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Wim Kösters, Stephan Paul and Stefan Stein

An economic analysis of the EU Commission's proposal for a new Consumer Credit Directive

Offering consumers more protection or restricting their options?

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An economic analysis of the EU Commission's proposal for a new Consumer Credit Directive – Offering consumers more protection or restricting their options?

1. Origins and objectives of the proposed new Consumer Credit Directive

The existing Consumer Credit Directive (87/102/EEC), which was amended in 1990 and 1998, sets out a legal framework for consumer credit throughout the EU. It aims to further the creation of a common market for credit, and to create an environment where consumers are sufficiently protected. In 1995, the European Commission presented a report on the practical application of the directive, and consulted those affected by it. In 1996, it published a report on the impact of the 1990 amendment (90/88/EEC), which looked at annual percentage rates. Then in 1997, the Commission issued a summary of responses to the 1995 report. All of this highlighted that the laws and regulations affecting consumer credit vary greatly between member states.

The Commission felt that it needed to revise the existing directive to reflect the significant changes to the consumer credit market that have occurred since it was passed in 1987. It initiated a series of studies into the regulatory situation within individual member states and produced a comprehensive comparative analysis. The Commission believes that while credit promotes economic growth and consumer prosperity, it also presents a risk to lenders and the threat of deception or insolvency to a growing number of consumers. For these reasons, individual member states had seen that the level of protection provided by the existing EU regulations was no longer sufficient, and had produced their own for new types of credit that are outside the scope of the original directive. However, the Commission believes this development has caused a competitive imbalance throughout the EU, which restricts the provision of consumer credit across national borders. This situation has affected the volume and structure of the demand for credit, and in turn the demand for goods and services.

The Commission concluded that owing to the differing legal provisions and procedures in banking and financing, consumers do not enjoy the same protection throughout the EU. It saw that the existing legal framework had to be revised in order to offer consumers and companies the opportunity to benefit from a common market.

On 11 September 2002, the Commission adopted a proposal for a new Consumer Credit Directive (CCD), which aims to create the prerequisites for establishing a more transparent and effective market. It intends to create a level of consumer protection that encourages the provision of consumer credit across national borders, offered at the best possible terms for lenders and borrowers.

2. Consumer protection and financial market integration – some fundamental principles

We can assume that consumers are protected most effectively when the credit market is functioning competitively within member states and throughout the EU as a whole (single market for financial services). This would allow them to choose freely between different suppliers. Consequently, this would limit the market powers of suppliers and force them to offer products according to consumer preferences at competitive prices, and have convenient services, product and process innovation and so on. Therefore, the regulations should include rules that prevent excessive competition (which might encourage unfair trading, harmful rivalry and so on) and too little competition (which might encourage monopolies or cartels and so on). At the same time, they should preserve an open market allowing new suppliers to enter freely and existing ones to leave. A crucial condition for an efficient and effective market is a "spirit of competition" between vendors – they should embrace competition and be willing to achieve corporate success through good performance and not by protecting against competition (through subsidies, sealing off markets, customs and so on) or committing fraud. It is also important that vendors i.e. banks observe the regulations for the provision of credit that affect them.

Efficient market competition also requires responsible and souvereign consumers, who reward "good" products with additional demand and ignore the "bad" ones. So it is also important that buyers do embrace a "spirit of competition". Consumers have to take responsibility for choosing the products that best meet their needs. This can only be achieved if the markets are transparent. Such transparency usually requires government regulations over the supply and quality information, consulting and so on. In addition to general regulations for protecting consumers against companies that dominate the market, these transparency rules are essential for a working competition.

From an economic point of view, this kind of consumer protection is necessary, but regulation that exceeds this level can be counterproductive. Excessive regulation can weaken the "spirit of competition" and could promote irresponsible action, the consequences of which will be attributed to others (for example, the companies and the general public). Over-regulated markets can also increase administration costs for the companies involved, negatively affecting consumers through higher prices, and reducing demand.

It is surprising that the political discussion about protecting credit consumers almost entirely neglects the economic costs involved, and often assumes that it can be achieved free of charge. However, it is shown that the costs in the form of unwanted effects on prices, employment and growth can be considerable, so it is necessary to conduct a careful economic analysis before introducing any measures.

It is a standard practice in economic policy analysis to carry out two examinations before intervening in the market or introducing government regulations. The first looks for any market failures, which can occur in the case of public goods, external effects or asymmetric distribution of information and so on. In the event of a market failure, the second examination has to determine whether political intervention or regulation could improve the situation. Badly conceived policies could make a poorly functioning market even worse, for a number of reasons. Politicians may not always act in the interests of the majority. For example, they might give in to the demands of certain electoral groups to gain votes, and disadvantage other market participants, at the expense of the overall welfare of the country. Or their policies might take only a short-term view neglecting long run effects resulting from the incentives set by the policy measures. This could increase unemployment, restrict growth and make the situation even worse for consumers, who really should have benefited.

We can see that the costs and benefits of the measures and regulations proposed by the new CCD should have been carefully weighed against one another before being implemented. This is the more important because the short- and long-term consequences will only become apparent gradually, and will be distributed among many people concerned. And new problems will compound the old ones, putting further strains on the EU's economy.

In section 3, we study the economic importance of consumer credit markets in the EU, before looking at the regulations of the draft directive and their implications in section 4 from an economic point of view (we have largely omitted a legal assessment). We set out our conclusion in section 5.

3. The economic importance of consumer credit in the EU

The central issue of this section is the economic importance of lending to private households in the single European market. We have carried out a comprehensive statistical analysis of the development and structure of the consumer credit markets in the EU, and likewise look at consumer indebtedness and debt overload (in which consumer credit represents only one component)[1].

3.1 Development and structure of the consumer credit market

Lending to the private non-banking sector tends to be divided into loans to private companies and loans to private households. Lending to private households comprises consumer debt and mortgage loans. We can define consumer credit as any loan taken out by a private household to finance consumer goods, such as a car or home furnishings, travel and so on.

There are substantial structural differences between the credit markets of the various member states in the EU. Each state has developed its own legislation, regulation, practices and credit culture, which have by now prevented the emergence of a single working European market of consumer credit. For example, some regulations impose restrictions on the flow of capital across borders, the size of loans and the interest rates that companies can charge. An intensive process of de-regulation started around 1980, in order to give a common framework to the credit markets across the EU. The aim is to create a common consumer credit market and to facilitate integration of the financial services markets through the regulatory principles of "mutual recognition", "principle of country of origin" and "minimum harmonisation". As a result of reforms that have already been implemented, competition within the financial services sector is rising and the supply of products has been improving.

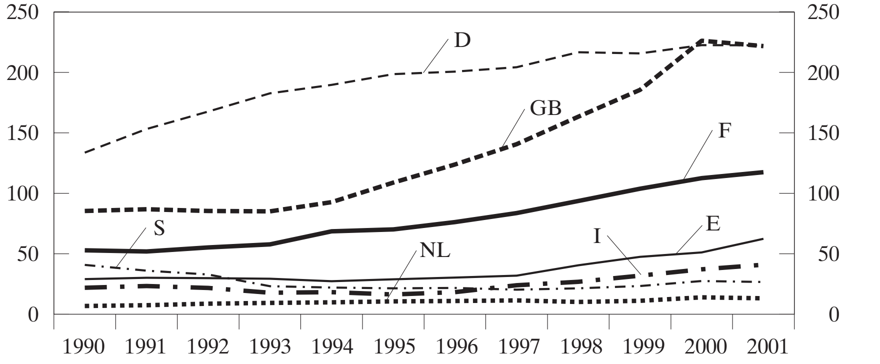
The level of borrowing by private households grew rapidly between 1970 and 1990 throughout the EU, which coincided with a fall in savings. In Germany, the increase in loans was particularly strong, reaching average growth rates of 16.4% (1970–1979) and 6.9% (1980–1989) (Diez Guardia 2000; Sieweck 2002). This led to Germany becoming the largest market for consumer credit in the EU, which by 1990 had grown to € 133.7bn.

Figure 1 shows the level of consumer debt from 1990–2001 for Germany, France, Italy, Great Britain, the Netherlands, Sweden and Spain. Great Britain, after initially slow growth, shows the strongest rise in the level of credit from the mid-1990s of all the countries we observed, and by 2000 reaches the same

---

1 The European Credit Research Institute (ECRI, Brussels) kindly provided the data for the analysis. The selection is based on the criteria of data availability, size of country and specific national structural differences.

Figure 1
Size of Europe's consumer credit markets
1990 bis 2001; € billion



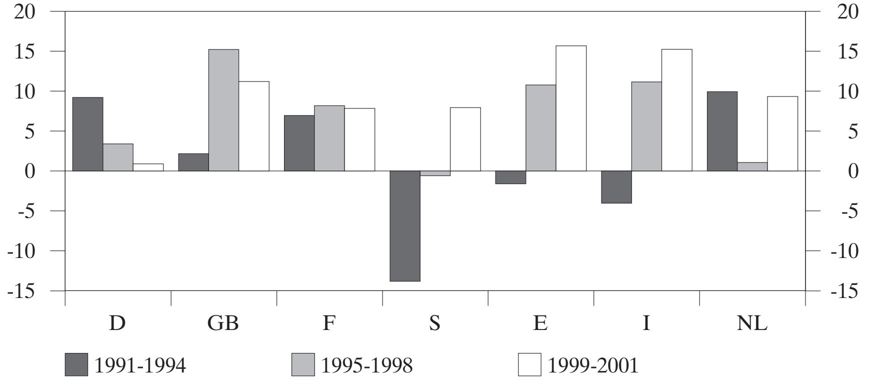
Source: ECRI.

level as Germany. However, Germany's initially high growth rates for consumer debt following the boom of the post-reunification period clearly fall, until reaching a standstill in 2001. With a volume of € 222bn each, these two markets are the largest in the EU – consumer borrowing in the remaining 13 EU countries together is only € 300bn. Taken together, Germany and Great Britain make up 37.7% of the EU's population (OECD 2000) but 60% of its total consumer debt.

Figure 2 shows average four-year growth rates for consumer debt. Despite the smoothing, we can see strong mean fluctuations at a national level. Notably, there is no dominating standard pattern of fluctuation between the countries. In France, the average growth rates lie evenly above 7%. In Sweden and Italy, there is a considerable fall in the level of debt at the beginning of the 1990s (–13.8% and –4.0%). In the following years, Italy and Spain show high and increasing growth rates of between 10% and 15%. The Netherlands shows a different pattern – at the beginning and end of the period under review, the level of consumer debt rises by an average of 10%, whereas growth rates between 1995 and 1998 reach a mean of just 1.1%.

A precise analysis of the reasons for the varied development of the credit markets within the EU does not fit within the remit of this report. Empirical studies highlight economic growth, trends in earnings, lending rates and other economic variables to explain the consumer credit products on offer and the demand for loans. In addition, they show that progress in deregulation and fiscal incentives contribute to explaining the growth in the credit markets and the specific national differences (Diez Guardia 2000; Bundesbank 2002). However, when comparing EU countries, some statistical idiosyncrasies emerge

Figure 2
Growth rates (nominal) of consumer credits
in %



Source: ECRI; own calculations.

(Diez Guardia 2000: 9ff.). For example, there are many differences between the definitions of lenders, borrowing households and underlying interest rates. In addition, consumers are increasingly using mortgage loans in place of traditional forms of credit to pay for goods, and it is difficult to separate them for analysis.

There are significant differences between the relative importance of consumer debt within national economies, just as we have shown that absolute variables have developed in a different way. We can measure how consumer debt fits into the economy by relating it to private consumption (Figure 3). This shows that consumer credit is significant for consumer spending. In the countries depicted it makes up more than 50% of the overall demand for goods and services. Therefore, ceteris paribus, consumer borrowing supports growth and employment in the economy.

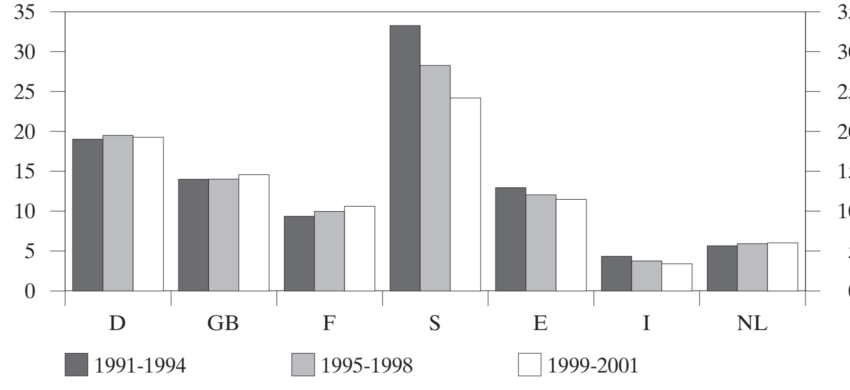
As Figure 3 shows, consumer debt as a percentage of private consumption between 1991 and 2001 remains relatively stable in Germany, at 19%. It has one of the highest figures, along with those for Sweden and Great Britain. Starting from an extremely high level of more than 33%, Sweden experienced a clear decline to below 25% between 1991 and 2001. At 4% and falling, Italy has by far the lowest value of the countries in Figure 3, while consumer credit also plays a comparatively minor role in consumption in the Netherlands, at around 6%. France (around 10%) and Spain (around 12%) come somewhere in the middle.

In order to evaluate the significance of the consumer credit market, it is important to assess the composition of debt at a national level, that is, to compare the

Figure 3

Consumer credit as a proportion of private consumption

in %



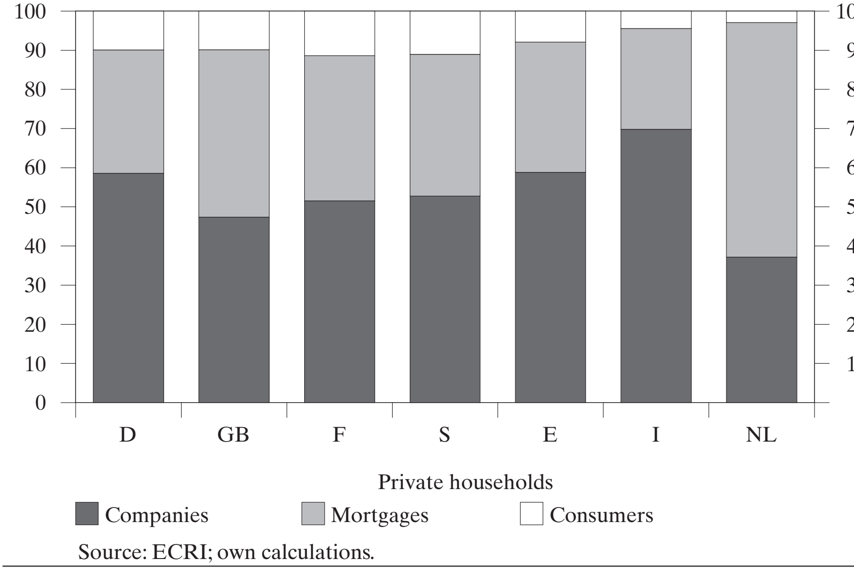
Source: ECRI; own calculations.

volume of consumer debt with other forms of credit in the private sector. Figure 4 breaks down debt in the private sector into consumer loans, (consumer) mortgages and loans to companies. A common feature is that mortgage loans take a greater share than consumer credit. In Germany, mortgage loans make

Figure 4

Composition of credit in the private sector

2001; in %



Source: ECRI; own calculations.

up around 30%, consumer credit 10% and the remaining 60% comprise company loans. The credit markets in France, Sweden and Spain are similar, and in Great Britain mortgages make up 43% of the total. Only in the Netherlands do mortgages (about 60%) have a greater share of the overall credit market than company loans (37%) and consumer credit (3%) combined. In Italy, consumer credit and mortages make up a much smaller part of the market than company loans. At only 30%, Italian private households have the lowest level of consumer borrowing of all countries examined.

So the credit markets in the EU show substantial structural differences – the amounts as well as the types of consumer debt vary. The relative significance of consumer credit within national economies – and so its relevance to growth – varies widely throughout the EU.

The main causes of the segmented consumer credit markets in the EU are natural market barriers such as differences in culture and language, geographical distance (mobility of demand) and personal preferences about the products of national lenders (trust, reputation, convenience and so on). Therefore, it is not surprising that consumer lending across national borders in the EU takes place on only a minor scale.

Although the available data on cross-border consumer credit lending in the EU is limited (OCR Macro 2001: 106f.), our analysis of the available material (cross-border lending for all credit to non-banks in the euro area) provides some revealing findings (Table 1). We can see that cross-border lending within the Euro area has been increasing – although at a low level – from 2.2% in 1997 to 3.4% in 2001 of which credit to the corporate sector presumably represents a larger share than to consumers[2].

Table 1

Domestic and cross-border lending within the financial sector in the Euro area
1997 – 2001

	1997	1998	1999	2000	2001
Total credits to non-banks (in € billion)[1]	5,905	6,349	6,867	7,491	7,952
Domestic transactions (in %)	91.6	91.6	90.4	89.9	88.9
Transactions with countries in the Euro area (in %)	2.2	2.6	3.0	3.2	3.4
Transactions with ROW (in %)	6.2	5.8	6.6	6.9	7.7

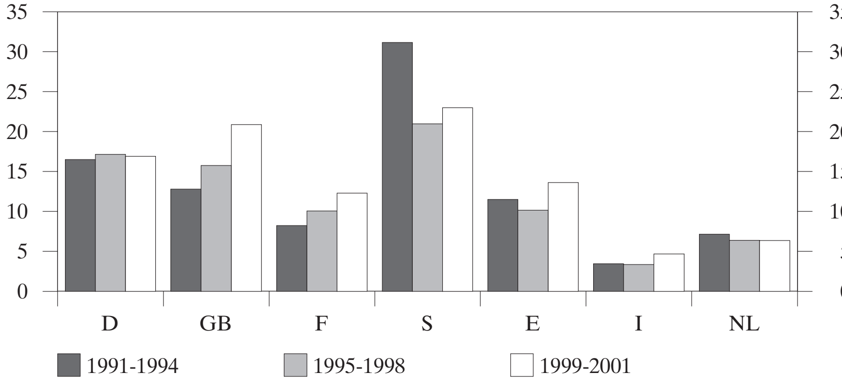
Source: Cabral, Dierick and Vesala 2002. Including credit to public authorities.

2 This is confirmed by the higher degree of integration in the EU market for company credit than consumer credit, which Kleimeier/Sander (2000) derive on the basis of price indicators.

Figure 5

Consumer credit as a percentage of available income

in %



Source: ECRI; own calculations.

When reconsidering the main causes of a fragmented market, we can see that the process of cross-border integration can only make slow progress, especially in markets for products for which the confidence and habits of consumers are essential. Consumer borrowing across national borders may increase in the long term as barriers within the EU weaken. However, government intervention can only ever be partially successful in removing the natural obstacles to a common market.

3.2 Private household debt

Consumers' level of debt varies throughout the EU (of which consumer loans are only one component). In our assessment of the situation, first we examine consumer credit products (on which borrowers make regular amortisation and interest payments) as a percentage of consumers' available income (Figure 5).

The results are as varied as they were when we looked at consumer credit as a percentage of private consumption. At the beginning of the period under review, Sweden has by far the highest level of private household debt, at 30%. The absolute decline in loan commitments (Figure 1) causes this figure to fall between 1995 and 2001. Nonetheless, private household debt in Sweden, at 23%, remains the highest of all the countries we examined. Only Great Britain, after a continuous rise until 2001 and with a share of roughly 21%, comes close. France shows an equally strong increase, although at a lower level, and the situation is more moderate in Spain. In comparison, private households in Italy and the Netherlands have low levels of debt, at 5% and 6%, respectively,

Table 2

Debt overload in Europe

	Source A	% of total population	Source B	% of total population
France	500,000 households	2.0		
Belgium	113,000 households	2.5	30,000–40,000 households	0.8
Great Britain	1 million people	1.6	200,000 people	
Germany	2.5–2.7 million households	7.0		
Netherlands	200,000 households	2.9		
Sweden			430,000 people	4.5

Source: San José Riestra 2002. – For the individual data sources and the required caution in interpreting the data material, see San José Riestra 2002: 20f.

in 1999-2001. The debt situation in Germany has been stable over the past 10 years – consumer debt as a proportion of available income is around 17%.

3.3 Private household debt overload

Private household debt overload has become a significant problem – the number of overindebted households in Germany alone is around 2.7 million.[3] European – at times even national – comparisons are difficult because the definition of debt differs widely and the methods of investigation and data sources vary. Table 2 makes a "preliminary approach" (San José Riestra 2002: 21) and shows some comparative European values from different studies.

However, there is no generally accepted definition of the limit of debt with which consumers can cope. Different empirical studies show that an increase in private household debt in the US will lead to a fall in consumption.[4] This is relevant for the EU because the development of private household debt in the US usually precedes that of EU countries. Consumer debt as a proportion of available income in the US recently reached 23% (2001). Similarly high values exist (for 2001) in the EU only for Great Britain (20.6%) and Sweden (22.6%). Germany (16.4%), Spain (15.1%), Ireland (14.9%) and France (12.4%) cover the middle ground. Lower rates are evident for Finland (4.7%) and Italy (4.8%).

When discussing the possible negative consequences of debt, we should also observe the level at which private households are building their financial as-

3 See Korczak (2001). A private household is generally deemed overindebted if after deducting all necessary cost of living expenses, the income of the household is insufficient to serve payments of interest and amortisation on the loan. See also Sieweck (2001).

4 The level of debt is likely to magnify economic recession: if consumers are less capable of servicing their debt, lenders will be more reluctant to extend credit to them. Demand then falls more than it actually would with a lower level of indebtedness." Jentzsch (2003: 12). See also McCarthy (1997) and Maki (2000).

sets. A study by Sieweck (2001, vol. 1, chapter 9) concludes that at the current 16 to 1 ratio of private financial assets to private debt, for consumption purposes one certainly cannot speak of a general situation of private household debt overload. The study goes on to state that despite a growing number of – at times severe – cases of debt overload, this situation does not apply to the majority of German households.

The difficulty for lenders comes in the ability to evaluate potential customers and assign a credit rating, which can anticipate insolvency or overindebtedness (see section 4). Unemployment, illness, marital breakdown or death of a partner, pregnancy or birth, and establishing a home are among the most usual causes of private household debt overload (Figure 6). Reifner (2002) estimates that unemployment, working fewer hours, loss of income when changing jobs, divorce and accidents cause debt overload in more than 80 % of cases.

In his report on overindebtedness in Germany, Korczak concludes that debt overload is related to social issues – he shows that it correlates strongly to lower education and professional qualifications, and comes from everyday problems that most of us experience (Korczak 2001: XXIV). Studies in France, Belgium and Austria (and the US) confirm these findings (Figure 6). Unemployment was singled out as a significant cause of overindebtedness.

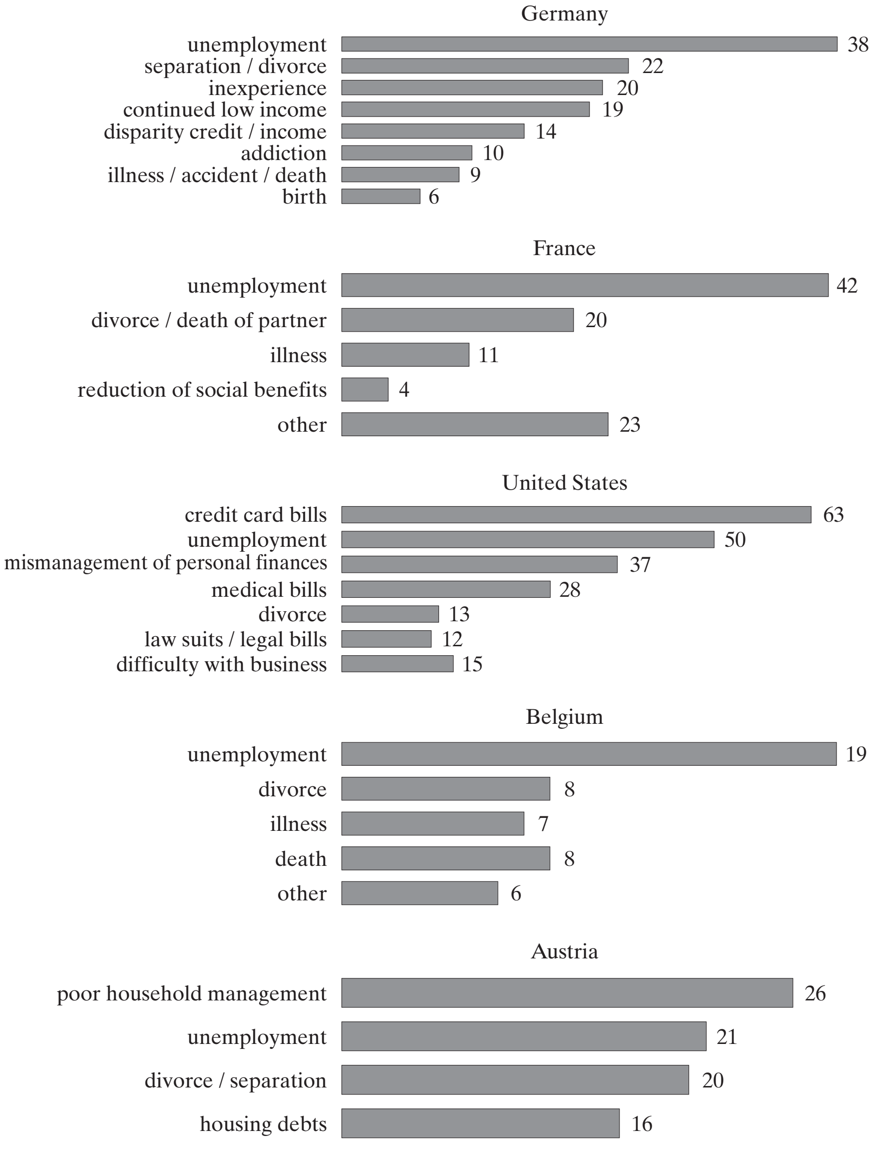
The economic evaluation of the EU's proposal for a new CCD rests on this empirical foundation. To the extent that the regulatory proposals will set wrong economic incentives and in turn will lower the volume of supply of consumer credits – results that still have to be established in section 4 – they will affect the economies of the individual member states in different ways.[5] The relatively high significance of consumer debt in Germany (as already mentioned its consumer credit market is the largest in the EU, and is one of the highest as a proportion of consumer spending) means that the proposals are relevant for economic growth and employment there in particular.

4. Regulations at the centre of the proposed new CCD and missed opportunities

As we have already said, competition offers consumers the best protection, from an economic viewpoint. In our view, a "spirit of competition" from both companies and consumers is the main prerequisite for fostering competition. Therefore, we have examined the regulations at the centre of the proposed directive to determine the extent to which they would promote a spirit of competition, or if they would restrict it. Our evaluation questions the directive's three goals, starting with its aim to make the market more transparent.

[5] For a general theoretical analysis of the correlation between lending, growth and employment, see Hung/Cothren (2002).

Figure 6
Overindebtedness trigger – international comparison
in %



Source: Korczak 2001: 136, for Germany (slightly shortened). International details by San José Riestra (2002) and Jentzsch (2003) with further references. For Belgium, only the measured values for critical life events are reproduced (further data at San José Riestra 2002).

4.1 Creating more transparency?

4.1.1 Transparency of price: annual percentage rates, lending rates and borrowing rates

The authors of the draft directive assume there is a lack of transparency in the market, which has come about from the development of new consumer credit products throughout the EU. Companies use various methods to calculate ("end") prices on different products, which they express as an interest rate and other components (commission and fees).

The Commission has adopted a generally accepted idea among economists that lenders throughout the EU should provide reliable pricing information, calculated according to standard methods. It believes that this will make the market more transparent, which will encourage competition and then consumers will be better protected – well-informed consumers have a better chance of choosing an appropriate credit product when they can base their decisions on reliable pricing information[6].

The proposed directive aims to increase transparency by obliging companies to issue three prices, which they must state in all advertising media on loan agreements and in credit agreements: annual percentage rates (APR), lending rates and borrowing rates. The APR should be calculated according to the overall costs of a loan – in addition to the interest and other charges, commissions and bank fees, it should include any other costs, even if they are being paid a lender, an intermediary or a third party. This would include any insurance premiums on the credit agreement (for example, credit default insurance on personal loans, or small or personal drawing credits). The exclusion of price components is limited to a minimum, in the drive for a "maximum of clarity". Separate from this, the total lending rate is the price the lender demands for giving a loan; it is calculated just like the APR but excludes the cost of third parties. The borrowing rate is the interest rate on the loan and does not include any further price components.

There are a number of problems with the proposals, first with the requirement that banks should take account of all the cost components of a loan in advance:

– Generally, it is not possible to quote reliable costs for all components of a loan when a customer signs a credit agreement (for example, notarisation, tax consultant fees and intermediary costs).

---

[6] However, market forces can also create transparency. There is no compelling need for state intervention: incomplete and unevenly distributed information from companies in an evolving economy must not be seen as an obstacle to competition, but rather as its constitutional prerequisite, its „motor". See Hayek (1945) and, for a modern overview, Erlei/Lehmann-Waffenschmidt (2002).

- Costs for appointed collateral vary greatly according to the type of loan and type of collateral.
- It is not possible to provide a reliable quote for charges in the event of non-fulfilment of a credit agreement on signing of the credit agreement.
- Insurance premiums, such as the remaining debt for term insurance, depend on the precise life and contractual circumstances (such as age, gender of borrower, and residual term of credit).

Second, the proposals interfere with the banks' price autonomy. The state distorts price signals by stipulating certain costing schemes, and so prevents the optimal allocation of resources in the national economy. Article 14 (3) determines that a "variable borrowing rate may not vary until the end of agreed periods provided for in the credit agreement and may do so only in line with the agreed index or reference rate". This would deprive banks of the option (which is currently an often used common agreement between the contracting parties[7]) to adjust borrowing rates in line with changes to refinancing conditions and in the capital markets. So the banks would be denied the opportunity to respond appropriately to qualitative changes in their risk position.

The draft directive also contradicts the central regulations of the New Basel Capital Accord (Paul, Stein 2003), to which all banks in the EU must adhere. In addition to the regulation already in place, the New Basel Accord aims at a more risk-oriented formulation of capital requirements for credit transactions, which should be reflected in the price of credit. The objective is to do away with a situation in which customers with strong credit rating subsidise those with poorer ones. To achieve this, banks will have to use complex risk assessment procedures, which will assess individual credit ratings as accurately as possible. Therefore, financial institutions will have to carefully consider the value of collateral and the risk of loss, and how these factors change throughout the lifetime of a loan.

Within the framework of the qualitative examination of risk management, financial institutions will have to submit proof to supervisory banking authorities that there is a link between their risk rating and pricing policy – they must orient their credit system's pricing policy towards the individual credit rating risk of borrowers. If there were changes to the risk parameters during the term of a loan or to the collateral, then, if the credit rating deteriorated, the creditor, according to the New Basel Accord regulations would have to adjust a fixed or variable rate of interest. However, the proposed new CCD prevents banks from doing this. So the proposals are inconsistent with other EU legislation,

[7] There are further varieties of interest adjustments that apply as a rule: (1) a *fixed interest* is agreed between creditor and borrower; (2) a *key rate agreement* is concluded; the interest rate agreed with the borrower is linked to the changes of a reference parameter (reference interest rate, index or similarly). See also Bundesverband Deutscher Banken (2002).

and if implemented would have a negative impact on banks' lending behaviour.

Third, a government "pricing authority" would be required to monitor the planned regulations. It would have to take its place next to an "authorising agency", which would likewise have to be created for creditors and their intermediaries. The bureaucratic expense of this is demonstrated by the excessive (above all in terms of personnel) costs of the supervisory review process of the banks in Pillar Two of the New Basel Capital Accord.

Fourth, we doubt that publishing three rates of charge would make it easier for consumers to take out loans – it is more likely to simply increase confusion at a higher level. Supplying consumers with ever more detailed information is too demanding, for time and resources are necessary to process such information, and important data cannot always be quickly separated from insignificant data. *Crow*, *Howells* and *Moroney* (1993; cited according to Cartwright 2001) report that although ¾ of the borrowers they interviewed had heard of the term annual percentage rate, only one in seven had a genuine understanding of what it means. Other studies have found that regulations to encourage transparency are useful only for better-educated consumers; so they can only be beneficial "if the consumer is intellectually and psychologically equipped to apply the information which disclosure regulation entitles him to have" (Cartwright 2001).

4.1.2 Best advice obligation

Within the scope of a "best advice obligation", the draft directive imposes extensive information and consulting responsibilities on banks, so that they must sell the most "suitable" loans to consumers. Consumers have to be informed "sufficiently" about the terms and costs of a loan, as well as the conditions of a credit agreement before signing it. The obligation to provide information applies to all features of a credit agreement, and some of these details must be stipulated within it.

The authors of the proposed new directive consider it necessary to set a general advice obligation for lenders and also "where appropriate" for credit intermediaries. Any consultation should be conducted in a manner that allows a consumer to choose the best type of loan from the range usually offered by the lender or intermediary. In particular, intermediaries must explain to the consumer the repayment options, the associated risks, the existence of any fixed repayment schedule, the scope for drawing down the credit and find out the purpose for which the loan is to be used.

In this respect a number of questions arise about how the regulations for providing advice will be implemented. For example, what if a lender offers a borrower what it thinks is the most suitable type of loan, but the borrower chooses a different product. The proposed new CCD – even if not clearly and distinctly – only deals with a lender's obligation to provide information and advice, and does not address borrowers' responsibilities. This creates additional risk for the credit markets, which rather than encouraging the protection of consumers, makes the situation worse for them. We can assume that if a borrower becomes insolvent, the case will go to court – and the outcome is unpredictable. The risks and costs associated with this will lead creditors to increase the prices of their products, and they will be significantly more prudent when offering loans, and yet refuse some requests. This is most likely to affect those in weak social positions, so that they will have to bear the costs of "improved" consumer protection. If, as a result, consumer borrowing falls, overall economic growth and employment in the EU will be affected.

In addition, the proposals limit consumer independence. Informed borrowers will no longer be in charge of their own decisions, but in the hands of "considerate" lenders, which must guide them. The proposals are based on the assumption that the responsibility for providing consumers with relevant information lies solely with the companies offering the products. They do not consider the responsibilities of borrowers to provide accurate information to a lender so that a situation of asymmetric information arises. For example, borrowers could withhold information about any health risks that might affect their loan repayments. The proposals of the new directive oblige lenders to obtain a high level of information about potential customers which even comprises everyday life risks and the "true" preferences of borrowers, who in turn could exploit this to their advantage if any problems with repaying a loan occurred.

The Commission's underlying assumption is that presently the quality of advice offered by banks and credit intermediaries acting in their interest is insufficient. Those offering loans "frequently do not have the basic knowledge that is required to sell the financial products that they distribute". Additionally, it believes that the quality of the checks in this respect is insufficient in the individual EU member states which is why banks and credit intermediaries are to be put under the supervision of a (new?) control and supervisory agency (Article 28).

The proposals leave open the criteria by which the supervisory agencies should assess the lenders. They deal only vaguely with the amount, structure and quality of necessary information. This means that lenders and their intermediaries will be able to hide some actions, even though under supervision. The authorities will have to rely on the prudence and honesty of the companies they are regulating. On the other hand, they themselves will also have the flexibility to interpret the regulations to meet. Therefore, there is a risk that cases dealing with similar issues will be treated differently by the same regulations, and lenders and their intermediaries will not be considered on equal terms.

In view of these fundamental reservations, we are concerned that the regulations deeply intervene with lenders' operations. A number of variables (such as the quality of employees in the market segments as well as in risk management and EDP systems) and processes (such as flows in credit consultancy) are set to be standardised; the standardisation even extends to the variables and processes associated with credit intermediaries (even if they are only subordinates), which would become the responsibility of the banks co-operating with them.

The process of verification would be extensive. Based on the experiences gained from other areas of regulation, in particular time consuming talks to employees within different levels of seniority and fields of work would be necessary in order to check the qualitative requirements of the directive. As a result, the proposals for registration and supervision by the authorities would lead to excessive bureaucracy (there are 2,400 existing banks in Germany alone, and an even greater number of credit intermediaries) without creating any benefits for consumers. Moreover, from an "ordnungspolitical" viewpoint such inspections of individual credit agreements to assess the "good" quality of advice from a lender or his intermediary are not consistent with the principles of a free market system.

4.2 Making the market more effective?

The proposed new CCD's second objective is to make the market more effective, so that it develops according to the preferences of those on both the supply and demand sides. It aims to accomplish this by introducing regulations that affect the way in which companies can market their products, and restrict the level of risk that they can take when offering loans.

4.2.1 Limiting marketing parameters

Financial service providers compete with one another through strategic positioning in the market. This could lead to them elaborating cost benefits, which would give them price superiority over competitors, or highlighting special benefits for consumers. The constant pursuit of strategic alternatives will be reflected in a company's marketing, its processes and products, and its ability to innovate. The more freedom companies have in this respect, the more intensive the spirit of competition. However, if regulations restrict a company's ability to create a unique selling proposition and to implement them in the market, the more the pressure to compete will subside (Kirzner 1988; Mises 1940).

In this regard, the proposals of the new directive aim to restrict a number of marketing tools:

- Article 5 of the directive targets doorstep selling and prohibits companies from negotiating credit and surety agreements outside of their business premises (permissible only at the request of a consumer).
- Article 7 prohibits any type of marketing, distribution or sale of personal data collected within the protected scope of the CCD, including modern database marketing for the benefit of actual customers.
- Article 15 contains a “black list” of certain clauses that must be excluded from credit and surety agreements. For example, part e) prohibits the practice of applying an initial call-in rate or discounted rate, which is later replaced by a rate that is higher and subject to the rules on variability. Part f) deals with balloon agreements, which oblige consumers to use the same lender to refinance the residual value or the final payment on a credit agreement for financing the purchase of a movable property or service.
- Article 16 subsection 2 prohibits banks from demanding indemnity for early repayment of credit agreements where the period used to fix the borrowing rate is less than one year; thus barring them from pricing their risk of interest rate volatility.

The compelling nature of these regulations prevents companies from using the above mentioned marketing tools to compete in terms of quality. The measures are designed to regulate areas where competition already exists and has created an effective market. However, the directive would penalise suppliers that highlight their competitive advantages, and design the type and content of their marketing accordingly. Such restrictive rules would result in marketing that was not geared toward consumers’ needs, leading to less competition. Competitive restrictions promote structural problems, help certain suppliers to survive (distorted competition) and increase barriers to potential new entrants.

Those regulations which limit the price autonomy of the contracting parties moreover distort the co-ordination of the individual plans by means of the pricing system.

4.2.2 Joint and several liability

A further important innovation of the draft directive is the extension of joint and several liability. This covers the liability of several persons who legally form a union, where each is individually obligated to the terms of an agreement. The amendment states that a consumer – “if the creditor and supplier of goods or services operate jointly in the market” – may claim payment from the creditor if a complaint against the vendor is justified but the vendor refuses to pay. This refers to a case when a supplier – even if only in a subordinate function – acts as a credit intermediary. So the draft directive takes an encompassing view of joint and several liability (Article 19, subsection 2): "If the supplier of goods or services has acted as credit intermediary, the creditor and the supplier shall be jointly and severally liable for indemnifying the consumer where the goods or services the purchase of which has been financed by the credit agreement are not supplied, or are supplied only in part, or are not in conformity with the contract for their supply".

We have a number of objections to this part of the proposals. First, there is no reason why such a borrower should enjoy a more privileged position (recourse against two debtors) than a consumer who acquires goods for cash or with the aid of a current account loan that is not tied to a specific purpose. A government reallocation of the risk positions freely contracted by the market participants neglects on the one hand the declared intention of the contracting parties for a specific agreement (in this instance, the division of purchase and financing), while on the other the buyer is not obliged to obtain accurate information about the reliability of the seller and the quality of the offer. This creates an incentive for improper behaviour that breaches contract[8].

Second, the circle of parties covered by the liability regulation (credit intermediaries and so on) is chosen in a diffuse way, which would lead to innumerable legal disputes within the EU. The Commission's explanations state: "The definition proposed covers any person who assists in the conclusion of a credit agreement, in other words not only the credit broker but also the delegated agents or bank agents as well as the suppliers of goods and the providers of services, main or subsidiary business undertakings, including marketing assistants." It continues: "The directive thus covers any person who provides a creditor with information to identify a consumer and directs the latter, for a fee, to a creditor for the conclusion of a credit agreement. This fee may take the form of cash or some other agreed form of consideration, such as computer support, access to the creditor's business network or overdraft facilities, for example." Even lawyers and notaries fall under the scope of the proposals if they refer clients to creditors.

Third, due to the higher liability risks for banks, the number of credit offers is likely to fall (and prices increase) particularly for consumers who find it difficult to raise finance through alternative routes. Under these proposals for joint and several liability and in the event of customer claims, the banks would have to enter into the responsibilities of those selling their financed goods and services. In the worst case they would even bear the risk of sellers' insolvency. Therefore, the banks not only would have to evaluate the acceptability of their

[8] See the analysis by Kanzler (1996: 143–164) on the problem of associated transactions under German law.

customers' credit risk rating, but also examine all the other parties involved in the circle of liability (the credit intermediaries in a broader sense), as well as assess the quality of the goods and services on offer. However, it would then become difficult to accurately assess risk. As in the case of responsible lending (which we discuss below), the banks would respond by rationing their offers and increasing their prices for certain (groups of) borrowers.

For example, it is likely that today's common practice of manufacturer-bound automotive banks financing used vehicles from other manufacturers will be suspended. According to Article 19, subsection 2 of the proposed regulation, the manufacturer-bound automotive bank would be responsible for customer claims against the automotive dealer. If a vehicle was defective, the borrower could direct his compliant towards the automotive bank, and leave it to handle the situation. The bank, on the other hand, would then have to work with the dealer to remedy the defects. So manufacturer-bound automotive banks could look at whether they should continue to finance used cars of any brand and age. They might decide, for example, only to finance used vehicles of their own brand (because it would be easier to anticipate any problems than with another manufacturer's car) and ones that are not more than a few years old (which would be less prone to problems) but in turn also more costly (so making them unaffordable for certain groups).

Our example shows how government interference into the freely contracted risk positions of market participants can distort competition: lending for a specific purpose is treated less favourably than lending for no specific purpose. This would affect banks that offer loans mainly for customers to purchase vehicles or mail order goods and draw a major share of their business from affiliated traders. Hereby, in many cases there are not only functional, but also often capital-related involvements with (car) manufacturers or dealers, so that switching to non purpose-related credits usually cannot be seen as a genuine alternative for those banks.

4.2.3 Right to withdrawal

Article 11 (1) of the directive's amendment regulates consumers' rights to reconsider an agreement: "The consumer shall have a period of fourteen calendar days to withdraw his acceptance of the credit agreement without giving any reason."

This is a classic tool (there are similar regulations in most EU countries), which enables the consumer to withdraw from a hasty commitment. Consumer protection groups believe this reinforces the consumers' position: it gives consumers the right to withdraw from an agreement without being exposed to the personal influence of the creditor. It seems the Commission does not trust its own idea that well-informed consumers can best protect themselves; and because of the "economic scope" and the "difficulty of the contractual matter" believes the right to withdrawal is a necessary protection against being tricked. The consumer is to be protected from entering into a hasty (and from the viewpoint of the regulating body false) contractual commitment.

This implies that it is the government's responsibility to protect consumers from their own decisions, which is in stark contrast to the principle of self-responsible action. Moreover, the risk of a consumer being tricked into signing a credit agreement is low. In most cases, the consumer takes the first step towards signing any agreement. So the proposals are extending a measure of protection to consumers who make hasty and careless decisions.

The proposal would further affect the banks' marketing strategy (see section 4.2.1). It seeks to regulate an area where the market has found its own solutions: under the pressure of competition, some banks already offer their customers the right to withdraw from an agreement. However, the new proposal would even out the playing field: every market participant would have to offer the same terms, so taking away the competitive advantage of the more innovative companies (Schumpeter 1934; 1947).

Offering consumers the right to withdraw would not make the market more effective. On the contrary, the changes to the risk for creditors and borrowers could bring about further rationing of loans (or price increases). Borrowers could sign contracts carelessly, without any accountability for supplying accurate information or acting responsibly (blank bond for carefree conclusion of contracts; Kanzler 1996: 140). For example, after getting confirmation for a credit agreement, the consumers could look for more favourable offers from a strong negotiating position, to the detriment of their first lenders. Consumers could withdraw from the credit agreement without giving any reason. Therefore, offering a consumer the most "suitable" loan (section 4.1.2) appears to be even more challenging.

4.3 Standardising consumer protection throughout the EU at a higher level?

The proposed CCD aims to standardise consumer protection throughout the EU at a higher level. For this purpose it aims to encourage "responsible lending" by credit institutions to prevent overindebtedness.

4.3.1 Responsible lending

In this respect, the key regulation of the proposed directive is the principle of "responsible lending" (Article 9), according to which a lender must act as a good creditor: "Where the creditor concludes a credit agreement or surety agreement or increases the total amount of credit or the amount guaranteed, he is assumed to have previously assessed, by any means at his disposal, whether the consumer and, where appropriate, the guarantor can reasonably be expected to discharge their obligations under the agreement".

In conjunction with Article 8 (central database) and Article 6 (exchange of information in advance and duty to provide advice) companies offering loans must use central databases to verify details provided by consumers or their guarantors, demand deposits from them, check the details of credit intermediaries, and offer the most suitable type and volume of loan. Civil or commercial law penalties (set out by the individual member states) will come into force if a creditor, based on the information obtained from a borrower, should have "reasonably" refused to offer a loan. According to the proposed directive, the creditor could lose out on interest payments on the loan or other charges by the creditor; and the consumer may be given the right to continue repaying in instalments the total amount of credit, if the creditor does not respect the provisions of responsible lending (article 31).

By this means the Commission is pursuing the goal of preventing consumer overindebtedness. If borrowers become overindebted through a critical life event beyond their control (such as unemployment or illness) then – so it is argued by the Commission – through no fault of their own they have got into serious difficulties. Following this argument, neither the borrower nor the creditor can be made fully responsible for the consequences. Since creditors are considered to be the more powerful party they should be more strongly obligated to resolve any events of debt overload and their consequences.

There are a number of problems with these proposals: First, it is in the interest of lenders to prevent credit default due to overindebtedness. If a borrower fails to repay a loan, the creditor has to adjust the value of its commitment, which reduces its profit and may even jeopardise its existence. This is why banks use a credit rating system before offering loans. A trend already driving the EU's credit economy is the development of modern solutions in credit risk management. Banks are using new procedures to evaluate borrower risk and reorganising credit risk management to lower the cost of risk and increase their profits. The most visible expression of this trend is the implementation of the New Basel Capital Accord. This new standard is forcing the industry more than ever before to implement risk-sensitive ratings that give a realistic assessment of an individual borrower's risk. The regulation of responsible lending in the proposed new CCD is therefore superfluous.[9]

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9 In March 2003 experts from 11 member states met for the first time within the framework of the „Mortgage loan" forum, which is to advise the Commission on issues about creating a European single market for housing credits. It is likely that the pursuit of the forum's goals („determining the factors which would most be in the way of a European mortgage loan market" and the „formulation of policy recommendations which are to show to the Commission the best way to accomplish

Second, however, it is almost impossible to accurately assess the risk of overindebtedness of private borrowers due to the findings on the causes of debt overload, which we examined in section 3.3. As stated, unemployment, divorce or illness are among the most important causes of overindebtedness. For example, bank advisers could not predict that a potential borrower will become ill in the future. For this reason, we are concerned that there will be an increase in the number of disputes (in legal territories yet to be harmonised). The Commission's "responsible lending" is a vague legal definition, which results in vague property rights[10].

However, it is clear that a company should act as a "good creditor" by refusing a loan to anyone it believes will not be able to repay it. Moreover, banks must offer their customers the most suitable loan (see section 4.1.2). But what this signifies in practical terms is unclear. Does it mean that creditors have to use information provided, for example, by SCHUFA, the German Credit Protection Agency, and other credit databases to which they have access, in addition to checking the information provided by the borrowers themselves? Or does this mean that the creditor also has to perform his own research into, for example, the probability of the borrowers losing their job or encountering economic difficulties following a divorce, which would jeopardise the repayment of a loan?

So the proposed new CCD gives much leeway for the courts at a national level. Since the legal systems and cultures vary between countries, the precise interpretation of responsible lending will also differ from one member state to another, which conflicts with the principle of a single European market. In addition, obliging national institutions to exchange information about outstanding loans and defaults aims to encourage a single market for financial services. However, some countries record only negative credit history information, while others also record positive information, which creates an uncertain situation for lenders. Will a lender in a country that records only negative information, which is offering a loan to a customer from a country that also records positive information but receives for reasons of reciprocity only negative information, be fulfilling its duties on responsible lending? These questions show that the proposed new CCD has been poorly co-ordinated with the directorate-general responsible for single market issues, if at all.

If these gaps and ambiguities in the regulation obstruct the creation of a single market for financial services, then there will be no increase in competition and

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an integrated market") will lead to a new directive. Here, the next conflict between the Commission and banks is already emerging, if the latter have to anticipate additional regulations and so higher costs when extending mortgage loans.

10 In a statement from the German Federal Ministry of Justice in January 2003 about the principle of decisiveness, it even sees „constitutional problems". The Ministry considers it questionable whether the regulation concurs with the contractual autonomy protected in the constitution. See Bundesministerium der Justiz 2002: 13–14.

the provision of consumer credit across national borders, which goes against the aims of harmonising consumer protection throughout the EU at a higher level.

4.3.2 How responsible lending affects economic growth and employment

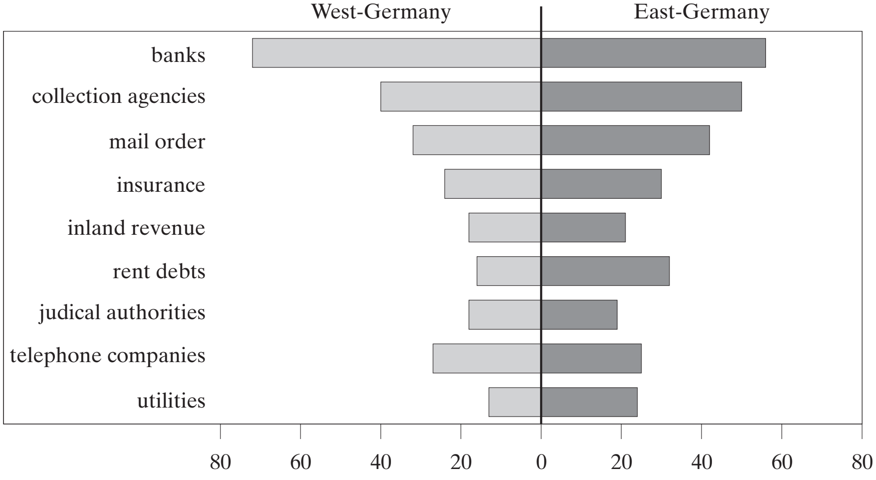
The proposed regulations – in particular the parts concerning responsible lending – threaten to reduce the volume of loans offered and increase their price due to the increased liability risks for banks. Mainly due to the planned regulation of Article 9, creditors will not be able to determine the risk of lending. They will have to assume that after offering a loan, the customer may do something to affect the agreement (hidden action). So creditors will have to change the way in which they offer loans. They could offer fewer loans to certain (groups of) borrowers, or raise interest rates to reflect the increased risks involved. However, both responses conflict with the social intention of the regulations. The restrictions that the proposals put on the consumer credit markets (also threatening from the best advice obligation, an expansion of the joint and several liability and the right to withdrawal) will have direct overall economic consequences. They may reduce gross domestic product growth rates and could raise unemployment.

Those reforms in the spirit of the state's making up our minds for us could harm the people they aim to help (such as those with no experience of dealing with banks or with a low income) because they may find it harder to get a loan or be excluded from them altogether.

A look at the type of debt owed by overindebted households shows that consumer loans granted by banks represent a significant share of the total, but by no means all of it (Figure 7). In addition to the money they owe to banks, collection agencies (to which the original creditors pass their bad debts) and mail order houses, many households have "primary debts" that include household rents, and utility and telecommunications bills. Consumers that are excluded from types of loans that fall under the "protective" realm of the proposed directive are likely to have to resort to other forms of financing and to institutions that fall outside the scope of the intended regulations. These private households would be driven into less protected areas of the market.

This may have a substantial indirect effect on economic growth and employment. Certain consumer groups would have their purchasing power limited and forced to move out of the protected part of the credit market, which would substantially increase the risk of debt overload. As a result, these consumers who have a verifiably high propensity to consume would no longer contribute to demand. In turn, this could lead to negative multiplier effects and thus may result in rising unemployment (Siebke, Thieme 2003).

Figure 7
Types of debt of overindebted households in Germany
in %



Source: Korczak 2001.

5. Conclusion

Although the aims of the proposed new CCD are positive, the current draft is unlikely to help to fulfil them. The regulations that are intended to protect consumers seem to work against their interests. They would not make the market more transparent or effective, increase the level of protection, or harmonise legislation throughout the EU. Instead, the proposals (which are well intended but excessive) would weaken the spirit of competition on both the supply and demand sides.

Consumer protection with a proper degree of moderation would involve regulation that strikes a balance between the consumer's (1) justified right to protection, (2) obligation to act responsibly and (3) right to self-determination instead of schoolmarmish government intervention.

It will become more important to enable consumers to protect themselves. This can only be achieved by providing them with appropriate advice and information; bank regulation is the wrong policy instrument for this.

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