most receptive household lending activity to new technologies and products. In addition, notably owing to the economic crisis and rising unemployment, these markets trigger a significant proportion of the over-indebted households. Finally, due

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[9] A non-financial corporation is a corporation or quasi-corporation that is not engaged in financial intermediation but is active primarily in the production of market goods and non-financial services.

[10] For example, in the UK, new business of consumer credit represents on average more than one-third of new business of residential loans in the period Q1 2009-Q1 2014. Considering the period Q2 1993-Q1 2014, the figure reaches 44.4%. The corresponding figure for the French consumer credit market in Q1 2009-Q1 2014 is 42.5%.

to their diversity and accessibility for a wide range of households (including the most vulnerable), consumer loans have almost continuously been at the centre of regulatory concerns. In that context, consumer loans have raised numerous questions in relation to disciplines as diverse as microeconomics (notably behavioural economics), macroeconomics (including national accountancy and monetary policies), statistics, consumer rights law and philosophy (notably regarding ethics).

This being the case, some of the thoughts and recommendations developed by this Task Force in relation to consumer credit markets could provide food for thought for other retail segments. Some specific topics addressed by the Task Force, such as the future integration of household credit markets and the questions on consumer protection, will inevitably embrace a broader scope of activities and will also help enrich the debate on the future contribution of retail finance in general to the European economy.

Consumer credit is a complex market whose analysis and monitoring can be approached through different perspectives. As such, the methodologies used to study its effects and drivers can differ significantly: some policy-makers will focus primarily on the growth impact of consumer credits, while some others will give priority to consumer protection.

Growth approach

The growth approach of consumer credit is twofold. Firstly, the quantitative approach is based on national accounts methodologies and, in recent years, has often advocated retail credit expansion. Within this approach, policy-makers typically adopt the expenditure approach of GDP by emphasising the interactions between consumer credit and aggregate private consumption of households. The second approach places the focus on the qualitative side of economic growth (qualitative approach) and might fall notably within the scope of the Europe 2020 strategy and its targets in terms of low-carbon economy.

Within the quantitative approach, although few studies have demonstrated it, consumer credit is generally considered to have a marked impact on private consumption of households, which remained by far the main contributor to real GDP in the EU-28 (between 2000 and 2013, on average, private consumption of households contributed to 57.8% of the real GDP in the EU-28). However, the contribution of private consumption to real GDP growth since the outbreak of the financial crisis in 2008-09 has been very poor, resulting in very low macroeconomic performances.

Between 2010 and 2013, the cumulative real GDP growth reached +1.2% in the EU-28 (down from +8.6% in the pre-crisis period of 2004-07); on the other hand, it stood at +6.1% in the US (vs. 8.0% in 2004-07). This significant transatlantic output gap in 2010-13 is essentially the result of differentiated contributions from private consumption of households: -0.4 percentage points (pp.) in the EU-28 (vs. +4.0% in 2004-07) and +4.6% in the USA (vs. +6.1% in 2004-07). In the meantime, the outstanding real amount of consumer credit contracted by -17.6% in the EU-28, while it increased by +12.4% in the US. This substantial differentiated development of consumer credit across the Atlantic in 2010-13 showcases the relations between consumer loans and the final expenditure of households.

Therefore, in the current context where the main aim of a significant part of EU macroeconomic policies is to foster a robust and sustainable economic recovery for the coming years, the role of the consumer credit market in the dynamism of household private consumption, the different channels and senses of causalities between both consumer credit and aggregate private consumption, and the factors shaping the demand and supply of consumer loans need to be carefully assessed.

On the other hand, the qualitative approach of growth places emphasis on the type of growth sparked by consumer credit. In other words, the regulators consider the type of products consumed through credit, rather than the overall volume of consumption supported by loans. Given that few policy initiatives have been taken to use consumer credit as a tool to achieve sustainable growth in an efficient and balanced manner, the present report will try to design some recommendations in that direction. The qualitative approach can be linked to the concept of sustainable growth, notably in the context of the Europe 2020 strategy.

Consumer protection approach

The consumer protection approach conducted at European or national level mostly intends to correct the different dysfunctions that might occur in the structure of household credit markets and that might lead to market failures. In recent decades, this approach has increasingly tried to alleviate the negative effects resulting from two types of market dysfunctions: information asymmetries between distributors/originators and borrowers and behavioural biases of borrowers.

Asymmetric information can be present on both the lender and the borrower side. Owing to their greater experience and knowledge of the financial products they are in charge of selling, lenders are expected to have

more information on the different features of the products than consumers. As a consequence, they might have some incentives to exploit existing asymmetries of information to boost sales to the detriment of consumers (moral hazard). On the other hand, customers typically have more information on their financial situation than the lenders. As a result, even though they are likely to be aware of their potential difficulties to reimburse the loan, some borrowers might be prone to provide a biased assessment of their own financial situation in order to contract loans.

The second type of potential market dysfunction can be sparked by behavioural biases of consumers. In short, behavioural economics tries to show that consumers do not systematically choose their products in their best interests, as their behaviour and purchasing strategies are markedly influenced by specific contexts and psychological factors. As such, the consumer protection approach of consumer loans is partly based on microeconomic concepts such as the nature of the consumer's rationality, the different cognitive biases of consumers and the ability of consumers to make optimal choices. The application of behavioural economics to questions of regulatory reforms and regulatory impact assessment triggers important debates about the appropriate consumer protection in relation to consumer credits and also questions the relationship between behaviourist research and regulation, and how both can interact with each other in an efficient manner.[11]

In recent years, both types of market dysfunctions have been increasingly placed within the scope of regulatory concerns, especially as the number of household bankruptcies and the share of non-performing loans have been on average higher than before the financial crisis, especially with the cases involving revolving loans. Although such trends contain a significant 'macroeconomic component', as the persistent recession/stagnation of most European economies has boosted unemployment rates and potential over-indebtedness, the increasing financial difficulties of these households have raised new concerns about consumer rights. National and European regulators have attempted to further enforce and/or even to amend the existing legislative framework in order to reinforce consumer protection through three main channels.

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[11] Consumer loans have attracted a great deal of attention from behavioural economists, since the flexibility of these financial products (from small to large amounts, many types of repayment strategies, with or without collaterals, etc.) makes them available to a wide range of households, including those with rather low income, poor collateral and poor education.

Firstly, regulators have highlighted the need for ethical behaviour across the retail financial industry. The driving force behind this regulatory strategy can be summarised in the motto "Provide customers with financial services they need and can afford". Overall, some elements of this approach are rather vague, as the necessary innovation process occurring in the financial industry leads to constant redefinitions of the concept of 'needs'; however, the 'can afford' principle is likely to offer a sounder base for further recommendations, notably by enhancing the responsible lending approach of financial institutions (FIs).[12] Responsible lending policies – typically requiring lenders to offer credit only if the borrower must be reasonably expected to repay the loan without substantial hardship – place greater responsibility on the lender to ensure that lending is consistent with the interests of the borrower.

The second strategy focuses on the type of information FIs are required to disclose. Here, the main challenge has been to find an appropriate balance between the quantity and the quality of the information, to achieve what some regulators call 'smart disclosure'. The behaviourist research placing the emphasis on the different cognitive biases affecting the decision-making process of consumers can help design more efficient regulations in that respect and favour better targeted information. In general, disclosure policy remains at the base of consumer policy, as it is less controversial and complicated to implement than some other policies aimed at improving customer outcomes (such as suitability requirements or restrictions on certain product features). Disclosure is indeed based on the principle of 'buyer beware', which assumes that if information is transparent and readily accessible, the burden of choice and subsequent outcomes should fall predominantly on the customer.

Finally, the third channel has enhanced the responsibility of consumers, whose choices can be more rational with appropriate financial education. However, some critics still doubt the effectiveness of financial education policies, highlighting the poor performance of this policy once it is evaluated through the cost-benefit analysis framework.[13]

Overall, the regulators following the growth approach of consumer credit (central banks, domestic ministers of economic affairs, etc.) have few or no links with regulators focusing on the consumer protection dimension of consumer loans (domestic ministers of social affairs, justice, etc.). This is

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[12] The scope covered by financial institutions (FIs) is provided in the Appendix 1.

[13] For example, see Bianchi et al. (2013).

especially the case for European regulators where, for instance, the Directorate-General for Economic and Financial Affairs generally highlights the need to "unlock credit in support of recovery" (see the Editorial of the European Economic Forecast published in February 2014),[14] while the Directorate-General for Justice and Consumers tends to emphasise the harmful effects of financial products such as consumer loans on a certain category of households.[15]

This state of affairs can lead to misunderstanding by both FIs and consumers, and contradictory policies. In recent years, both domestic and European regulators focusing on growth aspects have continuously promoted retail loans, including consumer credit, and highlighted the economic risk of having too many financially constrained households, thereby sometimes downplaying the harmful effects of over-indebtedness. On the other hand, the policy-makers adopting the protection approach have mostly emphasised the difficulties of some households, especially those with poor incomes and collateral, perhaps sometimes to the detriment of households with rather healthy balance sheets.

Therefore, one of the main objectives of the first part of the report will be to find an appropriate balance between the revival of consumer credit, which is necessary to support real economic growth, and efficient and perhaps targeted consumer protection. In other words, the aim is to define an equilibrium where both lenders and borrowers can find satisfaction.

As such, the Task Force will first provide some original tools to foster the positive impact of consumer credit on economic growth. At a microeconomic level, the different issues and possible frameworks regarding efficient consumer protection will be revisited and some original answers will be provided. Finally, we will propose some new perspectives and philosophies to design recommendations which can combine both economic growth and consumer protection considerations.

Integration, consumer protection and growth

In the second part of the Task Force, the analysis will try to determine the available options for reaching an appropriate balance between dynamic integrated credit markets and efficient consumer protection.

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[14] See European Commission (2014a).

[15] See for example the "Study on the functioning of the consumer credit market in Europe" (2013, p. 193).

Firstly, some questions will be raised regarding the added value that further integration of the household credit might achieve for both lenders and borrowers. In the context of the implementation of the banking union, the ECB highlights the need to reduce the integration gap between retail and interbank markets in order to alleviate systemic risks in the banking sector. The explicit objectives behind the setup of the banking union are primarily to reinforce financial stability and to sever the sovereign-bank links, while little or nothing is said about credit growth and consumer protection. Within the current debate about the banking union, very few analyses have indeed attempted to demonstrate in detail the real impact of further financial integration on credit growth and consumer protection.[16]

Therefore, one of the goals of the Task Force will be to try to analyse the feasibility and the effects of further integration of household credit by adopting FIs and consumers perspectives. In other words, what type of integration can better serve credit growth and consumer rights and to what extent can it so?

Digital banking and new business models

Secondly, the Task Force will analyse the prospects offered by the digital evolution and will assess how EU regulation on digital matters could serve both lenders and borrowers. In particular, the Task Force will emphasise the need for simplification and flexibility of the electronic signature: indeed, such an improvement could contribute noticeably to the growth of distance credit and, in the meantime, reinforce consumer protection.

Lastly, the Task Force will determine in what sense and to what extent the introduction of new technologies, products and entrants to consumer credit markets can affect both the supply of consumer credit and consumer protection. In this respect, a particular focus will be made on the possibilities in terms of growth and customer relationships offered by peer-to-peer lending and crowdfunding. The Task Force will also assess what risks can emerge from the developments of these new business models, products and technologies and the different available options for policy design.

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[16] For example, the potential negative effects of the banking structural reform (which will grant the single supervisor the power to separate retail activities from trading activities) for the stability and economic efficiency of household retail activities do not seem to be appropriately assessed in the impact study of the COM proposal published in January 2014.

CHAPTER 2. SCOPE AND MARKET ASSESSMENT

In section 2.1, definitions of consumer credit will be provided according to two different approaches: the statistical approach and the legal approach. Section 2.2 will present the main types of consumer loans. Some specific types of financial products, which can challenge the definitions of consumer credit, will be analysed in more detail. In addition, the main elements defining the scope of the Consumer Credit Directive (CCD) will be presented, as well as some policy implications resulting notably from the differences between the legal and statistical approaches. Finally, in section 2.3, a market assessment will be provided for both the overall consumer loan markets and the different groups of products.

2.1 Statistical and legal definition

Two approaches can be adopted to define a scope for consumer credit: the statistical approach and the legal approach. Within the *statistical approach*, a very general definition, published by the ECB in its statistical glossary, is as follows: 'loans granted to households for personal use in the consumption of goods and services. Credit granted to the sole proprietors and unincorporated partnerships is comprised in this category if the reporting FI knows that the loan is predominantly used for personal purposes'. In the database of the Bank of England, consumer loans are defined as follows: 'a loan that established consumer credit that is granted for personal use; usually unsecured and based on the borrower's integrity and ability to pay'.

At the EU level, the *legal approach* is intimately linked with the 2008 Consumer Credit Directive. This key piece of European legislation provides extensive definitions of consumer credit. As such, it defines key related concepts as follows:

- *"consumer" means a natural person who, in transactions covered by this Directive, is acting for purposes which are outside his trade, business or profession;*
- *"creditor" means a natural or legal person who grants or promises to grant credit in the course of his trade, business or profession;*
- *"credit agreement" means an agreement whereby a creditor grants or promises to grant to a consumer credit in the form of a deferred payment, loan*

or other similar financial accommodation, except for agreements for the provision on a continuing basis of services or for the supply of goods of the same kind, where the consumer pays for such services or goods for the duration of their provision by means of instalments.

2.2 Different types of consumer credit

Typology

Partly in line with the Study on the functioning of the consumer credit market in Europe, published in July 2013 for the European Commission, this report considers seven categories of consumer credit:

1. *Overdrafts*

2. *Open-ended credit or revolving loan*

3. *Unsecured credit not linked to purchase of a good or service and with contractually determined credit amount and repayment period*

4. *Unsecured credit linked to the acquisition of new good or service*

5. *Secured credit linked to the acquisition of a new good where the surety is the good bought*

6. *Credit not linked to the acquisition of a new good or service and secured by movable property owned by the borrower (The security remains with the lender in safekeeping)*

7. *Leasing*

Typically, an overdraft allows the individual to continue withdrawing money even though his account has no more funds. *There are two main types of overdraft: the authorised overdraft and the unauthorised overdraft (overrunning).* The former concerns formal contractual arrangement allowing an individual to access funds in excess of the balance of a current account held at an FI.[17] The latter is a tacit acceptance of the access by an individual to funds from a current account either in excess of the contractual limit set by the FI, i.e. in excess of the overdraft facility that was granted, or in case no overdraft facility has been granted. The contractual limit is either the account's balance or the maximum amount of the authorised overdraft.

The *open-ended credit or revolving loan is a credit agreement without fixed duration*. This type includes credits which must be repaid in full within or after a period; however, once repaid, this credit becomes available to be

[17] Interest is not always charged on the amount which is an overdraft.

drawn down again. A revolving loan can be provided through three main types of credit instruments:

- Personal line of credit: Formal contractual arrangement allowing an individual to borrow in one or several steps up to the limit specified in the contract at a time chosen by the borrower. Once the credit is repaid, new credit can be drawn down. Such credit is also called a revolving credit.
- Credit card: This type of card allows the cardholder to decide how much to pay of the monthly balance shown on the monthly card statement subject to a minimum payment and an overall credit limit. Such cards are issued by financial institutions and a variety of retailers. In the latter case, the cards are also referred to as store cards. Interest is not always charged on the outstanding balance.
- Charge card: This type of card requires the cardholder to pay the full balance shown on the monthly card statement within a specified period, typically two to four weeks. Such cards are issued by financial institutions and retailers.

The unsecured credit not linked to purchase of a good or service and with contractually determined credit amount and repayment period is provided on the basis of a credit agreement in which the total amount of the credit is specified and the repayment method (instalments or one-time payment at the end of the credit agreement) is specified. The credit is not linked explicitly in the credit agreement to the acquisition of a particular product or service.

The unsecured credit linked to the acquisition of new good or service is provided on the basis of a credit agreement in which the total amount of the credit is specified and the repayment method (instalments or one-time payment at the end of the credit agreement) is specified. The credit is linked explicitly in the credit agreement to the acquisition of a particular good or service. The credit is unsecured. Such credit is also referred to as store/credit/mail order instalment credit. Typical examples of this type of credit include credit facilities offered by some furniture and electronic retailers, some distance-sellers, etc.

Secured credit linked to the acquisition of a new good where the surety is the good bought is provided on the basis of a credit agreement in which the total amount of the credit is specified and the repayment method (instalments or one-time payment at the end of the credit agreement) is specified. The credit is linked explicitly in the credit agreement to the

acquisition of a particular good and is secured by the good being bought on credit. A typical case concerns a loan for a car.

Credit not linked to the acquisition of a new good or service and secured by movable property owned by the borrower. The security remains with the lender in safekeeping. Related products include notably the loans extended by the pawnbroker in the UK, the '*prêteur sur gage*' in France and the '*Pfandleiher*' in Germany.

Finally, leasing has become a very common financial product across the EU-28 and consists of a legal document outlining the terms under which one party agrees to rent an asset from another party. A lease guarantees the lessee (the renter) use of an asset and guarantees the lessor (the property owner) regular payments from the lessee for a specified period of time. Both the lessee and the lessor must uphold the terms of the contract for the lease to remain valid. At the end of the contract, the lessee has generally the possibility to acquire the rented asset versus a payment usually equivalent to the estimated residual value of the asset.

Some ambiguities on some loans to household and non-profit institutions serving households (NPISHs)

Some ambiguities can be raised regarding the classification of some financial products as 'consumer loans'. In the statistics defined and published by the ECB, *consumer loans are included within the group 'lending by FIs to households and NPISHs'. There are two other types in this group according to the methodologies developed by the ECB*:

- Loans for house purchase: "*credit extended to households for the purpose of investment in housing, including building and home improvements*; the following types are included: loans secured by residential property (i.e. mortgage loans) that are used for house purchase and, where identifiable, other loans for house purchase provided on a personal basis or secured by other types of asset".
- Other loans: "*this includes loans granted to households for purposes other than consumption and house purchase*. This may include professional loans, debt consolidation,[18] education, etc. The category may also

[18] The debt consolidation loans correspond to the combining of several unsecured debts into a single, new loan that is typically more favourable. As such, debt consolidation involved taking out a new loan to pay off a number of other debts. The new loan may result in a lower interest rate, lower monthly payment or both.

include loans for consumption purposes to sole proprietors and unincorporated partnerships if these are not reported under the category 'credit for consumption'".

Although the three statistical categories of lending by FIs to households and NPISHs are commonly used in the EU-28, *the lines between them can sometimes be unclear*. For example, in some countries, some loans granted for the purpose of extending an already acquired house or significantly improving this house are classified as consumer loans, while definitions of the ECB classify them as loans for house purchase. As such, several national banking associations in the EU-28 provide data on total gross and outstanding residential loans, with a distinction between the purchase of a house and the improvement of an already acquired house.

The line between 'consumer loans' and 'other loans' can also be challenged for some financial products.[19] The statistical distinction is indeed not always respected at national level. For example, in the case of overdraft (which is in principle classified as a consumer loan), it appears that some central banks classify such credit under 'other lending', often because they have no information on the purpose of the overdraft, i.e. for consumer purposes or for business purposes, when the account holder is an individual who is also self-employed (European Commission, 2013).

For some other financial products, *the statistical and the legal approach can have opposite views regarding their classification as 'consumer loan' or 'other loans'*. This is notably the case for leasing. Depending on some of its features, statistical and legal approaches at European level can use different methodologies for classification. Both the ECB and the EC and its CCD do not include "leasing and hire purchase with possibility but no obligation to buy at the end of the contract" in their scope for consumer loans. This is confirmed in the scope defined by the CCD, Article 2, d (see row 12 in Table 2.1, which reveals the difficulties of setting a clear scope for the CCD) and by the detailed ECB glossary of statistical terms. However, both approaches have divergent views when the contract between the lessee and the lessor stipulated that the former has the obligation to buy the asset at the end of the contract. In that case, the CCD includes leasing as a consumer loan, while the statistical classification of the ECB still excludes it.

Consumers, e.g. can use debt consolidation as a tool to make it easier to get out of student loan debt, credit card debt and other types of debt that are not tied to an asset.

[19] Overall, the category "other lending" has relatively poor consistency across the EU-28.

Finally, for types of credit within the scope of both the CCD and the ECB data, *the volume of credit in the ECB data will be larger than the one subject to the CCD because all consumer credit agreements below €200 and above €75,000 are outside the scope of the CCD* (European Commission, 2013).

Table 2.1 Difficulties of setting a clear scope for the CCD

Type of credit	**All credit agreements are *sui generis* outside the scope of the CCD**	**Certain credit agreements may be outside the scope of the CCD because of various exclusion factors foreseen by the CCD. These cases are detailed below**	**Likelihood that the credit agreement is outside the scope of the CCD***
1. Authorised overdraft		If the overdraft has to be repaid within one month, but Art. 6(5) of the CCD imposes the obligation to provide certain information, including the APR (if the overdraft has to be repaid on demand or within three months, only certain articles of the CCD apply and member states may decide that the APR does not need to be provided. the total cost of the credit must appear in the overdraft agreement)	Undetermined
2. Unauthorised overdraft (overrunning) – only Articles 1 to 3, 18, 20 and 22 to 32 of CCD apply			Low
3. Personal line of credit		If credit is free of interest and without any charges or if credit is free of interest, has to be repaid within three months and only insignificant charges are repayable or credit is for less than €200	Low
4. Credit card		If credit is free of interest and without any charges or if credit is free of interest, has to be repaid within three months and only insignificant charges are payable or credit limit is below €200	Low

5. Charge card		If credit is free of interest and without any charges or if credit is free of interest, has to be repaid within three months and only insignificant charges are payable or credit limit is below €200	Low
6. Personal loan by traditional lenders		If credit is for less than €200	Low
7. High interest loans by specialised lenders (for example, doorstep loans or home collected credit)		If credit is for less than €200	Medium
8. High interest, short-term loans provided by specialised lenders and typically repaid on pay day (e.g. payday loans)		If credit is for less than €200	High
9. Unsecured credit linked to the acquisition of new good or service		If credit is free of interest and without any charges or if credit is free if interest, has to be repaid within three months and only insignificant charges are payable or maximum credit is below €200	Low
10. Secured credit linked to the acquisition of a new good where the surety is the good bought		If credit is free of interest and without any charges or if credit is free of interest, has to be repaid within three months and only insignificant charges are payable or maximum credit is below €200	Low
11. Credit secured by movable property owned by the borrower and the security is kept in the safekeeping of the lender	Outside the scope of the CCD		

12. Leasing and hire purchase with obligation to buy at the end of the contract		If credit is free of interest and without any charges or if credit is free of interest, has to be repaid within three months and only insignificant charges are payable or maximum credit is below €20	Low
13. Leasing and hire purchase with possibility but no obligation to buy at the end of the contract	Outside the scope of the CCD		
14. Special loans granted to a restricted public under a statutory provision with a general interest purpose and at a lower interest rate than those prevailing on the market	Outside the scope of the CCD		

* Judgment of a likelihood that a credit agreement is outside of the scope of the CCD.
Source: Ipsos and London Economics (2013).

Scope of the European regulation

In the Article 2 of the CCD, the scope of products to which the Directive shall apply integrate different key criteria. Firstly, as mentioned above, only credit agreements involving a total amount of credit between €200 and €75,000 are considered within its scope. Secondly, the CCD clearly excludes all credit agreements whose purpose is to retain rights in land or in an existing or projected building. Thirdly, overdraft facilities are included provided that the credit does not have to be repaid within one month. However, some ambiguities remain regarding authorised overdraft that has to be repaid within one month (see Table 2.1). In addition, some articles might apply to unauthorised overdraft. Fourthly, credit agreements related to personal line of credit, credit card, charge card, unsecured credit linked to the acquisition of new good and service, secured credit linked to the acquisition of a new good where the surety is the good bought and leasing and hire purchase with obligations to buy at the end of the contract are excluded from the scope in case:

- the credit is free of interest and without any charges,
- the credit is free of interest, has to be repaid within three months and only insignificant charges are repayable or
- the maximum credit is below €200.

Fifthly, high interest loans by specialised lenders (for example, doorstep loans or home collected credit) and high interest, short-term loans provided by specialised lenders, and typically repaid on pay day (for example, payday loans) are quite likely to be excluded from the scope and to be regulated at national level.

Table 2.1 reveals the overall difficulty of harmonising the scope of the CCD across the different member states. The different domestic typologies and regulations make it therefore very difficult for the CCD to ensure perfect consistency across countries.

Policy implications

The scope defined by the CCD is relatively ambitious and includes diverse products in terms of risks and dynamics. This high heterogeneity could partly explain the difficulties of adopting the text in the first place and of implementing it at country level, especially regarding information disclosure requirements. Several voices during the Task Force criticised such a wide scope, as loans of €200 may require different rules than loans of €75,000. The key argument highlighting the risk and costs resulting from the application of broadly identical regulation to the whole segment of household retail financial products, including mortgage loans and other loans, could also be validated for the already much diversified consumer credit segment.

Nevertheless, once placed within the **cost-benefit framework**, regulations based on a case-by-case approach typically trigger very high costs (for both policy design and implementation), which will most likely more than overcome the expected benefits. Inversely, the application of similar regulations to a wide spectrum of financial products should lower costs, but benefits might also be poor and some rules counterproductive for numerous products. As a result, one of the tasks of any policy aimed at regulating activities in household retail finance is to define in advance the optimal benefit to the cost ratio of a regulation, corresponding to a specific segmentation of the regulated products.

Regarding the definition of perimeters, *the differentiation between the legal and the statistical approaches in the determination of the scope of consumer loans could alter somewhat the feasibility of rigorous impact assessments at the European level*. Indeed, due to this differentiation, it is likely that it is

impossible to have a precise statistical representation of the scope of products covered, for example, by the CCD in the whole EU-28. The effectiveness of impact assessment at the design and/or implementation stage can therefore be negatively affected.

Recommendations 2.2

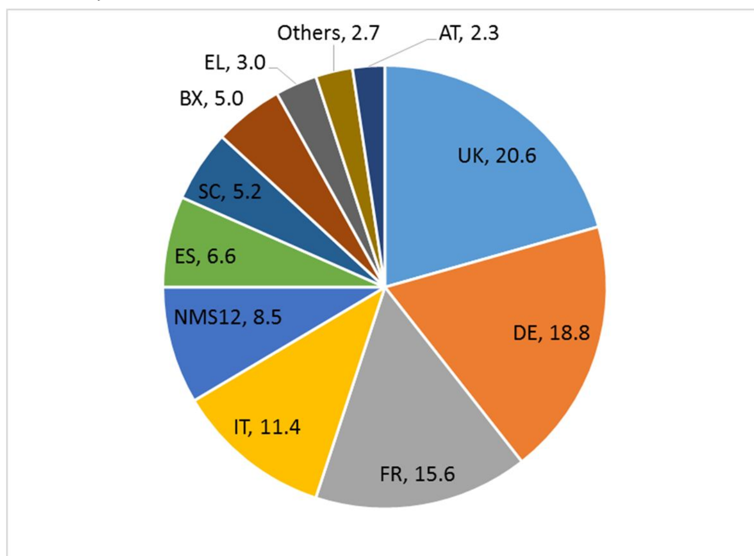
- 2.2.1 Define an optimal benefit to cost ratio of a regulation, corresponding to a specific segmentation of the regulated products.
- 2.2.2 Promote the harmonisation of the legal and statistical approaches in the determination of a scope for consumer credit, in order to have consistent data which can adequately reflect the scope of products of the CCD.

2.3 Market assessments

Overall picture in 2013

In 2013, Germany and the UK were the two largest domestic markets in the EU-27, combining around €366.5 billion of assets, namely almost 40% of the total outstanding amount of consumer loans in the EU-27 (see Figure 2.1).

Figure 2.1 Domestic market share of consumer loans (in % of EU-27 total, in €, current prices, 2013)



Note: NMS12 = New member states joining the EU in 2004 (10) and 2007(2). BX=Benelux.

Source: CEPS-ECRI statistical database.

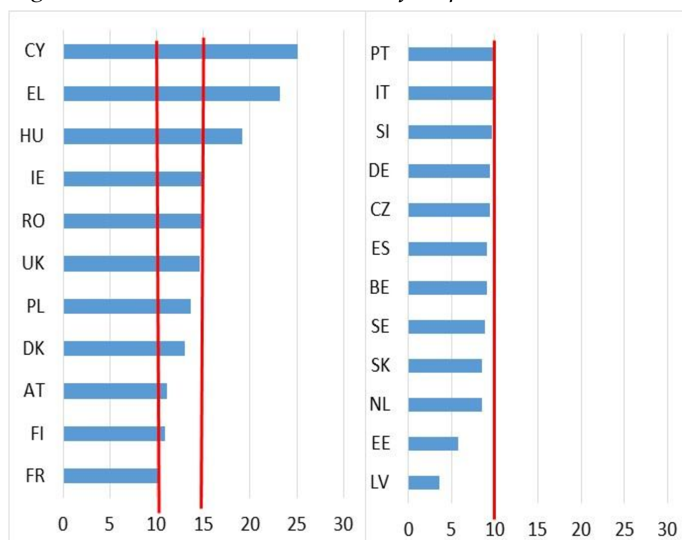
The French market ranked third, with a market share of 15.6% and €145 billion of loans under custody, while the Italian market held 11.4% of the EU-27 total. Notably, the markert share of the NMS-12 (Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia) stood at 8.5% in 2013.

In relative terms, *the oustanding amount of consumer credit to household disposable income ratio (CCDI)*[20] *differed markedly across the EU-*27 (see Figure 2.2). In 2013, the contributing countries could be roughly divided into three groups: one with ratios above 15%; a second with medium values (between 10% and 15%); and a third with low ratios (below 10%). Overall, contrary to mortgage loans, where mortgage loans to household disposable income ratios depend somewhat on different geographical areas,[21] there did not seem to be any specific geographical distribution in consumer loans to disposable income ratios in the EU-27. For example, ratios varied markedly between Central and Eastern European economies: on one hand, Hungary was included in the group with high ratios (19.2%) and Romania and Poland registered medium values (14.9% and 13.6%, respectively); on the other hand, values observed in Estonia (5.8%), Latvia (3.6%) and Slovakia (8.5%) were very low. Regarding the largest domestic markets, the UK scored pretty high (14.6%), whereas France and Germany recorded significantly lower values (10.4% and 9.5%, respectively).

[20] Disposable income is the amount of available income after all the transfers (taxes and subsidies) have been made.

[21] The outstanding residential debt to disposable income ratio is high in most Northern European economies, such as those of Denmark, Ireland, the Netherlands, Sweden and the UK; medium in most Central and Southern European economies (France, Germany, Greece, Portugal, etc.) and low in most Central and Eastern European economies (Czech Republic, Lithuania, Poland, Romania, etc.).

Figure 2.2 Consumer credit as % of disposable income, 2013



Note: Red lines show thresholds of 5%, 10% and 15%.

Source: CEPS-ECRI statistical database.

Overall trends

At end-2013, the total amount of outstanding credit for consumption in the EU-27[22] contracted by -4.5% year-on-year (vs. -3.7% in December 2012) and -0.7% quarter-on-quarter (vs. +0.1% in the previous quarter). *This poor year-on-year performance is mainly explained by the aggregate year-on-year contribution of the three main domestic markets (France, Germany and the UK)*, which was significantly negative in December 2013 (-2.7% vs. -1.7% one year earlier). On the other hand, Denmark, Luxembourg and Sweden contributed positively to the aggregate figure.

The amount registered at end-2013 for the EU-27 reached 86.8% of its level in December 2007.[23] However, this aggregate figure masked diverse growth dynamics in consumer credit at country level. Some countries

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[22] The sample includes countries for which data on consumer credit are available between January 2003 and December 2013: the EU-15 countries, the Czech Republic and Hungary, i.e. 92.8% of the total EU27 figure in December 2013.

[23] December 2007 was chosen as the base month for three reasons. Firstly, it provides some of the last data before the start of the financial crisis in the second half of 2008. Secondly, in December 2007, the proxy used for the EU-27 was close to its historical high recorded in September 2008 (€864.1 billion vs. €873.5 billion). Finally, the choice of December for both 2007 and 2013 allows for better control of seasonal effects.

experienced robust growth over the period 2007-13. Out of the seven countries which recorded cumulative growth above 20% between 2007 and 2013, five were among the NMS-12 (Bulgaria, Czech Republic, Malta, Poland and Slovakia).

Within a context of households' deleveraging, some other domestic markets observed a marked contraction over the same period: total consumer credit declined by a cumulative -34.3% in the UK, -37.6% in Lithuania, -38.5% in Ireland and -40.3% in Spain. Nevertheless, once adjusted for exchange rate movements, the contraction recorded for the UK stood at -25.3%.

Considering pre-crisis dynamics, it is worth noting that between January 2003 and December 2007, credit for consumption was on a robust upward trend in the EU-27, mirroring upward trajectories in the Czech Republic, Hungary and all the EU-15 member states, excluding Germany (see Table 2.2). Between December 2007 and December 2013, these trends either reversed or eased noticeably for all the countries of the sample, except Luxembourg and Sweden.

Table 2.2 Slope of the linear trends (average of 2007 = 100)

	Jan 2003-Dec 2007	**Dec 2007-Dec 2013**		**Jan 2003-Dec 2007**	**Dec 2007-Dec 2013**		**Jan 2003-Dec 2007**	**Dec 2007-Dec 2013**
Austria	0.48	-0.25	Germany	-0.25	0.10	NL	0.44	0.14
Belgium	0.15	-0.17	Greece	1.26	0.09	Portugal	0.63	-0.30
Czech Rep.	1.41	0.62	Hungary	1.62	0.02	Spain	0.96	-0.76
Denmark	0.60	-0.50	Ireland	0.93	-0.96	Sweden	0.65	0.81
Finland	0.78	0.21	Italy	0.85	0.20	UK	0.33	-0.39
France	0.38	-0.03	Lux.	0.21	0.74	EU27*	0.42	-0.17

Note: Figures are calculated based on values expressed in euro.

* Proxy for the EU-27.

Source: Own calculations based on European Central Bank data.

Drivers behind overall trends

Different macroeconomic factors could explain the evolution of consumer credit since 2007 in the euro area. The amount of credit for consumption is the result of a confrontation between the demand for consumer loans and the availability of this financial product. Regarding the former, gross disposable income of households is likely to be one of the main drivers, while

the level of interest rates on new consumer loans typically reflects the availability of consumer credit to households.

Last but not least, housing prices can affect consumer credit through the demand and the availability of loans, since both borrowers and lenders will consider housing prices when getting involved in a consumer loan. As housing is a major component of households' wealth, rising house prices may stimulate consumption by increasing households' perceived wealth, or by relaxing borrowing constraints.[24]

Based on simple correlations, gross disposable income of households (correlation of 35%) and nominal house prices (24%) are likely to have played a significant role in the euro area between 2007 and 2013. However, interest rates on new loans appeared to have had little impact (-4%).

Finally, some specific domestic and European rules may have influenced somewhat the dynamics of consumer credit markets over the last decade. An empirical study aimed at measuring the precise impact of the regulatory framework on consumer credit would be very useful to understand what has been at stake with the different related regulations. Nevertheless, although useful, such a study is generally very difficult to conduct, especially as the scale of a regulation can hardly be translated into figures. Some strong restrictive assumptions will therefore be necessary and are likely to weaken the interest of such impact studies.

Trends by type of products

The breakdown of consumer credit by type of products is accessible for a certain number of national central banks. *Very little data on a breakdown is accessible at the ECB level for outstanding amounts.* In its yearly Statistical Package on household finance, ECRI presents the breakdown for some countries, based on domestic methodologies (see Table 2.3). However, no consistency exists at EU level on this breakdown, partly mirroring different market practices and social norms, as well as differentiated institutional background and processes in the collection of data.

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[24] In addition, against the backdrop of rising housing prices, households are more likely to purchase a dwelling, resulting in higher demand for consumer loans to fund new appliances, furniture, etc.

Table 2.3 Poor statistical consistency across countries for the different types of consumer loans (outstanding loans, % of the total)

	2001	2007	2013		2001	2007	2013
Belgium	**13.2**	**18.1**	**21.1**	**Italy**	**41.2**	**97.8**	**106.1**
Hire purchase	8.7%	9.8%	4.4%	*Credit cards*	11.2%	12.6%	na
Instalment payment loans	72.0%	71.5%	73.4%	*Loans for purchases of motor vehicles granted by finance companies*	na	na	na
Leasing	0.3%	0.2%	0.0%				
Opening of credits	19.1%	18.5%	22.1%				
				Poland	**11.4**	**26.4**	**33.3**
Czech Republic	**0.9**	**5.2**	**7.3**	*loans on current accounts*	22.6%	11.1%	8.0%
Debit balances on current accounts	8.5%	8.5%	6.2%	*loans related to credit cards*	3.1%	9.3%	8.7%
Receivables from payment cards	0.0%	8.0%	12.6%	*other (including hire purchases)*	74.3%	79.6%	83.3%
Consumer purpose-credit on goods and services	91.5%	5.2%	9.1%				
Consumer nonpurpose-credit	0.0%	78.3%	72.1%	**UK**	**232.6**	**268.3**	**191.6**
				credit cards	30.2%	28.5%	36.4%
Greece	**7.9**	**31.9**	**28.4**	*other*	69.8%	71.5%	63.6%
Credit cards	47.4%	29.1%	20.7%				
Against documents	0.0%	0.0%	10.7%	**Japan**	**113.2**	**59.2**	**64.7**
Personal loans	52.6%	70.9%	65.7%	*card loans*	40.7%	40.4%	45.1%
				loans with instalment repayments	59.3%	59.6%	54.9%
Hungary	**1.0**	**9.6**	**11.0**				
Overdraft	na	12.1%	13.6%	**US**	**2146.6**	**1776.9**	**2245.9**
Personal loans	na	22.3%	10.5%	*revolving*	38.9%	38.3%	27.7%
Car purchase loans	na	10.4%	8.8%	*non revolving*	61.1%	61.7%	72.3%
Consumer loans for purchase of goods or other	na	3.3%	1.1%				
Mortgage loans for consumption purpose	na	51.9%	65.9%				
France	**117.5**	**155.6**	**145.3**				
Advances on debit accounts	6.0%	4.8%	4.9%				
Personal loans	42.9%	50.0%	58.6%				
Utilisation of opened permanent credit accounts	26.2%	23.2%	15.7%				
Financing of purchases by instalment credit	20.5%	14.2%	9.5%				
Leasing and related	1.8%	2.7%	3.3%				
Other (incl. differed payments on cash and debit cards)	2.6%	5.1%	8.0%				

Note: Data in bold correspond to the outstanding value of consumer loans, in euro at current prices.

Sources: CEPS and ECRI.

The data provided in Table 2.3 reveal highly diverse breakdowns between EU-28 member states. To a certain extent, such diversity is likely to obstruct the conduct of consistent impact assessment by product groups across the EU-27. For example, the analysis of the impact of the CCD on the activities of personal loans could be developed only for a certain number of countries, notably Hungary, Greece and France. Therefore, high differentiation in the collection, classification by sub-groups and publication of data most likely does not facilitate the design, calibration and implementation process of policies at European level.

Nevertheless, in short, existing data can reveal several significant trends at domestic level. Firstly, the market share of personal loans has increased markedly in France, notably resulting from the negative effect of the 'Lagarde law' (2010) on the activities of revolving loans and has remained very high in Greece. Secondly, the market share of credit card loans has gradually increased in the UK, amounting to roughly 36% of total consumer loans in 2013. Opposite trends can be observed in Greece, where this type of loan has lost broadly one-third of its pre-crisis market share. Thirdly, the distribution of activity volumes across product categories has remained relatively stable in Belgium and Poland.

Recommendations 2.3

- 2.3.1 Promote the analysis of macroeconomic drivers behind the dynamics and trends in consumer loan markets.
- 2.3.2 Promote the harmonisation of statistical breakdowns of consumer loans by products across the EU-28 + EEA.
- 2.3.3 Enhance the development of strong methodologies to conduct appropriate impact studies of specific regulations on the dynamism of household credit markets.

CHAPTER 3. GROWTH APPROACH

The growth approach of consumer credit is twofold: on one hand, policy-makers emphasise the amount of growth (*quantitative approach*); on the other hand, some policies are designed to enhance its content (*qualitative approach*).

The *quantitative approach* is based on national accounts methodologies and, in recent years, has often advocated that regulators have to "unlock credit in support of recovery" (see the Editorial of the European Economic Forecast published in February 2014).[25] Within this approach, regulators typically adopt the expenditure approach of GDP by emphasising the interactions between consumer credit and aggregate private consumption of households. The objective is therefore to promote consumer credit as a tool to encourage private consumption. Different policy-makers are involved in that process.

First, by lowering their policy rates, central banks typically try to ease lending standards and encourage consumer credit in order to give a boost to household consumption. This policy aims to influence consumer credit directly and targets an indirect positive impact on private consumption. Secondly, tax policies aim at influencing private consumption essentially by cutting or hiking indirect taxes on consumer loans. The effectiveness of decreasing indirect taxes would partly depend on the ability of some consumers to contract loans to acquire specific goods, such as eco-friendly cars or windows. The quality of the framework ruling consumer loans is therefore vital. This brings us to the third type of policy-maker, who are directly involved into the design of the regulations and rules of consumer credit markets. During the regulatory design process, these regulators should keep in mind that these rules should help find an appropriate balance between financial stability, consumer protection and growth.

The second growth approach places the focus on the qualitative side of economic growth (*qualitative approach*) and might fall notably within the scope of the Europe 2020 strategy and its targets in terms of low-carbon economy. Given that few policy initiatives have been taken to use consumer credit as a tool to achieve sustainable growth in an efficient and balanced manner, this report offers some recommendations in that direction. The *qualitative approach* is closely linked with the concept of sustainable growth.

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[25] See European Commission (2014a).

3.1 Quantitative approach

Subdued private consumption of households

At a macroeconomic level, although few studies have demonstrated it, *consumer credit is generally considered to have a noticeable impact on private consumption of households, which remains from far the main contributor to real GDP in the EU-28* (between 2000 and 2013, on average, private consumption of households contributed to 57.8% of the real GDP in the EU-28). However, the contribution of private consumption to real GDP growth since the outbreak of the financial crisis in 2008-09 has been very poor, resulting in very low macroeconomic performance.

Between 2010 and 2013, the average annual real GDP growth reached +0.4% in the EU-28 (down from +2.8% in the pre-crisis period 2004-07); on the other hand, it stood at +2.0% in the US (vs. +2.6% in 2004-07). This significant transatlantic output gap in 2010-13 was primarily the result of differentiated contributions from private consumption of households: -0.1 percentage point (pp) in the EU-28 (vs. +1.3 pp in 2004-07) and +1.5 pp in the US (vs. +2.0 pp in 2004-07). *Considering long-term developments, the average growth recorded in 2010-13 in the EU-28 was much below its long-term average: indeed, between 1996 and 2007, the average contribution of real private consumption to GDP stood at +1.4 pp (vs. 2.4 pp in the US).*

Table 3.1 Developments in consumer loan markets and key macroeconomic variables

	EU-28			US		
Period	1996-07	2004-07	2010-13	1996-07	2004-07	2010-13
Outstanding consumer loans (yearly average real growth)	+7.9%	+4.8%	-6.2%	+4.2%	+2.2%	+4.0%
Real private consumption (yearly average contribution to real GDP growth)	+1.4 pp.	+1.3 pp.	-0.1 pp.	2.4 pp.	+2.0 pp.	+1.5 pp.
Real GDP (average yearly growth)	+2.6%	+2.8%	+0.4%	+3.2%	+2.6%	+2.0%

Source: ECRI Statistical Package 2014 and Eurostat.

The poor macroeconomic performance in the EU-28 raises the question on the relation between potential and effective growth in private consumption of households. One possible approach is to analyse the fluctuations in the ratio

of private consumption to household disposable (PCDI). Steady ratio values imply stable saving rates (saving to disposable income ratio) and a growth in private consumption similar to disposable income. However, rising values of the PCDI mirror growth in private consumption above its potential (and vice versa).

In comparison with 2004-07, the average PCDI recorded over the period 2010-13 contracted in most EU-15 economies, notably in Sweden (-5.6 pp), Denmark (-4.6 pp); the UK (-3.9 pp), Ireland[26] (-3.7 pp), Portugal (-2.8 pp), Finland (-1.6 pp), Spain (-1.5 pp), the Netherlands (-0.7 pp) and France (-0.5 pp). *Compared to long-term average (1995-2007), the average PCDI also decreased in the majority of EU-15 countries for which data are available, albeit generally at a slower pace:* -5.6 pp in Sweden, -2.7 pp in Denmark, -1.4 pp in Portugal, -1.3 pp in Finland, -1.1 pp in Spain, -0.9 pp in the UK and -0.5 pp in France.

These numerous contractions reveal the poor performance of household private consumption since 2010 and partly result from the need of households to rebuild their balance sheets, especially by boosting their savings in the aftermath of the financial crisis (as a response to the ensuing heightened economic uncertainties). As such, households have gradually substituted debts for savings, resulting in a significant decrease in consumer credits in recent years. *Between 2010 and 2013, the real outstanding amount of consumer loans recorded a cumulative contraction of -17.6% in the EU-28 (while, it increased by +12.4% in the US).* Considering annual data over the period 2003-13, the nominal stocks of consumer loans and private consumption of households (both time series in variations) are highly and positively correlated in the EU-28 (more than 50%; see Figure 3.1).[27] Since 2010, this correlation has been much higher.

The very high positive correlation since 2010 between outstanding consumer loans and private consumption has resulted from some combination of two effects: on one hand, as analysed above, deleveraging needs of households due to the rising uncertainties and economic difficulties prompted many households to substitute debts and consumption for

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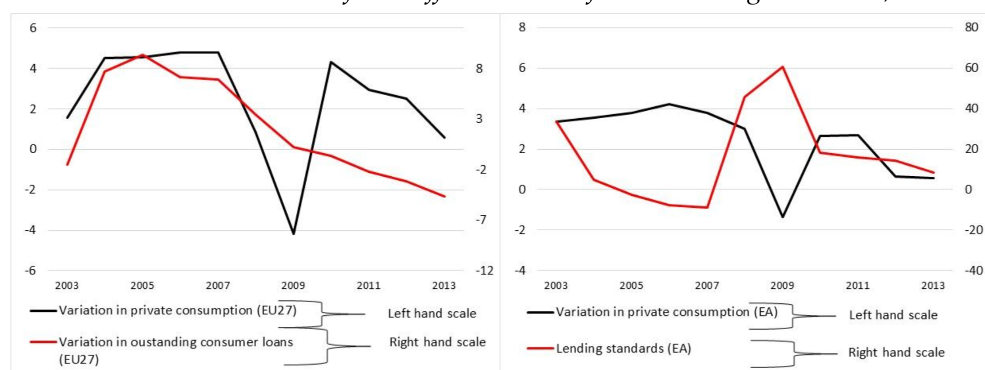
[26] For Ireland, the analysed period is 2010-12 instead of 2010-13.

[27] New loans would be more appropriate there than outstanding; however, it is rather difficult to have consistent data on new loans across countries. Nevertheless, outstanding data can also be a good proxy for the activity of consumer loan markets since it also includes new loans and is therefore directly affected by the fluctuations in new businesses.

savings. As such, the lower preference for current consumption has led to decreasing demand for consumer credits. On the other hand, the internal difficulties of consumer credit markets, owing notably to growing regulation and damaged reputation of consumer credit products, put a noticeable drag on consumption possibilities of households, resulting in poor macroeconomic performance. The present analysis proposes to focus on the second interpretation, as it could help understand how to boost the efficiency of the consumer credit market and economic growth.

Figure 3.1 Real private consumption; outstanding amounts of consumer credit and lending standards (variation in % for real private consumption and outstanding amounts and annual value of the diffusion index for the lending standards)



Note: Data on lending standards are based on the methodology of the diffusion index. The 'diffusion index' is the weighted difference between the share of FIs reporting that credit standards have been tightened and the share of FIs reporting that they have been eased. The diffusion index is constructed in the following way: lenders who have answered "considerably" are given a weight twice as high (score of 1) as lenders having answered "somewhat" (score of 0.5). Positive values imply a tightening in lending standards.

Sources: ECRI Statistical Package and European Central Bank (Bank Lending Survey).

Credit supply

The equilibrium of the consumer credit market results from the confrontation of the supply of consumer loans with the demand for these loans. Supply can be approached in different ways; however, one common approach is to analyse the lending standards as they are perceived by FIs across the euro area. The Bank Lending Survey (BLS) published on a quarterly basis by the ECB is a significant help in this respect since it is based on consistent methodologies over time and across countries and integrates a wide pool of FIs, covering most of the euro-area market. However, one of the

main limits of this approach is that it is survey-based and mainly depends on the perception of FIs.

Regarding overall lending standards on the consumer credit markets, the diffusion index published by the ECB for consumer loans in the euro area displays a high negative correlation with private consumption (-60%), which could show the importance of lending standards for dynamic private consumption (see Figure 3.1). This observation leads to analysing the drivers behind lending standards assessed in the BLS. As shown by Table 3.2, mainly economic phenomena, such as the risk on the collateral demanded and expectations regarding general economic activity, have substantially contributed to tightening lending standards since the outset of the financial crisis.

Table 3.2 Lending standards and main drivers (cumulative value of the diffusion index)

Factors	**Cumulative impact**		**Correlation with lending standards (Q1 2003-Q3 2014**
	Q1 2008-Q3 2014	**Q1 2010-Q3 2014**	
Bank competition	-19.7	-18.7	0.54
Cost of funds and balance sheet constraints	103.3	49.0	0.75
Creditworthiness of consumers	200.1	78.8	0.90
Expectations regarding general economic activity	184.8	64.7	0.91
Non-bank competition	2.4	-4.1	0.53
Risk on the collateral demanded	110.3	35.2	0.87

Note: Data on lending standards are based on the methodology of the diffusion index. The "diffusion index" refers to the weighted difference between the share of FIs reporting an increase in loan demand and the share of FIs reporting a decline. The diffusion index is constructed in the following way: lenders who have answered "considerably" are given a weight twice as high (score of 1) as lenders having answered "somewhat" (score of 0.5). Positive values imply an increase in demand.

Source: European Central Bank (Bank Lending Survey).

However, other factors partly shaped by the new banking regulation have also weighed down lending standards. As such, *the "cost of funds and balance sheet constraints" (see the definition in Box 1) have been the third*

contributor to the tightening of lending standards since 2010. The gradual implementation of the price-based ratios, e.g. the liquidity ratios (liquidity coverage ratio and net stable funding ratio), admittedly have the merit of reinforcing financial stability; but they can also weaken the liquidity positions of some retail FIs by heightening funds and balance sheet constraints. Depending on the intensity of the practised pass-through by FIs, the increased cost of funds can result in tightening lending standards.

Poor demand for consumer credit

As expected, the correlation between household private consumption and the demand for credit loans published in the context of the BLS is positive and very high (above 67%). Regarding the macroeconomic backdrop, consumer confidence and spending on durable consumer goods are the two main negative contributors to the demand for consumer credit (see definition of "consumer confidence" in Box 1 below).

Box 1. Glossary of bank lending terms

Lending standards

Consumer confidence

Consumers' assessments of economic and financial trends in a particular country and/or in the euro area. They include assessments of the past and current financial situations of households and resulting prospects for the future, assessments of the past and current general economic situation and resulting prospects for the future, as well as assessments of the advisability of making residential investments, particularly in terms of affordability, and/or major purchases of durable consumer goods.

Cost of funds and balance sheet constraints

A bank's capital and the costs related to its capital position can become a balance sheet constraint that may inhibit the expansion of its lending. For a given level of capital, the bank's loan supply could be affected by its liquidity position and its access to money and debt markets. Similarly, a bank could abstain from granting a loan, or be less willing to lend, if it knows that it will not be able subsequently to transfer the risk (synthetic securitisation) or the entire asset (true-sale securitisation) off its balance sheet.

Credit standards

The internal guidelines or criteria that reflect a bank's lending policy. They are the written and unwritten criteria, or other practices related to this policy, which define the types of loan a bank considers desirable and undesirable, its designated geographical priorities, collateral deemed acceptable or unacceptable, etc. For the purposes of the survey, changes in written loan policies, together with changes in their application, should be reported.

Collateral

The security given by a borrower to a lender as a pledge for the repayment of a loan. This could include certain financial securities, such as equity or debt securities, real estate or compensating balances (a compensating balance is the minimum amount of a loan that the borrower is required to keep in an account at the bank).

Non-FIs

In general, these consist of non-monetary financial corporations, in particular insurance corporations and pension funds, financial auxiliaries and other financial intermediaries.

Source: Bank Lending Survey, European Central Bank, January 2015.

Household savings have also dragged down markedly the demand for consumer credit. The lack of consumer confidence reflects the poor economic prospects and rising unemployment rates and might have prompted many households to accumulate precautionary savings in order to insure against the risk of lower future income. Rising household savings despite the successive cuts in policy rates of many central banks (which aim at promoting consumption and credit over savings) can also result from the gradual mistrust in the financial products of consumer credit. *Households prefer accumulating target savings in order to cope with significant expenditures*, such as the purchase of durable goods, the payment of tuition fees, vacation spending, etc., *rather than acquiring the good first through consumer credit and accumulating the necessary savings later, under the form of gradual debt repayment*. Several policies can alter somewhat the dynamics of target savings. Admittedly, cultural and social factors can explain much of the target saving's process; however, any policy aimed at reinforcing the quality of the contracts of consumer loans, especially in terms of consumer protection, is likely to lift the demand for households' loans and to bring down the accumulation of target savings.

Table 3.3 Demand and main drivers (cumulative value of the diffusion index)

Factors	**Cumulative impact**		**Correlation with lending standards (Q1 2003-Q3 2014**
	Q1 2008-Q3 2014	**Q1 2010-Q3 2014**	
Consumer confidence	-301.9	-138.0	0.81
Household savings	-83.9	-56.6	0.70
Loans from other banks	-40.3	-34.4	0.03
Other sources of finance	-18.6	-11.6	0.57
Securities purchases	-94.8	-23.9	0.40
Spending on durable consumer goods	-227.5	-125.5	0.92

Note: Data on lending standards are based on the methodology of the diffusion index. The "diffusion index" refers to the weighted difference between the share of FIs reporting an increase in loan demand and the share of FIs reporting a decline. The diffusion index is constructed in the following way: lenders who have answered "considerably" are given a weight twice as high (score of 1) as lenders having answered "somewhat" (score of 0.5). Positive values imply an increase in demand.

Source: European Central Bank (Bank Lending Survey).

Pros and cons of quantitative approach

The quantitative approach is used extensively by central banks when designing their monetary policies. *Modern economies are essentially based on debt accumulation,* as shown by the economic growth dynamics in the two decades preceding the financial crisis of 2008-09. As a result, the easy monetary policies currently conducted by many central banks in the EU-28, including the ECB,[28] should help to avoid possible long-term economic depressions, as experienced by the Japanese economy from the mid-1990s to the second half of the 2000.

However, according notably to the Bank for International Settlements (BIS) (2014), *ultra-easy monetary policies are likely to build up stocks of debt above optima, resulting in rising financial fragility.* Typically, the costs of easy monetary policies will become apparent only over time and with hindsight,

[28] In a context of persistent poor economic performance and the fading out of HICP inflation, the ECB lowered its key interest rate six times between November 2011 and June 2014, by a total of 135 bps. These successive cuts are a strong signal that the ECB's intention since 2011 has been to enhance lending to the real economy and to promote consumption and investment over savings.

as has happened often enough in the past. Indeed, the financial instability resulting from the increasing stock of debt in the long run remains undetected by policy-makers since they are essentially focused on short-term business cycle dynamics, thereby missing the debt dynamics. The implied question in the present report is to assess if the potential build-up of consumer credit in the coming years in order to boost private consumption can significantly contribute to financial instability. One related question is to assess whether consumer credit markets are systematically important for the financial sector.

Considering the criterion of the stock of debt to evaluate the systematic importance of a financial activity, consumer credit pales in comparison with housing debt, non-financial corporation debt and sovereign debt (in the euro area 12, in 2012, the gross debt to GDP ratio were respectively 7.0%, 41.3%, 44.5% and 93.5%; the average recorded over the period 2001-12 reached respectively 7.3%, 36.7%, 43.5% and 75.3%). Nevertheless, the exclusive use of the criterion of "stock of debt" to assess the systemic importance of a financial activity presents major flaws and reveals the limits of the quantitative approach of consumer credit. Admittedly, in a context of increasing financial fragility, the corresponding value of the volume of non-performing consumer loans might be much below housing loans and the implied systemic risk relatively low. However, on one hand, unexpected rising volumes of loans in arrears may be of concern for specific bank business models; on the other hand, the number of affected households and the real impact on individuals, the economy and society might be very significant and can hardly be assessed through a quantitative approach.

New ways for improving the quantitative approach

Economically speaking, the phenomenon of over-indebtedness in consumer credit is likely not to have a marked impact on the economic growth due to the low amounts involved. Nevertheless, from society's perspective, over-indebtedness in consumer credit can have three other significant impacts (World Bank, 2013):[29]

- *Social*: over-indebtedness and the ensuing drops in available cash flow bring increased social stratification as well as worsening opportunities for the poor;

[29] See also Civic Consulting (2014) and Banque de France (2014).

- *Political*: regulatory failure to limit over-indebtedness may discredit the political process as well as financial supervisors if the over-indebtedness issue becomes widespread and politicised;
- *Perception of justice*: predatory lenders may be seen as immune to prosecution when over-indebted clients fail to get protection in court.

Therefore, one option to partly control for these effects when shaping monetary and macro-prudential policies would be to place further emphasis on constraints mirroring levels of risk judged as "socially acceptable". Such constraints would try to find an appropriate balance between the commercial and financial risk-bearing capacity of FIs and the financial risk-bearing capacity of households. This would imply that for any levels of credit and consumption growth, a maximum level of acceptable risks shared by both lenders and borrowers should be defined. For FIs, levels of costs judged as acceptable for a specific credit expansion should be set. As regards households, a maximum level of over-indebtedness or/and financial bankruptcies should be defined in the related models.

At first, such an option may seem unrealistic and perhaps politically void. The integration and the emphasis of such constraints in macroeconomic models designed to conduct the monetary and macro-prudential policies may indeed look very complex; nevertheless, the main challenge would most likely be empirical rather than theoretical. For example, as far as we know, *there is currently no commonly accepted definition of over-indebtedness in the EU-28 and, as a result, no consistent methods to measure it*. A 2010 European Commission study endeavoured to develop a common over-indebtedness definition across the EU and put forward a set of criteria to be applied for this purpose:

- The unit of measurement should be the household because the income of individuals can be pooled – and indeed, is usually assumed to be pooled – between household members.
- Indicators need to cover all financial commitments of households – borrowing for housing purposes, consumer credit, paying utility bills, meeting rent and mortgage payments and so on – and not to be confined to just one aspect.
- Over-indebtedness implies an inability to meet recurring expenses and, therefore, it should be seen as an ongoing rather than a temporary, or one-off, state of affairs.
- It is not possible to resolve the problem simply by borrowing further.

- For a household to meet its commitments, it must reduce its expenditure substantially (or find ways of increasing its income).

However, such criteria, though they might be widely accepted in principle, give rise to serious problems when it comes to measurement. In order to promote sustainable growth, policy-makers need a practical tool to detect possible over-indebtedness (World Bank, 2013). To this end, several studies have converged on a common set of indicators (BIS 2010) and considered four aspects of over-indebtedness (see Table 3.4).

Table 3.4 Common indicators of over-indebtedness

Category	Indicator
Cost of servicing debt	Households spending more than 30% (or 50%) of their gross monthly income on total borrowing repayments (secured and unsecured)
	Households spending more than 25% of their gross monthly income on unsecured repayments
	Households whose spending on total borrowing repayments takes them below the poverty line
Being in arrears	Households more than two months in arrears on a credit commitment or household bill
Number of loans – heavy use of credit	Households with four or more credit commitments
Subjective perception of burden	Households declaring that their borrowing repayments are a "heavy burden"

Source: d'Alessio & Iezzi (2013).

Recommendations 3.1

- 3.1.1 Promote consumer credit as a tool to boost macroeconomic private consumption and, as a consequence, real GDP growth. Consumer credit can play a noticeable role in the economic recovery in the EU-28 + EEA.
- 3.1.2 Promote research on the interactions between the dynamics in consumer credit markets and economic growth.
- 3.1.3 Promote research on the effect of the regulations of price-based ratios on the dynamics in household retail financial products such as consumer loans.

- 3.1.4 Integrate and emphasise constraints reflecting "socially acceptable levels of macroeconomic risk" in macroeconomic models designed to conduct the monetary and macro-prudential policies. For microfounded macroeconomic models, policy-makers should keep in mind that it is necessary to maintain a satisfactory level of standard deviation of microeconomic risk.
- 3.1.5 Reinforce the consistency in the statistical measurement of over-indebtedness across the EU-28 member states.
- 3.1.6 Develop practical tools to detect possible over-indebtedness, for example, by considering four key aspects of over-indebtedness: cost of servicing debt, being in arrears, the number of loans – heavy use of credit – and subjective perception of burden.

3.2 Qualitative approach

As shown in section 3.1, consumer credit can play a role in the economic recovery in the EU by supporting private consumption of households. However, *consumer credit can also influence the type of consumption of households.* This financial product has often been described as essential for specific economic sectors, such as in the case of the car industry or home appliances. By providing access to finance to individuals and households, consumer credit supports the social and economic well-being of millions of consumers across Europe. It also benefits manufacturers and retailers, as a key tool for their sales. Vehicles, higher education and home repairs are examples of assets and services financed by consumer credit. Going further into the reasoning, consumer credit can also influence the content of the consumed product or even services.

The question here is to assess whether this consumer credit could significantly contribute to some of the priorities and targets of the Europe 2020 strategy, one of whose main priorities is to deliver growth that is sustainable, by decisively moving towards a more competitive low-carbon economy. Most of the current European debate on the achievement of a low-carbon economy focuses on the necessity of companies to use more sustainable resources and to provide more ecologically friendly products on retail and b-to-b markets. The debate is also promoting civic behaviour of households, who should sort their waste and limit their consumption of resources to what is vital. However, little is said about how households could afford ecologically designed products.

The energy transition promoted by the Europe 2020 strategy cannot focus only on non-financial corporations' production processes; it must also focus on solutions enabling households to afford these products. Some initiatives already exist regarding the purchase of ecological cars through subsidies and tax cuts; however, these incentives are essentially local and very few initiatives have been taken regarding the funding possibilities of such products.

In order to contribute to the achievement of the Europe 2020 targets, which aim at reducing greenhouse gas emissions by 20% (or even 30% if the conditions are right), having 20% of energy from renewables and recording a 20% increase in energy efficiency, regulators should place further emphasis on the different means at the disposable of households to fund the purchase of ecologically designed products. Among these means, consumer credit products could be an interesting tool. Indeed, the set-up of an adapted framework for consumption finance could help households purchase ecodesign products, thereby leading to a new cycle of consumption and contributing to the development of new economic sectors with ecological concerns.

In the car industry, the need to readjust the purchase of cars from those with diesel to those with clean-running engines has been promoted in many EU member states, and some financial incentives exist. But few use consumer credits as a support. New patents and new technologies will gradually lead to the mass production of electric cars (for example, Tesla Motors aimed at offering electric cars at prices affordable to the average consumer by 2017). This move in the consumption patterns from thermic to electric could be accelerated by the promotion of specific funding tools.

Regarding appliances, consumer credit could participate in a progressive shift of household behaviour to the purchase of appliances that consume less electricity and less water. New information and communication technology (NICT) mobile equipment is also important in this respect.

Finally, many investments in the housing sector depend on the access of households to appropriate consumer credits. The objective of making houses more environmentally friendly has also been served by financial incentives, but few or no policies have been implemented to ease the funding conditions necessary to achieve these investments. Some of the key investments involve thermal insulation for energy saving, phonic insulation and domestic renewable energy.

In this context, the "qualitative growth" objective of consumer credit is feasible only if the appropriate products are precisely defined and merchandised for these new markets. The Directive 2009/125/EC on ecodesign adopted by the EU on 21 October 2009 provides the EU framework for the setting of ecodesign requirements for energy-related products. Thanks to this framework, regulations have been implemented on voluntary agreements for different groups of products (see Table 3.4). The use of labelling based on the regulations has raised the awareness of consumers on the energy efficiency of the purchased products and could ease the implementation of tax policies targeting funding conditions.

One possibility to enhance energy transition in private consumption would therefore be to allow consumers to deduct all or part of the interest rates related to a loan funding ecodesign products. Such a policy would target primarily linked-loans and the deduction process in the tax declaration could be easily legitimated by the labelling of the product in terms of ecodesign. The deductibility of interest rates has been extensively practiced for housing loans in a certain number of EU countries (Belgium, the Netherlands, Sweden, etc.) in order to promote home ownership and support real estate developments. A similar process could be adopted for consumer loans: interest deduction based on the purchase of ecodesign products could have four main positive outcomes:

- contributing to the energy transition in household private consumption,
- creating growth opportunities for the household retail banking activities,
- helping FIs to reinforce their legitimacy in the economy, notably by promoting their ethical features and
- reconciling consumers with consumer credit.

Nevertheless, should the regulator question the possibility of implementing such incentive tools to use consumer loans to fund consumption of eco-design products, *strong analytical and empirical evidence will be required before any implementation is done*. First of all, further research should be conducted on the real contribution of private consumption to the energy transition process. Provided that these findings confirm the key role of consumption habits in the possibility to achieve some of objectives of 2020 Europe, further research will need to be developed on the potential role of consumption loans in that context. *Only if well-founded studies confirm the strong link between consumer loan and energy transition, could regulators consider the use of tools such as tax breaks to help consumers fund their eco-design products through consumer loans.*

Table 3.5 Implementing regulations for EU ecodesign legislation by product

Type of product	**Regulation/Directive**
Power transformers	Commission Regulation (EU) No 548/2014 of 21 May 2014
Domestic cooking appliance	Commission Regulation (EU) No 66/2014 of 14 January 2014
Heaters and water heaters	Commission Regulation (EU) No 813/2013 of 2 August 2013 Commission Regulation (EU) No 814/2013 of 2 August 2013
Vacuum cleaners	Commission Regulation (EU) No 666/2013 of 8 July 2013
Computers	Commission Regulation (EU) No 617/2013 of 26 June 2013
Energy star	Regulation (EU) No 174/2013 of 5 February 2013 Commission Decision 2014/202/EU of 20 March 2014
Household tumble driers	Commission Regulation (EU) No 932/2012 of 3 October 2012
Circulators	Commission Regulation (EU) No 622/2012 of 11 July 2012
Water pumps	Commission regulation (EU) No 547/2012 of 25 June 2012
Industrial fans	Commission Regulation (EU) No 327/2011 of 30 March 2011
Household dishwashers	Commission Regulation (EU) No 1016/2010 of 10 November 2010
Household washing machines	Commission Regulation (EU) No 1015/2010 of 10 November 2010
Lighting products in the domestic and tertiary sectors	Commission Regulation (EC) No 1194/2012 of 12 December 2012 Commission Regulation (EU) No 347/2010 of 21 April 2010 Commission Regulation (EC) No 859/2009 of 18 September 2009 Commission Regulation (EC) No 244/2009 of 18 March 2009 Commission Regulation (EC) No 245/2009

Refrigerators and freezers	Commission Regulation (EC) No 643/2009 of 22 July 2009
Televisions	Commission Regulation (EC) No 642/2009 of 22 July 2009
Electric motors	Commission Regulation (EU) No 4/2014 of 6 January 2014 Commission Regulation (EC) No 640/2009 of 22 July 2009
External power supplies	Commission Regulation (EC) No 278/2009 of 6 April 2009
Simple set-top boxes	Commission Regulation (EC) No 107/2009 of 4 February 2009
Standby and off mode electric power consumption of household and office equipment	Commission Regulation (EU) No 801/2013 of 22 August 2013

Source: European Commission.

Recommendation 3.2

- 3.2.1 Study the role of household private consumption in the "energy transition" process upheld notably by the Europe 2020 strategy and assess which role consumer loans could play in that context.

CHAPTER 4. CONSUMER PROTECTION APPROACH

A significant part of policies conducted at European or national level are intended to correct the different dysfunctions that may occur in the structure of credit markets. All in all, at microeconomic level, there are two main types of dysfunctions that might lead to market failures: information asymmetries between distributors/originators and borrowers, and behavioural biases of borrowers.

Asymmetric information can be present on both the lender and the borrower sides in any credit market. Owing to their greater experience and knowledge of the financial products they are in charge of selling, lenders are expected to have more information on the features of the products than consumers are. As a result, they might have some incentives to exploit existing asymmetries of information to boost sales to the detriment of consumers. Furthermore, constant financial innovation admittedly leads to more choices for consumers and should therefore raise their welfare; however, financial innovation may result in higher product complexity and therefore should contribute to further information asymmetries, by introducing potential difficulties for borrowers to understand the pattern of costs/returns and the risks embedded (de Manuel et al., 2014). In this context, lenders may have incentives to exploit existing and new information asymmetries in their own interests (moral hazard), notably by selling consumer loans which are not necessarily in the customer's best interest.

On the other hand, customers typically have more information on their financial situation than the lenders. As a result, even though they are likely to be aware of the potential difficulties in reimbursing the loan, some borrowers may be prone to providing a biased assessment of their own financial situation in order to contract loans.

The second type of potential market dysfunction can be sparked by behavioural biases of consumers. In short, behavioural economics tries to show that consumers do not systematically choose their products in their best interests, as their behaviour and purchasing strategies are markedly influenced by specific context and psychological factors. More specifically, three cognitive limits may induce the violation of rational assumptions (Jolls et al., 2000):

(1) Bounded rationality: limits faced by human beings in terms of accessible information, mental capacity and available time (Simon, 1957).

(2) Bounded willpower: people act in conflict with their long-term interests, even though they anticipate negative effects in so doing, e.g. smoking, overspending today instead of saving for old age (de Manuel et al., 2014).

(3) Bounded self-interest: people care about treating others fairly because they want to be treated in the same way: agents will act 'nicer' or 'nastier' depending on how the other party treats them.

These limitations in the ability of consumers to maximise their welfare can trigger two specific market dysfunctions. Firstly, owing to their cognitive limitations, consumers might not capture, process and use the available information in an optimal manner. Secondly, certain characteristics of the consumer loans or the sellers' strategies might have been designed intentionally to exploit consumer misconceptions and this exploitation might lead to a significant decrease in consumer welfare.[30] For example, some innovations in the mortgage market in the years preceding the 2008-09 financial crisis targeted financially constrained households and offered products with variable interest rates and repayment schemes secured by unrealistic housing prospects. Overconfidence was present on both sides – the lenders and the borrowers – and these products were designed partly in response to the *temporal discounting* bias of some customers, i.e. the tendency to discount future gains more than losses.

Persistent information asymmetries and behavioural biases of consumers are likely to spark market dysfunctions, primarily to the detriment of customers' welfare and, to a lesser extent, to the detriment of credit providers. Against this backdrop, public interventions are necessary, especially to enhance consumer protection, and often result from some

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[30] For many financial products and selling strategies, the determination of an appropriate distinction between *intentional* and *unintentional* can be challenging, especially in a given environment of relatively high competition, continuous marketing campaigns and permanent financial innovation. All in all, product design is sensitive to drivers of demand and many of those drivers have a noticeable behavioural bias content. Therefore, it makes sense for regulators to intervene only if this exploitation leads to a significant decrease in consumer welfare.

combination of information disclosure requirements and responsible lending[31] as well as borrowing rules.

As such, this chapter will first focus on policies enhancing information disclosure requirements, their pros and cons and their ability to improve the setup of an effective market of consumer loans. Then, some emphasis will be placed on policies aimed at improving responsible lending of FIs. This second range of policies will follow a lifecycle framework, by highlighting a pre-contractual approach and a reimbursement approach. Finally, the third section will propose a possible alternative approach to traditional policies based on information disclosure and responsible lending.

Box 2. Behavioural economics and consumer protection

An increasingly popular topic

As analysed by Harford (2014), behavioural economics has become increasingly popular in recent years. In 2002, the Nobel Memorial Prize in economics was awarded to the psychologist Daniel Kahneman, a researcher often considered as one of the main contributors to the creation of behavioural economics. A decade later, in 2013, a behavioural economist, Robert Shiller, was given the Nobel Prize amid much praise and publicity. In the meantime, several bestselling books have been published on the topic, notably by Ariely (*Predictably Irrational: The Hidden Forces That Shape Our Decisions*, 2008), Thaler & Sunstein (*Nudge: Improving Decisions about Health, Wealth, and Happiness*, 2008) and Kahneman (*Thinking, Fast and Slow*, 2011).

Resulting in part from the popularity of the topic, public policy is using behavioural economics to an increasing extent to design better policies. In the UK, the Behavioural Insight Team (BIT) was set up by the coalition government in 2010 to apply insights of behavioural economics to government policy and was partly privatised in February 2014 for the purpose of advising foreign governments on that matter.[32] Still in the UK, the Financial Conduct Authority (FCA), which was formed by the UK government in spring 2013 with the objective of regulating financial firms providing services to consumers, published its first Occasional Paper on "Applying behavioural economics at the Financial Conduct Authority".

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[31] Responsible borrowing standards may also be relevant but are not addressed in the present report.

[32] In this context, the BIT developed a new policy framework that integrated simple principles to use behavioural insights in an efficient manner: "in order to encourage a behaviour, make it Easy, Attractive, Social and Timely (EAST)."

Across the Atlantic, the Consumer Financial Protection Bureau (CFPB), an independent agency of the United States government founded in 2011 and responsible for consumer protection in the financial sector, relies significantly on behavioural economics when conducting research on consumer behaviour.[33] In addition, the White House officially launched its own Social and Behavioural Sciences Team in January 2014, partly modelled on the UK's BIT and covering a broad scope of topics.

Finally, in the European institutions, the Commission has shown growing interest in the possibilities offered by behavioural economics when designing consumer protection regulations, especially in the field of retail finance. Various conferences and workshops on this topic have recently been organised, notably by DG Consumer Affairs and DG Internal Market and Services.[34] In 2010, the DG Consumer Affairs conducted its first behavioural study on consumers' decision-making in retail investment services, showing that simpler and standardised product information significantly improves investors' decisions. In February 2014, the Mortgage Credit Directive was adopted with some elements partially based on behavioural insights (notably with some recommendations on the framing of some disclosed information). And it seems there is more to come.

A complex discipline, object of several criticisms

Until recently, policies regarding consumer behaviour and protection were (or pretended to be?) mostly influenced by neoclassical economics and, as such, have relied on "analytic, a priori analyses of the making of rational decisions" (Shafir, 2008). While it is rather normatively based, this model, commonly known as the 'rational agent', had been the main conceptual framework promoted in academic and policy spheres and gradually shaped economics and the design and conduct of policy. However, an alternative approach, developed originally by Thaler (1980) has progressively gained momentum in policy-making circles and has challenged the neoclassical key assumption of 'rational agent'.

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[33] One of the main promoters of the CFPB set-up, e.g. Sen. Elizabeth Warren, was a strong advocate of the use of behavioural insights at the CFPB (see www.forbes.com/sites/moneybuilder/2011/06/17/the-soft-power-of-the-consumer-financial-protection-bureau/) and the Academic Research Council of the CFPB includes notable behavioural economists such as Richard H. Thaler.

[34] For example, the conference on emerging challenges in retail finance and consumer policy, jointly organised by DG Justice and Consumers and DG Financial Stability, Financial Services and Capital Markets Union, on 18 November 2014 had an entire session devoted to "behavioural economics and financial services".

This theory, commonly named behavioural economics, "combines economics and psychology to produce a body of evidence that individual choice behaviour departs noticeably from the one predicted by neoclassical economics in a number of decision making situations" (Ginsburg et al., 2012). The departures from rational-choice behaviour are supposed to result from an individual's 'cognitive biases', often defined by behavioural economists as systematic failures of consumers to act in their own interest because of defects in their decision-making process.

The rising popularity of the behavioural economics approach among policy-makers has sparked several criticisms regarding its soundness and foundations, especially by some notable psychologists. Among the most prominent critics, Gigerenzer (2009) argues that "the individual has a biased mind and ignores part of the available information, yet a biased mind can handle uncertainty more efficiently and robustly than an unbiased mind relying on more resource-intensive and general-purpose processing strategies". However, these models can hardly help us understand the way households budget their spending or choose a particular type of consumer loan (Harford, 2014). More generally, the main criticism of behavioural economics concerns the attempt of this discipline to formulate general laws of human behaviour, while problem-solving approaches are rather *ad hoc* and vary noticeably from one individual to another.[35] As such, many critics conclude that behavioural economics can hardly provide consistent guidelines for policy design.

Some other ardent critics place the focus on the philosophical and political issues of applying behavioural insights to policy-making. These critiques denounce the paternalistic drift of such an approach, which in the end could pose a significant threat not only to the right of free enterprise, but also to the freedom to choose and hence "to err in making important decisions" (Ginsburg et al., 2012).

[35] As a result, most of the empirical research on this topic considers a specific market and/or product, within a given economic, sociological and cultural environment, and produces findings that are hardly consistent with other markets or environments.

Table 4.1 Behavioural biases of particular relevance to financial products

Psychology of scarcity	Day-to-day challenges and stress, especially those associated with poverty, leave little room for error and can drain mental resources and actually make it difficult to make good decisions.	Consumers of different income levels perform equally well when presented with low-value financial decisions, but performance of lower-income consumers deteriorates when the value of the financial decision increases.
Availability	The memories that come to mind are not always the ones that are most helpful, or even the ones a person wants to remember. Instead, some memories are simply more likely to come to mind, especially those that are associated with strong emotions.	Consumers have greater recall of negative experiences of peers presenting complaints to financial institutions, and so are disinclined to attempt to have their own complaint resolved.
Hassle factors	Small barriers such as filling out forms or waiting in lines. While these costs may seem trivial, reducing or relieving them can have an outsized impact.	Consumers may fail to submit a complaint due to perceived inconveniences like having to speak with someone in a branch or fill out forms.
Hyperbolic discounting	Greatly discounting future costs or benefits relative to immediate costs or benefits.	Expensive consumer credit seems like a good deal to cover short-term needs, even if the long-term costs are significant.
Information and choice conflict	An increase of options may make it more difficult for consumers to select a single option.	Consumers who want to purchase insurance may end up not doing so when presented with *too many* plans or options presented in diverse ways, making it difficult to compare choices.
Positive framing	Presenting information or choices in a way that accentuates positive aspects of the consequences or outcomes. Whether a choice is framed in a positive or negative way can have a huge impact on how people	Messaging that links money with specific goals leads to higher saving rates than if saving intentions are left vague or broad.

	evaluate the choice. Framing the future in a positive way can motivate people to work hard to attain the positive outcome.	
Present bias	Weighing present concerns more than future ones. People make plans to do unpleasant tasks "tomorrow" – and make the same choice to put the action off when "tomorrow" becomes "today"!	A consumer opens a savings account with the intention of depositing regularly, but her balance quickly falls to zero as she fails to deposit each day in favour of paying for daily temptations and expenses.
Social norming	Behaviour and actions that are driven by actual or perceived behaviour of a peer group.	Informing citizens how many of their peers have already paid taxes increases the likelihood they will pay their own taxes.

Note: This list is meant to be indicative, not exhaustive. Additionally, specific biases likely manifest in different ways depending on context, so this is representative, rather than definitive. It is also difficult to link an observed behavioural tendency with one single explanation from behavioural research; often, multiple psychological biases can help to explain and understand a specific human behaviour, rather than just one.

Source: Mazer et al. (2014).

4.1 Information disclosure policies

Principles

The first strategy focuses on the type of information FIs are required to disclose. In the context of household loans, there are three phases to consider: advertising phase, pre-contractual phase and contractual phase. The information provided during the first two phases is essential to helping customers make appropriate choices and opt for the financial product which corresponds best to their needs. The last phase provides the information on the rights and responsibilities of both the lender and the borrower for an appropriate execution of the contract. The purpose of contractual information is also to have a clear reference document in case of litigation. It is generally divided between general and particular conditions and includes all or part of the pre-contractual information. The disclosure of contractual information may influence the final choice of customers regarding the preferred financial product, even though customers are less likely to turn back once they enter the third phase.

At European level, the CCD and the MCD contain several provisions on information disclosure during the three phases, as one of their main goals is to harmonise as much as possible the obligatory information included in these three phases (see in particular the Standard European Consumer Credit Information and the European Standardised Information Sheet).

Advantages

Disclosure policy is often at the base of consumer policy, as it is likely to be less controversial and complicated to implement than some other policies aimed at improving customer outcomes (such as suitability requirements or restrictions on certain product features). Disclosure is indeed based on the principle of 'buyer beware', which assumes that if information is transparent and readily accessible, the burden of choice and subsequent outcomes should fall predominantly on the customer (Mazer et al., 2014).

At the core of this policy, the CCD (as well as the Mortgage Credit Directive) places the emphasis on a standardised way to calculate the annual percentage rate (APR). The objective of such a policy is twofold:

- on the supplier side, to encourage fair competition by pressuring firms to compete on price and quality and
- to help consumers in their decision-making process.

As such, disclosure policies are designed not only for the benefit of consumers, but also of producers.

On the lender side, clearer and standardised disclosure should result in common terminology and standards, thereby reducing administration costs of bringing new products to the market. To a certain extent, this type of disclosure framework should favour 'healthy' financial innovation and should also contribute to the reinforcement of transparency in consumer credit markets; such disclosure policies are in line with the objective of mitigating information asymmetries and their negative effects, and appear to be essential to maintaining effective credit markets with fair competition. At an aggregate level, systematic marked distortions in the quality and harmonisation of the available information are indeed likely to result in artificial opportunities for growth and sub-optimal market equilibriums.

On the consumer side, one of the main advantages of standardised disclosure is to alleviate search costs. In a context where products have standardised information, consumers should be more capable of comparing products and the selection of the product should correspond further to the real need of the customers. Nevertheless, the implementation of harmonised disclosure contains several pitfalls.

Disadvantages

First of all, *many consumers typically do not shop around when seeking a financial product* (Mazer et al., 2014). According to the EC (2010) in its study on "Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective", only one investor in three compares investments from more than one provider or considers more than one product from a single provider. The corresponding figures for consumer credits are likely to be broadly similar. Many customers establish partnerships with FIs based on time and trust, especially in some EU countries. In that case, standardised information disclosure aimed at easing comparability can have a significant impact only if the lender proposes different products to his customer; the question on ethics of the lender is essential within this framework and should be addressed by policies based on the approach of responsible lending (see section 4.2).[36]

Another question triggered by these analyses is to assess to what extent standardised information could encourage customers to shop around. To our knowledge, no empirical study confirms the positive impact of a standardised annual percentage rate (APR) on the share of consumers comparing products. Due to the low enforcement of the disclosure requirements adopted within the CCD, such a survey would be difficult to conduct at the EU level. The report on CCD implementation published by the Commission on 14 May 2014 indeed finds that:[37]

- only 22% of advertisement correctly discloses the standard information required;
- information on costs is not clearly disclosed;
- 27% of advertisements with cost information do not provide a representative example; and
- in only about a half of advertisements with sufficient information does the APR seem to be correctly calculated.

Therefore, according to this survey, further enforcement is needed before assessing the impact of the CCD information disclosure on the desire of consumers to shop around.

Secondly, by considering only customers who shop around, several empirical studies question the ability of information disclosure policies to

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[36] Nevertheless, as developed in the last part of the report, the fast growth of digital banking and comparability websites is expected to boost the share of customers shopping around.

[37] See European Commission (b2014).

improve financial decision-making (Willis, 2005; de Meza et al., 2008; Agarwal et al., 2009). Findings of these studies confirm that even though customers have better information, they do not always choose the optimal option. There are five main reasons to explain the difficulty customers have in making appropriate decisions despite improved information, each of these reasons implying specific policy recommendations.

Reason 1: Firms often shroud the high prices for complementary add-ons

As developed notably by Gabaix et al. (2005), firms often shroud the high prices for complementary add-ons, hereby revealing a typical case of information asymmetry. The authors identify conditions under which shrouding survives in competitive equilibrium and show that competition will not induce firms to reveal information that would improve market efficiency. Firms will not educate the public about the add-on market, even when unshrouding is free. The 2014 report on CCD implementation confirms this view, as still very few FIs advertised cost information with a representative example despite the fact that the CCD had been transposed for a few years in most EU member states. Better enforcement of the disclosure provisions in the CCD could partly resolve this problem.

Reason 2: The quantity of information is too great

Even though they do have all the necessary information, consumers do not choose the optimal option, simply because the quantity of information is too great. This question of quantity is especially important for the contractual phase, when lenders often have to disclose contractual information to comply with both the European and domestic requirements. Too often, European requirements are simply added to the domestic ones, resulting in a tremendous amount of information that very few customers consider. This 'quantity race' can be heightened by FIs themselves for legal protection purposes. In order to be covered in case of litigation, many FIs indeed add some contractual information, notably by placing some focus on borrowers' responsibilities in case of difficulties. In the end, whatever is the policy choice, both domestic and European regulators, as well as FIs, *should keep in mind that too much information tends to be counterproductive*. Most likely, there exists a threshold in terms of quantity of information beyond which any added information, whatever its pertinence, may act as a drag on the ability of customers to choose the best option.

An appropriate quantity of disclosed information at all stages of the "loan process" is essential in order to ensure the setup of an "efficient

market". Indeed, the overload of information can result in marked market dysfunctionalities, as consumers are discouraged from finding the needed information. In theory, large amounts of disclosed information should help alleviate the endemic problem of information asymmetries in household credit markets, but in practice, "too much information kills the information" and the problem of information asymmetries remains or is even higher.

Reason 3: Consumers do not understand the available product information

Even though they do have all the necessary information and the quantity of information available is "reasonable", consumers do not necessarily choose the optimal option, simply because they do not understand the available product information. Behavioural economics can offer multiple perspectives on these issues, by providing food for thought on the different biases of consumers. For instance, APR is a complex statistic that can be misunderstood: some people believe that an APR of 10% means that the interest charged would be 10% of the amount borrowed regardless of loan duration; others believe that it is a rate measure based on the initial, not the average, amount borrowed (McHugh et al., 2011). In Box 3, Rob Ranyard proposes different information disclosure options to improve the understanding of financial information by purchasers of consumer loans, notably by publishing more comprehensive comparable information than APR. The author considers the following options:

- for all fixed repayment credit, clearly presenting the monthly repayment, the loan duration and either the financial charges or total cost;
- financial charge per month (or relevant instalment period);
- for revolving credit, the publication on monthly account statements of total costs and loan duration for a range of monthly repayments.

In the context of "Reason 2" and "Reason 3", the head of the European Insurance and Occupational Pensions Authority (EIOPA) recently declared (June 2014) for the case of insurance and pension products that: "giving more information doesn't work. Most people don't read or understand the lengthy pages containing complicated product information…What we need is 'smart disclosure', with a focus on consumers". In other words, *the information disclosed should be reasonable in quantity, easily understood by most consumers and target primarily the main needs of consumers*. As such, the setup of a hierarchy of customer needs with a specific ranking for each need, although somewhat awkward, is likely help reinforce the efficiency of policies based on mandatory information disclosures.

*Box 3. Cost disclosure in the retail credit market: research and policy implications**

Consumer borrowing has been described as a decision-making process with three stages (see Kamleitner & Kirchler, 2007 and Kamleitner et al., 2012). First, deciding whether to spend or not, or to defer spending; and if deciding to spend, whether to fund it from current assets or income, or from expected future income, i.e. borrowing now and repaying later. The second stage involves choosing a specific credit option, while the third focuses on the management of repayments. From the point of view of rational lifecycle theory it makes sense to borrow sometimes, to maximise satisfaction across the lifespan. There are, however, significant psychological factors underlying the decision to borrow. For example, in our ongoing research on spending and borrowing at Christmas (McNair et al., 2013), we found that willingness to borrow was inversely related to money management skills, and positively related to two psychological variables: a maladaptive coping style based on denial, and materialistic values. This suggests that support for money management and financial literacy could be more effective if these related psychological issues were addressed as well.

The aim of this article is to summarise research findings concerning the second and third stages of the borrowing decision process and briefly consider their policy implications. The focus is the cost and loan duration information that borrowers require both for informed credit choice, and for repayment decisions with revolving credit agreements such as credit cards. We have considered these issues from a mental accounting perspective, first introduced by Shefrin & Thaler (1988), proposing that borrowers can represent instalment credit in terms of two alternative mental accounts: a *total account*, in which all future repayments are treated as equivalent to a current cost, added together to give the total cost of the loan; and a *recurrent budget period* account, whereby each future monthly budget period is seen as equivalent, or similar to, the current budget period. In the latter case, each future repayment is integrated into its associated budget period, so that the weekly or monthly repayment amount is the most important aspect of cost. The loan duration, or number of budget periods in which the repayment is required, is also important from this perspective (see Ranyard & Craig, 1995).

The annual percentage rate (APR) measure of credit cost

The first issue to consider is the role of APR in credit choice. On the positive side, it is a widely accepted standard of comparison based on a standard time period that is easy to use with a simple 'take the best APR' rule. In fact, in our research (Ranyard et al., 2006), we have found that many people use APR appropriately in this way. On the negative side, however, APR is a complex statistic that can be misunderstood: some people believe that an APR of 10%,

for example, means that the interest charged would be 10% of amount borrowed regardless of loan duration; others believe that it is a rate measure based on the initial, not the average amount borrowed (McHugh et al., 2011). It has even been reported that a few credit card users believe that a higher APR indicates a cheaper loan. Finally, we have found that with flexible credit, estimates of the loan duration or total cost are less accurate when APR is given (Ranyard & Craig, 1993).

So while it is useful for many borrowers, the understanding of APR needs further support: perhaps by the teaching and learning of an approximate APR formula (Yard, 2004), essentially drawing attention to APR's relation to the average, rather than the initial loan. Second, an additional measure of relative cost, the financial charge per week or month, could be routinely provided. This is a user-friendly measure on a familiar scale that can be used to compare credit options for the same amount but different APRs or different repayment schedules.

Financial charge and total cost information

Other important aspects of the cost of borrowing are the financial charge, which is the sum of all charges incurred during the lifetime of the loan, and the total cost, which is the amount borrowed plus the financial charge. These are limited because they are absolute measures that don't take into account the duration of the loan. Nevertheless, they are easy to understand and consistent with one of the ways that people naturally think about instalment credit, in terms of the total account mentioned earlier. In addition, we have found that: 1) with revolving credit, estimates of loan duration are more accurate when total cost is given (McHugh & Ranyard, 2012); 2) total cost information moderates the effect of APR in credit decisions (European Commission, 2014); and 3) together with loan duration information, it leads to higher credit card repayments (Gross & Souleles, 2002).

In view of these and related findings, the following can be suggested with respect to presenting cost information. First, as presently required in most countries, an accurate value of the APR of all credit offers should be disclosed clearly at an appropriate point in the sales process. Disturbingly, a recent survey by the European Commission found that APRs advertised by some lenders across the EU were often substantially inaccurate (Soman & Cheema, 2002). Second, for all fixed repayment credit, a clear presentation of the monthly repayment, the loan duration and either the financial charge or total cost is essential. In addition, we would like to see the financial charge per month (or relevant instalment period) presented so that the relative cost of loans for the same amount and duration can be compared more transparently.

Finally, for revolving credit, we recommend that total cost and loan duration information for a range of monthly repayments should be presented on monthly account statements.

Credit limit and minimum repayment information

Two items of information on credit card statements, credit limits and the required minimum repayment, have been found to affect spending and borrowing in unintended ways. On the former, it has been found that borrowers can interpret credit limits as a signal for their future income, and also that higher credit limits encourage spending (Stewart, 2009 and Hershfield & Roese, 2014). This leads to the suggestion that lenders should set credit limits with reference to its affordability for a reasonable loan duration.

On minimum repayment information, research has shown (Navarro-Martinez et al. 2011) that its mere presence acts as an anchor for repayment decisions, and those who repay more than the minimum are influenced by it. Secondly, it has been shown that raising minimum repayments raises borrowers' repayment levels more than proportionately. This leads to the suggestion that regulations for a minimum repayment level above 2% should be considered (it has been calculated that with APR of 14%, repaying at 2% of the balance takes about 19 years). If, however, the level of minimum repayment were set too high, missed payments could become problematic.

Other supplementary information

There has been some recent research investigating ways to mitigate the anchoring effect of minimum repayment information. While informing borrowers of the long-term consequences of repaying only the minimum had little effect, informing them additionally of the repayment necessary to repay in three years, as required by the US CARD Act of 2010, increased the proportion of credit card users repaying at that level, and sometimes raises the proportion repaying more than that amount. However, it has also been reported that a significant number of users may pay *less* when the three-year payment amount was less than they would have paid otherwise. Nevertheless, we have found in a recent study that anchors higher than three-year repayment amounts increase the proportion of users repaying at or above such higher levels. This reinforces the policy suggestion made earlier for revolving credit: total cost and loan duration information for a range of monthly repayments should be presented on monthly credit card statements.

* We are grateful to Task Force member Rob Ranyard of the University of Leeds for contributing the text in this box.

Reason 4: Specific presentation of the information may have an impact on consumers' choices

Some findings of behavioural economics place emphasis on the impact of a specific presentation of the information on consumers' choices. Some companies do comply with disclosure requirements, however they can be biased in the transfer of information by highlighting specific elements and covering some others, depending on marketing strategies. The question is therefore "how the information is disclosed?", rather than "which information is disclosed?"

Some initiatives were already taken in several member states to promote the incorporation of warnings in the disclosed information, such as, "Be careful, borrowing money also costs money". In general, empirical studies and surveys demonstrate the positive impact of warnings on consumer behaviour (Cox et al., 1997 and Chater et al., 2010). In the former article, consumers were more likely to react to an adviser remuneration disclosure if it incorporated warnings. The authors tested a number of disclosure statements including the addition of the second sentence (with and without emphasis) of "The advisor will be paid proportional to what you invest. Notice that this means that the advisor did not necessarily have your own investment earnings in mind when he gave his advice". Typically, there appears to be much greater scope to provide warnings to consumers in the purchase of high-risk products, especially products with high interest rates.

However, policies promoting the use of warnings have also some limits. Firstly, the effectiveness of warnings depend on a number of factors, in particular, good design (Argo and Main, 2002) and it seems difficult to regulate such characteristics. The final decision will be taken by micro-prudential supervision, which, in certain member states, is already granted the power to decide if a leaflet related to a financial product presents the required financial information in a satisfactory manner. Secondly, warning labels can have counterproductive effects on the behaviour of FIs, as they give the possibility to lenders to avoid or reduce their liability. As such, the use of warnings could partly reduce incentives for responsible lending by FIs. Thirdly, in line with the effects of warnings observed in the tobacco industry, policies promoting the use of warnings are likely to have little effect on overconfident customers. Finally, warnings could reduce well-being if they make some people feel worse without changing their behaviour (Tooth, 2012).

Reason 5: Regulatory efforts in improving disclosure may come at an opportunity cost of regulatory efforts elsewhere

Finally, as analysed by Tooth (2012), regulatory efforts in improving disclosure may come at an opportunity cost of regulatory efforts elsewhere: excessive focus on improving product disclosure may distract regulators from more effective methods of addressing poor decision-making by consumers. One of the main concerns in the CCD implementation seems to be the inconsistent application of required information disclosure and the significant resources allocated to improve the enforcement of these provisions. Such resources could be used for designing new provisions, better adapted to the evolution of the financial markets.

Recommendations 4.1

- 4.1.1 Promote further enforcement of the CCD, especially regarding advertised cost information with a representative example.
- 4.1.2 Enhance the design and implementation of policies where the information disclosure requirements at the advertising stage, pre-contractual stage and contractual stage should be reasonable in quantity, easily understood by most consumers and targeted primarily towards the main needs of consumers.
- 4.1.3 Overall, promote further research into the optimum amount and structure of informational material that consumers are prepared to take into consideration when deciding on financial products, particularly consumer loans.
- 4.1.4 Enhance the use by regulators and FIs of a specific ranking for each type of customer needs in terms of information, in order to reinforce the efficiency of policies based on information disclosure.
- 4.1.5 Promote the use of simpler tools than APR to help customers compare the financial services available.
- 4.1.6 Promote the use of warnings in the disclosed information (by also considering the limits of such practices).

4.2 Responsible lending policies

Regulators have also highlighted the need for ethical behaviour across the retail financial industry. The driving force behind this regulatory strategy can be summarised in the motto "Provide customers with financial services they need and can afford". Overall, some elements of this approach are

rather vague, as the necessary innovation process occurring in the financial industry leads to constant redefinitions of the concept of "needs"; however, the "can afford" principle is likely to offer a sounder base for further recommendations, notably by enhancing the *responsible lending approach* of FIs. Responsible lending policies – typically requiring lenders to offer credit only if the borrower must be reasonably expected to repay the loan without substantial hardship – place greater responsibility on the lender to ensure that lending is consistent with the interests of the borrower. It also encourages FIs to develop appropriate follow-up of the financial capacity of customers to reimburse the loan during the whole contractual period. As such, the traditional business model of FIs is likely to be redefined markedly in the coming decades.

Article 45 of the MCD, "Further initiatives on responsible lending and borrowing", provides the possibility for the Commission to submit a comprehensive report assessing the wider challenges of private over-indebtedness directly linked to credit activity, hereby leading to possible legislative proposals. Nevertheless, it is mentioned that the deadline of such a report would be only "by 21 March 2019".

The CCD does contain some provisions on the necessity of the lenders to assess the consumer's creditworthiness (Article 8 in the CCD) but does not include any specific measures on over-indebtedness (see, however, Recitals 26 and 27).

At macroeconomic level, within the growth approach, we analysed that central banks should integrate further tools to control for possible over-indebtedness, the main challenge being the absence of consistent methodologies across the EU member states to measure over-indebtedness. But, *the question of over-indebtedness and its prevention is also essential at the seller level and similar questions remain on its definition.* Policy orientations aimed at preventing over-indebtedness at both macroeconomic and microeconomic levels are twofold. On one hand, some specific policies target practices before the signature of contracts (*pre-contract approach*); on the other hand, some other tools are designed to promote a better follow-up during the repayment period (*reimbursement approach*).

Relationship with the client: Pre-contractual approach

In the aftermath of the 2008-09 financial crisis, increased macroeconomic focus has been placed on the necessity to implement appropriate monitoring mechanisms at an early stage in credit market development, to detect potential debt stress (reflecting market segment on the road to over-

indebtedness) and prevent ill-considered lending practices, thereby avoiding risks to financial markets, consumers' and the regulators' credibility (Davel, 2013). *Lender practices and borrower behaviour are at the core of policies aimed at curbing debt stress.*

Policies aimed at reinforcing responsible lending typically assume that lenders are often in a better position to assume the optimal level of borrowing, owing to their greater experience in loan contracts than borrowers. As a result, lenders are supposed to be less prone to behavioural biases such as overconfidence or biased risk assessment (Tooth, 2012). However, in a specific context (especially when the economy is booming, as was the case in the years preceding the financial crisis), sales agents can also suffer from overconfidence. In addition, against the backdrop of ambitious commercial targets and high sales inducement practices, lenders may lack incentives to ensure that the lending is reasonable. The absence of responsible lending requirements could prompt some specific sellers to exploit the behavioural biases of customers in an inappropriate manner, especially in the case of the most vulnerable consumers. In recent years, researchers and policy-makers have gradually placed emphasis on two main types of consumer biases (very present among the most vulnerable consumers): *tunnelling* and *temporal discounting*.

The former has been extensively developed by Mullainathan et al. (2013) in their best-seller *Scarcity: Why Having Too Little Means So Much.* The author defines "tunnelling" as the behaviour of consumers focusing disproportionately on the task at hand, at the expense of other equally or more important tasks. Some customers struggling to pay their bills may ignore financial management principles and could be susceptible to taking out loans they might not be able to afford. However, there is also countervailing evidence that a significant proportion of consumers on lower incomes make considered decisions and trade-offs and deliberately choose credit products that they know will mesh with their personal circumstances.[38]

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[38] For example, the 2011 report "Making Ends Meet" by Consumer Focus in the UK concluded: "The precariousness of low-income consumers' finances and personal circumstances means that they often have to prioritise control…clarity…and convenience…over long-term cost. Unlike more affluent consumers, they cannot afford to take the risk of the fees and penalty charges for missed payments that come with more mainstream products. Instead, many low-income consumers rely on more expensive payment methods and financial

The latter refers to a time-inconsistent model of discounting. Some customers tend to discount future gains more than losses. In other words, these decision-makers feel disconnected from their future selves, an experience that leads them to prefer smaller immediate gains to large future gains. Both biases are typically involved in cases of multiple debts and should be continuously and carefully addressed in sales strategies of FIs.

Going beyond the case of the most vulnerable consumers, some voices have been raised in recent years to favour policies aimed at promoting an appropriate *socio-economic* approach of FIs sales strategies. In other words, the products designed for and proposed to customers should respond to their socio-economic status and the content should be salient to consumers' financial lifecycle. Possible criteria involved in such a process are the age and the composition of the households. For example, empirical research often suggest substantial decreases in consumption after retirement, regardless of income patterns and an increasing spending share in health issues.

Relationship with the client: Reimbursement approach

In recent years, some national regulators in the EU-28 have gone beyond the recommendations and provisions included in the CCD, *by gradually placing the focus on a risk management approach of over-indebtedness not only before the signature of a loan agreement, but also during the repayment period.* Various member states have adopted general recommendations on the need for FIs to implement processes of detection of future potential over-indebted households and to organise an appropriate accompanying of the concerned households when necessary (for example, the French government adopted in November 2014 some recommendations requiring financial institutions to implement early warning systems in order to detect potential over-indebtedness during the repayment phase).

Until recently, the typical FI business model included five phases in the life of a consumer loan that lead to difficulties of repayment by the consumer.

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products, such as cash, certain types of credit (e.g. home-collected credit…) and prepayment meters…which are better suited to their priorities for day-to-day money management. A consistent feature of our research findings is that low-income consumers' choices are based on an active weighing up of the costs and benefits of the products they consider available to them. Often this means having to make difficult trade-offs between cost and other priorities, given the limited choices on offer".

- First, the bank performs the creditworthiness assessment of the client asking for a loan (in line notably with the provisions of the CCD on the obligation of customer creditworthiness for any consumer loan).
- Secondly, both the lender and the borrower come to an agreement with specific conditions.
- Third, even though the creditworthiness process was performed properly and the repayment schedule was designed in accordance with consumer possibilities, some unpredictable events can still occur and negatively affect the ability of the customer to reimburse his loan. For example, an accident, illness, natural disaster, separation or divorce, or the loss of a job can markedly weaken the financial situation of the customer, who is likely not to be able to commit to the repayment schedule.
- Fourth, the bank transfers the file of the customer to its collection process in order to find solutions for recovering the owed amount.
- Fifth, should the customer not be able to reimburse the loan, his file will be transferred to judicial institutions.

The new approach promoted by some member states is that FIs should voluntarily investigate the risk of over-indebtedness of their customers before it materialises. As such, FIs are encouraged to develop prevention programmes before entering phase four. This early-stage detection system is perfectly in line with the political objectives of detecting and curbing debt stress, both at microeconomic and macroeconomic levels. Within this framework, lenders are able to identify vulnerable customers before their financial difficulties become insurmountable and solutions could be found even before initiating the collection phase. Some FIs have developed two different ways of detecting vulnerable customers:

- a scoring system identifies the likelihood of a customer missing a repayment within a given period and
- a phone service available to all customers in case of financial difficulties.

Resulting from these two processes, the bank can provide a service whose main aims are to confirm whether or not the targeted customers are financially vulnerable and to offer personalised solutions where needed. In that context, the initiation of a collection phase, often costly in terms of resources for both lenders and borrowers, could be avoided.

Nevertheless, no matter how beneficial such a system may be, the question remains as to how to encourage and promote such practices in

credit markets. Indeed, binding regulations may trigger negative outcomes that outweigh any positive effects. This is because such interventions can affect the normal risk-taking processes that are integral to all lending formats, reducing product diversity and choice and also potentially reducing credit supply. In addition, the implementation of early detection processes may spark higher than optimal costs, especially for smaller loans. Should these costs be partially or fully passed through to the interest rate on the loan, some borrowers will in the end also be penalised. Borrowers with healthy finances during the whole life of the loan may even be the big losers in such a system, as they would indirectly subsidise to a certain extent the detection of the borrowers who may encounter financial difficulties during the reimbursement period.

The present Task Force considers that the best way to encourage the implementation of early-detection processes is to use regulatory incentives as opposed to binding rules. For instance, tax deductibility or processes that ease the impact of CRD4 (liquidity ratios and capital ratios) conditional on the implementation of effective and satisfactory early-detection processes might be usefully explored.

Recommendations 4.2

- 4.2.1 Place further emphasis on the prevention of over-indebtedness in the European policy design, notably by encouraging the set-up of early-stage detection of potential over-indebtedness in order to alleviate collection/juridical costs of FIs and arrears and perhaps bankruptcy costs of households.
- 4.2.2 Use regulatory incentives (such as tax deductibility, or some easing in the implementation of CRD4 price-based ratios, etc.). This would avoid the significant risk of binding regulation leading to negative outcomes that could easily outweigh any positive effects.

4.3 A possible alternative approach to consumer protection: External assessment?

Another line of action towards consumer protection may be the use of external ratings to assess the responsible lending practices of FIs.[39]

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[39] This practice has been extensively used in food and consumer products, especially with the eco-labels providing sustainability measurement directed at consumers to help them take environmental concerns into account when shopping.

For the case of consumer loans, a potential rating may focus on two different aspects of the services:

- "Process focus": the labelling process could assess the quality of the processes used by FIs to implement responsible lending practices. This can include, for example, the commitment of the organisation to deliver clear and transparent information to the customers, an appropriate training of the sales employees, a pertinent process to detect risks of over-indebtedness during the whole life of the loan, etc. To a certain extent, such ratings may result from a combination of information disclosure and responsible lending approaches. In that context, the labeller indeed certifies that the lender is acting in a responsible way and this information is disclosed to the consumer through a marking.
- "Result focus": while the "process focus" option places the emphasis on the quality of the means used by the FIs to provide loans, the "result focus" essentially considers results. It is therefore tempting to oppose an "obligation of means" to an "obligation of results". The latter can rely on different ratios to assess the performance of the organisation: the default rate, the proportion of customers in arrears, etc. One of the main difficulties of the "result focus" approach resides in the methodological inconsistencies in the definition of default and/or arrears, not only across countries, but also across companies. Furthermore, the rate of default or any other ratios aimed at reflecting the share of customers having difficulties in reimbursing their loans can depend markedly on the macroeconomic environment in which the lenders operate. In order to remain effective, the labeller would need to update its criteria on a regular basis, which seems rather counterproductive. Finally, the consumer loans market is segmented into types of products and customers. Some groups of products imply greater risks, hereby resulting in higher rates of arrears. Therefore, the implementation of labelling practices based on "result focus" methods could lead to a marked impoverishment of service choices on the market, as different classes of products would enter directly into competition through biased criteria of comparison.

External ratings on the responsible lending practices of FIs could generate different advantages, especially by addressing some key market dysfunctions. For customers, such a practice should contribute to alleviating the risk of moral hazard sparked by information asymmetries in the credit markets. Furthermore, the choice made by customers should be eased with

a consistent methodology of assessment across the FIs providing consumer loans. Should such ratings include the assessment of practices of FIs in line with the respect for the environment or with a better quality of life for the population, this should also contribute to the achievement of Europe 2020 objectives, by, for example, helping consumers take environmental concerns into account when choosing a loan.

As regards the lenders, external ratings on responsible lending can enable them to reduce their costs when they attempt to highlight the benefits of their financial services when compared to those of their competitors. Indeed, providing such benefits typically induce some costs and FIs need to convince consumers to pay a higher price than for competing services on the market.

Nevertheless, the implementation of external ratings systems can trigger different risks and disadvantages, and such an option should be carefully assessed before any further policy involvement. First of all, the structure of the agencies providing these ratings remains one of the key issues. Should it be a centralised public body, a purely private organisation in competition with others or a hybrid centralised organisation, owned for example by a consortium of FIs, one can question the independence of the external assessor from the lender and therefore the credibility of the assessor.

Secondly, the effectiveness of external ratings as a communication tool can be questioned. For the food industry, the use of labels by customers has often been revealed as inconsistent. In addition, some customers may lack interest in the information provided by the label. Even though the consumer may be interested in the rating, many customers might find the use of ratings difficult as they contain too much information, much of it is not understood, is confusing and is poorly presented. Finally, should the customers not trust the body providing the ratings on the responsible lending dimension of FIs, such external ratings might even be counterproductive. The reputation and credibility of the external assessor are therefore essential to ensuring a proper rating system.

Last but not least, the assessment of FIs and some important parts of their internal processes is already performed by supervisors and controls have been reinforced markedly in the context of the recent new regulatory packages, especially at European level. Some risks of regulatory overlap would be quite likely, triggering in the end non-optimal compliance costs for FIs and higher interest rates for consumers in case of significant pass-through.

Therefore, in the current state of play, the positive role that external assessment can play in credit markets remains rather hypothetical and further studies will be needed before deciding if this would become a viable option.

Recommendation 4.3

- 4.3.1 Assess the possibility of conducting a survey on the different practices in terms of external assessment of responsible lending practices of FIs in European member states.

CHAPTER 5. INTERACTION BETWEEN INTEGRATION, CONSUMER PROTECTION AND GROWTH

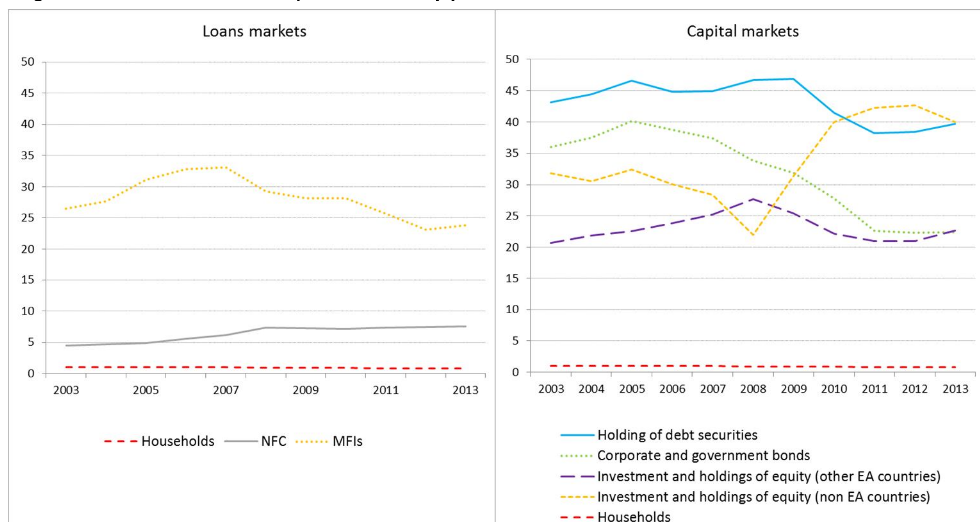
The motivation for regional integration in Europe has most of the time been political rather than economic (Kleimeier et al., 2007) and the long-term objective, as originally advocated by Jean Monnet, has been to create the "United States of Europe". However, the means to achieve that goal have been most of the time economic: for instance, the Treaty of Rome of 1957 identifies in Article 2 the creation of a unified economic area with a common market as the task of the Community.

Regarding the economic benefits of further integration, the European institutions have generally remained vague, especially in respect of financial markets. For example, in the Article 20 of the Lisbon European Council (2000) dealing with "Efficient and integrated financial markets", the word "transparent" has been preferred to "integrated": "Efficient and transparent [not integrated] financial markets foster growth and employment by better allocation of capital and reducing its costs". All in all, the concept of integration has generally been analysed as an objective rather than as a driver for stability, consumer protection or growth in the retail financial markets.

However, notably in the context of the ongoing implementation of the banking union, a new approach has recently been adopted in the concept of financial integration, which emphasised *the need to raise the "quality" of the financial integration in the euro area* (Draghi, 2014). In Mario Draghi's view, the incomplete financial integration achieved before the crisis, with highly integrated interbank markets and largely fragmented retail banking, made it susceptible to systemic crises. The market share of cross-border lending between monetary and financial institutions was indeed much greater than that of households' loans (see Figure 5.1) and, despite a pronounced decrease in recent years, remains more than 20 pp higher. It is also worth mentioning that cross-border lending is much higher for non-financial corporations (average of 6.3% between 2003 and 2013), mirroring the ability of large multinationals to contract loans all over the EA-12. The assessment is similar with capital markets, where the share of cross-border activities for corporate and government bonds and equities is on average much greater than 20%.

Two conclusions can be made from the observations of these figures. Firstly, household credit is national at best, even within the euro area (Lannoo, 2008).[40] Secondly, the integration gap between interbank markets and household credits can lead to marked disequilibria, as was the case in the years leading up to the financial crisis when FIs used short-term and debt-based funding to increase lending to favoured domestic sectors such as real estate, especially in Ireland and Spain (Draghi, 2014).

Figure 5.1 Cross-border provisions of financial services in the EA12 (in %)



Notes: NFC stands for non-financial corporations. FIs stands for monetary and financial institutions.

Sources: ECB, ECRI calculations.

As a result, one of the objectives of the ECB and the banking union for the coming years is to enhance the integration of the household credit sectors all over the EU, notably via the Single Supervisory Mechanism (SSM). Further integration admittedly will trigger destabilising effects (contagion and higher risk-taking resulting from asymmetric information problems associated with cross-border lending); however, in a context where both the

[40] Pushing the reasoning even further, household credit is even local rather than national, hereby reflecting the nature of the market for goods funded through consumer credit. Indeed, most households applying for consumer loans intend to acquire a product whose sales point is located in the same region. To a certain extent, the development of the digital economy may open up the market for goods and encourage further European integration of consumer credit markets.

retail and the interbank markets are well integrated, the stabilising effects of a quality integration (increased portfolio diversification, which will allow FIs to reduce their exposure to domestic shocks, and improved allocative efficiency) are expected to overcome the destabilising ones.

In this context, most of the current debate on integration and banking union focuses on the related benefits in terms of stability for the European financial sector and the overall economy and nothing or little is said about the effect of further integration on consumer protection and credit growth in the EU. The positive impact on growth and consumer rights is generally expressed as a simple statement and, to our knowledge, no impact study quantifying or even demonstrating this positive effect has been published. It could be argued that a process of financial integration based on stability could be beneficial for both consumers and FIs, due to the downside risks of financial crisis. However, excessive emphasis on stability in an integrated financial sector could also result in unreasonable rigidities, which might hamper business initiatives. Such a paradigm is likely to impede markedly the pace of financial innovations, thereby limiting the number of choices for households and hindering credit growth opportunities.

Therefore one of the objectives of this chapter is to contribute to move the debate on banking union and integration further towards the question of dynamic credit markets and consumer protection. As such, the chapter will first determine what an integrated retail financial market is, what are the implications for both consumers and lenders and how it can be achieved. The definition of this theoretical integrated retail financial market will then help assess what are the best forms of integration. The chapter will show that the policy objective of significant cross-border lending makes sense in household retail lending only if certain very restrictive preconditions have been fulfilled. Rising integration through the "mergers and acquisitions" channel seems more probable, but can spark different risks such as reorganisation costs, etc. From these analyses, this chapter will be able to draw up some recommendations.

5.1 Law of unique price: Implications for consumer protection and credit growth

Definitions and implication for lenders and borrowers

In its Financial Integration Monitor 2005, the European Commission adopted the following definition for the concept of financial integration:

> Financial integration is a process, driven by market forces, in which separate national financial markets gradually enter into competition with each other and eventually become one financial market, characterised by converging prices, product supply and converging efficiency/profitability among the financial services providers.

When opting for this definition, European regulators drew inspiration from the economic concept commonly known as the "law of one price": this means that when inter-market trading starts, observed differentials in the prices of commodities and services will tend to diminish and eventually disappear given the absence of "any abnormal shocks"[41] to the system and the existence of individuals' capability and willingness to engage in arbitrage[42] (Ayadi, 2011).

This definition of integration needs to be approached in a dynamic context. Recurrent external shocks (caused by new technologies, tax policies, etc.) can affect household domestic retail credit markets in a differentiated manner and spark disequilibria in the short term, notably resulting in rising spreads between similar financial products across domestic markets. Provided that FIs have the will and the ability to engage in arbitrage all over the EU, the markets will naturally move towards a new equilibrium in a medium- or long-term horizon. As such, during this period of transition, opportunities of growth and profits for FIs are recurrent. Of course, the speed of convergence will depend on the willingness and ability of FIs to go into this direction, or in other words, whether such integration processes make business sense.

On the consumer side, the European Commission's definition of financial integration implies that for a given household and financial product, the price would be similar in all the EU-28. *This policy objective, which is already stated for credits to non-financial corporations, especially to SMEs, could be a marked contributor to consumer protection, since it would result in the achievement of fair pricing for all EU households,* or at least would imply downside risks of over-pricing. Against the backdrop of a fully functional

[41] "Abnormal shocks" to the system are typically shocks which trigger a significant systemic risk and, as such, lead to very deep disequilibria, with long-term consequences.

[42] Arbitrage means the simultaneous purchase and sale of an asset in order to profit from a difference in the price. It is a trade that profits by exploiting price differences of identical or similar financial instruments, on different markets or in different forms. Arbitrage exists as a result of market inefficiencies; it provides a mechanism to ensure prices do not deviate substantially from fair value for long periods of time.

single market, a creditworthy household that could not borrow from a domestic bank would borrow directly from a bank in another member states instead (Coeuré, 2014). However, once again, this view should be placed in a dynamic context: external shocks can distort the credit markets, leading to rising spreads and the objective of consistent pricing across households will be gradually achieved before another shock occurs.

Necessary conditions

The conditions necessary to the achievement of equilibria in line with the law of unique price are numerous and the challenges of implementing these conditions seem tremendous. The Commission's definition is based on the postulate of perfect competition on the supply side. This would imply perfect mobility, perfect information, the absence of any situations of price-making (triggered by any form of oligopoly), etc., all over the EU. The implementation of the SSM with consistent cross-country requirements, compliance and rules should help significantly in this respect, notably by reducing hidden barriers to cross-border activity linked to national preferences (Draghi, 2014).[43]

Regarding demand (which is not considered in the definition), this equilibrium also implies perfect information and mobility. By definition, as the demand for household credit is extremely scattered and no form of concentration can be observed, a high quality of the information and a high mobility of household demand are essential to achieve such an equilibrium.

Nevertheless, overall, very strong barriers remain in the EU to achieving the necessary conditions for quality integration, resulting in continuous and significant risks of market distortions. In theory, there are two main types of barriers – *natural* and *structural* – which can affect both demand and supply of household retail loans.

Firstly, *natural barriers* refer to geographic proximity,[44] the differences in languages and cultural differences, etc.[45] Most of these barriers are very

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[43] Issues such as the protection of national champions or supervisory ring-fencing of liquidity will not be relevant anymore.

[44] As such, according to Benoît Coeuré (2014), "in the euro area today, it is the location of borrowers, rather than their creditworthiness per se, that matters most for access to finance, in particular for SMEs".

[45] Among the cultural differences directly affecting consumer credit markets, the heterogeneity in "commitment behaviour" across member states may involve

difficult to overcome unless substantial changes are made in consumer preferences and trends and commercial strategies. Nevertheless, typically, the change in commercial strategies has a very significant fixed cost. These barriers concern both the lender and the borrower: for example, in the case of direct cross-border lending, the former most likely needs skills in foreign languages to satisfy foreign customers, which can be costly, while the latter might be uncomfortable with the practices of the foreign seller or suffer from some sense of insecurity, as he is not totally sure about his rights in this foreign country.

Secondly, *structural barriers* can be overcome either by market players or by regulators. They concern all the fixed costs incurred in cross-border expansion owing to different regulations, reporting, tax systems and any other impediments.[46] For example, differentiated requirements and creditworthiness decision-making systems across countries can intensify complexity and therefore increase costs for both lenders and customers engaged in cross-border lending.

Some of the structural barriers are partly shaped by natural ones. For instance, differentiated cultural preferences could trigger heterogeneous behavioural biases across member states, resulting in differentiated policy responses. Owing to cultural differences, the framing of information can vary markedly across countries and can require different consumer protection policy approaches. The differences in cultural preferences and habits have also led to different legal systems: countries inheriting Latin legal systems rely rather on codes, while the Anglo-Saxon type of legal system is based further on jurisprudence. Therefore, the barriers resulting from the different legal systems can combine both structural and natural elements.

For the case of retail financial services, integration remains elusive because financial products reflect the legal, tax and regulatory systems under which they are executed and these systems differ widely across member states (Ayadi, 2011). The integration process in financial services is typically founded on the interaction between minimum harmonisation, mutual recognition and home country control. Such principles have often produced

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different types of pricing and contracts and may be a barrier very difficult to overcome for a foreign FMI.

[46] For example, regulations regarding usury differ widely across member states and some financial products available in some member states could hardly be developed in some others.

mixed results because of the major obstacles they have encountered.[47] The combination of natural and structural barriers indeed cause the implementation process of EU law to be often overly complex, sometimes resulting in a framework where *regulation differentiation across EU member states is even higher than before the EU decided to legislate in a specific matter.*

As such, some voices question the harmonisation benefits of the Consumer Credit Directive. The report on CCD implementation published by the Commission on 14 May 2014 partly confirms this view, notably by revealing different levels of implementation, numerous exceptions, poor enforcement of mandatory information disclosure, etc. Therefore, the report recommends better enforcement and further exchanges of experiences between member states in order to enhance a better harmonisation. Another possible approach would be to conduct an impact assessment whose main purpose is to compare the level of European harmonisation in consumer credit rules between "before the domestic implementations of the CCD" and "after the domestic implementations of the CCD". Such assessments, which could be conducted for other European regulations, would reveal the real harmonisation impact of the Directive and would therefore help reinforce the overall coherence of the single market strategy for the case of retail financial services.

Finally, in order to contribute to an informed and appropriate debate on the effects of steps aimed at enhancing financial market integration, mono-causal indicators based on prices or quantities alone might not be sufficient. To a certain extent, policies that promote "optimal integration" do not necessarily aim to maximise the amounts of cross-border business or to approach as much as it is possible the law of unique price, but they need to interpret regulatory effects against the background of secondary effects. The process and costs of reaching a new equilibrium must not be left aside.

For example, each new piece of legislation will necessarily have uneven effects on the different banking markets in the EU, depending on the vicinity of the legal situation of the respective banking sector to the new rules. Thus the cost to adapt to the new situation will be divided unequally

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[47] Minimum harmonisation can lead to indefinite negotiation processes, which often result in the watering down of the main provisions and leave room for national discretion. Mutual recognition has its virtues and deficiencies, but in practice it is hard to satisfy home and host country supervisors, particularly when the subsidiarity principle ought to be respected. Home country control can work when institutions enter into a foreign market through a branch but not through a subsidiary (Ayadi, 2011).

across Europe. It remains an open question what the optimum is in this regard – for example, on vitality and productivity of the respective banking sector.

Furthermore, if business models of suppliers need to be adapted due to a changing regulatory landscape, it may be the case that competitive banks cease to be a counterforce on the domestic market. In the long run that may damage the intensity of competition and thus customer choice and the quality of supply.

Indexes to measure financial integration

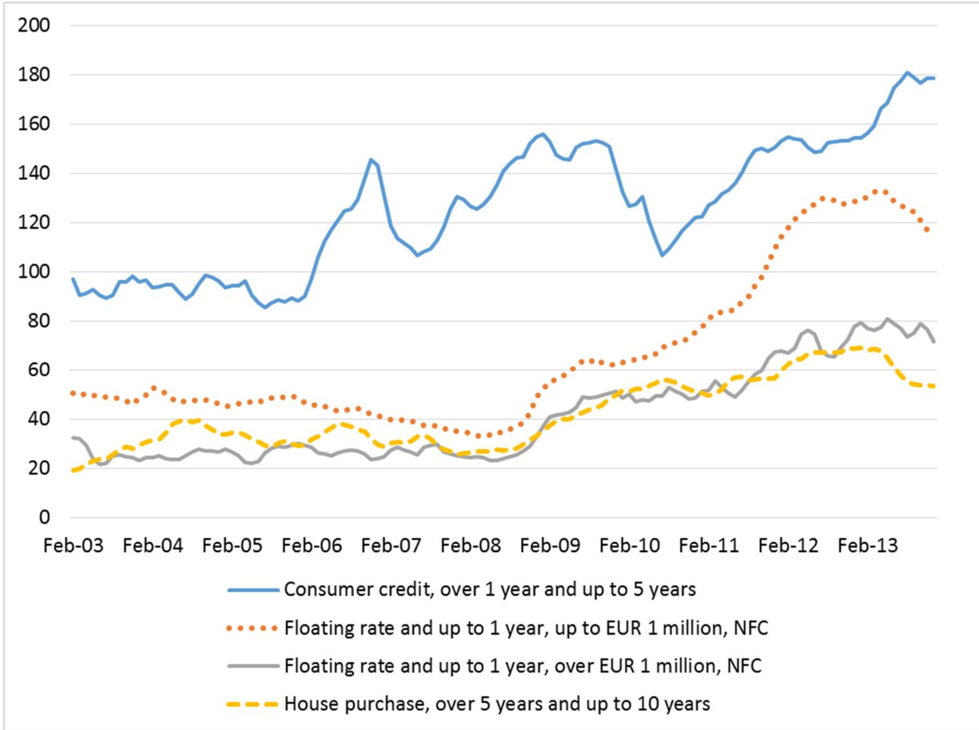
Finally, among the available indexes to measure the level of integration over time, European policy-makers and some studies often refer to the cross-border standard deviation of FIs interest rates on retail loans (CBSD). The data produced by this index (see Figure 5.2) tend to confirm the negative impact of the financial crisis on the intensity of integration of the non-financial corporations' credits, housing loans and consumer loans. At first, the impact seems to be less significant for the latter; nevertheless, the related time series has moved along a noticeable upward trend since mid-2008. In other words, consumer credit markets have gradually drawn away from the assumption of the law of unique price in recent years, while they remained at a stable short distance from this assumption in the years preceding 2006.

The main advantage of CBSD indexes is that they are based on data published with very high periodicity and relatively consistent methodologies. They provide a synthesis of the level of macroeconomic integration of these different retail banking segments. Nevertheless, they also present some significant disadvantages. One of the most important is the inability of these indexes to control for the economic developments in member states. Indeed, the law of unique price implies that for a given household and financial product, the price is similar in all the EU-28. The average quality of the creditworthiness of households in a given country is highly correlated with the economic situation of this country: poor macroeconomic performances with rising unemployment and depreciating collateral values are likely to reduce the average quality of creditworthiness assessments, leading to rising interest rates.

Conversely, better economic prospects are likely to boost the average quality of creditworthiness assessment, resulting in contracting interest rates. *Therefore, a microeconomic approach notably based on surveys with FIs or households could give a better estimate on the evolution of integration across*

domestic credit markets (although such a methodology might be costly and provide results with wider periodicity than with CBSD).[48]

Figure 5.2 Cross-border standard deviation of FIs interest rates on retail loans



Source: ECB.

Recommendations 5.1

- 5.1.1 Promote research on the impact of further financial integration on consumer protection and growth and on the determination of an optimal level of integration, thereby assessing in particular the implied costs of further integration.

[48] Currently, the Bank Lending Survey published by the ECB provides quarterly data on the margin of two groups of consumer loans: average loans and riskier loans. Based on this methodology, perhaps it could be possible to have data on the tightening or easing of lending standards (at best, data on the value of interest rates) of several classes of consumer loans: for example, low risk, medium risk and high risk.

- 5.1.2 Develop different channels to enhance integration of retail financial markets and assess which ones are the most effective.
- 5.1.3 Develop impact assessments whose main purpose is to compare the level of European harmonisation in consumer credit rules between "before the implementation of the CCD" and "after the implementation of the CCD"; such methodologies could be applied to other segments of retail finance and even beyond.
- 5.1.4 Highlight the limits of the indicators of cross-border standard deviation of FIs interest rates on retail loans (CBSD) to measure the intensity of integration in household credits.
- 5.1.5 Promote a microeconomic approach notably based on surveys with FIs or households could give a better estimate on the evolution of integration across domestic consumer credit markets.

5.2 Cross-border lending: Myth or reality?

In the European institutions, cross-border lending has remained one of the key topics of the integration of retail finance**.** For example, the Study on the functioning of the consumer credit market in Europe funded by the European Commission (2013) includes a large survey on cross-border lending. Yet, the achievement of large-scale cross-border lending requires very specific conditions which are far from being fulfilled.

Cross-border lending occurs when a borrower contracts a loan with a lender, whose license is registered in another euro area country. Statistically, the basic principle to be accounted as cross-border lending is that the asset of the bank and the corresponding liability of the household are both registered in different member states.

Typically, there are two main types of cross-border lending regarding retail household credit:

(1) lending through branches in other member states; and
(2) direct cross-border lending (defined as: the consumer credit is booked in an institution's home country and the borrower resides in another member state).

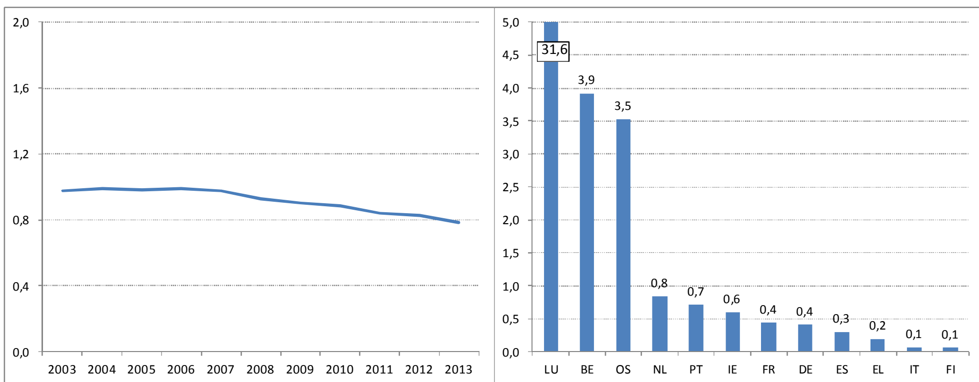
Overall, in the last decade, the market share of cross-border lending in the segment of household retail loans has remained extremely low in the EA-12 and has even moved along a downward path since 2007 (see Figure 5.3). In 2013, the distribution across EA-12 member states shows that only small open economies, such as Austria, Belgium and Luxembourg, registered

noticeable cross-border lending (see Figure 5.4). All the other economies recorded levels well below 1%. *The specific case of Luxembourg, where the market share of cross-border lending reached a stunning 31.6% in 2013, can be explained by a very high international mobility of workers*. Many workers in Luxembourg are indeed residents in a neighbouring country: while their residences are located in Belgium, France or Germany, they work in Luxembourg and are likely to have their financial wealth partly or entirely managed in FIs located in Luxembourg. Against this backdrop, contracting a loan abroad is common practice. Luxembourg is a perfect case study to analyse the necessary framework for large-scale cross-border lending. However, its structure can hardly be applied to the whole EU-28.

No consistent data are available across countries on cross-border lending exclusively for consumer credit. Nevertheless, some EA-12 countries such as Luxembourg and the Netherlands published data with robust methodologies on these issues and confirm the low share of this type of integration: in 2013, cross-border lending in consumer credit reached 12.8% in the former (vs. 31.6% for the whole household credit activities) and 1.6% in the Netherlands. According to "the study on the functioning of the consumer credit market in Europe" funded by the European Commission (2013), survey-based data show a figure of 1.4% in the whole EU-27 for the year 2011.

Figure 5.3 Cross-border lending in retail household credit (in % of total outstanding household credit, EA-12)

Figure 5.4 Cross-border lending in retail household credit (in % of total outstanding household credit, in 2013)



Source: ECRI calculations based on ECB data.

The impact of both natural and structural barriers seems exacerbated by cross-border lending. Some policy-makers expected that the introduction of a common currency would limit the negative impact of both natural and structural barriers and give a boost to this type of financial practice, but it has never really happened, despite the efforts of the ECB. The main reason behind this failure is the inability to harmonise markedly tax and regulatory systems across the EU. Therefore, the development of cross-border lending would make sense as a policy objective only if a certain degree of regulatory and tax harmonisation is achieved.

Regarding regulatory harmonisation, some policies may have a significant impact on the integration of consumer credit through the channel of cross-border lending, although they are not specifically designed for retail financial services. For example, the increasing opportunities offered by digital technologies and the commitment of the new Commission to set a European digital market in the coming years may have significant integrating effects on consumer credit markets. Indeed, the expanding digital economy may gradually alleviate the negative impact of geographic barriers on cross-border lending, through the development of distribution channels covering the whole European territory for both goods and loans. As such, both digital banking and digital shopping of goods should help integrate further the retail banking segments, including household ones.

Recommendation 5.2

- 5.2.1 Promote the idea that the development of cross-border lending would make sense as a policy objective only if a certain degree of regulatory and tax harmonisation is achieved.

5.3 Cross-border mergers and acquisitions (M&As)

Definition and state of play

Foreign FIs can consolidate through two processes: on one hand, two foreign FIs can combine to form a new bank (merger); on the other hand, one bank can purchase a foreign bank and no new bank is formed (acquisition). In the current context, integration in retail banking via cross-border M&A is promoted by European regulators, notably because there is intrinsic value for retail FIs in being physically present in local markets as it lowers the costs of monitoring (Coeuré, 2013). Retail banking integration in the form of cross-border M&A can improve allocative efficiency by increasing the distance

between the main shareholders of a bank and the vested interests in the country where the bank operates.

Regarding cross-border M&As in the consumer credit market, the European market has observed a certain form of disintegration since the financial crisis of 2008-09, in line with the developments observed in many other banking segments. Several FIs have adopted refocusing or retreating strategies in the aftermath of the financial crisis: Capital One, the Royal Bank of Scotland Consumer Finance, Fortis Consumer Finance, KBC Consumer Finance, General Electric Consumer Finance, Citibank, LaSer, MBNA, etc., and only a few have entered the European market since then (Crédit Mutuel, Tesco Personal Finance). As a consequence, while the European consumer finance competitive mapping in 2005-06 typically showed five pan-European leaders and numerous European challengers, the disintegration process occurring in recent years led to a dramatic evolution in the European competitive environment, with only two pan-European leaders and several former European challengers following refocusing or retreating strategies.

Impact of regulatory systems on the intensity of cross-border M&As

The objective of the European regulators to reverse this process of disintegration through cross-border M&As requires an analysis of the main drivers behind cross-border M&As. Among the different factors driving the propensity of FIs to engage in cross-border M&As, quality and regulatory systems play a key role. Two theories compete in the literature about the impact of the quality and regulatory systems on cross-border M&As: the "outcome hypothesis" and the "governance hypothesis" (Manchin, 2004).

The "outcome hypothesis" predicts more intense cross-border M&A activities in countries where the investor protection is better (Rossi & Volpin, 2002). There are two main reasons behind this positive relationship. Firstly, strong institutions entail better funds availability. Secondly, efficient, better functioning firms might be more attractive for acquirers than firms with lower levels of investor protection and efficiency.

The "governance hypothesis" suggests more cross-border M&As between FIs with different levels of investor protection. In this context, contrary to the "outcome hypothesis", FIs active in corporate controls targets FIs with rather poor investor protection and poor governance. The main intuition behind this approach is that an inefficiently managed firm becomes a target due to the expected increase in its value after restructuring. In addition, the improved governance of the merged foreign bank might encourage policy-makers of the country to reinforce investor protection

rules. The "governance hypothesis" approach can apply to the numerous cross-border M&As that occurred in the Central European and Eastern countries at the end of 1990s and in the first half of the 2000s, before the political integration of these economies into the European Union. In mid-2000s, for example, retail FIs were mostly owned by EU-15 or US FIs in Poland. Such a process occurred because EU-15 and US FIs could easily increase the value of these financial organisations after restructuring and a positive change in governance. As a result, more harmonised regulatory systems do not consistently lead to further cross-border M&As.

Impact of economic developments on the intensity of cross-border M&As

The research suggests, however, that the economic environment positively influences the pace of cross-border M&As in a consistent manner. Periods of economic growth trigger more business opportunities for FIs, resulting in further incentives for cross-border M&As. Conversely, economic recession or weakening generally spark disintegration processes, mirroring the wish of FIs to reposition themselves in their core domestic market. According to Daluiso (2013), in the sub-period 2009-13, the share of deals involving only FIs within the euro area increased from 50% of the total to 56%; however, the jump was mostly driven by a marked increase in the share of deals involving only FIs within the same euro area country, which went from 33% to 45%. On the other hand, the geographical distribution of deals in the US has not changed. In other words, with the financial crisis and the ensuing very poor economic performance of the euro area economy since then (in 2010-13, the cumulative growth in real GDP reached +2.4% in the euro area (vs. +9.4% in 2004-07) and +9.0% in the US (vs. +12.1% in 2004-07)), the borders of the bank M&As in Europe have shrunk behind the national frontiers, while the same did not occur in the US.

As such, promoting cross-border M&As in a context of economic stagnation seems hypothetical. *The return of economic growth, rather than further harmonised rules in the euro area, seems to be the prerequisite for further integration through cross-border M&As.* In a context of a virtuous economic circle, economic growth and increasing business opportunities favour consolidation processes across the euro area and a better allocation of resources, which, in turn, contribute positively to economic growth (see Figure 5.1).

Recommendations 5.3

- 5.3.1 Promote the idea that the prerequisite for further integration through cross-border M&A is economic growth.
- 5.3.2 Promote research on the main regulatory drivers behind cross-border M&As.

CHAPTER 6. DIGITAL BANKING AND NEW/RELATED BUSINESS MODELS

In the past decade, the European economy has become increasingly digital, as organisations and individuals have relied more and more on digital technologies such as the internet or smartphones. Given that banking revenue is generated by an older and wealthier population, it took more time than in some other sectors to reach critical mass, but in the end, the banking sector is no exception. According to McKinsey (2015), the share of digital disruption in banking revenues stood at 1% before 2010, reached 11% in 2014 and is expected to achieve broadly 60-65% by 2020.[49] In 2018, in Europe, around half of new banking revenues will be captured by sales via online/mobile channels.

This rapid evolution triggers numerous regulatory questions on the technologies used in the process and on the new entrants using business models primarily based on digital elements. First of all, the regulatory framework of these technologies has been progressively adapted in order to facilitate business opportunities and competition among suppliers, as well as to reinforce consumer protection and to accelerate the set-up of a single digital market. Indeed, these new technologies spark not only new opportunities for growth in the banking sector, but also new risks (in terms of security, privacy, etc.).

As regards new opportunities, the digital technologies should, on one hand, bring a considerable amount of workable data to FIs and, on the other hand, ease markedly credit processes by accelerating decision-making and credit approval/management. The former opportunity raises questions about the use of the collected data and is related to privacy concerns. Such concerns were notably addressed in a previous ECRI Task Force on "Towards Better Use of Credit Reporting in Europe" (Pyykkö & Steinbauer, 2013). In the present Task Force, discussions were rather on the latter opportunity and some debates have been developed on the regulatory question of electronic identification, especially through the design and implementation of the eIDAS in the EU-28 and its implications for the banking sector.

[49] According to McKinsey, digital disruption in banking revenues reflects the share of new revenue captured via the online/mobile channels.

The business opportunities created by the digital technologies, combined with the persistent mistrust of the public towards the traditional FIs, have favoured the emergence of new entrants with new business models and new channels to fund consumer loans. The appearance of these new entrants, based notably on the business models of peer-to-peer lending and crowdfunding, have also benefited from lower regulatory requirements than traditional FIs, both for their structure and the services they provide. This state of play raises two main types of issues. On the one hand, lower regulatory constraints for new entrants should trigger lower costs for these organisations: this may lead to competition issues. Constraining regulations are indeed not equally applied across the whole spectrum of household retail finance and, to a certain extent, this could harm the position of traditional FIs with respect to their ability to compete on equal and fair terms.

On the other hand, the completely new nature of the new entrants could spark new risks, both in financial terms and in consumer protection terms. The very original structure of these new entrants, the poor aggregate data on these businesses (market shares, financial risks, etc.) and the new nature of the services provided are a challenge to the regulator and questions remain on the best regulatory approach at European level.

Therefore, the first section of this chapter will place the focus on the new digital technologies, with an emphasis on electronic identification, while the possible regulatory options for two of the main new business models in the banking sector, crowdfunding and peer-to-peer lending, will be analysed in the second section.

6.1 New technologies: Questioning electronic identification

In a speech addressed to the European Parliament on 15 July 2014, Jean-Claude Juncker, President of the European Commission, emphasised that the creation of a connected digital single market can generate up to €250 billion of additional growth in Europe during the next Commission's mandate. At the core of this digital agenda is the implementation of the Electronic identification and trust services (eIDAS). This regulation, which entered into force on 17 September 2014 and will be gradually implemented in the coming years, aims at strengthening the EU Single Market by boosting trust and convenience in secure and seamless cross-border electronic transactions.

There are three implied objectives behind this regulation:

- ensuring mutual recognition of e-identification means,[50]
- enhancing electronic trust services (e-signatures, e-seals, e-registered delivery services, time stamping and website authentication) [51] and
- promoting electronic documents.

For the case of the consumer loan market and other types of household credit markets, this new regulation should address some market dysfunctions resulting from very complex procedures of identification, as well as from security and reliability issues. Fast and reliable electronic identification should be in the interest of both lenders and borrowers. Firstly, it should positively contribute to the proper functioning of the distance credit market, as the eIDAS should facilitate online seamless consumer experiences without face-to-face verification.

As regards the question of cross-border lending discussed in chapter 4, a similar process of electronic identification accepted all over the EU should help limit the negative effects of some natural and structural barriers. With consistent electronic identification in the whole EU, the problem of geographic distance could be partially resolved, while some of the costs involved in cross-border expansion for FIs could be reduced. Nevertheless, such positive effects on the development of cross-border lending will remain marginal should some other barriers not be progressively removed, such as differentiated requirements and creditworthiness decision-making systems across countries and very diverse domestic tax systems. The eIDAS could also contribute to slightly limit the negative effect of these other barriers by facilitating the access of FIs to local credit-rating of customers and contact with public administrations (tax agencies). Therefore, these different positive effects of the eIDAS on cross-border lending make sense only if the EU-28 can implement their interoperability across the different organisations, FIs, public authorities, etc., and enhance cooperation between member states.

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[50] The "eID" is based on four key principles: mandatory cross-border recognition only to access public services; full autonomy for private sector; principle of reciprocity relying on defined levels of assurance and interoperability; and cooperation between member states.

[51] The "trust services" relies on three principles: non-discrimination in courts of electronic trust services *vis-à-vis* their paper equivalent; specific legal effects associated with qualified trust services and non-mandatory technical standards ensuring presumption of compliance, implying technological neutrality.

Finally, reliable e-ID, e-sign, e-seal, e-registration, etc., should lead to lower risks for FIs. First of all, as shown by different surveys across the EU-27, a significant share of electronic demand for credit is based on fraudulent motives to get cash and, as such, using fake identification. The implementation of the eIDAS with the mandatory use of electronic identity cards should contribute significantly to resolve this problem. Relying on trusted credentials, the electronic identification promoted by the eIDAS should also make it easier to meet some specific regulatory requirements such as those related to anti-money laundering.

Recommendations 6.1

- 6.1.1 Promote digital processing as a channel to reinforce European integration of retail banking services.
- 6.1.2: Enhance the enforcement of the eIDAS at member state level.
- 6.1.3: Enhance the interoperability of the eIDAS across the different organisations, FIs, public authorities, etc., and cooperation between member states.
- 6.1.4: Avoid overly prescriptive new legislation, particularly in the field of electronic banking, in order to not stifle the development of innovative new products. Promote research on how regulation can achieve the optimal balance between trust and innovation.

6.2 New business models: Crowdfunding and peer-to-peer lending

Definition

The line between peer-to-peer lending and crowdfunding is sometimes ambiguous. The distinction between both approaches can be made on the risk-sharing dimension. For the case of peer-to-peer lending, one agent decides to lend to another agent, without the use of an official financial institution as an intermediary and implies the absence of risk-sharing (all the risk is born by the borrower). On the other hand, the crowdfunding approach also implies the absence of a financial intermediary such as a bank in the loan to individuals; nevertheless, contrary to peer-to-peer lending, crowdfunding involves a certain level of risk-sharing since a pool of individuals will lend money to the counterparty and all borrowers bear part of the whole financial risk.

Overall, there are four main types of business models relying on crowdfunding schemes:

1) Donation crowdfunding
2) Reward crowdfunding
3) Equity crowdfunding
4) Debt crowdfunding

- *Donation crowdfunding*: Under donation crowdfunding, contributors fund projects, companies or causes, without receiving money or any other rewards in return. This business model is notably used for charity purposes and, due to the absence of yields or rewards, is often considered as the simplest form of crowdfunding.
- *Reward crowdfunding*: Reward crowdfunding follows the same model as donation crowdfunding, yet people receive a reward in return for their contribution. Rewards are non-monetary. For example, people may receive a CD, a discount, or an opportunity to pre-order the product that's being funded (sometimes called 'solution crowdfunding').
- *Debt crowdfunding* (or loan crowdfunding): Debt crowdfunding is the first kind of investment crowdfunding, which allows individuals or businesses to borrow money from a group of people rather than from a bank. With debt crowdfunding, investors lend money to a company or an individual and receive interest on their investment. Ideally, businesses are able to get funded at a lower interest rate. Quite simply, debt crowdfunding functions as a quick and easy business loan, yet companies pay interest directly to their investors rather than to a bank. New entrants based on such business models are likely to be in direct competition with traditional providers of consumer loans.
- *Equity crowdfunding* (or equity-based crowdfunding): Equity crowdfunding is a second type of investment crowdfunding, where investors receive equity or company ownership in return for their contribution. With equity crowdfunding, the expectation is that investors will receive a dividend or appreciation on their investment. Equity crowdfunding platforms allow businesses to raise capital without undergoing the costly process of an IPO (initial public offering).

Box 4. Trends in the UK and in the US

Overall, financial organisations based on peer-to-peer lending (P2P) and crowdfunding business models still hold a marginal market share of total retail lending. Nevertheless, they have registered rapid growth in recent years and should gradually acquire noticeable market shares. According to KPMG, the volume of loans provided by P2P FIs in the UK increased by +74.3% between 2010 and 2013, while the amount remained stable for the five largest FIs and grew by 17.3% for challenger FIs. All in all, P2P FIs should supply broadly 1% of total loans by 2020 and, given the type of loans offered by P2P FIs, the corresponding market share of total consumer loans should be much above 1%. Nevertheless, no data is published yet at a European level on the contribution of new business models such as P2P and crowdfunding to credit markets. As the UK is one of the most advanced markets on these issues, reliable data has been regularly published on P2P and crowdfunding activities and can help better understand the dynamics at stake.

First of all, regarding the type of customers using P2P platforms in the UK, the average age is 42 years old and 80% of borrowers are male. The distribution in terms of salary range is as follows: 25% earn less than €32,750, 57% have an income between €32,750 and €65,500 and 18% earn more than €65,500. Secondly, for 42% of the loans, the purpose is vehicle purchase, for 26% it concerns home improvement and for 25% the purpose is debt consolidation. Thirdly, in 2014, more than €700 million were lent via peer-to-peer lending, for an average amount borrowed of €7,167 and for an average number of crowd lenders per loan of 201.

Interestingly, 54% of borrowers had received an offer of a loan from a bank, but still chose P2P lending. Overall, the top five reasons borrowers chose P2P over traditional consumer credit in the UK are:

1) Better interest rates
2) More flexible terms, e.g. early repayment
3) Ease of use
4) Transparency
5) Speed

In the US, still according to KPMG, the average age and salary of P2P borrower on the Prosper platform are 46 years old and €69,241, respectively. The main purpose of these loans is debt consolidation and the average amount borrowed and interest rate payable are respectively €11,159 and 14.19%. Overall, the US online marketplace lending industry grew to over €5 billion in 2014, while total lending through Lending Club in Q3 2014 reached €1 billion.

Current and forthcoming regulations

The development of crowdfunding business models can favour financial innovations and, by increasing the number of choices for consumers, can contribute to further economic welfare. Nevertheless, in the current state of play, the emergence of crowdfunding activities for the purpose of funding projects, causes or small businesses is likely to spark three types of market dysfunctions. Firstly, the low regulatory pressure on these new entrants compared with traditional banking business models could lead to competition issues. Secondly, scant regulation can trigger new risks in terms of consumer and investor protection. Finally, one can question the impact of these lightly regulated activities on financial stability. Therefore, it makes sense to question the importance of these dysfunctions and to assess if further European rules might be necessary.

Admittedly, several existing European legislative frameworks are likely to address some of the risks triggered by these new entrants (see Boxes 6.1 and 6.2). Depending on the business model of the platform, different European regulations can indeed already apply to crowdfunding platforms and help alleviate some specific risks. Nevertheless, there are currently no European rules designed for the sole purpose of regulating crowdfunding platforms.

Should the European regulator decide to legislate on that matter, (s)he will face significant challenges. First of all, the dynamics and the importance of these new entrants differ markedly across European countries. Secondly, to our knowledge, there are no consistent statistics collected at European level to reflect the developments of these new providers in the different member states and in Europe in general. As such, the extensive study on the functioning of the consumer credit market in Europe funded by the European Commission in 2013 stated: "While formal peer-to-peer consumer lending organised through intermediaries such as Ratesetter, Zopa and Funding Circle is subject to the CCD, such lending is not covered by the study due to a lack of data".

Thirdly, as analysed above, crowdfunding involves a different kind of business, implying different types of risk. Fourthly, it is currently difficult to assess the macroeconomic financial risks triggered by crowdfunding platforms. For example, crowdfunding is admittedly growing at a sustained pace in different European economies; however, its overall market share of total credit remains very low and, as such, it seems to be appropriate to conclude the existence of low systemic risk for the moment. Nevertheless, these implications on financial stability could change in the future, should

these innovative business models continue to grow at a steady pace. Fifthly, some countries, such as France and the UK, have already set a certain amount of rules to regulate crowdfunding platforms. The enactment of European legislation could then lead to potential overlaps.

Therefore, against such a backdrop, it seems legitimate to question the added value of rules enacted at European level. Placing the focus on financial stability issues, specific European legislation might be necessary once banking activities based on crowdfunding business models reach a critical mass, resulting in possible systemic risks should these activities collapse. Regarding competition issues, the key goal is to assess the extent to which the regulatory gap is a driver of unfair competition and if this differentiation in regulation leads to market failure. Finally, in terms of consumer/investor protection, one can wonder if these new entrants can spark new types of risks and if these risks are sufficiently addressed by the existing European regulation. In other words, what types of information asymmetries are at stake and are there significant risks of marked moral hazard?

Among the possible options, European or national regulators could either extend the scope of the current Consumer Credit Directive in order to include crowdfunding platforms for a certain number of provisions or set a completely new regulation. Should regulators opt for the second approach, a strong cost-benefits assessment would be necessary.

Box 6.1 Regulatory framework likely to be applicable to crowd lending/peer-to-peer lending

Likely to be applicable to the platform	**Likely not applicable to platforms**
PSD (Payment Services Directive) E-money Anti-money laundering	CRD4/CRR CCD (if lenders do not act in professional capacity) Mortgage Credit Directive Deposit Guarantee Schemes

Box 6.2 Regulatory framework likely to be applicable to debt-based crowdfunding (depending on business model)

MiFiD
ICS
Prospectus Directive
Possibly AIFMD, EuVECA
Possible PSD

Recommendations 6.2

- 6.2.1 Enhance the production of consistent data across the EU-28 on the aggregate activities of new banking business models.
- 6.2.2 Promote the enactment of a European regulation tailored to crowdfunding and peer-to-peer lending business models once the market using these new business models has reached a critical mass, likely to spark noticeable systemic risks.

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Appendix 1. Glossary of Abbreviations

APR	Annual percentage rate
CCD	Consumer Credit Directive 2008/48/EC
CBSD	Cross-border standard deviation of FI interest rates on retail loans
EC	European Commission
ECB	European Central Bank
EU	European Union
eIDAS	Electronic Identification and Trust Services
FCA	Financial Conduct Authority
FIs	Financial Institutions (includes Monetary and Financial Institutions and Other Financial Institutions)[52]
MCD	Mortgage Credit Directive 2014/17/EU
pp	Percentage points
PCDI	Private consumption to household disposable income ratio
SSM	Single Supervisory Mechanism

[52] According to the ECB, monetary and financial institutions are financial institutions which together form the money-issuing sector of the euro area. These include the Eurosystem, resident credit institutions (as defined in EU law) and all other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than FIs and, for their own account (at least in economic terms), to grant credit and/or invest in securities. The latter group consists predominantly of money market funds.

Still according to the ECB, other financial Institutions are corporations or quasi-corporations other than insurance corporations and pension funds that are engaged mainly in financial intermediation by incurring liabilities in forms other than currency, deposits and/or close substitutes for deposits from institutional entities other than FIs, in particular those engaged primarily in long-term financing, such as corporations engaged in financial leasing, financial vehicle corporations created to be holders of securitised assets, financial holding corporations, dealers in securities and derivatives (when dealing for their own account), venture capital corporations and development capital companies.

APPENDIX 2. TASK FORCE MEMBERS, INVITED SPEAKERS AND OBSERVERS

Chair:	**Eric Delannoy** Former Vice President, Weave
Rapporteur:	**Sylvain Bouyon** Research Fellow, CEPS and ECRI

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Invited Speakers

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Ann Börestam, Principal Market Infrastructure Expert, Payment Systems & Market Infrastructure, European Central Bank

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