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Retail issues, consumer policy and payment systems

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HEARING ON RESPONSIBLE LENDING AND BORROWING 3 SEPTEMBER 2009

1. WELCOME ADDRESS: CHARLIE MCCREEVY, INTERNAL MARKET AND SERVICES COMMISSIONER

The welcome address by Commissioner McCreevy is available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/363&format=HTML&aged=0&language=EN&guiLanguage=en>.

2. INTRODUCTORY REMARKS

Introductory remarks were made by Sharon Bowles, MEP, Chair of the Economic and Monetary Affairs Committee, European Parliament. A summary of her remarks is available at: http://ec.europa.eu/internal_market/finservices-retail/docs/credit/resp_lending/speech_bowles_en.pdf.

3. PANEL 1: HELPING CONSUMERS CHOOSE APPROPRIATE PRODUCTS

Moderator: **Jacqueline Minor**, Director, DG Health and Consumers

Panellists: **Alain Gourio**, Head of Group Legal Coordination, BNP Paribas
Marta Gellová, Secretary General, Association of Financial Intermediaries and Financial Advisors of the Czech Republic
Mary O'Dea, Acting Chief Executive and Consumer Director, Irish Financial Services Regulatory Authority
Mick McAteer, Director, Financial Inclusion Centre and member of FIN-USE

Ms Minor opened the panel remarking that we share a common ambition on how to enable consumers make wise choices. Education is part of the solution. However, too much information can impede consumers' choices. As such, the amount of information available should be reduced. Consequently, many consumers rely on advice, however, this does not necessarily always deliver the right outcome. Concerning advice, 50-80 % of German investment products are cancelled the first year because there is a potential conflict between advisors' incentives and the best interests of the client. We should look at what should be done with commissions, also whether there are other means to protect consumers like greater supervision of advisors and their qualifications, a possible legal framework for intermediaries.

Question 1 *Consumers receive a range of written and oral communications from their lender or intermediary at different stages in the lending process. Should they also receive advice, on top of the information? How can lenders ensure that such advice is objective, and that recommendations to borrowers are not based on sales targets or remuneration structures for the client-facing staff?*

Mr Gourio answered that there should not be a duty but a possibility for consumers to receive advice because in order to give a personalised recommendation to a prospective borrower to choose a certain product, all elements need to be given. The Mortgage Credit White Paper and Consumer Credit Directive acknowledge that advice should not be a legal obligation. MiFID also recognises that advice is a separate service. Advice is a special service separate from a credit operation, and compulsory advice is pointless and costly because many consumers do not want it. Mr Gourio indicated that mortgage credit is not complicated, and a creditworthiness assessment is performed by all credit institutions. Lenders could deliver advice only on a range of products. Advice is a service that a consumer is likely to have to pay for, and even if it is part of the range of services provided, not all consumers would be interested in it, it needs to be paid for by all consumers. Advice should be optional – and where it exists, it should be objective. Remuneration structures should be neutral vis-à-vis products to sustain an objective approach to advice.

Question 2 *How can borrowers be sure that intermediaries are offering them the most suitable product on the market, not the one that pays the intermediary the most commission? (Suggestions here could include the provision of independent advice paid by the consumer, the recording documenting of the advice given or the shifting of the burden of proof to intermediaries).*

Ms Gellová answered that remuneration can change an advisor's point of view but there is a long-term interest to serve the client's needs because clients are your only assets. An independent financial advisor can give advice on a range of products for which he is licensed and qualified to give advice. It is up to the client to choose whether to go to an independent financial advisor or ask advice from a lender or intermediary. A few points will need to be kept in mind: there needs to be a willingness to pay for advice separately, and for the moment consumers are not searching independently for advice but are relying on advice provided in the sales process. In the UK, fee-based advice makes up only 5 %, in the Netherlands 3 % of the market, in other markets even less. Intermediaries should provide consumers with a record of what was said during the advice process because the situation of the consumer may change. To Ms Gellová, self-regulation works well when clients are given model products and they are aware of risks.

Question 3 *Recently, Ireland has been criticised for the excessive lending policies of some financial institutions and the appropriateness of loans for certain borrowers, despite the extensive body of material available to inform consumers, backed by the Irish Consumer Protection Code. What more should regulators be doing? For instance, should there be more, more prominent and more effective risk warnings?*

Ms O'Dea stated that the consumer angle is only part of the issue. Strong macro-prudential measures are also needed that would enable to forecast liquidity and insolvency issues. Information helps individuals. Mortgage and borrowing decisions were taken at a specific point in time. Now as incomes are falling because of the recession, individuals are facing difficulties in paying back their loans because such a situation was not predicted. She mentioned that in Ireland they have learned from past lessons, having suffered from both the global liquidity problem and the local bubble. The Irish system of regulation has changed – now they do onsite inspections, analyse business models and risks. The government plans to merge the financial regulator and the central bank. Consumer information issues will be dealt with by a separate consumer agency. Concerning statutory codes and warnings, Ms O'Dea believes that they must be a deterrent for the worst part of the market using them, i.e. the lowest common denominator determines what must be in the Code. In Ireland, there is a statutory Consumer Code covering consumers and small companies since 2007 where the key concept is suitability (covering affordability and whether a product is suitable for an individual's particular circumstances). Institutions are obliged to know their customers, to act in their best interest and demonstrate it after the sale has been concluded (the burden of proof lies with the lender). A person in arrears must be informed immediately of the situation, and a "breathing period" needs to be established by the institution. Concerning the role of information, the need for individuals to understand their own exposures to risk is ignored because information is provided in difficult language. A verbal interaction needs to take place. Well-informed consumers can take better decisions. Financial education is also really important although takes time to be effective. In the future, the serious mis-pricing of credit risk would need to be addressed. This needs to be done for consumers as it is unreasonable to expect consumers to understand these issues. Crisis has shown that the examination of regulatory structures is very important. But consumers do not understand regulatory structures. The key concepts for responsible lending are suitability, risk management, and statutory codes. For responsible borrowing – information and education.

Question 4 *Consumers have been saying for several years that lending needs to be undertaken in a more responsible manner. However, lenders argue that they are just meeting consumer demands. How can an appropriate balance between responsible lending and access to credit be achieved?*

Mr McAteer welcomed the initiative which he said is in the interests of society as a whole. This initiative needs to be looked at in conjunction with other initiatives. He pointed out that FIN-USE's opinions on different financial services issues can be found on the Forum's website. He said that, in his personal view, education and information have limited effect because in complex financial services markets what matters is what happens before a consumer is given choices. Buying a home is the third most stressful life event after bereavement and divorce, making rational decision-making difficult. It is also important to understand the different dynamics in savings and lending markets. There is a fundamental difference between saving and borrowing. Lenders have not been lending responsibly. The average UK client has reached the average level of personal

debt of £23,000 while the average UK income is £18,000 per year. Consumers need meaningful choice, credit to low-risk consumers needs to be restricted. Many consumers do not have any choice but to turn to sub-prime lenders. In the UK, licensed lenders can charge up to 1050 % of APRC. There is a conflict of interest – the income of bank employees cannot depend on how much they sell. But we would also need to be careful about the impact of regulation on consumers because the consequences of over-regulation can be as damaging as under-regulation, contributing to financial exclusion. In the UK market, the four biggest lenders have a too large share of the market, limiting competition and choice. Consumers do have responsibilities but the main focus should be on lenders. Lenders' main focus should be on the responsibility because they have information whether a consumer is worthy of a loan or not. Lenders' responsibility after the point of sale is crucial. Currently in the UK fees of £50 a month are being imposed by lenders to overindebted people for arrears.

Questions/remarks from the audience

Oliver Roethig of UNI-Europa Finance said that consumers have a right to good advice and employees have a right to give good advice. Unions of financial services employees should be involved in the process of policy making in the area of responsible lending as they represent key stakeholders. Operating procedures, such as incentive systems, training and sales targets, should be taken into account by supervisors when they assess the risk management of a company. These issues should be examined by financial institution management. In reality it does not work. Some employees see themselves as sales persons rather than advisors.

Udo Reifner, European Coalition for Responsible Credit, said that the Commission and consumers are drifting away from each other. Mixing responsible lending and borrowing is a big error, as it is failing to identify the responsibility of lenders for products which vulnerable consumers are drawn into choosing, especially since most credit is actually for the refinancing of already existing credit. Core question arises after contract has been concluded – for debtors, the service after contract signature is very important. He commented on the dominance of panel speakers at the hearing from Member States that have followed the same broad policies, which at least facilitated less responsible lending practices. He highlighted the different necessary level of protection inherent between credit as a service (where the borrower needs the cash) and investments (where the consumer provides the cash). We need more empirical evidence and less model assumption about what lending achieves in practice. He ended by saying that the erroneous mindset of certain stakeholders when looking at the issue of responsible lending could be seen in the words of the title of this panel 1; “Helping consumers choose appropriate products” which he believes should really have been entitled “Helping consumers USE appropriate SERVICES” if we wanted true responsibility in lending.

Reine-Claude Mader Saussaye of the French Consumer Association shared the view of Mr McAteer that education is not the only answer. Need also to consider current income and employment as well as future prospects. The current crisis, with rising unemployment, illustrates how difficult this is. Many people have hard time evaluating how they will be able to pay back in years to come. There are however different types of consumer: informed and less informed. Lenders have to give advice. It is good that credit is being refused now. We need to give consumers time to shop around before deciding.

Marcin Kawinski from FIN-USE made a comment to Alain Gourio that mortgage is not a simple product. Both the client and the lender should be responsible and have the courage to say no. More responsibility should be on the lender since they are more informed. The information provided also needs to be clear and simple. Concerning financial education, we cannot expect people to get knowledge at an academic level, we can give them only very simple information. The rest is for lenders and intermediaries. We need independent advice and to promote this kind of service. Client needs to pay for it although they might be reluctant.

Dermott Jewell of the Irish Consumer Association said that the system has been broken for a long time. Commissions and fees come in a variety of forms that are often not transparent. Consumers pay at every stage throughout the system. Responsibility ends when problems start! The commission-based structure needs to be abolished, along with self-regulation.

Chris Cummings from the UK Association of Independent Financial Advisers said that there is a need for a level playing field between lenders and intermediaries in responsible lending and borrowing. There is a distinction between an investment market where consumers provide the money, and consumers' desire for credit. In the UK, part of the problem is fractured regulatory system and a lack of supervision in the credit market. Promotional information is handed out at point of sale but it is too late since the moral contract to proceed is already there. We need a disclosure of remunerations. Financial education cannot be the main solution.

In conclusion, panellists were given the floor to give a short final statement.

Mr Gourio was surprised at what Mr McAteer said about bank behaviour because in continental Europe such practice is not possible. The French market does not have a problem of lack of competition on the side of the offer – the problem is rather with lack of demand (it has gone down 40 %). The government asks lenders to lend but consumer associations are more reluctant. In France, only 0.78 % of mortgage credit is bad debts.

Ms Gellová stated that over-regulation leads to more disagreements and problems. Responsibility should be shared between lenders, intermediaries and consumers. Suitability and affordability are key terms.

Ms O'Dea explained that there is a large responsibility for financial institutions to ensure that their employees are well trained on the sales process. Networks of employees are important. It is important to understand different sales practices, however employees may wish to remain anonymous in providing the information to the regulator. The incentive of the seller – is it to sell as many products as possible or the right products? In long term it is never in the interests of the institution to mis-sell. Consumers do not want to pay a flat fee because they do not know what it is for. Industry needs to explain why an additional advice service is important. It is also necessary to differentiate between information and education, the latter being a longer term goal. Finally, certain practices, such as automatic top ups on credit cards, are banned in Ireland.

Mr McAteer said that two thirds of lending in the UK is done by the four biggest lenders. Lenders are told to have good balance sheets but at the same time to lend. Unless we address incentives of staff we will not be successful. More consumer/public interest representatives should be on the boards of the financial institutions and the supervisors. Somebody needs to dare to ask awkward questions.

4. PANEL 2: AN APPROPRIATE FRAMEWORK FOR NON-BANK LENDERS AND CREDIT INTERMEDIARIES

Moderator: **Monique Goyens**, Director-General, European Consumers' Organisation (BEUC)

Panellists: **Jan-Erik Nyberg**, Project Leader, Swedish Consumers' Association,

Theodor Kockelkoren, Member of the Board, Dutch Financial Market Authority,

Tony Ward, Chief Executive, Home Funding Limited,

Hervé Wignolle, President, Syndicat des Intermédiaires en Opérations de Banque (French Association of Credit Intermediaries),

Piero Antonio Rumignani, Head of Business Development, UniCredit Household Financing.

Ms Goyens opened the panel with remarking that in her opinion creditworthiness assessments are currently not sufficient for lending responsible as there is a lack of training as well as issues around remuneration, professional liability, the division of responsibility and complaint handling on the distribution side. A lot of differences exist in national frameworks which prevent consumers and providers from benefiting from an internal market.

Question 1 *What can regulators do to help restore consumers' trust in the institutions they interact with – be they intermediaries, banks, or non-bank lenders?*

Mr Nyberg started with saying that Swedish studies revealed that Swedish consumers had a rather high trust in financial providers up to the start of the crisis which was on the same level as the trust in the royal family. Trust levels were increasing between 2002 and 2007, which were years of economic growth. Trust levelled out in 2007/2008. Regarding the possible actions to restore consumers' trust, Mr Nyberg suggested seven points: First, since trust in financial providers seems to be related to economic growth, macroeconomic policy should focus on restoring growth. Second, capital requirements should be reconsidered to avoid too much cyclicalities as systems seem to work well in good times but are too restrictive in bad times. Third, financial literacy should be increased. Fourth, the remuneration of providers should be made more transparent. Fifth, the original lender should be kept responsible for the loan even if loans are later on sold to other institutions. Sixth, independent and unbiased financial advice should be promoted and consumers should be convinced that they would be prepared to pay for financial advice like they do for legal advice. Seventh, a discussion on moral hazard should be initiated as trust cannot only be too low but also too high. The ideal level would be enough trust with some scepticism.

Question 2 *Could more be done to improve the consistency of the regulation, authorisation and supervision of credit intermediaries and non-bank lenders across Europe? Does the current regulatory patchwork lead to negative outcomes for consumers?*

Mr Kockelkoren said that the patchwork of regulation indeed leads to negative outcomes as businesses tend to move toward the lowest standards and legislation needs to raise these standards. He gave an example from the Netherlands supporting this argument. While Dutch legislation has been introduced on consumer loans, including mortgage loans, the issue of insurance sold together with credit products was left open. Problems are arising now from this gap. Mr Kockelkoren emphasised that it would be important to have a consistent EU framework on responsible lending as this was one of the causes of the financial crisis and borrowers have lost trust that lenders, advisors and intermediaries act in their interest. The Dutch system sets out requirements for intermediaries, advisors and lenders with regard to integrity, expertise and sound business practices. Lenders should be obliged to lend responsibly and advisors to only recommend suitable products. It also needs to be ensured that consumers get the necessary information regardless of which distribution channel he is using. This is important as, while it is generally true that lenders have the same interest as borrowers that borrowers can afford their products, there are still some differences. For instance, payment insurance sold together with a credit is beneficial for the lender as the money lent is insured but might not be good for the consumer. When considering an EU framework, it should be rather principles-based, since differences between products have to be taken into account as, for instance point of sale credit and consumer credit should be treated differently from mortgage credit. National tax regimes of Member States also have an impact on the assessment of product affordability.

Question 3 *The study on the role and regulation of non-bank mortgage lenders identified several regulatory gaps in relation to the authorisation, regulation and supervision of non-bank lenders across the EU. Should these regulatory gaps be closed? If yes, how should this be ensured?*

Mr Ward said that the Commission's study on the role and regulation of non-bank mortgage lenders revealed many gaps in regulation and supervision of non-bank mortgage lenders as well as big differences between Member States including on funding regulations. These differences cause additional costs for non-bank mortgage lenders, impose barriers to access of other EU markets (in addition to natural barriers like language, culture, etc) and raise competition issues as there is no level playing field across the EU. Mr Ward suggested that, while trying to plug the gaps would be the right move forward intellectually, there is not an ideal model which fits all Member States as national markets have evolved over time according to national challenges. For instance, the UK market for first-time buyers is very different from the German market which is due to easier access in the UK to credit as well as a different rental market in both countries. Mr Ward advised that he was aware that the UK FSA is currently considering whether the capital requirements for non-bank mortgage lenders should be moved in line with credit institutions. According to Mr Ward, non-bank mortgage lenders are however no riskier than credit institutions and do not hold deposits. Evidence to support this is that it saw credit institutions in the UK that have had to be bailed out by the government in the recent months rather than non-credit institutions. Mr Ward argued that while it would not be possible to close all regulatory gaps, a level playing field with regard to funding should be created. He closed by emphasising again that in his view it would, at this moment in time, neither be required nor appropriate to try to unify the framework for

non-bank mortgage lenders given the significant disparity in local markets across Europe.

Question 4 *How can it be ensured that intermediaries are appropriately qualified for the tasks that they undertake? Should different levels of qualification be envisaged based on the sector (mortgage/ consumer credit/ point of sale credit)?*

Mr Wignolle stated that the issue of inappropriate borrowing ('malendettement') is missing in this discussion. In this respect the duration of a credit is very important since it is difficult to foresee how the borrower's circumstances may develop in the future. Consumers could be faced with rising debt by engaging in different loans with different maturities which might not always be appropriate, e.g. financing the purchase of furniture with an overdraft. Since inappropriate borrowing causes a lot of detriment, Mr Wignolle proposed a licence for all those which provide the consumers with information, assistance or education. It is difficult to ensure that intermediaries are qualified for their tasks. The Consumer Credit Directive does not adequately address this issue. To improve the qualifications of intermediaries, Mr Wignolle suggested two possible ways: a diploma or an authorisation requirement. The diploma would entail a rather long time perspective as there is currently no education specifically for intermediaries. The authorisation to be active as an intermediary could include verification of expertise, civil professional requirements and minimum capital requirements and could be exercised by a public authority. If EU legislation were considered, several conditions need to be taken into account: it has to be applicable to intermediaries in all 27 Member States, the currently active intermediaries should be able to continue their activities keeping their current rights and the regulation should be adapted to developments. An ethical code could be established which, inter alia, could set out fees and conditions, ensure access by intermediaries to databases and foresee penalties in the event of non-compliance by intermediaries. While it is important to identify the different types of intermediaries, there should not be different qualification requirements for different types of intermediaries and any regulation should be applicable to all.

Question 5 *Do you believe that there is an unlevel playing field between the different credit distribution channels (intermediaries, non-bank lenders, credit institutions) across Europe? What is the effect of this? (If yes, what could be done to alleviate these problems?)*

Mr Rumignani stated that adding legislation before the impact of the ongoing transposition of the Consumer Credit Directive can be assessed may lead to confusion and contribute in the end to an unlevel playing field, contrary to any possible initial aim. Mr Rumignani added that he does not feel that there is a strongly uneven playing field between distribution channels, at least not at the national level. Lenders, which operate their own distribution networks, and intermediaries have developed well-established and well-functioning co-operation models over the years. Besides this, he questioned whether there is any acute need for EU action as cross-border lending is still only a marginal business, and probably will remain so in the future. . When considering any initiative, the different roles in the distribution chain and particularly the lending responsibility need to be carefully distinguished and attributed. The sub-prime crisis, as an example, has shown the negative consequences when roles are mixed up and lending responsibility does not square with the bearing of credit risk. Against this background, a good rule would be to reserve access to credit databases to those responsible for making credit decisions and bearing the related risk, and only to these, not involving intermediaries, as suggested as a

possibility in some documents. With regard to what can cause gaps in the level playing field, Mr Rumignani said that the obligation to provide advice may be such a case if proportionality is not applied. Diversity among intermediaries has to be taken into consideration. There are material differences between, for example, a broker who maintains a stable relationship with his/ her borrowing customer and the seller at a Point of Sale where a relationship is rarely established. This issue is material in business and economic terms as PoS lending represents in many countries not only a pillar of consumer lending (e.g. POS lending represents close to half of outstanding consumer loans in Italy) but also a proven and historically low cost borrowing instrument for the consumer. Besides the impracticable and probably costly solution of having a PoS salesperson dealing with issues relating to responsible lending, there are also potential issues relating to the handling of sensitive data about the borrower. This could possibly result in a conflict with his/ her right to privacy. Excessive legislation may seriously damage this channel, also to the detriment of the consumer.

Questions/remarks from the audience

Chris Cummings of the UK Association of Independent Financial Advisers (AIFA) reported that a UK study found that trust in independent advisors has been increasing in recent years, while trust in lenders has been decreasing over recent months. This is supported by UK FSA statistics which show that the number of complaints against intermediaries has been decreasing recently. It is important that consumers understand who is a lender and who is an intermediary. Regarding the access of intermediaries to credit databases, he suggested that consumers should be able to decide if they are willing to provide intermediaries with access to their data or not.

Alain Gourio (BNP Paribas) said that a level playing field between providers is needed. A differentiation should however be made between independent and tied intermediaries as the latter work under the responsibility of the lender.

Reine-Claude Mader Saussaye (CLCV) remarked that the consumer protection level is very different in Member States and needs to be improved to ensure a good base level of consumer protection across Europe. This could be achieved by harmonisation, but not necessarily maximum harmonisation. In France, credit intermediaries have improved their image due to an improved internal organisation.

Summing up the discussion, the panellists gave a short final statement. Mr Nyberg stated that it is very important that consumers understand who their lender is and that the lender stays responsible throughout the lifetime of the loan. Mr Kockelkoren said that it is important that lenders sell a suitable product. A functional approach is needed with regard to the different types of intermediaries, however, all should have some level of expertise, training and duty of care. Mr Ward stated that it is not possible to have one set of EU legislation for non-bank mortgage lenders but obvious gaps should be identified and closed. He added that the currently negative perception of securitisation should be revised. Mr Wignolle said that credit should be granted in a responsible manner and all actors in the distribution channel should be responsible. Mr Rumignani agreed with Mr Nyberg that consumers must know who their lenders are and added that differences between categories of intermediaries need to be taken into account when considering legislation.

5. VIEW FROM THE EUROPEAN PARLIAMENT

Malcolm Harbour, MEP, Chair of the Internal Market and Consumer Protection Committee (IMCO), European Parliament provided his views on responsible lending and borrowing.

He began by explaining that the IMCO Committee had been very much engaged in the issue of responsible lending and borrowing in the context of the Consumer Credit Directive. However, due to the Parliamentary recess, the Committee had not yet addressed newer developments.

With regard to the Consumer Credit Directive, the Parliament had been deeply engaged in discussions concerning the area of credit regulation and the requirements to lend responsibly. This was a major advance for the EU credit market, but was only agreed by setting a very high level of consumer protection. The provisions aimed at protecting the consumer from irresponsible lending and borrowing were among the most difficult areas in which the right balance was achieved. As a result, negotiations took a long time, showing just how difficult attempts to harmonise significantly different EU markets are.

In terms of information, IMCO spent a lot of time on this issue and insisted on standardised information to inform consumers and facilitate comparison. The idea of standardised information has been extended to other non-financial services areas such as timeshare. As regards responsible lending and the regulation of intermediaries, it is hard to get the balance right. Financial services providers should ensure that intermediaries do the job properly. On the cross-border exchange of credit data, it is clear that lender's ability to decide who to lend to relies on data from credit registers and information provided by consumers. However, this data is only valuable if used properly.

Mr Harbour was of the view that the Consumer Credit Directive is an important advance: it provides the first pan-EU framework for dealing with responsible lending. Transposition of the Consumer Credit Directive is spurring major reviews of the credit framework, including in the UK. Transposition of the Consumer Credit Directive therefore needs to be completed and its impact assessed to see how it works.

In terms of mortgages, the EU market is very diverse with different legal frameworks. There is no clear added value in developing cross-border mortgage markets. The Commission should look at the added value before considering any policy measures. Having said that, standardisation of information would be positive. As such, the Commission should think of pragmatic measures like asking Member States to apply the Consumer Credit Directive to mortgages.

Finally, on financial education, he stated that he was pleased to see that the Commission was acting on many of the Parliament's recommendations in this area. He mentioned that IMCO worked on an initiative report last year concerning improving consumer education and awareness on credit and finance, which called on the European commission and Member States to build on existing programmes and further encourage non legislative measures. Education in financial literacy and exchanging best practises between Member States will play an important role in addressing irresponsible lending and borrowing. Furthermore, IMCO has recently voted on a draft budget for Internal Market and Consumer Affairs, where it increased the amount of money available for financial education activities.

To conclude, he stated that high standards in responsible lending are extremely important for consumer and economic welfare. The EU does have a further role to play, but not necessarily a legislative one and there are lots of alternatives to legislation which should be considered and focused on. In 2010, IMCO is considering inviting members of national parliaments to Brussels to talk about what's going on in the area of responsible lending.

6. PANEL 3: ASSESSING SUITABILITY AND CREDITWORTHINESS

Moderator: **Elemér Terták**, Director, DG Internal Market and Services

Panellists: **Manfred Westphal**, Federation of German Consumer Organisations (vzbv)

Edward Harley, Retail Policy, UK Financial Services Authority

Joseph Delhaye, Vice President and Head of the Legal Department, Banque et Caisse d'Epargne de l'Etat (BCEE), Luxembourg

Didier Muraille, Member of the Expert Group on Credit Histories, Banque Nationale de Belgique

Jan Molenaar, Executive Vice President and Head of Domestic Lending, Rabobank Nederland

Mr Terták stated that lending can only be deemed as 'responsible' if granted on the basis of a thorough assessment of the borrower's capacity to repay, and if it is suitable for the borrower's needs and circumstances. To do this, lenders and intermediaries have to rely on the information that the borrower provides to them and on information they can obtain on the borrower's past borrowing behaviour, his credit history. There are also a great many diverging opinions on the use of different forms of credit data. And then there is the issue of 'dangerous credit products'. Some seem to think that some of the more recently introduced credit products such as self-assessment mortgages or interest-only loans are inherently dangerous and should be taken off the market. Others argue that these loans are a valid option, especially for people with irregular income flow, such as the self-employed or freelancers. Finally, the issues of assessments of suitability and creditworthiness must also be seen in the context of the prudential requirements for lenders.

Question 1 *Consumer representatives on the Expert Group on Credit Histories failed to endorse the final report due to concerns about data protection and the use of credit data. Similar concerns were voiced in a recent report published by the German Federal Ministry of Food, Agriculture and Consumer Protection. Do you not think that the increased use of credit data and/or credit scoring could enable lenders to act more responsibly? Do you think that other measures are therefore required to ensure that consumers obtain a suitable product?*

Mr Westphal stressed that the consumer organisations on the Expert Group on Credit Histories did not agree with everything as it appeared in the Final Report. In his opinion, the Final Report did not reflect the conclusions of the talks in the Group accurately and there were different views on data protection as well as the usability and relevance of credit data. He attributed this to the general imbalance between consumer and industry representatives in working groups with industry representatives usually having more resources, and thus being in a better position to draft meeting minutes etc. He concluded that it is difficult for consumer associations to get their points across.

He then turned to the importance of creditworthiness assessments, but also pointed out problems associated with scoring. Active, relevant and complete data is important for assessing creditworthiness to avoid misleading scores. He referred to evidence from a study on credit scoring in Germany that has found a high percentage (45 %) of inaccurate and incomplete credit reports. In addition, the transparency of how the scores were calculated was inadequate and thus not a valid tool. As a conclusion of the study, lenders should not rely too much on this sort of data and scores.

The next point addressed was product suitability. Mr Westphal pointed out problems with opaque and risky products. As specific problems in Germany, he mentioned usury, changes in terms and conditions, expensive payment-protection insurance products, problematic commission structures, revolving credit products, and 'legal spam'. In this context, he called for simpler products. Moreover, he pointed out that information about potential dangers of products is not adequate and the provisions of the CCD not sufficient. He suggested transposing the rules of the Directive for investment funds to credit and referred to the one-page standardisation as an example of good practice.

Mr Westphal subsequently pointed out that responsible behaviour of lenders should go beyond the pre-contractual stage and cover the whole period from first contact, through the advertisement until the credit is paid back.

Question 2 *The UK lending system has come under a lot of criticism for irresponsible lending policies. However, the UK is one of the few countries in Europe to have a clear 'responsible lending' obligation in place for all lenders. What has led to this apparent contradiction: a lack of understanding of what it means to lend responsibly or a lack of appropriate supervision/enforcement? How will you address these problems in your forthcoming mortgage review?*

Mr Harley began by clarifying that in the UK only secured credit is within the scope of FSA regulation while unsecured credit is regulated by the Office of Fair Trade (OFT). He pointed out that mortgage markets in the UK have worked rather well for a lot of people, particularly in the prime market which has features which suggest competition is working well. He then provided some figures on the UK market. At its peak in 2007, 15 % of mortgages had LTVs greater than 90 % and 5 % had mortgages with LTVs more than 95 %. Repossessions have been increasing in 2008 and are expected to increase further 2009. In 2007, 40 % of mortgage advances were self-certified. Self-certified mortgages are four times more likely to get into arrears. There have been problems but not everything is broken.

He pointed out that there has been an assumption that it is in the prudential self-interest of lenders not to lend irresponsibly. In this context, the UK has focussed on predatory lending which he defined as lending where there has never been any chance that the borrower can repay the loan. He argued that by and large this rule has worked. For the UK a sustained period of low inflation, low unemployment, property appreciation and consistent growth, meant that market confidence was high. Consumers were willing to take on ever increasing amounts of debt and lenders were happy to oblige, with some irresponsible lending as a result. Many factors were at play, but of note in the UK was securitisation as a wholesale funding source: this allowed lenders to transfer risk, reducing their incentive to care about default risk.

He pointed out that the FSA is carrying out a Mortgage Market Review the aim of which is a sustainable market for all participants which offers consumers flexibility and choice. The UK is looking at a range of possible tools. Analysis has shown that other countries use a wide range of tools including prudential requirements, lending thresholds, mortgage insurance obligations and various forms of product regulation. There is a 'complicated story' on the effectiveness of lending thresholds. In the UK, LTVs actually fell in recent years and cannot be considered as a direct driver of boom and bust. LTIs are a blunt indicator of affordability since there is no strong evidence of a link between LTIs and arrears. He also referred to the observation that LTIs have risen strongly in boom years. The FSA will publish a Discussion Paper on Mortgages on 19 October 2009.

Question 3 *What could be done to strengthen lenders' assessment of the suitability of a given product for a given consumer? Would suitability tests (à la MiFID), restrictions on loan to value or loan to income ratios help ensure that borrowers get a suitable product?*

Mr Delhaye highlighted the importance of trust and pointed out that the bank he is working for has recently increased both market share and loan portfolio. He explained his interpretation that lending is the coming together of lender and borrower in the consumer interest and his reasoning that banks have no incentive to sell unsuitable credit products, because lenders have no interest in non-performing loans. For example, Basel II increased the cost of risky loans and foreclosure procedures are very costly. Unless a bank originates to distribute, there is no point in irresponsible lending. He also described that products, e.g. 30 year loan, are designed to consumer needs or have evolved along those needs. Product regulation would reduce the variety of products and hamper innovation. He also emphasised the importance of financial education and teaching people to save. Mr Delhaye concluded with a comparison and possible conclusions of the suitability test in MiFID for the issue of responsible lending.

Question 4 *Do any changes need to be made to the current access to credit histories in the EU? How can credit registers help lenders (and intermediaries) make accurate creditworthiness assessments?*

Mr Muraille explained that credit registers exist in 26 Member States (all except Luxembourg). The function of credit registers is to collect data on credit granted and provide information to lenders (as raw data or in form of scores) while the lending decision remains with to the lender. He stressed that credit registers are a critical element of the financial infrastructure but are useless if not used by lenders, so suggested mandatory consultation. He pointed out that data content and data protection principles are fragmented across Europe. Subsequently, he addressed the issue of the rationale for cross-border data sharing and concluded that data sharing seems currently not necessary

since there is little appetite for cross-border credit by borrowers or lenders. Regarding the issue of positive/negative data, he concluded that databases that include positive and negative data are superior to databases with only negative data. He added that another problem of cross-border data sharing is the varying definition of defaults across countries. Regarding cross-border access to credit registers, he also pointed to the market developed solutions that do already exist.

Mr Muraille highlighted the importance of accurate data and explained the Belgian practice where the first time negative information gets into the register, a letter is sent to the consumer by the register for information and verification purposes. He explained that it is important that data is comprehensive and up to date, and the scoring system reliable in order to support the lender with the lending decision and to help with issues such as fraud detection.

Mr Muraille then provided some further details on the situation in Belgium: in Belgium, consultation of the credit register before the credit decision is mandatory and the information from the register is available for the data subject free of charge. The register ensures full coverage and exhaustive information with all types of credit should be recorded. Moreover, there is an external Committee including all relevant stakeholders attached to the register.

Question 5 *Are there such things as inherently unsuitable credit products for retail clients or is the problem more of the suitability of a given product for a given consumer?*

As far as retail credit is concerned, Mr Molenaar pointed out transparency problems, hidden costs and fees as well as features such as lock-ins that may render a product unsuitable for certain clients. He concluded though that there is no such thing as unsuitable products, but rather that a product may be unsuitable for certain customers. He addressed suitability for a given consumer as the main issue that includes three aspects: the product should be in the best interest of the individual consumer; the consumer needs to understand the product; and the long-term affordability of the product ensured. Regarding the first aspect, the best interest of the consumer, the 'Know your customer' principle applies and lender should be able to prove that the product was in the best interest of the consumer. He pointed out that keeping evidence in the files works very well for consumers as well as lenders. As far as consumer understanding is concerned, he referred to the information provision that currently comprises more than 150 pages in the Netherlands and may cause an information overload for the consumer. The concept of long-term affordability is codified by the 1989 Voluntary Code of Conduct by the mortgage industry that all mortgage providers in the Netherlands have signed up to. He referred to long-term affordability as a safeguard for suitability whereby loan-to-income ratios (LTIs) play a key role in assessing long-term affordability. The approach in the Netherlands is different from the UK approach and has worked very well so far. The Dutch approach includes standards to be followed from the National Institute for Consumer Budgets. He concluded that these rules and standards have prevented the emergence of a subprime sector in the Netherlands.

Questions/remarks from the audience

Klaus Schlee of SCHUFA pointed out the importance of credit registers in general. SCHUFA works with positive data as well as negative data. Subsequently, he made three additional points. First, with regard to the quoted study on credit scoring in Germany, he challenged the methodology applied. He also emphasised that there is no obligation to deliver information to the register and that a full coverage of potential borrowers cannot be achieved. His second point was about transparency and that his company provides 24/7 online system granting access to consumers. They have experienced 500 000 users in four years, which he described as rather small number given that there is a data set with 65 million entries. He added that SCHUFA has several hundred employees exclusively for the purpose of dealing with consumer's requests. Finally, he rejected the point made earlier that credit scores tend to raise prices for consumers and highlighted the validity and non-discriminatory power of scores. He added that credit registers and referencing companies in Germany are supervised by the financial regulator and quoted the *Doing business 2008* report ('Getting Credit') by the World Bank that pointed out the importance of credit registers for the economy.

Dirk Stein of the Association of German Banks pointed out that, in practice, banks do not rely exclusively on credit scores from databases for the creditworthiness assessment, but also on other methods, i.e. income verification, housekeeping bills. He put into question the point made by Mr Westphal that there is a problem with usury in Germany, stressing that there is not a single case of usurious banking practices currently before the German courts. He also challenged the point made about the prevalence of revolving credit products in Germany and said that revolving credits play virtually no role in Germany because of the widespread use of overdraft facilities. He furthermore remarked that he is not aware of the initiative to develop responsible lending standards in Germany that had been mentioned by Mr Westphal.

Mr. Zarco Pleguezuelos of ADICAE remarked that consumers are not properly represented in consultative panels. He furthermore pointed out that lenders must prove suitability and legislation should be introduced whereby the onus of proof should rest with the lender. The third point he made was about tying practices. He stated that there was a lack of transparency, e.g. where credit was sold together with life insurance including prepayment of premiums.

Andrew Heywood of the UK Council of Mortgage Lenders described mortgage markets as national markets with national issues that require national solutions. Although there is evidence of poor practices across Europe in retail lending, there is no need for an EU solution.

Mr Dieter Korczak (Institut für Grundlagen- und Programmforschung) introduced himself as the author of the study 'consumer information scoring' on the quality of credit reports and scores in Germany that has been referred to several times before in the hearing. He referred to evidence suggesting that the default rate of loans is generally rather low across Europe and only 2 % in Germany. Unemployment and divorce main reason for default. He said it was not as much data as possible that is important but rather 'relevant' data (the key variables are income, expenditures and costs of living). He also remarked that credit registers never provide evidence for the reliability of their systems even though it would be easy to do so.

Summing up the discussion, the panellists gave a short final statement. Mr Westphal talked about the need for targeted data collection. He also re-emphasised the prevalence of revolving credits and other risky products in Germany, and pointed out that the providers of such products are often foreign rather than domestic banks. He referred to the standards of responsible lending that are currently being developed by his organisation in cooperation with some banks. Mr Harley pointed out the possible impacts of lending thresholds. He referred to the subprime market, citing evidence indicating that subprime lending is not per se problematic, and that restrictions could potentially lead to exclusion. Mr Delhaye talked about the changing landscape in the industry and stressed that the concepts of creditworthiness and suitability should not be mixed up: while creditworthiness is an assessment to be carried out by lenders, suitability is closely linked to advice. Mr Muraille reemphasised the importance of credit registers as service providers for banks and lenders that are obliged to assess creditworthiness. Mr Molenaar remarked that there is no European mortgage market and pointed out that every country is different.

7. MEGLENA KUNEVA, CONSUMER COMMISSIONER

Commissioner Kuneva's speech is available at: http://ec.europa.eu/commission_barroso/kuneva/speeches/responsible_lending_and_borrowing_030909_en.pdf.

8. CLOSING STATEMENT: JÖRGEN HOLMQUIST

The closing statement was given by Jörgen Holmquist, Director General, DG Internal Market and Services. The speech is available at: http://ec.europa.eu/internal_market/finservices-retail/docs/credit/resp_lending/speech_holmquist_en.pdf.