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Much Ado about Little? Agreement on the Consumer Credit Directive Reached

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After more than four years of discussions, European policy-makers have finally broken the stalemate over the draft of a new Consumer Credit Directive and agreed on harmonised rules. With the political agreement in the EU Competitiveness Council in Brussels (21.-22. May 2007), policy-makers have finally put to rest the most contentious issues that have hampered political agreement in the past. But whether the Consumer Credit Directive will create a more integrated and competitive consumer credit market in Europe is still an open question. The reasons why a cross-border credit market is virtually not existent are not only related to whether or not conditions for credit have been harmonised, but rather to a broader set of issues involving natural market barriers, limited consumer attention and probably market access problems in retail finance.

It is argued that the new rules will help to open the €800 billion-a-year consumer loan market which is fragmented along national borders and thus denies consumers greater choice at competitive prices. The Council will soon formally adopt its common position and will forward the text to the European Parliament for a second reading. The most contentious issues on the political level were: pre-contractual and contractual information, right of withdrawal and early repayment, creditor compensation and the calculation of the Annual Percentage Rate of Charge (APR).

For pre-contractual and contractual information, the Council decided to introduce a standardised format to enable comparisons of credit products for consumers ('Standard European Consumer Credit Information'). This measure is intended to increase market transparency. The right of withdrawal holds now for 14 days. For early repayment, it has been decided to include a right of compensation to the creditor in some circumstances. This right applies if the early repayment falls within a period for which the borrowing rate is fixed. In addition, creditors may indicate the interest rate and the charges and/or to display the APR according to national law. To enhance national transparency, member states must inform the Commission about national measures if they make use of the regulatory choices provided for in the draft Directive.

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Although these rules might bring down the cost for lenders that are active in several markets, it is questionable whether this proposal will have a major impact on cross-border lending. As with the first Directive of 1986, the Commission seems to overestimate the role of consumer protection for market integration. Europe's integration of consumer credit markets has so far fallen short of expectations. Most retail banking – savings, borrowing and current account services – is still national. This picture has not changed much over the past decades. For instance, in the Cecchini Report (1988), price differences of more than 200% were identified for different financial products. Ten years later, this price differential analysis was replicated and the European Commission found that significant price differences remained across countries, although the price ranges narrowed by 30% in some instances.

While standardisation of information and consumer protection rules is essentially not a bad idea – theoretically it reduces costs and enables consumers to compare offers more easily – the effect on market integration might be limited. The Commission rarely takes demand-side characteristics into account for the simple reason that it can not tackle those in many instances. For example, it is an open question whether consumers are truly interested in comparing offers on a European-wide basis or if language, distance or information costs pose significant obstacles to integration. These uncertainties together with market access problems due to information asymmetries or strong incumbents might diffuse the effects of stronger consumer protection.

In addition, consumers in Europe display different preferences and attitudes towards credit use. Outstanding loans as a share of annual consumption expenditure of households are especially high in the UK (18.2%), Austria (19.3%), or Ireland (23.2%) compared to new markets such as Estonia (4.9%) and Latvia (3.3%) according to statistics compiled by ECRI. While some markets are fast growing, especially in the new member states, growth of consumer credit levelled out in other markets such as Denmark, Portugal or France. The Commission has published a number of papers for building a common market, such as the *White Paper on Financial Services 2005–2010*, the results of the sector inquiry into retail banking or the *Green Paper on Retail Financial Services in the Single Market*. In the latter, the Commission states that it will tackle barriers in retail banking: besides payment cards it aims at ensuring access to credit registers and payment and settlement systems. Again, these measures are primarily aimed at the supply side.

A LOOK BACK: THE CURRENT RULES ARE FROM THE 1980S

The current rules for consumer credit primarily stem from the Directive on Consumer Credit of 1986, whose main purpose was to create an environment in which consumers are protected, equally throughout the EU. This Directive set out common definitions of legal terms such as 'consumer,' 'creditor' and 'credit agreement'. It stated what contracts should contain and introduced the concept of the APR. The main principle applied was that of *minimum harmonisation* – member states must take over the rules at least as stated in the Directive, but they may apply stricter rules for consumer protection at the national level. This Directive, however, barely changed the picture of consumer credit markets which remained fragmented along national borders. It was amended twice, in 1990 and 1998. In 1990, policy-makers introduced a harmonized concept for the calculation of the APR with further technical details introduced in 1998. Although these measures did not change the picture of (non-) integration much, they had as effect that a more or less harmonised definition of APR was implemented across the EU.

In 2000, the Commission started consultations to revise the Directive in the belief that it was out of date as it was based on the 'cash society' of the 1970s. In addition, it argued that the Directive was not optimal from the point of view of the Single Market as it set out basic rules, but Member States could go beyond them. And this was exactly what has happened: the member states adopted different definitions and measures, without providing for mutual recognition, with the consequence that consumer protection regimes remained non-harmonised. In September 2002, the Commission published an ambitious draft

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version of a new Consumer Credit Directive with which it intended to achieve two purposes: a high degree of consumer protection as well as *maximum harmonisation* of consumer credit laws in Europe. It redefined the scope of the Directive, included credit intermediaries, set up an information framework and demanded a more equal distribution of rights as well as obligations for creditors and borrowers.

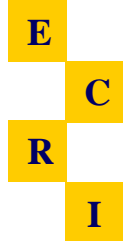
This proposal met fierce criticism from all sides: banking associations criticised it as too comprehensive and strict, consumer associations found it too lax and economists wondered whether it would have any discernible impact on market integration. There was an extensive debate culminating in hearings in the European Parliament in March of 2004, after which the Commission issued a first amended proposal in November 2004 and a second amended one in October 2005. Although it concerns a fairly limited area of economic activity, it is rather rare in the European Commission's history that a proposal is modified twice. Some credit providers have argued that there was no need for a Directive, as it is not worth the effort. Policy-makers, on the other hand, would say that this is a chicken-egg problem: as long as a limited form of harmonisation is not undertaken, cross-border credit will not develop. The Commission argues that it is necessary for firms to realise scale and scope economies, and for markets to become more competitive.

In October 2005, the European Commission published a considerably slimmed down version as compared to the previous proposal. Some elements of the previous version, such as unfair credit terms and performance of credit agreements were dropped, while others were narrowed down, such as the controversial concept of responsible lending. The Directive did also no longer cover mortgage credits (based upon equity releases), nor was there a requirement for member states to ensure the operation of central databases in their territory. But the Directive maintains the full harmonisation approach for consumer credit as defined by the directive, meaning that for some areas (such as definitions) member states are not allowed to impose additional rules or diverge otherwise. It is remarkable that the Commission chose to stick to the maximum harmonisation approach for that proposal, notwithstanding the preference of the European Parliament and the member states for minimal harmonisation and mutual recognition.

NEW PROPOSED RULES: SLIMMED DOWN AND TARGETED HARMONISATION

The Council has now adopted the targeted harmonisation approach, meaning full harmonisation though some options and national leeway in others. For instance, member states can diverge in the display of standard information for advertising. The new proposal kept some of the controversial elements of previous drafts, such as the right of withdrawal, early repayment and linked agreements. The regulations apply only to loans of between €200 and €100.000. Mortgage credits are exempted from the Directive as well as hiring and leasing agreements where an obligation to purchase the object is not foreseen. It also does not apply to credit agreements which are granted in the form of an overdraft facility and which have to be repaid within one month. Another important aspect is that the new proposal retains the rules for database access. For instance, it mandates that member states must ensure access to such databases on non-discriminatory terms. In addition, in case where a credit applicant is rejected based upon consultation of such a database, the applicant must be informed without charge of the result of the consultation and the particulars of the database, which is either a credit bureau or public credit register.

Considering the vast efforts already invested in this Directive, any agreement must be welcomed. However, it is questionable if this directive will really have a major impact on further integration of consumer credit markets in Europe. Whereas it might decrease the costs of business for the banking industry common standards for consumer protection might not immediately lure consumers into accepting non-national banking services. However, considered the increased efforts to strengthen competition (through competition inquiries) and initiatives concerning payment services, it may change more than the 1987 directive did at the time.



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