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## **PUBLIC CONSULTATION ON RESPONSIBLE LENDING AND BORROWING IN THE EU**

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## INTRODUCTION

### 1.1. Scope and objectives of the consultation

In its Communication to the Spring European Council *Driving European Recovery* of 4 March 2009<sup>1</sup>, the European Commission undertook to come forward with measures at EU level on responsible lending and borrowing, including a reliable framework on credit intermediation, in the context of delivering responsible and reliable markets for the future and restoring consumer confidence. Responsible lending means that credit products are appropriate for consumers' needs and are tailored to their ability to repay. This may be obtained through having an appropriate framework in place to ensure that all lenders and intermediaries act in a fair, honest and professional manner, before, during and after the lending transaction. Responsible borrowing implies that – in order to obtain a credit – consumers should provide relevant, complete and accurate information on their financial conditions, and are encouraged to make informed and sustainable borrowing decisions.

Most lenders are already subject to EU regulation, for instance through the Consumer Credit Directive<sup>2</sup> and the Capital Requirements Directive. Credit institutions must ensure that they have made provisions in their capital holdings that are commensurate with the risks they undertake, including credit risks. When adequately supervised, credit institutions therefore have an incentive to lend responsibly, as the risk profile of their borrowers has an impact on the capital they must hold. Furthermore, it is in lenders' interests to lend responsibly, in order to avoid damaging and expensive defaults, write-offs and home foreclosure procedures. Nevertheless, as evidence from the current economic crisis has shown, there is still significant room for irresponsible lending and borrowing to take place. The Single Market Review of November 2007 and the White Paper on the Integration of EU Mortgage Credit Markets of December 2007 had previously identified certain areas of work of direct relevance to responsible lending and borrowing: pre-contractual information, advice, assessment of creditworthiness, conduct of business rules and credit intermediation. Progress has been made on many of these issues, including the establishment of the Expert Group on Credit Histories<sup>3</sup>, the launch of consumer testing on an amended European Standardised Information Sheet for mortgage loans, an ongoing study on the costs and benefits of various policy options with regard to mortgage credit and the completion of a study analysing the market for credit intermediaries in the European Union<sup>4</sup>. In the area of consumer credit, a major step towards a high level of consumer protection across the EU was achieved with the adoption of the Consumer Credit Directive, which focuses on transparency and consumer rights. However, as this Directive is only due to be implemented by June 2010, it is not clear what effect its provisions will have, and certain issues, which, deliberately, were not or only partially harmonised in the Directive, such as the regulation of credit intermediaries and the provision of advice, may need to be worked on in light of the financial crisis.

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<sup>1</sup> COM (2009) 114, available at [http://ec.europa.eu/commission\\_barroso/president/index\\_en.htm](http://ec.europa.eu/commission_barroso/president/index_en.htm).

<sup>2</sup> Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC, OJ L 133, 22.5.2008, p. 66.

<sup>3</sup> For more information see [http://ec.europa.eu/internal\\_market/finservices-retail/credit/history\\_en.htm](http://ec.europa.eu/internal_market/finservices-retail/credit/history_en.htm).

<sup>4</sup> *Study on Credit intermediaries in the Internal Market*; Europe Economics, 15 January 2009, available at [http://ec.europa.eu/internal\\_market/finservices-retail/credit/intermed\\_en.htm](http://ec.europa.eu/internal_market/finservices-retail/credit/intermed_en.htm).

This consultation seeks to build on this work and help the Commission to analyse certain outstanding issues with regard to responsible lending and borrowing. Certain of the topics being addressed, such as information, conduct of business and the role of intermediaries, are consistent with those that were addressed in the recent Communication from the Commission on Packaged Retail Investment Products<sup>5</sup>. Also, the recent Commission Recommendation on remuneration policies in the financial services sector<sup>6</sup> seeks to address excessive risk-taking by financial services employees.

## **1.2. Importance of credit markets**

Responsible lending is important because of the significant role that credit markets play in the economy throughout the EU. In 2007, outstanding residential mortgage lending in the 27 EU Member States represented over 50.1 % of EU GDP. Mortgage debt to GDP ratios have however risen steadily across almost all EU countries in recent years<sup>7</sup> reflecting the higher value of household assets as well as rising numbers of mortgage borrowers. As alluded to above, developments in mortgage markets played a significant role in at least exacerbating the effects of the financial crisis in several EU Member States, such as Spain, Ireland, the UK, Latvia and Lithuania.

In 2007, outstanding consumer credit lending in the EU27 represented 7.7 % of EU GDP. Recent data also shows an increase in the household credit, particularly during the financial crisis. Loans to households (including consumer credit, loans for house purchase and other credit) in the euro area stood at almost EUR 4.9 billion in the first quarter of 2009, up from EUR 4.8 billion in 2007<sup>8</sup>.

Growing household credit should be seen in the wider context of overindebtedness. A recent study on over-indebtedness has shown that 38 % of respondents agreed that they were having difficulties, to a certain extent, with paying their bills<sup>9</sup>. Responsible lending could therefore be a partial solution to the problem of overindebtedness.

## **2. PRACTICES PRIOR TO THE LENDING TRANSACTION**

### **2.1. Advertising and marketing**

In the financial services sector as much as in any other sector, advertising and marketing should be fair, must not mislead and must not put undue pressure on the prospective customer. Some examples of potentially misleading marketing practices by lenders and intermediaries include the advertising of a low interest rate, when the criteria for

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<sup>5</sup> COM(2009) 204, available at [http://ec.europa.eu/internal\\_market/finservices-retail/investment\\_products\\_en.htm#communication](http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm#communication)

<sup>6</sup> Commission Recommendation on Remuneration policies in the financial services sector, C (2009) 3159 of 30 April 2009.

<sup>7</sup> European Economics: *Financial Innovation and European Housing and Mortgage Markets*, Morgan Stanley, 18 July 2007, p. 2.

<sup>8</sup> ECB data. See: <http://sdw.ecb.europa.eu/reports.do?node=100000143>.

<sup>9</sup> European Commission, Directorate General for Employment, Social Affairs and Equal Opportunities: *Towards a common operational definition of over-indebtedness*, 2008, p. 10.

qualification for such a low rate are not made clear to potential borrowers, and marketing documentation in which intermediaries induce borrowers to believe that they can authorise loans, where, in fact, only the lender can make this decision. The Consumer Credit Directive explicitly addresses the information to be presented in advertising of consumer credit, while, with the exception of the provisions of Unfair Commercial Practices Directive<sup>10</sup>, no such requirements are in place with regard to the advertising and marketing of mortgage credit.

## **2.2. Pre-contractual information**

Clear information is an essential element in responsible lending and borrowing. Borrowers must be in possession of all necessary information to make an informed decision as to whether the credit product they are being offered is suitable for them. Such information could include the various potential (long-term) risks associated with credit, such as the impact of foreign exchange fluctuations, interest rate variations and changes in asset prices. It is further vital that information be clear, understandable and comprehensive, without being excessively detailed.

The most significant piece of information disclosure in this context is the pre-contractual information on the credit offer itself. Results of consumer testing undertaken by the Commission<sup>11</sup> have shown that it is very important for consumers to obtain pre-contractual information in a structured form that allows for comparison between offers. The results indicate that the information should be comprehensive and employ simple wording with limited use of technical jargon.

At the EU level, the content and format of the information to be provided to customers of consumer credit are set out in detail in the Consumer Credit Directive which prescribes the use of the Standard European Consumer Credit Information (Annex II of the Directive). In the area of mortgage credit, the European Standardised Information Sheet for Mortgage Credit (ESIS) forms part of the Code of Conduct for Home Loans. Both are contributing to a large degree of standardisation of pre-contractual information for consumer and mortgage credit respectively.

However, these initiatives have their limitations. The provisions of the Consumer Credit Directive do not apply to mortgage credit, unless the Member States decide to submit mortgage credit to its rules. The ESIS is a non-binding self-regulatory instrument, of which the level of implementation in the EU Member States has been very mixed and is only applicable to lenders who sign up to the Code. The format and content of the ESIS are currently being revised, involving extensive testing with consumers to ensure that it presents only the most useful and relevant information in a way that is easy for borrowers to understand. The Commission is also currently examining the costs and benefits of

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<sup>10</sup> Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair consumer-to-business commercial practices in the internal market. The Unfair Commercial Practices Directive (UCP) contains a minimum harmonisation clause in relation to financial services which allows Member States to maintain or adopt stricter and more detailed rules to protect consumers, where necessary, for example, with regard to information requirements. The Directive includes a black list of banned commercial practices across the EU. Other provisions prohibit misleading information, omitting information, and aggressive practices.

<sup>11</sup> For more information see:  
[http://ec.europa.eu/consumers/rights/docs/PCI\\_final\\_report\\_22Feb2008\\_en.pdf](http://ec.europa.eu/consumers/rights/docs/PCI_final_report_22Feb2008_en.pdf).

certain policy options regarding the ESIS, including extending its scope of application to credit intermediaries, and making its provision legally binding, rather than a self-regulatory commitment under a code of conduct.

Transparency on the nature of commissions and fees paid to intermediaries and bank client-facing staff by the lender and, sometimes, by the borrower is also highly important, and there are varying approaches this information disclosure in EU Member States. This issue is revisited in Section 5 on Credit Intermediaries.

### **2.3. Risk guidance**

As a complementary measure to the above-mentioned information provision, one could also consider the development of risk guidelines, which could be provided to the consumer before purchasing a credit product. Such risk guidelines would alert potential borrowers to the risk involved in the credit product they intend to buy and allow them to better assess which product is suitable to their needs. In that context, such guidelines could be provided in the context of the borrower's discussions with the lender or intermediary, or could be generally available for example through internet or by other organisations and authorities. Existing online education tools could also be enhanced to include such guidelines.

**Question 1:** Do you have evidence of misleading or unfair advertising or marketing practices with regard to mortgage and consumer credit?

**Question 2:** What are your views on the development of risk guidelines?

## **3. BUSINESS PRACTICES IN THE CONTEXT OF LENDING TRANSACTIONS**

### **3.1. Suitability and Creditworthiness**

Another reason why the Commission is looking at the issue of responsible lending and borrowing is because some borrowers have been granted credit that was unsuitable for them or their needs. The issue of suitability is therefore one that may need to be addressed.

Suitability can be approached in one of two ways – the suitability of the product design, and the suitability of the product for a particular borrower. As far as product design is concerned, there has been an explosion in credit market product innovation in recent years, with products such as buy-to-let, interest-only and self-certification mortgages and revolving credit taking a significant market share in some Member States. Although in some Member States, there are statutory limits on loan-to-value and loan-to-income ratios, this is by no means the case across the EU, and such ratios have risen substantially in many markets, with loans of 100 % and more of the purchase price of the property, or over five times annual salary multiples, being not uncommon at the height of the property price boom. Although the offering of such products has been significantly curtailed since the onset of the financial and economic crisis, the inherent suitability of some credit

products, when available for purchase by retail customers, is now being called into question<sup>12</sup>.

Recent experience has also pointed to there being room for improvement in the suitability assessments of particular credit products for particular borrowers. Examples here include the sale of 'teaser rate' loans that the borrower would need to refinance within a short period of time or risk moving to a much higher repayment level that may be unaffordable for him; and loans issued in foreign currencies, without the borrower having an understanding of the impact that exchange rate fluctuations would have. One of the reasons why a consumer might not purchase the best product for his needs may be that a mortgage lender or credit intermediary has assessed his financial circumstances incorrectly, insufficiently, or not at all. The Consumer Credit Directive<sup>13</sup> restricts itself to a requirement on lenders to assess the consumer's creditworthiness on the basis of sufficient information obtained from the consumer or obtained from a database such as credit registers. It leaves it to the Member States to take appropriate measures to promote responsible lending practices.<sup>14</sup> Furthermore, it gives Member States a deliberately large margin to design a duty to assist consumers in order to decide which credit product is the most appropriate for his needs and financial situation.<sup>15</sup> In the investment field, the Markets in Financial Instruments Directive requires that investment firms, when providing investment services to clients, obtain sufficient information on the client's knowledge, experience, financial situation and investment objectives to assess whether the investment service or product envisaged is suitable for the client.<sup>16</sup> While in the consumer credit and investment area there are at least these, sometimes limited, rules, no such obligations are in place at all with regard to mortgage lending. In some Member States there are already legal requirements in place for mortgage lenders or credit intermediaries to assess the creditworthiness of a consumer and his compatibility with particular credit products<sup>17</sup>, while in other Member States there are no such conditions.

Although there is a general expectation that lenders and credit intermediaries will perform a creditworthiness assessment of the borrower in the context of the particular transaction envisaged, it appears that there are currently a number of disincentives from doing so. For instance, a lender may opt to provide a risky loan because it can always resort to the sale of the property held as collateral in case the borrower defaults, it can transfer the risk of default to third parties by issuing residential mortgage backed securities<sup>18</sup> or even sell the loan portfolio. Moreover, lenders and credit intermediaries

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<sup>12</sup> For instance, in the UK, the FSA's Turner Review published on 18 March 2009 questions whether product regulation should not be considered.

<sup>13</sup> Directive 2008/48/EC, Article 8.

<sup>14</sup> Directive 2008/48/EC, Recital 26.

<sup>15</sup> Directive 2008/48/EC, Article 5(6), Recital 27.

<sup>16</sup> Directive 2004/39/EC, Article 19.

<sup>17</sup> The requirement to assess the suitability of mortgage products to the personal circumstances of the consumer is set out in the national law of Austria, Belgium, Hungary, Ireland, Malta and the Netherlands. In the UK the requirement to assess the suitability of the product for the borrower is only relevant where advice is given.

<sup>18</sup> Currently being addressed in the revision of the Capital Requirements Directive.

may have incentives not to undertake a thorough creditworthiness assessment to speed up the process and thereby gain new clients. The cost of performing such assessment is also particularly relevant for the lender or credit intermediary.

In respect of credit intermediaries or bank employees, they may not perform a thorough creditworthiness assessment and thus provide unsuitable loans to borrowers, simply because they receive higher commissions for such loans. The credit intermediary may be led to make an insufficient or incorrect creditworthiness assessment in cases where his payment is conditional on a contract being signed, and not on the fact that the borrower respects his contractual obligations and repays the loan. The credit intermediary may not have access to credit databases for the performance of the creditworthiness assessment<sup>19</sup>. Furthermore, the fact that in some Member States there are no rules on professional qualifications, authorisation and registration of credit intermediaries, people who are acting as credit intermediaries while lacking sufficient skills may perform inadequate or incorrect creditworthiness assessments.

**Question 3:** In your view, are there certain (categories of) credit products that are inherently unsuitable for sale to retail borrowers? Would you welcome a set of standardised or certified credit products to be offered to consumers?

**Question 4:** Do you consider that mortgage lenders and credit intermediaries should always perform creditworthiness and/or suitability assessments before granting consumer and mortgage loans? For mortgage credit, what are your views on the criteria to be used in assessing suitability such as loan-to-income ratios or loan-to-value ratios?

**Question 5:** How should the lender or credit intermediary demonstrate or document the adequacy of the creditworthiness and suitability assessment?

### 3.2. Advice standards

Providing advice is distinct from providing information. While information merely describes a product, advice implies the provision of a recommendation for an individual consumer to opt for a given product. When advice is given, it should be objective, based on the profile of the borrower, and commensurate with the complexity of the products and the risks involved. However, given that providers of advice on credit products, namely credit intermediaries and bank staff, are often remunerated based on sale commissions and fees, there is potential for conflicts to arise with such principles for advice provision.

The Consumer Credit Directive does not regulate advice, but as a first step calls for adequate explanations to be given to the borrower, so that he can assess whether the proposed credit is adapted to his needs<sup>20</sup>. With regard to mortgage credit, there are currently no rules at EU level on the provision of advice. The 2007 White Paper on the

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<sup>19</sup> The Consumer Credit Directive lays down the principle of non-discriminatory cross-border access by creditors to credit databases, but this applies only for consumer credit and does not apply to intermediaries. However, the Directive ensures in any case that the creditor himself has to carry out the creditworthiness check.

<sup>20</sup> Directive 2008/48/EC, Article 5(6).

Integration of EU Mortgage Credit Markets<sup>21</sup> stated that mortgage lenders should provide full information and adequate explanations to the consumer, so that the latter makes a well-informed choice, but should not be legally compelled to provide advice. It also stated that it wishes to promote high-level mortgage advice standards, whilst recognising that not all consumers need the same level of advice.

Advice provisions are already present in some financial services legislation, such as the Markets in Financial Instruments Directive (MiFID)<sup>22</sup> and the Insurance Mediation Directive<sup>23</sup>. A number of Member States also apply advice standards, for instance the UK, Denmark and Ireland. Examples of such standards include requirements:

- to act honestly, fairly and professionally in the best interests of the borrower;
- to take reasonable steps to obtain all relevant information to assess the borrower’s knowledge and experience relevant to mortgage credit, his financial situation and his objectives;
- to assess the affordability of the product for the particular borrower;
- to determine whether the product is suitable for the borrower’s needs and circumstances;
- to ensure that the product recommended is the most suitable among all the products available;
- to alert the borrower at an early stage of the costs for receiving advice;
- to provide written documentation as to the grounds on which advice for a specific product is being given;
- to provide a warning if the borrower wishes to purchase a product that the lender or intermediary deems not to be appropriate;
- to disclose actual or potential conflicts of interest, including the level of remuneration paid to the intermediary or bank client-facing staff member for the specific product being advised.

Going beyond these existing standards, lenders could also be encouraged to draw up internal advice guidelines of sufficient detail addressing the suitability of different products for certain categories of consumers.

**Question 6:** Do you think that these advice standards would be appropriate in an EU context? Are there others that should be considered? What would be the most appropriate means to introduce and enforce the application of advice standards? Please explain.

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<sup>21</sup> COM (2007) 807, available at [http://ec.europa.eu/internal\\_market/finservices-retail/credit/mortgage\\_en.htm](http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm).

<sup>22</sup> Directive 2004/39/EC, Articles 19(1) and (4).

<sup>23</sup> Directive 2002/92/EC, Article 12(3).

#### 4. RESPONSIBLE BORROWING

Responsible borrowing means that individuals, when seeking to buy a credit product, will make efforts to inform themselves of the products on offer, be honest when providing information on their financial situation to the lender or credit intermediary, and take their personal and financial circumstances into account when making their decision. As a consequence, this prudence should help the borrower to select the credit product that is most appropriate for their needs, potentially leading to lower default and foreclosure rates. If borrowers do not behave responsibly, this will undermine the positive effects that could be achieved through policies on responsible lending.

As stated in the 2007 White Paper on the Integration of EU Mortgage Credit Markets, a necessary condition of responsible borrowing is financial education, as financially literate consumers are more able to understand and assess their financial situation and the credit products on offer by different providers, and make an informed choice on the most suitable product for them. To that end, the Commission has adopted a Communication on financial education<sup>24</sup>, aiming at empowering consumers' understanding of financial services and make them confident when making a purchase, and developed initiatives in this regard including an online education tool, Dolceta<sup>25</sup>, a group of experts with practical experience in the area, a database of relevant schemes in the EU and the provision of patronage to selected events. However, it does not always follow that even financially literate consumers will choose to borrow responsibly. The possibility exists that consumers provide false or inaccurate information to their lenders concerning their financial situation in order to get loans that would otherwise not be available to them. Responsible borrowing is therefore also associated with the provision of correct, complete, precise, and sufficient information from the borrower to the lender. Irresponsible purchases of certain credit products such as 'self-certification mortgages', and a subsequent inability to repay debt, has been seen as a contributor to the financial crisis in some EU Member States<sup>26</sup>.

In most cases involving credit, the borrower is requested to provide the lender with information that is relevant to the proper assessment of the former's financial situation. This documentation usually consists of, among others, employment status, level of income from employment and other sources, income of spouse, and any other existing financial obligations. When providing this documentation, the borrower should be honest and provide true and complete documentary proof of his past, present, and future financial situation. Furthermore, it should be possible for the lender to verify the information provided to him by the borrower, where such an attempt does not run contrary to rules on data protection.

**Question 7:** Apart from a focus on financial education, are there any measures that could be taken to encourage responsible borrowing?

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<sup>24</sup> Communication from the Commission: Financial Education, [http://ec.europa.eu/internal\\_market/finservices-retail/docs/capability/communication\\_en.pdf](http://ec.europa.eu/internal_market/finservices-retail/docs/capability/communication_en.pdf).

<sup>25</sup> [www.dolceta.eu](http://www.dolceta.eu).

<sup>26</sup> E.g. in the UK, Bradford & Bingley, a self-certification specialist whose mortgage lending business was nationalised in September 2008, had to make provisions of £ 173.9 million for suspected fraudulent borrowing. Source: Bradford 1 Bingley Annual Report and Accounts 2008.

## 5. CREDIT INTERMEDIARIES

In the context of responsible lending, a key actor that has previously attracted little attention at EU level is the credit intermediary. The Commission recently engaged an external contractor to undertake a broad study of the market for credit intermediaries in the EU<sup>27</sup>. The study looked at the profile and activities of credit intermediaries, examined whether their services entailed any potential for market failure or consumer detriment and outlined the legal framework in which they operate. The study showed that credit intermediaries play a significant role in the provision of credit in the EU. For instance, credit intermediaries were involved in the intermediation of 41.5 % of all residential mortgages issued in the EU between 2006 and 2007. For consumer credit this amounted to 28.8 %<sup>28</sup>. Intermediaries are also very active in the provision of point of sale credit and business finance.

### 5.1. Defining credit intermediaries

The term 'credit intermediary' is defined at EU level in the Consumer Credit Directive as "a natural or a legal person who is not acting as a creditor and who, in the course of his trade, business or profession, for a fee, which may take a pecuniary form or any other form of financial consideration (i) presents or offers credit agreements to consumers; (ii) assists consumers by undertaking preparatory work in respect of credit agreements other than referred to in (i); or (iii) concludes credit agreements with consumers on behalf of the creditor"<sup>29</sup>. The Directive deliberately regulates only certain information obligations for credit intermediaries (Articles 5, 6 and 21) while the obligations are alleviated for suppliers of goods or services acting as credit intermediaries in an ancillary capacity (Article 7). Its definition of credit intermediaries concentrates on credit agreements with 'consumers'<sup>30</sup>, but many credit intermediaries also facilitate the access to credit for SMEs and other legal persons. Furthermore, the Consumer Credit Directive definition only covers credit provision between EUR 200 and EUR 75 000. It does not include mortgage credit agreements<sup>31</sup>. It is therefore open to question whether the definition of credit intermediary in the Consumer Credit Directive can or should apply also to intermediaries engaged in mortgage credit mediation.

Credit intermediaries can also be classed horizontally between tied (agent) and independent (broker) intermediaries. An independent intermediary or broker is a neutral third party who is not contractually linked to one or more credit providers. A tied credit intermediary has a contractual relationship with one or several credit providers who are, in turn, responsible for the activities performed by their tied agents. Borrowers may not always be aware of the implications of this difference in terms of the range of credit products that are offered to them and the interest the credit intermediary may have in

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<sup>27</sup> *Study on Credit intermediaries in the Internal Market*; Europe Economics, 15 January 2009, available at [http://ec.europa.eu/internal\\_market/finances-retail/docs/credit/credit\\_intermediaries\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances-retail/docs/credit/credit_intermediaries_report_en.pdf).

<sup>28</sup> Europe Economics study, 'POS' data column P34.

<sup>29</sup> Directive 2008/48/EC, Article 3(f).

<sup>30</sup> Directive 2008/48/EC, Article 3(a).

<sup>31</sup> Directive 2008/48/EC, Article 2(2)(a).

selling certain products. In the insurance field, the distinction between tied and untied intermediaries is made clear in the Insurance Mediation Directive<sup>32</sup>.

**Question 8:** Do you consider that the scope of the definition of Credit Intermediary as set out in the Consumer Credit Directive could also be applied to the mediation of credit not covered by that directive? Would it be appropriate to differentiate between full-time credit intermediaries and persons who offer credit intermediation on an incidental basis? Please explain why (not).

**Question 9:** Do you think policymakers should make distinctions between credit intermediaries in terms of the products they sell (mortgage, consumer credit, 'point of sale' credit)? Should credit intermediaries be treated differently in terms of the status of their relationship with lenders (tied versus untied intermediaries)? Please explain your answer.

## 5.2. Role of credit intermediaries

Credit intermediaries could be an important vehicle in enhancing the circulation of financial services in the internal market by facilitating market access for lenders wishing to enter a new market without establishing a presence in the market itself. They can also benefit consumers by bringing added transparency on the wide variety of players and products available. Intermediaries have also been known to help in finding cheaper interest rates<sup>33</sup>.

Nevertheless, credit intermediaries' activities do entail certain risks for the borrower, owing to the strong asymmetry of information between the borrower and the intermediary. The key issues include the influence that the remuneration of credit intermediaries can have on the advice that intermediaries give, and the disclosure of the contractual arrangements between intermediaries and lenders.

Furthermore, in cases where there is no requirement for registration, licensing or authorisation of credit intermediaries, or where such requirements are particularly light, there is a danger that individuals without the requisite professional knowledge or of questionable personal character could establish as credit intermediaries.

**Question 10:** Could you give examples of cases of misconduct, mis-selling or any other instances of consumer detriment linked to credit intermediaries in your country?

## 5.3. Framework for intermediaries in the EU

Credit intermediation is characterised by an inconsistent regulatory patchwork:

Credit intermediaries per se are not subject to EU regulation. Only some deliberately restricted aspects of credit intermediaries' activities are covered by provisions of the Consumer Credit Directive. Given that many credit intermediaries also intermediate in other financial products, such as insurance, savings, and investment products, they may

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<sup>32</sup> Directive 2002/92/EC, Article 2(7).

<sup>33</sup> The study on Credit Intermediaries in the Internal Market quotes research which found that the average initial mortgage interest rate achieved by a borrower approaching a lender directly in the UK was 6.31 %, with the equivalent rate achieved through mortgage intermediary being 5.48 %.

currently be subject to provisions of the Markets in Financial Instruments Directive (MIFID)<sup>34</sup> and the Insurance Mediation Directive for their intermediation of those products, but not for certain credit products (e.g. mortgages).

Twenty-two Member States have decided to introduce some sort of regulation themselves<sup>35</sup>, leading to considerable divergence in the nature of this regulation between Member States. This divergence is further intensified by the fact that even within individual Member States, there are differences in the level of regulation applicable to different credit products.

This regulatory gap, and the fact that (mortgage) intermediation is not regulated at all in some Member States may provide opportunities for unscrupulous activity. The lack of coherence between requirements for credit, insurance and investment intermediation may also prove burdensome for multi-product intermediaries. And the lack of an EU-wide framework for credit intermediaries could mean there are missed business opportunities for intermediaries wishing to operate cross-border.

**Question 11:** Does the regulatory patchwork for credit intermediaries present a problem, in your view?

#### **5.4. Information disclosure on credit intermediaries**

##### *5.4.1. Information disclosure on the lender/intermediary relationship*

Section 2.2, above, described the pre-contractual information that should be provided to borrowers. However information on the intermediary is not addressed in the standardised information documents. Article 21 of the Consumer Credit Directive outlines some limited obligations on credit intermediaries, namely to disclose the tied or untied nature of the intermediary, and to disclose fees payable by borrowers to intermediaries.

For mortgages, the guidelines set out in the ESIS do not provide for the disclosure of information on the lender-intermediary relationship, specifically the disclosure of information on the commission structure and the amount paid by the lender to the intermediary to provide mediation services on its behalf. Similarly, neither the ESIS nor the Standard European Consumer Credit Information Sheet deal with commissions or fees which bank employees receive. Commission and fee structures have a particular influence on the lending transaction. The way in which intermediaries and bank client-facing staff are remunerated could have an impact on their incentive to offer one or the other product to the client. The most common forms of remuneration are commission-based remuneration schemes, whereby payment is conditional on a contract being signed and volume-based commissions, whereby the payment is expressed as a percentage of the volume of credit agreed by between the parties. Each of these can give incentives to staff and intermediaries to present to the borrower products for which they are being paid the best commissions, rather than those that have been judged to be the most suitable for the borrower's needs.

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<sup>34</sup> Directive 2004/39/EC.

<sup>35</sup> Study on Credit Intermediaries in the Internal Market.

The potential conflicts of interest that arise with these fee structures could be addressed in a number of ways: caps or ceilings on the amount of commission (for instance, in Austria a ceiling of five per cent of the gross credit sum applies), outright bans on commissions on credit sales, or through targeted information disclosure. The latter is one of the requirements contained in the Markets in Financial Instruments Directive to address inducements for the sale of investment products, alongside the obligation to ensure that inducements are designed to enhance the quality of the service and do not impair compliance with the duty to act in the best interests of the client<sup>36</sup>. With risk based remuneration schemes, the intermediary is paid on condition that the borrower respects his contractual duties on the repayment of the loan, thereby providing an incentive to the intermediary to be realistic in the types of loan the borrower can sustain. In the Netherlands, this type of remuneration structure has resulted in a ban on one-off commissions, but rather payments may be spread throughout the duration of the credit product.

#### 5.4.2. *Information disclosure on the intermediary/borrower relationship*

Of further importance is the disclosure of information on the specific fees (if any) payable by the borrower to the intermediary for the provision of the service. Certain Member States have put rules in place governing these fees<sup>37</sup>. Requirements for information on fees payable by the borrower to the intermediary are also set out in the Consumer Credit Directive in Article 21(b), however this is only with regard to consumer credit within the scope of that directive. No such obligation exists for mortgage credit. As such the borrower may not be in a position to compare the whole set of fees applicable to different credit offers.

**Question 12:** What would be the most appropriate way to address potential conflicts of interest, particularly with regard to fee/ bonus/ commission structures? Should any measures in this regard apply to bank client-facing staff as well as intermediaries?

### 5.5. **Registration, licensing and supervision of credit intermediaries**

Approaches to the registration, licensing and authorisation of credit intermediaries differ considerably between EU Member States, with varying application of prudential standards (e.g. minimum capital requirements for credit intermediaries), and professional requirements and standards (e.g. minimum training and professional requirements). Unlike credit institutions and insurance intermediaries, credit intermediaries are not subject to requirements at EU level on prudential standards to carry out their business. Examples of such standards could be minimum capital requirements or professional indemnity insurance<sup>38</sup>, the aim of which would be to help ensure a minimum level of professionalism in the sector, and to give borrowers the confidence that they could claim against intermediaries if they have been given misleading advice.

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<sup>36</sup> MiFID implementing directive 2006/73/EC, Article 26.

<sup>37</sup> Regulation dealing with fee disclosure or governing the fees between the credit intermediary and the borrower apply in Austria, Belgium, Bulgaria, Estonia, France, Germany, Ireland, the Netherlands and Malta. In Belgium, direct and fixed fee schemes are prohibited and credit intermediaries are not allowed to accept commission from borrowers.

<sup>38</sup> For example, Article 4(3) of the Insurance Mediation Directive sets out the professional indemnity insurance requirements for insurance and reinsurance intermediaries.

Eight Member States require that credit intermediaries be registered, with five Member States operating a licensing regime, imposing certain minimum qualification standards and a 'fit and proper' test, while only five require that they be authorised to carry out this particular activity. Nine Member States do not require any specific professional requirements, registration or authorisation. Mortgage intermediaries in the UK, the Netherlands and Austria are required to take out professional indemnity insurance. Minimum capital requirements are in place in Bulgaria, Germany, Malta and the UK. Other Member State prudential standards include the requirement for a sound business plan and the requirement to comply with money laundering legislation.

There are no provisions in EU legislation for the ongoing supervision of credit intermediaries. This contrasts with the Insurance Mediation Directive (IMD), which states that insurance intermediaries shall be supervised by the competent Home Member State authority where the intermediary has its residence or head office. In addition, the IMD in its Article 9(1) introduces the principle of cooperation between competent authorities of the various Member States in order to ensure the proper application of the Directive.

In considering the framework in which credit intermediaries operate, the various approaches that could be considered could include:

- enabling supervisory authorities to assess whether intermediaries are involved in the provision of high-risk credit (in this context, it is worth noting that unregistered credit intermediaries have been identified as playing a key role in the distribution of inappropriate products to mortgage borrowers in the US, contributing to the current financial crisis);
- helping to give borrowers confidence that the intermediary has suitable qualifications and expertise, and that there is an authority to which they could turn in the event of a dispute;
- creating a level playing field between intermediaries at the EU level and opening up the possibility to provide cross-border intermediation services under a 'passport' system, as is currently the case for insurance intermediaries;
- providing a basis on which to determine the authorisation of access by intermediaries to borrowers' credit data.

In the insurance sector, the Insurance Mediation Directive sets out a detailed framework for the registration and licensing of insurance intermediaries (Article 3).

**Question 13:** What are your views on the registration and supervision of credit intermediaries?

**Question 14:** What are your views on prudential and professional requirements for credit intermediaries (such as minimum capital, professional indemnity insurance, educational or professional qualifications)?

## **5.6. Complaints and redress**

Out-of court redress systems ensure that consumers have a means to settle disputes with their financial providers without the need for long and costly court procedures. It may also give consumers greater confidence to use the financial sector.

Six Member States<sup>39</sup> currently regulate access to formalised or streamlined systems of alternative non court based dispute resolution (ADR) for clients of credit intermediaries, but these are the minority.

In the insurance field, Articles 10 and 11 of the Insurance Mediation Directive provide for complaint and redress procedures.

**Question 15:** How do you think the activities of credit intermediaries could be brought within existing complaints and out-of-court redress mechanisms?

## 6. NEXT STEPS

Building on previous consultations and policy development in the area of retail financial services, and especially mortgage credit, this consultation seeks to strengthen and deepen the Commission services' understanding of the remaining issues surrounding responsible lending and borrowing, and to inform our analysis of the varying policy options in this area.

Stakeholders are invited to send their responses to the questions raised in this document **by 31 August 2009** to [markt-retail-consultation@ec.europa.eu](mailto:markt-retail-consultation@ec.europa.eu). Responses will be placed on the Commission's website unless explicitly indicated otherwise by the stakeholders in their response.

The Commission will organise a hearing on Responsible Lending on 3 September 2009 at which, inter alia, a conclusion will be drawn on the consultation launched by this paper and discussions will be held with stakeholders on the most appropriate policy responses to the challenges faced by borrowers and the financial services industry in this regard.

The Commission will draw on the results of this consultation process to consider the most appropriate next steps.

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<sup>39</sup> UK, Bulgaria, Denmark, Ireland, Malta and the Netherlands.