

Study on interest rate restrictions in the EU

Final Report

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Submitted by

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Executive summary

This study provides the European Commission with a comprehensive **inventory** of the types of interest rate restrictions that exist in the EU Member States (Part 1) and gives an assessment of the **impact** of these on both credit markets and people (Part 2).

- **Part 1** offers an inventory of interest rate restrictions in the EU Member States and details the mechanisms and levels at which interest rate ceilings are set in those countries with such a regulatory structure in place.
- **Part 2** discusses legal IRR as interventions in the market and its effects on competition and on social and economic welfare.

Both parts relate to each other through their **common definition** of Interest Rate Restrictions, (referred to as IRR throughout this study), and the purpose of IRR which is to ensure that consumer credit markets function well and that they promote the social welfare of people by means of appropriate and adequately priced credit products.

The report indicates that there is considerable variation in the attitude of EU Member States towards the regulation of consumer credit prices. In addition, even where there is a desire to regulate prices, **Member States vary considerably in the extent to which they seek to achieve this and the methods that they adopt:**

- In some Member States strict interest rate caps are defended because credit at a high price may increase **consumer insolvency** and reflects the **mal functioning of markets** especially for small amounts of credit.
- In others, the absence of such regulations is justified primarily on the basis that caps would **reduce access to credit, especially for people with moderate means**.

The report does not provide a **one-dimensional answer** to these questions.

- The concept of **usury** is one uniform underlying theme. The patterns of existing IRR are all derived from this historical principle. Interest derived from credit has been morally rejected and even criminalised where it amounts to the exploitation of personal weakness but has got different legal forms according to the differences in the development of consumer credit markets.
- Public control of credit and the use of credit by consumers, as well as the general attitude to consumer credit, remain diverse and do not lend themselves to simple assumptions and **solutions**.

The report therefore provides information as to the regulatory choices, the role of legal harmonisation in EU consumer credit law and information as to the factors which may favour one or the other solution.

In addition to **written material** in the form of case law, legislation and legal literature, economic research and **statistical data**, both parts of the report rely on responses to **three questionnaires** containing open and closed questions received from a legal expert in each of the 27 Member States, as well as responses from 20 individual providers, from 34 provider associations, from 47 consumer organisations, from 44 public authorities in all Member States and from 12 other institutions.

Legal part

The legal part of the report provides a consistent inventory of existing IRR in EU Member States and shows how they are designed and function within the different legal systems.

In its opening **theoretical section**, the legal part of this study defines what amounts to IRR in the context of the various regulatory systems and legal frameworks and cultures.

- The term '**Interest Rate Restrictions**' refers to all legal rules that limit the price of credit contracts. In other words, the study is concerned with existing laws and legal rules and their application in limiting charges imposed by lenders, directly or indirectly, for the use of capital by borrowers.
- As far as the terms used to describe credit-related phenomena are concerned, the report uses the **language of the EU Consumer Credit Directive** (Directive 2008/48/EC, referred to as 'CCD 2008' throughout this study)
- But we do not use the CCD 2008's product-specific restrictions to define its **scope**.

Three precautions have been taken in arriving at an analysis of **the implications of such law to this economically defined phenomenon**

- **Legal rules** are only one factor in determining access and pricing in the market
- The existence of legal rules as such does not reveal how **effective** these rules are
- The same legal concept may be used quite differently in different **legal cultures** which have remained separate for centuries.

This has led to the **definitions** set out in Figure 1 of this report and in the questionnaires. The types of credit have been broken down into: **general-purpose credit** (instalment, revolving, small secured, micro) and **mortgage credit**. Interest rate restrictions (IRR) have been distinguished into direct IRR **on the rate level** (contractual, default), and indirect IRR on the **methods of calculation** (APRC, compounding, variability), **other cost elements** (contractual charges, default charges), and on **other credit parameters** (instalments, life-time, amount of credit).

While direct IRR limit the contractual interest rate or the amount of interest that can be charged indirect IRR have a restrictive impact on the cost of credit. With respect to indirect IRR, all Member States provide for rules which contain some restrictions on the pricing of credit.

With direct IRR there is a big difference between the **historical concept of usury and some forms of interest rate ceilings**.

- All Member States subscribe to the principle of "**good morals**" or "**fairness**", which explicitly forbids usury, under criminal as well as private law, or implicitly incriminates the intentional exploitation of the weakness of another person at an individual level through extortionate pricing, especially in relation to credit.
- With the exception of two Member States (Ireland and Romania), all have IRR in relation to **default interest**.
- 14 Member States had either some form of an **absolute ceiling** (Greece, Ireland, Malta) or a **relative ceiling** based on a reference rate (Belgium, Estonia,

France, Germany, Italy, the Netherlands, Poland, Portugal, Slovakia, Spain, Slovenia).

The **concept of “usury”**, “extortionate pricing” in credit or “unfair credit” is mostly linked to the interest rate charged and to exploitation of the borrower. In some Member States it may be used more indirectly in the context of criminal lending (Italy, Malta, Estonia, Denmark), anatocism (Romania, Luxembourg) or it may simply be applied to high-priced loans (Portugal, France, Belgium, Spain, Slovenia, the Czech Republic, Slovakia, Hungary, Ireland, the UK and in German case law).

The **body of law governing IRR** still covers rules inherited from past centuries, which may have been modernised or adapted to modern usage, or which may just remain dormant. Such rules reflect the **traditional ban on interest**, which operated from ancient times until the 19th century, as well as rules derived from the end of the 19th century, when interest was regulated to protect **agrarian interests** against money interest, rules on illegal lending practices, and modern market-driven rules intended **to prevent over-indebtedness** and provide consumer protection.

While modern interest rate ceilings are typically imposed administratively, courts in Germany have transformed the ancient subjective principle of good morals into a modern objective interest rate ceiling, a process that would in principle be open to Member States with no interest rate ceiling; some initial forms of this may also be identified in Estonia, Spain and Sweden.

- From the perspective of the contractual interest rate itself there are three countries with an **absolute ceiling** in the tradition of usury, and this does not seem to have had much impact on the economy (Greece, Ireland, and Malta).
- Countries which use **relative interest rate ceilings** based on an average market rate, multiplied by a quota such as that applied in France of one-third, or based on a money market rate multiplied by four, as in Poland, have developed fairly new systems with a high degree of effectiveness (Belgium, Estonia, France, Germany, Italy, the Netherlands, Poland, Portugal, Slovakia, Spain, Slovenia).

The **spread of interest rate ceilings** is quite high.

- It may range from as high as 453% pa for a small loan in Slovenia to a cap of 13.2% pa for a long-term loan there, while in France the spread between ceilings for the different forms of credit was between 5.72% pa and 21.63% pa as at March 2010.
- Some countries provide such ceilings **only exceptionally**: for example in Spain where they apply only to overdraft credit and protected housing loans; in Ireland where they are confined to credit unions and moneylenders; in Greece to non-banks; in the Netherlands where mortgages are excluded; and in Malta where further exemptions apply.
- Countries which use relative interest rate ceilings have developed **classes of credits** defined mainly by credit type as a basis for fixing the reference rate, which may be derived from national markets or from the EU (Belgium).

With regard to **default interest rates** many countries provide statutory rates which apply where no other rate has been agreed.

- Austria, Belgium, Denmark, France, Finland, Greece, Hungary and the UK use the **contractual interest rate** as a maximum.

- Bulgaria, the Czech Republic, Denmark, Estonia, Finland, Germany, Italy, Luxembourg, Poland, Portugal, Slovakia, Spain (overdrafts only) and Slovenia provide a **statutory external ceiling**.

With regard to **enforcement**, many systems apply.

- At the level of **supervision**, the central bank may have responsibility (Italy, Portugal), with lending restricted to institutions licensed by the bank, by a licensing authority (such as a Ministry as in the case of Belgium or a specialist agency in the UK, France, Netherlands, Estonia, Germany), by a consumer protection authority (Ireland, Bulgaria, Latvia), by a Market Inspectorate (Slovenia), by a Consumer Ombudsman or by a Financial Authority as in Finland.
- **Civil law sanctions** include the reduction of the interest to either the principal or a permitted rate of interest or the nullity of the contract with the possibility of judicial allocation of the obligations under the contract.
- Other forms are **criminal sanctions** or the **loss of a licence**.

The **effectiveness** of direct IRR is related to whether legal rules manage to be **self-executing** since official enforcement mechanisms are costly and only able to cover a minimum of cases directly.

- Law on paper ("in the books") only creates law in practice ("in action") where it serves as a guideline for individual **orientation**, as a **threat** where breach leads to 'naming, blaming and shaming' in the market or where it serves as an effective **barrier to entry** into the market.
 - **Private law** rules are closer to the consciousness and morals of people but require private investment to enable access to justice.
 - **Administrative rules** have no enforcement cost for consumers but depend of the existence of sufficient and efficient administrative power.
 - **Criminal sanctions** are often an exaggerated barrier and are difficult to apply to the morally indifferent behaviour of profit maximisation, which may favour a split between the mainstream and factually unregulated shadow markets.
- For IRR in consumer affairs it is important that the rules are **clear**, discriminate well between right and wrong, do not depend on individualised administrative or court decisions case by case and are **easy to generalise and apply**.

With regard to these criteria, the survey found significant **differences in assumed effectiveness** according to the legal form of the regulation in question.

- General principles of **good morals** and good faith in private law are close to individual consciousness but produce cases with little effect on the general level of interest rates in the market,
- Administrative rules of **prudential regulations** in bank supervision and access, if not combined with private law sanctions and the involvement of specialist consumer agencies, effectively exclude outsiders and illegal lenders but have less impact on mainstream providers.
- Well placed seem to be strict and morally neutral **interest rate ceilings** set administratively under private law. In this regard, Germany is an exception,

where such a system has been developed purely on the basis of the general principle of good morals under private law. But such systems are particularly exposed to circumvention through purely nominal pricing and ancillary services.

An **assessment of all responses** from all stakeholders showed quite strong agreement even between providers and consumer organisations, as to the overall effectiveness of their national IRR in regulating credit prices on the market. The following classification reflects only a general assessment and does not claim to provide facts or representative opinions, merely indications. It should be noted, especially where low effectiveness is assumed, that it included responses from Member States with no significant IRR.

Direct IRR are seen as follows (average grade from 1 to 5 in parentheses).

- (1) France, Belgium, Portugal: **very effective** (4.5)
- (2) Cyprus, Denmark, Finland, Italy, Netherlands, Slovenia: **effective** (4.0)
- (3) Poland, Austria, Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Slovakia, Slovenia, Sweden, Romania: **indifferent** (3.0)
- (4) Spain, Germany, Greece, Hungary, Luxembourg, Malta, Slovakia, UK, Ireland: **less effective** (2.1)
- (5) Ireland: **not effective** (1.0)

The results coincide roughly with the general assumption that strict interest rate ceilings are the most effective, especially if they have been in place for a long time, whereas general principles alone appear to give rise to concerns as to effectiveness.

IRR as a form of price regulation must use a **comprehensive and effective interest rate** which effectively covers all cost elements, calculated objectively, which are imposed on the consumer in relation to a credit agreement.

- Historical IRR such as anatocism or absolute and even some relative legal interest rates on default still refer to **nominal interest rates**. They do not cover additional cost elements or disadvantageous rules on compounding and calculation. They are open to circumvention and thus additional rules are needed to fill these loopholes.
- Modern IRR rate ceilings refer to the already harmonised price disclosure rules for the **APRC in Annex 1 of CCD 2008**. This solves a number of these problems but also import others.
 - o The **method** of calculation and the definition of compounding periods are restricted to the use of the actuarial method.
 - o **Fees** charged separately from interest within the same contract or for brokerage must be included.
 - o **Rent** agreements (financial leasing) or **deferred payments** (hire or instalment purchase), in which time prices are applied that are not defined as interest in the conventional sense, are also covered.
 - o While disclosure rules regulate the APRC with regard to competitors, rate ceilings regard the factual burden a borrower is able to carry. This is why the focus on voluntary inclusion of additional cost elements may be good for price disclosure while leading to circumvention in usury law.

Some exceptions in price disclosure law to certain forms and amounts of credit are **not applicable to IRR** and even undermine their effectiveness where they are most needed. Nine Member States therefore have different regimes while four Member States still apply

disclosure exemptions to IRR and seven will adapt disclosure rules to the needs of IRR legislation after implementation of CCD 2008.

- **Small amounts** of credit are expressly covered by IRR in Belgium, Estonia, France, Germany, the Netherlands (recent inclusion).
- **Revolving credit** is addressed specifically in Spain and covered without exemption by IRR in all Member States.
- **Short-term** loans are included but were allocated significantly higher interest rate ceilings where IRR is specific to certain products, as in France. The ceiling in Slovenia is extremely high.

As far as the inclusion of **cost elements from ancillary services** is concerned, the debate about IRR resembles the debate about the APRC and whether such services provide for a special advantage in addition to the loan and whether they have been contracted voluntarily. These questions are the subject of controversy in all Member States with IRR, which remains unresolved.

- **Payment protection insurance** is sold with credit on a large scale, especially in the UK, France, the Netherlands and Germany, and significantly increases the level of payments due from the consumer. Experts and consumer advocates claim that hidden kick-back provisions and the financing of the premiums through the banks resemble charges which are already covered by the definition of the APRC.
- **Combined endowment credit** which diverts loan repayments to an investment product (capital life insurance, construction savings plans) with lower interest earned than through direct repayments reach higher prices if both products are seen as one.
- **Fees for cash withdrawal** of small amounts of credit card credit can increase the burden of payments significantly.

A number of Member States have **indirect IRR** which aim to address the additional cost separately.

- The traditional principle of **anatocism** is still applied, especially to default interest but with decreasing effect.
- Belgium has developed a special regulation of reference rates for **variable credit**.
- Poland has a general **IRR for fees**. Special provisions which allow the reduction of fees are in force in Belgium, Germany, the Czech Republic, Estonia and Malta.
- Some Member States, such as France, Finland and Italy, allow judges to waive default interest or even **reduce the principal** in case of default.

The **CCD 2008** has had an impact on IRR in practice. Implementation had been completed by only five Member States by March 2010, but in another 12 Member States a draft was imminent.

- Only a few countries (Portugal, Netherlands, and France) have **used the implementation** expressly to introduce or change IRR.
- In many countries, implementation had a strong **indirect effect** on the selection of financial products for the application of IRR since most tend to harmonise interest disclosure rules with rules restricting interest.

The idea of “**(ir-)responsible lending**” developed in the 2002 draft of the Directive and repeated in the recitals of the final version in 2008 requires certain restrictions with regard to over-indebtedness and thus comes close to being a form of IRR.

- The UK and Finland have incorporated this principle into their rules.
- Some **providers** and provider associations use it to describe their overall behaviour in consumer credit.
- Some Member States have used its impact on assessing the **creditworthiness** of consumers, requiring or recommending certain loan-to-income ratios which have an indirect effect on interest rates through risk-based pricing.

The common principles of **fairness** in competition, standard contract terms and consumer information law, already harmonised through the respective EU Directives, do not cover the pricing of credit. Its underlying legal concepts of transparency and fairness are more procedural than substantive. They regard the way products are marketed and serviced while the questions of IRR, especially usury and high prices, are left to the “**fundamental principles of national regulation**” where in civil law “good morals” are applied. Art. II-7:301 of the Draft Common Frame of Reference define such principles in future EU-contract law as “principles recognised as fundamental in the law of the Member States”. But the common reference point, assumed as a market with functioning competition, has led to the application of the fairness principle with regard to IRR in some cases as well. The European Court of Justice has just ruled that a Spanish law could also extend the EU concept of unfairness to IRR (EJC Dec. of June 3, 2010 C-484/08).

- Rules concerning the assessment of the debtor’s ability to pay are seen as part of responsible behaviour in fair competition in the Czech Republic, Estonia and Ireland.
- The UK and Finland’s approach to responsible lending includes fundamental principles as well as fairness principles. Estonia and Ireland explicitly describe high cost of credit as potentially “unfair” in their legislation. Also Germany used standard contract term law to void clauses on interest compounding.

Economic part

The economic part of the report aims at explaining the economic, social and financial consequences of interest rate restrictions. Due to the complexity of market phenomena and because of a lack of comparable datasets across countries, it is not possible to identify a set of unambiguous effects. However, the report examines a number of hypotheses concerning the impacts of IRR and presents the available data in relation to these, as well as provides a theoretical framework for understanding the effects of IRR. Within the testing of the hypotheses the economic part of the report refers only to direct IRR in the form of interest rate ceilings. Furthermore, because IRR in 5 of the 14 Member States with ceilings have to be considered insignificant mainly due to their scope of application (Estonia Greece, Ireland, Malta, and Spain) analysis has centred on the group of countries with significant IRR in place - a group which is therefore comprised of 9 Member States (Belgium, France, Germany, Italy, the Netherlands, Poland, Portugal, Slovakia and Slovenia).

The **theoretical discussion** details the reasons for *differential interest rates* as well as the effect of interest rate restrictions on *capital allocation*.

- The level of interest rates charged on consumer credit depends on the **market level of interest rates, the bank's margin and a component which compensates the lender for the risk of a borrower's default**, which in turn depends on the collateral, the credit history and the income/wealth situation of the borrower. Due to the fixed costs to each loan, small amounts of credit may be relatively expensive. As the risk of low-income borrowers is perceived to be high, lenders charge these customers higher interest rates.
- Legal interest rate restrictions reduce the lender's opportunity to charge risk-adjusted costs. Obviously, and depending on the level at which the restriction is set, this decreases his willingness to lend. As a consequence, **high-risk borrowers may be denied credit access in the presence of legal interest rate restrictions**.

To discuss the implications of these supply-side mechanisms, the theoretical discussion also focuses on consumer credit, taking into account both neoclassical and behavioural views of *consumer choices*.

- Acknowledging that consumers make choices according to their own preferences, we demonstrate in a classical framework how a decision to finance consumption by credit arises from the **preference to smooth consumption** over time. This makes consumer credit different from other types of credit (eg. for investment purposes), which are taken out for a project to earn a positive (monetary) return. The neoclassical view postulates that, when households decide about their consumption, saving and borrowing, they not only consider their *current* income but also their expectations about their *future* income. High interest rates are incorporated into the consumers' choice of their optimal consumption behaviour.
- This neoclassical view has an important implication for credit *demand*: **no borrower ever borrows more money than he or she can reasonably expect to pay back** in future periods. Credit demand is thus *not* simply the equivalent of a shortage of funds. While it is possible to compensate a *temporary* negative income shock by means of credit, the neoclassical model does *not* provide a rationale for credit as a means to "make ends meet" for deprived households who do not have a realistic perspective of an improvement of their situation.
- *Behavioural* biases (such as wishful thinking or underestimation of exponential growth) may lead to systematic (and predictable) deviations from rational behaviour which lead to suboptimal consumer decisions. **These biases challenge the view that borrowing decisions are an unambiguously rational consumption optimisation**.
- As a consequence of *wishful thinking*, consumers' beliefs about *event risk* may be distorted: they may be willing to borrow money even when it is rather unrealistic that their future income will be sufficient to repay the debt. Consumers may also *underestimate the true cost of borrowing*. This might occur because they hold erroneous beliefs about the actual time period during which they will use the credit. It might also stem from conceptual difficulties to understand the effect of interest rates compounding over longer horizons (*underestimation of exponential growth*). In these cases, **consumers' credit decisions are not necessarily optimal**, and may ultimately be an important driver of over-indebtedness.
- If consumers' credit decisions are optimal, it is advisable to remove barriers to credit access. If they are *not necessarily* optimal, one solution would be to accept barriers to credit access for selected groups of the population. As interest rate restrictions *theoretically* reduce credit access, one can therefore either *oppose* interest rate restrictions or *endorse* them, according to the extent of rationality

one assumes. **However, there is a trade-off between reducing credit access for irrational or uninformed consumers** (which is beneficial, as these are protected from becoming over-indebted) **and excluding consumers who are able to make appropriate credit decisions** (which is negative as it reduces their options to choose from). Whether subject to strong cognitive biases or not, consumers with debts will nevertheless be subject to external factors that can put pressure on their ability to service their debts to maturity.

In the light of this trade-off, it is important to evaluate whether the mechanisms postulated by theory are observed in reality and to what extent their effects are economically important (and not just minor compared to other influencing factors). To do so, we first conduct a **survey of existing studies on interest rate restrictions**, which reveals the following:

- Numerous empirical studies have been devoted to determining the economic impact of interest rate restrictions. However, **most of these studies are on the United States**, not on European countries. This has an advantage for the examination of the economic effect of interest rate restrictions: the studies compare legally and economically relatively similar entities (ie. the U.S. states) which may regulate interest rates in different ways. The observed differences between the considered entities can then - with some caution - be identified as the effect of interest rate restrictions. Due to the heterogeneity of EU Member States, a comparable exact identification for the EU is not feasible.
- However, it is a severe disadvantage for the purpose of this report that these studies look at US interest rate caps, which are relatively low (eg. 12%). **In Europe, interest rate caps are frequently at higher rates.** The results obtained for low levels of interest rates cap (eg. reduced credit access) need not necessarily be transferable to higher levels of interest rate caps.
- Comparisons of different states in the United States of America with different interest rate regulations typically suggest that **tighter interest rate restrictions lower credit access for low-income customers as well as total consumer credit.** Some studies also indicate that small amounts of credits are less often available in the presence of IRR. However, they tend to **deny a relationship between interest rate restrictions and the interest rate level for average (non-high-risk) customers.**
- Studies on payday loans, in particular in the USA, point at two further aspects: credit is not per se beneficial (especially in the long run). Furthermore, when thinking about effectively banning a financial product, **it is crucial to take into account evasion strategies of potential borrowers.**
- Unlike in the United States, any study which compares EU Member States will face severe problems identifying the exact effects of interest rate restrictions, as observations are also determined by a multitude of other economic and regulatory factors. Existing **policy-oriented reports on countries of the European Union argue therefore either on theoretical grounds, or provide empirical facts which cannot be unambiguously attributed to interest rate restrictions.**

To demonstrate the heterogeneity of consumer credit markets across the Member States of the European Union, and to provide a comprehensive picture of their importance, we give an **overview of the consumer credit markets in the 27 EU Member States**. We discuss the markets for total credit to households, housing credit, and consumer credit (without housing) for all EU 27 countries. Where illustrative, we also provide separate analyses for EU 25 or EU 15 countries or the New Member States.

More detailed information is also given for six countries, which serve as **case studies** in this report: Germany, France, the Netherlands, Poland, Sweden and the UK. The reasons behind this choice include diversity in terms of economic characteristics, financial cultures, size and attributes of the consumer credit markets, as well as the heterogeneity of the legal framework of interest rate restrictions in these countries. It is this heterogeneity in the chosen countries which allows us to draw conclusions with regard to the effect of interest rate regulation on consumer credit markets and over-indebtedness, and to appreciate reasons for different outcomes in credit markets beyond interest rate regulation. The case study countries can be summarised as follows:

- The countries selected represent more than half (54%) of the population of the EU 27. Furthermore, they accounted for **nearly two-third** of the volume of total credit to households and consumer credit to households in EU 27 countries at the end of 2008.
- The six countries included in our study differ considerably in **market size and market structure**: half of the selected case study countries – the UK, Germany and France represent the countries with the largest national consumer credit markets. The remaining case study countries included in the study - Poland, Sweden and the Netherlands make comparatively small contributions to the overall volume of credit to households in Europe. The former 3 countries are also the **most populous** countries in Europe and are included in the survey alongside smaller countries.
- The selected countries have different consumer credit regulations and, in particular, **different levels and forms of IRR**. Included in the study are Sweden and the UK. Neither of these countries have interest rate restrictions. In contrast, in Germany and France regulations of consumer credit interest rates have been in effect for a long time and in Poland interest rate caps were only recently introduced.

To guide the reader of this report through relevant issues regarding interest rate restrictions, we consider a set of different hypotheses. For a **discussion of these hypotheses**, we summarise existing evidence from the *literature*, and derive conclusions from the *collected data*. In addition, we consider the *responses of questionnaires answered by particular stakeholders* in the consumer credit market, such as public authorities, consumer associations, providers and provider associations. The survey enables us to learn from stakeholders' experience with regard to the effect of interest rate restrictions (or lack of thereof) on the credit markets in the respective countries. It also allows a comparison of the answers from stakeholders in countries *with* IRR with the answers of those from countries *without* IRR, and a qualitative discussion of the differences. The inclusion of heterogeneous stakeholders (regulators, consumer organisations, provider associations) will enable us to consider potentially divergent perspectives about issues in question in a balanced way. Accordingly, we base our judgement of the hypotheses on several sources: the interpretation of existing data, previous empirical evidence, as well as the information from Stakeholder Questionnaires.

The first hypothesis (**H1**: *IRR reduce credit access, in particular for low-income borrowers*) is generally found to be *plausible*:

- High-risk borrowers requesting small-amount credit can only be served when a certain threshold interest rate is exceeded. Hence, they may not be served credit in the presence of IRR.
- One needs to keep in mind that, due to the relatively high levels of interest rate ceilings in most European countries, the scope of the interest rate restrictions is not expected to be equivalent to the ones documented in the US a few decades

ago. Rather, it is likely that access to mainstream credit (including overdrafts and revolving credit) remains rather unaffected by IRR, while there may still be missing credit options to low-income borrowers which are served in the high-cost credit segment in some countries.

- Note that the *desirability* of such credit access to this specific population group is subject to political controversy.

In the light of our analysis, a second hypothesis (**H2**: *IRR lead to a decline in the volumes of consumer credit granted*) appears *unlikely* to hold in an economically significant way.

- The relevant market segments of high-cost credit (which are most affected by IRR) only constitute a relatively small fraction of the entire consumer credit market in which they exist. A lack of these market segments is unlikely to lead to an economically significant drop in the volume of credit markets, as the latter is affected by a multitude of other factors, as well.
- Economic activity is unlikely to be significantly supported by the presence of high-cost credit (ie. the absence of IRR).

Hypothesis **H2a** (*Without IRR, more product types exist in the market*) appears *plausible*:

- Countries *without* IRR tend to have a higher prevalence of personal loans/auto loans than countries *with* IRR. It is also likely that interest rate restrictions prevent the market entry of one or more forms of high-cost credit.
- A relationship between the importance of certain credit types and interest rate restrictions is unlikely to be purely mechanistic. Rather, lower levels of consumer credit and the tougher regulation of credit (including IRR) may both be consequences of a third factor - the country's attitude towards credit.

With respect to **H3** (*IRR lead to credit from non-bank sources, such as paying bills late*), our results remain *inconclusive*.

- Some argue that the existence of high-cost credit helps households to avoid obtaining credit from (potentially expensive) non-bank sources, such as utility providers. However, it does not appear that there are systematic differences in lending from non-bank sources between countries with and without IRR.

A related claim in the context of interest rate restrictions is addressed in **H4** (*IRR lead to a substantial illegal market in lending*).

- There is no convincing comprehensive data to evaluate this hypothesis. Due to this lack of data, we evaluate the evidence on **H4** to be *inconclusive*.

The related hypotheses **H5** and **H5a** address the effect of interest rate restrictions on the *level* of over-indebtedness and on its *growth rate* after an economic shock, respectively.²

- We conclude that a direct influence of interest rate restrictions on the level of over-indebtedness, as **H5** suggests, is *unlikely*.

² **H5**: *The lack of IRR leads to a higher level of over-indebtedness*; **H5a**: *The lack of IRR has particularly adverse effects on default rates/over-indebtedness in the presence of negative shocks (eg. recessions) to the economy.*

With respect to **H5a**, we obtain *inconclusive* results: the most current figures do not reveal a particularly pronounced increase of over-indebtedness in the aftermath of the financial market crisis.

- However, there are no official data covering the years 2009 and 2010, and the views collected from stakeholders indicate that there might be a link as postulated by **H5a** in those years. We therefore recommend re-evaluating this issue in the next year when the relevant data are available.

With respect to the hypothesis **H6** (*The average consumer - or even more so: low-risk consumer - would be granted cheaper credit in the presence of IRR*), we find *inconclusive results*.

- Due to the lack of micro data on individual credit cost before and after the introduction of IRR, we focus on average interest rates. Drawing on these data and findings from the Stakeholder Questionnaire, there is no unambiguous evidence that average rates are declining, as **H6** postulates.

In contrast, it appears *plausible* that **H7** holds (*IRR lead to increased charges as providers will try to compensate the reduced interest revenues by increased charges*).

- There are examples from different countries illustrating that providers react to regulation by charging fees for which the regulation does not apply.

The evidence on **H8** (*IRR represent barriers to consumer credit market integration*) is *inconclusive* for two reasons.

- Firstly, it appears that it is not the mere presence of an interest rate restriction, but rather the *variety* of IRR (presence and non-presence) that are potentially an impediment to market entry.
- Secondly, the institutional setting is also diverse across countries along several other dimensions, such that it is hard to assess how important interest rate restrictions are in this environment.

Hypothesis **H9** (*IRR lead to lower levels of competition in the consumer credit industry*) is found to be *unlikely* to hold, as the level of competition differs (according to several criteria) across countries regardless of the presence of IRR.

- It has also been documented in other studies that there is a low level of competition in high cost credit markets in the UK, a country without IRR in these segments. This also deemphasises the role of interest rate restrictions in the context of competition.

The last hypothesis **H10** (*IRR lead to a convergence of all consumer credit interest rates at the level of the interest rate cap*) implies that providers use an exogenously given interest rate cap to coordinate their (non-competitive) price setting at a rate just below the cap. Other studies have found some evidence on this issue. We demonstrate that the results on this hypothesis are *inconclusive*:

- Whether or not the phenomenon captured in **H10** occurs crucially depends on the market structure and the exact way in which interest rate restrictions are implemented.

In summary, we find that there are less clear-cut implications of economic significance of interest rate restrictions than it is sometimes argued. It is apparent that IRR do shape the supply side of the consumer credit market in three respects:

- Firstly, it is likely that the existence of interest rate restrictions excludes some customer groups from credit access (which might or might not be an explicit *objective* of the introduction of IRR).
- Secondly, there might be a reduced set of credit types, as some credit types with very high interest rates are not offered in the presence of interest rate restrictions.
- Thirdly, one needs to keep in mind that suppliers can (to some extent) structure their credit product in a way so that the existing interest rate regulation does not apply.

We also conclude that many observations on credit markets are not only driven by regulatory conditions (affecting the *supply side*), but also by the actual behaviour of the *demand side*:

- As particularly explained in our discussion of **H1** and **H2a**, it is more realistic to assume that there are clear patterns in the attitude towards credit across countries which may explain both the preferences for strict interest rate regulations prevailing in some countries and, eg. reduced incidence of credit of their consumers.

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Introduction

In line with the dual objectives of this study, namely to identify existing interest rate restrictions in EU consumer credit markets and to assess their effects on those markets and society in general, this report is structured in two parts with annexed materials.

A first part of the report contains a **comprehensive inventory of the types of interest rate restrictions** that exist in the EU Member States and outlines the differences between underlying national legal, social and cultural traditions and circumstances surrounding IRR and the protection of borrowers against exorbitant charging by credit providers. It starts by providing the theoretical background and framework for an understanding of the concrete situation in the Member States. In Chapter 1.1, definitions are elaborated, terms of the study clarified, the philosophy of regulation and concept of usury explained and the range of possible forms of IRR presented. In these opening sections and throughout the report, the study applies a legal methodology to assess the common roots, principles and conflicts of existing rules. A socio-legal methodology is used to assess the cultural background for such rules and their effectiveness in practice.

Chapter 1.2 details the mechanisms and levels at which interest rate ceilings are set in those countries with such regulation. Direct regulation of credit markets through the use of contractual interest rate ceilings are the most recognisable form of IRR and pages 64-78 give details on the few Member States with absolute ceilings followed by those countries where a relative interest rate ceiling (also known as a floating cap) is applied. Country tables are provided showing the level of the ceilings for the different classes of credits where distinctions are made on the basis of credit type or amount. This part of the report also contains information on sanctions, enforcement regimes and an explanation of the various ways in which ceilings can be calculated and set. In addition, Section 1.2.2 gives a comprehensive inventory of rules governing interest rate levels in default.

While direct IRR limit the contractual interest rate or the amount of interest that can be charged, Chapter 1.3 presents the various forms of indirect IRR in Member States. Restrictions on other cost relevant factors may have an equivalent effect to interest rate ceilings. Details on such general restrictions on fees and charges are reported here. In addition to providing information on the rules governing the use of compound interest rates in EU Member States, there is also a section covering on the regulation of interest rate *variability*, which is currently more related to disclosure and bilateral requirements rather than strict restrictions on the interest rate as such.

With harmonisation of consumer-related rules in the different Member States, the legal survey then proceeds to discuss the EU Consumer Credit Directive of 2008 (CCD 2008) and an extension of its scope to smaller amounts of credit in some jurisdictions in Chapter 1.4. The study also addresses certain legal aspects related to high-cost credit and their social impact in Chapter 1.5. The first part of the report ends with Chapter 1.6 summarising and reproducing the views of Stakeholders of European consumer credit markets on various aspects of IRR.

A second part of the report focuses on the economic, financial, and social impacts of interest rate restrictions. Related debates about the **economics of interest rate restrictions** can be at least traced back to a controversy between Adam Smith and Jeremy Bentham in the late 1780s:³ Interestingly, Adam Smith, the proponent of the *invisible hand*, argues in favour of a legal interest rate ceiling to shift capital allocation towards more productive users, an outcome which he considers to be socially more

³ For more details of this controversy, see Persky (2007).

desirable. In contrast, Jeremy Bentham points out that high cost of credit will attract economically weaker people who may rationally decide that the expenses for interest payments are outweighed by the value of the loan to them.

Modern economics has advanced in its understanding of complex credit markets (including the role of asymmetric information and imperfect competition). Chapter 2.1 details the reasons of differential interest rates as well as the effect of interest rate restrictions on capital allocation. Economic theory has also refined its analysis of consumer choices. In general, it acknowledges that consumers spend, save and borrow money according to their individual preferences and their budget. The chapter also demonstrates how a decision to finance consumption by credit arises from the preference to smooth consumption over time. However, individual financing decisions are found to have adverse individual as well as social effects such as over-indebtedness. Therefore, Chapter 2.1 also shows the limitations of consumer rationality due to cognitive biases and the inability to manage complex decisions. Based on these theories we state a series of conceivable hypotheses on the impact of interest rate restrictions.

Note that, for three reasons, this study primarily focuses on consumer credit rather than credit to businesses (eg. SMEs, self-employed, micro enterprises): firstly, interest rate restrictions are frequently introduced as a means of consumer protection, since consumers are the ones considered to be otherwise offered (excessively) high interest rates. Secondly, as banks are reluctant to lend at high risk premia to small businesses to avoid adverse selection, small enterprises (and micro enterprises) are frequently financed by credit types originally designed for consumption purposes (eg. overdraft of the (private) current bank account, credit card). However, it is not feasible to make a clear empirical distinction between consumer finance and the financing of a (start-up) enterprise. We therefore conjecture that the implications of the hypotheses derived for consumers also hold for small and micro enterprises. Thirdly, a thorough discussion of the financing of small and medium-size enterprises (SME) would require considering a variety of aspects (eg. optimal leverage, moral hazard, the role of mezzanine capital and equity) which are clearly beyond the scope of this study. We will nevertheless briefly discuss similarities and differences between consumer credit and business credit (including microfinance) in the context of interest rate restrictions in Section 2.1.5.

Due to the relevance of consumer credit markets and their regulation, it is not surprising that economic impacts of interest rate restrictions have been the focus of empirical studies, both with an academic as well as a policy-consulting perspective. Chapter 2.2 provides a comprehensive survey of this literature. It stresses that empirical evaluation of interest rate restrictions can only be made when the counterfactual situation is identifiable, eg. due to close similarity of countries unaffected by this regulation. As Chapter 2.2 details, this requirement is more easily met in the analysis of the US markets rather than European markets. However, the typical historical interest rate cap in the US is lower than typical interest rate restrictions in European countries, which makes the transferability of these results questionable. Chapter 2.2 therefore also takes a closer look at more recent studies on interest rate restrictions in Member States of the European Union.

Chapter 2.3 then turns to the description of the markets of credit to households. It provides a comprehensive overview of the markets for total credit to households, housing credit, and consumer credit (without housing) for all EU 27 countries. Where illustrative, it also provides separate analyses for EU 25, EU 15 countries or the New Member States.

Chapter 2.4 presents a more detailed discussion of the credit markets in the case study countries. These countries are Germany, France, Sweden, Poland, the UK and the Netherlands. As detailed in Section 2.4.1, these countries are particularly well suited as case studies as they exhibit typical features in terms of the interest rate restrictions as well as economic circumstances.

Chapter 2.5 discusses the hypotheses stated in Section 2.1.4. To do so, we summarise existing evidence from the literature, and derive conclusions from the collected data. In addition, we consider the responses of questionnaires answered by particular stakeholders in the consumer credit market, such as regulators, consumer associations, providers, and provider associations. The survey enables us to learn from the experience of stakeholders with regard to the effect of interest rate restrictions (or lack of thereof) on the credit markets in the respective countries. It also allows a comparison of the answers from stakeholders in countries with interest rate restrictions (IRR) with those from countries without IRR, and a qualitative discussion of the differences. The inclusion of heterogeneous stakeholders (regulators, consumer agencies, supplier associations) will enable us to consider potentially divergent perspectives about issues in question in a balanced way. Accordingly, we base our judgement about the hypotheses on several sources: the interpretation of existing data, earlier empirical evidence, as well as the information from stakeholder questionnaires.

1 Legal survey of interest rate restrictions

1.1 Legal theoretical background

In this section we provide the theoretical background and framework for an understanding of the concrete situation in the Member States as described through the reports of legal experts and the various stakeholder groups.

1.1.1 Definition of interest rate restrictions (IRR)

The Handbook of research on international consumer law⁴ introduces its chapter on price controls with the following short overview of the presence of interest rate ceilings:

“Many countries in both the developed and developing world have interest rate ceilings on consumer credit.⁵ These include France, Belgium, Netherlands, Poland, Slovakia, Ireland, some Australian states, Canada, some US states, Brazil, South Africa and Japan.⁶ The German Supreme Court has established a de facto ceiling through its interpretation of the BGB. In addition, Islamic banking prohibits the taking of interest and uses a profit-sharing model.⁷

The primary contemporary objective of interest rate ceilings is to protect those of modest or low income from paying excessively high prices for credit. These ceilings often include both consumer and business borrowers in the scope of their protection. Given the different markets and forms of credit, countries often have a variety of ceilings. In France, interest rate ceilings differ depending on the type and length of loan: they are established at one third above the prevailing market rate for the particular market segment.⁸ South Africa has adopted a similar approach, with loans divided into seven categories.⁹ In Germany, the Supreme Court has established a very strong presumption that interest rates that are double the relevant market rate are contrary to good morals (section 138 of the BGB).¹⁰ In contrast, the UK has not had general interest rate ceilings on credit since 1854 when Parliament, following Jeremy Bentham's strictures against usury, abolished the usury laws.¹¹

This reveals that there are a number of definitions of interest rate restrictions, stemming from the fact that they have often been introduced to achieve distinct policy objectives. We therefore begin by defining what we mean by interest rate restrictions and considering some of the complexities that arise for the conduct of the study. A set of key terms for use in the study is set out as a result.

⁴ Ramsay, I. in Howells, G., Ramsay, I., Wilhelmsson Th. (2010) pp 397 ff.

⁵ There is a large literature from differing academic perspectives on interest rate ceilings. For a recent overview, see Howell, N. (2005) and references cited. Elizabeth Warren and Amelia Warren Tyagi have argued for the reintroduction of interest rate ceilings in US consumer credit. See Warren, E., Tyagi, A. (2003), pp. 144-52. See references in Kraft et al. (2008), pp. 409-12. For economic explanations, see Glaeser, E., Sheinkman, J. (1998), Posner, E. (1995), p. 283 et seq.

⁶ See discussion of Japan in Kozuka, S.; Nottage L. (“The Myth of the Cautious Consumer: Law, Culture, Economics and Politics in the Rise and Partial Fall of Unsecured Lending in Japan” in J Niemi, I Ramsay and W Whitford (eds) *Consumer Credit, Debt & Bankruptcy: Comparative and International Perspectives* (Oxford, Hart 2009).

⁷ See Aidit bin Hazi Ghazali (1994), p. 443 et seq.

⁸ See Code de la Consommation L.313-3.

⁹ See 42(1) NCA.

¹⁰ For a brief account of the German law of usury, see Markesinis, B. et al. (2006), pp. 250-53. The German courts may use two tests: double the average and a standard of 12 per Cent above relevant rates. The latter was used during periods of high Inflation and consequently high interest rates.

¹¹ Although the Moneylenders Acts 1900-1927 (abolished in 1974) did contain a presumption that interest rates over 48 per cent were unconscionable.

We then proceed to consider the concept of usury, detailing the provisions which exist in this regard in each of the Member States, and historical fluctuations in its application.

We then categorise existing forms of IRR, which we then use in the remainder of the Chapter when considering responses to the survey of experts, and we conclude with consideration of enforcement issues.

1.1.1.1 Legal and economic definitions

The term, 'Interest Rate Restrictions' in consumer credit markets refers to all rules that limit the price of credit contracts. The study is concerned with existing law and its application. It is not a legal study in its strictest sense, which would need to consider the broader discussions that have taken place since the middle ages concerning how concepts of usury became part of modern law¹² and the specific forms of interest rate restrictions that arose as a result. Instead, this study is concerned with interest rate restrictions that currently exist as legally or factually binding rules that limit the amount of money a lender can charge, directly or indirectly, for the use of capital by the borrower. Interest Rate Restrictions will be abbreviated and referred to as '**IRR**' for simplicity and ease of reading throughout this report.

It should be noted from the outset that there are three complicating factors of relevance to the study:

Firstly, there is no direct way of assessing the effects of the enormous amount of credit legislation with regard to the pricing of credit, since too many variables may intervene. From a supplier's perspective, all legal rules require them to take special precautions or put procedures in place, and these ultimately contribute to the overall cost of providing credit. The study cannot take all of these variables into account and is therefore only concerned with identifying the legal forms of IRR that exist and comparing whether, and how far, we can attribute observed impacts on prices to them.

Secondly, the definition and measurement of the price of the credit itself is of critical importance, and rules affecting the calculation and disclosure of interest have effects on the operation and forms of IRR. For example, the interest rate defined in Article 3 of the CCD 2008¹³ is used both to disclose the total price of a credit contract in a comparable way ("Annual Percentage Rate of Charge") and as a means of calculating the amount of interest due ("Borrowing Rate").

Thirdly, some legal concepts are either not present in all Member States or are used differently amongst them. In order to facilitate the studying of the economic and social effects of IRR, we have adopted a broad definition as follows:

"Legal Interest Rate Restrictions are all legal rules, from whatever source they come, which intentionally restrict the price of consumer credit."

As far as self-regulatory rules exist, they are either directly or indirectly part of legal rules because private law gives contractual consensus the status of state sanctioned law ("freedom of contract") or incorporates such rules as "commercial habits", "good morals" or "good faith" into the body of law.

¹² See for **Germany**: Liebner, K. (2010); Dilcher, J. (2002); **USA and Great Britain**: Temin P., Voth, J. (2008), pp 743-758; Bodenhorn, H. (2007), pp.179-202; **France**: Pikulska-Robaszkiewicz, A. (2000), pp. 715-734; **Italy**: Olivi (1990); Spina, R. (2008); **Spain**: Vitoria, F. (2006).

¹³ Directive 2008/48/EC of the European parliament and of the Council of 23 April 2008, on credit agreements for consumers repealing Council Directive 87/102/EEC. Referred to as the "Consumer Credit Directive" or "CCD 2008". Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:133:0066:01:EN:HTML>.

As far as the enormous amount of historically developed moral, religious and ethical rules are concerned these rules have mostly led to legal rules which have thus gained acknowledgement and effectiveness. In so far those moral rules which are broadly shared in a country are usually incorporated into the law. Those exemptions where in a rather small and homogeneous community like for example the Scandinavian countries moral restrictions are so widely accepted that even without legalisation they have a high degree of effectiveness we have integrated them into our observations.

In economic terms, this is therefore a study of the impact of price controls in consumer credit markets.

For the economic part of this study the word "consumer credit" and "interest rate" are common, well-defined and explored. This is even true for EU law. Article 3 (c) Directive 2008/48/EU defines a "credit contract" legally by reference to the economic concept of "consumer credit" and sets out a number of its legal forms including 'deferred payment' and 'loan', but it also adds a saving clause by introducing the term "similar financial accommodation".

„**'credit agreement'** means an agreement whereby a creditor grants or promises to grant to a consumer **credit** in the form of a **deferred payment, loan or other similar financial accommodation**, except for agreements for the provision on a continuing basis of services or for the supply of goods of the same kind, where the consumer pays for such services or goods for the duration of their provision by means of instalments;”

It thus combines the Common Law tradition - which uses economic denominations in its credit legislation - with the civil law approach, which in the Roman tradition of formalised legal language ("Begriffsjurisprudenz"¹⁴) keeps more strictly to forms.¹⁵

Assessing the national rules on "credit" is therefore easy in those countries that use this word as a core legal concept.

But in the civil law tradition¹⁶ such purpose-driven denominations are seen as detrimental to the requirements of the rule of law. For example, France and Germany both prefer concepts that refer to the legal forms in which the economic activity is exercised. In private law they prefer legal forms like a "loan" (Darlehen, prêt) or an instalment purchase ("Stundung" deferred payment).

To cover the same rule in the UK as in Germany the words credit and interest rate have to be translated into the different legal forms used in their respective legislation. For this, EU law provides assistance. The 1987 EU Directive on consumer credit (CCD 1987), the original CCD, aimed at bringing about a degree of approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit¹⁷,

¹⁴ Especially for money terms see Ott, K.-O. (1998).

¹⁵ See for example Part II of the UK Consumer Credit Act 1974 (1974 c. 39) which is similar to the EU Directive defining credit contracts by "credit".

¹⁶ Section 488 (1) of the German Civil Code uses the term "loan": "(1) The loan contract obliges the lender to make available to the borrower a sum of money in the agreed amount. The borrower is obliged to pay interest owed and, at the due date, to repay the loan made available to him." Similar the French definition in Article 1892 Civil Code: "A loan for consumption is a contract by which one of the parties delivers to the other a certain quantity of things which are consumed by use, on condition that the latter shall return as much to him in the same kind and quality."

¹⁷ Council Directive 87/102/EEC of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit. This Directive was subsequently revised twice by Council Directive 90/88/EEC of 22 February 1990 amending Directive 87/102/EEC (setting out a single mathematical formula for calculating the APRC throughout the Community and for determining credit cost items to be used in the calculation), itself amended by Directive 98/7/EC (focusing on the calculation of the APRC). Directive 87/102/EEC was later repealed by Directive 2008/48/EC of 23 April 2008 on credit agreements for consumers (CCD 2008).

introduced a purpose-driven approach into the national systems of countries governed by codified civil law. Germany incorporated the use of the word “Credit” (Kredit), formerly unknown in Private Law in its 1971 Consumer Credit Code. It returned to the formalised legal language (“Loan”) in 2002 when integrating credit law into its Civil Code.

The maximum harmonisation approach of CCD 2008 Article 3 is now the key to the different legal languages. Each Member State will have to define which legal forms and rules of their own legal order qualify for what the Directive defines as “credit” for “consumers”.

As the Directive aims to cover all legal forms in all Member States which serve the purpose of credit it leaves some scope for interpretation. Whilst it sets out a number of forms of credit which must be included, such as loans, deferred payments, overdrafts, credit cards, it remains open to other and new forms of what would be recognised as credit or an interest rate in economic terms.

We share this open approach and seek to cover interest rate restrictions for all legal forms which objectively function as credit, even if they have a different legal designation¹⁸.

1.1.1.2 Terms used in the Study

This is why the study is focussed on all legal forms covered by the definition of the CCD 2008 without regard to its exemptions in Article 3. We therefore cover all regulations with reference to “credit” or its forms like “loans”, “leasing” “hire purchase” etc where we expected that different forms of IRR might be feasible.

Definitions of the key terms used in the study are set out in the table below.

Table 1: Definitions of key terms used in the study

Credit	“whereby a creditor grants or promises to grant to a consumer credit in the form of a deferred payment, loan or other similar financial accommodation” (from CCD 2008).
Instalment credit	The borrower is provided with a fixed amount to be repaid over a given period by a fixed number of repayments called instalments (usually constant over time) Examples: Personal loans, car loans, and hire-purchase agreements.
Revolving credit	A permanent reserve of credit whose limit is authorised by the creditor; the consumer repays the sum used according to the allowances stated in the credit contract and the reserve reconstitutes itself as repayments progress. Mechanism of repayments can take different forms, including the regular repayment of a percentage of the outstanding balance, with or without a minimum amount, the periodic payment of a fixed amount, or the payment of interest charges regularly and the repayment of the credit at the end of the agreement Examples: credit cards, revolving credit accounts, and overdraft facilities. Examples: line of credit, running account credit, overdraft, credit card credit.

¹⁸ Historically this was especially true for certain contracts which are presented in the form of a hire agreement. Article 3 of the Directive defines as “credit” (d) hiring or leasing agreements where an obligation to purchase the object of the agreement is (not) laid down either by the agreement itself or by any separate agreement”

Secured credit	A credit in which the borrower pledges some asset as collateral for the credit. Creditor recovery of the surety can be limited to the collateral (non-recourse) or not. Examples: mortgage loans and home equity loans (a form of equity release).
Interest Rate Restrictions	Absolute or relative rate ceilings (fixed administratively, by statute or court rulings); Laws designed to prevent exploitation and unfair competition with effects on credit cost; Capped default interest rates and early repayment fees; Restrictions on the compounding of interest and the use of variable rates; Other forms of restrictions to the level or rate of interest including moral consensus; Anti-Trust regulation.
Borrowing rate	"(j) 'borrowing rate' means the interest rate expressed as a fixed or variable percentage applied on an annual basis to the amount of credit drawn down" (from CCD 2008).
Annual Percentage Rate of Charge (APRC)	"(i) 'annual percentage rate of charge' means the total cost of the credit to the consumer, expressed as an annual percentage of the total amount of credit, where applicable including the costs referred to in Article 19(2); (g) 'total cost of the credit to the consumer' means all the costs, including interest, commissions, taxes and any other kind of fees which the consumer is required to pay in connection with the credit agreement and which are known to the creditor, except for notarial costs; costs in respect of ancillary services relating to the credit agreement, in particular insurance premiums, are also included if, in addition, the conclusion of a service contract is compulsory in order to obtain the credit or to obtain it on the terms and conditions marketed" (from CCD 2008).
Default interest rate	The interest rate with which the amount of money concerning capital due after default is calculated (ie. charges for non-compliance, late payment or interest charged on overdue payment).
Legal interest rate	The interest rate provided by statute to be used when no contract or agreement exists between the parties. Sometimes referred to as the statutory interest rate (eg. a rate used by default because none has been specified, or rate used for statutory payments such as taxes). Though the term is sometimes used to refer to the IRR ceiling, this is misleading and inaccurate. It is distinct from the "lawful interest rate" (rate that falls within the limits allowed by the usury laws) and from the contractually-agreed rate of interest (conventional rate).
Cost	In addition to interest the cost of the credit is made up of fees and charges:
Finance charges	The charges for interest. These charges depend on the borrowing rate, the amount and the duration of the credit. (The borrowing rate can be fixed or variable and its level depends on the characteristics of the credit, the creditor and the borrower. Calculation of interest charges could be straightforward or not when the credit includes difference balance segments with different borrowing rates, limits, and introductory rates and charges).
Non-finance	Administrative fees (set-up costs, maintenance costs), servicing fees

charges	linked to payment transactions and drawdown, fees and charges for sureties and ancillary services (bank accounts, credit insurance and payment protection insurance), but also early repayment fees and fees for failures to comply (late payment charge, exceeding credit limit).
Providers	Banks (commercial banks, mutual and cooperative banks, savings banks); Finance companies/mortgage specialists; Doorstep tallymen; Moneylenders; Brokers; Insurance companies; Vendors; Mail order companies; Service providers; Associations/coops/unions (if not banks); State agencies (housing, welfare etc); Private persons (family, friends etc); Pawn brokers; Other.
Legal sources	Statutory law; General Civil Law ; Special Credit legislation; Competition Law; Penal Law; Procedural Law; Administrative (Public) Law; Court decisions; Self Regulatory rules (codes of conduct, issued by arbitration bodies, professional rules) ; General Conviction, religious, moral, voluntary ethical rules etc.
Enforcement agencies	Civil courts; Consumer courts; Consumer Ombudsmen (official or private); Police; Central bank; Banking Authorities (supervisory); Fair Trading Offices; Cartel Offices; Attorney General etc..

Source: iff.

Figure 1: Forms of consumer credit and Forms of IRR

Types of Credit (listed by form)	Interest Rate Restrictions (IRR)
I. General-purpose credit <u>A. Instalment credit</u> • Instalment loan (auto loan, home appliances, energy saving projects) • Variable rate credit (variable interest rate, variable repayment. Not credit card) • Fixed repayment credit for general purpose (single repayment) • Financial leasing • Hire purchase agreement (vendors, service providers etc) • Point-of-sale financing (vendors) • Deferred payment in sales contracts (instalment sales) • Home equity loan (second mortgage loan for financing consumption) <u>B. Revolving credit</u> • Overdraft (including credit/deferred payment from debit cards also called "credit cards") • Overrunning (exceeding current account overdraft) • Revolving credit account (with or without credit card support) • True credit card credit (if repayable in instalments with own credit facilities) • Deferred debit card credit (incl. if charge card pay-later facility is less than 3 months of credit, also from stores) <u>C. Small secured credit</u> • Pawn broking • Payday loan (up to 6 months) • Other: please indicate <u>D. Micro credit</u> II. Mortgage Loans • Mortgage loan • State subsidised mortgage loan • Savings and loan schemes • Endowment loan (linked to capital life insurance, savings or investment contracts) • Other: please indicate	I. IRR on the rate level <u>Contractual interest rates</u> • Rate caps (absolute or relative) – objective control • Usury (general ceilings, case by case, in connection with other items, administrative or civil law, penal) – subjective control <u>Default charges</u> • Default interest rate caps II. IRR on methods of calculation of the rate • Anatocism (restrictions on interest on interest) • Mathematical rules (beyond the CCD 2008 restricting interest) • Interest compounding periods (compounding interest to capital) • Variability of interest rate (interest rate caps to floating or progressive rates) III. Restrictions on other cost elements <u>Contractual charges</u> • Insurance fees (amount, purpose, financing, commissions etc) • Broker fees (amount, purpose, financing) • Account holding fees • Maintenance fees <u>Default charges</u> • Penalties • Amortisation (allocation of payments to reduce outstanding principal, priority in reducing interest, cost or capital) IV. Restrictions on other credit parameters • Instalments (size, number, period) • Lifetime of the credit (duration) • Total amount of credit • Net amount of a credit

1.1.2 Empirical survey

The main source drawn on by this report is questionnaires and discussions with experts and stakeholders. The questionnaires and discussion materials have been developed on the basis of a number of studies iff has already conducted with regard to interest rates and over-indebtedness in Europe. However, existing literature and research on the specific question of IRR is still rather limited. A number of economic studies in the U.S. are discussed in the economic part¹⁹ and there is a vast literature discussing the legal dogmatics of usury, especially from an historical perspective.²⁰ But there are only very few empirical studies which assess the existing modern forms IRR.

Only two studies directly using empirical data have recently been published – one in the UK in 2004, the other in France in 2009. Other studies published in Poland, the Netherlands and Slovakia mainly use English data, while a forthcoming study by the Danish government has yet to be made available to the public. According to the information from national experts, there are additional reports on interest rate restrictions in another six Member States.²¹

The English study, widely distributed in Europe²² and elsewhere, was conducted by TNS Global Market Research for Policis, a consultancy in specialist research, which conducted this project at the request of the UK Department of Trade and Industry.²³ Its main finding was that usury ceilings in Germany and France had led to a high degree of exclusion from small loans for poor people in these countries and created a market for illegal lending. These findings have been referenced on several occasions but have also been criticised.²⁴ The French study was conducted in 2009 by the French government²⁵. It concludes that the problems of usury today are concentrated in consumer credit, and especially in certain forms of revolving loans and small loans, which play an important role among insolvent households in France, as opposed to mortgage loans. The report

¹⁹ See at pp 158 ff.

²⁰ See above FN 5.

²¹ From the national discussion concerning IRR in a wider sense a number of publications, papers, parliamentary motions and studies have been named by the experts which mostly do not provide empirical evidence beyond those known from the main studies. Belgium : Révision du mode de fixation des taux annuels effectifs globaux en matière de crédit à la consommation (2006) at http://statbel.fgov.be/fr/binaries/354_tcm326-41864.pdf; Czech Republic: Ministry of the Interior of the Czech Republic - Prevention of indebtedness study. Liberalni Institut (Schwartz, 2007); Denmark Ministerial working group to analyze the effect of APR-ceilings in other countries (report not yet published) . France: Rapport sur les modalités de fixation du taux de l'usure", General Inspectorate of Finance & General Inspectorate of Social Affairs, Februray 2009. See <http://www.responsible-credit.net/index.php?id=1980&viewid=45728>; Lefebvre, M. F. (2008), Rapport d'Information sur les emprunts immobiliers à taux variable, Paris: Assemblée Nationale Treizième Législature N° 744 (26 mars 2008) p 53 (II A 2 c); Germany: Report by the Bundesbank concerning the change in statistics and the Report on its implications by Hartmann-Wendels/Spörk in 2006. See: <http://www.responsible-credit.net/index.php?id=1980&viewid=45755>; Netherlands: study on SMS-credit and pawn-brokers was done in 2009. See Report from "Research voor beleid". <http://www.responsible-credit.net/index.php?id=1980&viewid=45753>; Poland: KPF commissioned a study evaluating the impact IRR have had on the market. The report was published in March 2009 (English translation available); Slovakia: A report by the Hayek Foundation see <http://www.responsible-credit.net/index.php?id=1980&viewid=45753>; UK: Financial Inclusion Taskforce on Access to affordable credit (2010); OFT study on High Cost Consumer Credit (2010).

²² See Eurofinans (2010), pp 6 ff; Project Associates, Briefing Note on Interest Rate Ceilings, 2009 (made for Provident in Poland); Information on the use of these data in the Japanese discussion was made available by Saya Ojama at the iff-Hamburg Conference on Financial Services, July 3, 2010.

²³ For a more critical evaluation see now Office of Fair Trading (2010).

²⁴ Policis (2006b); Policis (2006a), pp 47-48; Policis (2004a); for a critical review of its methodology, sample and legal understanding see Reifner, U., Knobloch, M. (2009). The respective part for France has not been mentioned in the French survey on these issues in 2009.

²⁵ Inspection générale des finances, Inspection générale des affaires sociales (2009).

cites Belgium, the Netherlands and Italy as other countries which have comparable IRR to France and sets the focus beyond access and onto two opposing views - the positive impact of rate ceilings on the risk of insolvency, which high cost credit entails on one hand, and its negative impact on access to small loans for people with low credit score values on the other.²⁶ Both studies are discussed later in the report.²⁷

In our empirical survey, a variety of different data sources were used, firstly to comprehend the idiosyncrasies of each Member State's credit market and secondly to assess the possible impact interest rate restrictions may have had and the potential effects these restrictions could have when applied to the markets in other Member States. We have restricted the selection of data to reliable industry and public sources that allow for comparison across the Member States and have also incorporated some national sources for specific phenomena which are measurable.

Telephone interviews with certain stakeholders were conducted and a number of face-to-face meetings were organised with certain specific stakeholders. Though stakeholders vary as to their usefulness and knowledge of the subject matter they have been able to contribute to the research. Additionally to the bilateral communication with stakeholders, part of the research team has presented the study to the Forum of users experts in the area of financial services (FIN-USE) set up by the European Commission.

The following section gives an overview of the stakeholders contacted and having contributed in some way to our research, however, the details of our methodology have been included in Annex III: Methodology of the research.

The Stakeholder Questionnaire (Annex X: Stakeholder Questionnaire) has been sent to over 330 agencies. Due to the fact that the three groups of stakeholders (public authorities, provider associations and consumer organisations) in countries with no actual discussion on IRR found that responding was not necessary for various reasons, iff had to use additional time and sources to solicit stakeholder involvement. To improve the response rates to the questionnaires, the participation of the provider associations at the EU level in the dissemination of both the Stakeholder Questionnaire and the Provider Questionnaire to their members and their members' members was respectively secured.

By securing the involvement and support of Eurofinas and the European Mortgage Federation in this way, we hoped to encourage responses from the national level.

Of the 333 agencies contacted and invited to participate in our research:

- 96 have completed a Stakeholder Questionnaire (though not all questions were answered in each of these);
- 12 have declined to answer because they did not consider their institution as sufficiently knowledgeable or with the competency about the issues covered by the survey;
- 41 have replied by sending material or a significant answer but without completing a questionnaire.

²⁶ "L'augmentation des taux d'usure, en élargissant les possibilités de prêt aux catégories les plus risquées, a pour effet d'accroître le niveau des difficultés d'endettement des ménages, Selon Georges Gloukoviezzoff, le flux de clientèle supplémentaire permis par la hausse des taux d'intérêt pratiques correspond à l'admission d'emprunteurs plus risqués, donc davantage sujets à des défaillances de paiement." op. cit. Annex 5 p 1.

²⁷ See 2.2.5 at pp 161 ff.

In addition, the economic team of this research conducted a survey of individual providers. Further details on the provider survey can be found in the Annex XII: Provider Questionnaire. All findings are reflected in the analysis of the hypotheses (Chapter 2.5).

Table 2 gives an overview of the numbers involved in the stakeholder survey and the respondents from the Member States that participated.

Table 2: Survey participation with the Stakeholder Questionnaire by stakeholder group

Countries	Provider associations		Consumer associations		Public Authorities		Others	
	Invited	Replied	Invited	Replied	Invited	Replied	Invited	Replied
Austria	3	0	2	0+(2)	3	1	0	0
Belgium	3	1	5	2+(1)	3	1+(1)	0	0
Bulgaria	2	0	6	1	2	1	0	0
Cyprus	2	0	2	0	5	3	0	0
Czech Rep.	3	3	4	1+(1)	3	1	2	2
Denmark	4	1	2	1	3	1	1	1
Estonia	1	0	2	0	5	2+(2)	1	1
Finland	1	1	4	2	3	2	1	1
France	3	2+(1)	13	5+(2)	6	1	6	1
Germany	10	2+(2)	3	1	4	1+(2)	5	0
Greece	1	0	5	1+(1)	1	1	0	0
Hungary	3	0	5	1+(1)	3	1	0	0
Ireland	4	0+(1)	4	0+(1)	2	1	1	0
Italy	6	2	8	2+(1)	2	2	1	0
Latvia	2	0	3	1	3	1	0	0
Lithuania	3	0	3	0	3	1+(1)	0	0
Luxembourg	1	0+(1)	1	0+(1)	2	1	1	1
Malta	2	0	2	0	3	1	0	0
Netherlands	4	1+(1)	2	1+(1)	3	2	2	1
Poland	5	1	2	1+(1)	3	3	0	1
Portugal	3	0	5	2	1	0+(1)	2	1
Romania	2	1	1	1	1	0+(1)	1	0
Slovakia	1	1	2	0	2	1	0	0
Slovenia	1	1	1	1	3	2	0	0
Spain	5	0+(3)	5	2+(1)	1	1	2	0
Sweden	4	1	2	1	5	1+(1)	1	0
UK	11	5+(1)	10	1+(2)	8	2+(3)	17	0+(2)
EU Institutions	8	0+(1)	2	0	0	0	2	0
Total	98	23+(11)	106	28+(16)	83	35+(12)	46	10+(2)

Source: Stakeholder survey. Note: The Stakeholder group Public Authorities (comprised of Regulators and Government) and Other (comprised of debt advisors, scientists and other experts) have been merged together for the purposes of analysis of the effects of interest rate restrictions in the later Chapters evaluating the impact on stakeholder groups. The number in brackets refer to additional responses that were not sent in the form of a completed questionnaire, thus are not part of the quantitative analysis in later Chapters of this report. Some authorities have responded to one questionnaire together ie. have submitted one response to which the different bodies have contributed. Furthermore, individual provider responses to the provider questionnaire are not included in this table (see: Annex XIII: Provider Questionnaire - Methodology and feedback).

iff contacted all national bankers' associations, bank supervision authorities and central banks, as well as consumer organisations in each Member State, using various channels.

The level of non-response may in some cases indicate relative low levels of interest in this area in the country concerned (eg. some German providers), but a lower than

expected response rate is primarily down to limited resources by the participants invited to contribute their views (eg. especially the consumer associations). The response rate from regulators was also more difficult to obtain than expected. Feedback would tend to suggest that other priorities have meant that a prompt and dedicated response to our survey was not always possible, though a public authority from every Member State was contacted, called and a statement of their views collected.

The legal findings have been integrated with those from the economic part²⁸. The inclusion of heterogeneous stakeholders (regulators, consumer agencies, provider associations) enabled the economic team to consider potentially divergent perspectives about issues in question in a balanced way. These responses to the Stakeholder Questionnaire were taken into account when describing the hypotheses used to analyse the impact, which interest rate restrictions can have. Alongside these written contributions, some oral communication helped clarify certain details and helped assess the strength of certain responses received from those respondents that completed a questionnaire. Chapter 2.5 reports on the quantitative evaluation of the responses from the questionnaire in light of the hypotheses. In addition Chapter 1.6 Stakeholder views on IRR contains further material and a selection of qualitative answers are provided in Annex XI: Tables of stakeholder responses and Annex XV: Stakeholder general feedback on IRR.

To favour transparency of the research content and methodology, the findings in this report were subject to verification ahead of its final version. This primarily took the form of forwarding our understanding of the legal situation, but also the economic or market information we had, to the public authorities to ensure that the content of the answers collected, primarily from our legal experts for the legal details, is accurate.

1.1.3 General principles of IRR in national legislation

There is one term that seems to summon up all forms of existing IRR: usury. It is used to describe a fixed rate cap in France (taux d'usure); governs the German Austrian model of "Wucher" (usury); and is the term underpinning those systems where the exploitation of market failure by the stronger party, which results in excessive prices, is seen as a contravention of good morals. The following table summarises sum indicators which are described more in depth in the following text.

Table 3: Usury legislation in the EU

Country	Denomination	"exploitation"	"ceiling"	Other
Austria	Wucher	Art. 879 alinea 2 4 th sentence und alinea 3 Civil Code (ABGB); Articles 154 and 155 Criminal Code Article 1 Law on Usury		
Belgium	Woeker/usure	Article 494 of the penal code	Article 1907ter BW	Article 87 No 1 WCK (ceiling)
Bulgaria	лихварство	Article 10 (3) of the Obligations and Contracts Act (default interest)		Art. 294 Commerce Act (anatocism)

²⁸ See 2.1.4 Resulting Hypotheses on page 155 for the hypotheses that were tested by the survey responses.

Cyprus	Τοκογλυφία/ Tokoglifia			
Czech Republic	Lichva/dobré mravy	Section 3 of the Czech Civil Code (Act. No. 40/1964) also in the criminal code (Act No. 40/2009 Coll)	"Four times the average" (court rule)	
Denmark	åger	Yes		
Estonia	liigkasuvõtmine	"good morals" (Civil Code)		
Finland	Kiskominen/ Koronkiskonta	Penal Code		
France	Usure		L313-3 of consumer code	
Germany	Wucher	Art. 138 al. 2 Civil Code; Art. 291 Criminal Code	Art. 138 al. 1 Civil Code ("good morals", double of the average)	
Greece	τοκογλυφία	Art. 404 Criminal Code		
Hungary	Uzsorakamat	Yes		
Ireland	Excessive	"excessive" Consumer Credit Act 1995 section 45		
Italy	usura	Art. 644 Criminal Code		
Latvia	Augļošana	Criminal Law Section 201 "deprivation of liberty"		
Lithuania	lupikavimas			
Luxembourg	usure	Art. 1907-1 of the Civil Code Article 494 penal code; article 1154 Civil code anatocism		Judge can lower interest.
Malta	usury	Illegal but with many exemptions for professionals		
Netherlands	Woekeraar/ wettelijke rente	No legal term. Usury is deemed a criminal	Fixed 'legal interest rate'	

		offense		
Poland	Lichwa	Usury for all transactions		
Portugal	Usura	cf. article 282 of the Civil Code ("Código Civil") and article 226 of the Criminal Code ("Código Penal")	cf. article 1146 of the Civil Code – non banking - and article 28 of Decree-Law nr. 133/2009	
Romania	camatarie	Criminal Code of 28 June 2004, published in the Official Gazette, Part I no, 575 of 29 June 2004		"usury" in art. 450 Criminal Code unauthorized lending if interest is higher than allowed or anatocism or for less than one year.
Slovakia	úžera, úžerníctvo, úrok	Criminal offence according to art. 235 of The Act No. 300/2005 Coll. - The Criminal Code.	>30% pa (Decree Ministry of Justice)	
Slovenia	oderušstvo	Article 119 of Code of Obligations; Obligacijski zakonik, OZ-UPB1, OJ 97/07. Article 214 of Penal Code; Kazenski zakonik, KZ-1, OJ 55/08)		
Spain	Usura	Abusively high interest rates Law on Usury of 23rd July 1908 «Ley Azcárate».	Art. 19 Consumer Credit Law (2,5 times "legal interest rate" for overdrafts' (Banks/Financial Inst.)	
Sweden	Ockret	Contracts act (Avtalslagen 1915: 218) section 31 paragraph 2.		Swedish Penal Code/Brottsbalken chapter 9 s 5 p 2: credit in a business activity or habitually or on a large scale, and extortionate
United Kingdom	Usury/unfair	Lending at excessive or exorbitant interest (not defined in legislation	For Credit Unions	

Source: Stakeholder and Expert survey.

In **Austria**, usury ("Wucher") is regulated in civil law (Article 879 alinea 2 4th sentence und alinea 3 Civil Code (ABGB). It means exploiting a disadvantage (such as inexperience, carelessness, or financial distress) to exact a larger than usual benefit. This exploitation is necessary for a situation to qualify as usury. The same definition can also be found in Article 1 Law on Usury (WucherG); similar to Articles 154 and 155 Criminal Code (StGB).

In **Belgium**, usury ("woeker") was regulated in 1935 in the civil code (BW). Violation could lead to a reduction of the contractual interest rate to the statutory interest rate. A usurer can also be penally sanctioned, according to article 494 of the penal code (Sw). The usury ceilings are laid down in article 1907ter BW. For its application an objective element (ie. an abnormal high interest rate) as well as a subjective element (ie. the abuse of one's financial subordination) should be present. This applies to all types of credit. The Belgian legislator has also adopted specific rules on usury in the Belgian consumer credit regulation ("WCK"). According to article 87, 1° WCK the interest is not payable by the consumer if the APR exceeds the legally determined APR

According to **Bulgarian** legislation and court practice usury is prohibited by Article 10 (3) of the Obligations and Contracts Act in so far as it is charged on default interest determined in accordance with Bulgarian National Bank regulations. Anatocism is allowed between commercial entities but has to be stipulated according to Art. 294 Commerce Act.

In **Cyprus**, usury, "tokoglifia" transliterated is not legally defined and there have been no interest rate ceilings for over a decade. Though lending transactions between private individuals have never been regulated, a usury bill called 'the Penal Code (Amendment) Law of 2010' is currently being proposed which will contain a definition of what usury actually is, including a reference rate which is likely to be stipulated.

In the Czech Republic the term "usury" (in **Czech**: "lichva") concerns an obligation which is inappropriate to the profit obtained through it. In most cases it is being understood as a credit with high interest. The duty not to apply usury interest arises from Section 3 of the Czech Civil Code (Act. No. 40/1964 Coll. as amended) which governs "good morals" (in Czech: "dobré mravy"). A court ruling of the Highest Court of the Czech Republic No. 22 Cdo 1993/2001 from 08. April 2003 defines usury contracts (in Czech: "Lichevní smlouvy") as contracts which involve abusing the inexperience, intellectual weakness or distress of a party to the contract, and whereby the contract arranges for the other party, or others, to be provided or promised to be provided with a performance which is in gross disproportion to the mutual performance. Usury contract under civil law is a contract where the party knew or should have known from the circumstances of the case that the other party is affected by the circumstances mentioned above, and utilized this fact. It is not required for this conduct to have been simultaneously identified as an offence in criminal proceedings. Usury contracts are null and void. A court ruling of the Highest Court of the Czech Republic from 15. December 2004, No. 21 Cdo 1484/2004, defines when an interest rate is considered to violate good morals and thus a credit contract as null and void (in Czech: "neplatný"). This is when the interest exceeds quadruple of an ordinary interest provided by commercial banks for the given credit type (a violation of good morals results in principle in nullity of legal action).

This matter is also covered by the current criminal law (the Czech Penal Code, Act No. 40/2009 Coll., as amended): Anyone who arranges for themselves or others to be provided or promised to be provided with a performance which is in gross disproportion to the mutual performance, or if he enforces or transfers the receivables arising with the intent to enforce them, commits a criminal act. This applies to cases when someone takes advantage of another's weakness, distress, inexperience, carelessness or disturbance only. Higher penalties are awarded to those who acquire for themselves or others considerable profit or a profit of significant amount, or who commit this crime as members of an organised group, or who by committing this crime cause a state of severe

need to others, or if this crime is committed during the state of emergency or state of war or during a natural disaster or other circumstances seriously threatening the life or health of people, public order or property.

The **Danish** word for usury is: åger (aager). Usury is illegal in Denmark and therefore the term is used to describe the criminal action. During the financial turmoil there has been a tendency to use the term more generally for high interest rates.

In **Estonia** "Usury" (liigkasuvõtmine) is not a legal term. In public discussions it refers to the current activities of many moneylenders, which offer easy ways of borrowing money (either through mobile phone, internet) but which charge unreasonably high interest rate. Legally it would fall under good morals a principle of the General Part of the Civil Code Act (Tsiiviilseadustiku üldosa seadus)

In **Finland** usury means generally to take advantage of a weaker person's situation. Legally it is in the penal code and refers to abusively high interest rates of a loan. Usury means either charging very high interest because of the borrower's weak situation or charging in general such high interest that it is disproportionate compared to the lender's risk and costs.

In **France** usury describes excessive interest rates. Any contractual loan granted at an annual percentage rate which, at the time of its granting, is more than one third higher than the average percentage rate applied by the credit institutions during the previous quarter for loans of the same type presenting a similar risk factor, constitutes a usurious loan (L313-3 of consumer code)

The **German** word for usury is "Wucher". It is used in the German civil code, section 138 (2) as a special example for a breach of "good morals": (1) A legal transaction which is contrary to public policy (public morals) is void. (2) In particular, a legal transaction is void by which a person, by exploiting the predicament, inexperience, lack of sound judgement or considerable weakness of will of another, causes himself or a third party, in exchange for an act of performance, to be promised or granted pecuniary advantages which are clearly disproportionate to the performance." In the German Criminal Code, section 291 states: "Usury": "(1) Whosoever exploits the predicament, lack of experience, lack of judgment or substantial weakness of will of another by allowing material benefits to be promised or granted to himself or a third person 1. for the rent of living space or additional services connected therewith; 2. for the granting of credit; 3. for any other service; or 4. for the procurement of one of the previously indicated services, which are in striking disproportion to the value of the service or its procurement, shall be liable to imprisonment of not more than three years or a fine.

The **Greek** definition of usury is in the Criminal Code (art.404) which since Greece has taken the German BGB as the basis for its legislation is identical with the above cited Article 291 of the German Criminal Code.

In **Hungary** the concept of usury is based on a Calvinist interpretation as profit from a neighbour's loss, rather than profit from a loan. This is why usury concerns a party's excessive benefits through exploitation of another party's situation.

The **Irish** Consumer Credit Act 1995 section 45 makes reference to where credit charges are "excessive". However, this provision remains largely untested in the courts. In any event, it does not apply to "credit institutions" as defined in section 2 of this act.

The translation of usury in **Italian** is usura. Usura is the activity of the one who lends money and ask for an excessive interest. There is no legal definition of usury in civil laws but it is covered by the definition of usurious interests. The criminal code describes the crime of usura at art. 644, as to obtain, or to obtain the promise of interests or other profits that are usurious under the law. It is specified that only law can determine when

interests are usurious, except the case of the so called *usura impropria*: in fact even the judge can establish that interests (or other forms of benefits) are usurious if they are disproportional to the situation considered, or if the debtor is in need or in economic difficulty. When this is committed by a bank or another financial intermediary it is always usury, and the sanctions are more severe.

In **Latvia** usury is called "Augļošana". It applies to the situation where a person makes loans, in whatever form, and knowingly takes advantage of the grave economic situation of the borrower, to impose terms and conditions that are excessively burdensome for the borrower. The applicable sentence is deprivation of liberty for a term not exceeding five years, or custodial arrest, or community service, or a fine not exceeding one hundred times the minimum monthly wage. (Criminal Law Section 201)

In **Lithuania** usury "lupikavimas" is not legally defined and there are no restrictions on interest.

In **Luxembourg** Article 1907-1 of the Civil Code states that in case the credit provider abuses from the inexperience of the borrower in order to obtain from his/her the promise to pay an excessive interest rate or any other obviously excessive benefits according to the risk coverage, the Judge can lower the interest up to the reimbursement of the principal plus the legal interest rate. Article 494 of the Luxembourg penal code states that whoever had provided another person with any kind of values, to an amount rate exceeding the legal interest rate, by abusing the weakness or the passion of the borrower can be sentenced to imprisonment (from 1 month to 1 year) or to pay a fine from €500 to €25,000). Apart from that article 1154 forbids anatocism applying for a period of less than one year (exception to this rule: when this anatocism is performed on a current account between a bank and its consumer).

In **Malta** usury is illegal but for professionals, banks and certain products many exemptions apply from its rate ceiling. It therefore concerns mainly non-professionals who prey on the desperation of other individuals who have gambling, drug or other substance abuse problems.

In the **Netherlands** Woeker (usury) is not a legal term. Professional lenders need a license and they risk legal sanctions if they charge more interest than the legal maximum. In the public discussion about the benefits of selling linked products like insurances which are not transparent to the borrower are labelled as usurious. Also short-term credit with high costs are deemed to be usurious.

Poland prohibits usury for all transactions between persons, not only contracts between professionals and consumers.

The **Portuguese** word for usury is "usura". In social terms, usury is considered to be the conduct of someone who charges extremely high interest rates. Legally, usury is slightly more complex than that. On one hand, interest rates above the maximum allowed by law (where there is any legal limitation) are considered usurious interest.²⁹ On the other hand, businesses where someone, with intent to achieve a pecuniary benefit for himself or for another person, exploiting a personal situation of need, mental illness, incapacity, incompetence, inexperience or weakness, causes the debtor to undertake to grant or promise to grant, in any way, benefits which are manifestly disproportionate, excessive or unjustified, may be voidable and give rise to criminal liability³⁰.

²⁹ Cf. article 1146 of the Civil Code – only for non banking operations – and article 28 of Decree-Law nr. 133/2009.

³⁰ Cf. article 282 of the Civil Code ("Código Civil") and article 226 of the Criminal Code ("Código Penal").

In **Romania**, generally usury known as "camatarie" is the practice of charging much higher interest rates than the market rate. In the Romanian Criminal Code³¹ the offence of "usury" was provided in art. 450. It was defined as : a) the operations of lending money or bonds as a profession by unauthorised persons, directly or through camouflage papers, if the interest is higher than the interest established by the law; b) the operations of lending money or bonds, carried-out by unauthorised persons directly or through camouflage papers, if they establish an interest capitalization for interests owed for a period of time shorter than a year. Usury is also defined by practices like interest on interest (anatocism) and is also mentioned in connection with a maximum interest rate or legal interest.

In **Slovakia**, usury is a criminal offence according to art. 235 of The Act No. 300/2005 Coll. The Criminal Code says usury is committed by the one who, abusing anyone's pressure, inexperience or rational weakness or any distress, receives (himself or for anyone else) a performance or a promise, and its value is in gross disproportion to the value of mutual fulfilment. Furthermore, usury is committed by the one who transfers such a claim with the purpose to exercise it or who exercises such a claim. To pay more than 30 percent for a loan, including fees for the year, was seen as usurious, according to a decree of the Ministry of Justice of Slovakia.

In **Slovenia**, usury ("oderuštvo") describes a practice of taking advantage of someone's position by charging too high interest rates or by setting too high price. A usurious contract ("oderuška pogodba") in private law is a contract, where one party takes advantage of the other party's emergency, difficult material position, his lack of experience, frivolity or dependence and assures to himself or to someone else a benefit that is in obvious disproportion to his own obligation (Article 119 of Code of Obligations; Obligacijski zakonik, OZ-UPB1, OJ 97/07). In criminal law usury ("oderuštvo") means the taking or assuring of a disproportionate benefit by taking advantage of weak party's difficult material position, lack of housing, need, lack of experience or frivolity (Article 214 of Penal Code; Kazenski zakonik, KZ-1, OJ 55/08)

In **Spain** usura describes abusively high interest rates. Interest rates to consumer loans are – generally speaking - free, subset to the agreement among the parties. However, Case Law and some specific Acts – namely the Usury Act of 1908 - establish that, the freedom to agree upon a certain level of interest rates should be analysed in the light of a number of issues like the relation between rates set in contracts and legal cost of money (legal interest rate), market practices, whether contractual or default interest. The contractual clause can be qualified as abusive clause in the sense of the Abusive Clauses Directive if the contract is concluded in relation with urgent necessities of the consumer. Failure to pass the test of the above criteria, may lead to the contract been declared void.

Usury in **Sweden** is regulated in penal law as well as in private law and both comprise all sorts of claims. The Swedish Penal Code (Brottsbalken) chapter nine section 5 paragraph 2 states: "... A person shall also be sentenced for usury who, in connection with the granting of credit in a business activity or other activity that is conducted habitually or otherwise on a large scale, procures interest or other financial benefits which is manifestly disproportionate to the counter-obligation. If the crime is gross, imprisonment for at least six months and at most four years shall be imposed." In private law, usury is regulated in Contracts act (Avtalslagen 1915: 218) section 31 paragraph 2. Usury arises when a party unjustly exploits a contract situation, for example where the other party is in desperate straits, is in a dependent relationship or more vulnerable due to a lesser understanding. In addition an obvious imbalance must exist between the performances under the contract, for example, that the services rendered are not worth the amount

³¹ Criminal Code of 28 June 2004, published in the Official Gazette, Part I no. 575 of 29 June 2004.

charged. Usury can be seen in contrast to duress and fraud, where the wrongful party created the situation. In the usurious context, the wrongful party exploits an already existing situation.

In the **United Kingdom** usury is commonly taken to mean lending at excessive or exorbitant interest, but it is not a term defined in legislation and there are no legal sanctions for the behaviour provided the lender is licensed by the regulator. However, a ceiling on the permitted level of interest that can be charged by Credit Unions in the UK does exist, and courts have the power to intervene in consumer credit contracts where the relationship between borrower and lender is considered to be 'unfair'.

1.1.3.1 "Prohibition of Usury"

Usury exists as a legal concept in the criminal and/or the civil codes of twenty-one Member States:

- Denmark, Finland, Latvia, Romania, Slovenia, and Malta have incorporated usury within their criminal codes
- Estonia, France, Hungary, Bulgaria and Spain have incorporated usury within their civil codes
- The Czech Republic, Belgium, Austria, Germany, Greece, Portugal, Slovakia, Poland, Sweden, and Italy have incorporated usury within both their criminal and civil codes

As a legal concept, usury commonly refers to the exploitation of another person's need, inexperience or weakness, for personal gain that is disproportionate, excessive or unjustified, although the precise position varies between states. For example, although no specific mention is made of the term usury in Luxembourg law, both its civil and criminal codes do contain provisions that prevent the charging of excessive interest as a result of the weakness of the borrower. In contrast, the law in Spain prohibits usury but does not define it. In Lithuania it is also possible that protection similar to usury law is afforded by a general prohibition of abuse of a person's rights contained in its civil code.

Penalties for the offence of usury within criminal codes vary. For example, Austria provides for the imprisonment of usurers for up to three years, whilst Latvia provides for terms of imprisonment of up to five years, community service, or a fine not exceeding one hundred times the minimum monthly wage. In practice, however, some of the usury legislation is not considered to be effective. For example, case law in Denmark has indicated that the courts are reluctant to intervene and that only an extremely high rate of interest would qualify as usury.

There are also variations in approach in respect of usury laws contained in civil codes. Some countries provide for usurious contracts to be voided in their entirety (eg. Hungary), while others provide only for a reduction in the interest rate payable (eg. Luxembourg).

1.1.3.2 Other legal terms

Aside from the incorporation of usury into legal codes, few Member States have adopted legal definitions for other terms such as 'sub-prime', 'last resort loans', 'fringe lending' etc., even though these are often in common use in their countries more generally.

The exceptions to this are:

- Belgium, which defines 'sub-prime' lending in respect of secured credits as "a credit agreement given to persons, whose income is not sufficient to repay the credit, but who receive the credit due to the supposed increase of the asset value of their immovable property".
- Romania, which defines mainstream credit ('credit de larg consum') as a loan granted for purchasing mainstream goods; and which defines moneylenders ('camatar') as people offering loans with very high rates of interest compared to the interest rates established by law.
- Legal definitions of moneylenders are also present in Bulgaria, Ireland, Poland, and Spain.

In the UK, the terms sub-prime and non-status lending have been used by regulators when conducting market investigations and setting out guidance for use by lenders in those market segments, and it is also possible to find case law which sub-divides the mortgage market into 'primary lenders', 'secondary lenders', and 'tertiary or non-status' lenders.³²

1.1.3.3 Historical impact

All these forms seem to reflect one single historical objective: the restriction of interest rates on credit as outlined in the historical review which follows below. However, as this overview reveals, these forms have quite distinct historical roots and serve different purposes even today.

- **Exploitation:** Most countries have a legal term known as "usury" in both criminal law and civil law. The wording of Article 138(2) of the German Civil Code (BGB) is typical. It identifies usury as the intentional exploitation of a weak person or situation to make excessive profits. Such models can be found in Germany, Austria, the Baltic as well as the Scandinavian states, in Greece, the Netherlands and Slovakia.
- **High interest:** A second form of IRR can be found in Romance countries such as Portugal, France, Belgium, Spain but also in Slovenia, Czech Republic, Slovakia, Hungary, Ireland, the UK and in German case law. Instead of exploitation this form of usury falls under civil law and relates only to the excessive level of the interest rate charged, in comparison with the average market rate.
- **Anatocism:** Romania and Luxembourg use the word usury in a more traditional sense, describing conduct in which ancient rules governing the calculation of interest calculation, and specifically anatocism, have been disregarded.
- **Criminal lending:** In Italy, Malta, Estonia and Denmark the meaning of usury seems to be reversed. All illegal credit activities are styled usurious, including illegal money lending, loans from unauthorised persons, and dubious lending procedures.

West's Encyclopaedia of American Law summarises the historical development of usury regulation as follows: "The charging of excessive interest in exchange for a monetary loan has been considered reprehensible from the earliest times. Chinese and Hindu law prohibited it, while the Athenians scorned persons who charged more than a moderate rate of interest for a loan. The Romans at one time abolished the practice of charging interest. Although they later revived it, the rates were strictly regulated.

³² Lord Justice Dyson in *Broadwick Financial Services Ltd. v. Spencer* [2002] 1 AER (Comm) 446.

During the Middle Ages in western Europe, the Catholic Church censured usurers, and when they died, the Crown confiscated their lands and property. In England, until the thirteenth century charging any interest was defined as usury. As commerce and trade increased, however, the demand for credit grew, and usury was redefined to mean exorbitant interest rates. In 1545 the English Parliament set a legal maximum interest rate. Charging higher interest constituted usury.... Organized Crime has traditionally relied on loan sharking as a source of income.”³³

The following chart has been constituted from literature and the answers of the experts consulted, and shows the fluctuations in the use of IRR over the course of the 20th century.

Figure 2: History of IRR in the EU Member States

	19th Century	1900-39	1940-69	1970-89	1990's	2000-04	2005-10	Today mid2010	Future post- 2010
Austria								-	
Belgium					I			ceiling	ch
Bulgaria								-	
Cyprus								-	
Czech Rep								-	I
Denmark								-	I
Estonia							I	ceiling	
Finland								-	
France			I		ch			ceiling	ch
Germany	I		R	I		ch		ceiling	
Greece				I	ch			ceiling	
Hungary				I		R		-	
Ireland		I			ch			ceiling	
Italy			I		ch	ch		ceiling	
Latvia								-	
Lithuania			I			R		-	
Luxembourg								-	
Malta	I			ch				ceiling	
Netherlands			I				ch	ceiling	
Poland		I					ch	ceiling	
Portugal				I	R		I	ceiling	
Romania		I	ch		ch	R		-	
Slovakia							I	ceiling	R
Slovenia				I	ch			ceiling	
Spain					I			Overdrafts	
Sweden								-	
UK	I	R		I				Credit Unions	

Source: Expert survey and various literature. Note: I=introduction, R=removal, ch=change in IRR method. Answers in the “post-2010” column refer to those Member States where discussions are ongoing and where a potential change could take place. No noteworthy history or current discussion on ceilings in: AT, BG, CY, FI, LV, LU, SE.

From this we can identify the following five historical waves of IRR:

- **Ban on credit:** The oldest form of IRR is a ban on money interest on arrears. Examples are mentioned in the Bible, the Koran, and the doctrine of Buddha and other religious figures. The charging of interest as such is criminalised. These

³³ See West's Encyclopedia of American Law on “Usury” <http://legal-dictionary.thefreedictionary.com/usurer>.

restrictions appear to have reflected the concerns of agrarian and pre-commercial economies in which trade and money was seen as a threat to the agricultural basis of society. Aristotle still thought that taking interest for lending money was theft and should be punished. It should come as no surprise that interest on interest (anatocism) was regarded as the worst form of unearned benefits, especially where this was charged to people already in default.

- **Regulated interest:** The historic development from agriculture to trade, industry and finally to the money (credit) society has gradually abolished these ancient attitudes, although they were still upheld by Canonical law until the end of the 19th century. But relics are still discernible in the rules on anatocism in contracts (ie. Article 248 BGB) and default (ie. Article 289 BGB), as well as in a number of legally determined interest rates (ie. Article 246 BGB (4% p.a.))
- **Supervised Moneylenders:** Removal of these barriers to interest in order to facilitate commerce and banking resulted in a side effect in the form of the emergence of usurious moneylenders, as described in the works of Dostoyevsky. While some countries reacted with a general bank monopoly on credit (ie. France, Germany, Netherlands, Italy), other states developed supervision and admission rules which legalised private moneylending while often subjecting it to specific restrictions in terms of the level of interest rates (eg. the UK Moneylenders Act, 1927).
- **Productive Credit Policies:** In the thirty years that followed the 1929 crash and the economic depression, the Keynesian idea that consumers should save money that industry could then borrow to support growth became a cornerstone of economic activity. Consumer credit, on the other hand, was seen as a threat to overall economic productivity for which savings were needed as a source of investment in production. Credit for consumption was seen as destructive. Stricter supervision also resulted in a number of IRR which were gradually removed when the money supply was liberated and consumption was identified as a motor of economic development from the late 1950's onwards (when, for example there was a significant and progressive relaxation of restrictions in the UK, and personal loans for consumption purposes were introduced at this time) and particularly following the Keynesian crisis of the 1970's.
- **Consumer Protection/Prevention of Over-indebtedness:** From 1970 onwards, the explosion of consumer credit and the corresponding phenomena of life-long debt and over-indebtedness stimulated a public debate about credit and debt. Catholic countries in particular argued that less credit for the poor would be better while Protestant cultures favoured easy access to what they considered an essential service. Meanwhile, the principle of "responsible lending" and restricting access to credit in some circumstances has been established. Rate caps are seen as part of this.

To adapt these findings to the different legal systems we have to take into account that, in civil law in particular, the same rules may persist but will have changed their purpose over time, which also in turn changes the way in which they are applied. Many of the ancient rules which tried to ban or at least restrict interest have been revitalised for consumer protection.³⁴ This is why, for example, rules which once served to ban interest-bearing credit altogether have been rediscovered as rules to limit over-indebtedness and poverty, especially in Romance countries. Furthermore, ancient rules in relation to exploitation are being revitalised as a means to cap interest rates, particularly with regard to consumer credit. As such old ideologies still persist and sometimes are upheld

³⁴ As an example for the principle of anatocism see Reifner, U (1992), pp 227-343.

as a moral background, the true functions of this legislation may sometimes be obscured and excluded from the debate. In any event, the revitalisation of IRR within the last 30 years in Europe and more recently in America shows that not only do they have an economic impact, but their moral and cultural significance should also be taken into account.

Based on the questionnaire responses received from stakeholders and details from the legal survey, Table 4 shows some of the main reasons identified for which Member States have decided to introduce interest rate restrictions.

Table 4: Main reasons for introducing IRR

MS	Main reasons for introducing IRR
With IRR ceilings	
Belgium	Consumer protection to prevent excessive rates and to prevent excessive volatility of variable rates in order to protect customers
Estonia	Consumer protection, the need to control over-indebtedness and mainly to prevent SMS loan providers from collecting unreasonably high interest rates
France	Other than the interest rate ceilings in the 19th century that were abolished in civil transactions in 1918, France has had interest rate ceilings from 1935. However they were modernised in 1966 in order to prevent abusive practices due to the market power of French banks. Ceilings were used to prevent the development of predatory lending to households in financial difficulty and were motivated by the problem of over-indebtedness and unfair practices of the banks that do not give all information needed to the consumers when they grant credit. They were also introduced to balance the relations between consumer and lender to prevent the lender from imposing conditions on the borrower at any price.
Germany	When in 1976 interest rates in instalment loans dropped significantly the press revealed that some specialist instalment banks, which were mostly subsidiaries of well-known commercial banks or savings banks, still sold instalment credit at the old high prices. This led notably to a court decision by the Stuttgart Court of Appeals which actively publicised its decisions based on the Roman principle of the <i>laesio enormis</i> . When the Supreme Court was finally seized of the question in 1981, public pressure and support for the Stuttgart court was so high that the Supreme Court sought a compromise rejecting the price control approach of the Stuttgart court but introducing an un rebuttable presumption that a bank abuses its power when selling overpriced credit to inexperienced consumers.
Greece	The Monetary Commission has issued a large number of decisions as far as the essential banking activities, deposits and provision of credit were concerned defining the interest rates, sometime providing a fixed ceiling, sometimes providing for a minimum or a maximum rate. Gradually, within the framework of the overall effort to liberate the function of the financial market, banking interest rates are also freely negotiable among banks and their clients either on the basis of decision of the Bank of Greece either on the basis of the lack of any relevant provisions. Such freedom led to abuses. This was the reason why the Bank of Greece intervened again, introducing a restriction regarding the default interest rate in the Act of the Governor of the Bank of Greece 2393/15.7.1996.

Ireland	The interest rate ceiling that exists for moneylending in Ireland, currently just below 190% APR, is a de facto ceiling in practice as it is the rate at which the highest charging moneylender is licensed to trade by the Financial Regulator (with annual applications for renewal of licences). With regards to the ceiling for credit unions (1% p.a.) this is largely to ensure the creation of sources of credit for the mutual benefit of its members at a fair and reasonable rate of interest.
Italy	The usury threshold has been introduced to prohibit credit where providers can apply excessive interest rate to people with poor credit histories and consequently to counter the crime of usury, which was very widespread in the past.
Malta	The maximum rate of interest has always been fixed by the Civil Code since its promulgation in 1868.
Netherlands	Controlling illegal financial activities, protecting consumers by preventing the charging of excessive interest rates and decreasing risk-taking behaviour on the part of credit providers.
Poland	To protect borrowers from excessive interest charges.
Portugal	The main purpose of IRR in Portugal is consumer protection which arises from two different types of reasons: i) ethical reasons; and ii) protection of the weakest party. The recent APR usury ceilings on consumer credit agreements (introduced following discussions concerning consumers' rights in 2009) are related to both types of reasons and were particularly established to avoid the charge of especially high interest on agreements entered by consumers who are not entitled to obtain credit in traditional banks. Likewise, the main goal of restrictions on unilateral changes of interest rates and restrictions on rounding interest rates is to protect the weakest party which is, in the overwhelming majority of cases, the consumer. The main reason was the economic situation/crisis and a concern to ensure that financial service providers did not distort the market with absurd interest rates from some institutions at unacceptable cost. The interest rates charged by credit institutions in consumer credit exceeded 30% because they used predatory lending in credit to expand the circle of debtors in order to compensate for rising numbers of bankruptcies and competition in the credit market; this reveals the 'reverse Robin Hood effect' of lending to the poor to maintain low interest rates for the wealthy. Excessive rates give rise to further breaches, thus maintaining people perpetually hostage to adverse credit scoring.
Slovakia	Excessively high interest rates on consumer credit and the popular perception that there are many people whose property is taken into possession by loan sharks as a result of high credit prices, which they can not repay.
Slovenia	While rules on usurious interest rates are relatively old, the rules on maximum APR for non-bank providers were introduced because of usurious practices of these providers in the past. Adoption of the Euro was also seen as a reason for revising the IRR regime.
Spain	Consumer protection was considered in the past as necessary for current account holders, who are in some cases unaware of the high cost of occasional overdrafts (ceiling on overdraft only). The abuses of financial institutions in a fully liberalised market, the ineffectiveness of the supervisory bodies and the systematic violation of the rights of consumers.
Without IRR ceilings	

Austria	The in-built economic imbalance of suppliers and consumers (for rules on default interest only)
Cyprus	The objective of the existing "usury bill" is to extend the basic penal code to criminalize the lending of money between private individuals at an unreasonably high interest rate (usury executed by loan sharks). In 1999, the interest rate ceiling was abolished in order to allow full liberalization of the interest rates in Cyprus in an effort to enhance competition in the banking sector
Czech Republic	To bring more clients into the system, more stable deposits, less risky loans and cheaper resources for granting loans (for the state subsidy of building savings only)
Latvia	To protect the average consumer and to reach a balance in the financial and capital markets between industry and consumers;
Romania	The Gov. Ordinance 60/2009 established a governmental fund to support young people to obtain a loan to buy a home. The State guarantees the credit offered by the bank and imposes a maximum limit on the interest rate (though access to such a fund is difficult). In respect of civil agreements, the limitation on legal interest was due to public concern, but no economic modelling was produced, therefore it was deemed a populist measure.
United Kingdom	Default/risk-based re-pricing - these restrictions were introduced mainly in connection with customers in financial difficulty. The Government decided that restrictions would take into account circumstances where defaults occurred. These provisions were agreed following consultation with the lending industry and do not seek to restrict pricing beyond default cases.

Source: Stakeholder survey.

In almost all Member States, the reasons mentioned above are still seen by stakeholders in those countries as valid. Comments from the minority of stakeholders tending to disagree with the original reasons for ceilings included "too restrictive regulation has counterproductive effects such as closure of the market, less innovative products" (Belgium) or that the credit market is much more competitive now than it was when the legal usury rate was introduced (France). This same respondent nevertheless went on to say "still, the financial crisis led the French government to consider that IRR are an effective protection against excessive exposure to risk by lenders and borrowers. Indeed, sub-primes and near-primes do not exist in France. The interest rate of revolving credit in France is relatively lower than in other countries, though it approaches the usury ceiling with an average APR of around 16-17%". Similarly, another French respondent mentioned that the current level of competition and state of the property market did not make the debate on IRR particularly topical with regards to mortgage credit but confirmed that, in the area of revolving credit (especially that combined with and accessed through a bank card), the need for ceilings was much more pronounced because of the particularly high cost of funds to lenders.

Table 5 gives some views on whether those reasons are still valid today:

Table 5: Some reasons why IRR is still valid today

MS	Stakeholder type	Reason

IT	Provider Association	We don't think that these reasons are still valid. In fact it has to be underlined that the limitation on the cost of credit has been ineffective in combating the illegal use of credit and has resulted in an instrument that has prevented the development of the credit market
NL	Other	They are still valid; coverage will be extended to loans with duration of less than 3 months, which have been exempt in the past. The extension of coverage has been decided because misconduct was apparent in relation to short-term loans
SI	Consumer Organisation	They are very valid and call for further improvements. In the new act on consumer credit, the above-mentioned rule will also be valid for credit below the limits on maturity/amount of the CCD, while membership fees" will now be part of the APR"
PL	Other	Positives of IRR regulations were discovered, and now it is well established as pro-consumer regulation.
PT	Other	Leaving the markets unregulated means that the situation is still very fragile.
RO	Provider Association	There is no evidence as to their effectiveness. Research shows they are not effective; they drive illegal lending and restrict access to regulated sources of credit. Furthermore, they encourage loan sharks and credit into non-taxable environments. Personal security issues also arise.
SK	Provider Association	We have never been provided with hard data from state institutions or regulators as to the reality. We believe that there were only tens of people suffering from a loss of property who complained to state institutions. So there were and are no real reasons for IRR regulations. What was really needed was the regulation of illegal lending.
ES	Consumer Organisation	Some view ceilings as more valid than ever in the context of the current crisis. Others consider that the maximum ceiling on overdrafts does not vary and is not suited to the reality of credit or to the reality of the Spanish family economy. This existing ceiling will presumably be suppressed once the transposition of the CCD 2008 is completed in Spain.
UK	Provider Association	The reasoning was reviewed extensively in 2009 after the credit crisis but remained unchanged. In the current uncertain economic climate there is no impetus to change the provisions in place for default fees and when risk-based re-pricing can be undertaken.

Source: Stakeholder survey.

1.1.3.4 Philosophy of regulation

The underlying philosophy of IRR may be reduced to five legal notions which roughly correspond to three distinct goals:

(1) the ethical and religious concept aimed at preventing the exploitation of need and weakness ("Do not exploit the poor because they are poor" Spr 22,22); (2) the market concept, aimed at regulating prices where competition either does not suffice or where it produces unwanted impacts on more vulnerable parts of society ("The poor pay more" (Caplovitz); (3) unwanted credit products seen as detrimental for the national economy ("Unearned bread" Eucken).

These aspects apply to all forms of IRR since the threat of circumvention of purely interest rate-related regulations leads to a number of additional rules concerning variability, compounding methods, annexed products, penalties and fees.

(1) Exploitation

- o **Individual usury** proscriptions, which view high interest as evidence of the exploitation of a weaker party. These exist in both private and criminal law. It presupposes ill intention, knowledge of the situation of the debtor and its active exploitation through exorbitant interest rates. These regulations are, however, not applied to commercial consumer credit providers, which target high risk groups with predefined interest rates and which thus escape the definition of "exploitation". It is a broad concept, however, in that it encompasses all charges or methods of calculation, and not interest charges alone.

(2) Market regulation

- o **Good Morals:** at one time, individual usurious relationships were merely restricted in some countries on the grounds of morality. This has now developed into a principle of market evaluation. It provides objective rate ceilings through court rulings in which, instead of individual exploitation, lack of market strength on the part of certain groups in society leads to pricing which operates as cartel practice. Like special regulation in other countries, the average market rate is used as a competitive "as if price", which can be compared to the contractual interest rate. A limit is set at a margin above this rate. In Germany the Roman *laesio enormis* of "double the average market rate", as is still cited in the Austrian Civil Code, has been cited as a justification.
- o **Administrative rate ceilings:** fixed by the Central Bank (France), a ministry (Italy), or a royal decree (Belgium), such ceilings no longer have any moral connotations. They simply assume that for certain types of consumer credit prices have to be kept within a certain acceptable limit.

(3) Product regulation

- o **Specific rate ceilings:** with regard to certain unwanted forms of credit such as the limits on overdraft credit in *Spain*, or in order to make certain forms of credit more affordable, for example pawnshop credit in *Germany*, small business loans in *France* or loans from Credit Unions (12%) in *Ireland and the UK*.
- o **Consumer credit prevention:** administrative rules in force in the 1950s were fixed by the central banks in order to curtail credit extension to consumers. These were all abolished by 1990 and are no longer in force. (*Greece, Luxembourg, Germany, Italy*).

1.1.3.5 Fairness and Good Morals – towards a general principle for IRR in European contract law?

Since the reception of the Roman *ius commune* in all Europe, all countries have a certain set of common legal foundations which also provide restrictions on the freedom to contract. As far as these common foundations are concerned, it may be expected that all EU Member States have some form of principles in private consumer or commercial law, as well as in administrative and penal law restricting levels of interest.

The similarity of the way in which Roman law treated interest on money (“specialis”) to the way it treated rent for things (“res”) and labour income (“operarum”), all of which were attributed to one unified rent contract, the *locatio conductio* (specialis, operarum or rei), suggests that existing principles governing wage and rent restrictions in all Member States should resonate in consumer credit law.³⁵ This is not, however, so. Tenancy and labour law have been kept separate. Credit law is treated as an integral part of contract law and, once an individual loan contract³⁶ has been issued providing for interest, it is governed only by restrictions common to all prices, and especially those in relation to sale contracts.

Within the general principles of contract law, based on sales law principles, only few exemptions to the principle of the freedom to fix of prices exist. These apply to goods of first necessity, such as water, electricity and telephone. The setting of prices is seen as the heart of a market economy and it should come as no surprise that EU Directives governing general consumer and contract law refrain from making general price restrictions which could also affect interest rates in consumer credit agreements.³⁷

The notion of “unfairness” could be misunderstood as a basic principle which covers both commercial practices and pricing. This is, however, only the case if the notion of unfairness is used as in continental European law, where the notion of “good morals” (*gute Sitten*, *bonnes moeurs*) or “good faith” (*Treu und Glauben*, *bona fide*) apply. Fairness is a procedural category which does not affect the substantive elements of the contractual exchange.³⁸ This is clear in codified civil law and seems also to be the case in common law, which the legal expert³⁹ for the UK explained as follows:

“The Unfair Commercial Practices Directive 2005/29/EC (UPCD) is not used to control costs or charges. This is dealt with through the prohibition on Unfair Relationship provisions of the Consumer Credit Act. We are not aware of any attempt to use the UK's implementing law in this way, but direct control of credit costs - as the question seems to envisage - is not what the Unfair Commercial Practices Directive set out to achieve. Instead this is a law aimed at outlawing practices that distort normal market function, by, for instance, misleading the consumer. UK version of these regulations have been used to impose some control on credit card default charges but not bank charges (which were held not to be default charges and part of the 'price'.

The Unfair Terms in Consumer contracts Directive 93/13/EEC (UCTD) is implemented in the UK by the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs). The UTCCRs protect consumers against unfair standard terms in contracts they make with businesses. The FSA is one of several named bodies who can take legal action under the UTCCRs to prevent the use of such terms. Our ability to control the cost of credit under the UTCCRs is limited due to the exemption from the assessment for fairness of the adequacy of the price in exchange for goods or services (Regulation 6(2)(b)). Following the Supreme Court decision in the recent bank charges test case in the UK (*OFT v Abbey National plc and Others* [2009] UKSC 6), it is clear that this exemption means that the level of a charge cannot be assessed for fairness under the UTCCRs where that charge is

³⁵ See Reifner, U., Nogler, L. (2010), pp 365 - 407; Reifner, U., Nogler, L. (2009) pp 437–455.

³⁶ In Roman law the loan contract was still split into two separate agreements one for the “free” loan and an additional agreement (stipulation) for the interest.

³⁷ See below 1.4 Effects of the CCD 2008 on IRR at p 111.

³⁸ See for the procedural use of fairness in the Draft Common Frame of Reference III. – 1:103: Good faith and fair dealing (1) A person has a duty to act in accordance with good faith and fair dealing in performing an obligation, in exercising a right to performance, in pursuing or defending a remedy for non-performance, or in exercising a right to terminate an obligation or contractual relationship.

³⁹ See Annex V: Legal Experts for names of the country experts.

levied in exchange for goods or services; this means the UTCCRs can not generally be used to restrain the cost of credit.

We understand that the current negotiations around the [draft] Consumer Rights Directive could change the effect of the exemption in the UCTD (and consequently in the UK implementing legislation), which could allow the level of a charge to be assessed for fairness but only for charges that are not part of the essential bargain (ie. only those charges which are not the main price). Even if this change were to happen, it is unlikely that interest rates could be assessable for fairness, as interest rates are likely to be seen as part of the essential bargain" of a contract, and hence not assessable for fairness."

The question of fairness apart, prices are not totally exempted from restrictions under contract law. The principle of good faith and good morals, which is partly referred to as a substantive fairness in Common Law⁴⁰, incorporates the idea of the exploitation of weakness which underpins the moral usury principle. "Unconscionable", "excessive", "unfair" pricing⁴¹ is therefore the counterpart for what in codified civil law is seen as contrary to "good morals" and more specifically to "usury". With its principle of "laesio enormis" it ultimately provides one single principle of IRR.

This principle appears to have lost its significance where individual exploitation is no longer the problem. Instead, lenders are not reproached for systematically overpricing products targeted at poor customers for the same reasons. Only Germany and Estonia have used this individual principle and extended it to such systematic overpricing. Of course individual usury remains a principle under all general contract law and it may under extreme conditions also be applied to a specific credit contract if individual exploitation can be alleged.

What in Germany and Lithuania has been developed from the legal doctrine of "Individualwucher" to a legal doctrine of "Sozialwucher" can probably better be explained by the two aspects of competition law: unfair competition and cartel law. While unfair competition is purely procedural, cartel law is focussed on the mechanisms of price generation in a competitive market as laid down in Articles 101 ff Lisbon Treaty. Under Art. 101 (1) (a), "purchase or selling prices" are subject to restrictions if competition has been excluded intentionally by consent. But the common justification for interest rate ceilings and objective applications of IRR refer to the systematic misuse of power in certain market segments, where vulnerable consumers pay high interest placing them at risk of overindebtedness. This comes closer to the idea of Article 102 (ex Article 82 TEC), according to which "any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in: (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions". Similar prescriptions exist in all national cartel law.

This principle does not, however, seem to be applied to IRR. Instead, one case was reported from Italy in which anti-trust law was invoked to void high interest rates for overdraft credit. Unlike typical antitrust cases, the lack of competition cannot be attributed to a mono- or oligopolistic offer structure, nor does it systematically affect general competition in these markets. Consumer credit markets are highly competitive. The existence of uniformly high prices close to the ceiling in revolving small credit, as condemned in the French government report⁴², is more of a problem in terms of borrowers' behaviour. It is the borrower who accepts disadvantageous prices or

⁴⁰ Reifner, U. (1999) pp 269 ff.

⁴¹ See for example Financial Services Authority (2009).

⁴² See IGF/IGAS (2009).

additional costly products because he or she does not seem to be able to make proper decisions in either -refraining from borrowing or in the choice of a more appropriate product. These problems are typical for consumer law but not for cartel law.

With the increase of interventions into the pricing of consumer credit for low-income consumers, a general principle is about to develop in which the ideas of “basic services” and of “price cartels” merge into something that could be called a compensatory pricing mechanism for fair competition.

The question has now been decided by the European Court of Justice (EJC Dec. of June 3, 2010 C-484/08) in the case *Caja de Ahorros y Monte de Piedad de Madrid v Asociación de Usuarios de Servicios Bancarios (Ausbanc)* decided first by the Supreme Court of Spain on the question whether the Spanish law on general contractual conditions can declare prices as unfair in the sense of Directive 93/13/EEC and with regard to Articles 2 EC, 3(1)(g) EC and 4(1) EC.

Advocate General Trstenjak in his opinion on this case delivered on 29 October 2009 (62008C0484) provides the following information on the Spanish law:

“8. Article 10a(1) of General Law 26/1994 of 19 July 1984 for the protection of consumers and users (Ley 26/1994 general para la defensa de consumidores y usuarios), which was added by Law 7/1998 of 13 April 1998 on general contractual conditions, provides as follows in relation to the definition of unfair terms: ‘All those terms not individually negotiated which, contrary to the requirement of good faith, cause a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer, shall be regarded as unfair terms. In any event, the terms listed in the additional provision of this Law shall be regarded as unfair.’”

In his decision of June 3, 2010 the ECJ concluded in a way which allows the inclusion of IRR into the fairness principle of the EU-Directives on a national level:

“1. Articles 4(2) and 8 of Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts must be interpreted as not precluding national legislation, such as that at issue in the main proceedings, which authorises a judicial review as to the unfairness of contractual terms which relate to the definition of the main subject matter of the contract or to the adequacy of the price and remuneration, on the one hand, as against the services or goods to be supplied in exchange, on the other hand, even in the case where those terms are drafted in plain, intelligible language.

2. Articles 2 EC, 3(1)(g) EC and 4(1) EC do not preclude an interpretation of Articles 4(2) and 8 of Directive 93/13 according to which Member States may adopt national legislation which authorises a judicial review as to the unfairness of contractual terms which relate to the definition of the main subject matter of the contract or to the adequacy of the price and remuneration, on the one hand, as against the services or goods to be supplied in exchange, on the other hand, even in the case where those terms are drafted in plain, intelligible language.”

The Spanish example is not isolated. In relation to the Unfair Commercial Practices Directive 2005/29/EC (UPCD), some experts identified indirect interest rate restrictions, including unfair changes of interest rates (UK), unethical business practices (Hungary), illegally high interest rates on default and in provisions preventing legal proceedings against a debtor when he has reached more than the accrual of arrears of three instalments.

1.1.4 Effectiveness

IRR are regulated under private or administrative law, have penal or administrative sanctions, lead to reduced claims on interest and are enforced either by special authorities, the attorney general or the civil courts. Our chapter on existing legal sanctions shows the greatest diversity, and this aspect should not be under-estimated. In sociology of law there is a distinction between the *law on paper* and *law in action*. Theodor Geiger⁴³ goes so far as to assume that legal rules which are not effective are not in fact part of the law. The implementation of a legal rule therefore depends on the way sanctions are structured and whether they have the ability to threaten the addressee effectively. It also requires accessible institutions sufficiently equipped to prosecute circumventions of the law. Because in private law consumers have to mobilise these sanctions, the effectiveness of the law also depends on access to the existing courts, the incentives to sue, and the expectation they have that the court will act in a reasonable time at reasonable transaction cost.

Moreover, administrative rules often lack effectiveness due to poor staffing of the various institutions. This is why sanctions that give consumers an incentive to sue their creditors or oppose their enforcement activities in court can sometimes be much more effective. If for example in Germany and Belgium a lender has higher interest rates than legally permitted he loses all the interest, while in the Netherlands only the element of the interest which is above the ceiling is void. But additional penal or administrative sanctions will again change the picture of effectiveness.

Finally, only countries with high levels of banking supervision, which are subject to ongoing duties to provide information on the loans they provide and have a legal monopoly over consumer credit provision, are in a position to produce valid data that could enable sound interpretation of economic effects. Even when reliable data exists, there will nevertheless be a need for assumptions to be made. This was evidently the case in the Policis report on Germany⁴⁴, where the significant market for illegal lending is hard to assess. The research on crime statistics⁴⁵ indicates the, often insurmountable, difficulties that exist in this respect.

Another important factor is the applicability of the IRR. If, as we have seen for Malta, the rules have many complex exceptions, consumers will probably not be able to apply the law to their individual case. This may also be true for ceilings that are fixed on a case-by-case basis by the court system as in Germany and Hungary, and where the outcome of the case is not predictable. Administratively fixed and adjusted interest rate ceilings such as those that exist in France may also be easier to publicise than ceilings that are fixed by law as a proportion of market rates, such as those that still currently exist in relation to overdraft credit in Spain.

The legal experts either underlined that IRR should be made effective or indicated that IRR had been “effectively” incorporated into the body of law. From their answers we therefore cannot derive any conclusion on how effective these regulations are in general, since this information is normally dealt with in economic or social science, while lawyers understand effectiveness mostly as enforceability.

Perhaps some insight can be derived from the opinions of all those interviewed experts, consumer organisations, providers and regulators. They were asked to assess the effectiveness of the existing IRR on a scale between 1 (not effective at all) and 5 (very effective) for their country.

⁴³ Geiger, T. (1964), p 44.

⁴⁴ See: Policis (2004b)

⁴⁵ Eg. Helfgott, J.B. (2008), pp 13 ff.

One might have assumed that since these opinions are purely subjective, regulators responsible for effectiveness and providers, who take a more critical view of IRR would tend to overstate effectiveness while consumer organisations would have more doubts. Instead the average ranking consumer organisations gave to the effectiveness of the relevant IRR was even slightly higher than that of regulators and government officials.

Only in the Netherlands, Austria, Finland and Poland did answers differ by more than two 2 grades, while for example in Cyprus, Italy and France the different respondents provided identical replies.

The following ranking should be taken with caution. Only half of the respondents gave this rough evaluation and they are not representative by country. It gives, however, at least an indication that countries with strict IRR are seen as having the most effective regulations.

Table 6: Member States by effectiveness of IRR

Member State	Average grade
France, Belgium, Portugal	4.5
Cyprus, Denmark, Finland, Italy, Netherlands, Slovenia	4.0
Poland, Austria, Bulgaria, Czech Rep, Estonia, Latvia, Lithuania, Slovakia, Slovenia, Sweden, Romania	3.0
Spain, Germany, Greece, Hungary, Luxembourg, Malta, Slovakia, UK, Ireland	2.1
Ireland	1.0

Source: Stakeholder and Expert survey.

The propositions with regard to IRR give some hints as to existing cultural and economic differences as well as to existing problems with IRR. We have refrained from sorting them according to the different groups.

The scope of application has been recently extended to small loans with a term of less than three months and the interest rate ceiling has been lowered recently in the Netherlands as a response to the ineffectiveness of the previous one. Similarly a Latvian, a Lithuanian and a French respondent argued that the system should be changed from product-specific ceilings (revolving, instalment credit, etc.) to a ceiling related only to the amount of credit.

French, Czech and German respondents criticised the fact that the price of the loan does not include all possible costs. The interest rate ceiling should have a clear relationship to the market price.

Better supervision was wanted in Hungary and Belgium. Supervision should include regular testing. A stricter licensing system instead of interest rate ceilings could

overcome illegal lending in Italy. In France, it was suggested that a register of credit agreements would be better than the existing rate ceilings.

Some respondents asked for a focus on factors which are not sufficiently taken into account. In Italy, the charges made by debt collection agencies, in Ireland and Lithuania mortgage loans and variable interest mortgage rates were mentioned. It was felt that traders should be more closely monitored.

Some Italian and French respondents asked for a complete removal of IRR, others, for example in Hungary, assumed that their markets are either not prepared for them or find them unnecessary. Respondents in the Czech Republic, Ireland, Finland and Lithuania would favour their introduction.

In conclusion, the effectiveness of IRR regulation depends largely on the existing national culture of law enforcement and the degree of bank regulation which leaves more or less space to high-priced credit. In general small loans, revolving credit and variable interest rates are seen as a problem. The choices for effectiveness lie between stricter supervision and private law approaches. Harmonised forms of IRR would probably have to take questions of enforcement and sanctioning into account in order to achieve comparable results with similar rules in all countries.

It also makes clear that the mere existence of IRR rules cannot be related to the questions of access to credit without taking into account their effectiveness. For a deeper insight, an in-depth study of two countries with opposing systems could help to clarify what the most effective forms of regulation could be.

1.2 Direct IRR

An ordinary credit contract often has two lives: the contractual state where the parties have set prices and terms, and the post-contractual state where a credit is in default after cancellation. The applicable interest rates between both periods may differ: the contractual interest rate and the default rate. While the first is at the core of the principle of freedom of contract, for the second, most legal orders either provide a legal regime or at least regulate these rates since the assumption that they have been freely convened is weaker even where this has been done in advance.

A further clarification is also necessary. The CCD 2008 distinguishes between the APRC for price disclosure and the borrowing rate for interest calculation. This distinction is due to the fact that the APRC does not allow for a comprehensive calculation of interest (it is in fact not an *interest rate* but a *growth rate* ($\text{Interest} = C_1 - C_0$; $C_1 = C_0 \cdot (1+i)^t$) while on the other hand the borrowing rate which allows for a much easier form of interest calculation ($\text{Interest} = C_0 \cdot i \cdot t$) does not provide for a correct representation of price relevant factors like different compounding periods or the inclusion of upfront fees and charges. Both forms are therefore in use. Though they do not lead to much differences in non-bank and short-term credit, it should nevertheless be kept in mind that historical interest rate ceilings, especially absolute interest rate ceilings or IRR designed for non-banks where computers have been or are still not available, use the borrowing rate. This is particularly the case where the “legal interest rate”, which is no IRR but a rate which is applied in such cases where no interest rate has been set by the contracting parties, is still regulated in the form of a borrowing rate. This is also true for all regulated default interest rates (for which the CCD 2008 also fails to prescribe the form of an APRC). On the other hand, modern IRR in the form of a relative ceiling for contractual interest rates in loans extended by professional money lenders, use the form of the APRC which is less prone to circumvention. In the following text we have tried to clarify this by using the distinctions of the CCD 2008.

1.2.1 Contractual interest rate ceilings

1.2.1.1 Types of ceilings – Which Member States and at what levels?

As shown in Table 7, in thirteen member states there are no ceilings in place that limit the amount of contractual interest that can be charged on typical credit agreements⁴⁶. However, the remaining fourteen states do have some form of ceiling for this purpose.

Of these, three Member States use absolute ceilings (fixed nominal rate caps) and eleven Member States have relative ceilings (ie. the ceilings are calculated in relation to a variable such as the average market rate or base rate), although Estonia and Germany, have only de facto ceilings.

There are four different institutions which can be involved, either alone or in combination with another institution, in fixing the maximum interest rates: the Central Bank, Government Administration, Legislator or Courts. While in Italy, Portugal and Malta the legislator fixes rate ceilings, in France, Belgium, Estonia and Poland (Lombard rate) it is the central banks that fulfil this task. Likewise, in Greece and Spain, the central bank is the core institution in so far as it fixes the legal interest rate upon which the IRR is based. This is in contrast to Bulgaria or Ireland where the government and a special

⁴⁶ In the UK, there is a limit on contractual interest rates that can be charged by Credit Unions, but these constitute less than 3 per Cent of the total consumer credit market, and there are no ceilings in place in respect of other types of lenders, so for the purposes of the classification, we have treated the UK as having no ceilings.

administration is respectively in charge. Finally, in Germany, the courts fix such general rate ceilings while in Hungary and the Czech Republic courts may fix individual limits.

Ceilings are set for a variety of periods. Poland and Germany set ceilings each month whilst over a third of Member States do not determine the period at all and do not review their ceilings at regular frequencies. Ireland reviews its ceiling on moneylender rates annually, but Belgian ceilings have only undergone four revisions since 1992. However, quarterly adjustments are the most common.

Differences also exist in respect of the number of decimal places that the APR ceiling contains (for example, in Belgium this ceiling is rounded up to the nearest half a percent whereas in Slovakia, two decimal places are shown).

Interest rate ceilings are, of course, only one form of IRR. In the remainder of this report, we refer to interest rate ceilings irrespective of whether or not the ceilings are absolute or relative. Table 8 on the following page thus sets out further details of interest rate ceiling levels in operation across the EU as at March 2010 and shows that for example high priced doorstep credit extended in the UK would face barriers to enter the market in those countries where IRR exist (see Section 2.5.3 discussing hypotheses H2a).

Table 7: Overview of interest rate ceilings in the EU

MS with contractual IRR (absolute)	MS with contractual IRR (relative)	No IRR
Greece*; Ireland; Malta*;	Belgium*; France; Germany; Estonia*; Italy; Netherlands; Poland; Portugal; Slovakia; Slovenia; Spain*	Austria; Bulgaria; Cyprus; Czech Rep; Denmark; Finland; Hungary; Latvia; Lithuania; Luxembourg; Romania; Sweden; UK*

Source: Expert survey. *Notes: This table does not report on other IRR forms (such as default interest ceilings, anatocism or specific limits affecting specific forms of credit such as state housing loans etc.). BE: Calculation method for the ceiling specifies the adjustment mechanism based on a reference index (Euribor), but the initial interest rate ceilings that served as a base were set by the government when the ceilings were first introduced in 1992; GR: Ceiling is for non-banks only; MT: Subject to exceptions (enacted by Legal Notice 142 of 2009); ES: Only concerns overdraft in current account; EE: Ceiling rates are published but no strict limits exist. We have included Estonia in this category because we consider the ceiling as a defacto ceiling as it is based on a similar court based system as that used in Germany); UK: Credit unions do face a ceiling but in view of their very small share of lending, we have classified the UK as having no IRR.

Table 8: Interest rate ceilings in the EU as of March 2010

Member State*	Maximum APR in Consumer Credit	Average Interest Rate	Scope**	Comments
Belgium	10-19.5%		All	Maximum APR vary according to the amount and the type of credit (12 categories). From 10% (Revolving Credit Account with no credit card for more than €1250) to 19.5% (for instalment loan agreements less than €1250). Credit term is not a discriminatory factor anymore.
Estonia	63.9%		All	Maximum APR equals 300% of average APR computed by central bank ($21.3\% \times 3 = 63.9\%$). Reset Monthly
France	5.72%-21.63%	8.12%-16.6%	All	Maximum APR equals a relative 133% of average APR computed by the Central Bank every 3 months depending on credit type (pending reform) and amount : from 5.72% (variable rate credit for home purchase) 21.63 % (Consumption credit for < 1524 €). Separate ceiling category for mortgage credit.
Germany	8.18%-16.4%	4.09%-8.2%	All	Maximum APR equals 200% of average APR computed by the Central Bank depending on credit type and term : from 8.18% (new business/housing loans with an initial rate fixation of >5 years and <10 years) to 16.4% (new business/consumer credit with an initial rate fixation of >5 years). A further ceiling condition alongside double average is a maximum of 12 percentage points over average rates.
Greece	Partly 6.75%		On non bank credit only	Greece abandoned the system of setting limits by administrative provisions in 1989. Hence, bank interest rates are free. But their non-bank credit rates are limited to absolute rate of 6.75% per annum.
Ireland	Partly 187%		Moneylenders only	Moneylenders are assigned maximum APR when getting their annual license. Credit Unions cannot charge more than 1% per month (12.68% APR).
Italy	4.38%-27.20%	4.38%-16.97%	All	Maximum APR equals a relative 150% of average APR computed by Ministry of Economy and Finance every 3 month depending on credit type and amount : from 4.38% (variable rate mortgage) to 27.20% (other family loans). There are 23 different ceilings.
Malta	Partly 8%		Many exemptions	All type of credits. Exemptions exist for banks.
Netherlands	15%		Not mortgages. Credit <€200 (to be included)	Maximum APR ceiling is equal to 12%pts + the legal interest rate (non contractual interest in case of default. As of march 2010: 3%). Legal IR reset every 6 months
Poland	20%		All	Maximum borrowing rate equals to 400% of the Central Bank Lombard Rate (5%, monthly reset). No distinction made by category or size of credit.
Portugal	6.7%-31.6%	5.03%-23.75		Maximum APR equals to 133% of the average APR computed every 3 months by Central Bank depending on credit type only. From 6.7% (Instruction, health and renewable energies credit) to 31.6% (Credit cards, credit lines, bank current accounts and overdraft)
Slovakia	11.52%-79.8%			Maximum APR equals 200% of the average APR for the type of consumer credit in question (30 ceilings by type, amount, term), and at the same time it cannot not exceed the amount equal to 400% of the weighted average APR for all types of consumer credits.
Spain	10%		Overdraft (could change), social housing loans	The APR cannot exceed 2.5 times the legal interest rate. For social housing loans interest is set by reference to indexes based on the legal interest rate.
Slovenia	13.2%-453%	6.6%-226%	On non bank credit only	Maximum APR equals 200% of average APR computed by Central Bank every 6 months depending on credit term and amount : from 13.2% (120 month 20K€) to 453% (2 month 200€)

Source: Expert Survey and national websites. Notes: *For greater detail on the usury ceilings in place, please refer to the respective country section in the following chapter. **The usury ceilings apply to all consumer credits (mortgage and non-mortgage) unless specified.

1.2.1.2 Absolute interest rate ceilings

All three Member States with absolute ceilings limit the application of these to specific types of credit provider or place significant limitations on their scope. In Greece, the ceilings do not apply to banks, and Malta also provides banks with significant exemptions, whilst Ireland limits the interest rates that can be charged by moneylenders and credit unions only.

1.2.1.2.1 Greece

There is a maximum contractual borrowing rate in Greece for non-bank credit only. The ceiling is currently 6.75% per annum. Bank credit is exempted in its entirety. The maximum contractual interest rate is regulated by administrative law and the government sets the interest rate, more specifically by Acts of the Council of Ministers on the basis of proposals from the Monetary Committee of the Bank of Greece.

1.2.1.2.2 Ireland

Generally speaking there are no interest rate caps on loans in Ireland. However, there is a maximum borrowing rate and this controls the level of interest rate that Credit Unions can charge (1% per month of the outstanding balance, so 12.68% APR). This figure is incorporated in legislation under the Credit Union Act.⁴⁷ Furthermore, the Financial Regulator is able to specify maximum interest rates that can be charged by moneylenders in Ireland as part of the licensing process. Moneylender licenses are reviewed annually and the current maximum level of interest that the regulator allows them to charge is 187% APR.⁴⁸ Furthermore, finance houses that are not credit institutions and who are mostly involved in car finance and hire purchase agreements are only prescribed for the purposes of the consumer credit legislation to charge an APR of up to 23%.

We will however, consider Ireland as a country without IRR for the purposes of our analytical work as there are no restrictions on interest rate pricing effectively in Ireland at present. Though there is no focus on restrictions on interest rate pricing at the current time, there are nevertheless certain prescribed scenarios (eg. where a fixed interest rate is set there are provisions that the fixed rate must be correctly applied etc.. with breakage applicable on early settlement of the agreement by the customer). Furthermore, under the Consumer Protection Code for Licensed Moneylenders of January 2009, prior to entering the agreement, the moneylender must

“prominently indicate the high-cost nature of the loan on all loan documentation where the APR is 23% or higher. This disclosure must take the following form: ‘Warning: This is a high-cost loan’.”

1.2.1.2.3 Malta

The maximum borrowing rate in Malta is set by law and has always been fixed by the Civil Code since its promulgation in 1868. According to Article 1852(1) of the Civil Code, the rate of interest on loans cannot exceed the interest rate of 8% per annum. Between 1868 and 1974 it was 6 % per annum. This rule however is subject to exemptions which

⁴⁷ Section 38 of the Credit Union Act 1997.

⁴⁸ See following link for the procedure: www.financialregulator.ie/industry-sectors/money-lenders/Pages/authorisation.aspx. Moneylenders apply for renewal of their licences annually from the Financial Regulator and this can be denied in case of infringement. Up until the Consumer Credit Act 1995, Moneylenders were licensed under the Moneylenders Acts 1900 and 1933. They were not allowed to charge more than 39% interest per annum (although this ceiling was often exceeded in practice).

results in banks not being subject to this ceiling.⁴⁹ In its last paragraph the law states that the misuse of such exemptions by “artificial, fictitious or simulated” “contract, arrangement, scheme, transaction” will void such arrangements. The exemptions can be summarised as follows:

- financial transactions where one of the parties is a designated entity: Provided that no party to the financial transaction may be a natural person;
- secured by a mortgage registered or recognised under the Merchant Shipping Act or the Civil Aviation Act;
- governed by a foreign country and the agreed rate of interest and, or compounding of interests are in accordance with international market conditions and the payer of interest is not a natural person;
- security (including guarantees, suretyships, indemnities and other similar undertakings, pledges, privileges, hypothecs, mortgages and any other collateral arrangements, whether by way of title transfer or otherwise) which is governed by Maltese law and which is entered for the purpose of, or in connection with, any transaction specified in paragraph (c);
- financial instruments of more than two million Euro;
- debt arrangement inside linked companies.

1.2.1.3 Relative interest rate ceilings

Although eleven Member States have relative interest rate ceilings which besides Spain are all provided in the form of an APRC there are considerable differences between them in respect of the way that these operate. For example, some implement different ceilings according to the amount of credit that is being extended, some impose different ceilings according to credit type, and some distinguish levels of ceilings on the basis of the duration of the credit agreement (see Table 7 on p63 for the overview). Portugal stands out with its new 2009 ceilings as it regulates them based on the purpose of the credit (ie. with separate categories of ceilings for education loans or auto loans). Four of the eleven Member States (Netherlands, Spain, Poland, and Estonia) have one unique ceiling level.

It should also be noted that in Slovenia ceilings only apply to non-banks as it was judged that the banks face sufficient competition to not warrant such regulation. However, in all of the other Member States there is no distinction made between bank and non bank credit as regards the scope of ceilings (although sanctions may differ as for example in Portugal where the rules of procedure and amounts of fines will be different depending on the creditor’s nature ie. financial institution or not). Whereas all systems based on an absolute ceiling calculate their ceiling from an exogenous source, of the eleven that have a relative ceiling that can fluctuate over time, only Belgium, Poland, and the Netherlands do not rely on prevailing market rates alone.

1.2.1.3.1 Germany

German court based jurisprudence limits lenders' flexibility by requiring them to charge no more than double the average market rate. It also imposes a second condition limiting the ceiling to a fixed pre-determined maximum margin set at 12 percentage points over

⁴⁹ The Interest Rate (Exemption) Regulations 2009 enacted by Legal Notice 142 of 2009 issued in exercise of the powers conferred on the Minister of Justice by article 1855A of the Civil Code further defines the special law: According to Article 3(1) thereof.

the average interest rate. This means that when the average market rates move above 12.1% APR, the ceiling level applied will no longer be twice this (ie. 24.2%) but instead be limited by the second condition to 24.1%. To illustrate the potential significance that the extra moderating effect of the second condition contains, imagine average market rates reach as high as 30%: this would lead to an authorised ceiling level set at 42% instead of 60% if only the first rule existed.

The average interest rates are related to real market developments. The banks had to report their interest rates and their spread to the German Central Bank, which then calculated the average. These average market rates were published by the German central bank (formerly referred to as the "Schwerpunkt Zinssatz") for overdrafts and instalment credits separately. In June/July 2003, there was a change because the "Schwerpunktzinssatz" were replaced by the average interest rates reported by the European Central Bank. Therefore, the ceilings lowered in July 2003 by approximately 7 percent. Interest rates exceeding the limits cause contracts to be held as usurious and declared void by the court.

1.2.1.3.2 Estonia

There are no fixed interest rate ceilings regulated in the law, however the latest court practice has shown that the court will intervene if the level of interest payments in comparison to the principal is unreasonably high. In a similar approach to the German system this has been found to be the case where the interest charged is three times more than the market average.

The Estonian central bank publishes the average APRs for all consumer loans granted by credit institutions to individuals on their website every month. There is no official publication of the ceilings but the current average is available on the central bank website⁵⁰ and as of March 2010 is 21.3% which would imply a ceiling of 63.9%. However, compared to the German system it is as yet uncertain as to how relevant and how much of a credible deterrent this ceiling is in Estonia.

1.2.1.3.3 France

France has a long history of using interest rate ceilings. Other than the interest rate ceilings in the 19th century that were abolished in civil transactions in 1918, the interest rate ceilings introduced in 1935 were modernised in 1966 and its system is once again undergoing change. It currently specifies a relative maximum APR of 133% of the average of rates⁵¹ found for different types and amounts of credit, for example by providing separate ceilings for revolving and instalment credit and for small and large sum credits. This led to a system of twelve separate ceilings, including six ceilings applicable to consumer credit. The rates as of the end of the first quarter of 2010 are shown in the table below.⁵²

⁵⁰ The fixed rate ceiling (concerning the annual percentage rate of charge) is published on the website of Bank of Estonia. These values are publicly available on a historical basis at http://www.eestipank.ee/dynamic/itp/itp_report.jsp?reference=152&className=EPSTAT&lang=en.

⁵¹ As opposed to the average interest rate statistics calculated by the ECB, the French central bank does not assign a weighting based on the size of the loan when calculating its average for the market segments.

⁵² See: <http://www.banque-france.fr/fr/statistiques/taux/usure.htm>.

Table 9: Interest rate ceilings in France

Credit category	Average APR	Interest rate ceiling at 01.04.10 (133% of average APR)
Mortgage loans to individuals (loans falling within the scope of Articles L.312-1 to L312-36 of the Consumer Code)		
Fixed rate loans	4.72%	6.29%
Variable rate loans	4.29%	5.72%
Bridge loans	4.69%	6.25%
Consumer loans to individuals (not falling within the scope of Articles L312-1 to L312-36 of the Consumer Code (called "cash loans", <i>crédits de trésorerie</i>))		
Loans of less than or equal to € 1524 (1) (2)	16.22%	21.63%
Overdrafts, loans and permanent financing of purchases or instalment sales over €1,524 mortgage and loan Life (1) (2)	14.59%	19.45%
Personal loans and other loans of a greater amount to 1524 €	6.64%	8.85%
Loans to legal entities with no industrial, commercial, craft, agricultural or professional non-commercial ⁵³		
Loans for purchases or instalment sales	7.15%	9.53%
Loans with an original maturity exceeding 2 years, variable rate (4)	3.99%	5.32%
Loans with a maturity over 2 years, fixed rate	4.31%	5.75%
Overdrafts (3)	10.00%	13.33%
Other loans with original maturity up to 2yrs	4.30%	5.73%
Loans to individuals acting on their business needs and legal persons having an industrial, commercial, craft, agricultural or professional non-commercial.		
Overdrafts (3)	10.00%	13.33%

Source: Bank of France. Notes: (1) Expressed as an APR as stipulated by the Consumer code; (2) Only the amount of credit actually used is considered when assessing the APR of an overdraft or a permanent loan; (3) Rates do not include the commissions on the highest overdraft amount reached during the month - the average rate of such fees actually collected in January 2010 amounted to 0.05%; (4) Average APRs of corporate loans with an original maturity greater than two years, variable rate, and an amount of less than €152,449 (rate is used by the tax authorities for calculating the maximum deductible interest on linked current accounts and was 3.99% for this category of loans in Q1 2010). Also not that the French ceilings do not apply to hire purchase agreements (unlike the Belgian regime).

⁵³ The concern with usury ceilings (as they are referred to in France) mainly concerns consumers. This is due to Article 32 of Law No. 2003-721 of 1 August 2003 for the economic initiative, which eliminated the crime of usury for lending to commercial, industrial or financial entities. An analysis is available on http://www.mediateur-republique.fr/fic_bdd/pdf_fr_fichier/1237289023_Modification_du_taux_d_usure.pdf.

The reform law on usury ceilings in May 2010 brought the following changes:

Article 1 (amended Articles L. 313-3 of the Consumer Code) on usury rates states that the maximum interest rates ('les taux de l'usure') will no longer be classified by credit type. Before the changes, specific usury ceilings were allocated to specific loan categories (cash/treasury loans, overdrafts, term loans, hire purchase financing, lifetime mortgages (equity release scheme), personal loans and mortgages). These usury ceilings are now defined only according to the amounts borrowed (with the exception of mortgage loans (home loans), loans to local authorities and business loans). A new decree will specify the new usury ceilings. Transitional measures will be introduced (over a maximum transition period of 8 consecutive quarters) by the Government to promote the implementation of the reform. In addition, to measure the impact of this reform (potentially only the first on usury ceilings) the Government has established a committee chaired by the Governor of the Bank of France in charge of 1) monitoring and analysing the effects of the changes made to the method of determining the rates ('mode de fixation') applicable to the level and the evolution in interest rates on consumer credit; 2) examining the methods and ways of financing (modalités de financement) available and being used by credit institutions doing the lending; and 3) analysing the level, developments and components of provider lending margins. The Committee, made up of the Governor of the Bank of France, an elected deputy, a senator and the Director General of the French Treasury, will meet at the initiative of its president at least once per quarter for two years. It will produce an annual report, which will be submitted to Parliament and Government.

1.2.1.3.4 Belgium

For consumer credit there are provisions on the maximum APR. The maximum APR is determined by Royal Decree (art. 20, § 1 WCK - Consumer Credit Act). But the APR is only the representation of the total cost of credit. It is nowhere used to calculate these cost for which other parameters especially the borrowing rate is used. In so far the government can determine the maximum total costs of credit, it can also set the maximum borrowing rate and, in the occurring case, the maximum recurring costs and the maximum non-recurring costs vis-à-vis a revolving credit account (art. 20, §2 WCK).

Consumer credits with a credit term of more than 5 years can be sold with variable interest rates. In this case additional rules apply the change of the APR according to article 9 WHK (Mortgage Credit Act) stipulating the rules on variable rate mortgage loans - art. 30, §2 WCK. For revolving credit accounts there is a specific rule providing for an absolute maximum interest rate. Art. 4, §4 of the Royal Decree of 4 August 1992 on the costs, percentages, the duration and the terms of repayment of the consumer credit stipulates that "if the revolving credit account foresees various borrowing rates depending on the drawdowns or on the instalments, none of these borrowing rates may be higher than the maximum APR determined in function of the amount of credit".

Overdrafts on bank accounts, which fall outside the scope of the WCK, are regulated by the law of 14 May 2001. This law applies to every bank account opened by a consumer at a bank or at the Postal Office and on which a debt balance occurs to which the WCK does not apply (art. 2 of the aforementioned law). The annual borrowing rate is capped to the maximum APR applicable pursuant to the WCK on open-ended revolving credit accounts where the total amount of credit does not exceed EUR 1,250. The costs linked to the credit cards do not need to be included in the total cost of the credit (art. 3).

The maximum APR for consumer credit in Belgium is based on a hybrid of mechanisms. While initially set as absolute rate ceilings, through a rather sophisticated ceiling setting mechanism, the ceilings are now relative ceilings since the setting of the ceiling level is dependent on changes to determined reference rates. The reference indices, which determine changes made to the ceiling, and the calculation method for mortgage loans

are set by the King (by Royal Decree) after consulting the Banking, Finance and Insurance Commission ("CBFA") (art. 9, §1, 3° WHK). Using monthly computed reference indices for variable rate mortgage loans on the basis of a constant-maturity yield curve, published by the Securities Regulation Fund ("Rentenfonds"), if significant changes have been registered, the maximum APR is then adjusted by an administrative procedure (by Royal Decree). Article 21 WCK further detailed by the Royal Decree of 4 August 1992 the relevant costs, percentages, duration and terms of repayment are taken into account. The ceiling depends on the credit type and the credit amount. For all consumer credit types 12 different maximum APR's are determined. Instalment loans, deferred payments in sales contracts, financial leasing, revolving credit card accounts and revolving credit accounts without cards are distinguished. A simplification in 2006 abolished a further distinction according to the duration of the credit.

The maximum APR is calculated on the basis of a reference rate. For all consumer credit agreements, with the exception of revolving credit accounts, the reference rate is based upon treasury certificates for 12 months (for credit amounts up to €1,250), linear bonds on 2 years (for credit amounts between €1,250 and €5,000) and linear bonds on 3 years (for credit amounts above €5,000). The reference index for revolving credit accounts is linked to the monthly average of the 3 month Euribor. The reference rates are calculated by Belgostat. The applicable maximum APR corresponds to the respective rounded reference rates.

Recently the maximum APR, applicable to all consumer credits, was adjusted for the 4th time since 1992. The maximum APR is published in the Official Journal. It is analysed every 6 months, to see if reference rates (Euribor term rates) have changed beyond 75 basis points in which case reference indexes and then APR ceilings will be adjusted accordingly, with a rounding to the nearest half a percentage point for the ceiling.

For consumer credit Table 10 shows the APR limits currently in place:

Table 10: Interest rate ceilings in Belgium

Credit Amount	Index	Instalment Loans/deferred payment	Revolving credit account with card*	Revolving credit account without card*	Financial Leasing
≤ €1,250	Index A	19.5%	15.0%	11.0%	13.5%
> €1,250 up to €5,000	Index B	15.0%	13.0%	10.0%	11.0%
> €5,000	Index C	12.5%	12.0%	10.0%	10.5%

Source: Official Journal. Note: Changes in the indices, when they are greater than 0.75 points, determine the adjustment mechanism of these rates. *These indices do not apply for revolving credit, the changes to the ceilings of which are based on the changes in the 3-month Euribor.

An opinion from the consumer council on changes to the fixing of maximum APRC was issued in May 2006 and led to some significant changes.⁵⁴ The objectives of the council were to: 1) simplify the existing IRR system by reducing the number of different ceilings (which stood at 28 before the change) and bringing the product categories in line with prevalence in the market; 2) introduce an automatic system for adapting the ceilings going forward (moving from the previous dependency on the King to make a decree to a method of objective adjustments based on evolution of a reference index from the

⁵⁴ Conseil de la Consommation, Belgique (2006).

financial markets); and 3) to reach a reasonable balanced solution acceptable to all parties involved (consumer associations and providers).

Finally, the maximum borrowing rate for overdrafts on bank accounts, which are regulated by the law of 14 May 2001 on overdrafts on bank accounts, is currently 11%. The maximum APR's are also published in the Official Journal. For variable rate mortgage loans, the reference indices are published monthly in the Belgian Official Journal. The current reference indices are also publicly available on the websites of the Securities Regulation Fund and of the Banking, Finance and Insurance Commission.

1.2.1.3.5 Slovakia

Slovakia introduced interest rate legislation only very recently (in its Consumer Credit Act 2008). Government Regulation No. 238/2008 Coll. sets the maximum APR to serve for the purpose of a usury ceiling). It is currently 79.08% (until 15th of May 2010). The Ministry of Finance of the Slovak Republic in cooperation with Národná banka Slovenska set these reference rates. The source data to inform this decision is provided by creditors who are obliged by art. 7a sec. 1 of the Act on to submit data on their interest rates to the Ministry and to the national central bank.

According to art. 1 sec. 1 of Regulation No. 238/2008 Coll., the maximum interest rate allowed is twice the average value of APR for the type of consumer credit being lent, and at the same time it cannot exceed four times the value of the weighted average APR cost and average interest rates for all types of consumer credits valid at the date of concluding the contract (Table 11).

The fixed rate ceiling is adjusted quarterly and the level is published on the webpage of Ministry of Finance of the Slovak Republic. The values of interest rate APR ceilings are publicly available at page of The Ministry of Finance of the Slovak Republic.⁵⁵ Slovakia also has rules concerning default interest regulation, which are set out later in this report (Chapter 1.2.2.3).

However, there is currently a discussion taking place and a new Proposed Act on consumer credit. All the interest rate caps related legislation could be repealed by this with alternatives suggested by increasing price transparency and improving the financial literacy of consumers. The interest rate ceilings do not apply to mortgage credit contracts. These are provided by mortgage banks according to general terms and conditions stipulated in art. 75 sec. 1 letter e) of the Banking Act. General terms and conditions of the mortgage credit and municipal loans may include some IRR.

Table 11: Interest rate ceilings in Slovakia

Type of consumer credit	Value	Contractual maturity				
		3 to 6 months	6 to 12 months	1 to 5 years	5 to 10 years	Over 10 years
Credit cards - the average interest rate (not APR)	39.00	x	x	x	x	x
Consumer loans with security or lease of up to €1,500 inclusively	x	76.00	45.24	48.58	35.06	21.38

⁵⁵ See <http://www.finance.gov.sk/Default.aspx?CatID=6865>.

Consumer loans with security or lease ranging from €1,500 to €6,500 inclusively	x	68.60	44.54	37.60	28.56	12.86
Consumer loans with security or lease of more than €6,500	x	47.74	34.50	22.78	20.48	11.52
Other consumer loans (not included above) amounting up to €1,500 inclusively	x	76.00	76.00	76.00	48.28	0.00
Other consumer loans (not included above) ranging from €1,500 to €6,500 inclusively	x	51.58	49.08	41.44	37.18	32.86
Other consumer loans (not included above) of more than €6,500	x	24.22	20.50	27.54	30.50	13.32
Four times the weighted average of the average values of the APRC and the average interest rate for all types of consumer loans	76.00	x	x	x	x	x

Source: Ministry of Finance of the Slovak Republic. Note: The ceilings are those of the first quarter 2010 and are valid for credit agreements concluded from 16 May 2010 to 15 August 2010. The maximum ceiling level in % is set at an accuracy of two decimal places.

1.2.1.3.6 Italy

Usury is a criminal offence in Italy and it provides a detailed system of usury ceilings based on 50% above calculations of the average charges in the market (APR or 'TEGM') for different types of credit and different credit amounts. While Italy, along with all other countries with relative IRR with exception of Poland, use the APRC of the CCD 2008, a big debate is taking place concerning the treatment of insurance costs which this Directive did not include if concluded "voluntarily".

The ceilings are effective for every kind of transaction or financial/credit operation, and for every kind of subject. Civil/contractual remedies, which include voiding the contract and/or substituting new interest rates into the contract can also be combined with criminal sanctions. The different types of credit, amounts, and ceilings put in place by Decree of 24th December 2009 are set out in Table 12.

Table 12: Interest rate ceilings in Italy

Type of credit	< €5,000	> €5,000
Savings and bank account (secured or unsecured)	12.85% + 50%	9.59% + 50%
Anticipations and corporate loans	10.26%+50%	5.43%+50%
Consumer Credit (instalment loans)	12.53%+50%	
Revolving credit (credit card)	16,97%+50%	12.79%+50%
Special purpose credit (finalizzato)	14.18%+50%	12.17%+50%
Mortgage loans	5.36%+50% (if fixed rate loans) 2.92%+50% (if variable rate loans)	
Salary and pension loans	15.53%+50%	12.46%+50%
All other family loans, finalized or not finalized including pawnbroking	18.13%+50%;	
All other family loans if provided by non-banks companies	14.41%+50%	
	Other amounts	
Auto leasing (and aeronautic leasing)	Ceiling for credit under €25,000: 14.31%+50%	Ceiling for credit over €25,000: 12.67%+50%
Equipment leasing:	10.34%+50% (under €25,000)	6.56%+50% (over €25,000);
Factoring	Ceiling for credits under €50,000: 6.14%+50%	Ceiling for credits over €50,000: 4.05%+50%
Overrunning on bank account	Ceiling for credit under €1,500: 19.96%+50%	Ceiling for credit above €1,500: 13.12%+50%
Real estate leasing	4.39%+50%;	

Source: Bank of Italy.

The types of credit are decided every year by Banca d'Italia, which collects data from all the credit providers. The rate ceilings are adjusted every three months by the Ministry of Economy and Finance, who approves the rates by decree and are published in the Italian Official Journal (Gazzetta Ufficiale). Furthermore, Italy has now explicitly harmonised the calculation of the APRC in usury with the APRC in price disclosure according to CCD 2008. A 2009 Decree of the Ministry of Economy and Finance involved changes to the statistics

behind the interest rate series on which the ceilings are based clarifying the classification for the applicable average interest rates for the usury test.⁵⁶ According to the press release of Banca d'Italia the new regime is especially important with regard to the calculation of the contractual interest rate. The comprehensive review of costs to be included in the calculation of the TEGM (APRC) and revision in the calculation of the interest rate series was part of the efforts by the authorities and legislators to harmonise the basis of calculating the APRC. Alongside changes in the statutory calculation and reporting scheme, the law has led to the inclusion of certain costs previously excluded from the Italian interest rate series used to determine the ceilings, such as the introduction of overrunning fees (*commissione di massimo scoperto*, CMS), of all kind of brokerage fees (when borne by the consumer) along with insurance cost.⁵⁷ The Bank of Italy collaborated with the Ministry of Economy and Finance in order for the new series of rates (and thus average rates) to be reported by providers starting in the third quarter of 2009 with changes to the ceilings based on the new methodology starting in 1 January 2010. The new APR and interest rate ceilings for Italy are now more comparable with the APR rates stipulated by the CCD 2008.

1.2.1.3.7 The Netherlands

The Netherlands stipulates two fixed 'legal interest rate' (*wettelijke rente*), one for business transactions and one for transactions with consumers. The consumer rate is currently 3% per year and this is the maximum that can be charged on default. An administrative ceiling is then set which governs the maximum APR that can be charged on contractual agreements as x% in addition to the legal rate. This is currently 12%, so the ceiling is 12% plus 3% = 15% for consumer credit agreements.

The level of the ceiling is set by the Minister of Justice and is published in the official *Staats courant* (an official bulletin of the State).

This 12% extra interest was lowered in 2006 from 17% to make it harder to charge high interest rates. However, some types of credit are not regulated, including credits that last for less than 3 months. Over the past 2 years, there has been a growth in payday loans (in Dutch better known as "flash credits") which are not regulated, and which have APRs as high as 600%⁵⁸.

However, when implementing the EU CCD 2008, these forms of credit will become regulated and the interest rate caps will apply. It is expected that this move will lead to the demise of payday lending in the Netherlands.

Other forms of credit are also not subject to the general interest rate ceiling, including business loans, mortgages, pawn broking, stick financing, and government loans. However, there is a code-of-conduct for Dutch mortgage suppliers, which allows contractual rates to be used to calculate loan-to-income ratios for mortgages where these are set to last for at least 10 years. If a mortgage is set to last for less than 10

⁵⁶ Decree with regard to "transitional provisions with the application of Article of Law on March 7 No .2 108" (published in G.U. of 29 July 2009), see: http://www.bancaditalia.it/vigilanza/contrasto_usura/doc_cons/istruzioni_teg/istr_usura_doc_consultazione.pdf.

⁵⁷ "Verranno, tra l'altro, considerati ai fini della definizione del tasso soglia le polizze assicurative, i compensi per i mediatori, nonché tutte le forme di remunerazione diverse dal tasso di interesse, come le commissioni di massimo scoperto e quelle per la messa a disposizione dei fondi nei limiti e alle condizioni consentiti dal legislatore. Per i compensi di mediazione è stata introdotta anche un'apposita rilevazione al fine di fornire un parametro specifico per valutare l'usurarietà di una componente di costo di rilievo e variabilità considerevoli, ma sinora priva di limiti definiti", from August 2009 press release at http://www.bancaditalia.it/media/comsta/2009/cs_usura_120809.pdf.

⁵⁸ A June 2009 report (in Dutch) looked at the issue of flash credits and the usury ceiling, available here: <http://www.responsible-credit.net/media.php?t=media&f=file&id=3872>.

years then the contractual rate is not used for this purpose but the lender must instead calculate the loan to income ratio using a set minimum interest rate. This is intended to prevent excessive mortgages from being offered based on low contractual initial rates.

1.2.1.3.8 Poland

Rate caps in Poland are subject to regulation in the Civil Code and in the Consumer Credit Act. The maximum interest rate in Poland is a relative rate ceiling for all types of credit, calculated by reference to the central Lombard rate multiplied by four. The current Lombard rate is 5% giving rise to a maximum borrowing rate of 20%⁵⁹. This mechanism for limiting interest rates was introduced in 2005 and, in contrast to the other Member State ceilings, the ceiling is set on the borrowing rate, and thus just on the interest rate, not the rate representing the total cost of the credit (ie. the APR). In line with this distinction, in addition, fees and additional charges related to the concluding of the credit contract are separately regulated as well, and cannot exceed 5% of the amount of the credit.

The rule applies to all credit types, depending only on central bank decisions (Monetary Policy Council) and the rates are reviewed monthly. Decisions concerning changes are published in the statements of the Central Bank's Monetary Policy Committee.

1.2.1.3.9 Portugal

The recent transposition into the Portuguese law of the CCD 2008 (June 2009) has established an interest rate cap on credit operations based on the APR. Maximum interest rates are only applicable to credit granted to consumers, are set quarterly by the Portuguese Central Bank and are based on the average of the interest rates applied by credit institutions in the preceding quarter. If these caps are exceeded, the credit is considered to be usurious and gives rise to criminal liability.

Decree-Law nr. 133/2009 establishes usury ceilings for: Instalment credit; Financial leasing; Hire purchase financing; Point-of-sale financing (the vendors/service providers act on behalf of credit institutions); All categories of revolving credit with the exception of overdraft facilities where the credit has to be repaid within one month.

The rate ceilings also vary in accordance with the purpose of the credit and are currently set at the levels shown in the table below:

Table 13: Interest rate ceilings in Portugal

Credit categories	Interest rate ceiling (2nd quarter 2010)
Education, health and renewable energy	6.7%
Leasing	7.3%
Other personal credits	18.9%
Auto leasing or hire purchase financing (new vehicles)	7.7%

⁵⁹ A history of the Lombard rate can be found under the following link: http://www.nbp.pl/home.aspx?f=/dzienne/stopy_archiwum.htm.

Auto leasing or hire purchase financing (used vehicles)	9.9%
Secured auto loans (new vehicles)	11.1%
Secured auto loans (used vehicles)	15.6%
Credit cards, credit lines, overdraft facility, overrunning	31.6%

Source: Bank of Portugal. Note: These APR usury ceilings shown apply to credit and financial institutions, other civil and commercial usury ceilings also exist but are not shown.

The ceilings are determined and disclosed by Bank of Portugal, and are set quarterly and published in the Official Bulletin of Bank of Portugal. However, the ceilings apply only in respect of credit amounts of between 200 EUR and 75,000 EUR. It is nevertheless important to point out that the subtypes of credit defined by the Bank of Portugal in order to fix APR usury ceilings raise a problem of concepts. In fact, there is no definition or list of "Education/Health" products or services except for tax purposes. Although, in what renewable energies concern, and also for tax purposes, there is a list (Regulation nr. 303/2010, from 8 of June 2010), treatment is complicated by the fact that electric vehicles will fall under the "auto" loan category. The APR usury ceiling that was introduced in the beginning of 2010 was the result of discussions concerning consumers' rights that took place during the early months of 2009 and which led, in June 2009, to the approval of Decree-Law nr. 133/2009 which was in some opinions, seen as hasty and a little careless. By transposing the CCD 2008 and introducing a new APR usury ceiling applicable to financial institutions, there is now some ambiguity since there are presently three usury ceilings in Portugal: (i) civil interest rates usury ceiling; (ii) commercial interest rates usury ceiling and (iii) APR usury ceiling. Only the APR usury ceiling is applicable to credit provided by financial institutions, however, it is not entirely clear if other creditors have to submit consumer contracts to more than one ceiling.

1.2.1.3.10 Slovenia

There are several interest rate related restrictions present in Slovenian legislation. Some of them are general and refer to all types of credit contracts (contained in the Code of Obligations, although some of these provisions are further limited to parties to non-commercial contracts), while others protect only consumers (contained in Consumer Protection Act and Consumer Credit Act).

Caps of penalty and contractual interest rates are set in the Code of Obligations (and breach of this provision can lead to contracts being voided). For consumer credits the interest rate ceiling (expressed as an APRC) is set at twice the average APRC charged by banks and savings banks (Article 18a) and is published in Official Journal by the Bank of Slovenia twice a year. The central bank calculates the level of APRs of credit institutions in accordance with Article 17 of the Consumer Credit Act and the ceiling is legally set by the Parliament.

Average effective rates are calculated for, and therefore ceilings set for, consumer credits for the following maturities and amounts: 2 months, 4 months, 6 months, 12 months, 36 months, 10 years; and 200, 500, 1000, 2000, 4000, 20000 Euros.

Table 14: Interest rate ceilings in Slovenia

Maturity (months)	Amount (EUR)	Average APR	APR Ceiling
2	200	226.5%	453.0%
4	500	44.3%	88.6%
6	1,000	21.3%	42.6%
12	2,000	12.4%	24.8%
36	4,000	9.6%	19.2%
129	20,000	6.6%	13.2%

Source: Bank of Slovenia. Note: The maximum rate is set at 200% of average consumer credit APRs charged by banks and savings banks (as of 1. 12. 2009, published by Bank of Slovenia on 31. 12. 2009, OJ 113/2009). Credits are put in the lowest category possible.

There is also a ceiling on default charges, which is set by statute as 50% above the sum of the statutory default interest rate of 8% and the ECB's main refinancing rate⁶⁰. There are also specific IRR for housing loans. The national housing saving scheme loan interest rates are fixed at 75% of the market yield from Republic of Slovenia bonds of maturities above 9 and a half years. The interest rate changes when the yield differs from base value by more than 10%. These differences are inspected twice a year (15th May and 15th November), while interest rates are accommodated once a year if in two consecutive tests yield differs from basis by more than 10%.

Finally, Slovenia also provides a cap on interest rates relating to ecological credits, which are currently set at 3.20% for maturities of less than five years and at 3.90% for maturities from five to ten years.

1.2.1.3.11 Spain

Spain has a general prohibition of usury which is not specific to credit.⁶¹ Using this concept courts have sometimes overruled certain loan agreements, if they find that they breach the law on usury. The Spanish Supreme Court has declared that in the appreciation of usury it will apply substantive criteria.⁶² But most court decisions relate to loans between individuals.⁶³ At a lower level there have been some attempts to apply the specific IRR for overdraft credit analogously to other credit contract too.⁶⁴

⁶⁰ Default interest rate ceilings as opposed to contractual rate ceilings are reported on for all the EU Member States in a subsequent section.

⁶¹ Law of Usury of 23rd July 1908 "Le «Ley Azcárate».

⁶² 26th March 1993 (RJ 1993, 2241).

⁶³ Supreme Court 30th December 1987 (RJ 1987, 9713), 24th April 1991 (with individual vote) (RJ 1991, 3025); 8th November 1991 (RJ 1991, 8148) and 29th September 1992 (RJ 1992, 7330) among others. For a contract between a bank and a consumer see Supreme Court 26th March 1993.

⁶⁴ I.e Audiencia Provincial of Girona, Sección 2ª, (auto) 15th December 2009, Judge Rapporteur: José Isidro Rey.

In general there is only the exemption for overdraft credit. Art 19 Consumer Credit Law 1995, provides that current account overdrafts cannot charge more than 2.5 times the level of the legal interest rate. The legal interest rate is set each year in the Budget Law and is currently 4%. ACT 7/1995, of March 23, on Consumer Credit (Article 19.4) holds: The interest applicable to overdraft facilities on consumers' current accounts shall not exceed, in terms of APR, 2.5 times the legal interest on money. Since Spain refers to the ancient legal interest rate of the civil codes which is disclosed in the form of a borrowing rate and since anyhow CCD 1987 did not require an APRC for overdraft credit this is the only known relative direct IRR which uses the borrowing rate.

There are some special sector specific rules. For instance some caps to applicable interest rates are found in relation with social housing acquisition (grant aided home purchase of homes). These form part of special programmes "Plan de Vivienda" which consists in a subsidised way of home acquisition. All autonomous communities have such programmes. Spain has a sophisticated system to regulate these interest rates on protected/social housing.⁶⁵ In this specific case the interest rates are in the form of the APRC and are set by reference to indexes, of with the "interés legal" is the index applicable to default.

The ceilings for protected housing are fixed by the National Minister on Housing, and /or by the competent regional ministry. As those caps are related to the "legal interest rate" the Budget Law which sets each year the applicable "legal interest" or "statutory rate" which currently is set at 4% until 31st December 2010 has to be taken into account. In long term contracts, the adjustment is done annually.

To fix these rates the Mortgage Loan Order (following order of May 5, 1994 on transparency of mortgage loans), requires the official setting of the following indexes or reference rates by the Bank of Spain and published monthly in the "Official Gazette". Its definition and way of calculation can be found in Annex VIII of the order.

- Reference rate for mortgage loans more than three years term for house purchase, granted by banks.
- Reference rate for mortgage loans, more than three years term for house purchase, granted by savings banks.
- Reference rate for mortgage loans, more than three years term, for house purchase granted by other credit institutions.
- Savings banks reference rate.
- Domestic income in the national debt secondary market for two to six years term.
- One year interbank rate

If the rate effectively imposed is higher than the rate described in the contract, there would be sanctions on the lender.

⁶⁵ Law 2/1994, of 30th March on subrogation and modification of mortgage loans; Law 41/2007, that modifies Law 2/1981, of 25th March, for the regulation of mortgage market and other laws of the Mortgage and Financial Systems, for the regulation of reverse mortgages and dependency insurance and which establishes tax regulations; Law 2/2009, of 31st March that regulates mortgage loan contracts and intermediary services with consumers.

1.2.1.4 Interest rate ceiling setup

Because of the possible complexity involved in attempting to control the pricing decisions of the credit markets, it is important to understand the various mechanisms and modalities open to regulators which determine how the interest rate restrictions operate and at what level the ceiling or ceilings will be set.

1.2.1.4.1 Exogenous reference point

A system based on an exogenous reference point is often suggested for a unique ceiling whereby an appropriate reference should be an index or rate representing the cost of resources for lending institutions. This can be done by having the system based on the addition of a flat predetermined margin in percentage points on top of a reference rate which could either be to the base rate of say the European Central bank (eg. as in the Netherlands) or to an interbank refinancing rate (eg. as in Belgium). The advantages of such a system are its simplicity and the level playing field it provides in terms of competition between different credit types. Proponents of such a system argue that it would solve the potential problem of the ratchet effect over time that is inherent in endogenous systems (phenomenon whereby the calculation of the usury ceiling based on average observable rates in time period t leads to further automatic increase in the ceiling in $t+1$ when providers seek to provide credit at prices as close to the ceiling as possible). A possible variation of such a regime would be to target specific credits with an extra exogenously referenced condition.

1.2.1.4.2 Endogenous reference point

The majority of Member States (see below) have a system that sets the interest rate ceilings relative to those rates observed in the credit markets in practice. Generally the preferred method of setting the ceiling is using a multiplication coefficient applied to the average rates in the market (or more often to sub credit markets), however there is also the possibility to apply a fixed interest rate margin to the average market rates as opposed to a multiple. One advantage of specifying a margin fixing the number of basis points above which a credit is considered usurious is that it limits the proportionality effects and thus allows providers of small-sized credit to have a more favourable treatment of their proportionately higher fixed costs vis-à-vis those extending larger loans.

A possible variation combining both systems of ceiling fixation is a model that superimposes a second ceiling condition on top of another eg. credit markets or specific credit categories would see a ceiling set on both average market rates and an exogenously determined limit. A host of other possible structures could exist. The French government report investigating possible revisions of the existing system in France also conducted simulations on a system of authorised coefficient ranges which would then allow the regulator to decide which categories get allocated which multiplication coefficient from within the range (with the advantage of allowing some steering in usury ceilings across categories).

1.2.1.4.3 Interest rate ceiling setting mechanisms in the EU

The majority of Member States with interest rate ceilings have chosen to determine their ceilings based on a multiplication coefficient. This coefficient varies from country to country. For those that apply the coefficient to average credit market prices, the following coefficients are being used: Portugal and France (x1.33); Italy (x1.5); Germany, Slovakia and Slovenia (x2); and Estonia (x3).

Poland also uses a calculation method based on a multiplication coefficient (of x4) but this is applied to an endogenous reference rate, namely a central bank rate as opposed

to rates contracted on the credit markets themselves. Likewise, Spain's ceiling applied to overdraft credit (which is being reviewed) uses a coefficient of the Spanish legal rate (x2.5).

Two countries with relative interest rate ceilings which do not have a system using a multiplication coefficient are Belgium and the Netherlands. In Belgium where the ceilings are calculated by category of credit based on their nature and amount, a complex system using initial absolute ceilings determined at one point in time in the past then uses diverse elements of reference for each category of credit. These references are exogenous to the credit market itself and are derived from fluctuations in specified financial market indexes of either the 3-Month Euribor, or the 1 year or 2 year government bond rates. In the Netherlands, the usury ceiling corresponds to the legal interest rate (set on the basis of the ECB base rate) plus a fixed margin irrespective of the amount of the credit. This margin currently stands at 12 percentage points (reduced from a previous 17%). The German mechanism of setting the ceiling also has a fixed nominal margin of 12 percentage points and this serves as a second control to the relative floating cap by limiting the dispersion of the ceiling from the mean. This is an extra constraint for times of high market rates which impose the average market rates plus 12 pp instead of the usual double the average of market rates. Slovakia has also implemented a double criterion for limiting the ceilings in order to restrain an excessive spread between the interest rates observed for the different credit categories, namely by having one unique overarching ceiling for all credit types together and set at four times the average for all credits (x4).

1.2.1.5 Sanctions

Under Chapter 1.1.4 we have dealt with the general questions of effectiveness with regard to any regulation of IRR in the law. In this part we will more specifically focus on those rules which directly affect the contractual interest rate. While it shares the importance of effective sanctions with all other legal rules, its specific problem lies in the fact that an interest rate is only a parameter which should "reflect" the true cost of credit and its burden onto the consumer.

Three types of sanction exist: civil, criminal and administrative.

- Civil sanctions include
 - o the reduction of the interest to either the principal or permitted rate of interest⁶⁶, or
 - o the nullity of the contract with the possibility of judicial allocation of the obligations under the contract
- Criminal sanctions include imprisonment and/or fines;
- Administrative sanctions will generally be loss of a licence to trade.

Some Member States, for example Belgium, France and Italy specifically include all three potential sanctions⁶⁷.

⁶⁶ For example Poland and Portugal (nr 3 art 28 Decree Law nr 133/2009).

⁶⁷ Belgium: Restriction to cash price or borrowed amount (art. 87, 1 WCK): criminal sanctions (art. 101,§, 4 WCK): administrative sanctions (art. 106,§ 1, art.107§ 1). France Arts. L 313- 4, (reduction of interest to legal limit, application of excessive payments to interest due and then to capital remaining due: contract not a nullity) L313-5 (fine up to €45,000 and or/imprisonment for two years with publication of the decision and temporary or permanent closure of the business). Slovakia: contract is voidable by consumer if interest rate ceilings contravened; Slovak Trade Inspection may impose a fine up to 500,000 SKK: Poland, excessive

In civil cases in some Member States the invalidity of the contract must be alleged by the borrower (eg. Slovakia), but in others it is a matter of ordre public.

A distinction might also be drawn between those Member States that prohibit usury in the form of judicial interpretation of a general clause. These include Germany, the Czech Republic, Estonia, Hungary, and Slovenia. In these Member States the consequences of a finding that an interest rate is “contra bonos mores” may be that the court will declare the contract null and void. In Germany the courts will permit the borrower to keep the loan but be absolved from repaying, thus acting as a deterrent to predatory lending more generally.⁶⁸

1.2.1.5.1 Public enforcement of usury/interest rate restrictions

Consumer credit institutions may be subject to a variety of public regulators in Europe. These include:

- Through the central bank (Italy, Portugal, France) with lending being restricted to institutions licensed by the bank;
- A licensing authority which may be a Ministry (Belgium) or a specialized agency (UK, Germany, Netherlands, Estonia);
- A consumer protection authority (Ireland, Bulgaria, Latvia) or Market Inspectorate (Slovenia);
- A Consumer Ombudsman along with a Financial Supervisory Authority (Finland).

Countries may have a number of agencies. The Ministry of Economic Affairs in Belgium authorises consumer credit institutions but mortgage companies are controlled by the Banking, Finance and Insurance Commission. Financial institutions in Ireland are licensed by the Central Bank, money lenders by the Financial Regulator. In France the new Autorité de contrôle prudentiel (2010) will co-operate with the DGCCRF (Directorate Générale de la concurrence, de la consommation, et de la repression des Fraude) in policing consumer financial services.

In many countries therefore there is *ex ante* control of most credit suppliers entering the credit market (and this will increase after implementation of the CCD 2008) with the possibility for the regulator in some countries to stipulate minimum capital requirements (France), a viable business model (Germany, UK) and to scrutinise the contracts of a company. The regulator may also have power to suspend the licence of the provider, as occurred recently in Italy where the Bank of Italy suspended Amex’s licence to issue new credit cards for alleged contraventions of art. 644 of the Criminal Code.⁶⁹ There are however still products which escape *ex ante* regulation like “express loans” in Lithuania and unregulated non-banks in Poland.

The UK also has a special illegal lending project dedicated to prosecuting loan sharks in England’s very poor neighbourhoods. A study of illegal lending in the United Kingdom estimates its prevalence to be about 165,000 or 0.44 per cent of the population, although the methodology used in this study has been called into question recently. The

interest is void and maximal rate replaces the contract rate. Italy: consequences of illegal rate is reduction to legal maximum (art 1419 cod.civ-1815 c.c.), possibility of pecuniary sanctions and possible suspension or revocation of authorization for supervised institutions (see eg. recent case of Amex suspension of licence).

⁶⁸ MS Germany see jurisprudence under art § 138.2; Czech Republic (contract void) court rulings 15 December, 2004, no 21 Cdo 1484/2004 and Nr 22 Cdo 1993/2001 from 08. April 2003 No.22 Cdo 1993/2001.

⁶⁹ See: <http://www.financialexpress.com/news/american-express-credit-cards-stopped/602332/>.

average amount lent in the UK illegal lending market is estimated to be very low, at only £250⁷⁰.

1.2.1.5.2 Private enforcement/ombudsmen

Ombudsmen are not generally viewed as an alternative means of addressing problems with high cost credit in those countries with ceilings (eg. Portugal, France, Italy, Belgium). Although the use of financial ombudsmen seems to be growing throughout the EU (eg. Slovakia, Slovenia, Spain) there was either not enough experience of these to comment on whether or not they had an impact on price, or where comments were forthcoming these indicated that only a modest impact could be discerned. The UK appears to have the largest Financial Ombudsman service.

1.2.1.5.3 Ability of courts to declare total cost of credit or interest rate excessive and reopen the terms of the agreement

This power exists in both countries with ceilings (eg. Belgium) and those countries without ceilings (eg. Denmark, UK). The conditions for doing this generally require a finding that the terms contravene a general clause such as *contra bonos mores* (Germany, Estonia), that the terms are “flagrantly unfair” (Denmark), or unconscionable (Sweden). Slovakia provides for the possibility of court intervention if the amount of interest “substantially exceeds the normal interest rate” and the Supreme Court of the Czech Republic struck down an agreement where the interest was more than four times the usual interest (Supreme Court of Czech Republic sp. Zn. 21 cdo 1484/2004). A similar decision can be found in Spain (eg. for a mortgage agreement of 20% when similar agreements are at 5%: Audiencia Provincial de Madrid, Seccion 12a, Sentencia de 14 July 2009, rec. 634/2007).

Much however depends on the circumstances. An interest rate that is twice or three times over the average rate charged by financial institutions might not be held to be unfair. Courts look to all the circumstances of the case and decide based on the fairness of the term and the market situation of the parties (eg. if the person lacks experience, or is vulnerable: Sweden, UK, Slovenia).

In Germany it appears that the courts apply an almost irrefutable presumption that one party is in a weak position where an interest rate is double the average. In the UK ss140A-D of the Consumer Credit Act 1974 (added in 2006), confer very broad powers on the courts to reopen and vary terms where there is an “unfair credit relationship”. However, early case law suggests that very high interest rates will be upheld if the rates are not different from those in the particular market (see Robert Shaw and Nine Regions (Log Book Loans) Ltd, where a log book loan of £3000 used to pay for a consumer vacation at APR of 119.6% was upheld because this was similar to charges made by pawnbrokers and others operating in the high cost sub markets).

High interest rates might also be challenged under legislation implementing the Unfair Terms in Consumer Contracts Directives in those Member States that have not included the limitation in the Directive on review of price clauses.

When the loan – or the interest – is declared void in Spain according to the 1908 law on usury, the debtor is required to return the principal, but is not required to pay any interest. This regime is an exception to Art 1303 Spanish Civil Code which, upon default, imposes full restitution with interests. This interpretation of the usury law as an exception to the Civil code was upheld by a Decision of the Supreme Court on January 9th 1933, and later Court Cases.

⁷⁰ See: Policis (2006b) pp 57, 76.

1.2.1.6 Member States with no special rate ceiling

According to the opinion of the legal experts as well as the responses given by various stakeholders, thirteen Member States do not have something that could be called a direct and targeted intervention into the price of credit apart from what has been described by reference to the general principle of good morals and fairness. These principles as described above in Section 1.1.3 forbid extortionate pricing in contracts in general if it amounts to the exploitation of the weakness of the contractual partner. While all Member States have a potential for IRR only 14 presently use this potential. Whether IRR will be introduced in the other Member States in the near future depends on political discussions that are presently taking place, and which are especially strong in the UK. While cultural and political reasons may play an important role in these discussions, much of it is due to the state of development of consumer credit in these countries which is discussed under Chapter 2.3.

Apart from Latvia, Lithuania, and Cyprus, all Member States are reported to have some form of doctrines which may be used to limit high cost credit in contracts. Romania, Denmark and the UK use concepts of fairness or unfairness and Austria uses the concept of unconscionability. Other either discuss its introduction or have a history of regulation and deregulation in this area.

Romania, following a decree law of 5 May 1938 set the level of the interest rate caps at 4% above the National Bank discount rate (with the possibility of different ceilings set for different periods and regions). By the decree of 9 August 1954 this was then repealed and the concept of a "legal interest rate", which was set at 6%, was introduced in its place. This law was further amended in 1998 and 2000 when the Romanian Government decided that the legal interest rate would not be applied to the interest due on any financial obligations charged or paid by the National Bank of Romania, other banks, the Office of Savings and consignments, credit cooperative organizations and the Ministry of Finance. This decision to exclude banks and credit lenders from a legal ceiling has been criticised on the basis that excessively expensive credits may be used to exploit debtors and might affect the re-launching of the national economy.

In Denmark, which has historically not been in favour of using IRR as a form of regulation, there has been debate since early 2009 when the opposition declared that it would introduce a bill concerning a rate cap corresponding to the central bank base rate plus 15 percentage points. The bill has not yet been introduced. The discussion has been reopened in February 2010 (not the least due to the so-called SMS-loans with APR's at more than 2,000 percent) with the Danish Consumer Council having expressed a wish for IRR.

In the UK there have been a number of attempts by consumer advocates to introduce rate ceilings, including the submission of amendments for this purpose during the passage of the recent Financial Services Act 2010. However, these were not passed and Government instead commissioned the Office of Fair Trading to review the case for ceilings as part of a wider review of high cost credit markets, whose final report was published in June 2010⁷¹.

In Cyprus an intense debate took place in 2010 on a legal cap on bank interest rates to consumers.⁷² The Cyprus legal environment is characterized by liberalization of interest rates and usury is not qualified as a criminal offence. The Central Bank of Cyprus in one of its statements had pointed out that usurious interest rates cannot be regulated and

⁷¹ See: Office of Fair Trading (OFT) (2010).

⁷² Eg. see following media link (in Greek): <http://www.mykypros.eu/cgibin/hweb?-A=60149&-V=ikypros&w>.

that consumers and providers have to take their own risks.⁷³ In Cyprus, no primary sources (legislation, jurisprudence) are available on the issue however information published in trustworthy press sources refer to the progress of the parliamentary work.⁷⁴

Though reality shows that interest rates in credit markets in Cyprus are not regulated (following the previous regime that had a 9% limit which has been abolished pursuant to the liberalization of interest rates), it is nevertheless legally interesting, since the phenomenon, which is considered to be a criminal offence in other jurisdictions (usury) is not currently sanctioned. This however may change pending discussions on a bill that has currently been drafted to criminalise the lending of money at an unreasonably high interest rate. The transposition of the CCD is expected to be transposed into national Law in October 2010. Furthermore, this liberalization of consumer credit was seen by our expert as not having led to a generalised social problem and is not considered to be a social issue of high concern. One reason put forward for that is the client due diligence, as applied by the credit institutions, before the credit decision and the self-binding conduct of credit institutions during the life of the consumer credit contract appear to be working rather well.

1.2.2 Default interest rate ceilings

1.2.2.1 Default interest rate regulation doctrines

An important tool for keeping credit contracts alive and for enabling consumers to resume normal payment of instalments, instead of an acceleration of payments and the resulting over-indebtedness, are regulations which cap default rate to take away the incentive of additional earnings in default. This discourages the creditor also from cancellation of the contract. The same applies for any late payments where default interest is due. The basic dogmatic assumptions about default interest vary according to the different legal systems. In the majority of Member States, default interest rates result either directly or indirectly from negotiations between the contracting parties. In some Member States, the contracting parties may negotiate freely on default interest rates and set them in the contract. Some Member States limit the right to define the default interest rate unilaterally but link its level to the agreed contractual rate plus a margin fixed by law. Other Member States consider default interest as part of a claim for damages and therefore limit it by market parameters and not by contractual parameters. In some Member States, both approaches are used. A legal default rate is applicable unless the parties agree on a higher default interest rate.

1.2.2.2 Statutory default interest rates

A majority of Member States provide statutory default rules with regard to default interest rates. These interest rates apply when the contracting parties do not agree upon the interest to be paid upon default and when the law provides for the right of the contractor to claim (additional) default interest. Statutory default interest rates and default interest rate ceilings should not be confused. Member States such as Latvia and Lithuania make use of statutory default interest rates but do not have explicit default interest rate ceilings. Conversely, in Bulgaria, the Czech Republic, Estonia, Germany,

⁷³ News report produced by Cyprus' major electronic news site (Sigma) and accompanied by a statement of the Director of the Legal Department of the House of Representatives Mr. Jonas Nicolaou and other parliamentarians explaining that liberalization of interest and non penalization of usury are related (in Greek). See: <http://www.sigmalive.com/news/local/170121>.

⁷⁴ Announcements in September 2009 of the works on transposing the EU Directive show that the expected Directive is considered to ensure common banking practice, which shows that consumer credit interest rates are decided and agreed upon on a case- by case basis available here in Greek: <http://www.philenews.com/main/75,1,29,0,17335-.aspx>.

Malta and Slovakia the statutory default interest also provides the default interest rate ceiling. In Austria and Hungary, default interest rate ceilings and statutory default interest rates exist, but are calculated differently.

Table 15: Statutory default interest rates in EU Member States

Statutory Default IR	Member States
No statutory default interest rate	Ireland, Romania, UK
Fixed statutory default interest rate	Austria, Belgium, Latvia, Lithuania, Luxembourg, Malta, Spain
Statutory default interest rate based on a reference rate	Bulgaria, Czech Rep, Estonia, Finland, Germany, Hungary, Italy, Portugal, Slovakia, Slovenia, Sweden

Source: Expert Survey.

Statutory default interest rates based on a reference rate are the most common among Member States. Eight Member States use an objective reference rate, while in Portugal alone the statutory interest rate is based on the contractual interest rate.

With regard to consumer loans, *Portuguese* law establishes a statutory default interest rate based on the contractual interest rate and the rate is determined by the addition of 2 percentage points to the contractual interest rate (cf. Decree-Law no. 344/78.) The parties may stipulate higher rates if they do not exceed the usury limits as defined under the applicable legal provisions. The relevance of statutory civil default interest rates is therefore limited.

In *Germany*, different statutory default interest rates apply to consumer mortgage lending and to other forms of consumer credit. Both are based on an objective reference index. Under section 288, 497 German Civil Code, the statutory default interest rate for consumer credit other than mortgage loans is five percentage points above the base rate as published by the German central bank. The Base Rate is based on the main refinancing operation rate as published by the ECB. For consumer mortgage loans the margin applied is 2.5 percentage points.

Seven Member States provide for fixed statutory interest rates.

The *Austrian* Civil Code, section 1000, provides for a fixed statutory (default?) interest rate of four percent per year. This interest rate is only applicable to consumer credit. With regard to commercial contracts, the statutory default interest rate is stipulated by the Austrian commercial law code, section 352, as eight percentage points above the base rate published by the Austrian Central Bank.

In *Lithuania*, the general rule is provided in Art 6.73 of the Civil code – the consumer debtor, must pay default interest at the legal rate of five percent per annum unless any other rate of interest has been established by law or under the contract.

Ireland, the UK and Romania do not make use of statutory default interest rates. Though the UK does control default interest through eg. the penalty doctrine, possibly under licensing, 140A-D, Unfair Terms in Consumer Contracts Regulations 1999, and FSA conduct of business rules. Though Romania has got provisions on legal interest rates, these provisions shall not be applied to the legal interest due for any financial obligations

charged or paid by the National Bank of Romania, other banks, the Office of Savings and consignments, credit cooperative organizations and the Ministry of Finance, as regulated under art. 10 of Ordinance no. 9 of 21 January 2000 of the Romanian Government on the legal interests due for financial obligations, about the legal interest rate.

1.2.2.3 Default interest rate ceilings

Default interest may be capped either by explicit default interest rate ceilings or by the ceilings provided by general usury legislation. In only a few Member States, there are neither explicit nor general ceilings applicable to default interest rates. The majority of Member States uses explicit default interest rate ceilings. Explicit default interest rate ceilings provide expressly for the upper limit of default interest rates the lender may apply. Explicit default interest rate ceilings may be relative or fixed. Relative default interest rate ceilings are based either on an objective reference rate or on the agreed contractual interest rate. In Member States where there is no explicit default interest rate ceiling, or in Member States where the explicit default interest rate ceiling depends on the agreed contractual interest rate, there may be an (additional) limit set by general usury legislation. In cases where the default interest rate is fixed or based on an objective market reference rate, there is no room for an additional usury ceiling, because the explicit ceilings supersede general usury legislation or jurisprudence.

Table 16: Default interest rate ceilings in EU Member States

Default IR ceiling	Member States
No explicit default interest rate ceilings (usury supervision might be applicable)	Ireland, Latvia, Lithuania, Romania, Sweden
Explicit default interest rate ceiling based on contractual interest rate (usury supervision might be applicable)	Austria, Belgium, Denmark, France, Finland, Greece, Hungary, UK
Explicit default interest rate ceiling based on an objective reference rate	Bulgaria, Czech Rep, Denmark, Estonia, Finland, Germany, Italy, Luxembourg, Poland, Portugal, Slovakia, Spain (overdrafts only), Slovenia
Fixed explicit default interest rate ceiling	Malta

Source: Expert Survey.

1.2.2.3.1 Member States with no explicit default interest rate ceilings

In Ireland, Latvia, Lithuania, Romania and Sweden there are no explicit default interest rate ceilings. Apart from Ireland, general usury legislation of individual Member States applies in this context. Subject to this legislation, the contractors may negotiate the level of interest due in the event of late payment.

To give an example, in *Lithuania* the parties may agree a default interest rate in the contract but the courts have the right to reduce unreasonable or obviously excessive default interest rates under art 6.73 of the Lithuanian civil code. Until 2008, it was practice for the courts typically to reduce default interest rates to 0.02% per day. Currently, there is a trend to move away from this practice and increase the level to which default rates are reduced

Even if legislation or the courts do not provide for explicit default interest rate ceilings, there are often stipulations as to the information required on default interest and the legal consequences of failure to provide such information. If the default interest rate is not agreed in the contract, a statutory interest rate is often applied:

In *Latvia*, section 1765 of the civil code states that the interest rate must be precisely stipulated in the document or transaction. If this has not been done, and in cases where the law requires the calculation of interest set by law, the interest rate must be fixed at six per cent per year. However in the event of delayed payment in relation to the purchase of goods or the provision of services where the consumer interest rate is not set by law, the interest rate is seven percentage interest points above the basic interest rate set by Central Bank of Latvia on January 1 and July 1.

Sometimes the creditor loses the right to charge default interest at all if there is no provision in the contract for default interest.

In *Ireland*, credit agreements must contain details of any costs and penalties in the event of breach of the agreement by the consumer. Failure to do so renders the agreement unenforceable against the consumer under section 38 Consumer Credit Act.

1.2.2.3.2 Default interest rate ceilings based on the contractual interest rate

In Austria, Belgium, Denmark, France, Finland, Greece, Hungary and the UK, there are default interest rate ceilings based on the contractual interest rate. In some Member States the default interest rate is limited by the agreed contractual rate:

In the *United Kingdom*, the Consumer Credit Act 1974, section 93, states that the interest may not be increased on default:

"The debtor under a regulated consumer credit agreement shall not be obliged to pay interest on sums which, in breach of the agreement, are unpaid by him at a rate—

- (a) where the total charge for credit includes an item in respect of interest, exceeding the rate of that interest, or*
- (b) in any other case, exceeding what would be the rate of the total charge for credit if any items included in the total charge for credit by virtue of section 20(2) were disregarded."*

In France, default interest rates are regulated correspondingly. According to Article L311-30 Consumer Code, in the event of default by the borrower, the lender may ask for immediate repayment of the capital outstanding, plus accrued interest which is due but unpaid. Until the actual settlement date, the outstanding sums are liable to interest on arrears at the same rate as the loan. A similar provision is applied on Consumer Mortgage Credit in default and not yet cancelled (Article L312-22 of the Consumer Code).

In addition, the lender may ask the defaulting borrower for compensation which, depending on the length of contract still left to run, is fixed according to a decreed scale.

There are also legal systems that relate the default interest rate ceiling to the contractual interest rate by increasing the contractual rate by a margin.

For example, based on the Act of the Governor of the Bank of Greece 2393/1996 07 15, the default interest rate in credit contracts may not exceed the contractual interest by more than 2.5 percentage points per year.

There is also a regulation in the *Austrian* Consumer Protection Act setting a relative maximum for default interest rates. According to section 6 paragraph 1 Z 13, the default interest rate on consumer loans can not be more than 5 percentage points per annum higher than the contractual interest rate.

1.2.2.3.3 Default interest rate ceilings based on an objective reference rate

The legal systems in Bulgaria, the Czech Republic, Denmark, Estonia, Finland, Germany, Italy, Luxembourg, Poland, Portugal, Slovakia, Spain (only for overdraft) and Slovenia provide for an explicit default interest rate ceiling that is based on an objective reference. Sometimes like in Bulgaria, Estonia or Germany, the default interest rate ceiling is conformant to the statutory interest rate that is to be provided when no agreement upon the default interest rate has been made.

In *Estonia*, any penalty for late payment required from the consumer may not exceed the amount stipulated by the Law of Obligations Act. The Law of Obligations Act provides the basis for calculating the legal default interest: the last interest rate applicable to the main refinancing operations of the European Central Bank before 1 January or 1 July of each year + 7 per cent per year is the interest rate on late payment (hereinafter referred to as the legal default interest rate).

In *Germany*, there are provisions regarding consumer credit in sections 497, 503 Civil Code. Section 497 (1) "Treatment of default interest, crediting part performance", states:

"To the extent that the borrower is in default in making payments owed on the basis of the consumer loan contract he must pay interest under section 288 (1) on the amount owed; this does not apply to real estate loan contracts. With regard to these contracts, the default rate of interest per year amounts to two and a half percentage points above the base rate of interest. In an individual case, the lender may prove that the damage was greater or the borrower may prove that the damage was less." Section 288 German Civil Code states:

"Default interest (1) Any money debt must bear interest during the time of default. The default rate of interest per year is five percentage points above the basic rate of interest." Borrower and lender may deviate from the provisions quoted above, but not to the disadvantage of the consumer.

In *Spain* Art 1108 Spanish Civil Code on "legal interest" relates default interest for late payment or late fulfilment of an obligation to the legal interest or statutory interest rate set each year by the Budget law. It is currently 4% until 31st December 2010. The Law 58/2003 on taxation fixes default interest in relation with tax (currently at 5%). Law 3/2004 of 29th December to fight against late payments in commercial transactions, following Directive 35/EC of 29th June 2000 on combating late payments in commercial transactions says that the level of interest for late payment ("the statutory rate"), which the debtor is obliged to pay, shall be the sum of the interest rate applied by the European Central Bank to its most recent main refinancing operation carried out before the first calendar day of the half-year in question ("the reference rate"), plus at least seven percentage points ("the margin"), unless otherwise specified in the contract.

There are also Member States where the default interest rate ceiling is calculated on the basis of the statutory default interest rate, which itself is based on a reference index.

In *Slovenia*, if the default (or contractual) interest rate exceeds the statutory level of default interest rate by 50 %, it is considered usurious, unless the creditor

proves that he did not use the debtor's emergency or difficult material position, his lack of experience, frivolity or dependence or that the benefit that he or someone else received did not significantly exceed the benefits of the other party (Presumption of usury, Article 377). The statutory default interest rate is basically 17 %, but the Government is authorised to change the statutory default interest rate, if the economic situation changes (Article 2). The government has so far carried out several reductions of the default interest rate based on the decision to change the statutory default rate (OJ 1/07); after the introduction of the euro it was decided that the default interest rate should be set at 8 % (real interest rate, determined in Code of Obligations) + ECB's main refinancing rate.

The default interest rate ceiling may also be based on the usury ceiling which in turn is based on an objective reference index.

To give an example, in *Italy*, Law 108/1996 fixes the usury ceiling not only for contractual interest rates, but also for default interest rates. As mentioned above, Banca d'Italia calculates the average contractual rates – TEGM – for various types of credit. Afterwards the Ministry establishes officially the average additional value of default interest rates in the credit market. The default interest rate ceiling is therefore based on the TEGM and then increased by the average additional value of default interest rates in the credit market provided by the Ministry of Economy, multiplied by 1.5. (TEGM+extra value given as a percentage point; majored by 50 %).

1.2.2.3.4 Fixed default interest rate ceilings

Explicit default interest rate ceilings that are neither based on the contractual interest rate nor on an objective reference point are not very common in Europe.

In *Malta*, there is a general rule under the Civil Code, Article 1139 which states that if the obligation has as its object the payment of a determinate sum, the damages ensuing from a delay in its execution may consist only of interest on the capital sum due calculated at the rate of eight per cent per annum.

1.2.2.4 Overview: Levels of default interest rate ceilings and statutory default interest rates

A full breakdown of the levels of default interest rate ceilings as well as of the levels of statutory default interest rates (that are applied when the contracting parties do not agree upon the default interest rates) across the Member States is provided in the table on the following pages. The table does not provide information regarding the average default interest rates applied on default. However, since default interest rates other than contractual IRR provide for a rate which is seen as an adequate expression of the damage the creditor incurs providers in general use the legal default rate as their contractual default interest rate. This is why the average default interest rates correspond to the ceilings given in the table. The table also contains calculated examples for a non-mortgage instalment loan, using reference data as of March 2010, and assuming contractual interest rate of 8 percent.

Table 17: Overview of default interest rate regulation in EU Member States

Member State	Default-IR Ceiling	Statutory default IR for consumer credit	Default IR Ceiling Example ⁷⁵	Comments
Austria	Contractual IR + 5 pp	4 % (fixed)	13 %	
Belgium	APR majored by 10 percent; ie. APR * 1.1	3.25 % (fixed)	8.8 %	
Bulgaria	<i>EURO Credits:</i> 3-month-Libor + 10 pp <i>Credits in Levs:</i> BR BCB + 10 pp	<i>EURO Credits:</i> 3-month-Libor + 10 pp <i>Credits in Levs:</i> Base rate + 10 pp	10.6 %	BRBCB = Base Rate Bulgarian National Bank
Cyprus	penalty fees applied to overrunning on the current account are limited. Also early repayment fees in mortgage loans (3%)	no	no	
Czech Republic	Repo-rate 2T CNB + 7pp	Repo-rate 2T CNB + 7pp	8.0 %	CNB = Czech National Bank
Denmark	LR + 7pp or contractual IR; whichever is higher	n/a	8.05 %	LR = Lending Rate Danish National Bank
Estonia	MRO + 7pp	MRO + 7pp	8.0 %	MRO = Main Refinancing Operation rate European Central Bank
Finland	<i>First 6 months of default:</i> BR + 7pp or contractual IR; whatever is higher <i>Default from the 7th month:</i> BR + 7pp	BR + 7pp	8.0 %	BR = Base Rate European Central Bank
France	<i>Mortgage credits:</i> Contractual IR + 3pp <i>None Mortgage credits:</i> Contractual IR	n.a.	8.0 %	There are other stipulations with regard to rescheduled or cancelled contracts.
Germany	<i>Mortgage credits:</i> BZ + 2.5pp <i>None Mortgage credits:</i> BZ + 5.0pp	<i>Mortgage credits:</i> BZ + 2.5pp <i>None Mortgage credits:</i> BZ + 5.0pp	5.12 %	BZ "Basiszinssatz" = Basic Rate German Federal Bank, based on Main Refinancing Operation rate ECB
Greece	Contractual IR + 2.5pp	n.a.	10.5 %	
Hungary	Contractual IR + 1/3 BRHNB	BRHNB	9.8 %	BRHNB = Base Rate Hungarian National Bank
Ireland	None. The default IR must be agreed and stated in contract.	/	/	Usury legislation might be applicable
Italy	(TEGM+ <i>extrapp</i>) majored by 50 %; ie. (TEGM+ <i>extrapp</i>)*1,5	MRO + 7pp	21.9 %	TEGM = Basic average IRs Italian Central Bank (differentiated by credit types) <i>Extrapp</i> = average additional value of default interests in the credit market MRO = Main Refinancing Operation rate European Central Bank

⁷⁵ Non-mortgage instalment credit; contractual interest rate set by 8 percent, reference rates as of March 2010.

Member State	Default-IR Ceiling	Statutory default IR for consumer credit	Default IR Ceiling Example ⁷⁵	Comments
Latvia	None. The default IR must be agreed and stated in contract.	6 % (fixed)	/	
Lithuania	None. The default IR must be agreed and stated in contract.	5 % (fixed)	/	Usury legislation might be applicable
Luxembourg	Legal IR + 3pp (where judgement)	3.5 % (fixed, yearly amended)	6.5 %	
Malta	8 % (fixed)	8 % (fixed)	8.0 %	
Netherlands	Statutory IR + 12pp	3 % (fixed, amended 5 times since 2002)	15.0 %	Default IR ceiling is the same as Contractual IR Ceiling
Poland	SL * 4	n.a.	20.0 %	SL = Lombard Rate National Bank of Poland ("Stopa Lombardowa") Default IR ceiling is the same as Contractual IR Ceiling
Portugal	Average APR majored by 33 %; ie. Average APR * 1,33	Contractual IR + 2pp	18.9 %	APR computed by central bank (differentiated by credit types) Default IR ceiling is the same as Contractual IR Ceiling
Romania	None	None	/	Statutory default IRs and IR Ceilings are not applicable for banks according to art. 10 of Ordinance no. 9 of 21 January 2000 of the Romanian Government.
Slovakia	MRO + 8pp	MRO + 8pp	9.0 %	MRO = Main Refinancing Operation rate European Central Bank
Spain	<i>Overdraft Credit:</i> Legal IR * 2.5 = 10.0 %	4 % (fixed, annually amended)	/	Legal IR determined on the basis of financial market trends
Slovenia	Statutory Default IR majored by 50 %; ie. Statutory Default IR * 1.5	Statutory Default IR = Statutory IR (8 %) + MRO	13.5 %	MRO = Main Refinancing Operation rate European Central Bank The calculation method of Default IR Ceiling is legally disputed.
Sweden	None. The default IR must be agreed and stated in the contract.	RRI + 8pp	/	RRI = Reference Rate of Interest, based on Main Refinancing Operation rate of the Central Bank of Sweden. Usury legislation may be applicable under penal law
UK	Contractual IR	None	8.0 %	

Source: Expert Survey.

1.3 Other cost relevant factors

The question of which costs payable by a consumer should be incorporated into the credit price under EU consumer credit regulations has been dealt with in another project report to the European Commission in 1998.⁷⁶ The information collected from the experts in this study confirm that there has been an ongoing shift from interest to other cost factors in consumer credit.

Although a minimum standard in the calculation of the APR has been reached Europe-wide there are general systems which allocate cost elements outside the in so far unchanged definitions of the APRC in Directive 87/102/EEC and 2008/48/EC. While in all Member States payments concerning services which are directly connected to the credit like administration and brokers' fees insurance fees irrespective of the purpose of the insurance, fees for bank accounts and bank cards are not included in practice.

Endowment life insurance credit has no integrated APRC in which the premiums and payments concerning the endowment are incorporated. Such products are nearly unknown in consumer credit as regulated by the CCD 2008 but concern primarily mortgage loans. In this area EU-law does not require inclusive pricing neither does national law.

In some countries like Austria, France and Greece, taxes are imposed on the extension of credit.

Payment Protection Insurance premiums in consumer credit have generally to be advanced in one single payment. This opens the product for additional financing since the consumer needs a credit to be able to pay this premiums in a lump sum. This practice has raised concern especially in the UK. But still the general exemption if the insurance is not "non obligatory" from its integration into the APRC also counts for these finance charges. Payment Protection Insurance has thus developed into a general outsourcing of credit risks at the cost of the consumer. The products are disadvantageous, extremely costly and applied inappropriately and to that extent, far too often. It seems as if the provisions paid to the banks for the extension of insurance products have become a main source of additional income for credit providers, escaping competitive forces.

Instead specifically charged bank account fees are not yet an economic problem. But in credit card credit the enormous fees charged for cash withdrawal with these cards can be seen as an additional cost for those customers who have no own bank account and use the cash withdrawal facility to get an easy and immediate short term instalment credit from the credit card issuer. If for example the fee for cash withdrawal is 3% of the credit amount this fee adds to the cost of the credit if (a) the credit card account has no assets and (b) it provides for own credit. Since only a few credit card accounts allow assets and since those credit cards are most used by low income households for access to small amounts of money ("payday loans") such cash withdrawal fees increase the cost of credit for these borrowers without leaving traces in the APRC.

Combined, endowment products which divert repayments of the credit into a form of savings agreement with lower interest returns in the savings than is charged in the credit like „endowment capital life credit“, „secured credit cards“, instalment or overdraft credit where assets are requested as a security may increase the amount of interest due through artificial additional demand for credit which the yield of the investment product does not compensate for. Such products may be as usurious as other products although its APRC will look significantly better.

⁷⁶ Reifner, U. et al. (1998).

Another form of circumvention is zero interest credit extended by banks owned by automobile companies. They hide that the buyer of the financed cars loses the cash payment premium which may amount to as much as 15%. One could call this a reverse cost element similar to a disagio in which interest is defined as capital and thus made invisible.

Already the 2002 Draft of a Consumer Credit Directive tried to address these problems by replacing the “voluntary” element as the core condition for “linked products”.⁷⁷

In its recital to Art. 12 of the draft a vast definition of all cost that should be included into the APRC had been favoured: “The total cost of the credit must include all costs, including borrowing rate plus all the other indemnities, commissions, taxes and charges of any kind that the consumer is required to pay for the credit regardless of whether these costs are payable to the creditor, to the credit intermediary, to the competent authority levying the taxes or to any other third party authorised to receive payments following the brokering or conclusion of a credit agreement or surety agreement.” Instead Directive 2008/48/EEC referred back to Directive 87/102/EEC where the question which cost from ancillary services had to be included was made dependent on whether such contracts had voluntarily been concluded.⁷⁸ Also circumvention through endowment credit and bank account fees had been taken into account.

1.3.1 Uniform definition of interest (rates)

Price disclosure and price restrictions have to refer to a price which is uniformly and objectively defined by law. In price disclosure law as well as in price restrictive law providers would have an unjustified advantage if they could use a price definition which would allow them to show a lower price than their actual cost structure would justify. Especially the possibility to split prices onto different contracts, to exclude certain cost elements, to use mathematical formulas which lead to incomparable prices etc. are of concern both for price disclosure law and IRR.

This problem has been acknowledged in all consumer related Directives with a wording similar to Art. 22 (3) of the CCD 2008 where it reads: “3. Member States shall further ensure that the provisions they adopt in implementation of this Directive cannot be circumvented as a result of the way in which agreements are formulated, in particular by integrating drawdowns or credit agreements falling within the scope of this Directive into credit agreements the character or purpose of which would make it possible to avoid its application.” This general principle of all consumer protection law either substantive or procedural has been further elaborated in the Directive itself with its gradual improvements in 1998 and 2008.

IRR stand in the legal tradition of price regulations expressed in the *laesio enormis*. Usury and good morals as well as substantive fairness principles focus on the comparatively high amount of money a consumer has to pay for a service or a good. But

⁷⁷ Proposal for a Directive of the European Parliament and of the Council on the harmonisation of the laws, regulations and administrative provisions of the Member States concerning credit for consumers (2002/C 331 E/39) COM(2002) 443 final — 2002/0222(COD) (Submitted by the Commission on 11 September 2002) OJ C331 E/200; for other drafts and alternative proposals see <http://www.responsible-credit.net/index.php?id=1884>.

⁷⁸ Art. 3 (g) of Directive 2008/48/EEC includes all cost “which are known to the creditor, except for notarial costs; costs in respect of ancillary services relating to the credit agreement, in particular insurance premiums, are also included if, in addition, the conclusion of a service contract is compulsory in order to obtain the credit or to obtain it on the terms and conditions marketed”. Art. 2 (g) of the 2002 Draft read: (g) ‘total cost of credit to the consumer’ means all the costs, including borrowing interest, indemnities, commissions, taxes and any other kind of charge which the consumer has to pay for the credit;” and Art. 12 (2) stated: “Costs relating to insurance premiums shall be included in the total cost of the credit if the insurance is taken out when the credit agreement is concluded”.

in credit the price in money units is incomparable because it depends on two other factors which differ from contract to contract: borrowed capital and time. This is why the price of the credit has to be represented by the interest rate which incorporate time and capital amount and offers thus a standardised from of prices.

The interest rate is therefore not the price of the credit but a parameter which in the form of the borrowing rate has been created in practice to calculate those parts of the credit cost which depend directly on the time of the loan.

Since other fees and obligations add to these costs, CCD 2008 has regulated a second parameter, the APRC, to give consumers a basis for comparing the different prices of credit on the market. Recital 19 states: "To ensure the fullest possible transparency and comparability of offers, such information should, in particular, include the annual percentage rate of charge applicable to the credit, determined in the same way throughout the Community." It should according to recital 20 of CCD 2008 "comprise all the costs, including interest, commissions, taxes, fees for credit intermediaries and any other fees which the consumer has to pay in connection with the credit agreement, except for notarial costs." Since also the method of calculation can be used to represent the same cost differently in the APRC also the method of calculation has been harmonised in Annex 1 of the CCD 2008 with the growth formula⁷⁹ which in distinction from the borrowing rate⁸⁰ also fixes the period where accrued interest should be compounded.

The table below shows the differences between both rates and reveals that effective IRR should focus on the APRC instead of the borrowing rate. The table also reveals that this process from the borrowing rate to the APRC has not yet been fully accomplished.

Traditional civil codes use borrowing rates for their historical regulation of the legal rate as well as for their rules on anatocism.⁸¹ Also default rates are usually defined in the form of borrowing rates in practice so that its regulation is adapted to it. Old fixed rate ceilings are mostly related to the borrowing rates since the emergence of a growth rate related form of calculation as it is present in the APRC has only emerged together with the spread of computer and their ability of approximations through iteration as described in the mathematical formula to Annex 1 of the CCD 2008.

⁷⁹ The growth formula can be written in the form of $C_1 = C_0 * (1 + i)^t$ wherein the initial capital C_0 has been grown into C_1 aduring the time t at a rate of $(1+i)$ where i represents the interest rate. The compounding period of 1 year is hidden in the exponent t since the calculation is based on years and therefore t is divided by 1 to mark this compounding period.

⁸⁰ Instead the borrowing rate is mathematically wrongly calculated in the form of $i = \text{cost}/(C_0 * t)$.

⁸¹ See ie. section 246-248, 289 German Civil Code.

Table 18: Borrowing rate and APRC

Credit Related Cost	Borrowing Rate (Art. 3 (j))	APRC (Art. 3 (i))
<i>Elements/parameters:</i>		
"Interest"	Yes	Yes
Closing fees	No	Yes
Broker fees	No	Yes
PPI Insurance fees	No	Mostly no
Finance Charge on Insurance fees	No	Mostly no
Cost of Refinancing	No	No
Standardised Method of Calculation	No	Yes
Early Repayment Charges	No	No
Compounding period	Monthly or arbitrary by payment periods	Standardised one year
Disclosure % p.a.	Yes	Yes
<i>Used for:</i>		
Legal interest rate	Yes	No
Usury ceilings	No	Yes
Default interest rates	Yes	Rarely
Anatocism	Yes	No
Variability	Yes	No

Source: Expert Survey and iff.

But indeed the problems of price disclosure and price regulation are not much different. A price which omits important parts of the cost prevents a rational choice but also the equal and just application of IRR. This is why all countries which have introduced direct IRR on the interest rate level use the APRC and no longer the borrowing rate.

For IRR a clear and comprehensive interest rate is even seen as more important than in price disclosure law where the underlying idea of capping interest rates is to prevent insolvency through high cost credit. From an insolvency perspective the monthly rate to be paid is the main factor that determines the disposable income and household liquidity. Thus before Directive 98/7/EC harmonised the APRC German courts still included the premiums of PPI with half of its value into that APRC which had to be compared with the average market rate while the then existing order for price disclosure excluded such premiums from it.

1.3.2 Anatocism and compounding

Traditional IRR were based on a quite simple understanding of interest which is still visible in its standardised form of % p.a. which assumes that the price of a credit can be expressed simply by relating the cost of the credit to one year and €100. The mathematical problems of such simplistic assumptions and the modern solutions offered by the introduction of the APRC are dealt with below.⁸² Since anatocism is a very old principle of IRR it is still related to the old form of interest rates now called borrowing rate in the CCD 2008. For this borrowing rate the period of interest compounding

⁸² See below at pp 91ff.

remains undefined if not by special contractual prescriptions. This problem is solved in the APRC where the mathematical formula assumes a compounding period of 1 year. In so far all those who use the APRC to define a usury ceiling do not face the problem of anatocism but even require anatocism as it is the case for Annex 1 of the CCD 2008.

But most systems still use a borrowing rate instead of the APRC to calculate the interest due. In this case compounding interest at intervals different from one year leads to enormous differences in the amount of interest due. Besides in default the traditional interdiction of anatocism keeps the amount of default interest under control. Where the borrowing rate is used for interest calculation the total cost of credit not only depends on the size of this rate, but also on the interest calculation method and on the rules providing for repayment of the debt.

With regard to the interest calculation, rules avoiding or forbidding compound interest have a great impact on the total cost of credit. Compound interest arises when interest is added to the principal, so that from that moment on, the interest that has been added also earns interest. This method is called compounding or anatocism. Anatocism conflicts with the Roman law principle, forbidding interest charges on interest. The actual position amongst the Member States is very diverse and depends on individual levels of credit use and consumer protection. Anatocism seems mathematically outdated since if taken seriously would provide for an arbitrary compounding period which is the lifetime of a loan. As this lifetime may vary no loan would be comparable to another loan with a different lifetime. This has led to its gradual abolition through exemptions for current accounts, overdrafts, revolving credit and credit-card borrowing. Many ways have been developed to overcome the irrationality of this principle but as long as instead of the arbitrary borrowing rate the APRC is not used exclusively also for the calculation of the interest due the questions remain unsolved.

While mathematical experts⁸³ reject anatocism as an outdated irrational legal form of mathematics, culturally anatocism is still seen as a means to prevent the exponential increase of debts through unpaid interest which bear interest again.⁸⁴ This is why with regard to contractual interest most countries have gradually abolished its effects or at least allow forms which could be called circumvention. Instead the focus of this principle are now default interest where alternatives have already emerged which no longer deny that any interest calculation needs compounding of interest but achieve the goals of this debtor protection principle for example by prescribing different accounts for interest and principal in default as the German expert reports.

In some southern European Member States such as Italy, that law remains in force and has been revived for consumer protection purposes. Further, rules providing for amortisation of a debt affect the total cost of credit. Amortisation (from Middle English "amortisen" – "to kill") is the process of decreasing an amount over a period of time. If a debt is to be paid back in instalments, the payments consist of interest and part of the principal. Therefore, after a certain portion of each payment is applied to the interest on the debt, any balance reduces the principal. In a situation of default, the instalment may not be sufficient to cover both interest and the principal. To avoid the accumulation of interest, some legal frameworks therefore have rules providing for the order in which interest and the principal have to be charged against the instalment.

⁸³ See for a fierce rejection of the idea of anatocism Seckelmann, R. (1989); Seckelmann was also the main expert for DG Sanco for the 1998 amendment to the Consumer Credit Directive.

⁸⁴ For this discussion see Reifner, U (1992), pp.227-243.

Table 19: Overview of rules on anatocism in the EU

Member State	Contractual interest allowed if convened in advance	Default interest allowed	Allowed after judicial procedures
Austria	Yes.	No (no more than the debt).	Yes
Belgium	No		Yes (agreement; 1 year)
Bulgaria	Yes (Bank loans only, not private loans)		Yes
Cyprus	Yes (but only twice a year)		
Czech Rep	No	No	No
Denmark	No		
Estonia	Yes		
Finland	No		
France	Yes	Yes	Yes (judicial decision or agreement; 1 year)
Germany	No (except for current account)	No (but not effective)	Yes
Greece	No		
Hungary	Yes		
Ireland	Yes		
Italy	No	Yes (if agreed and six month)	Yes (if agreed and six month)
Latvia	Yes (but only after one year)		
Lithuania	Yes (if agreed and not against good faith)		
Luxembourg	Yes (but only for one year; exception current account)		
Malta	No (but exception if commercial use and for one year only).		
Netherlands	Yes (but limited by the maximum interest)		
Poland	No	No	Yes

Portugal	No	Yes (if agreed after default and for one year)	Yes (for one year)
Romania	No		
Slovakia	Yes		
Slovenia	No (but higher interest rates are permitted)		Yes
Spain	No		
Sweden	Yes (but good morals)		
UK	Yes		

Source: Expert Survey.

The following selected information from the experts shows the diversity of answers given to the old principle of anatocism.

In **Austria**, in the absence of any other agreement in the contract, section 1335 Austrian Civil Code (ABGB) applies. The creditor cannot claim default interest exceeding the sum of the original debt if he does not take legal action. From the moment the creditor takes legal action against the debtor he can claim default interest again, which can then result in a sum larger than the original debt.

In **Belgium**, compound interest is restricted by the Civil Code, the Mortgage Credit Act and the Consumer Credit Act. Under Article 1154 of the Belgian Civil Code, it is possible for interest to attract further interest, but this possibility is subject to two conditions. The first relates to the method to be used. This form of interest may be imposed either by a Court decision, or by a specific agreement between the parties. The second condition imposes a minimum time limit of one year over which compound interest is chargeable. Art 14 Consumer Credit Act establishes that there is an obligation to determine the exact amount of credit in the credit agreement. Art. 10 Mortgage Credit Act only provides for interest calculated on the principal sum outstanding. General civil law also provides rules on amortisation. This provision (art. 1254 Civil Code) applies to all credit types. Unless otherwise agreed upon by the creditor, **no** payments can be allocated to the outstanding principal prior to reducing the interest (art. 1254 BW). For consumer credit, the regulation is somewhat more complex. As long as the loan is not terminated, the above rule in article 1254 BW applies, ie. payments should first be allocated to the interest and only afterwards on the remaining capital. However, if the consumer loan is terminated, under article 27f, §5 WCK payments may be allocated first to the remaining capital and then to the interest.

In the **Czech** Republic anatocism is not allowed. The right to demand an ancillary right from an ancillary right by a decision of the Highest Court of the Czech Republic from No. 35 Odo 101/2002 because this option is neither granted by the Act No. 513/1991, Coll., as amended, the Commercial Code ("Commercial Code") nor the Act No. 40/1964, Coll., as amended, the Civil Code ("Civil Code").

The Danish expert reported that there are no legal provisions governing the repayment of debt in general. Restrictions on default interest imply that it is necessary to have a separate account for default interest. In general the borrower decides how the payments should be divided between principal and interest (in a very few statutory cases payment is debited to the interest first).

In **Estonia**, the Law of Obligations Act provides regulations governing restrictions on the calculation method of default interest. A penalty for late payment cannot be required for a delay in the payment of interest (anatocism). Agreements which derogate from such requirements to the detriment of the obligor are void. The above does not preclude or restrict the right of the obligor to claim compensation for damage caused by a delay in the payment of interest. With regard to amortisation, the Law of Obligations Act also stipulates the order of the repayment of debts in default. If, on the basis of a credit contract, a consumer has made a payment which is insufficient for the performance of all obligations which have fallen due, the payment must cover firstly, the expenses incurred in collection of the debt, secondly, the principal sum owed, thirdly, interest, fourthly, other obligations.

In **Germany**, as in the Northern Member States, anatocism as a historical principle has been largely abandoned. The Civil Code prohibits a contractual clause allowing interest to be added "in advance" to the principal sum outstanding. However, some exceptions have been created. First of all, exemptions apply to current accounts. Another exemption has been applied to a *disagio*, a situation where interest is prepaid and thus added to the principal. As German law allows an agreement that outstanding interest should bear interest again, it is quite difficult to distinguish whether such an agreement was made in advance. With regard to default interest alone, the German Civil Code, Section 289 prohibits the compounding of interest on default interest. The right of the obligee to compensation for damage caused by the default remains unaffected. Notwithstanding these exceptions, it must be emphasised that Germany has also revived the idea of limiting pyramid debts through specific legislation governing interest on consumer credit in the event of default. According to section 497 (2) German Civil Code interest incurred after default has occurred must be booked to a separate account and may not be paid into a current account together with the amount owed or other claims of the lender. With regard to such interest, the lender may claim interest on interest as further damage but limited to the amount of the statutory rate of interest, which amounts to up to 4 percent (see section 246, section 289 sentence 2 German Civil Code).

According to the French Bankers' Association interest capitalization is authorized in **France**. However, it is regulated in respect of interest due: this interest may only produce interest if, by virtue of the agreement, this interest is due for at least an entire year (Article 1154 of the Civil Code). The draft legislation on consumer credit reform makes express reference to this rule, which is nevertheless already generally applicable, for consumer credit. Moreover, there is other legislation in existence capping the costs that the Banks can collect (incident charges, etc.) but these laws do not relate to interest rates strictly speaking.

There is comprehensive regulation in **Greece** restricting anatocism. Credit contracts made before 1998 may provide that interest in default is anatocised after the first day of default every 6 months (or longer period if agreed – a shorter period is forbidden). If there is no agreement in the credit contract regarding anatocism, then anatocism may take place according to art.296, which provides that interest on interest may be paid only if agreed or only after issuing proceedings. But in both cases, the interest due may refer to a period of at least a full year. As an exception to this rule, art.111 of the Introductory Law to the Civil Code provides for the possibility of anatocism every six months. If they do not provide for anatocism, anatocism may take place every 12 months. After 1998, Law 2601/1998 is applicable, (Official Journal A 81/15.4.1998) article 12, under which interest may be charged on the default interest, if this is agreed by the parties, starting from the first day of default. The resulting interest is added to the amount of the capital due at intervals which may not be less than six months. As regards contracts already concluded by that date, the same law provides for automatic anatocism every 6 months, even if the contract did not make any provision at all for anatocism.

In **Italy**, anatocism is forbidden with regard to default interest under art. 1282 civil code and confirmed in fairly recent but authoritative jurisprudence. Anatocism is permissible

only in litigation, starting from the date of the judicial summons. Italy has a long history regarding provisions on anatocism. In fact, art. 1283 of the civil code partially allows anatocism, as an exception to the general prohibition. This rule provides that unpaid interest may generate further interest, but only from the date of the summons or, in relation to a contract, subsequent to the date of default, and only if the interest has been due for six months. Generally the Italian civil code forbids the compound capitalisation of interest, but, notwithstanding these rules, in Italian banks the contractual use of anatocistic clauses has been common for nearly half a century, especially in contracts governing bank accounts, because this status quo was unanimously supported by case law. In 1999, the Italian Supreme Court -Corte di Cassazione - changed its approach in certain decisions referring to contracts governing bank accounts. The Court confirmed that no bank practices can repeal art. 1283 c.c., thereby declaring the most common anatocistic clauses void. To avoid contradictions between the different rules and credit operators, the Italian legislator modified art. 120 of TUB (D.Lgs. 385/1993, the main source of rules for banks and other credit operators) with the D.Lgs. 342/1999, establishing the principle of equal compounding of interests, both bearing and payable, saving the effects for past contracts. This was declared unconstitutional at first instance by the Corte Costituzionale and then corrected by the legislator. The Supreme Court has confirmed its 1999 change of direction in the interpretation in some important decisions (Cass. 17813/2002, referring to loans and the Cass. S.U. 21095/2004). The court considers void every anatocistic clause even in contracts stipulated before 1999, and that every method of composite compounding interest that has the same purpose of anatocism is also void.

In **Luxembourg**, Article 1154 civil code prohibits anatocism when interest is calculated on a period of less than one year. However, this prohibition is not applicable when carried out in relation to a consumer's current account. Furthermore, there is a rule that repayments in default are first applied to reduce the principal.

In **Portugal**, anatocism is generally forbidden and it is only allowed by Portuguese law in two circumstances: as an agreement between the borrower and the lender, posterior to the maturity of interest, or as a Court notice to the debtor in which he is informed that he must capitalise interest earned or proceed to payment under penalty of capitalisation. The law also stipulates that only interest corresponding to a minimum period of one year may be capitalised. Nevertheless, these rules will only be applicable if they are not contrary to rules or private uses of commerce (cf. article 560 of the Civil Code) leaving a possibility for bank anatocism – which is very common practice in Portugal and allowed by the majority of judicial decisions. Moreover, there is a special law concerning banking anatocism (articles 5 and 7 of Decree-Law nr. 344/78) which establishes that it is forbidden to capitalise interest corresponding to a period of less than three months.

According to the Civil Code of **Malta**, no interest may be charged until the due date and from the date of legal proceedings claiming such interest, or from the date of a subsequent agreement. Statute in Malta follows the Code Napoleon (art. 1154) and allows for no exception to the rule. However, jurisprudence in Malta has always held that this provision of the Civil Code may be derogated through commercial usage (eg. Edwin Vassallo v. Salvatore Ballucci 30.04.1947 Civil Court, First Hall). Maltese courts have however followed French Courts which (except for some dissenting judgements) have held that the Civil Law rule does not apply to commercial debts. The French Court of Cassation has held that the capitalisation of interest in a current account takes place *de plein droit* or *ipso iure* when the interest is annual, without the need for a judicial demand or a subsequent agreement (Daloz, *Compte Courant*, judgement of 26.05.1812, Cour D'Orleans 26.08.1840, Cour de Bordeaux 09.08.1940, para 74 and 96, pages 585 and 590 of *Repertoire de Legislation*, Vol XI. Paris Edition, Bureau de la Jurisprudence Generale, 1849). The same principle has been adopted by the Maltese courts - Negte. Alfonso Ellul v. Negte. Giovanni Mifsud 12.11.1901 Commercial Court, Vol. XVIII.iii.53; Onor. Alfonso Maria Galea et. Ne. V. Ferdinando Hass, 19.04.1926 Kollez.

Vol.XXVI.iii.633; Negte. Francesco Tabone v. Luigi Piovano 11.05.1929 Commercial Court confirmed by the Court of Appeal on 29.06.1929.

1.3.3 Variability of interest rates

The relevance of an IRR on the variability of the interest rates (ie. limits to the variation of rates) in a given country will first of all depend on the prevalence of credit extended at a variable rate of interest in the overall credit market. This proportion of variable rate credit, both in mortgage and non-mortgage consumer credit markets, varies considerably between Member States, for example, while in Slovakia almost all types of consumer credit are sold at a variable interest rate, in Portugal instalment credit and revolving credit is more commonly found to have a fixed interest rate. In the UK, all types of loans, mortgages, credit cards, personal loans can be sold with caps. There are also variations within Member States between the different forms of credit, eg. in Denmark, though the market share of variable interest bank loans is estimated at approximately 90 percent of all bank loans, only 50 percent of all mortgage loans are at variable rates.

IRR has the same effects on variable rate credit as fixed rate credit. Each variable rate credit starts at the time of the conclusion of the contract with a contractual interest rate just as it is the case for fixed rate credit. Equally, in default, the default interest rate replaces the interest rate for variable and fixed rate credit alike. Since IRR is always attached to the initial contractual interest rate, there is no difference between the two interest rate forms with regard to form and effects of IRR.

But this does not make specific regulations on variable rate credit totally impossible.

There is only one example in the EU where a Member State has implemented a special rate ceiling concerning the variability rate itself. In **Belgium**, for mortgage loans, the variable (also called floating) interest rate must not only be linked to a reference rate (art. 9, §1, 3° WHK) like in many other countries but can only increase by a maximum of 2% during the first 3 years of the mortgage loan (art. 9, §1, 8° WHK), thereby protecting these borrowers from large shifts in interest rates. If the contracting parties agree on a floating interest rate, only one floating interest rate per mortgage loan is allowed (art. 9, §1 WHK). The reference indices must be chosen as a function of the period between two alterations of the interest rate. The list with the reference indices and the calculation method is determined by the King (by Royal Decree) after consulting the CBFA (art. 9, §1, 3° WHK), and is published monthly by the Securities Regulation Fund ("Rentenfonds"). The floating interest rate is linked to a reference rate, more specifically to reference indices (art. 9, §1, 3° WHK; cf. infra).

Equally if the change of interest rates for revolving credit in Belgium exceeds 25% in relation to the original borrowing rate and if the revolving credit account was agreed for a term of at least 1 year, the consumer has a right to terminate the revolving credit account within 3 months as from notification by the credit provider (art. 60 WCK).

However, in contrary to fixed rate credit where one rate dominates the lifetime of the credit, in a credit concluded at a variable rate of interest, the interest rate may be changed unilaterally in the subsequent period after the conclusion of the contract. Since only the initial rate is the contractual interest rate the official interest rate ceiling only applies to this rate. This may induce suppliers to provide so-called teaser-rates where a variable rate credit carries a low initial interest rate at the beginning which is consequently increased so that the overall average interest rate of the contract may well go over the rate ceiling.

This problem is not specific to IRR, and is even more striking with regard to price disclosure where a provider may cheat competitors by luring consumers into his teaser rates while exploiting them later. This is why Article 5 (1) (f) CCD 2008 (similar wording

in Article 6 (1) (e); 10 (2) (f); 10 (5) (e)); addresses “the conditions governing the application of the borrowing rate and, where available, any index or reference rate applicable to the initial borrowing rate, as well as the periods, conditions and procedure for changing the borrowing rate; if different borrowing rates apply in different circumstances, the abovementioned information on all the applicable rates”. While the European legislator may have thus already addressed the problem of teaser rates with its rules concerning the APRC, the rules governing the variability of interest rates however, do not oblige Member States to regulate “any index or reference rate, and ... the periods, conditions and procedure for changing the borrowing rate” but limits itself to its mere “disclosure” “where available”. Recital (32) clarifies that:

“this is without prejudice to provisions of national law not related to consumer information which lay down conditions for, or prescribe the consequences of, changes, other than changes concerning payments, in borrowing rates and other economic conditions governing the credit, for instance rules providing that the creditor may change the borrowing rate only where there is a valid reason for such change or that the consumer may terminate the contract should there be a change in the borrowing rate or in some other economic condition concerning the credit.”

These rules can therefore not be called IRR. Furthermore, the national rules on the adjustment and adaptation of variable interest rates during the lifetime of a contract are generally not seen as part of IRR and are not made to render rate ceilings more effective, notwithstanding the limiting effect they will certainly have. These national rules follow the philosophy that a consumer who has agreed to a certain initial interest rate should not be subject to unilateral arbitrary increases of this rate. The legal principles which govern such rules are laid down in the civil codes. For example, Section 315 of the German Civil Code states that “where performance is to be specified by one of the parties to the contract, then in case of doubt it is to be assumed that the specification is to be made at the reasonably exercised discretion of the party making it.” In paragraph 3 of this section, the final decision whether this discretion has been “equitable” is given to the courts. German courts still use this rule to require that variable rate credit refer to an objective reference rate, be adapted in equal terms and under equal conditions.

Since this area does not concern IRR but just a harmonisation of disclosure rules, in the same way the rules govern the construction of the APRC, we will only give Member State examples below:

In **Austria** Section 6 par. 1 No 5 KSchG stipulates that the decisive circumstances for the variation of the interest must be clarified in the contract. They have to be justified and not dependant on the decision of the creditor. There are two kinds of clauses which are often used in contracts and are the subject of many court decisions. Zinsgleitklausel: This is a contractual arrangement that links the interest rate to a specified variable reference parameter, so that the interest rate varies automatically if there is a variation of the reference parameter. Information to the customer about the variation in the interest rate is only declaratory. The court states that falling interest must be realised within the same time and in the same amount as the increasing interest. Zinsanpassungsklausel (Zinsänderungsklausel): Gives creditors freedom to design interest rates. They can adapt the interest rate if the terms of refinancing change on the capital market. Such clauses are only effective if they are specific enough to enable the consumer to judge ex ante within which borders the variation of the interest rate is due. To act arbitrarily at the expense of the debtor must be impossible (otherwise the clause will not be incorporated into the contract) OGH 4 Ob 73/03v.

For **Belgium** (already mentioned on the previous page) mortgage loan agreements must have a predetermined objective reference rate. In addition they must stipulate that variations in the interest rate (in minus or in more) are limited to a pre-determined fixed difference in relation to the original interest rate (art. 9, §1, 7° WHK).

In **Bulgaria** Article 5 (1) 10 Consumer credit act requires similar information.

In **Estonia**, the Law of Obligations overdrafts stipulates that, before entering into an overdraft agreement, the credit institution must notify the consumer of the interest applicable at the time of notification and the conditions for changing the interest rate.

Finland forbids changing fixed interest rates in its Consumer Credit Act, but if such rates are convened the reference rate must be objective.

In **Greece** Act 2501/1992 of the Governor of the Bank of Greece obliges the provider to inform the client of the reference interest rate.

In **Hungary**, recent amendments to Section 210 of Act No. CXII of 1996 on Credit institutions and Financial Enterprises provide that, in loan contracts with consumers and in financial leasing agreements, interest, fee or costs elements alone may be increased unilaterally to the disadvantage of the customer, but other elements of the contract may not (including the reasons for change). An increase is only possible if an objective reason has arisen as specified in the contract and reflected in the bank's "pricing policy".⁸⁵

Furthermore, interest rates can be modified when changes in the usury ceilings call for a change in the interest rate to bring it below the ceiling. For example, in the **Netherlands**, if the maximum interest rate is changed, the interest rates must be adapted unless the loan is due in the next year, in which case the interest rate remains unchanged.

Ireland only requires according to Consumer Credit Act. Under s. 149, that customers must be notified of increases in charges.

In **Italy** the courts use the unfair contract terms rules to limit arbitrary increases of interest rates.

Latvia's Consumer Credit Agreements No.692 (2008) Act for overdraft, credit card credits, mortgage loans, deferred payment in sales contracts provides one statutory provision – agreements should provide interest rate, interest rate change periods and its rules

In **Poland**, though the Banking Act contains provisions which require customers to be informed of the mechanism of variations in interest rate, disclosure of some details is not required (eg. central bank interest rates, currency exchange rates, stock exchange indexes). However, the proposal by the Polish government for the implementation of the CCD imposes more detailed information requirements on credit providers.

In **Portugal** cf. Circular nr. 1/2008/DSB of Bank of Portugal requires that adaptation is done at a regular period. The need for information and termination by credit types is subject of Decree-Law nr. 133/2009 and Article 14 of Decree-Law nr. 133/2009.

In **Romania**, the Emergency Ordinance no. 174 of 19 November 2008 for the modification and completion of consumer protection laws and regulations and the 2010 Romanian Bill on credit agreements for consumers, require a written consent of the consumer that the rate may be changed, notification of each modification 30 days in

⁸⁵ This document, which is not public, though the objective reasons applied by the bank regarding unilateral changes themselves are, is filed with and supervised by the Supervisory Authority for Financial Institutions (PSZAF). The Pricing Policy will be supervised in the light of an official Code of Conduct, adopted on 16 September 2010 and entered into effect on 1 January 2010. The wording of the Code of Conduct is available in English at: <http://www.pszaf.hu/data/cms2043240/codeofconduct.pdf>.

advance and give a consumer 15 days after reception of such notification to accept or reject these changes.

According to Art. 4 sec. 2 letter h) of The **Slovakian** Act on Consumer Credit, the consumer credit contract must contain conditions for change of variable annual interest rate, as well as index or reference rate applicable to the original variable annual interest rate. According to the Annex to the Decree of the Ministry of Finance of the Slovak Republic Nr. 620/2007 Coll., establishing a template for terms and conditions of credit agreements, in the Formulary about contractual conditions of consumer credit must be filled some specific information.

In the **UK**, the new s78A Consumer Credit Act 1974 imposes a duty on creditors to give information to debtors on changes in interest rates, implementing article 11. Other than regulations on the unilateral power to vary the contract or unfair terms, the Financial Services Authority principles of “treating customers fairly” would also apply. There are also rules that have been recently agreed between government and industry applicable to changing interest rates on credit and store cards. Other regulation is based on principles derived from a provider’s duty to execute bona fide contracts. An example from the UK, where there are regulations on interest rate changes, shows that under contract law a unilateral power in contract to alter the interest rate is subject to an implied term that the lender will exercise his discretion “honestly, and not for an improper purpose, capriciously or arbitrarily”⁸⁶ and would not act in a manner which no reasonable lender with a knowledge of the facts would have done.

In some countries, there are further stipulations in relation to non-compliance by providers with the rules on reference indices or frequency and method of amendment of interest rates. In **Germany**, for example, the courts replace the defective term with a term which complies with the rules, so that the variation is made on the following terms: the reference index is either the average interest applied to the contract (index-source: German Central Bank) or the three-months Euribor; the interest rate is adjusted quarterly (new jurisprudence: monthly); the interest rate is adjusted if the spread of the index compared to the previous quarter’s index exceeds 0.25 percent (new jurisprudence: no threshold).

In **Finland** for example, if the bank’s financial situation is seriously prejudiced, the bank may, instead of allowing the loan to fall due, raise the interest rates. However, before this is actually done, the bank must first consult the Finnish Financial Supervision Authority.

In the present crisis, the issue of interest rates and their variation has been of great relevance in **Spain**, where Court decisions are pending with regard to a number of claims led by consumer associations (such as the Spanish Association of Consumers ADICAE) involving over 20 financial institutions. These providers issued mortgages with a so-called “clausula suelo” or “ground clause”, with the effect that interest rates in variable rate mortgages would not be reduced below certain limits. This concern was also raised during the research team’s meeting with the FIN-USE, at which a Spanish member argued that the study of interest rate restrictions should also be concerned with reporting on regulations controlling the floors as well as the caps. The consumer detriment resulting from such practices, which have only been found in Spain, are based on the granting of loans whose essential features on the limits to the adjustment of the interest rates were not made clear to the borrower.

“The indiscriminate introduction in a surreptitious way by the Spanish banking industry of the abusive so-called ‘Floor and Cap clauses’ on thousands (nine out of ten) of mortgages fees signed from 2008 up to the present moment, preventing consumers and SME to take

⁸⁶ Paragon Finance Plc v. Nash 2001 Court of Appeal at p 32; Mindy-Chen-Wishart (2008), p 110.

advantage of the sharp drop in Euribor. Thus, thousands of consumers are suffering the paradoxical situation that while Euribor is 1.24 % at the current moment, they are facing an interest rate of the 6.38 %. As a result and depending on the amount of the loan, they are paying abusive interests (from € 2,500 to 6,000 a year) to banks”.⁸⁷

The subject of variable rate credit is also under discussion in the context of specific problems in certain Member States. In **Austria** for example, where the combination of fixed and variable interest rates in long-term mortgage credit is a popular product (eg. a 20 year loan at a fixed interest rate of 4% for the first six years and 14 years at a variable interest rate), an ongoing political discussion is taking place. It is based on the fact that the constellation is seen by some as quite problematic for consumers because of the potential for significant differences between fixed and variable interest rates, which are not predictable.

1.3.4 Fees and charges

As already mentioned above⁸⁸ there are other cost elements like closing and disclosure fees, broker fees, payment protection insurance (PPI) fees, finance charge on insurance fees, early repayment charges and commission on linked products that are related to the cost of credit. The Member State reports from our legal experts indicate a quite liberal regime regarding restrictions on fees in the European Union. Regulatory gaps seem to exist especially with regard to PPI, as described in subsection 1.3.4.2 below. Table 20 shows the situation in the EU 27 Member States covering both general restrictions and payment protection insurance.

Table 20: Restrictions on general fees and charges including PPI in the EU

Member State	General fees and charges	Payment Protection Insurance
Belgium	No fees for credit intermediaries for consumers under article 65, §1 WCK. But only if credit entered into with his help. 50% of commission must be spread. Only administrative set-up costs, fees and costs for valuing the house may be charged to the borrower.	No obligation to use the sum borrowed to finance other financial instruments (article 31, §2 WCK; art. 18 WHK). Mortgage loans: if the insured dies, the insured principal must be used to repay the outstanding balance (art. 6, §3 WHK).
Cyprus	No general restrictions. Penalty fees to overrunning on the current account. A 3% limit for penalty fees for early repayment mortgage loans but case by case basis.	
Czech Republic	Contractual penalty if unreasonably high, the court may reduce it.	
Denmark		Agreements concerning commission must be spelled out in advance. The same goes for the costs and nature of any linked product.
Estonia	If a contractual penalty is unreasonably high, the court may reduce it to a	

⁸⁷ See: FIN-USE (2010), p 4.

⁸⁸ See Table 18: Borrowing rate and APRC at p 94.

Member State	General fees and charges	Payment Protection Insurance
	reasonable amount with regard to the economic situation of the parties.	
Germany	Fees can be found ineffective if they unreasonably disadvantage the other party. Excessive fees for exceeding an overdraft can be void. Foreclosure fees in credit contracts without prejudice of the amount are void.	Payment protection insurance is intended to lower the default risk for both lender and borrower and therefore should influence the usury rate at equal terms.
Ireland		There is a specific prohibition on the linking of services including payment protection insurances in the case of housing loans.
Italy		Regulation of insurance brokers approved obliges insurance companies and brokers clearly to express the amount of commission or costs paid in collective credit insurance agreements.
Malta	No specific restrictions on fees, but the Malta Financial Services Authority (MFSA) regularly reviews the charges list of the banks and issues instructions for changes if the charges are considered too high.	
Poland	Direct floating ceiling on fees and additional charges (not included in the APR) may not exceed 5 percent of the amount of the loan.	Only Member State where fees and additional charges (not included in APR) may not exceed 5% of the amount of the loan. Insurance is thus regulated.
Portugal		Linked insurance premium must decrease with the residual debt. It is forbidden to make the credit conditional upon the purchase of PPI or any other financial product.
Romania		Only the following allowed for a loan: a credit check fee, a credit management fee or a checking account management charge, compensation in the event of early repayment, insurance-related costs, penalties, and a single charge for the services provided at the consumers' request.
Slovakia	The borrower is not liable for payment of any charges about which the requisite information is not properly provided (art. 4 sec. 4 consumer credit act).	
Slovenia	The borrower is not liable for payment of any charges about which the requisite information is not properly provided (art	

Member State	General fees and charges	Payment Protection Insurance
	6 consumer credit act).	
Sweden	The borrower is only liable to pay special compensation for the credit (charges), in addition to or instead of interest, if such charges relate to costs which the lender has incurred for the loan and if the charges are specifically identified in the agreement.	
UK		No PPI sold at the point of sale is considered. Debtor can only be contacted for sale of insurance after 7 days. Sale of single premium insurance also prohibited by the Financial regulators. Fines on the grounds that a firm must pay due regard to the interests of its customers and treat them fairly.
No Restrictions reported	Austria, Bulgaria, Finland, France, Greece, Hungary, Latvia, Lithuania, Luxembourg, Netherlands, Spain	

Source: Stakeholder and Expert survey.

1.3.4.1 General restrictions

Apart from methods of calculation of the APRC, nine Member States (Austria, Bulgaria, Finland, Greece, Hungary, Latvia, Lithuania, Luxembourg and Romania) report no restrictions on fees.

As summarised in Table 20, of all Member States, only **Poland** reports a general direct floating ceiling on fees to be specified stated in the law. Under art 7a Consumer Credit Act, fees and additional charges (not included in the APR) related to the conclusion of the credit contract may not exceed 5 percent of the amount of the loan. The financial regulator, the Ministry of Finance, reports that, due to the statutory interest rate ceiling, the level of other charges, fees, etc. resulting from the contract has risen significantly in Poland. As a result, the overall cost of credit is less clear to consumers and that it might still exceed the optimum level of interest rates. Although the law on consumer credit sets a limit for the overall level of fees resulting from the conclusion of a contract, the definition did not seem broad enough to prevent providers from moving the costs of credit to unrestricted areas.

In **Belgium** there are restrictions on fees for credit intermediaries and non-finance charges. Under article 65, §1 WCK and article 13 WHK, no fee is payable to the credit intermediary by the consumer (direct or indirect); the credit intermediary is only entitled to a commission for credit agreements validly entered into with his help. At least 50% of the commission must be spread depending on the credit type and duration (article 65, §§ 3-4 WCK). The following restrictions on non-finance charges are stipulated in article 11 WHK: except for the legal charges on the mortgage and charges due pursuant to other legal provisions, only administrative set-up costs, fees and costs for valuing the house may be charged to the borrower; fees and costs for valuing the house are only due after valuation of the house. If they are charged, the creditor must provide the borrower with

a copy of these costs in advance; administrative set-up costs are only due after an offer has been sent to the borrower; no agent or another intermediary may burden directly or indirectly the credit applicant with costs (art. 48 WHK).

In some Member States the creditor must inform of all fees in the credit agreement and if not face legal consequences.

For example in **Germany**, the civil code provides that the consumer credit agreement must show fees and other expenses payable by the debtor and related to the receipt of the loan (German Civil Code, section 492). At the time of execution of the agreement the consumer must also be informed in writing of the fees imposed from the moment of execution of the agreement, as well as the conditions under which they may be charged. The borrower is not liable for payment of any charges about which the requisite information is not properly provided (section 494 German Civil Code). Similar rules are applied in **Slovakia** (art. 4 sec. 4 consumer credit act) and in **Slovenia** (art 6 consumer credit act). Likewise, **the Swedish** Consumer Credit Act (1992:830) art 12. Section 12 states: "The borrower is only liable to pay special compensation for the credit (charges), in addition to or instead of interest, if such charges relate to costs which the lender has incurred for the loan and if the charges are specifically identified in the agreement.

Few Member States report that certain fees might be reduced or even declared void either by the courts or by a financial service authority.

In **Estonia**, the Law of Obligations Act provides for the possibility of applying a reduction in contractual penalties. If a contractual penalty is unreasonably high, the court may reduce it to a reasonable amount at the request of the payer, taking into particular account the extent to which the obligation has been performed by the party, the legitimate interests of the other party and the economic situation of the parties. The same method is effective in the **Czech Republic**. Also in **Germany** there are restrictions under jurisprudence (case law), limiting "freedom of the contract" in relation to the type of fees that might be charged by banks. Section 307 German Civil Code declares a standard term and condition to be ineffective if it unreasonably disadvantages the other party. The rule is applied not only to contractual terms and conditions in credit contracts but also to some fees. Recently the courts have declared fees for exceeding an overdraft to be void. Furthermore, an ongoing debate was reported as to whether foreclosure fees in credit contracts without prejudice of the amount are void. In **Malta** there are no specific restrictions on fees, but the Malta Financial Services Authority (MFSA) regularly reviews the charges list of the banks and issues instructions for changes if the charges are considered too high.

1.3.4.2 Payment protection insurance

One important method of circumventing interest rate restrictions is through "voluntary" credit insurance or other charges not included within the concept of interest. Experts report that in Poland, France (over 70% of revolving credit), Germany (over 50% of instalment loans) and the United Kingdom this kind of ancillary service is widespread. With regard to Payment Protection Insurance (PPI, Residual Debt Insurance, Outstanding Debt Insurance) structural features are reported for the UK and the German market which adversely affect competition. Those features exert little competitive pressure on the distributor at the key point of sale, the complex nature of the contract, making comparison difficult, the lack of product information prior to the point of sale, very low levels of cancellation or switching by consumers, problems faced by stand-alone providers in reaching consumers and "vertical integration" (one company offering both the credit contracts and insurance contracts).⁸⁹ Furthermore, the conduct of firms has an

⁸⁹ Office of Fair Trading (2007), pp 2 ff.; Reifner, U., Knobloch, M., Knops, K, (2010), pp 20 ff.

adverse effect on competition: the OFT reports that consumers either assume or are told that buying insurance would positively effect the decision to grant a loan. Poor upfront information is regarded as having a negative impact on competition, as well as the fact that the competition is centred on the loan and not on the insurance.⁹⁰ As a result of the lack of competition, there is little pressure on the price of Payment Protection Insurance. This is why those prices differ greatly, even when products with almost identical features are considered.⁹¹ John Fingleton, OFT Chief Executive summarised the findings of the market investigation as follows:

*'Our examination of the evidence presented to date gives us reasonable grounds to suspect that there are features of this market which restrict competition to the detriment of consumers. Despite some evidence of a degree of consumer satisfaction with aspects of the product, the evidence as a whole suggests consumers get a poor deal.'*⁹²

According to the Office of Fair Trading⁹³ in the **United Kingdom**, there are about 20 million payment protection insurance policies currently in force, and about 6.5 to 7.5 million are sold annually. Both the Gross Written Premium (GWP) and the number of policies indicate a rapidly growing sector between 2000 and 2005. The average yearly rise of GWP in these years amounted to more than 18 percent. The OFT reports an average claims ratio⁹⁴ for all Payment Protection Insurance in the UK of approximately 20 percent and states that these figures are low compared with other forms of insurance.⁹⁵

In **Germany**, debtors very often dispose of payment protection insurances on their loans. According to the BaFin (the German Banking Supervision, Insurance Supervision and Securities Supervision), at the end of 2008 there were 2.84 million payment protection contracts, with a total sum insured of about 21 EUR billion⁹⁶. Although there is empirical evidence that the main triggers of default and over-indebtedness in Germany are forced unemployment, forced short-time working, failed self-employment and divorce⁹⁷, payment protection insurances very often only cover the life-risk of the borrower. For this reason, this insurance very rarely assist with the main triggers for default in Germany, ie. unemployment and divorce. As in the UK, the Insurance Claims Ratio is very low. Although there has been a rise in credit defaults from 2.3 percent in 2007 to 2.5 percent in 2008⁹⁸, the insurance claims ratio has fallen from 13.92 percent of GWP to 12.18 percent, as is shown by the following table:

⁹⁰ Office of Fair Trading (2007), pp 3 ff.

⁹¹ Office of Fair Trading (2007), pp 41 ff.; Reifner, U., Knobloch, M., Knops, K, (2010), pp 47 ff.

⁹² See OFT press release 15/07, 7th February 2007.

⁹³ All Data from Office of Fair Trading (2007).

⁹⁴ Claims paid as a percentage of the Gross Written Premium.

⁹⁵ Comprehensive Motor Insurances: 82 percent of GWP, Medical Insurances: 80 percent of GWP, Pet Insurances: 72 percent of GWP, Household Insurances: 54 percent of GWP.

⁹⁶ Data from BaFin, Statistic on life insurances, tables 150(1) and 150(2). The BaFin Statistic contains only a part of the market of PPI.

⁹⁷ These triggers are reported in approximately 55 per Cent of all cases as the main trigger of over-indebtedness while debt advisors report only in one of 100 cases, that the death of the partner was the main factor. See Knobloch, M., Reifner, U., Laatz, W. (2009), p. 23.

⁹⁸ According to SCHUFA, the biggest German Credit Register (see SCHUFA Kredit-Kompass).

Table 21: Payment protection insurance in Germany, 2001–2008, EUR (size, claims, claims ratio)

year	Insurance claims (EUR)	GWP (EUR)	Insurance claims ratio according to GWP (%)
2001	49,000,000 €	288,000,000 €	17.01%
2002	52,000,000 €	408,000,000 €	12.75%
2003	53,000,000 €	391,000,000 €	13.55%
2004	54,000,000 €	292,000,000 €	18.49%
2005	56,000,000 €	283,000,000 €	19.79%
2006	47,000,000 €	307,000,000 €	15.31%
2007	43,000,000 €	309,000,000 €	13.92%
2008	38,000,000 €	312,000,000 €	12.18%

Source: SCHUFA Kredit-Kompass.

Given with the above findings and concerns in relation to the payment protection insurance market and its lack of competition, there is relatively little regulation of the prices and fees involved. Nine Member States reported restrictions or regulations on payment protection insurance. Only one Member State, Poland, reported imposition of a floating maximum on such fees. In the UK, the Competition Commission banned the sale of Payment Protection Insurance at the point of sale of the loan outright, but the Competition Appeal Tribunal revoked the ruling. All other reports (Belgium, Denmark, Germany, Ireland, Italy and Spain) concerned the regulation of information, such as up-front information as to the fees involved in related financial products.

In **Belgium**, neither the creditor nor the credit intermediary may oblige the consumer to use the sum borrowed to finance other financial instruments (article 31, §2 WCK; art. 18 WHK). If the loan is offered to the consumer with a linked payment protection insurance policy ("outstanding balance insurance"), with linked income insurance or with linked supplementary invalidity insurance, the charges relating to these forms of insurance must be included in the total cost of credit. This article does not apply to loans in which the amount of credit exceeds 5,000 EUR or if the insurance agreement was signed at the consumer's explicit request and after the loan was already signed (article 31, §4 WCK). Finally the WHK on mortgage loans sets a restriction on the financing of linked outstanding balance insurance policies. If the insured dies, the insured principal must be used to repay the outstanding balance (art. 6, §3 WHK). The creditor may only stipulate that the linked policy be applied for its benefit if the proceeds of sale of the security are insufficient to repay the mortgage loan (art. 26, §3 WHK).

In **Denmark**, agreements concerning commission must be spelled out in advance. The same goes for the costs and nature of any linked product.

In **Germany**, according to section 492 (6) German Civil Code, the costs of any residual debt insurance or other insurance taken out in connection with the consumer loan contract must be set out in the contract. Furthermore, under section 6 of the Statutory Order on Price Quotation (Verordnung zur Regelung der Preisangaben), "all other costs", including payment protection insurance fees, must be included in the APR, but only where the insurance is a pre-condition of the loan. Because of this exemption, there are very few contracts where the insurance fees are included in the APR. The Statutory Order on Price Quotation has been amended recently (effective from June 11, 2010) and now states that fees for payment protection insurance must be included not only when they

are pre-condition of the loan but also if they are pre-condition for *the intended conditions of the contract*. Payment protection insurance is intended to lower the default risk for both lender and borrower and therefore should influence the interest rate where the provider applies “risk-based-pricing”. In spite of this, there is so far no evidence that there has been a change in providers’ practice of not including the fee in the APR.

Credit intermediaries must be licensed in **Ireland** (section 144 Consumer Credit Act 1995) and must, in advance of an agreement, disclose in writing to the consumer the existence of any commission arrangement (section 148). Furthermore, according to section 127 Consumer Credit Act 1995 there is a specific prohibition on the linking of services (including payment protection insurances) in the case of housing loans. Where, in connection with the making or arranging of a housing loan, more than one service is made available by a mortgage agent or one or more of his subsidiaries, the agent shall not, and shall ensure that each of his subsidiaries does not, make the services available on terms other than terms which distinguish the consideration payable for each service so made available; nor shall any of the subsidiaries make the services available on terms other than terms which make that distinction.

In **Italy**, in 2009 a number of actions regarding payment protection insurance policies have been approved. In particular, the regulation of insurance brokers approved by ISVAP (Reg.5/2006 as modified by provisions approved in 2009) obliges insurance companies and brokers clearly to express the amount of commission or costs paid in collective credit insurance agreements. This is valid only for insurance sold under the form of collective agreements, but the prospect of extension of the rule is being discussed.

As mentioned before, **Poland** is the only Member State that reports that fees and additional charges (not included in APR) related to conclusion of the credit contract may not exceed 5% of the amount of the loan. In the cost of credit the cost of insurance and the cost of establishing collateral are not included.

In what concerns mortgage credit, **Portuguese** Decree-Law nr. 222/2009 establishes that the linked insurance premium must be proportionate to the amount of the debt, which means that the premium must be reduced alongside amortisation of the loan. For the types of credit subject to Decree-Law no. 133/2009⁹⁹ it is forbidden to make the conclusion of a credit agreement conditional upon the purchase of any other financial products. The same rule is established for mortgage loans under Decree-Law no. 51/2007.

Though **Romanian** regulations introduced a prohibition against new fees and charges associated with loans in 2008, the Romanian Bill on credit agreements for consumers 2010 states that the creditor may charge only the following amounts for a loan: a credit check fee, a credit management fee or a checking account management charge, compensation in the event of early repayment, insurance-related costs, penalties, and a single charge for the services provided at the consumers’ request.

The **UK** Competition Commission enacted the Payment Protection Insurance Order 2009 under which the sale of payment protection insurance at the point of sale was banned. The lender may contact the debtor after 7 days to sell insurance. The sale of single premium insurance was also prohibited. Barclays Bank appealed this Order to the Competition Appeal Tribunal and the Point of Sale prohibition was quashed and returned to the Commission for reconsideration.¹⁰⁰ The Financial Services Authority has taken 22

⁹⁹ Instalment loans, Financial leasing, Hire purchase financing, Point-of-sale financing and all categories of Revolving Credit except for overdrafts were the credit has to be paid back within one month.

¹⁰⁰ See Competition Appeal Tribunal, judgement Case number 1109/6/8/09 from 16th October, 2009, http://www.catribunal.org.uk/files/Judg_1109_Barclays_16.10.09.pdf.

enforcement actions against regulated firms for the mis-selling of payment protection insurance since 2005 and sent a Dear CEO Letter in February 2009 requesting firms not to sell single premium insurance with unsecured personal loans. The Enforcement Actions in relation to PPI usually involved contraventions of regulated firms' fundamental obligations under the Principles for Business to "take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems" and "a firm must pay due regard to the interests of its customers and treat them fairly".¹⁰¹

1.4 Effects of the CCD 2008 on IRR

1.4.1 EU Directives and national IRR

IRR is concerned with the setting of prices. Instead contract law and especially EU consumer law relates the setting of prices to the parties of the contract while monitoring the procedures and transparency of the process.

This is why the Consumer Credit Directive¹⁰² (CCD 2008) is, as far as prices are concerned, exclusively focussed on price disclosure. It even explicitly refrains from harmonising price regulation and in Recital 30 leaves IRR regulation in particular to the national legislator. While usury had been mentioned in an earlier draft, the regulation now in force expressly alludes to this restricted purpose more indirectly. For example, Recital 22 states that for special IRR "prohibiting the creditor from requiring the consumer, in connection with the credit agreement, to open a bank account or conclude an agreement in respect of another ancillary service, or to pay the expenses or fees for such bank accounts or other ancillary services", the "Member States should remain free to maintain or introduce national provisions."

Directive 2005/29/EC on unfair commercial practices defines its area of application in Art. 2 (d) as 'business-to-consumer commercial practices' (hereinafter also referred to as commercial practices)" which "means any act, omission, course of conduct or representation, commercial communication including advertising and marketing, by a trader, directly connected with the promotion, sale or supply of a product to consumers". While the Directive contains many rules on price disclosure as well as the calculation of prices or the use of prices in advertisements, the setting of the price itself does not fall under the notion of "unfair commercial practices" as defined in this Directive as well as in national law.

The same is true for Directive 93/13/EEC on standard contract terms, "whereas, for the purposes of this Directive, assessment of unfair character shall not be made of terms which describe the main subject matter of the contract nor the quality/price ratio of the goods or services supplied".

Although the Directives are quite clear in this respect, at EU level experts suggested that standard contract law may for example be used to qualify default interest clauses as forbidden penalty clauses or extortionate pricing as "unfair". In this respect we have argued that in future IRR may be dealt with as a form of cartel law.¹⁰³

However, besides these general questions about the appropriate place for IRR in the body of national and EU law, there is a more or less effective relationship in practice

¹⁰¹ <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>.

¹⁰² 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.

¹⁰³ See 1.1.3.5 Fairness and Good Morals – towards a general principle for IRR in European contract law? at pp 54.

between IRR and consumer credit legislation in that national legislators tend to provide harmonised rules for credit products which use the same definitions for IRR as they are used in general consumer credit law.

It has been shown above¹⁰⁴ that the core element of IRR, the interest rate, is largely pre-defined by the creation of a special interest rate for price disclosure (APRC) under EU law. While older IRR rules still refer to the rate of borrowing, the modernisation of consumer credit law has directly affected this element.

CCD 2008 does not prevent national legislators from using both its definitions and denominations and its rules on scope and circumvention. Furthermore, questions of how the restricted interest rate should be calculated both mathematically and legally, whether small loans of up to €200 (Art. 2 (2) c) or for less than three months (Art. 2 (3)) are included and whether only consumers (Art. 1) or all borrowers are covered, whether mortgages (Art. 2 (2) a) or certain micro-loans are excluded (Art. 2 (2) l) must increasingly be regulated in conformity with general consumer credit law. Since national credit disclosure law is ruled by the maximum harmonisation approach of Art. 22 (1) of the CCD 2008, this means that large parts of national IRR are also indirectly regulated by EU law.

1.4.2 Implementation of CCD 2008

As at March 30, 2010 only a few Member States had incorporated the CCD 2008 into national law. In most Member States, a draft was in the legislative process. In Ireland and Poland, details of transposition were still being debated while for some Member States no proposal or details were available.

Table 22: Transposition of the CCD by March 2010

Implemented (effective)	Bulgaria (12.5.10); Estonia (1.5.2009), Germany (11.6.10), Hungary (14.12.09), Portugal (1.7./1.10.09)
Draft, Proposal	Austria, Belgium, Czech Republic, Denmark, France, Greece, Latvia, Lithuania, Netherlands, Slovakia, Slovenia, UK
Under Discussion	Ireland, Poland
No details available	Cyprus, Finland, Italy, Luxembourg, Malta, Spain, Romania, Sweden

Source: Expert Survey.

It was reported that only in Portugal had transposition had a direct effect on IRR and usury ceilings were enacted for the first time along with general implementation of the Directive. Other direct effects were reported in Poland, where IRR for additional costs of credit, currently limited to 5% of the loan value, were removed. In Belgium IRR on early repayment fees for full repayment are now regulated and the calculation of interest rates was amended in Austria and Denmark.

In the opinion of many of the experts, however, the CCD and the passing of the Directive on Unfair Commercial Practices 2005/29/EC (UCPD) had at least side effects on the regulation of specific credit types, on calculation methods for interest rates, and on closer regulation of early repayment fees. When asked about which credit types should be

¹⁰⁴ See p 91.

regulated within the scope of the CCD 2008, credit card loans and revolving loans were mentioned.

In some Member States, implementation of the CCD 2008 had an effect on additional types of credit which will be newly regulated as a result of its implementation. New regulation affecting IRR was reported in relation to financial leasing (Austria), a €150 limit on micro-credit (Sweden), effects of overrunning a bank account (Austria, Belgium, Czech Republic, Slovakia), of overdraft credit (Czech Republic, Slovakia), linked credit agreements (Czech Republic, Slovakia), financial leasing (Austria, Slovakia), mortgage loans (Lithuania, Romania), credit intermediaries (UK), or new credit classifications from €21,500 to €75,000 (France).

1.4.3 Small amounts of credit

The CCD excludes credit of less than €200 (Article 2 (2)c) from its scope but allows such loans to be incorporated into national legislation. (Recital 10).

- Only four countries will, after the transposition of the CCD, continue to exclude such small credit in general from disclosure law as well as from IRR.
- Seven countries have, on the other hand, included such small loans into disclosure law as well as into general IRR, some only recently using the transposition of the CCD.
- Nine countries have a mixed regime.

The Netherlands recently included small loans into price disclosure law, expressly because it wanted to regulate IRR. This shows that the transposition of EU regulation on consumer information may also be influenced by IRR legislation at national level.

The following table gives examples of how the exemptions from disclosure law are applied or not applied in IRR. Since the question was asked in relation to all kinds of IRR, including the general principle of IRR, the table is especially interesting where the answer is homogeneous.

Table 23: Small credit and the CCD

Country	Included Disclosure/IRR	Remark
Austria	Yes/Yes	
Belgium	No/Yes	€200 partially excluded from WCK (art. 3, §2 WCK). IRR apply (default charges, APRC, sanctions)
Bulgaria	No/?	€200 excluded under Art. 4, (1) 1 Consumer Credit Act.
Cyprus	No/?	Excluded €200.
Czech Rep	No/No	Less than CZK 5000 (approx € 200)
Denmark	No/No	Excluded for less than €200.
Estonia	Yes/Yes	Law of Obligations Act § 403 changed in 1.05.2009
France	No/Yes	regulated if for a term of more than 3 months but all are covered by IRR.
Germany	No/Yes	€200 excluded but IRR is not affected.
Hungary	Yes/Yes	
Lithuania	Yes/Yes	LTL 1000 (approx €290). The proposed Consumer Credit Law will regulate all loans.
Luxembourg	No/Yes	Under €185.92 excluded
Malta	No/Yes	€202.66 excluded. These rules do not affect IRR
Netherlands	Yes/Yes	Exemption only until 11 June 2010 if their term was longer than 3 months. (Wet Financieel Toezicht)
Portugal	No/No*	€200 excluded, usury ceilings (Decree-Law no. 133/2009) not applicable. But non-bank credit (art. 1146 of the Civil Code).
Romania	Yes/Yes	Law no. 289 of 24 June 2004 is not applicable to loans for a total of less than €200 but this will change in 2010
Slovakia	Yes/Yes	Not excluded under civil law (Civil Code - Act No. 40/1964 Coll.), consumer law (art. 52-54) and contract law (art. 657-658).
Slovenia	No	Excluded below €170 but after transposition of CCD at €200
Spain	No/Yes	Under €150 excluded
Sweden	Yes/Yes	Consumer Credit Act 1.1.2011, micro-credit, short-term loans will then be included

Source: Expert Survey.

1.4.4 Short-term loans

The Directive also addresses short-term loans for less than one month (Art. 2 (2) i) or three months (Art. 2 (3)) if certain other conditions are also met. This has led to a number of different exemptions for both credit disclosure law and IRR which, in some countries, resemble the regulatory provision in Latvia, Estonia, Netherlands, Sweden, Bulgaria. Czech Republic, Lithuania, Luxembourg for small loans.

In other countries, there are quite sophisticated regulations which take into account the role of short-term credit in relation to overindebtedness.

In **Great-Britain**, the provisions of the Consumer Credit Act 1974 apply in particular to Payday Loans and Home Credit Agreements (both debtor-creditor agreements). Home

Credit Agreements (weekly collections) are also subject to the Home Credit Market Investigations Order 2007, which requires home credit lenders (a) to share customer repayment data with other lenders (b) to publish on a website financed by the main lenders cost information on their loans and (c) to draw the attention of borrowers to this website in account statements provided to borrowers.

In **Portugal**, short-term loans for a term of less than 3 months granted by credit institutions are included within the scope of Decree-Law no. 133/2009 (which transposes the CCD 2008) and, for that reason, the usury ceilings set in that legislation are also applicable to these loans. Special bank accounts exist which are normally conceived as an overdraft facility on the deposit account into which the borrower's salary is paid. In 2009, the consumer association magazine, *Proteste*, (from DECO) published a comparative study of those accounts, concluding that the APR on them ranged from 12.46%, and 24.16%. Normally, those accounts do not charge maintenance costs and there are a few other "benefits", depending on the bank.

In **Belgium**, consumer credit law distinguishes between revolving credit accounts and other short-term consumer credit agreements. Revolving credit accounts, which are repayable within 3 months and the amount of which does not exceed €1,250, are excluded from the scope of the Belgian Consumer Credit law (art. 3, §1, 4° WCK). Both conditions (ie. repayable within 3 months and maximum amount of €1,250) are cumulative. Other credit agreements are excluded from WCK if the loan is repayable within 3 months (art. 3, §1, 3° WCK). If excluded from the WCK, general civil law provisions will nevertheless be applicable.

In **Denmark**, these short-term loans are not covered by the Danish Consumer Credit Agreement Act. However guidelines have been set up by the Danish consumer ombudsman and the industry in relation to distance sales of short-term or small loans ("sms- and web-loans")

In **Finland**, if the duration of the loan is less than 3 months and no interest is charged, the standard form for pre-contractual information and a written form of contract need not be used (Consumer Protection Act chapter 7 paragraph 3).

In **Slovenia**, short-term loans are not regulated by the Consumer Credit Act, unless they exceed 300% of gross personal income for the previous month (or, under the draft new Consumer Credit Act, unless significant charges are payable). All interest arising from obligations are regulated by the Code of Obligations (*Obligacijski zakonik*, OZ-UPB2).

1.4.5 Responsible lending

Also the principle of responsible lending in the 2002 draft of the CCD has not been overtaken as such into the 2008 final version where Art. 8 refers only to the assessment of the creditworthiness of the consumer. But recital 26 underlines that "responsible lending" is a general principle underlying the whole Directive when it says:

"Member States should take appropriate measures to promote responsible practices during all phases of the credit relationship, taking into account the specific features of their credit market. Those measures may include, for instance, the provision of information to, and the education of, consumers, including warnings about the risks attaching to default on payment and to over-indebtedness. In the expanding credit market, in particular, it is important that creditors should not engage in irresponsible lending or give out credit without prior assessment of creditworthiness, and the Member States should carry out the necessary supervision to avoid such behaviour and should determine the necessary means to sanction creditors in the event of their doing so. Without prejudice to the credit risk provisions of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the

business of credit institutions (1), creditors should bear the responsibility of checking individually the creditworthiness of the consumer. To that end, they should be allowed to use information provided by the consumer not only during the preparation of the credit agreement in question, but also during a longstanding commercial relationship. The Member States' authorities could also give appropriate instructions and guidelines to creditors. Consumers should also act with prudence and respect their contractual obligations."

Although information and education are seen here as the primary tools, the principle of responsible credit is seen by both providers¹⁰⁵ and consumer organisations¹⁰⁶ as much broader and as including substantive behaviour in terms of the pricing and servicing of credit contracts.

1.4.5.1 General principles of good morals and bona fide

General principles concerning the need for lenders to exercise good morals or fairness in contract law, as well as concepts of force majeure and bona fide exist in sixteen Member States¹⁰⁷. In some cases, these have been used by courts in attempts to restrict over-indebtedness. For example, the Belgian courts have held that credit providers violate this requirement to enter into bona fide contracts if they lend money to people who, at the outset of the contract, cannot reasonably be expected to maintain the payments.

In other countries (for example, Estonia, Greece, Slovenia, Lithuania, Luxembourg, and Germany), the concept of good morals appears to be very closely linked to the concept of usury, and is used for protection against the exploitation of weakness or lack of experience on the part of the borrower. For example, the Lithuanian Civil Code requires that contracts be fair and reasonable and gives people a right to apply for the interest rate on an agreement to be reduced on the basis that it does not conform to *ordre publique* and principles of good morals.

In some countries, general principles appear to allow courts to intervene even where the agreement is not found to be usurious. For example, in Slovenia, the Constitutional Court ruled in case no. U-I-202/93 (6.10.1994) that, regardless of any indicators of usury, an agreement under which interest accrued within a short space of time to match the level of the principal fell foul of the bona fide principle.

However, questions remain as to the effectiveness of these general principles and the experience across Member States varies. For example, in Italy, social force majeure is a common topic of debate among legal academics but does not appear to be positively reflected in court decisions and, in Hungary, it is also noted that the courts rarely apply the principles directly.

1.4.5.2 Specific provisions

Specific provisions, for example requiring the lender to assess the creditworthiness of the borrower and to provide an adequate explanation of the credit product, are now found

¹⁰⁵ See WOCCU (2008); IFC (2008); Cetelem (2006); UK British Bankers' Association (2005); BIS (2007); INGO (2005).

¹⁰⁶ Principles N° 3 of the European Coalition for Responsible Credit refers to IRR when it says: "P3 Lending has at all times to be cautious, responsible and fair. 1. Credit and its servicing must be productive for the borrower. 2. Responsible lending requires the provision of all necessary information and advice to consumers and liability for missing and incorrect information. 3. No lender should be allowed to exploit the weakness, need or naivety of borrowers. 4. Early repayment, without penalty, must be possible. 5. The conditions under which consumers can refinance or reschedule their debt should be regulated."

¹⁰⁷ The countries are Austria, Belgium, Czech Republic, Denmark, Estonia, Germany, Greece, Hungary, Italy, Lithuania, Luxembourg, Poland, Romania, Slovakia, Slovenia, and Spain.

(or are being introduced) in Member States as a result of the provisions of the CCD 2008. Earlier Directives, for example in respect of Unfair Contract Terms 29/2005 are also relevant across Member States. However, some countries have additional protections in place to ensure responsibility in lending. Examples in this respect include:

- The UK and Finland have responsible lending rules covering the consumer lending process from marketing, through loan applications and decisions, to debt recovery, requiring lenders to consider how they can help people with debt problems.¹⁰⁸ The Financial Services Authority in the UK also provides conduct of business rules for mortgage lending which address responsible lending issues including creditworthiness and arrears handling
 - o Estonia and the Czech Republic have guidance on this issue, for example the Czech Republic encourages creditors to investigate the debtor's capacity to repay the debt in the Ethical Codex of the Financial Market
 - o In Ireland the Consumer Protection Code 2006 contains specific 'Knowing the Consumer and Suitability' provisions that encourage responsibility in lending
- The UK also provides courts with the power to re-open consumer credit agreements where these are found to constitute an 'unfair credit relationship' (Ss 140A-D, Consumer Credit Act 2006), although there are only a small number of decisions concerning the interpretation of these sections from the lower courts at present
- Some countries have also put in place formal limits on loan to value and loan to income ratios which have turned into classes for risk based pricing so that lower ratios can lead to lower interest rates but there is a wide variation in practice:
 - o Austria and Germany had formerly 60% loan to value ratios for mortgage credit from banks which issue related bonds. But these limits have no effects on the contracts itself but are only used today for attributing different interest rates.
 - o Poland places loan to value and loan to income limits on bank credit only
 - o Hungary has issued a Responsible Lending Decree that imposes a debt to income limit for consumer credits and there are also limits on loan to value lending for mortgages and car purchase
 - o the Netherlands provides guidelines in its Code of Conduct for creditors concerning the amount of money that should be left following credit repayments to meet essential household expenditure
 - o Romania obliges banks to analyse the repayment capacity of credit applicants and provides a limit on the maximum level of repayments relative to income.

¹⁰⁸ The licensing regime established by the UK Consumer Credit Act 2006 includes irresponsible lending as factor in determining whether lender's conduct is deceitful, oppressive or unfair (s25(2)(B)). Lenders are therefore expected to conform to principle of "fair treatment of borrowers" "Borrowers should not be targeted with credit products that are clearly unsuitable for them, subjected to high pressure selling, aggressive or inappropriate coercion, or conduct which is deceitful, oppressive, unfair or improper, whether unlawful or not".

- o In Italy there are no formal restrictions but there is an 'implied limit' of one-fifth of monthly income

However, beyond the requirements to check the creditworthiness of borrowers and the specific provisions set out above there are no other obligations placed on lenders to prevent over-indebtedness. Statutory requirements for lenders to act in the best interests of the borrower are usually regulated in public law and not in the form of a contractual obligation to the consumer. But some examples of this can be found in Belgium, where the law does place lenders under an obligation to provide the most suitable credit product for the customer's needs (art. 10, 11 and 15 WCK), and in Finland¹⁰⁹ and Ireland¹¹⁰. Suitability requirements are also mentioned in the Czech Republic's Ethical Codex for the financial market¹¹¹ and in some countries has been established through case-law as a result of the general principles requiring good morals (for example, Denmark¹¹²). In the UK, suitability is also an issue in respect of 'advised sales' of certain financial products including payment protection insurance.¹¹³

Finally, it should be noted that in addition to the implementation of the EU Directive on Unfair Contract Terms, the concept of unfairness has a wider application in the legal systems of some, but by no means all, Member States. The inclusion of 'unfair credit relationship' in Section 25(2)(B) of the UK Consumer Credit Act 2006 is a case in point, but other examples include:

- In Estonia, 'unfairness' occurs if there is an unreasonable imbalance between the amount of credit and the interest charged and in Ireland, sections 47 and 48 of the Consumer Credit Act 1995 provide courts with the power to set aside completely or partially re-open and re-write agreements if a charge is excessive
- In Germany, Hungary, Latvia, Lithuania and the Netherlands the concept of unfairness appears as 'good faith' and 'reasonableness'.

In contrast, unfairness is not a concept which has a legal definition for the purpose of credit regulation in Austria (although the concept of unconscionability applies), Bulgaria,

¹⁰⁹ Actual bill implementing the CCD 2008 (Directive 2008/48/EC).

¹¹⁰ "Knowing the Consumer and Suitability" provisions of the Consumer Protection Code 2006 <http://www.financialregulator.ie/processes/consumer-protection-code/Documents/Consumer%20Protection%20Code.pdf>.

¹¹¹ See at <http://www.clfa.cz/index.php?textID=94>.

¹¹² Executive Order of the Danish Financial Business Act for "good business practice for financial undertakings". The executive order contains requirements regarding advice, information on the product, assessment of the borrower, the suitability of the product, the borrower's willingness to take risks etc.

¹¹³ The vastest reference to responsible lending principles are made in the UK in the bill MCOB 11.3. <http://fsahandbook.info/FSA/html/handbook/MCOB/11/3> New s55A of CCA 1974 implementing 2008 Directive but it requires only advice and information and does not contain IRR as such. It requires creditors to provide adequate explanations of credit and must include: 55 (A)(2) (a) the features of the agreement which may make the credit to be provided under the agreement unsuitable for particular types of use, (b) how much the debtor will have to pay periodically and, where the amount can be determined, in total under the agreement, (c) the features of the agreement which may operate in a manner which would have a significant adverse effect on the debtor in a way which the debtor is unlikely to foresee, (d) the principal consequences for the debtor arising from a failure to make payments under the agreement at the times required by the agreement including legal proceedings and, where this is a possibility, repossession of the debtor's home, and (e) the effect of the exercise of any right to withdraw from the agreement and how and when this right may be exercised and check creditworthiness which may include checking databases. Creditworthiness Assessment must be made before making agreement or significantly increasing credit under the agreement: Creditworthiness assessment must be based on sufficient information obtained from — (a) the debtor, where appropriate, and (b) a credit reference agency, where necessary (55(B)(3) The Lending Code (a voluntary code overseen and enforced by the Lending Standards Board—for further details see <http://www.lendingstandardsboard.org.uk/>) requires that "before lending any money; granting or increasing an overdraft, or other borrowing, subscribers should assess whether the customer will be able to repay it.

France, Malta, and Portugal. In Spain the term is interpreted as 'abusive', which indicates a high threshold in order to be satisfied and this is also reported in Denmark where the terms of agreements have to be flagrantly unfair in order for the courts to intervene.

1.5 Social impact of high-cost credit

This part of the research focuses on the legal aspects related to high-cost credit. The expression "usurious" is applied by lawyers and judges where the cost of credit is unacceptably high. The level of acceptability varies significantly in the different Member States. In the Catholic culture, high interest still tends to be identified with exploitation; in Protestant cultures on the other hand, high interest reflects high risk. Interest rates of more than 100% on small loans are thus acceptable in some countries while they are unthinkable in others.

Both notions "high" and "usurious" are thus more representative of attitudes within the EU than indicative of an objective threshold. They reflect the impact of higher cost on liquidity, solvency and the productive use of consumer credit on the one hand, and the view that access to credit, even at high cost, may help overcome a liquidity crisis or give access to necessary opportunities for future earnings on the other.

1.5.1 Credit products

1.5.1.1 Non-bank credit and small loans

High interest, especially for small amounts of credit, pay-day loans, credit card credit, sms credit and other specialist forms of credit have been mentioned by regulators and in various reports.¹¹⁴

The assessment of the questionnaire responses, including those from experts and stakeholders, is set out in the table below. Respondents were asked to reply to the question "How would you assess the different credit forms/types/products with regard to the attributes/market features below?" by means of a scale between 1 (insignificant) and 5 (very significant). The responses reflect the findings of the French government¹¹⁵ that prices of small loans are especially high and that revolving credit systems tend to operate to the disadvantage of consumers.

¹¹⁴ See for the UK: Office of Fair Trading (OFT) (2010); Collard, S., Kempson, E. (2003); DTI (2006); New Economics Foundation (2009); for France: Inspection générale des finances, Inspection générale des affaires sociales (2009). A 2006 study in Ireland showed that money lenders were charging high cost credit with research showing finding that 'Four out of 10 people on social welfare are in the grip of moneylenders, who are charging interest rates as high as 188 per cent.' Research carried out by University College Cork as cited in Office of Fair Trading (2009) (Annexe B: A report by Europe Economics for the OFT - International research: Case studies on Ireland, Germany and the United States, December 2009, p 47.

¹¹⁵ Inspection générale des finances, Inspection générale des affaires sociales (2009).

Table 24: Assumed problems with different credit forms/types/products

	High cost credit				Consumer detriment				Lack of transparency	
1	SMS	4.5		1	SMS	3.6		1	Pawnbroking	2.3
2	Payday	3.8		2	Credit card	3.4		2	Point-of-sale	2.8
3	Pawnbroking	3.5		3	Other loan	3.3		3	Home loans	2.9
4	Home loans	3.5		4	Point-of-sale	3.3		4	Payday	2.9
5	Point-of-sale	3.4		5	Overdraft	3.2		5	SMS	3.1
6	Credit card	3.2		6	Payday	3.0		6	Overdraft	3.1
7	Overdraft	3.2		7	Home loans	2.9		7	Other loan	3.2
8	Other loan	3.2		8	Auto	2.9		8	Auto	3.2
9	Auto	2.8		9	Mortgages	2.8		9	Credit card	3.3
10	Mortgages	2.4		10	Pawnbroking	2.7		10	2nd charge	3.3
11	2nd charge	2.3		11	2nd charge	2.7		11	Mortgages	3.5

Source: Stakeholder Survey. Note: Scores in the table reflect the mean averages of all responses received to question SQ 4.3. The scale for answers was between 1 (insignificant) and 5 (very significant)

Reliable empirical data as to the prices of different forms of credit according to size, form and distribution channel are only partially available and are confined to the UK and France. The economic part of this report will show the overall cost of consumer credit in general. Comments from the experts may help to identify possible problem areas.

In twenty-five Member States¹¹⁶, experts reported concerns as to the level of interest and charges in their respective credit markets. In Bulgaria in particular, high interest in all sections of the Bulgarian credit market were mentioned. In the other Member States, high prices were reported only in specific market segments, with considerable variations. A breakdown of the areas of the credit market causing concern among our experts across the Member States is provided in the table on the following page. The key observations are:

- In Italy, Malta, and Austria concerns about the price of credit associated with the purchase of goods (where point of sale contracts may also lack cost transparency) were reported.
- In four Member States (Austria, Germany, the Netherlands and Spain), all countries where nearly all credit is extended via the banking system, problems with the cost of unauthorised overdrafts on current accounts were reported. It was noted that the level of interest charged by banks was sometimes difficult to determine because the true cost of credit was hidden in other costs but, once these elements included in the calculation, bank interest rates could be as much as 30% (Germany) when the cost of refinancing and insurance premiums were taken into account.
- In six countries, revolving credit was reported as a source of high interest. These include Luxembourg, which does not have a significant problem with high-cost credit in general, but where the Luxembourg expert considers international credit card providers as charging high fees when credit limits are exceeded. In Italy, the report reveals that a credit card provider was prevented by the authorities from

¹¹⁶ No problems with specific products were reported by the expert from Cyprus and no information is available concerning Greece.

issuing revolving loan cards because of the high interest rates being charged, which exceeded the usury rates.

- In twelve states, experts reported that problems of high-cost credit have been identified in the non-banking and specialist lending sectors in particular. According to the Office of Fair Trading, the cost of short-term loans provided by moneylenders to lower-income groups are a particular problem in the UK. Similar information comes from our Irish, Polish, Latvian and Hungarian experts. Payday loans, auto-title lending, rent-to-own credit, and pawnbroking were also mentioned.
- In four states (Denmark, Finland, Estonia and Slovenia), experts and consumer organisations were particularly concerned by the cost of SMS loans, which were observed to charge average rates, up to 2,000 percent in Denmark, for example.

Table 25: Incidence of high-cost credit in EU Member States

No problem reported	Cyprus	1
Bank credit: over-running on accounts	Austria, Germany, Netherlands, Spain	4
Revolving credit	France, Germany, Italy, Luxembourg, Portugal, UK	6
Non-banks/specialist lenders	UK , Poland, Portugal , Romania , Czech Republic , Hungary , Ireland, Slovakia, Latvia, Lithuania, Sweden	12
SMS Loans	Denmark, Estonia, Finland, Slovenia	4
Auto leasing/hire-purchase/point-of-sale	Italy, Malta, Austria	3
Pawn-broking	Portugal, Belgium	2
All types of credit	Bulgaria	1

Source: Expert survey

High-cost credit is generally linked to sub-prime customers and is therefore often associated with development of a sub-prime credit market as the following table reveals.

Table 26: Development of EU subprime lending markets

Member State in order of the development of sub-prime lending market in 2007	
UK	Highly developed
Ireland	
Spain	
Netherlands	Somewhat developed
Belgium	
Portugal	
France	Undeveloped
Finland	
Germany	
Sweden	
Denmark	
Norway	
Italy	
Greece	
Austria	

Source: Datamonitor

1.5.1.2 Revolving credit

The CCD 2008 has given revolving credit a "light regime". Overdraft credit for less than one month (Art. 2 (2) e) is totally excluded while all other overdraft credit is privileged according to Art. 2 (3). In Art. 3 (3), the "tacitly accepted overdraft" is qualified as a contractual obligation called "overrunning" and not as "default". Credit card credit and open-end credit are not specifically addressed as products which would need more consumer protection.

The features of such products are especially that they are "revolving" which means that they can exist eternally because either new credit is taken up before the old credit is repaid or the residual debt is rolled over into a new loan. The risk of market rate change is shifted to the consumer via variable rates.

The opinions of stakeholders with regard to such products, as revealed in Table 24,¹¹⁷ show that such products as seen as potentially high cost, lead the ranking scale with products of this revolving form of credit found in second (credit card) and fifth (overdraft) position on the scale measuring responses to the question of which products can be assumed to be detrimental to consumers.

Against this background it may be understood why the Dutch legislator removed the exclusion from this form of credit from interest rate ceilings and why the French government focussed on such products in their report which we consider below.

The French government report was initiated by the Ministry of Economy, Industry and Employment and was conducted by both the Finance and Social Affairs departments. Its

¹¹⁷ See p 120.

task was to analyse existing links between the modalities of the various usury ceilings and to investigate the exclusion of certain categories of borrower together with the persistence of high interest rates in certain market segments. The study was specifically concerned with providing answers to the policy questions of whether existing usury ceiling categories should be adapted and whether the calculation method of the ceilings themselves should be adapted¹¹⁸.

The main findings of this French report¹¹⁹ were that the continuing existence of interest rate ceilings was justified in France in terms of the protection of borrowers in markets that are not structurally competitive. It also found that the ceilings contribute to the prevention of exclusion associated with excessive indebtedness by hindering the emergence of very high-cost credit targeted at the category of people most at risk and subject to precarity, and who also prevent the highest risk to lenders.

Revolving credit was the main instigator of the French review of usury ceilings, which followed an analysis of statistics on indebtedness as well as the publication of a study on revolving credit and responsible credit.¹²⁰ According to this study, the problems with usury are currently concentrated in the area of non-mortgage consumer credit, as opposed to mortgage credit, and are primarily debated within the context of a specific form of credit (revolving credit¹²¹) and its impact on over-indebtedness. Interest rates are significantly higher for these forms of credit compared with instalment loans. The report found from an analysis of central bank data that access to these forms of credit is easier than to instalment loans and that they are present in more than 80% of cases of over-indebtedness. The French government report¹²² confirms that for France the ceilings are one lever available to the authorities in the context of responsible credit as envisaged in the framework of the CCD transposition.

The findings of the government study of revolving credit included the following:

- Consumer access to revolving credit faces no restriction whatsoever (judging from distribution of interest rates collected by the French central bank) and there remains evidence that specialist lending institutions (non-banks) do not base their pricing directly on the level of risk presented by the borrower.
- Revolving credit and instalment loans differ significantly as to the amounts borrowed. Although 50% of revolving credit is for amounts of less than €1,524, 28% is for amounts equal to or greater than €3,000 (falling to an 8% share for amounts greater than €6,000). It is these large amounts of revolving credit that appear to be substituting themselves for the typically more appropriate instalment loans that face a competitive disadvantage from the lower interest rate ceilings applied to those credit types and those amounts.
- The supply of small size instalment loans is as of yet underdeveloped with only 4% of personal loans being extended for amounts less than €1,524.¹²³

¹¹⁸ The reform paths contemplated could be either regulatory (eg. modifications in the credit categories and ceilings) or legislative (eg. modifications to the principle of fixation which are currently based on market rates existing in practice, or the principle of uniform application of a coefficient which is currently 1.33).

¹¹⁹ See IGF/IGAS (2009), p.3.

¹²⁰ See Athling (2008).

¹²¹ The term 'revolving credit' refers to credit products that are not paid back in a fixed number of payments, such as credit cards (also referred to as renewable or permanent credit in France – crédit renouvelable/prêt permanent/credit revolving).

¹²² See IGF/IGAS (2009), p.4.

¹²³ This has led to certain French stakeholders interviewed for the governmental study being in favour of other modifications to the existing ceilings including ADIE a microcredit specialist who called for a revaluation of

1.5.2 Consumer welfare

Opinion as to whether high rates of interest are a problem varies significantly according to differing perspectives and differences in the development of the market in credit products.

In five Member States, experts are of the opinion that usury is not an issue in their countries, either because they have effective anti-usury legislation in place (France, Netherlands, Luxembourg) or because existing laws do not have to be applied very often and there are few court cases, which suggests that the incidence of usury is low (Sweden, Austria). As a consequence, they did not express a view about the social impact of usury. However, experts in the vast majority of Member States did hold views on this issue. These included some countries with laws designed to restrict usury but where nevertheless it was felt that usury had not disappeared completely (for example, Germany and Portugal), as well as countries where there was an absence of usury law. The main impacts identified were exacerbation of poverty and hardship, increased over-indebtedness, insolvency and homelessness, increased crime and exclusion of young people from future services.

There were concerns that high-cost lending is particularly targeted at people on low incomes and that credit is taken out in order to pay for essential items of household expenditure as a result of inadequate incomes. This was particularly found to be an issue in the Czech Republic, Slovakia, Slovenia, Ireland, Romania, Poland, and the UK. In these countries, usurious loans were reported as leading to:

- A spiral of increased indebtedness, often because expensive credit was used to cover fees and charges for prior default
- Inability to maintain essential payments in other areas of the household budget (eg. rent and utilities)

In Romania and the Czech Republic, the legal experts had concerns that low education levels amongst the poor meant that they did not fully understand the consequences of taking out very high-cost credit for their future finances. However, education was not identified as the main issue in the other countries referred to above. These countries focused instead on the predatory behaviour of lenders or on the lack of other, more affordable, credit options for people on low incomes.

Experts in Estonia and Slovakia reported that the cost of usurious loans contributes to over-indebtedness more generally, and not only in low-income groups. For example, in Estonia it was reported that much over-indebtedness derives from high interest rates, or contractual penalties, which leads many people to borrow more, at usurious rates, in order to cover the debt in default. This has caused a situation in which large numbers of people have become personally bankrupt, surrendered their homes and sold their property. In Slovakia concerns about the practice of securing high-cost consumer loans property, causing people to lose their homes, prompted an amendment to Article 53, Section 7 of the Civil Code in November 2008, and this now prevents this practice.

Experts in Italy, Greece, Malta, Romania and Slovakia linked high interest rates to crime and illegal money-lending (Greece, Malta, Southern Italy) or debt recovery practices (Romania).

the category by amount of the credit from the current €1,524 delimitation (unchanged and un-adjusted for price inflation since 1990 when it was converted from FRF10,000) to €2,350 (representing their median loan value). Providers of pawnbroking credit also subject to the same usury ceilings were also in favour of increasing the amount of credit in this category but for different reasons as they argued that they were inclined to provide cash for transactions below €1,524 because the authorised ceiling enables them to charge substantially higher prices than for loan amounts extended above this amount).

Whereas existing consumer debt, student loans in the UK, unpaid bills in Germany and overdraft credit in France were seen as detrimental to the creditworthiness of those people affected, in Finland concern was raised that the use of high-cost SMS loans will lead to long-term exclusion from mainstream financial services in the future as many young people are unable to sustain their payments.

1.5.3 Assumed effects on credit markets

While providers put more emphasis on possible negative effects of IRR on access to credit for persons on a low income¹²⁴, nineteen of our expert opinions saw positive effects for responsible credit markets – some country expert views are shown below.

- for the Netherlands the presence of IRR are a factor in preventing the growth of a harmful sub-prime market,
- for Denmark and Luxembourg restrictions on default fees are considered to be an important protection for consumers at a point when their bargaining position is weak, but the restrictions are not considered to be onerous for providers,
- for Estonia, IRR are considered important for setting boundaries on the cost of credit. Although these may have had an impact on the profit margins of some providers, there is no evidence that providers have withdrawn from any markets as a direct consequence of the restrictions,
- for Cyprus, a possible introduction of IRR would according to the Cyprian expert encourage self- regulation by providers.

There were also concerns that IRR could lead to a focus on less transparent products and to opaque charges for example

- in France, IRR are considered to have narrowed the credit options for near-prime and sub-prime consumers, increasing their reliance on revolving credit
- in Germany, the IRR have caused lenders to hide charges and fees rather than include them in the interest rate, reducing the transparency of prices for consumers.

1.6 Stakeholder views on IRR

With regard to mortgage credit, the European Commission had already collected the views of stakeholders in its consultation on the Green Paper on mortgage credit in 2006¹²⁵. Three questions were asked in relation to interest rate ceilings: Do usury rules impact on integration? Should usury rules be examined in a broader, non-mortgage specific, context? Do caps on compound interest rates impede integration? The responses were unanimous that “usury rules” should be examined in a broader, non-mortgage specific context. Thus, although this study is part of DG Market’s work programme in the context of the follow up work to the White Paper on Mortgage Market Integration, it is focused on consumer credit in general, with unsecured credit over shorter terms being the form of credit most affected by interest rate restrictions.

The following arguments were then raised in the responses from provider associations to support their view that usury rules represent a barrier to integration and competition. It

¹²⁴ See Section 2.1 Economic Theoretical background at pp 142ff.

¹²⁵ Feedback on the consultation on the Green Paper on Mortgage Credit (2006), see: http://ec.europa.eu/internal_market/finances-retail/docs/home-loans/feedback_gp-en.pdf.

was felt that they reduce competition in the market; they potentially hide the true price of credit products and thus lead to the cross-subsidisation of products; they reduce the products available in the market; they act as a disincentive to product innovation (with the result that sub-prime borrowers may be excluded from the market).

In contrast, those supporting usury rules made the following points. Usury rules have no or only very limited impact on cross-border activity; they are considered as part of general wellbeing and should therefore be respected by all lenders, irrespective of their country of origin; Caps are an illustration of the social and human aspects of mortgage credit. These arguments have been examined in detail in our analysis section (Part 2) in relation to consumer credit in general. In the closing sections of Part 1 below, we provide additional stakeholder views on issues related to IRR. Further tables with selected responses can also be found in Annex XI: Tables of stakeholder responses.

1.6.1 Political and legal discussions

While in half of Member States there were no specific political and legal discussions aimed at making credit more affordable for consumers, in the other half various political and legal approaches were under discussion and had been partially implemented.

In some Member States the **implementation of usury ceilings** for consumer credit have been discussed in the recent past (Slovakia in 2007, ongoing discussions in Hungary and in the UK in 2004 and in the context of the Financial Services Act 2010).

In Portugal, transposition of the CCD 2008 into national law had the result that, that since the beginning of the current year 2010, **usury interest rates** are established (quarterly), as are rates applicable to **some sub-types of revolving credit** and instalment credit.

In France, by contrast, there was discussion of lowering usury ceilings on revolving credit by modifying existing ceiling categories. Another approach was discussed in Slovakia, where the idea of a **license to provide money** was advanced as a means of preventing usury.

The discussion about the regulation of exorbitant interest rates and fees for consumer credit, in particular credit card credit and store cards, was interrupted by the national election in the UK and has not been concluded. At a political level, there has been discussion of whether **usury ceilings** lead to greater **credit exclusion** and a less diverse set of credit options for lower-income consumers and whether they help consumers in that situation. The government has currently increased the social fund, which provides interest-free loans to low-income consumers (70% of payments are made to lone parents and the disabled). In the UK, there is currently a great deal of focus on the affordability of credit, and although instant loan companies and payday or doorstep lenders with high interest rates are seen as problematic by some consumer advocates, because of the far higher than average interest rates charged to their customers, recent conclusions from the UK Consumer watchdog the OFT and the Financial Inclusion Taskforce stress that the context is a market segment that is simply lacking alternatives from the supply side of the market, which could imply that the persons currently being served could face other problems should this high-cost source of credit be removed.¹²⁶

There has also been discussion of **specific credit products** in the recent past. In Austria there was discussion of linkage of overdraft interest rates to the Euribor Index in order to reduce the interest rate. In Denmark SMS- and web-loans have recently led to political discussions. In Lithuania and Sweden, the regulation of micro-credit and short-term

¹²⁶ See Financial Inclusion Taskforce (2010).

loans, which are not regulated by the current CCD, are under discussion at a political level and short-term loans have been integrated into consumer credit regulation. In Belgium, there has been debate of the imposition of a limit on the early repayment fee charged on mortgages.

In Scandinavia and the Baltic states, **SMS loans** are under discussion.¹²⁷ On February 25, 2009 Estonia passed an amendment to the principle of good morals contained in Art. 86 of its Contract Law (GPCCA), specifying that a contract is void if one party knew or should have known that the other party entered into the transaction because of urgent needs. This principle is similar to that developed by the German Supreme Court in 1981, which also reversed the burden of proof of the intention to take advantage of the weakness of another.

In Italy, a number of measures have made specific forms of **credit more flexible for consumers** in order to soften the burden of the financial crisis and unemployment. Following legislation linking state subsidies to more generous conduct towards debtors affected by unemployment (Tremonti decree), the Italian Banking Association (ABI) recommended to its members that they should offer a voluntary stay in possession procedures, or even payment holidays of at least 12 months in relation to mortgage loans in particular.¹²⁸

In Poland and the Czech Republic, on the other hand, there is an ongoing debate about making consumer **loans harder to obtain** because of existing problems with increasing credit volumes and over-indebtedness, rather than making credit more affordable.

Table 27: Legal and political discussions

Implementation of usury ceiling	Slovakia, Hungary, UK
Specification of usury ceilings (definition, specific products)	Portugal
Modifying/lowering usury ceilings	France
Discussion of exclusion of consumers in case of usury ceilings	UK
Licence for money lending to avoid usury	Slovakia
Indexation of interest rates	Austria
Regulation of specific credit types (micro-credit, short-term credit)	Lithuania, Sweden
Flexible rules and soft law in case of default	Italy
Discussion of whether lending should be constrained to protect consumers	Poland, Czech Rep

Source: Expert survey.

¹²⁷ See Saare, K., Sein, K., Simovart, M.A. (2010), pp 129 -142.

¹²⁸ Piano Famiglie of December 2009.

For more information on the level of discussions of IRR in the different Member States and details on the studies produced on the subject in those respective countries, see Annex XV: Stakeholder general feedback on IRR. The Annex also sets out some of the policy concerns identified in Member States without interest rate ceilings as relevant to the decision not to introduce them. Many of the arguments and recurrent concerns that introducing interest rate ceilings could reduce access to legitimate sources of credit and increase the use of unlicensed sources of credit, are set out in detail and evaluated in Chapter 2 of this report. On the other hand, in four Member States (the Czech Republic, Denmark, Finland, and the UK) there have been plans to review the position on ceilings and to reassess the viability of this form of regulation in the future.

- Two bills regulating the IRR have not been adopted. Several reasons were identified as to why interest ceilings are unlikely in the near future: 1) strong lobbying by the credit industry; 2) liberal position of National Bank (no ceiling is necessary); 3) the weak position of consumer protection organisations (Czech Republic).
- A ministerial working group is expected to publicise a report analysing the effects of introducing APR ceilings (Denmark).
- Fast loans are harmful, perhaps ceilings and other restrictions are needed (Finland).
- At present there are no plans to change state policy regarding IRR, however if public pressure for restrictions rises, this might be evaluated and considered in the future (Latvia).
- The position on interest rate ceilings was reviewed by the UK Government in mid-2009. No changes were introduced. UK credit regulation was fully reviewed and amended in 2006 and has since been further amended to incorporate the EU CCD 2008. No further changes are considered to be in consumers' interests. The new UK Government's five-year programme proposes new regulatory powers to cap interest rates on credit and store cards although here the primary issue is probably re-pricing. The new Government will also be influenced by the OFT's review (UK).

Political pressures were identified by respondents the most likely factors in policy change and several respondents shared the view that, as elections approach, there is a tendency for politicians to favour more populist measures. They considered that IRR could be one such measure.

1.6.2 IRR and consumer over-indebtedness

One of the main objectives of IRR and capped interest rates in particular is seen as the prevention of overindebtedness.¹²⁹ There is also extensive literature about the factual reasons for overindebtedness and its relationship with short term credit.¹³⁰ In social science there is a consensus that overindebtedness is primarily related to unemployment,

¹²⁹ See the official reports in France and the UK cited at FN 24 and 25 as well as the information given above at Table 4: Main reasons for introducing IRR.

¹³⁰ A summary of the situation in the EU in 2003 including national legal rules concerning the prevention and rehabilitation can be found in a project report by iff for DG Health and Consumer Protection Directorate-General in the first half of 2003, see: Reifner, U. et al. (2003). Books with still valid information are Reifner, U., Ford, J. (1992); Hörmann, G. (1993); Ford, J. (1988); Berthoud, R., Kempson, E.: (1992); Lord Crowther (1971). Knobloch, M., Reifner, U., Laatz, W. (2008); Knobloch, M., Reifner, U., Laatz, W. (2009); Holzschek, K., Hörmann, G., Daviter, J. (1982). Domont-Naert, F. (1993); Niemi-Kiesiläinen, J., Tala, J., Wilhelmsson, T. (1991); Caplovitz, D. (1963); Caplovitz, D. (1974); Duhaime, G. (2003).

loss of income, illness and separation (80%) and secondly to excessive and irresponsible borrowing (20%). A vast body of rules, in contract law and insolvency law which have been put together in another project¹³¹ have been developed to manage the rising problems of overindebtedness which are especially visible in countries where consumer credit has become the basis of individual consumption.

This report draws only the opinions of experts and stakeholders as to the reasons for overindebtedness, and these are summarised as follows:

- A sudden decrease in income because of unemployment, divorce or illness, at the moment also caused by a shifting economy (Austria, Finland, France, Germany, Ireland, Netherlands, Portugal, UK),
- Low income (Czech Rep, Ireland, Netherlands), increasing living costs (Poland) and
- Overestimation of ability to repay credit (Czech Rep, Netherlands)

Unemployment was cited as the most important factor in over-indebtedness. The focus was not on dangerous credit products or supplier or consumer behaviour, but on changing household circumstances. The answer from the Dutch expert summarised the point:

There are four causes: 1. Survival debts: the debtor has insufficient income to meet living expenses; 2. Overspending: the debtor has enough money, but has too many loans, spends too much and therefore has financial problems; 3. Adaptation Debts: debts are the result of a significant change in expenditure or income, for example in situations of divorce, unemployment, disability and so on; 4. compensation debts: these debts are caused by psychological problems such as drug addiction or gambling. These causes are the real problem, consumer credit merely exacerbates existing problems.

In addition to consumer credit, other types of debt were cited as a reason for over-indebtedness, such as energy, healthcare and telephone bills, tax debts and rent arrears.

The official French report and an industry sponsored briefing note on the subject of IRR also point to specific credit products, particularly small loans and revolving credit, which are overrepresented in overindebted households.¹³² This is easy to explain by the fact that people on low incomes, with no prospects and/or existing debt do not qualify easily for long-term instalment credit or mortgage loans. If they cannot pay the monthly instalments they have recourse to small and easy access credit which is provided in the form of credit card credit, payday loans or overdraft credit. In these segments, providers are often more generous with regard to creditworthiness since typically only small amounts are at stake, the sum can be rolled over and the price of the loan is set higher than in a more competitive consumer credit market.

This is reflected in some responses where strategies and types of providers were mentioned. Products with significantly higher interest rates as a driver of overindebtedness were mentioned by the experts in Estonia, the Czech Rep and Austria. In Ireland, non-banking institutions which lend at interest rates of up to 187% APR were mentioned and the Danish expert and the Finnish Consumer Ombudsman both cited SMS loans. In France, revolving loan accounts were specifically named as most used by over-indebted households (10% of over-indebted households have mortgage loans, 91% have

¹³¹ See Reifner, U. et al. (2010); Whitford, B., Ramsay, I., Niemi-Kiesiläinen, J. (2009).

¹³² See IGF/IGAS (2009) and Project Associates (2009).

revolving credit and 50% have instalment credit). The Belgian expert reported that such credit contracts have the highest default rates compared with other credit types.

Table 28: Late payments per credit type in Belgium in 2009

Revolving loan accounts	44.9%
Instalment loans	36.3%
Deferred payment in sales contracts	10.6%
Mortgage loans	7.9%
Financial leasing	0.4%

Source: 2009 Statistical report by the Central Individual Credit Register, www.nbb.be, pp.58-61 (figures on the collective debt settlement procedure).

The assessment of mortgage loans varied. While in Hungary and Ireland, mortgage loans were named specifically as risky credit products, in France and Belgium default levels in these segments were said to be lower than average.

Easy access to new forms of credit product was also cited in Estonia and Denmark, specifically SMS loans and Web loans. It was reported from Latvia that the absence of regulation and control mechanisms in the past had led to a significant rise in over-indebtedness, which is now a serious problem in that Member State.

The level of consumer credit penetration explains why the experts in some Member States saw over-indebtedness as more of a problem for the future (Italy, Malta). Changing bank behaviour in encouraging consumers to borrow money more readily was seen as a source of concern.

Table 29: Specific types of credit, behaviour and providers in relation to over-indebtedness

Type	Example	Member States identified
Credit products with significantly higher interest rates	money-lending, SMS loans, Web loans,	Estonia, Czech Rep, Denmark, Ireland
Non-banking institutions, sub-prime sector - significantly higher interest rates	intermediaries, pawn brokers	Czech Rep, Austria, Ireland, Portugal
Revolving credit	credit card credit	France, Belgium, Portugal
Mortgage loans	irresponsible lending, high loan to value ratio, subprime second charge lending	Ireland, Hungary, UK
Easy access / new	SMS loans, Web loans,	Estonia, Denmark

forms of credit	point of sale financing, credit card credit	
Coping strategies of consumers	new credit to pay back old debts etc.	Germany, Italy, Poland, UK
Behaviour of banks	Encourage consumers to borrow more, increasing per capita level of consumer credit	Ireland, Italy, Malta
Lack of regulation in the past		Latvia

Source: Stakeholder and Expert survey.

Member States where stakeholder respondents did not unanimously see over-indebtedness as being a problem in their country include Belgium, Denmark, Finland, Italy, the Netherlands, Slovakia, Spain and the UK. Responses identifying the problem as very severe came from Austria, Denmark, France, Hungary, Latvia, Lithuania, Poland, Portugal, Spain, Sweden, and the UK.

With regard to the recent trend in over-indebtedness, there has been a clear deterioration because of the economic and financial crisis (and its negative effect on the labour market) over the past two years.

However, specific stakeholder responses may be identified with an assessment that there has been a marked deterioration, and these may be contrasted with responses reporting a stable or only marginal deterioration. One UK respondent even said that he "cannot answer this question, because we disagree with its assumption that there is 'a problem'". A relatively small percentage of UK consumers have problems with unsecured consumer credit, but over many years, this percentage has remained remarkably stable. This reflects the fact that the key driver of problems are unexpected life events. A recent BIS survey suggests that arrears levels may even have fallen in the last twelve months".

The following situation described by the expert for Denmark, can be taken as an example of the general developments. As banks became more lenient in their credit policies in the years prior to the financial crisis (access to credit was eased for a given level of disposable income), finance companies had to become even more lenient. In the end almost anybody could take out consumer credit, regardless of their level of disposable income. Consumer credit was widely available in retail stores, grocery stores, and consumers were sent pre-approved credit offers without even asking for them. Furthermore, credit cards were marketed aggressively by grocery stores, trade unions, banks, shopping centres etc. As real estate prices were increasing rapidly, people felt richer and were taking out more credit. This also had a 'keeping-up-with-the-Joneses'-effect and social norms regarding buying goods on credit were changing. Deregulation of the mortgage market and the lowering of taxes helped fuel the price-bubble resulting in increasing levels of indebtedness and thereby increasing the risk of over-indebtedness. Unemployment is now rising and contributing to the increasing numbers of people unable to meet their financial commitments.

Table 30 shows a few different responses from stakeholders for countries where the overindebtedness trend is seen as worsening significantly for consumers. Further responses on the extent to which over-indebtedness is a problem and/or faces an increasing trend are available in Annex XI: Tables of stakeholder responses.

Table 30: Member States facing a significantly worsening trend in over-indebtedness

Latvia	Government official	Due to recent financial and economic crisis, unemployment has increased significantly in Latvia, causing dramatic increase of indebtedness.
Portugal	Consumer Organisation	Recourse to the courts (insolvency process) and extra-judicial mechanisms of debt mediation has increased dramatically in recent years.
Lithuania	Other	The Authority receives more complains from the consumers in debt
Czech Republic	Consumer Organisation	The Czechs have discovered credit in the last decade. In recent years, household debt grew fast, but in connection with the crisis now rising unemployment and declining ability to repay the loans. Irresponsible borrowing also plays a role. Insufficient regulation of consumer credits and insufficient regulation of arbitration proceedings.
Spain	Consumer Organisation	The family overindebtedness has grown systematically to top of the income in the later years, so the ratio between both variables has grown from 45% in 1995 or 76.7% in 2001 to exceed 140% in 2008.
United Kingdom	Consumer Organisation	The problem has worsened recently because of the effect of the downturn in the UK economy, with a steep rise in unemployment through early 2009. However there is some evidence that consumer credit debt levels were beginning to stabilise just before the recession (2006-2007) as growth rates in consumer credit lending slowed significantly and some 'responsible lending' initiatives (such as better data sharing) arguably began to have some impact on lending practices.
France	Government official	This problem has improved as data suggest. The system for dealing with cases of overindebtedness has a single point of entry, the household debt commissions, whose secretariats are administered by the Banque de France. During the last few years, the number of cases these commissions had to deal with increased significantly (+15% between 2008 and 2009). The number of households currently concerned by this problem is roughly about 750,000.
Estonia	Other	Very easy access to different loans during past five years and current situation of the labour market has significantly worsened the situation

Source: Stakeholder survey.

1.1.1 Preferred characteristics of an interest rate ceiling

The details of the interest rate ceiling put in place by the authorities are important and analysis of the their effect and their administrative complexity will very much depend on how and at what level they are set and for which credit markets. When stakeholders were asked about the form of regime which interest rate ceilings should take, there was a clear majority (68%) in favour of relative rates in preference to a method based on an absolute fixed rate ceiling. Likewise, 80% of respondents would be in favour of different ceilings calculated for different credit types as opposed to a single ceiling applicable to all consumer credit. This reflects the need to understand the differences and consider the details of the sub-markets when envisaging their regulation. One provider respondent helped clarify this need to recognise the heterogeneity of credit products as follows:

"We strongly refuse the idea of caps, but if there should be some level of regulation, it is better to make differences between loans based on their maturity, value, surety, type of provider and type of customer served. For instance it is impossible to cap mortgages the same way as credit cards, personal loans, car leasing and revolving credit."

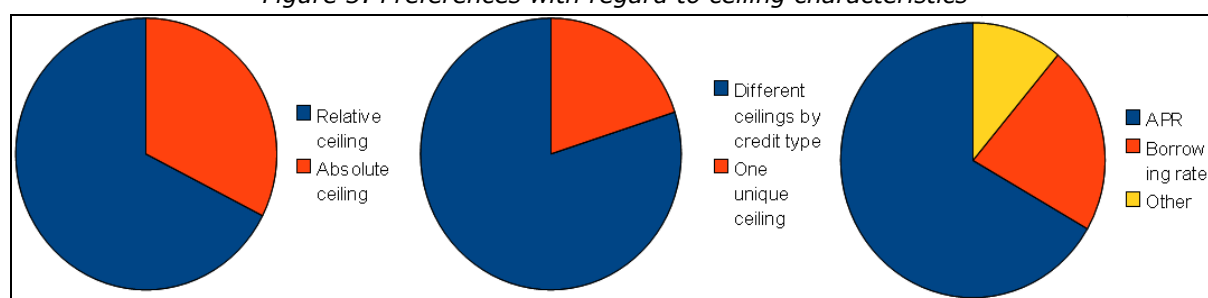
Respondents repeatedly stressed that there are clearly distinct sectors and different products within the market and that this would require different types of regulation. Whereas respondents emphasised that a mortgage credit is hardly comparable to a

consumer credit (in terms of duration, rates, amounts, other conditions etc.), others said that the different level of consumer protection between mortgage loans and consumer loans justifies the difference in treatment. One UK respondent said that “if a rate cap were to be applied, out preference would probably be for caps to be capable of tailoring to different market sectors. It is hard to see how a single rate for mainstream mortgage credit and short term unsecured credit to higher risk borrowers would have any real meaning”.

A French respondent rightly pointed out that the different ceilings should not be by type of loan but by size of the loan extended (amount of money borrowed) as this according to her would be more efficient. Likewise, several respondents agreed that it would seem that levels need to be much higher for small and short-term loans than for large and long-term loans (Finland). Below are examples of some of the responses in favour of different ceilings. The caps have to be different. The credits have a different nature, the commitments of the consumers have to be different too (France). The market is just the difference between the offered goods. Unification leads to a reduction in diversity of supply. The same applies to credit caps (Czech Republic). To reflect the different product types and how they are operated/used, eg. to reflect the different amounts of credit typically associated with different product types (UK). We cannot imagine -if at all- the existence of one unique ceiling level for all types of loans, given the huge variety among them (Spain). A unique ceiling would be ineffective for large credits and too effective on small credits (France). One of the classical (but relevant) arguments against any ceiling is the relationship between security of the loan and the rate level (Czech Republic).

The main arguments put forward for preferring a unique ceiling were related to the scope of the interest rate restriction in the country of the respondent, whereby mortgage loans may not be subject to the ceilings affecting unsecured consumer credit. We reproduce here a few examples of stakeholder comments. Cap should be set for unsecured loans. Regulation should aim simplicity of understanding (Slovenia). There is no need for complex and detailed rules (Netherlands). There is no need to have many different levels (Finland). It is easier to explain to consumers if there is only one level (for non-mortgage consumer credits) (Netherlands). It is quite hard to distinguish between types of loans (Netherlands). Unique ceiling otherwise banks will give up the types of loans with the lowest rates and try to promote the most expensive ones (Belgium). This last point is exactly what the French experience has shown and which has been thoroughly documented and researched in the governmental study published last year.¹³³

Figure 3: Preferences with regard to ceiling characteristics



Source: Stakeholder survey. Note: Using survey responses to questions SQ 1.27-31.

The precise answers on details of the IRR mechanism will depend on the circumstances and the details on a case by case basis and one respondent rightly pointed out that no systematic answer can be given, however these revealed preferences do suggest that an

¹³³ See Chapter 2.5: Discussion of the hypotheses.

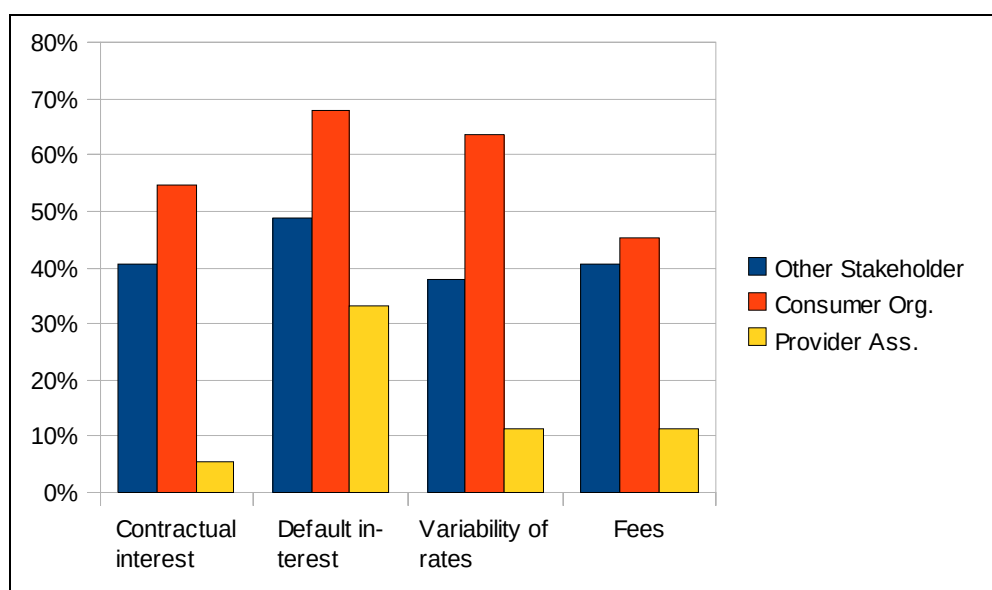
APR level for the maximum price is the more appropriate measurement to use when fixing and monitoring consumer credit offers so that they remain below this ceiling (70%). The borrowing rate was not seen as a sufficiently robust measure of price for the purposes of interest rate restrictions for the reason that other costs would be passed on to the consumer with an equivalent effect to an excessive (above the ceiling) cost of the credit. Examples from those respondents in favour of the APR as a measure of the ceiling include: "APR is the basic cost of the loan and that is how the consumers could assess the loan and compare the loans of different banks" (Bulgaria); "If fees and charges are not included in the cap, rules will probably be very ineffective and easy to circumvent" (Finland). Furthermore, a number of respondents stressed that the APR is the rate that is unified and used in all EU Member States and therefore the most appropriate because fees and charges are part of the cost for the borrower.

A monitoring of a mixture of both APR and the borrowing cost was suggested by 2 respondents in order to facilitate the keeping of a level playing field (Netherlands, Portugal) and 5 respondents suggested that the ceiling should neither target the APR nor the borrowing rate but a wider definition than the current APR eg. in France and Italy where it was mentioned that all costs should be included if excesses are to be seriously prevented. Furthermore, two Czech respondents pointed to the example of the Polish model where additional regulation should accompany the ceiling on the price eg. "APR as it is computed now does not include everything. *Laesio enormis* - of certain level of increase should be considered" and "if there would be a reason for the regulation by some form of cap, then it is necessary to regulate compulsory associated costs (fees and charges). Again, it depends on the specific reason of regulation". With regards to providers being able to avoid breaching the ceiling by introducing additional fees outside the interest rate used for the ceiling, one provider association from the UK firmly responded that "There should be no caps. If there are, any fee or charge that is excluded will simply be used to circumvent the cap. No jurisdiction has a cap that cannot be circumvented". One UK respondent mentioned fees associated to overdrafts when he said "We would support effective controls of ancillary and contingent fees and charges. It is not clear how these could be easily incorporated into APR or borrowing rates other than by way of representative examples that may not be particularly realistic (unless perhaps maximum charge per period limits are applied) There is an argument that charges should be incorporated into APRs for cost comparator purposes. However the main area of benefit here would arguably be unauthorised overdraft charges which we understand the CCD 2008 does not require to be shown in APR examples".

1.6.3 Importance and adequacy of IRR regulation in the EU

Results from the stakeholder survey show that deregulation is generally preferred by provider associations and public authorities and others for all of the four forms of IRR presented in the table below, with the exception of default interest rate ceilings which half the 'other' stakeholders find necessary.

Figure 4: Stakeholder preferences for regulation (% who answered yes)



Note: Answers to the question "With regard to IRR in your country, are you in favour of IRR? How important is this regulation for? Interest rates should be capped; Default interest should be capped; Variability of interest rates in variable rate credit contracts should be regulated; Level of fees and charges should be regulated (SQ 1.26).

1.6.3.1 Regulation of contractual interest rate:

Among the recurrent arguments against regulation of interest rates was that interest rate caps are shown to create a series of adverse unintended outcomes and tend to harm those they are intended to protect. Provider associations were quoted as saying "Competition in Belgium is very strong, which means that lenders selling products which are too expensive or on too severe conditions will automatically set themselves out of the market" (Belgium) or "the main impact of the caps would be worsening of the access to credit. A rejection rate in the banks will increase just because of the individual cost of risk (of worse-profile clients) will not cover maximum rate" (the Czech Republic). "Any move to regulate the area would represent a significant departure for the mortgage model in Ireland and is not necessary, given that competitive mortgage interest rates" (Ireland). UK Provider Associations generally stressed that rate caps may often create a series of adverse unintended outcomes and tend to harm those they are intended to protect, and or they believe that "IRR do not deliver sufficient consumer benefit when viewed against the impact on the competition, product availability, and consumer choice" (UK). Whereas consumer organisations and regulators have said "it is better to educate consumers not to spend money they haven't earned yet; save first, spend later. Of course, a special case is the mortgage credit. Here we have a misbalance in the present time: consumers had obtained a credit for a house whose price now has diminished" (Romania), "a point of departure should be that the market determines the prices, but for compelling reasons restrictions might be considered" (Finland), or "interest rates should be regulated by market to offer consumer competitive products for adequate price. Regulation on IRR might be effective in relation to specific credit types, such as credits for low-income consumers" (Latvia).

The main reason given for the high importance of regulation of contractual interest rates was obviously because excessive rates should be avoided, but also that low-income consumers will be most affected because they more than others take credit with high interest rates. Further stakeholder views in favour of regulation included to take away the propensity of lenders (and borrowers) to take higher risks (Netherlands) or to prevent abusive use of their market power by lenders ie. to ensure a fair competition

(France). Dutch stakeholders generally agreed that although consumer credit interest rates should be capped to protect consumers, that in mortgage credit markets, these loans do not need capping because there is enough other regulation for protection purposes. One German respondent highlighted the complexity of the regulation of interest because limits to interest rates were needed to exclude a) abusive rates that are enforced on consumers in need, b) endangering interest rates that are posing a risk to a consumer to fulfil the contract, c) instruments to ensure that interest rates cannot develop in a way that it will cause a damage (such as described in b)). Furthermore it was stressed that even if a real and transparent competition provides for adequate and re-financeable rates, this should not be taken for granted and effective action by those authorities in charge of the financial market and competition should be taken to ensure this ability is really working.

1.6.3.2 Regulation of default interest:

Regulation of interest rates on default are the most accepted of the IRR forms in the table above by the different stakeholders generally. 3 examples of the stakeholder views in favour of deregulation include reasons because default interest is already regulated in consumer credit and limited to 10% of the contractual APRC (Belgium); there should not be stricter regulation of default interest rates than for the interest rate of the original loan (Denmark), or simply that default interest should be agreed between lender and borrower at the outset prior to entering into an agreement (Malta).

In the UK where no ceilings exist, default interest cannot be greater than the interest on the initial loan. UK respondents from provider associations agreed that this is an important safeguard for consumers and that it strikes the appropriate balance between the interests of the lender (who should be able to cover his losses) and those of the debtor, who needs to be protected against unexpected and punitive action at a time when he is in difficulties. However, these comments were made in respect of the UK credit industry generally because in the case of home collected credit, default interest is not levied on the consumer and hence the above mentioned rule is not applicable for them. Another UK respondent nevertheless pointed out that despite Section 93 of the Consumer Credit Act 1974 controlling default interest and Section 86F limiting interest charges on default sums to simple interest, there is currently no general control of compounding of default interest and it could also be argued that allowing lenders to charge default interest at the agreement rate (rather than say the funding cost) allows additional profit to arise from financial difficulties.

Among the proponents of regulation are respondents from: Austria, where the argument was often used that if the default interest rate is capped the costs will be more transparent; Poland where excessive punishment of a delay in payment should be reduced; and the Czech Republic where this IRR form was generally seen as forming part of the general prevention on usurious practices. Examples of arguments from respondents who deemed that it was very important for default interest rates to be capped include: In order to protect vulnerable consumers it is very important that default interest rates are capped (Finland); It is necessary that the cost is reasonable and especially that either propose a solution based on the situation of the borrower (France); Regulation on default interest rates is important to prevent over-indebtedness of consumers. However, it should be general enough stating overall rules and boundaries and not numeral caps (Latvia).

While default interest rate regulation is seen as necessary for cases of inevitable default, a number of respondents pointed to the need, prior to that, to have providers giving their customers a greater ability to fix a contract in particular in times and circumstances where new economic conditions affect the borrowers situation. Fixing undue compensation was seen by one German respondent as rather making it even more unlikely that a consumer can be prevented from being pushed into insolvency.

1.6.3.3 Regulation of variability of interest:

With regards to stakeholder views on the need for regulation of the variability of variable rate credit, the majority found existing rules such as not permitting unilateral changes by one of the parties etc.. as appropriate regulation. Stakeholders alluded to already existing regulation which has proven important in their countries, but one respondent from Denmark mentioned that they should be equal for banks and for finance houses.

Two Member States said this IRR form was of great importance for the following reasons: The unsophisticated borrower is not able to perceive the dangers which come with the gamble on future reference indexes that come with variable rate offers (France) and the regulation is very important especially concerning how and to what extent the contractual interest rate is affected by the changes in the benchmark interest rate, so that consumers know in advance their exposure to interest rate risk (Greece). A different French respondent nevertheless pointed out that though regulation is needed as a consequence of the volatility of interest rates, a soft form of regulation has proven efficient whereby a cap can be negotiated between the lender and the borrower, which in his eyes is more flexible than a legal cap.

A Polish consumer association respondent stressed the fact that a consumer must know what the rules of variability actually are. UK respondents stressed this point too, by saying that the conditions under which rates can be varied must be transparent to the consumer at the outset with one respondent saying that these variation clauses are a necessity for loans over long terms. Whereas one UK respondent said that the variability in interest rates in variable rate credit contracts should be regulated (and indeed it is - not least through European law on unfair contract terms) to ensure fairness and transparency, he did not however agree that it requires regulatory thresholds on the extent of variability. Another UK stakeholder said that current UK case law on lender's ability to vary loans (fixed term in particular) is very unsatisfactory, despite currently only limited evidence of widespread abuse by lenders. However in the UK there has been recent voluntary agreement by UK card issuers on re-pricing credit card debt and more regulatory action is perhaps likely on this.¹³⁴

Arguments put forward by those who were not in favour of regulation included: There should be regulation on the total debt loading burden level, not the form of the loading (Czech Republic); There does not seem to be reasons to interfere with the market (the Netherlands); The variability of interest rates should be regulated only by contractual terms between the bank and its customers (Italy); Variable rate contracts are often open-ended. Lenders therefore need to be able to vary the rate of charge over time to reflect both the cost to them of raising money and the borrowers' risk. The latter will undoubtedly evolve over time, especially for products such as credit cards which may last for 30+ years. If lenders were not permitted to vary rates in this way, such contracts would not be offered. (UK)

With regards to mortgage credit, a Belgian provider association clearly stated that deregulation was very important. This is mainly because regulation regarding variability is very strictly regulated in Belgium with the maximum variability of the mortgage credit rates is annually (which is interpreted in neighbouring countries as a type of fixed rate), but also because they have reservations on the way the restriction mechanism operates: "The reference rate is an index of the assets side of the balance sheet of the lender and should be an index regarding the debts of the lender. From a prudential point of view, it makes no sense to provide for caps on variability knowing that the market rates can fluctuate as strongly as was the case in the early eighties. The calculation technique for the variability of the rate is incorrect from a financial point of view: the variation should

¹³⁴ See for instance: http://www.theukcardsassociation.org.uk/files/credit_and_store_card_review_-_joint_government_industry_statement_15.03.10.pdf.

follow the fluctuation of the reference rate in the sense that a contractually fixed margin will have to be added to the reference rate. The restrictions on the annual variability are unacceptable from a prudential point of view.

1.6.3.4 Regulation of fees and charges:

Below are examples of responses from the different stakeholders regarding their views on regulation of fees:

- An Austrian government official tends to find a regulation concerning the level of fees and charges welcome but also mentioned that such a regulation may minimize the competition. From the consumer's view it would be important to regulate a maximum level of fees and charges.
- A Belgium Provider Association mentioned that competition was very strong. Considering this, lenders selling products which are too expensive or on too severe conditions will automatically set themselves out of the market. The information disclosure (prospectus, tariff of the interest rates and the costs) seems important to them.
- A Czech Provider Association agreed that regulation should not be implemented on costs and fees. Another even pointed out that according to their opinion a regulation of prices would not necessarily result in a lesser payment for consumers but rather the contrary would be the case. Furthermore, they doubt that a regulation would mean wider access to credit or a wider range of products offered.
- A Bulgarian Provider Association stated that competition between the banks would ensure adequate fees and charges as well as adequate service quality. According to them a possible regulation may have a negative effect on the free market, and that there should be, however, a requirement for full disclosure of fees and charges related to every loan product, in order to eliminate the possibility for banks to collect hidden charges.
- A Provider Association from Malta stressed that the level of fees and charges should depend on market forces as well as the cost structure of the lending institution, a view shared by the UK Provider Associations who also favoured deregulation because while the focus in the UK is on providing transparent information to consumers, lenders should nevertheless be able to set charges and fees to reflect the administration costs involved. Others in favour of deregulation of fees and charges but also supporters of an open and comprehensible calculation of these include a Latvian government official and a Slovenian consumer respondent who was in favour of regulation by market measures alone because it felt that caps on the APR are a more effective method of regulation.
- A Danish Consumer Organisation pointed out that only an APR-ceiling would be effective. A sole cap of interest rates would result in higher fees and charges. They already experience that some providers on the 'second market' charge excessive fees and/or charges. This makes the loan appear cheaper if the borrower pays attention to the interest rate only. As many consumers fail to understand the concept of APR, or how to use it for comparison of different credit offers, this practice is well established. Finnish regulators also deem a cap on charges and fees alone as insufficient.
- According to an Estonian government official, their market is too small for effective competition. Therefore providers are in no need to lower interests or charges.

Most Provider Associations object an IRR and a cap on fees and charges. From the received questionnaires also many other stakeholders like banking or financial regulators from newer EU Member States oppose the idea of a statutorily regulated IRR. Consumer Organisations seem to be more sceptical concerning the regulation through the free market alone. As one Spanish Consumer Organisation pointed out that a legal solution would lead to a balanced society rather than diminish the offer made by lenders. Without the IRR certain social groups would be excluded from credit means.

1.6.3.5 Adequacy of regulation facing providers

When asked about the adequacy of IRR in terms of the nature of the provider extending the credit, the table below shows how stakeholders have scored financial institutions and moneylenders

Table 31: Adequacy of IRR regulation facing banks and non-banks

	Banks	Non-banks
Overall	3.1	2.5
Consumer Organisations	2.6	1.9
Provider Associations	4.0	3.8
Other stakeholders	3.0	2.4

Source: Stakeholder survey. Note: Average answers from all stakeholders to the question: "How would you describe the adequacy of the actual level of regulation of IRR faced by banks and non-banks?" (Q1.25 - the scale for answers was: 1 - very insufficient; 2 - insufficient; 3 - just adequate; 4 - more than sufficient; 5 - excessive).

We see from Table 31 above showing average scores from responses, that as expected non-banks are seen to have less adequate IRR regulation than banks, and that provider responses overall see the level of IRR regulation as adequate. Regarding banks, an insufficient level of interest rate regulation was reported from Denmark, Finland, France, Germany, Lithuania and Spain, whereas respondents from Belgium, Czech Republic, Estonia, Italy, Netherlands, Poland, and the UK judged the level of regulation to be more than sufficient or even excessive. Respondent views on level of adequacy in the regulation of IRR affecting non-bank lenders shows a similar grouping of countries where it is less than adequate with the addition of the Czech Republic to this group and the removal of Germany. The scores provided for the sub groups making up the non-bank provider group show that finance companies and mortgage specialists were seen marginally more adequately regulated than moneylenders overall (2.8 versus 2.2 respectively). Whereas the Belgian provider association affirmed that there was an efficient legislation of credit in Belgium, it also expressed a strong view that mortgage credit is ruled by an outdated regulation. Other respondents remarked that some banks were only banks in name and concern was expressed that any IRR should really need to apply to all loans granted to consumers irrespective of the type of the creditor.

1.6.4 IRR and other regulatory options

Findings of the survey have also helped to situate IRR with respect to other potential alternative forms of regulation of credit markets and the overall results give an indication as to the average regulatory usefulness as seen by the stakeholders surveyed (which are equally balanced in terms of responses used between provider associations, consumer associations and other stakeholders made up primarily by the public authorities). Rankings of results to SQ 1.23 asking which of the following seven regulatory activities

would have the most pronounced effects on the four desired outcomes shown in Table 32 below.

Table 32: Ranking of IRR as a policy measure alongside other alternatives

	<u>In reducing cost of credit</u>			<u>In reducing overindebtedness</u>	
1	IRR	3.9	1	Responsible lending	4.4
2	Responsible lending	2.8	2	IRR	3.6
3	Limiting rolling -over	2.6	3	Disclosure	3.5
4	Disclosure	2.5	4	Bankruptcy (general)	3.3
5	Bankruptcy (general)	2.2	5	Limiting rolling -over	3.2
6	<i>Bankruptcy (easier insolvency)</i>	1.8	6	<i>Bankruptcy (easier insolvency)</i>	2.6
7	<i>Bankruptcy (earlier discharge)</i>	1.8	7	<i>Bankruptcy (earlier discharge)</i>	2.4
	<u>In improving credit access</u>			<u>In widening variety of products</u>	
1	Disclosure	2.5	1	Responsible lending	2.6
2	Responsible lending	2.4	2	Disclosure	2.4
3	IRR	2.2	3	IRR	2.4
4	Bankruptcy (general)	2.1	4	Limiting rolling -over	2.1
5	Limiting rolling -over	2.0	5	Bankruptcy (general)	2.1
6	<i>Bankruptcy (easier insolvency)</i>	1.9	6	<i>Bankruptcy (easier insolvency)</i>	1.8
7	<i>Bankruptcy (earlier discharge)</i>	1.8	7	<i>Bankruptcy (earlier discharge)</i>	1.7

Source: Stakeholder survey. Note: The values are mean averages of answers given to SQ 1.23 (Scale: 1 - opposite effect; 2 - no effect at all; 3 - very little effect; 4 - some effect; 5 - strong effect).

Interpretation of the ranking above should be subject to caution because the answers received have a strong element of subjectivity and the choices do not capture the complexity of the issues. For example, when assessing the impact which interest rate restrictions may have on the different variables, answers will hopefully have been based on the assumption of setting ceilings at a reasonable level. The replies will therefore often reflect more of a personal opinion of the respondent rather than report on the observed effects locally as in many cases the stated scenarios have not actually been experienced locally.

The tables nevertheless indicate that IRR are overall recognised as a useful regulatory option to reach certain policy objectives and especially seen as having an impact on the cost of credit relative to other regulatory options in consumer credit markets. Some of the additional comments stressed that

- If it were easier to get out of debts it would make it easier to have a fresh start but that on the other side access to credit would be more difficult. To make insolvency easier and enable earlier discharge would have a positive effect on the level of over-indebtedness for obvious reasons but it would make the cost of credits increase because they would become riskier for the banks (the consumer would be easier allowed not to pay back). Allowing for easier insolvency processes were not overall seen as having too much of an effect on either cost, access, over-indebtedness or the variety of credit types offered, although it was reported to mean better protection for consumers that are passively indebted, guaranteeing the coverage of basic needs and facilitating and easing repayment of debts. Likewise, it was seen by some as uncertain as to whether banks would significantly change their credit policy should insolvency or bankruptcy become

easier. Furthermore, it was also specified that insolvency is a method to fight existing over-indebtedness. Although it may very well improve proceedings to a more responsible lending as lenders have to care about a success of contract much stronger than before, this however, does not need to have direct link to reduced costs or a wider variety of products though it may.

- Opponents to regulation generally have reported that all these supposed protections should end up harming consumers with one respondent stating that each of the mentioned proposals is likely to lead to a contraction in supply of legal credit pointing out that the reasons differ slightly: For instance, in his view rate caps and responsible lending rules have direct rationing effects. By contrast, 'easier' bankruptcy forces up lender losses, which produce indirect rationing effects (arising because the bankruptcy losses increase lender costs and make more customers unprofitable to serve). The same respondent also states that overall consumer detriment would be the most likely outcome, for the following reasons: (a) on overindebtedness, a consumer can be 'overindebted' even though he has no credit debt. Such a consumer's position is worse if he has no access to the smoothing capabilities that credit provides; (b) on overindebtedness, a consumer can also be overindebted to an illegal lender. It is worth stressing that illegal lenders are not concerned with legal controls or protections for consumers; (c) on overindebtedness, a consumer can be overindebted on retail credit liabilities (even on '0%' credit) even though he may have no outstanding cash credit; (d) on reduced cost of credit, rate caps create displacement effects whereby credit costs are, for instance, recovered via fees or charges other than those included in the APR, or displacement effects occur as the market shifts towards retail credit as a way to avoid the effects of the rate cap. Finally, charges on illegal loans far exceed any market norms; (e) in terms of access to credit, the reality is that rate caps, responsible lending rules, constraints on refinancing and easier bankruptcy all cause credit supply to contract. Reduced supply means it becomes harder, not easier, for consumers to get credit; (f) all these proposals for regulatory action would be likely to reduce the variety of products - particularly small-sum products - available in a market.
- With regards to the variety of products, it was generally seen that the regulatory interventions listed would not increase this and as one respondent said "only deregulation would achieve that". In terms of IRR and wider variety of products in the mortgage credit market, there was a noticeable increase in variety following IRR regulation in Belgium but one respondent specified that "this was the experience of the Belgian lenders in the nineties in the mortgage credit market, but this is not a definite outcome as it depends on the way the restrictions are formulated".
- IRR were also reported to generate big costs for legitimate lenders as they would need to take into account the added compliance costs, however the costs of alternative regulation was not referred to it such answers. Furthermore, one respondent said that "reduced levels of overindebtedness can only be achieved by promoting smaller fixed sum loans as opposed to large loans or running account credit yet all consumer credit regulation actually penalises small fixed sum loans and promotes running account credit and large loans thus increasing overindebtedness, not decreasing it".

2 Economic Part

2.1 Theoretical background

2.1.1 Outline

This part of the study aims at discussing relevant aspects of the functioning of credit markets and the role of interest rate restrictions in a comprehensive way. It provides the economic framework for the hypotheses which are tested in the subsequent chapters of this study. The theoretical discussion proceeds along the two dimensions *individual choices* and *market outcomes*.

2.1.1.1 The individual choice of credit - an overview

In a first part (2.1.2) we discuss the role of credit from the perspective of economic decision-making by an *individual consumer*.¹³⁵ Acknowledging that consumers make choices according to their own preferences, we demonstrate in a classical framework how a decision to finance consumption by credit arises from the preference to smooth consumption over time (2.1.2.1). As modern economic research has made serious objections to some of the underlying assumptions in the classical approach, we also discuss cognitive biases and irrational decisions of the customers in more detail (2.1.2.2).

Overall, the results of part (2.1.2) can be summarised as follows:

- When households decide about their consumption, saving and borrowing, they not only consider their *current* income but also their expectations about their *future* income.
- From an individual's point of view, credit access may be desired as it allows households to bring forward future income and compensate for sudden drops in current income.
- Even if interest rates are high, these costs are incorporated into the consumers' choice of their optimal consumption behaviour. From the perspective of an individual, interest rate restrictions may be considered to be harmful as they may make credit less accessible to certain groups of households.
- *Behavioural* biases may lead to systematic (and predictable) deviations from rational behaviour, which lead to suboptimal consumer decisions. These biases (such as wishful thinking or underestimation of exponential) challenge the view that borrowing decisions are an unambiguously *rational* consumption optimisation.
- As a consequence of *wishful thinking*, consumers' beliefs about *event risk* may be distorted: they may be willing to borrow money even when it is rather unrealistic that future income will be sufficient to repay the debt.
- Consumers may also *underestimate the true cost of borrowing*. This might occur because they hold erroneous beliefs about the actual time period during which they will use the credit or its actual cost (ie. interest rates plus other costs). It might also stem from conceptual difficulties to understand the effect of interest rates compounding over longer horizons (*underestimation of exponential growth*). The resulting consumption decision might be distorted as consumers do not

¹³⁵ Different views originate from, eg. Friedman (1957) and Modigliani (2005) on the one hand and, eg. Kahneman/Tversky (1974), Fehr (2002) on the other.

properly take into account how much loan repayments reduce their future consumption.

According to this view, consumers' credit decisions are not necessarily optimal. Firms may exploit the consumers' cognitive biases to increase profits. Limitation to credit access (eg. through interest rate restrictions) might thus be beneficial to protect consumers from voluntarily taking decisions that may actually decrease their welfare. As a consequence of these various aspects, there are competing explanations for over-indebtedness:

- According to the permanent income lifecycle hypothesis, only *unexpected adverse shocks* should lead consumers into over-indebtedness. Such shocks can affect a consumer's total resources, as well as on a consumer's expenditures.
- In reality, however, consumers' consumption plan may a priori be unsustainable due to limited rationality or irrational behaviour. Further prominent explanations for why households end up in over-indebtedness are moral hazard (due to consumer insolvency regimes), market failure (information asymmetry between lenders and borrowers), lack of financial literacy and supply-driven over-indebtedness.

The theoretical focus on *consumption smoothing* as the most important driver of borrowing takes account of the fact that this study primarily focuses on consumer credit, rather than business loans.

- In the context of businesses, in particular small and medium size enterprises (SME), credit serves to *finance a profitable investment* when internal funds do not suffice.¹³⁶ Among consumers, in contrast, credit is a matter of preference (under a budget constraint) rather than of positive investment returns. For companies, the investment opportunity decides whether or not a credit (for micro companies even high cost credit) yields profitable returns to the borrower.
- However, there are both practical overlaps as well as differences between the uses of consumer credit on the one hand and business loans on the other.

2.1.1.2 Interest rates and capital allocation - an overview

In a second part (2.1.3) we discuss market outcomes of interest rate restrictions, in particular with respect to capital allocation and interest rates. We sketch the choice set of the supply side and demonstrate how lenders allocate their capital to different subgroups of consumers and why they charge different interest rates for each of these groups. We discuss the role of interest rate restrictions in different settings. We show that, from a theoretical point of view, interest rate restrictions may serve as a device of consumer protection if a policy maker seeks to restrict credit access for specific subgroups of the population. The results of part 2.1.3 may be summarised as follows:

- The level of interest rates charged on consumer credit depends on the market level of interest rates, the bank's margin and a component which compensates the lender for the risk of borrower's default, which in turn depends on the collateral, the credit history and the income/wealth situation of the borrower.¹³⁷ Due to the fixed costs to each loan, small amounts of credit may be relatively

¹³⁶ According to the *pecking order theory*, companies first attempt to refinance their investments by internal sources, before turning to - more expensive - external sources. Among these sources, debt refinancing is considered to be less expensive than equity refinancing.

¹³⁷ Galor and Zeira (1993).

expensive. As the risk of low-income borrowers is perceived to be high, lenders charge these customers higher interest rates.

- Legal interest rate restrictions reduce the lender's opportunity to charge risk-adjusted costs. Obviously, this decreases the willingness to lend.¹³⁸ As a consequence, high-risk borrowers may be denied credit access in the presence of legal interest rate restrictions.
- As lenders are not always fully aware of the borrowers' riskiness (information asymmetry), they are unable to accurately estimate risk-adjusted costs. Thus, it is rational for lenders to keep the interest rate level low and simultaneously reduce the amount of loans offered in the market. Legal interest rate restrictions are only effective if they are below such market-based interest rate ceilings. They are beneficial if the welfare gain from lowering interest rates for those who are served outweighs the welfare loss due to a reduction of credit availability.
- Banks frequently do business with private consumers, many of whom only have limited experience in financial affairs. Hence, banks can be seen as the more sophisticated contractor. Recent models have therefore discussed the case in which banks have an informational advantage over their customers. In this case, they could lend more aggressively. If aggressive lending takes place in a specific market, interest rate restrictions can be beneficial, as they reduce interest rates as well as the group of consumers which obtain credit although they would not do so if they were fully rational.

2.1.2 The individual choice of credit

2.1.2.1 The Classical view on consumer credit demand

2.1.2.1.1 Permanent income hypothesis and consumption smoothing

The classical economic view on consumer behaviour stresses the idea that households are *rationally anticipating* their future income and future financial needs. They do not know these financial variables with *certainty*, but are at least able to form *reasonable assumptions* about them. Consumers also have a realistic view about the uncertainty they face in the future.¹³⁹

As a consequence of this behaviour, households do not necessarily spend the exact amount of their income they have just earned. Instead, they *save money* to transfer current income to the future, and *take out loans* to dispose of future income to meet the needs of today's life circumstances.¹⁴⁰

¹³⁸ Villegas (1982).

¹³⁹ Following Friedman (1957) and Modigliani (2005), consumers form their expectations regarding future income based on the expected value of the probability distribution of income in each period. For an amplification on the measurements of expected income, see Friedman (1957, pp.23-25) and Modigliani and Ando (1963).

¹⁴⁰ See Friedman (1957, p.7).

Figure 5: The benefits of borrowing and saving

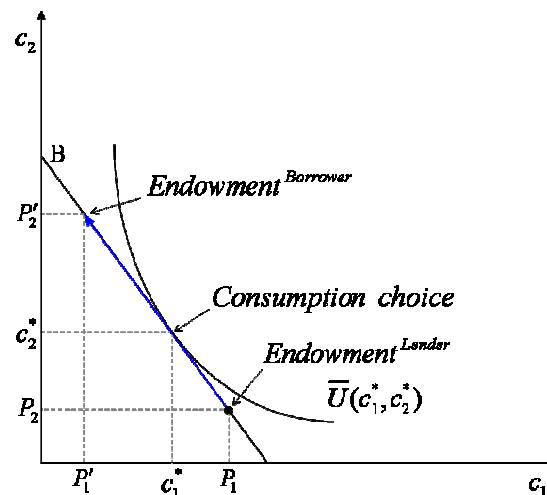


Figure 5 illustrates how consumers may take advantage of transferring or borrowing money. In this stylised example, households live in two periods, “today” and “tomorrow”. They have preferences about an ideal combination of consumption today c_1 and consumption tomorrow c_2 , which are given by the specific curvature of the indifference curve U . However, households have to take into account how much they earn today and tomorrow to determine the budget constraint they may not exceed. For this reason, the position of any feasible optimal combination of c_1^* and c_2^* must not be to the right of the straight line B . Now, imagine the household earns P_1 now and expects to earn P_2 in the future. Given the ability to save, the household will transfer money to tomorrow so that it can consume today and tomorrow. Similarly, if the household earns today but expects to earn P_2' tomorrow, it will borrow money to come to the same combination of consumption today and tomorrow. Note that, if the household lacks the opportunity to borrow or save today, it cannot reach the optimal consumption point (c_1^*, c_2^*) , but will end up on a lower indifference curve.

It is obvious that this example with two periods is a strong simplification of consumers’ life cycles. Nevertheless, the core idea holds in more complex settings: consumers can save and borrow whenever they feel that their current income is different from (the current value of) their expected average future income, regardless of whether a business cycle shock, a sudden job loss or the stage in the life cycle (eg. student age) has caused this deviation. Taking account of the complexity of real life circumstances, economists have also incorporated further aspects into their models, such as

- ...the role of **uncertainty about future income**: These models typically imply that consumers increase their savings (“precautionary savings”) to have some buffer in the case of adverse events.¹⁴¹
- ...the role of the **life cycle**: These models bring a more realistic structure into the typical consumption pattern of households: Households do not necessarily want to have an equal amount of consumption in all periods, but consume according to their needs (eg. raising children).¹⁴²
- ...the role of **investment into durable goods**: At certain points in life, people tend to spend money on specific goods they will take advantage of for many years

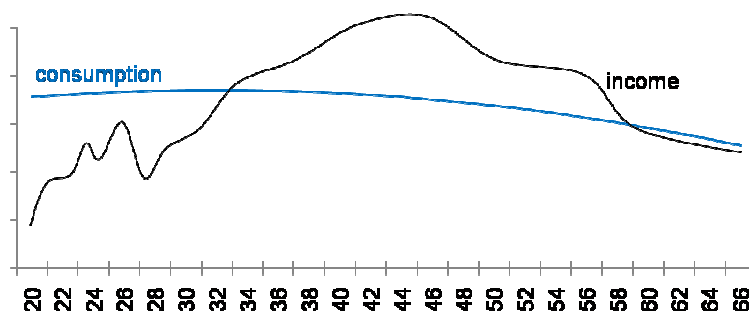
¹⁴¹ See Modigliani and Brumberg (1954) or Lusardi (1998) for an empirical confirmation.

¹⁴² See Deaton (1992), pp. 5-6, for an analysis of the influence of external influencing factors on consumption; and Zeldes (1989) for a detailed description and classification of external influencing factors.

(eg. housing).¹⁴³ As consumers prefer to purchase these goods earlier, they tend to increase borrowing at the early stages of life.

While these models come closer to a more realistic consumption pattern of households, they still rely on a crucial assumption: Households base their decision on their (reasonable) expectation of their life-time income, which they consider their overall “budget constraint”. As a result, they show some pattern of *consumption smoothing*, such as that represented in Figure 6:

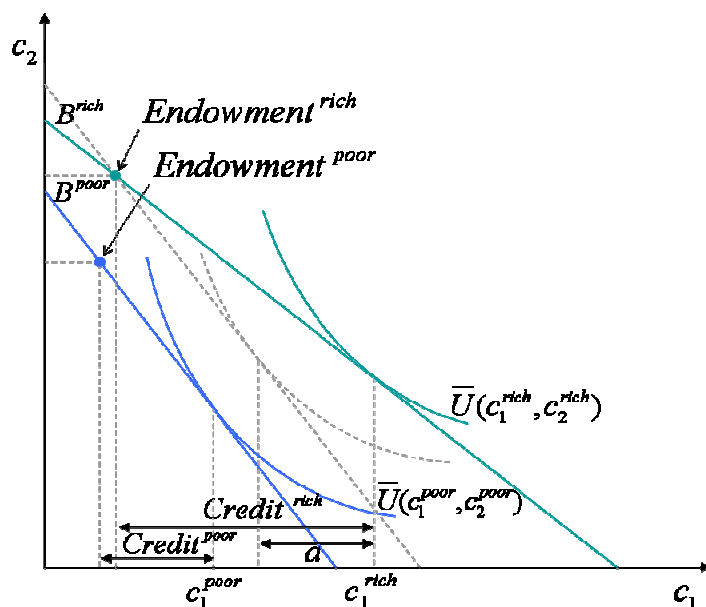
Figure 6: The idea of consumption smoothing



2.1.2.1.2 The interest rates level and consumption smoothing

Interest rates are both the compensation for saving money and the cost of borrowing. As a consequence, it is intuitively plausible that consumers *borrow less* when the interest rate level is high, and *more* when the interest rate level is low.¹⁴⁴

Figure 7: The effect of lower interest rates



¹⁴³ See Deaton (1992), pp.10ff.

¹⁴⁴ Rising interest rates make consumption today more expensive relative to consumption tomorrow (substitution effect), and the same burden of interest payments tomorrow finances less consumption today (income effect). Hence, both the substitution and the income effect lower borrowing when interest rates rise (see Varian, 2003, pp.137ff).

Figure 7 illustrates this idea. It follows the above example (Figure 5) and shows two groups of consumers with identical preferences but different life-time incomes ("rich" and "poor" consumers) and, as a consequence of their credit rating, different borrowing interest rates charged by banks. The different interest rates are reflected by the differently sloped budget constraints: for the poor borrower, it is more costly to borrow against future income and to consume now. When both groups expect their future average income to be higher than the current one and prefer to spend more than the current income, both groups of consumers will borrow money today. However, the rich group will borrow a larger fraction of the current income than the poor group, as it is less costly to do so. The distance "a" denotes the amount of money the rich group borrows in addition because it faces lower interest rates than the poor group.

This example reveals an important point: In the classical view, rational consumers take the level of interest rates into account when they decide how much of their future income they currently want to consume. From the consumers' perspective, high interest rates make consumption smoothing by borrowing more costly but not necessarily undesirable. And consumers may be willing to give up a substantial fraction of their total consumption if it enables them to consume at the "right" time.

2.1.2.1.3 The desirability of credit access from the classical perspective

According to the classical view, households decide about their consumption, savings and borrowing behaviour according to their *preferences*, the *interest rates level* and their expectation about their *future income*. This optimal choice may only be feasible when they have access to the credit market. Following this idea, any institution restricting the access to credit leads to an inferior situation for the households. It has been frequently argued (see next chapter) that interest rate restrictions have this effect.

Figure 8: Disadvantage of poor borrowers without credit access

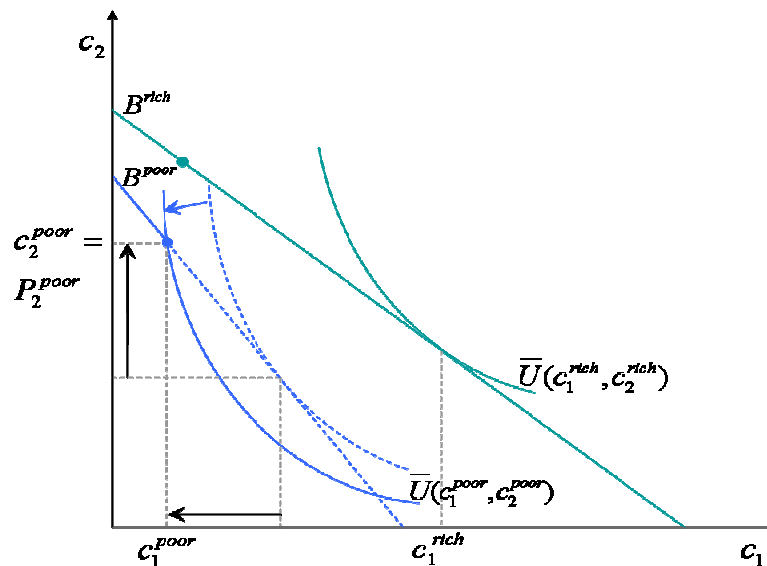


Figure 8 illustrates why limited credit access is problematic from the classical point of view. If, due to interest rate restrictions or any other reason, poor consumers are excluded from credit markets, they have to rely solely on their current income to finance their current consumption. As a consequence, consumption levels may vary significantly over time (as in the illustration above). As consumers would prefer more balanced consumption, they are deprived of *utility* (as represented by the lower indifference curve). Following this rationale, policy measures to enhance credit access are beneficial to consumers, no matter how high the charged interest rate.

It has to be stressed, however, that this model assumes that no borrower ever borrows more money than she can reasonably expect to pay back in future periods. While permitting the compensation of temporary negative income shocks by means of credit, the model does *not* provide a rationale for credit as a means to “make ends meet” for deprived households who do not have a realistic perspective of an improvement of their situation. Hence, *permanent* financial shortages (compared to desired expenditures) cannot just simply be set equivalent to the *need for credit*.

2.1.2.2 A Behavioural View on Consumer Demand

2.1.2.2.1 Behavioural economics

Inspired by findings from psychology, behavioural economics explains the economy by models which assume that people are not fully rational. In particular, it challenges the classical view that people form their *beliefs* correctly when they receive new information. It also argues that people make *choices* which are not in line with a maximisation of expected utility.¹⁴⁵ Behavioural economics aims at making more accurate predictions by incorporating *more realistic* assumptions about economic actors.¹⁴⁶

Psychological experiments have shown that people rely on *heuristics* which allow them to reduce the complexity of a problem. While this natural behaviour is useful in many aspects of daily life, it sometimes comes with *cognitive biases*. These biases may lead to systematic (and predictable) deviations from rational behaviour.¹⁴⁷ This fact can sometimes be exploited eg. by corporate managers who adapt products and marketing strategies according to consumers’ biased behaviour, in order to increase their profits.¹⁴⁸ When producers cause substantial harm to consumers by taking advantage of their irrational behaviour, action of regulatory authorities or policymakers could be advisable.

The optimisation of consumption over time, which has been discussed in Chapter 2.1.2.1 as a rationale for consumer credit, relies strongly on the assumption of consumer rationality. Besides other aspects, we have assumed that...

- ...people know their future preferences and take them into account when making choices in the present.
- ...people form their expectations about their future income and its variations properly and take them into account for their budget constraint.
- ...anticipate the cost of borrowing correctly.

As we will detail in the following paragraphs, these assumptions cannot be taken for granted with universal validity. Even if there are some customers whose behaviour is close to rational, there may still be others for whom this is not the case. For the latter, however, the interpretation of borrowing as a device of *consumption optimisation* may be misleading. Instead, borrowing might be triggered by cognitive biases and lead to a *suboptimal strategy* from the consumers’ perspective.

¹⁴⁵ See Barberis and Thaler (2003).

¹⁴⁶ See Rabin (2002).

¹⁴⁷ See Kahnemann and Tversky (1974).

¹⁴⁸ For example, Stango and Zinman (2010b) discuss how lenders can exploit the fact that consumers persistently underestimate the APR in credit contracts when it is not explicitly detailed.

2.1.2.2.2 The role of unrealistic optimism (wishful thinking)

Psychological studies have documented that people tend to process information in a way which makes their beliefs overly optimistic.¹⁴⁹ In particular, people believe that negative events are less likely to happen to them than to *others*. The opposite holds true for positive events.¹⁵⁰ People underestimate *event risks* such as becoming unemployed or severely ill, and thus overestimate their expected future income. Conversely, in case of financial distress, *wishful thinking* might lead to the perception of a consumer that her income will recover in the future.

As a consequence of wishful thinking, consumers may be willing to borrow money even when it is rather unrealistic that future income will be sufficient to pay the instalments. Such behaviour, however, contradicts the idea of consumption smoothing by the means of borrowing: this concept necessarily implies that households are borrowing *within the scope* of their expected lifetime income. They borrow today because they may *rationally expect* future income to be sufficient to pay back the loan. This idea might appear realistic, in particular, for young households who expect their income to rise in the future. However, when notorious low-income households *overestimate* their future income growth, they may find themselves in a situation in which they lack liquidity to pay back their loan. In the worst case, this initial unrealistic optimism leads to the necessity to refinance old debt with new debt, although it remains unrealistic that the income situation will improve in the future.

Other aspects of consumers' financial behaviour have already been discussed with unrealistic optimism as a potential cause: some consumers tend to choose credit card contracts with high interest rates and low fees, although it would be more advisable for them to choose a different contract with lower interest rates and higher annual fees. It has been argued that *wishful thinking* makes these consumers erroneously expect that they will not overdraw their credit card. As a consequence, they assume that they will not have to pay interest and do not take the cost of credit into account when choosing the credit card contract.¹⁵¹

Similarly, it is perceivable that some consumers are overly optimistic with respect to the time in which they will have repaid the loan: as they wish to repay their debts as soon as possible, they do not expect their debts to persist.¹⁵² Consequently, they do not properly incorporate high levels of interest rates into their consumption smoothing decision and underestimate their true cost of borrowing.

2.1.2.2.3 Impatience

Other studies have documented that people are overly impatient when it comes to deciding between small benefits in the present and large benefits in the future.¹⁵³ They exhibit preferences which are not consistent in a dynamic way: they have relatively high discount rates over short horizons, whereas the discount rates are rather low over long horizons.¹⁵⁴ Those people who prefer present gratification take out more credit than they

¹⁴⁹ Eg. Brown and Taylor (1988).

¹⁵⁰ See Weinstein, 1980.

¹⁵¹ See Yang, Markoczy and Qi (2003). Ausubel (1991) even argues that this behaviour of a subgroup of consumers provides a rationale for interest rate stickiness in credit card markets. Callem and Mester (1995) provide empirical evidence on this conjecture for the US market.

¹⁵² This behaviour is not limited to private households: Landier and Thesmar (2009) document that overly optimistic entrepreneurs are more likely to take short-term loans (instead of long-term loans) than realistic entrepreneurs.

¹⁵³ See Fehr (2002) for a discussion of this phenomenon.

¹⁵⁴ This phenomenon is called Hyperbolic Discounting, See Laibson (1997) for a standard reference.

rationally should. As a consequence, they face higher costs of their consumption as expected.¹⁵⁵ Some forms of credit take advantage of this psychological bias, encouraging this behaviour:¹⁵⁶ Examples for this are all kinds of “buy now, pay later” schemes, such as low upfront interest rates and increasing interest rates at a later stage of the loan cycle, a scheme which is also known as “teaser rates”. Also, offers of revolving credit can encourage consumption which would otherwise not have occurred.¹⁵⁷

2.1.2.2.4 Discounting and the role of interest rates

In Chapter 2.1.2.1.2 we discussed the effects of the level of interest rates on the consumption smoothing decision. Like most classical theories, it imposes that consumers *correctly perceive* the decline in future consumption which results from the interest payments on the loan. Recent evidence, however, reveals that this assumption generally does not hold: the effects of interest rates are difficult to evaluate as people tend to *underestimate exponential growth*.¹⁵⁸ As a consequence of this cognitive bias, people tend to underestimate how quickly the interest rates on an outstanding balance compound. This leads to an underestimation of the future value of a given present value.¹⁵⁹ It has to be noted that the extent of this bias differs from one person to the next. There is empirical evidence from the United States underlining the relevance of the exponential growth perception bias for household decisions on credit finance.¹⁶⁰

As a consequence from these effects, consumers may not be able to anticipate the exact cost that will be charged over the years for early consumption based on borrowing. Hence, consumers do not fully take into account how much their future consumption will be reduced when they take out a loan to finance current consumption. Due to the exponential growth of interest rates, this bias has particularly severe consequences when interest rates are high:¹⁶¹ when, for instance, short-term loans with high interest rates are rolled over several times, interest charges quickly accumulate in addition to the initial principal. Given the exponential growth bias, consumers are unaware of this when signing a loan contract for the first time. This may lead to a level of credit which is not sustainable in the long run.

2.1.2.2.5 The desirability of credit access from a behavioural perspective

As discussed in the preceding paragraphs, psychological and cognitive reasons challenge the view that people are *generally* able to anticipate future income fluctuations as well as the cost of credit in a realistic way. These insights imply that borrowing decisions are not *always* optimal (as described in Chapter 2.1.2.1), but based on misconceptions and result in doing harm to *some* consumers in the long run. This view of imperfect consumer

¹⁵⁵ Heidhues/Köszegi (2010) discuss the welfare implications of this behaviour and conclude that a ban of large penalties of deferring credit could be welfare enhancing.

¹⁵⁶ Vandone (2009, p. 20).

¹⁵⁷ Kilborn (2005 p. 22) advances the opinion that the effect of hyperbolic discounting is “especially pronounced in the average consumer credit transaction, particularly those involving revolving credit sources like credit cards. Consumer credit facilitates, indeed, enhances consumers’ susceptibility to the bias toward present consumption and against delayed gratification. Hyperbolic discounting explains (at least in part) why consumers can only be expected to overvalue the benefits of ‘buying now’ and downplay the costs of ‘paying later’.”

¹⁵⁸ See Wagenaar and Sagaria (1975) as a fundamental reference.

¹⁵⁹ See Stango and Zinman (2010a) for a detailed discussion. Lusardi and Mitchell (2007) provide independent evidence of the poor ability to compound interest rates among older US citizens (50+).

¹⁶⁰ Stango and Zinman (2010a) demonstrate that those people with severe biases have substantially larger short-term-debt-to-income ratios. In contrast, long-term debt ratios are not significantly affected by the severity of the bias.

¹⁶¹ See Eisenstein and Hoch (2005).

rationality is also backed by recent contributions underlining a low level of understanding in personal financial issues (financial literacy).¹⁶²

The effect of these misconceptions is most adverse for customers with low income and wealth and little opportunity of improving their fortune.¹⁶³ These vulnerable customers may not necessarily benefit from improved credit access. Rather, it may be advisable to restrict credit access for those groups for which irresponsible borrowing would bear particularly damaging (private as well as social) consequences, such as (irreversible) over-indebtedness. As interest rates restrictions rule out those credit options which would otherwise be offered to vulnerable customers, they can be targeted at reducing credit access. In this sense, interest rate restrictions could play a *desirable role*, as they reduce the occurrence of credit finance among these particularly vulnerable consumers¹⁶⁴ On the other hand, this obviously implies that also those low-income borrowers who would not borrow irresponsibly or in an irrational way (with respect to future income expectations) will suffer from reduced credit access to credit and consumption smoothing.

2.1.3 Interest rate restrictions and capital allocation

2.1.3.1 Risk-adjusted interest rates and the effects of restrictions

Interest rates charged on consumer credit are essentially composed of four elements: the market interest rate, operational costs, the bank's profit margin and a compensation for default risk.

Operational Costs Lenders have to borrow funds in capital markets to provide loans to borrowers. They also have to cover their expenses for doing business (operational costs, cost of equity). Interest rates and fees charged on loans thus have to cover fixed and variable costs of providing credit services. Based on this aspect alone, interest rate restrictions (IRR) may have two effects (*operational cost considerations*): first, since the interest margin decreases, the lender may exploit other sources of income to earn her required return, eg. fees. Second, if the overall volume of credit decreases due to IRR, overheads have to be distributed to a lower number of total credit, increasing the average interest rate.

Risk Adjustment This view, however, ignores important aspects of credit lending: lenders also have to protect themselves against financial losses due to the customer defaults. Wherever possible, lenders evaluate the riskiness of their customers based on financial features, such as their income and assets. In particular, they consider the buffer between income and essential expenses a borrower has. The larger the buffer, the less likely borrowers will default on their loans. As low income customers only have a small buffer, lenders face an increased risk of default. To compensate for higher risk, low-income borrowers are required to pay a higher interest rate compared to average customers. From an economic point of view, this kind of price discrimination is efficient and maximises credit supply in the market.¹⁶⁵

¹⁶² Lusardi and Tuffano (2009) find a poor understanding in fundamental concepts of debt among US households. Miles (2004) also documents central misunderstandings among borrowers in UK with respect to debt interest rates. Atkinson et al. (2006) document that some UK customers have bought financial products in an unwise manner.

¹⁶³ See also Lusardi and Tuffano (2009).

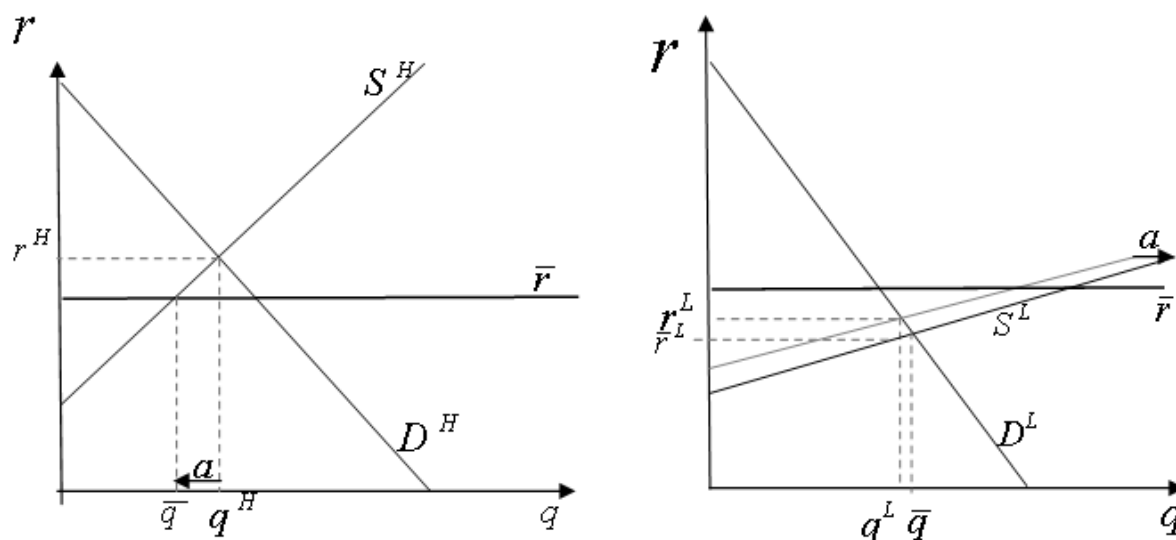
¹⁶⁴ In this vein, IGF/IGAS (2009) describe the exclusion of specific groups of the population as one of the purposes of interest rate restrictions.

¹⁶⁵ Smith (1970) points out that, in the case of inelastic demand, banks do not have to charge preferential rates which take account of risk characteristics. Rather, they could charge a higher interest rate (potentially up to an interest rate ceiling) for all loans. Smith demonstrates, however, that lenders do offer preferential

If legal regulation enforces interest rate restrictions, banks are only able to charge interest rates which compensate up to a specific level of risk. All customers beyond this risk level cannot be served with credit at the legal maximum of interest rates. In this setting, interest rate restrictions may exclude borrowers with higher risk from being provided with credit.

In this context, it has to be noted that the exclusion of high-risk borrowers from the credit market alters the market conditions (*market equilibrium considerations*): interest rates restrictions may affect the amount of credit available to less risky customers:¹⁶⁶ in a competitive market, prices of credit fall, and low-risk customers can borrow more money not at higher, but even at lower prices. Figure 9 illustrates this idea: The left figure shows that the quantity available for high-risk borrowers drops; those who still receive credit are charged lower interest rates (the interest rate cap). The right-hand figure shows that the amount supplied by banks to less-risky customers increases. As demand is assumed to be constant, this group is able to borrow more at lower prices. It has to be noted, however, that the total amount of credit decreases as the riskier customers are rationed out.

Figure 9: Effect of IRR on high-risk (left) and low-risk (right) borrower



Whether average interest rates increase (as suggested due to the considerations of operational costs) or decrease (as suggested by the market equilibrium considerations) after the introduction of interest rate restrictions is ultimately an empirical issue. We return to this aspect in Chapter 2.5.

Profit Margins Under perfect competition, lenders are not able to earn profits higher than the costs they are facing for operating in their business and bearing the risk. However, when markets are not fully competitive, profit margins can be remarkably higher, as prices (in this case: interest rates) are not competed down in the interplay of supply and demand.¹⁶⁷ In this context, interest rate restrictions could redistribute banks'

rates and concludes that borrowers' demand is sufficiently elastic to justify risk-adjusted pricing where possible.

¹⁶⁶ This is demonstrated by Blitz and Long (1965), who also discuss the case of a monopolistic bank: when the bank is able to differentiate between customer risk types, interest rates restrictions are not suitable to force the monopolist to reproduce the competitive outcome. The allocation of capital and the respective cost of capital is ambiguous in this setting.

¹⁶⁷ Note that even very high interest rates are not necessarily a sign for excess profit of a lender, which could only arise in the case of lacking competition: Skiba/Tobacman (2007) demonstrate that even very high

profits to borrowers. However, it has been argued that this policy instrument has difficulties reproducing the competitive outcome when a monopolistic bank is able to differentiate between customer risk types.¹⁶⁸ Rather than curbing monopoly rents, antitrust policies have to ensure a sufficient level of competition in the markets irrespective of the restrictions on interest rates.

Convergence to the cap level When demand for consumer credit is fairly inelastic in markets with oligopolistic players, interest rate restrictions might serve as a focal point for collusive lenders.¹⁶⁹ Hence, even if the ceiling is initially not binding interest rates would increase and converge to the level of the ceiling.

Note that this behaviour arises in the case of *fixed* rate caps or in the case of *fluctuating* rate caps which are tied to a *specific external reference*, such as an interest rate decided on by a central bank. In contrast, reference rates which are *endogenously* determined (such as average observed interest rates of previous periods) respond to the price-setting behaviour of lenders: even if suppliers' prices converge towards an existing rate cap, the next period's cap will be accordingly higher; as a consequence, there is no *focal point* for collusion in the long run.

Tacit collusion distorts existing competition and results in higher average interest rates. Whether this behaviour, which is possible from a theoretical perspective, occurs in reality in the presence of interest rate restrictions, is again an empirical issue. (We come back to this point in Chapter 2.5)

Further note, that collusive behaviour is weaker the higher the cap is set above the initial market interest rate hence it could cause only a small, if any, upwards fluctuation of the average interest rate.

2.1.3.2 The effect of asymmetric information (supply side)

So far, we have assumed that lenders are actually *able* to discriminate between riskier and less risky borrowers. However, this need not be the case. It might be that lenders cannot (fully) *observe the quality* of borrowers (*asymmetric information*). In the extreme case, they have to charge a single interest rate for all customers. If low-risk borrowers are not willing to pay the market clearing interest rates, the lender would only attract high-risk borrowers (*adverse selection*). To avoid this, it is rational for lenders to keep the interest rate level low (to attract low-risk borrowers as well) and to lower the amount of loans offered in the market (*credit rationing*).¹⁷⁰ This is how an interest rate ceiling as well as credit rationing may naturally arise from market forces.¹⁷¹ This implies that legal

APRs of US payday lenders may be reconciled with competitive markets, as these corporations face high per loan and per store fixed costs.

¹⁶⁸ See Blitz and Long (1965): the allocation of capital and the respective cost of capital is ambiguous in this setting.

¹⁶⁹ See Knittel and Stango (2003).

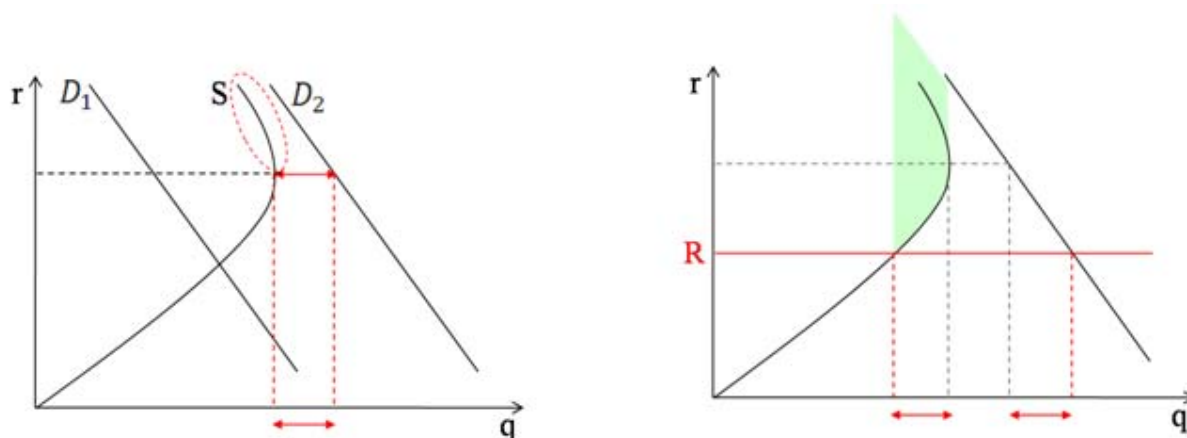
¹⁷⁰ This idea of asymmetric information in credit markets and potentially resulting credit rationing has been developed by Stiglitz and Weiss (1981).

¹⁷¹ Note that these considerations are not a rationale for why interest rate ceilings arise automatically by market forces in *all* types of credit: for example, asymmetric information may lead to a *floor* in interest rates for credit types which are closely linked to payment devices. Ausubel (1991) discusses this case for credit cards, assuming that some low-risk borrowers falsely expect not to use their credit card as a source of credit and are thus insensitive to high interest rates.

interest rate restrictions can only be considered effective when they are below market-based interest rate caps.¹⁷²

This idea is illustrated in Figure 10. Note that, in the left figure, the supply curve is “backward bending”. If the demand function looks like D_2 , some consumers are denied credit access although they may be willing to pay higher interest rates than the market rate. The right figure illustrates that an interest rate restriction R will only be effective if it is below the equilibrium interest rate cap.

Figure 10: Credit markets under asymmetric information



Effective interest rate ceilings have two implications in this setting: they lower the average interest rates and exclude more potential borrowers from being served with credit. These effects are only jointly beneficial if the benefits from lowering interest rates for those who are served outweigh the welfare loss due to reduction of credit contracts. It has to be noted, however, that according to this model, interest rate restrictions do not alter the *credit rationing behaviour* of lenders as such: if interest rate restrictions are *ineffective*, the market-based interest rate cap remains; if they are *effective*, credit rationing even occurs in a more pronounced way.¹⁷³

When lenders find ways to overcome information asymmetry, they are ultimately able to supply more credit. *Collaterals* can be particularly important in this respect:¹⁷⁴ banks can offer credit contracts *with* as well as *without* collateral requirements. Low-risk borrowers are more strongly inclined to choose a contract with *lower* interest rates and *stricter* collateral requirements, whereas those who are more likely to fail choose the contract *without* (or *weak*) collateral requirements instead. Contracts which are *dissimilar* enough in terms of collateral requirements and interest rates enable lenders to set discriminate prices and to ultimately increase the level of credit provided. In this context, it has to be noted that interest rate restrictions may again result in lower total credit supply, as they weaken the lenders' ability to differentiate their products in a sufficient manner.

¹⁷² This is also pointed out by Villegas (1989). He also shows that, if the interest rate restriction is below the market interest rate, funds are shifted to countries with rationed borrowers in countries without interest rate restrictions. In this case, the conclusions made in Figure 5 do not hold any more.

¹⁷³ Coco and Meza (2009) discuss these effects in detail and argue that moderate interest rate restrictions below the market outcome are beneficial.

¹⁷⁴ The role of collaterals as a separating device to overcome asymmetric information has been proposed by Bester (1985).

2.1.3.3 The effect of asymmetric information (demand side)

In the preceding Chapter 2.1.3.2, we have assumed that borrowers are better informed about their own riskiness than lenders. However, this need not be true in all segments of consumer credit: Instead, it is perceivable that lenders have past experience within a local region or among a group of potential borrowers, whereas the borrower is rather inexperienced in financial affairs.¹⁷⁵ In this case, it is possible that lenders approve credit although they know that it is against the households' interest (*aggressive lending*).

If lenders are too aggressive in a market segment, low enough interest rate restrictions can have positive effects on consumers' welfare: they constrain lenders' aggressiveness to a smaller fraction of the consumers, as would be the case in the absence of IRR. The remaining borrowers would face lower interest rate payments. Note that this argument *in favour* of interest rate restrictions implies that *fewer* households are served when legal interest rate restrictions are effective. This illustrates why, in the context of aggressive lending, it can be seen as socially desirable that less households encounter the problem of being provided with credit access detrimental to their interest.

It has to be noted, though, that under certain circumstances aggressive lending does not necessarily arise when lenders are better informed than borrowers. Under circumstances, lenders may even act too conservatively and offer less credit than desirable.¹⁷⁶ This situation could again be *worsened* by IRR. Unlike in the case of aggressive lending, one would not see merits in reducing the number of households served with credit, but would rather find further credit supply advisable.

Hence, the desirability of interest rate restrictions does not ultimately depend on the question of whether or not lenders may be better informed about default risk than borrowers. Rather, it depends on whether these lenders are in a position to offer their credit contracts in an *aggressive way*. Deciding about the usefulness of interest rate restrictions thus requires deciding whether the amount of credit supplied in a market segment is considered to be sufficient, non-sufficient or even exaggerated.

2.1.4 Resulting Hypotheses

Whether or not the theoretical considerations above are relevant for the real-world consumer credit market is ultimately an empirical issue. To make the ideas of Chapters 2.1.2 and 2.1.3 tractable, we formulate them in the form of several hypotheses. This allows discussing specific findings of existing literature as well as of our data analysis and the responses from the questionnaires in this study under the guidance of theory.

The following hypotheses concern the discussion about credit access and credit supply in Chapter 2.1.3. For some issues, they have different implications for *average borrowers* as well as *low-income* borrowers.

The first hypothesis is a central argument which is common to theories assuming that banks have the ability to differentiate between different customer types.

¹⁷⁵ This paragraph follows Inderst (2009). He argues that the underlying assumptions are realistic when the borrowers are households. One may expect to find different levels of this demand side information to be a disadvantage for different customer groups within the household sector. Bond et al. (2009) make similar arguments for mortgage markets and discuss the role of collaterals.

¹⁷⁶ Inderst (2009) points out that the market structure determines whether an informed lender behaves in an aggressive or conservative manner. If she has monopolistic power, aggressive behaviour is rational; if she faces (uninformed) competition, conservative behaviour is more likely. Bond (2009) also concludes that competition lowers aggressive lending in most cases.

H1: IRR reduce credit access, in particular for low-income borrowers.

As a consequence to the exclusion of some subgroups, the overall amount of credit might drop:

H2: IRR lead to a decline in the volumes of consumer credit granted.

A related aspect is that, in the presence of interest rate restrictions, banks are not able to offer certain types of products in the market. For example, the presence of interest rate restrictions could imply that lenders are not able to cover the fixed costs of small amount credits when they face limits to interest rates. We will therefore consider the hypothesis

H2a: Without IRR, more product types exist in the market.

If *H1* can be confirmed, this will have two potential implications for low-income households: On the one hand, interest rate restrictions might prevent credit access for high-risk borrowers, leading to a lower level of over-indebtedness (see **H5**). On the other hand, consumers might try to find other, not regulated, sources of the desired credit supply. This leads to the hypothesis

H3: IRR lead to credit from non-bank sources, such as paying bills late.

In the same vein, it is also sometimes argued that

H4: IRR lead to a substantial illegal market in lending.

In the debate on interest rate restrictions, it is also frequently argued that

H5: The lack of IRR leads to a high level of over-indebtedness,

which ultimately draws on behavioural assumptions as discussed in Chapter 2.1.2.2: in this context, the motivation of this hypothesis would be, for example, that people may *underestimate the true cost of borrowing* and are not able to sustain the high levels of debt. Thus, we also consider a sub-hypothesis of **H5**:

H5a: The lack of IRR has particularly adverse effects on default rates/over-indebtedness in the presence of negative shocks (eg. recessions) to the economy.

This could hold true due to overoptimistic behaviour of consumers: in good times, they might underestimate *the risk* of future negative shocks in their credit decisions.

Some theories imply that average borrowers – unlike high-risk borrowers – face lower interest rate charges when there are interest rate restrictions. We therefore investigate whether

H6: The average consumer (or even more so: the low-risk consumer) would be granted cheaper credit in the presence of IRR.

Note that, as discussed in Chapter 2.1.3.1, one might as well expect the opposite conclusion from an increased need to cover operational costs, which would result in an opposing hypothesis.

Some potential mechanics on the supply side of the market are rather obvious. Lenders could try to circumvent the regulation, such that

H7: IRR lead to increased charges as providers will try to compensate the reduced interest revenues by increased charges.

As different regulations across various countries cause additional costs for those who consider entering a foreign market, we also hypothesise that

H8: IRR represent barriers to consumer credit market integration.

Decreased profit opportunities in the consumer credit segment could have the effect that

H9: IRR lead to lower competition in the consumer credit industry.

Finally, it has been argued that interest rate restrictions could serve as a focal point for implicit collusion, which could imply that:

H10: IRR lead to a convergence of all consumer credit interest rates at the level of the interest rate cap.

2.1.5 Credit to consumers vs. credit to businesses

The content of the hypotheses in Chapter 2.1.4 reveals, once again, that this study takes a focus on *consumer credit* rather than credit to *business* (eg. SMEs, self-employed, microenterprises).

In general, business loans and consumer credit are conceptually distinct products: rational borrowers will only borrow if the expected *return* from their investment will exceed the level of the cost of credit they need to pay.¹⁷⁷ In contrast, consumers do not expect a monetary gain from their investment, but borrow to increase their utility level by smoothing consumption over time. Consumer credit is, unlike business credit, ultimately a question of preference (given a budget constraint) which cannot be judged on the basis of profitability considerations. Note that in this context, consumer credit is also very dissimilar from micro investment credit in developing countries (note that there is also micro credit for consumption purposes in those countries). As a consequence, credit access to *small investment* credit in developing countries and to *consumer* credit in the EU Member States are likely to have different macroeconomic effects. While the former is found to promote economic development directly by creating *entrepreneurship*, the latter may only affect the economy's demand side through the *consumption channel*. The theory presented in this section and the hypotheses on consumer credit take account for this fact.

Nevertheless, other aspects described above also remain valid in the context of business loans: entrepreneurs can also be subject to some behavioural biases (eg. over-optimism) inducing over-borrowing. However, unlike in the case of private consumers, legislators typically do not see the need to protect businessmen against their behavioural biases. When interest rate restrictions are implemented, they are typically targeted at the protection of consumers rather than SMEs, self-employed or micro enterprises¹⁷⁸.

While interest rate restrictions primarily target credit to private households, one has to acknowledge that consumer credit is also used to finance part of the businesses of self-employed persons. However, it is impossible to determine to what extent the reported figures in the remainder of this report contain credit to businesses. Still, it is important to note that, when talking about consumer credit in this study, this discussion has implications for the level of financing of self-employed and small enterprises. In this sense, our findings on the hypotheses also apply to small (micro) enterprises and the self-employed.

¹⁷⁷ See also Fernando (2006).

¹⁷⁸ With the exception of Italy where the ceilings apply to both business loans and consumer loans, and France where ceilings still apply to overdraft credit granted to businesses.

2.2 Existing studies on IRR

2.2.1 Outline

Numerous empirical studies have been devoted to determining the economic impacts of interest rate restrictions. Ideally, two identical countries should be compared which only differ solely in terms of their interest rate restrictions in order to find unambiguous empirical support for any of the hypotheses discussed above. As this is not feasible in reality, researchers try to find situations which come close to this requirement. However, one has to be careful about the external validity of these findings, which might still be idiosyncratic to the considered time or country. This chapter provides an overview of these studies and their findings in the context of our hypotheses. It can be summed up as follows:

Carefully observed natural experiments date back to the 19th century or earlier. They suggest that interest rate restrictions reallocate capital in favour of socially superior groups.

Comparisons of different states in the United States of America with different interest rate regulations typically suggest that tighter interest rate restrictions lower credit access for low-income customers as well as total consumer credit. Some studies also indicate that small amounts of credits are less often available in the presence of IRR. However, they tend to deny a relationship between interest rate restrictions and the interest rate level for average (non-high-risk) customers.

Studies on payday loans, in particular in the USA, point at two further aspects: credit is not per se beneficial (especially in the long run). Furthermore, when thinking about banning a financial product, it is crucial to take into account the evasion strategies of potential borrowers.

Unlike in the United States, any study which compares EU Member States will face severe problems to identify the exact effects of interest rate restrictions, as observations are also determined by a multitude of other economic and regulatory factors. Existing policy-oriented reports on countries of the European Union argue therefore either rather on theoretical grounds, or provide empirical facts which cannot unambiguously attributed to IRR.

While the studies from the US are the only ones which provide solid evidence on the causal effects of IRR, they have the disadvantage of looking at low levels of interest rate caps, while typical caps in the EU are higher. The results are thus only partly transferable to European legislation.

2.2.2 Natural experiments

There are only few natural experiments from situations in which effective interest rate restrictions have been introduced from one day to the next, and where data is available. Where these natural experiments exist, they may give us some hints about the mechanisms. Fortunately, the effect of interest rate restrictions have been fruitfully investigated by economic historians analysing changes in legislation which had occurred more than a century ago: Bodenhorn (2007) analyses the 7% interest rate ceiling in **mid-nineteenth century New York**. He finds support for the hypothesis that, in the presence of interest rate restrictions, the level of illegal lending is high (supports **H4**). He further concludes that the average loan size increases while the average maturity decreases. This study also questions the effectiveness of usury laws, as it suggests that customers decide to pay an illegally charged usurious rate to a bank because they fear to lose the benefits of the long-term relationship if they do not pay. However, it is obvious that the latter point is strongly dependent on the legal system, the enforcement of

interest rate restrictions, as well as the effectiveness of fighting illegal lending by the government. Going even further back in time, Temin/Voth (2007) investigate the effects of a legal change in **Britain in 1714**. They find that a decrease of the interest rate restriction from 6 to 5 percent lead to an increase in minimum and average loan size and improved credit access for nobles (as in line with **H6**). Similarly, Benmelech/Moskowitz (2010) find that the interest rate restrictions imposed in different **US states in the 19th century** are in the interest of wealthy borrowers, since these can escape credit constraints due to their reputation.

Although, obviously, these results have to be understood in the context of the social structure of those days, they make an important point: restricting interest rates could reallocate credit supply at the expense of socially and economically inferior households (**H1**).

2.2.3 Comparison of different States within the USA

With respect to more recent regulations and social circumstances, academic studies typically focus on specific markets in the USA. The advantage of this approach is that they can compare legally and economically relatively similar entities (ie. the U.S. States) in which the regulation of interest rates can differ from State to State. The observed differences between the considered U.S. states can then -with some caution- be identified as the effects of interest rate restrictions.¹⁷⁹ However, it is problematic for the purpose of this report that these studies look at interest rate caps which are relatively low (eg. 12%). In Europe, the interest rate caps are frequently at higher rates.

Goudzwaard (1968) analyses **consumption credit** by 32 "State Small Loan Licensee Reports" of lender operations in **1964**. He finds a relationship between charged interest rates and the riskiness of the lenders' portfolios. He also shows that the lenders in the 11 states with the highest interest rate ceilings have loss rates which are 50 percent above those of the providers in the states with the lowest interest rate ceilings. This finding provides evidence for the conjecture that credit access for high-risk (low-income) borrowers is higher when interest rate ceilings are higher (**H1**), but also to the hypothesis that the existence of high cost credit increases credit default, which might be interpreted as over-indebtedness (**H5**). Wolken/Navratil (1981) consider the introduction of a 12 % interest rate ceiling for some parts of US Credit Union sector. They find lower average interest *rates* (**H6**), but at the same time reduced credit supply (**H2**).

Villegas (1982) considers consumption credits taken out to **finance a vehicle** and analyses the characteristics of people who are rationed out of the market. Based on more than 1,000 observed loans in **1973/1974**, he demonstrates that interest rate restrictions are effective in this specific market. He shows that households with low expenditure or who want to borrow small amounts face the highest interest rates, but are also most likely to be rejected (**H1**). The probability of rejection decreases when interest rate ceilings are set at higher levels. He rejects the idea that, in the presence of interest rate ceilings, lenders charge lower interest to an identical loan compared to a situation without interest rate restrictions. Rather, lower average interest rates in countries with IRR arise from the fact that high-borrowers are excluded from the market. Based on data on 250 **auto loans** from the **1983** Survey of Consumer Finances, Villegas (1989) finds that low-income consumers tend to have higher consumer credit in states without IRR (**H1**). He further demonstrates that middle-income households also hold less credit after the introduction of IRR. As a consequence, he argues that interest rate ceilings lead to an overall drop in available credit (**H2**). He rejects the hypothesis that distributional effects of interest rate ceilings lower the interest rates paid by low-risk borrowers (**H6**). Villegas

¹⁷⁹ It has to be noted that such a comparison across EU countries is problematic, as these are much more heterogeneous than the US states.

(1987) analyses the same dataset and demonstrates that usury ceilings lower the probability of low-income borrowers holding revolving credit (**H1**), whereas they do not affect high-income borrowers. More recently, a stricter legislation on (subprime) mortgage credit in North Carolina has been found to reduce credit access of high-risk borrowers (**H1**), but not that of low-risk borrowers (Elliehausen 2004).

As can be seen, the experience from the USA over the last decades confirms that IRR reduce credit access for low-income borrowers. (While these empirical findings are in line with theory and can be assumed to hold for European countries as well, it remains unclear how to evaluate the *consequences* of reduced credit access.) Typically these studies find that credit access does not improve (at lower cost) for average or low-risk borrowers when interest rate restrictions are present.

2.2.4 Payday loans: the discussion of the desirability of credit access

While most of the studies cited above are based on the notion that credit access is *per se* beneficial, the considerations about consumer rationality in chapter 2.1.2.2 challenge this view: those customers who tend to underestimate negative consequences of repaying a loan could be better off when not taking out a credit in the first place. Attanasio et al. (2008) find strong evidence that low-income customers are very insensitive to the level of interest rates. It is therefore perceivable that they are willing to accept credit even at conditions that turn out to be adverse in the long run.

A very recent strand of economic literature dealing with **payday loans** discusses the pros and cons of increased credit supply in a more balanced way.¹⁸⁰ It is still debated *“whether payday loans are viewed as a tolerable high-cost form of emergency short-term credit, or [...] a highly addictive source of easy money that hooks the unwary consumer into a perpetual cycle of debt.”* (Stegman 2007). Zinman (2008) investigates the effect of the interest rate cap on payday loans in Oregon.¹⁸¹ He finds that payday credit access is strongly reduced (**H1**) in Oregon compared to Washington state. He reports that due to the introduction of the interest rate cap, the share of respondents reporting difficulties obtaining short-term credit rose by 17-21 percentage points. Zinman explicitly notes that the welfare implications of this are unclear and not testable by the underlying data, as they depend on the model of consumer choice. He emphasises that, as a consequence, potential payday borrowers increasingly turn to suboptimal substitutes, such as paying bills late or overdrafts on the checking account (**H7**). Zinman demonstrates that the financial condition of borrowers suffers as a consequence of an interest rate cap. He admits, however, that this finding is a short-term effect and does not necessarily reflect the long-term consequences of denied credit access.

To fill in this gap, Karlan/Zinman (2009) identify a positive role of increased consumer credit access (which implies that **H1** is valid) to households in South Africa over a 27-month horizon. They see this finding as evidence against the hypothesis of negative long-run effects of a “debt trap” when credit is approved. It remains questionable, though, whether these 27 months are sufficient to capture all long-term effects and to what extent this experience from South Africa can be transferred to European countries. Casting doubts on financial wisdom of consumers, Agarwal et al. (2009) document that US payday borrowers tend to have unused liquidity by their credit card provider. Given the availability of liquidity and the costs of payday lending, this contradicts a conventional understanding of financial planning. The authors also describe that payday

¹⁸⁰ Payday loans are typically defined as a small amount, short term credit (only for a few days until the following payday). The lender receives, in return, a post-dated cheque. Payday loans are controversial due to their high annualised interest rates charges.

¹⁸¹ Zinman (2009) reports that under this regulation, the maximum combination of finance charges and fees that can be charged to Oregon borrowers is \$10 per \$100, with a minimum loan term of 31 days.

borrowers typically have experienced declining credit card liquidity during the six months preceding their first payday loan. While these findings may be seen in the context of consumer irrationality, they do not reveal anything about a scenario without payday lending (which could arise when regulators introduce low interest rate caps). Some studies point to the fact that interest rate restrictions targeting payday lending are only effective for some financial products. Alternative sources of finance with inferior conditions to low-income customers (eg. paying bills late) could still remain accessible for low-income customers (**H3**). Some studies on payday loans in the US therefore discuss whether or not it is desirable to ban payday lending given the alternatives in place. Some argue that high cost credit, eg. payday loans, may be “*well suited to the specific needs of high risk borrowers*” (Policis 2006a, p.3): this kind of credit can be taken for a very short time span and on a small credit amount. This implies that borrowers have to substitute them with less suitable (longer term, higher amount) credit if payday loans are banned.

However, evidence from other studies suggests that the actual needs of many payday borrowers are not ultimately met with *short-term* credit: based on a survey in 2000/2001 among US payday loan customers, Ellihausen/Laurence (2001) report that 40 percent of payday loan customers rolled over more than five loans in the preceding 12 months. 10 percent of the borrowers even rolled over an existing loan more than 14 times.¹⁸² Stegman/Faris (2003) point to a direct relationship between industry revenues and the incidence of repeat borrowing of payday loan borrowers, which they quantify based on a sample of suppliers from North Carolina in 1999/2000. They conclude that legal action should not aim at a prohibition of payday loans, but limit the rollover of payday loan debt.

While these contributions highlight the circumstances and implications of a specific US product, they underline two aspects: credit is not per se beneficial, and, when thinking about banning a financial product, it is crucial to take into account the evasion strategies of potential borrowers.

2.2.5 Reports about IRR in EU Member States

As studies on the US markets can not necessarily be transferred to the European situation, some **policy-oriented reports** have taken on the task to deliver empirical evidence from **European countries** in that issue. However, a challenge they face is that European countries are more heterogeneous than US states, which complicates the identification of causal effects compared to the settings in most of the studies cited above. A study by Policis (2004) on behalf of the *Department of Trade and Industry* (DTI) in the United Kingdom aimed at providing an evidence-based analysis of regulatory conditions and its effects for the UK, USA, France and Germany. Policis (2004) presupposes that the **demand** for consumer credit is equally prevalent in all countries, “*irrespective of the regulatory or cultural context*”. As a consequence of this assumption, Policis (2004) interprets low level of credit as an indication for low levels of credit **supply**. It points out that low income borrowers prefer “readily accessible cash” without delivering collaterals and seek low transaction costs and low efforts to obtain a loan. The presence of IRR is described as reducing the diversity of credit products available to low-income borrowers (**H2a**). In particular, interest rate ceilings are seen to cause the lack of a subprime credit market in Germany and France: according to the study, IRR in Germany are used as a policy instrument distorting risk-adjusted pricing by lenders with the purpose of excluding higher-risk groups from credit (**H1**). Policis (2004) demonstrates that interest rate restrictions are effective in the sense that providers of loan products for low-income households withdraw from countries with restrictions on interest rates. Referring to their initial assumption that credit demand is universal in all

¹⁸² Similar behaviour is also reported for Florida and Oklahoma payday borrowers by the figures in Veritec Solutions (2005a) and (2009), respectively.

countries, Policis (2004) concludes that reduced credit access leads to an increased usage of “second-best” options, such as paying bills late (**H3**) and illegal lending (**H4**).¹⁸³ Interestingly, Policis (2004) bases its assessment of credit *demand* on the lack of opportunity of households to spend a larger amount without borrowing. Policis (2004) does not, however, take into account that borrowing in the context of optimal consumption smoothing not only implies a shortage of funds (“need” for credit),¹⁸⁴ but also the capability of paying off the debts later: if someone is not able to save €500 for a major expenditure, it is also very likely that he or she will be in arrears on a loan for this expenditure. We will return to this argumentation by Policis (2004) when we discuss **H4** in Chapter 2.5.5 on page 269.

In a different study, Policis (2006a) attributes different *macroeconomic developments* in France, Germany and the UK to different regulatory conditions in consumer credit markets. It states that the German regulation hinders providers from lending to low-income households, while the French legislation can be circumvented. Policis (2006a) hypothesises that the tough regulation in Germany leads to a lower level of consumer credit (**H2**), which is ultimately interpreted a cause of its *lower economic growth*.¹⁸⁵

Contrary to the relationship discussed in our theoretical part (**H5**), Policis (2006a) hypothesises that a lack of suitable credit supply for low-income borrowers increase the *likelihood of over-indebtedness*, as alternative sources of credit (including from illegal sources) are more damaging to consumers. We will provide more evidence on the latter point in Chapter 2.5.6.

More recently, the Office of Fair Trading (OFT 2010) has issued a report on high cost credit in the **UK**. It summarises that high cost credit is primarily demanded by lower-than-average levels of income and people with poor credit history. It concludes that high cost credit markets function well in the sense that they meet the demands of their clients, but that there are low levels of competition in those markets. As the lack of price competition in some of these markets is found to lead to excessively high prices, the report discusses several potential policy measures to bring prices down. It concludes that price controls (ie. interest rate restrictions) are not appropriate: the report hypothesises that the suppliers would respond to price controls by restricting the “*type and risk of consumers they are willing to supply*” (**H1**). It also argues that “*suppliers could cease offering a particular product*” (**H2a**) and that suppliers could try to circumvent specific price controls by imposing unregulated fees (**H7**). OFT (2010) describes recipients of high cost credit to have limited options and to need the money for non-discretionary expenditure. It also acknowledges that some stakeholders question whether some consumers groups should have access to credit, but see this point outside the scope of their report.

Bialowolski (2009) discusses the introduction of interest rate restrictions in **Poland in 2006**. He points out that interest rate ceilings lead to decreasing credit access (**H1**) and argues that this reduces welfare: assuming that current interest rates reflect equilibrium rates, he estimates a credit demand curve from an overlapping-generations model as well as a credit supply curve from survey questions to suppliers. For the latter, he finds that a reduction of the interest rates due to a legal obligation by one percent leads to a decrease in credit supply by 15 percent, which he estimates to generate costs for both households and financial institutions of 100 mio PLN and 500 mio PLN respectively. Bialowolski (2009) demonstrates that the size of this effect depends on the elasticity of

¹⁸³ Based on the identical data source, the same line of reasoning is also made in Policis (2006b).

¹⁸⁴ The argumentation by Policis (2004) understands credit access to be *desirable*. Albeit not explicitly mentioned, it draws on the idea of optimal consumption smoothing in the neo-classical sense, see Section 2.1.2.1.1.

¹⁸⁵ See Chapter 2.5.2 for a detailed discussion of this point.

demand. It should be noted, however, that like any quantification of welfare effects, Bialowolski (2009) relies on specific assumptions about consumer and supplier behaviour to estimate the demand and supply curve: for example, the exact results also depend on the calibration of the underlying macroeconomic model. The need for such assumptions complicates the analysis, particularly in heterogeneous markets, where the estimation of demand curves is even more cumbersome, if not “impossible” (Smith 1970). Bialowolski (2009) ignores the heterogeneity with respect to the riskiness of loans as well as the elasticity of demand for different consumer types, and assumes that there is a single interest rate prevailing for all kinds of consumer credits. As discussed in Chapter 2.1.3, however, it would be more appropriate to consider various interest rates depending on the individual situation of the customer. The (static) welfare considerations of Bialowolski (2009) are also ignorant of potential long-term effects of credit access, which materialise when a customer defaults on his or her loan.

IOO (2009) investigates the **Dutch** market for *Flitskrediet*, which are loans of less than 1 month to maturity. The report points out that this market segments exists due to its exemption from interest rate regulation and that the extension of existing interest rate restrictions from other market segments would not allow this market type to survive. This line of reasoning is in line with **H2a**.

IGF/IGAS (2009) investigates the functioning of the French interest rate restrictions and suggests technical changes. Equivalent to the view in our study, the report points out that the issue of interest rate restrictions primarily affects, if at all, consumer credit other than mortgages. It compares the average level of effective interest rates across European countries and concludes that the existence or non-existence of interest rate regulations is not correlated with the interest rate level, as **H6** would suggest. The study points out that reducing the level of credit access to specific consumer types is one of the purposes of interest rate restrictions, and discusses the trade-off between the effectiveness of the measures with respect to the targeted group on the one hand and excluding excessively many consumers from credit on the other. The study stresses that the existing interest rate restrictions lead to substitutions among different types of credit favouring revolving credit. It documents that low-income borrowers are more likely to use revolving credit rather than instalment credit. The study also describes that, for small revolving credit, it appears that typical interest rates cluster at the level slightly below the usury ceiling, as **H10** suggests.

2.2.6 Summary

The following table summarises the results of existing empirical studies with respect to our hypothesis in Chapter 2.1.4. There appears to be a consensus that interest rate restrictions lower credit access for low-income customers (**H1**), lower total credit (**H2**) and lead to less product choice (**H2b**). It is more controversial whether credit costs decrease for average customers (**H6**), and whether credit access is per se desirable or leads to increased levels of over-indebtedness (**H5**).

Table 33: Overview of the hypotheses

Study	Data	Hypothesis	Confirmed?
Bodenhorn (2007)	New York 19 th century	H4	YES
		H2b	YES
Temin and Voth (2007)	Britain 1714	H2b	YES

		H7	YES
Benmelech and Moskowitz (2010)	US 19 th century	H7	YES
Goudzwaard (1968)	US 1964	H1	YES
		H5	
Wolken and Navratil (1981)	US Credit Unions 1970's	H7	YES
Villegas (1982)	US 1973/1974 (Vehicle finance)	H1	YES
		H2b	YES
		H7	NO
Villegas (1989)	US 1983 (Survey of Consumer Finances)	H1	YES
		H2	YES
		H7	NO
Villegas (1987)	US 1983 (Survey of Consumer Finances)	H1	YES
		H7	NO
Elliehausen (2004)	North Carolina (Mortgage credit)	H1	YES
Zinman (2008)	Oregon/ Washington Payday loans	H1	YES
Karlan and Zinman (2009)	South Africa	H1	YES
Elliehausen and Laurence (2001)	US payday loan customers	H5	YES

Policis (2004)	UK, USA, France, Germany	H1	YES
		H4	YES
Policis (2006a)	France, Germany, UK	H5	NO
		H2	YES
Bialowolski (2009)	Poland	H1	YES
IOO (2009)	Netherlands	H2a	YES
IGF/IGAS (2009)	France	H6	NO
		H10	YES

2.3 Credit market overview

2.3.1 Outline

This part of the study provides facts and figures about the markets of credit to households. We distinguish the markets for consumer credit (which do not include mortgages) and the markets for consumer mortgage credit. This chapter first gives a comprehensive overview of the credit markets in all 27 Member States of the European Union over the period 1995-2009. For some aspects, it also considers specific subgroups, such as the EU 25, the EU 15 and the New Member States.¹⁸⁶

As the analysis in this section shows, we observe several trends during the period 1995-2008.

- Households' credit is an important element of the EU economy. At the end of 2008 the estimated volume of *total credit to households* (outstanding) stood at EUR6,781.88 billion or about 54.3% of EU GDP.¹⁸⁷
- The six countries with the largest volume of *total lending to households* in Europe in 2008 were Germany, the UK, France, Italy, Spain and the Netherlands. Together they accounted for nearly 80% of the overall volume of total credit outstanding in EU 27 at the end of 2008.
- The importance of the *total lending to households* across countries varies significantly: from 128% of GDP in Denmark, to 18.8% of GDP in Slovakia.
- The six countries with the largest volume of *consumer credit* in Europe in 2008 were the UK, Germany, France, Spain, Italy and Poland. These countries represent 79% of the overall volume of consumer credit outstanding in EU 27 at the end of 2008. As is the case with total lending to households, the relative importance of consumer credit shows significant variability across EU countries: from 57% of GDP in EU 15 to 26% in the New Member States.
- In 2008 for the first time since 1995, after more than a decade of robust growth, *consumer credit* in the European Union slowed down and declined by about -5%. Notwithstanding, consumer credit in the New Member States demonstrated double-digit growth (17.9%).
- *Consumer credit* plays an important role in financing current consumption of European households. On average, consumer credit accounted for 15.2% of final consumption expenditure across the EU countries at the end of 2008.
- The level of *indebtedness* as measured by the ratio of consumer credit outstanding relative to the disposable income was 15.4% on average across the EU 27 countries.

¹⁸⁶ EU 25 includes EU 27 countries except for Bulgaria and Romania. The EU 15 comprised the following 15 countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom. New Member States include Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia.

¹⁸⁷ Data source: ECRI (2009), "Lending to Households in Europe. ECRI Statistical package 1995-2008", European Credit Research Institute (ECRI), Brussels. It should be pointed out that this estimate is likely to be lower than the true size of the consumer credit market as not all institutions providing consumer credit are covered by the available statistics.

- The first look at the differences in *consumer credit interest rates* reveals differences across the New Member States and the EU as a whole with the nominal levels of interest rates being almost double the EU average figures for most of the types of credit.

2.3.2 Data availability and definitions

The problem of availability and heterogeneity of existing data on consumer credit in the EU is well known.¹⁸⁸ The European Central Bank (ECB) uses monthly data provided by the national central banks to calculate average figures for the Euro area and the EU. This bears two problems: the figures are not necessarily harmonised across countries, and they do not necessarily capture the entire credit markets.

As a result of the lack of harmonised data on consumer credit in the EU, in this study we rely on data from a number of sources, including European Credit Research Institute (ECRI), national associations of providers of consumer credit, European and National Central Banks. In this chapter we rely heavily on the dataset prepared by ECRI (2009). This dataset provides information on total credit to households (includes mortgage credit, consumer credit and other credit) for the EU and a number of other developed and developing economies during the period 1995-2008.¹⁸⁹

All these data originate from national central bank statistics, who publish figures referring to consumer credit granted by monetary financial institutions (MFIs) only. Unfortunately, this fact implies that other financial intermediaries which service private sector in general and households in particular, such as financial vehicle corporations, hire-purchase companies, leasing and factoring companies, insurance, loans and securities dealers are usually not included in the statistics provided by the official sources. A report prepared for the European Commission – DG Health and Consumer Protection carried out an extensive survey of the financial regulators, banking associations, creditors associations and consumer organisations in the 27 Member States of the European Union.¹⁹⁰ It concluded that a majority of industry associations do not collect any statistics on consumer credit provided by non-MFIs. Only three financial regulators out of eleven which responded and five banking associations out of sixteen which responded to the GHK survey collect some data. This implies a significant gap in the data on consumer credit markets. As a consequence, the parts in this study relying on official data are expected to underestimate the true size of the consumer credit markets in some market segments as not all institutions providing consumer credit are covered by the available statistics.

To fill in this void, the ECB has recently launched the *Eurosystem Households Finance and Consumption Network*, which will conduct the *Survey on Household Finance and Consumption*. Among other goals, the survey will provide harmonised EU-wide household-level data on access and use of credit by European households (ECB, 2009). As the data collection for the first wave of the survey only started in 2009, this source cannot yet be incorporated into this study.

¹⁸⁸ See, eg. Vandone (2009).

¹⁸⁹ Please see Annex V for details of the main definitions used in relation to ECRI dataset.

¹⁹⁰ GHK (2009), "Establishment of a Benchmark on the Economic Impact of the Consumer Credit" Directive on the Functioning of the Internal Market in This Sector and on the Level of Economic Protection (European Commission, DG Health and Consumer Protection, Brussels).

2.3.3 Overview of household credit in the EU 27

2.3.3.1 Total credit to households

As can be seen from Figure 11, the volume of credit outstanding varies substantially among the EU 27 countries. This is natural as it reflects the size of the population and domestic economies. In Germany, which had the highest volume of total credit in absolute terms in 2008, it stood at the level of EUR 1,406 billion. The smallest volume of total credit in absolute terms is registered for Malta at the level of EUR 3.2 billion. The six countries with the highest volume of consumer credit in the EU 27 group are (in descending order): Germany (EUR 1,406 billion), the UK (EUR 1,096 billion), France (EUR 921 billion), Spain (EUR 880 billion), Italy (EUR 515 billion) and the Netherlands (EUR 429 billion).

Figure 11: Total credit to households in EU 27 countries, 2008; EUR billion

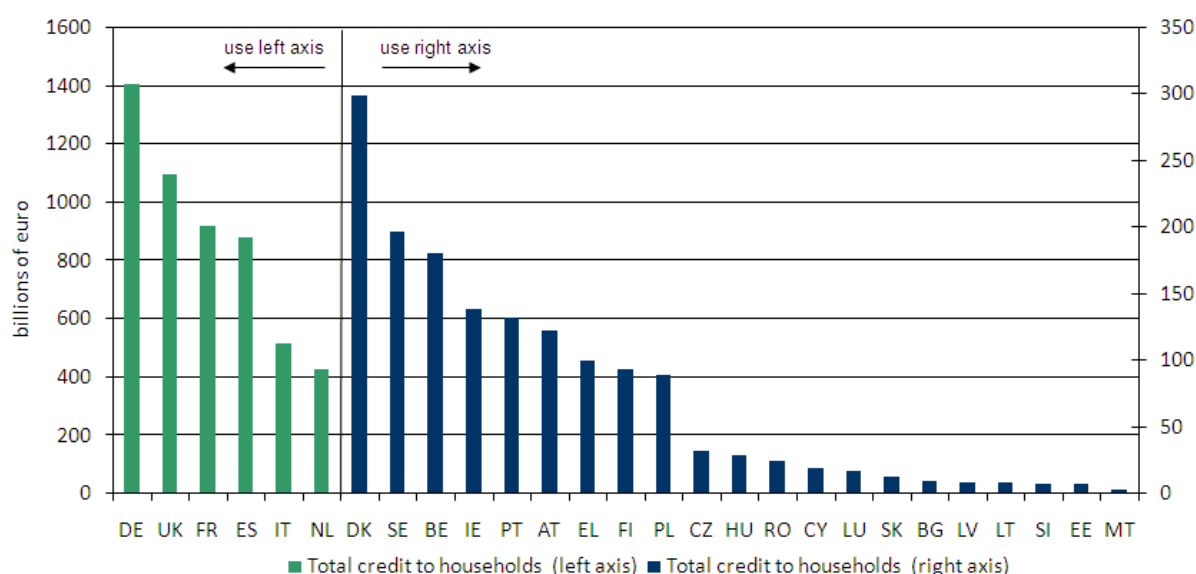


Table 34 shows that the ranking of the countries with the largest volume of total consumer credit has remained largely the same since 1998. Interestingly, however, the dynamic of credit growth differs substantially: since 2003, for instance, the volume of total credit to households in Italy has grown by an astounding 170% in nominal terms. In 2008 the six countries mentioned above (Germany, the UK, France, Italy, Spain and the Netherlands) accounted for nearly 80% of the overall credit to households.

Table 34: Countries with the highest volume of total credit to households, EUR billion

Country	1998	Country	2003	Country	2008
Germany	1,179	Germany	1,426	Germany	1,406
France	417	UK	1,224	UK	1,096
Italy	205	France	583	France	921
Spain	202	Spain	409	Italy	880
Netherlands	190	Netherlands	343	Spain	515

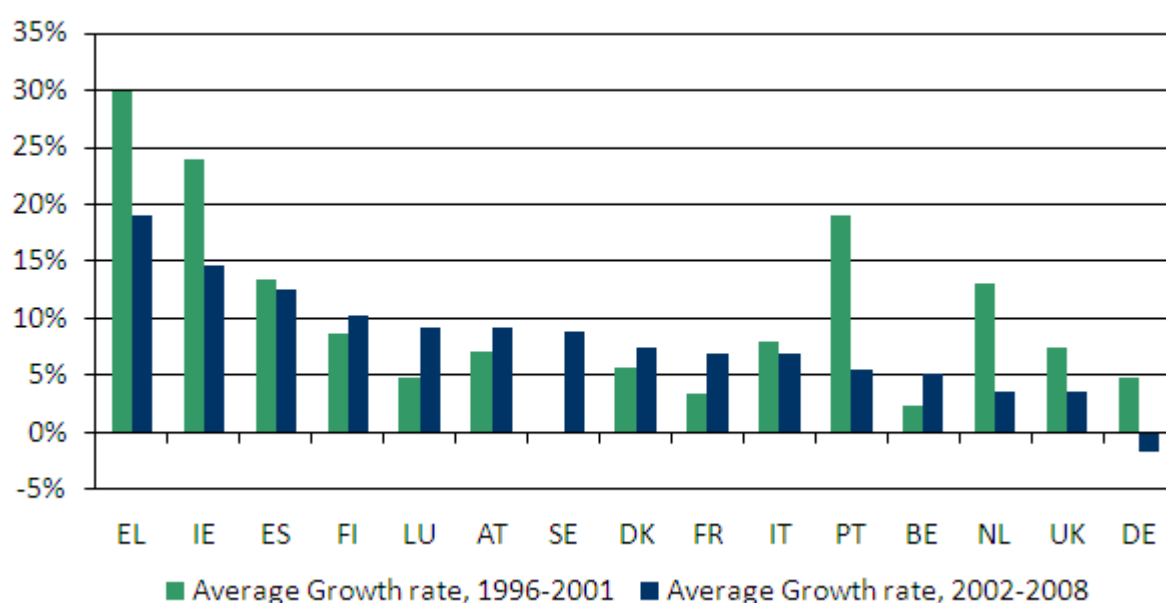
Denmark	126	Italy	327	Netherlands	429
Total, EUR billions	2,319		4,312		5,247
Total EU 27, EUR billions	2.583		5,121		6,782
Total, % of EU 27 total	89%		84%		77%

Source: ECRI (2009), "Lending to Households 1995-2008", own calculations.

Note. The ranking for 1998 does not include the UK due to lack of data in the ECRI statistical package.

As Figure 12 and Figure 13 show, total credit to households grew rapidly during the last two decades across the European Union. Average annual growth rates in the EU15 and New Member States during 1996-2001 stood at 11% and 29% respectively. While growth in EU15 countries slowed down during the next seven years to 8% per annum, it accelerated to 39% per annum in the New Member States. In effect, in three New Member States, Romania, Latvia and Lithuania, total credit grew by more than 50% per annum (89%, 66% and 52% respectively). Countries with the lowest growth rates during 2002-2008 were Netherlands, UK and Germany (3.6%, 3.6% and -1.6% respectively).

Figure 12: Total credit to households in EU 15 countries, average annual real growth rates; in %



Source: ECRI (2009), "Lending to Households 1995-2008", own calculations

Figure 13: Total credit to households in New Member States, average annual real growth rates; %

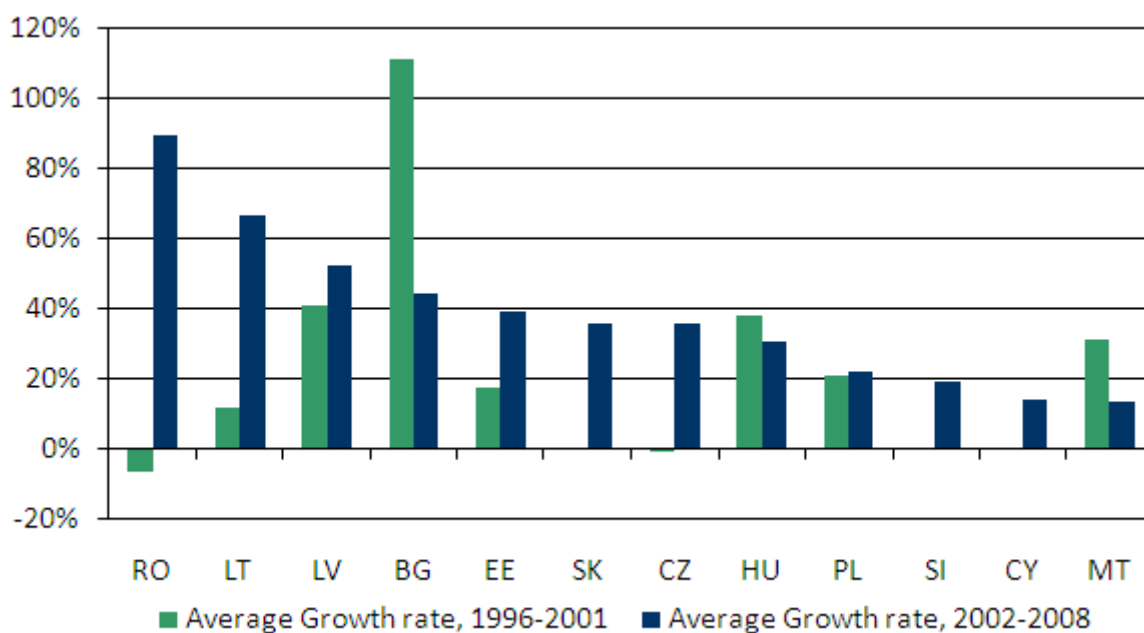
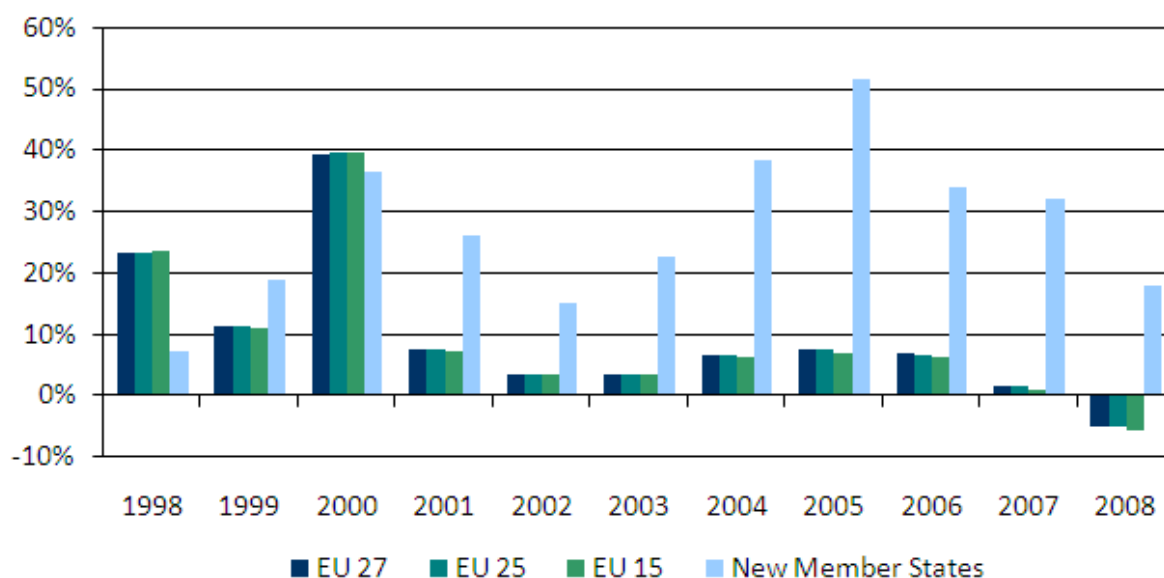


Figure 14 shows annual growth rates across EU 15, EU-25, EU 15 and New Member States. The graph shows that the growth in the older Member States slowed down substantially during 2007-2008, the years of financial turmoil. In contrast, growth in the New Member States persisted. In 2008 EU 27, EU-25 and EU 15 all documented negative growth of -5%. However, growth of total credit in the New Member States, albeit slowed down since 2006, was still at significant 17.9%.

Figure 14: Real growth rates of total credit to households in EU countries; 1998-2008; %



2.3.3.2 Total credit to households per capita

This ranking is different if one takes into account the *size of population*: looking at the volume of total credit to households on per capita basis in Table 35, we find the six countries in which household credit per capita was the highest in 2008 to be Denmark

(EUR 55), Luxembourg (EUR 36 thousand), Ireland (EUR 31 thousand), the Netherlands (EUR 26 thousand), Cyprus (EUR 25 thousand) and Sweden (EUR 21 thousand).

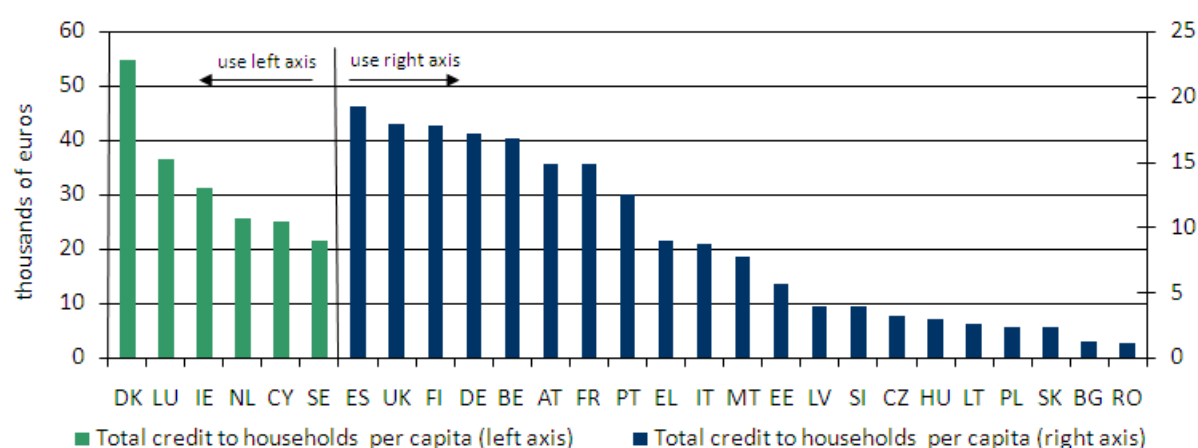
Table 35: Countries with the highest total credit to households per capita in EU 27; 1000 EUR

Country	1998	Country	2003	Country	2008
Denmark	23.756	Denmark	33.722	Denmark	54.595
Luxembourg	15.652	Luxembourg	22.053	Luxembourg	36.402
Germany	14.366	Netherlands	21.165	Ireland	31.322
Netherlands	12.159	UK	20.546	Netherlands	25.664
Belgium	9.915	Germany	17.282	Cyprus	25.080
France	7.144	Ireland	17.221	Sweden	21.448
Median, EU 27	4.744		8.124		12.471
Standard Deviation, EU 27	6.489		9.048		12.678

Source: ECRI (2009), "Lending to Households 1995-2008", own calculations.

As Figure 15 demonstrates, the dispersion of total credit to households on per capita basis is substantial among the EU 27 countries. The country with the highest credit per capita in 2008, Denmark, shows a total credit per capita of EUR 55 thousand, while Bulgaria, the country with the lowest level of consumer credit per capita shows EUR 1.22 thousand.

Figure 15: Total credit to households per capita in EU 27 countries, 2008, EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

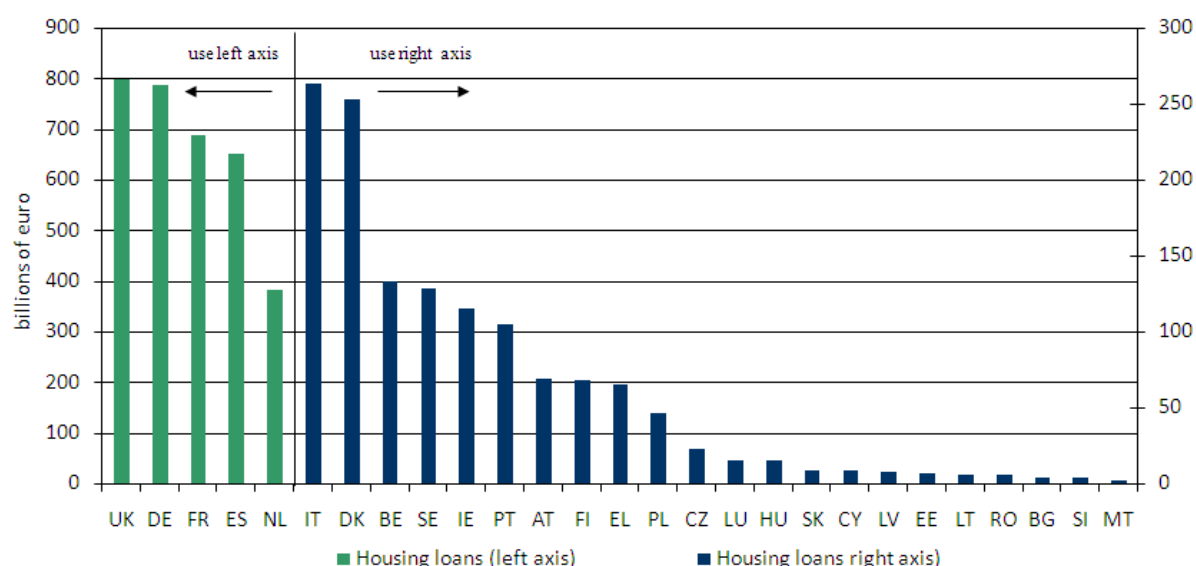
Denmark and Luxembourg remained the countries with the highest per capital credit during the period from 1998 to 2008. The Netherlands belongs to the top six countries of both total credit as well as per capita credit. For Ireland, it is interesting to point out that high growth rate of credit to households propelled it from number six to number three on

the list within the period of just five years. Table 31 details the growth rates of credit to households per capita during the two sub-periods: 1998-2003 and 2003-2008.

2.3.3.3 Housing loans (mortgages)

At the end of 2008, the volume of housing loans in the Member States of the European Union stood at EUR 4,653 billion. The six countries with the highest volume of housing loans are (in descending order): UK (EUR 798 billion), Germany (EUR 787 billion), France (EUR 687 billion), Spain (EUR 650 billion), the Netherlands (EUR 382 billion) and Italy (EUR 263 billion) (Figure 16). Together, these six countries account for EUR 3,568 billion or 77% of the overall volume of housing loans in the European Union. Notably, the ten New Member States that joined the EU in May 2004 (the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia) account for only EUR 126 billion or less than 3% of the overall volume of housing loans in the EU.

Figure 16: Housing loans in EU 27 countries, 2008; EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

As Table 36 demonstrates, the ranking of the top six countries has remained nearly unchanged throughout the last decade and included the UK, Germany, France, the Netherlands and Spain. However, the fraction of the top six countries in the overall housing credit market had decreased from 92% in 1998 to (a still substantial) 77% a decade later.

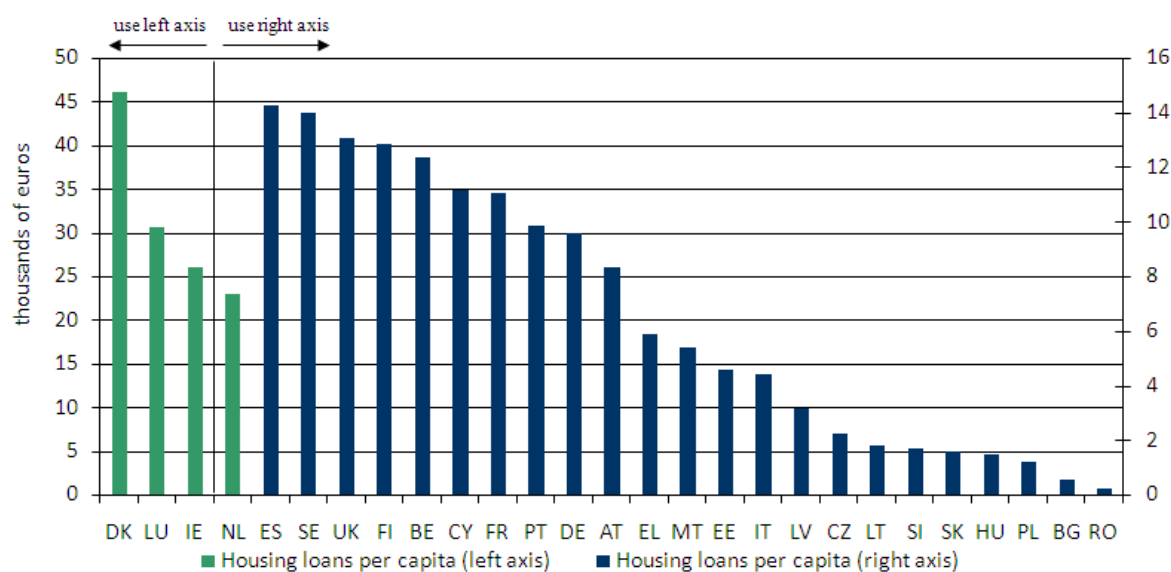
Table 36: Countries with the highest volume of housing loans; EUR billion

Country	1998	Country	2003	Country	2008
Germany	527.268	UK	901.620	UK	797.937
France	259.212	Germany	744.714	Germany	787.339
Netherlands	160.671	France	383.407	France	687.217
Spain	123.256	Netherlands	300.901	Spain	649.849
Italy	63.466	Spain	275.958	Netherlands	382.190
Belgium	60.575	Denmark	154.664	Italy	263.072
Total, EUR billions	1194.448		2761.264		3567.604
Total EU 27, EUR billions	1,297.469		3,333.527		4,653.340
Total, % of EU 27 total	92%		83%		77%

Source: ECRI (2009), "Lending to Households 1995-2008", own calculations. **Note.** The ranking for 1998 does not include the UK due to lack of data in the ECRI statistical package.

In 2008, the largest housing debt *per capita* in the EU is found in Denmark (EUR 46 thousand), Luxembourg (EUR 31 thousand), Ireland (EUR 26 thousand), Netherlands (EUR 23 thousand), Spain (EUR 14 thousand) and Sweden (EUR 14 thousand). As with total credit, Ireland has quickly moved from position five (in the ranking in 2005) to position three in just five years. During this time, the housing loans taken out per capita in Ireland nearly doubled from almost EUR 14 thousands to EUR 26 thousand.

Figure 17: Housing loans in EU 27 countries per capita; 2008; 1000 EUR



Source: ECRI (2009), "Lending to Households 1995-2008".

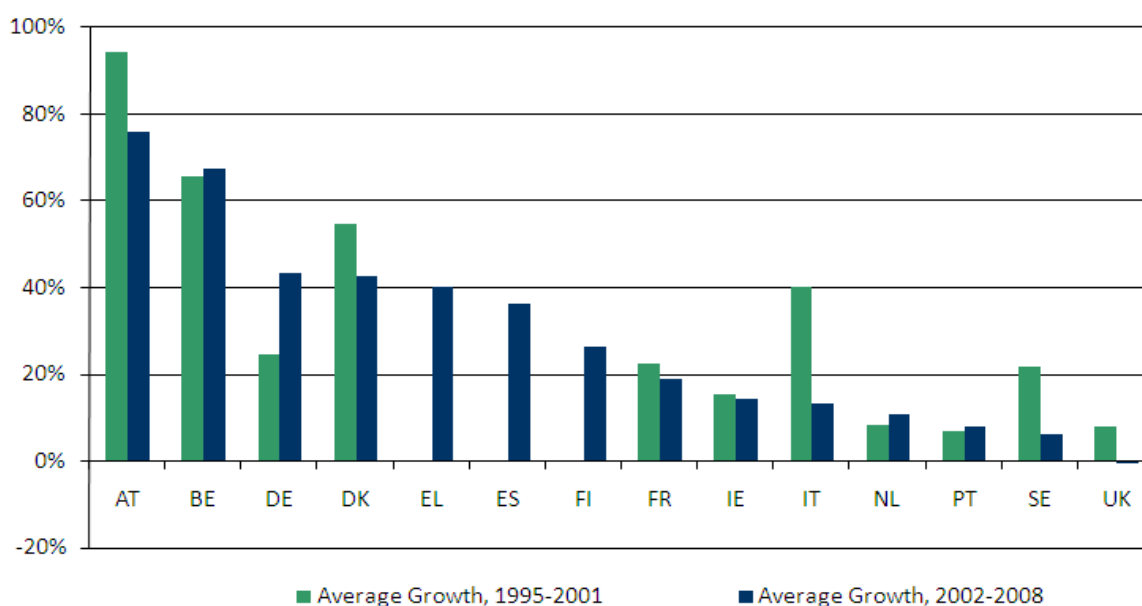
Table 37: Countries with the highest housing loans per capita in EU 27; 1000 EUR

Country	1998	Country	2003	Country	2008
Netherlands	10.264	Denmark	28.727	Denmark	46.131
Luxembourg	10.148	Netherlands	18.546	Luxembourg	30.661
Germany	6.427	Luxembourg	17.323	Ireland	26.031
Belgium	5.931	UK	15.139	Netherlands	22.880
France	4.439	Ireland	13.867	Spain	14.245
Ireland	4.285	Sweden	9.334	Sweden	13.989
Median, EU 27	2.942		5.589		8.343
Standard Deviation, EU 27	3.317		11.598		10.678

Source: ECRI (2009), "Lending to Households 1995-2008", own calculations.

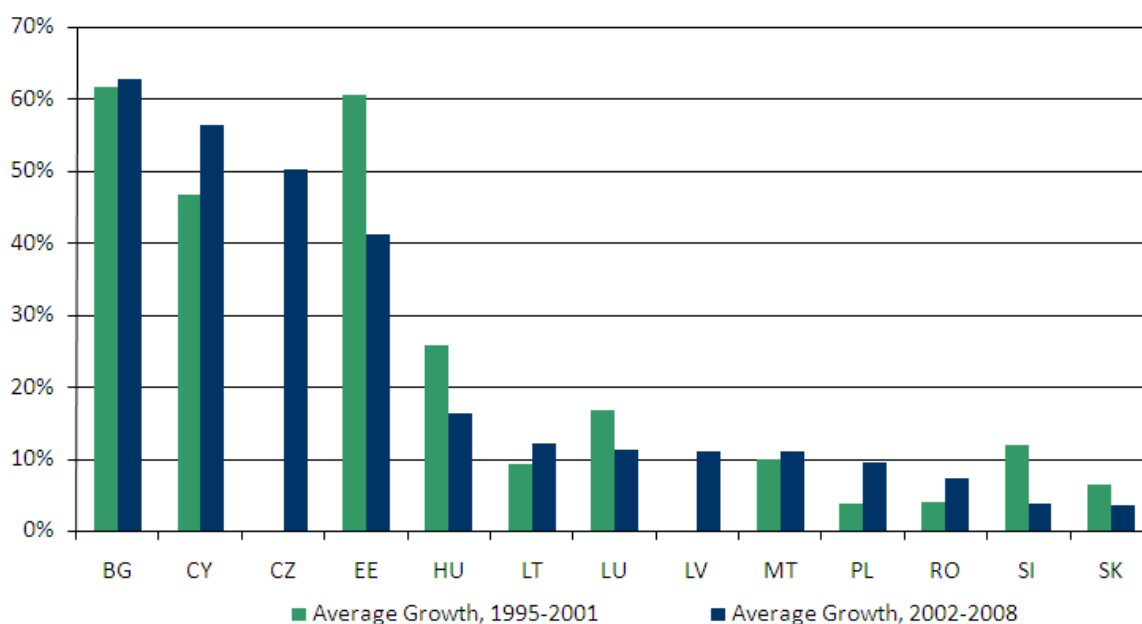
Like in case with the total credit to households, housing loans have grown substantially during the last two decades (Figure 18-Figure 19). Average annual growth rates for EU15 and New Member States were 33% and 23% , respectively, during 1996-2001. During 2002 to 2008 average annual growth rates stood at 29% and 23% respectively. Accordingly to the European Mortgage Federation factors such as increasing house prices, a healthy labour market, increasing incomes and, tax-deductability of mortgage interest payments in some countries have all contributed to enormous growth in mortgage lending in recent years (European Mortgage Federation, 2009). The highest growth rates are found, again, in the New Member States: housing loans in Bulgaria, Cyprus and the Czech Republic have grown by more than 50% in each year between 2002 and 2008 (63%, 56% and 50% respectively). The lowest growth rates in this period were observed in Slovenia, Slovakia and the UK (3.8%, 3.6% and -0.1%).

Figure 18: Housing loans in EU15, average annual real growth rates; %



Source: ECRI (2009), "Lending to Households 1995-2008".

Figure 19: Total credit to households per capita in New Member States, average annual growth rates; %

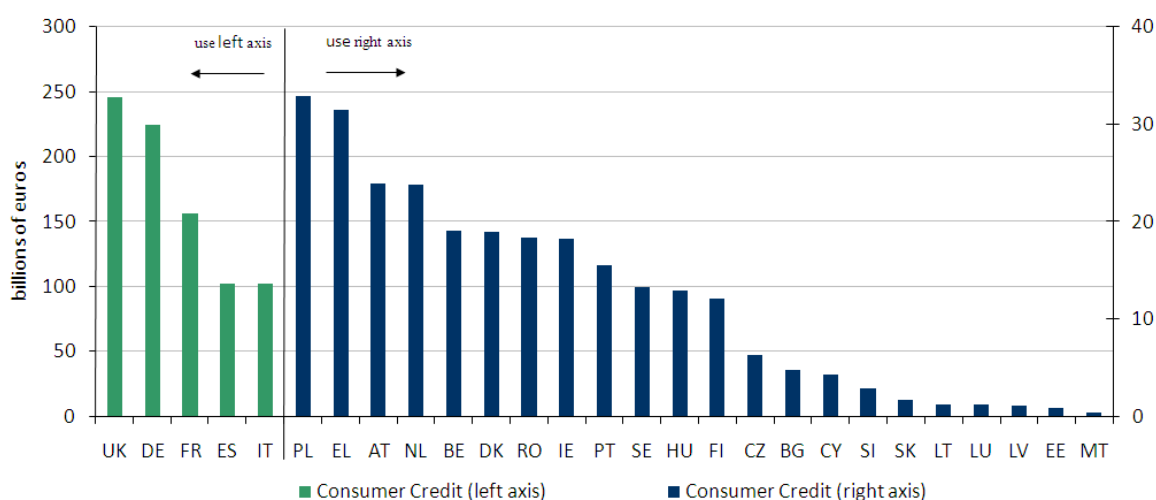


Source: ECRI (2009), "Lending to Households 1995-2008".

2.3.3.4 Consumer credit

At the end of 2008, the total volume of outstanding consumer credit in countries of the European Union stood at EUR 1,094 billion. The countries with the highest overall volumes of consumer debt were: UK (EUR 245 billion), Germany (EUR 224 billion), France (EUR 156 billion), Spain (EUR 102 billion), Italy (EUR 102 billion) and, somewhat surprisingly, Poland (EUR 33 billion). It has to be noted that Poland first appeared in this ranking in 2008.

Figure 20: Outstanding consumer credit in EU 27 countries; EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

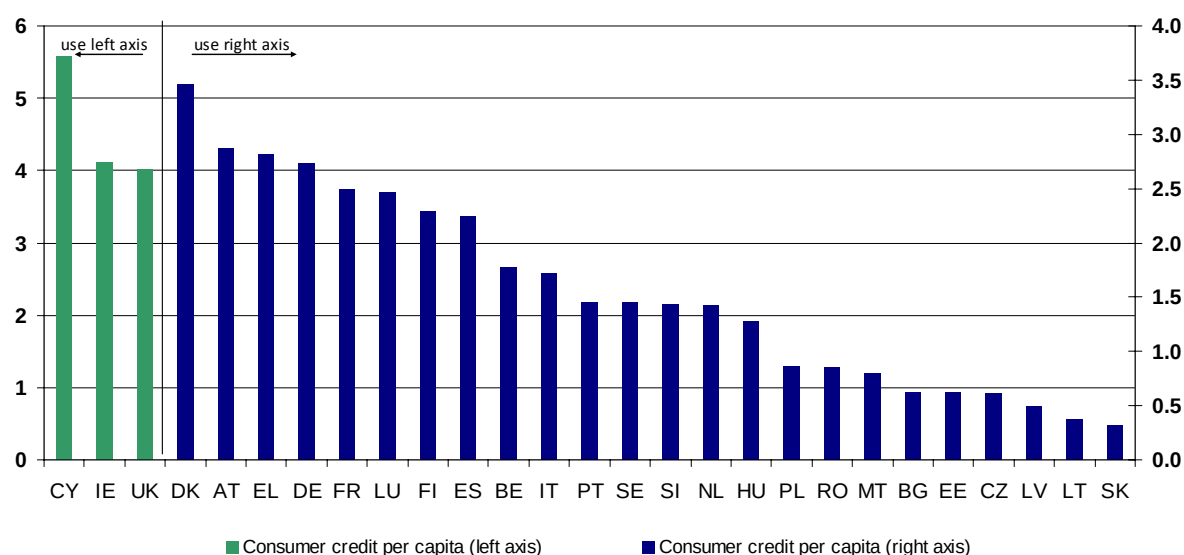
Table 38: Countries with the highest volume of consumer credit; EUR billion

Country	1998	Country	2003	Country	2008
Germany	216.637	UK	256.312	UK	245.217
UK	150.741	Germany	230.913	Germany	224.046
France	93.797	France	127.695	France	155.733
Spain	36.652	Spain	55.529	Spain	102.331
Italy	27.202	Italy	50.109	Italy	101.825
Austria	14.825	Austria	20.906	Poland	32.803
Total, EUR billions	539.854		741.465		861.954
Total EU 27, EUR billions	590.804		854.021		1093.847
Total, % of EU 27 total	91%		87%		79%

Source: ECRI (2009), "Lending to Households 1995-2008", own calculations.

When we look at consumer credit on per capita basis, the composition of the top countries is rather different. This finding suggests that the occurrence of consumer credit is highly diverse across the Member States of the European Union (Figure 21).

Figure 21: Outstanding consumer credit in EU 27 countries; 2008; per capita



Source: ECRI (2009), "Lending to Households 1995-2008".

The countries with the highest consumer credit share per capita are Cyprus (EUR 5.6 thousand), Ireland (EUR 4.1 thousand), UK (EUR 4.0 thousand), Denmark (EUR 3.5 thousand), Austria (EUR 2.9 thousand) and Greece (EUR 2.8 thousand). Denmark entered the list in 2003, while Cyprus and Greece were the "new-comers" in 2008. This suggests a rapid growth of consumer credit in these three countries (Table 39).

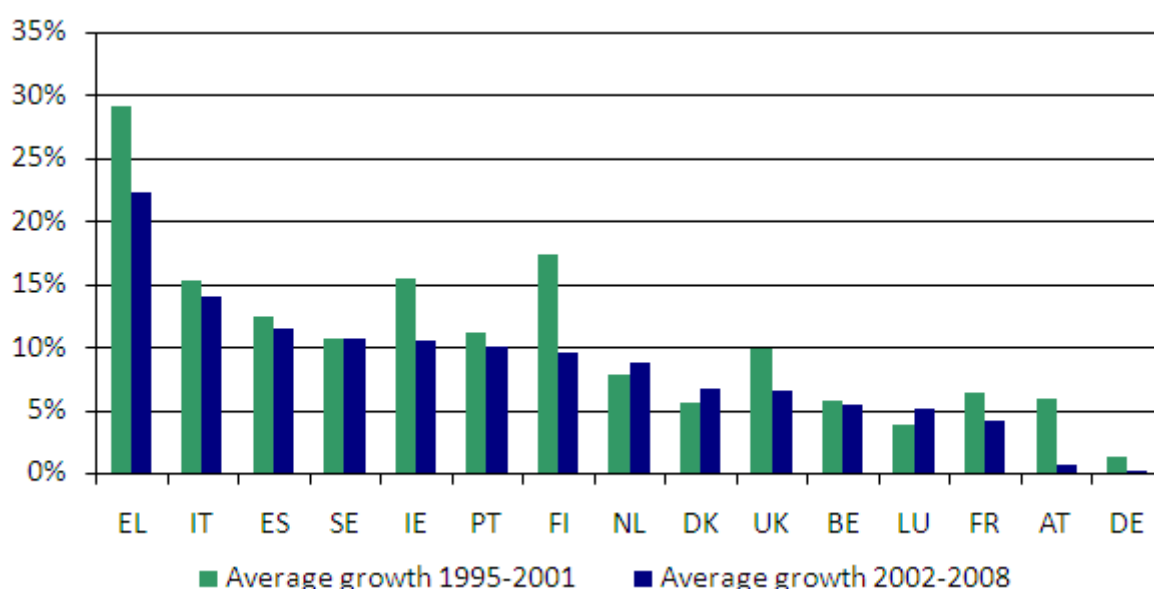
Table 39: Countries with the highest consumer credit per capita in the EU 27; 1000 EUR

Country	1998	Country	2003	Country	2008
Germany	2.641	UK	4.304	Cyprus	5.581
UK	2.578	Ireland	2.847	Ireland	4.107
Luxembourg	1.949	Germany	2.798	UK	4.015
Austria	1.858	Austria	2.575	Denmark	3.462
France	1.606	Luxembourg	2.354	Austria	2.876
Ireland	1.361	Denmark	2.246	Greece	2.812
Median, EU 27	0.695		1.097		1.453
Standard Deviation, 27	0.853		1.150		1.318

Source: ECRI (2009), "Lending to Households 1995-2008", own calculations.

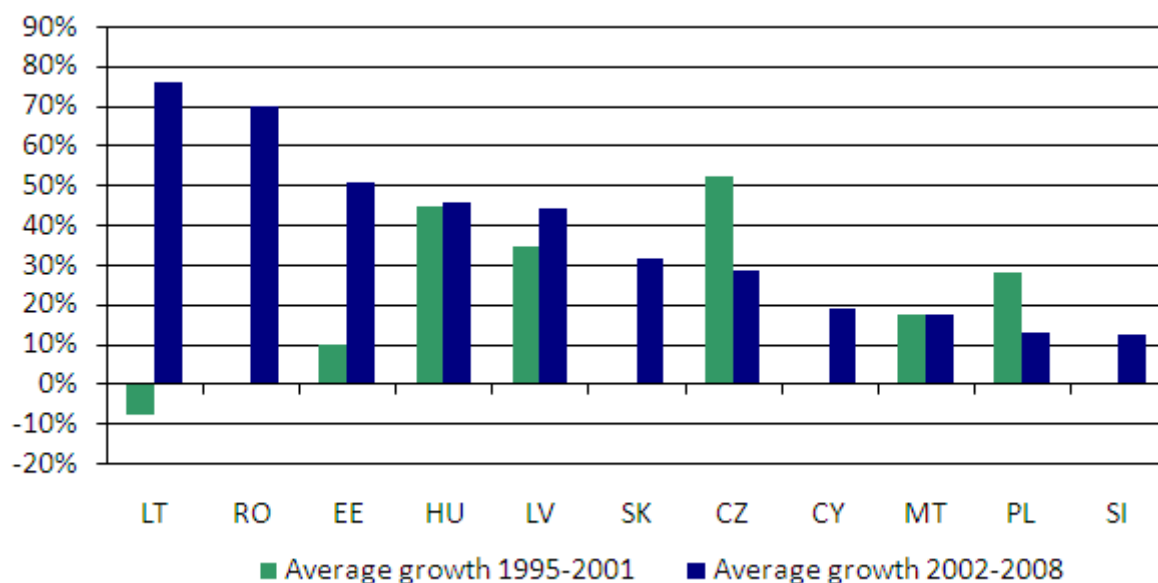
The last two decades saw a rapid expansion of consumer credit in the European Union. As is the case with total credit and housing loans, consumer credit grew more rapidly in the New Member States than in older Member States (Figure 22-Figure 23). Average annual real growth rates in Member States between 1996 and 2001 and 2002-2008 were 16% and 37% respectively. Figures for EU15 for the same two periods are 11% and 8% respectively. Consumer credit grew the fastest in the Baltic States and Romania and Hungary, with all these countries having annual growth rates above 40% during 2002-2008. France, Germany and Austria showed the lowest growth rates during the same period (4.1%, 0.7% and 0.1% respectively).

Figure 22: Consumer credit to households per capita in EU15, average annual growth rates; %



Source: ECRI (2009), "Lending to Households 1995-2008", own calculations.

Figure 23: Consumer credit to households per capita in New Member States, average annual growth rates; %

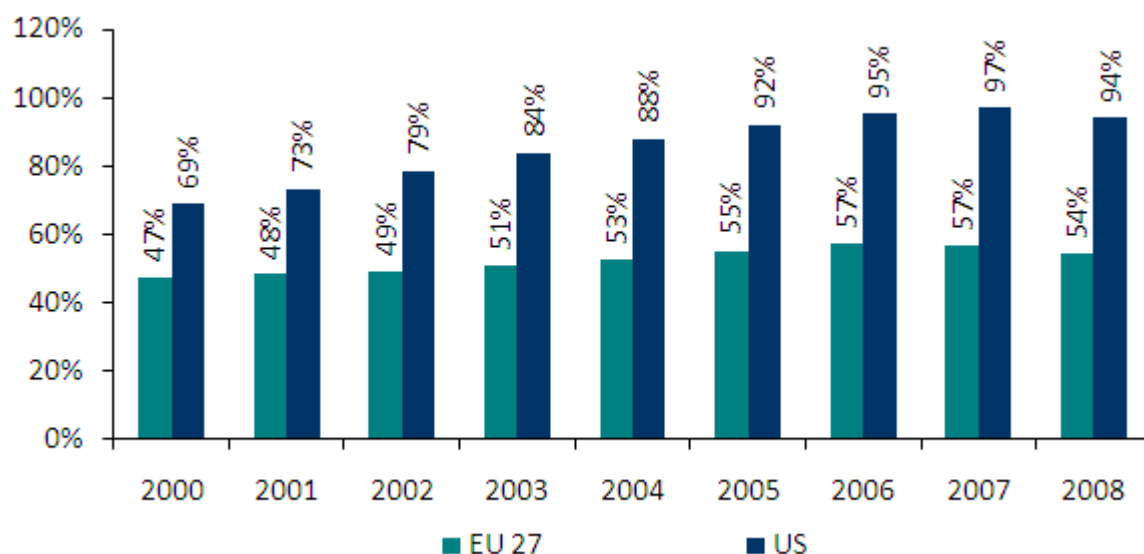


Source: ECRI (2009), "Lending to Households 1995-2008", own calculations

2.3.3.5 The diffusion of credit to households

In previous parts we have described the volumes outstanding of credit to households and its main trends in the last decade. These figures, however, say little about their *affordability*. In a further step, we thus turn to the question about how important credit is relative to the sizes of domestic economies. When looking at the ratios of respective measures of credit to GDP, Figure 24 shows that during the last eight years the ratio of total credit to GDP in the EU 27 has fluctuated between 47% and 57%. The ratio showed a slight, yet distinct, upward trend until 2006 after which it slowed by less than 1% in 2007 and by about 2% in 2008. We do not observe abrupt changes in this indicator and may say that during the last eight years, total credit to households accounted for about half of the GDP in the European Union on average. The figure shows that with respect to this variable, the situation in the EU is rather different from that of the USA, where the proportion of the credit to households in GDP has been steadily increasing in the last eight years and has grown by about 25%: from 69% in 2000 to 94% in 2008.

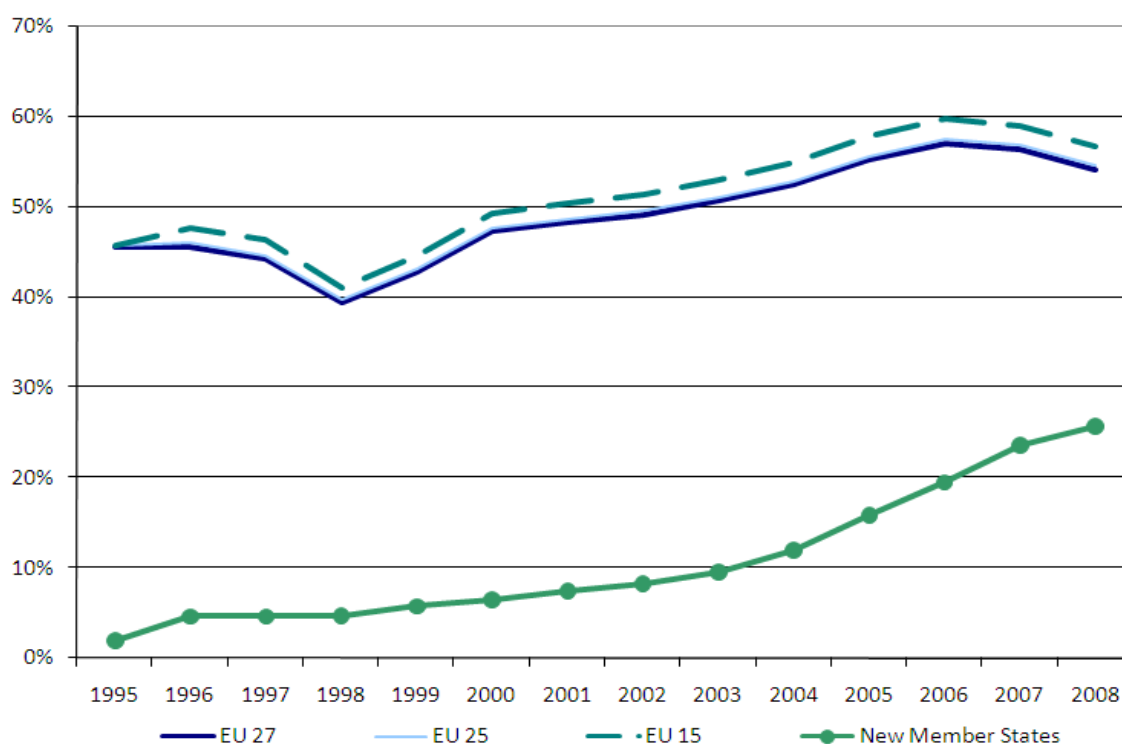
Figure 24: Development of total credit to households in % of GDP; EU 27 and USA; 2000-2008



Source: ECRI (2009), "Lending to Households 1995-2008".

However, the average figures for the whole of the EU conceal differences between the old and new members: in particular, we observe that the importance of the credit relative to GDP is still significantly smaller for the New Member States of the EU. Only after 2003 did the consumer credit reach more than 10% of GDP of these countries and at the end of 2008 this figure stood at about 26% (Figure 25).

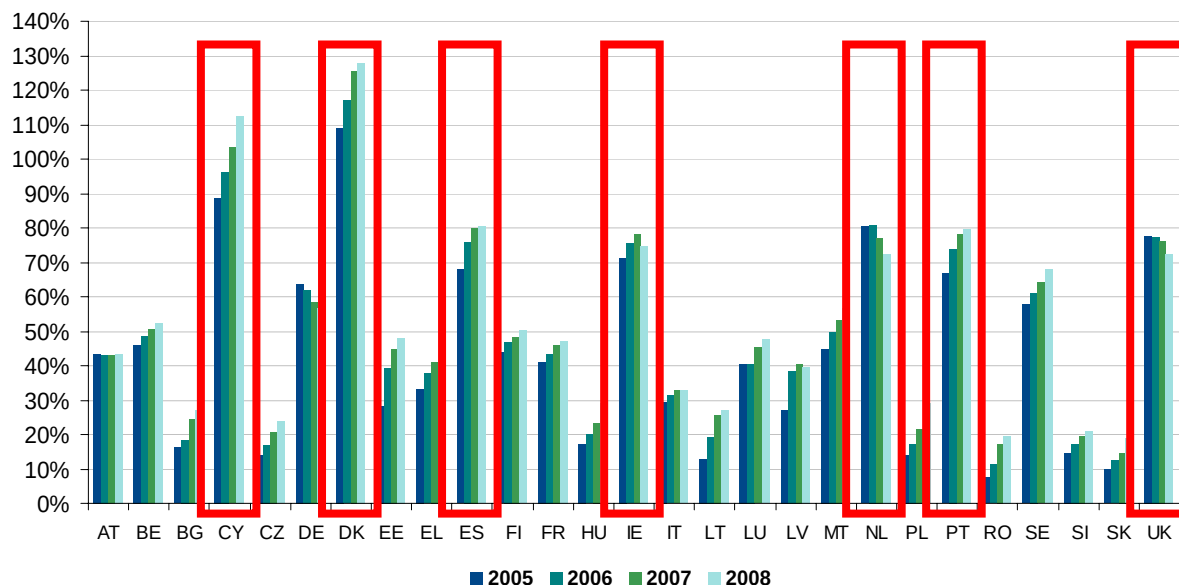
Figure 25: Development of total credit to households in % of GDP for different EU country groups; 1995-2008



Source: ECRI (2009), "Lending to Households 1995-2008".

Credit to households plays the most significant role with respect to the overall economies in the following of the EU countries (in descending order): Denmark (128%), Cyprus (113%), Spain (80%), Portugal (80%), Ireland (75%), the Netherlands (73%) and the UK (72%) (Figure 26).

Figure 26: Total credit to households outstanding, % of GDP; 2005-2008

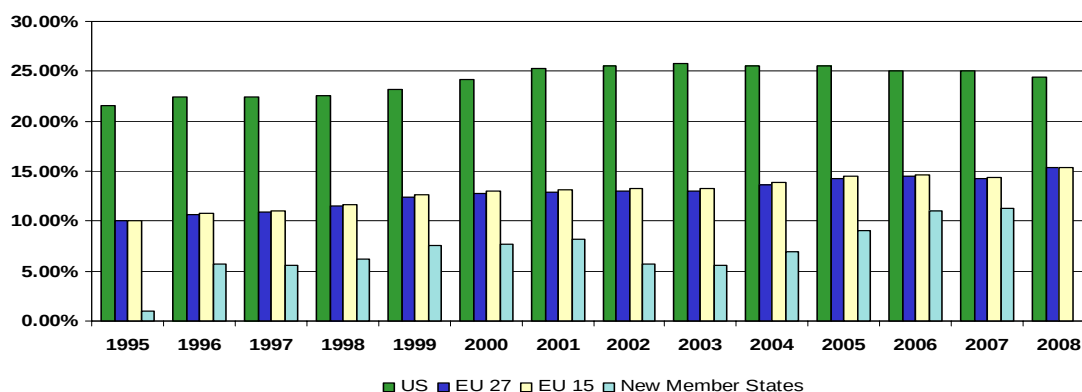


Source: ECRI (2009), "Lending to Households 1995-2008". Top seven countries with the highest level of diffusion of total credit to households relatively to GDP are highlighted in red.

2.3.3.6 Role of credit for household income and consumption

At the end of 2008, consumer credit accounted for an average of 15.4% of the disposable income among the EU 27 countries. Comparing this figure with that of the US (where at the end of 2008 it stood at 24.4%), this level can be considered moderate. However, it is noteworthy that we observe opposite trends in Europe and in the US after 2003. While it decreased slightly in the USA between 2003 and 2008 (from 25.8% to 24.4%), it grew slightly in Europe (from nearly 13% to 15.4%) (Figure 27). Again, while the levels were still lower among the New Member States, those countries exhibited the strongest growth since 2003.

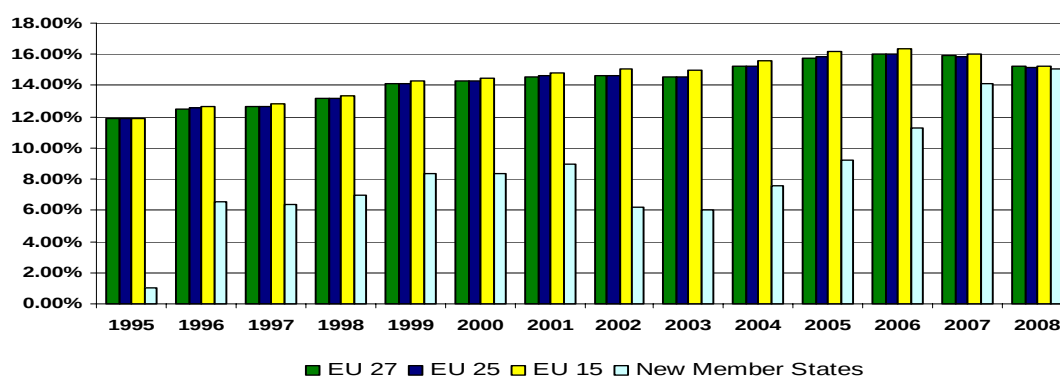
Figure 27: Consumer credit in the EU 27 and the US as a % of Disposable Income; EU and USA; %



Source: ECRI (2009), "Lending to Households 1995-2008".

These figures indicate that consumer credit plays an important role in consumption expenditure of European households: at the end of 2008, consumer credit as a percentage of final consumption stood at an average of 15.2% across the 27 EU countries (Figure 28). This figure is very close for the subgroups of EU-25 and EU 15 countries. It should be pointed out that for the New Member States this figure has converged in the last thirteen years to the EU 27 level, as that figure rose from slightly more than one percent in 1995 to 15% in 2008.

Figure 28: Consumer credit as a percentage of final consumption; Expenditure of households; %

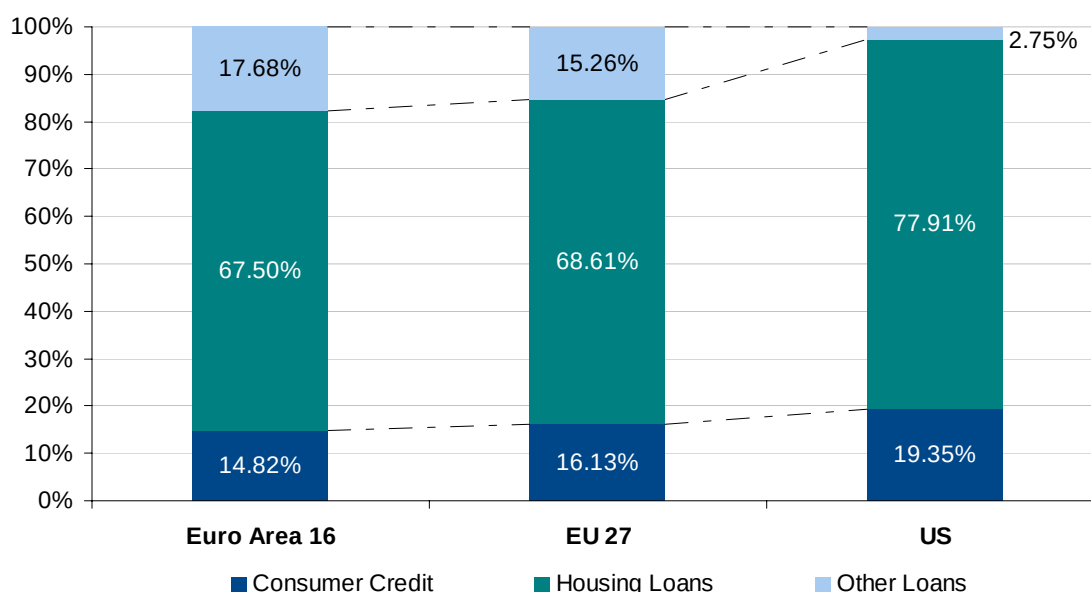


Source: ECRI (2009), "Lending to Households 1995-2008".

2.3.3.7 Credit to households: distribution by category

Figure 29 shows that, compared to the US, both consumer credit and housing loans represent lower fractions of credit to households in the EU: housing loans account for about 69% in the EU 27, while these are nearly 78% in the USA. US consumers also rely heavier on consumer credit than their European peers: the fraction of the consumer credit in the total credit to households stood at 16% in the EU 27 and at 19% in the USA.

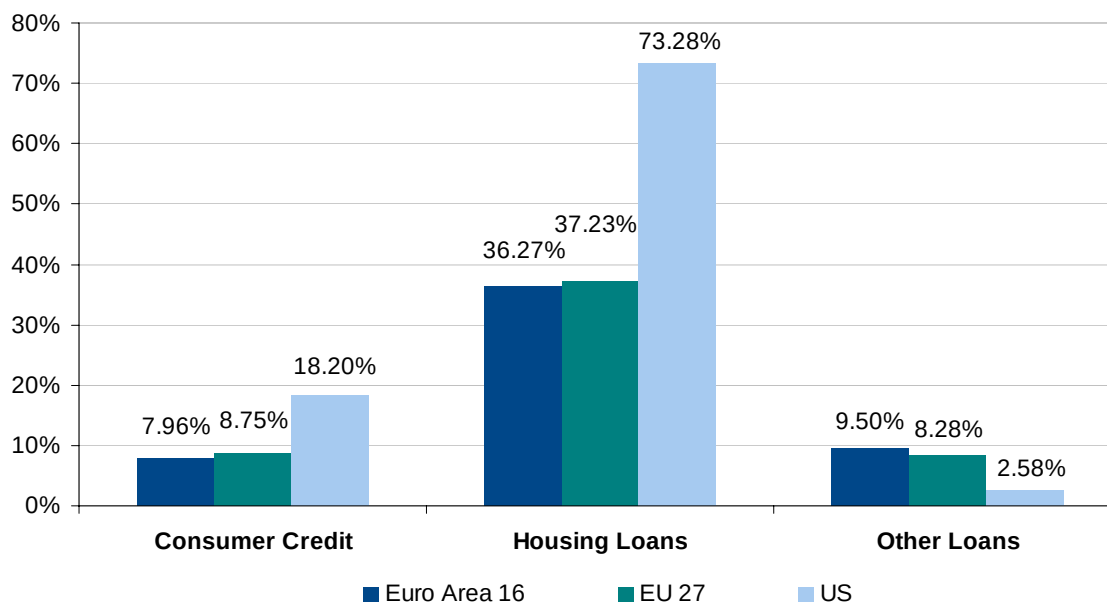
Figure 29: Distribution of total credit to households by MFIs in Euro area 16; EU 27 and US



Source: ECRI (2009), "Lending to Households 1995-2008".

Loans to households are also more important for the US economy than for the European economy when they are measured as ratios relative to the corresponding GDP. Housing loans account for about 73% of GDP in the USA and only about 37% in the EU 27. However, even in the EU these numbers are far from being insignificant. Consumer credit accounts for about 18% of the GDP in the USA and only about 9% of EU GDP.

Figure 30: Lending to households by credit type, % of GDP; EU 16; EU 27 and US



Source: ECRI (2009), "Lending to Households 1995-2008".

Table 40 highlights some of the trends in terms of development of total credit to households and its two major components, housing loans and consumer credit, as a percentage of GDP during the period 2000-2008. Several major trends should be pointed out:

- There is a substantial and monotonic increase in the importance of the total credit relatively to the overall economy in all of the three considered EU country groupings (EU 27, EU 15 and New Member States), and particularly so among the New Member States, which saw more than five-fold increase in this indicator.
- A similar trend is taking place with regard to housing loans, with the housing loans to GDP ratio among Member States increasing by more than 21 times.
- There is stabilisation in the importance of consumer credit among the earlier EU members and a two-fold increase among the New Member States.

Table 40: Development of total credit to households as % of GDP in the EU 27; 2000-2008

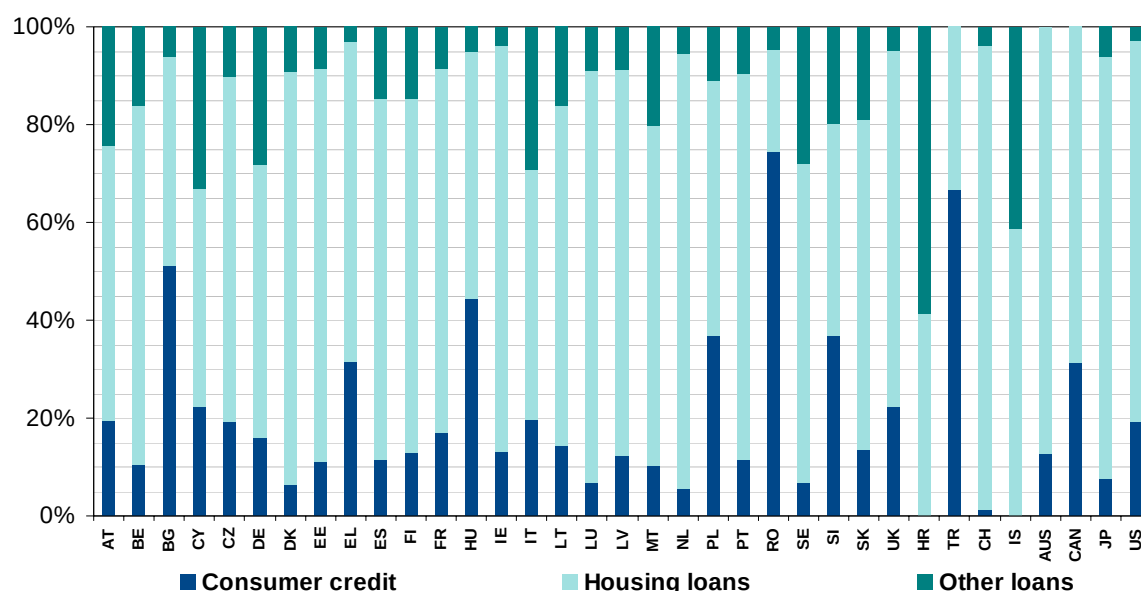
	Total Credit	Housing Loans	Consumer Credit
1998			
EU 27	39.47%	20.36%	7.71%
EU 15	40.99%	21.11%	7.81%
New Member States	4.69%	0.64%	4.23%

2003			
EU 27	50.78%	33.23%	8.51%
EU 15	52.92%	34.55%	8.74%
New Member States	9.54%	4.88%	3.63%
2008			
EU 27	54.25%	37.23%	8.75%
EU 15	56.70%	39.24%	8.74%
New Member States	25.67%	13.73%	8.88%

Source: ECRI (2009), "Lending to Households 1995-2008", own calculations.

Figure 31 highlights the distribution of total credit across the individual EU 27 countries in 2008. In that year, countries with the highest proportion of housing credit were: the Netherlands (89%), Denmark (85%), Luxembourg (84%), Ireland (83%), Estonia (81%) and Latvia (79%). Countries with the highest proportion of consumer credit were: Romania (74%), Bulgaria (51%), Hungary (44%), Poland (37%), Slovenia (37%) and Greece (31%). Finally, Cyprus (33%), Italy (29%), Germany (28%), Sweden (28%), Austria (24%), and Malta (20%) show the highest proportions of the other loans to households.

Figure 31: Distribution of lending to households; 2008



Source: ECRI (2009), "Lending to Households 1995-2008".

2.3.4 Interest rates on credit to households in the EU

Changes in interest rates affect the cost of capital and thus influence investment and saving decisions by households. The interest rates charged by financial institutions, in combination with the volumes of lending and borrowing, may help to shed light on

structural developments in the consumer credit markets and can provide important information for the analysis of stability and integration in this sector.

2.3.4.1 Definitions

In this section we provide a snap-shot of interest rates on consumer credit products charged by monetary financial institutions (MFIs). The statistical requirements for interest rate statistics produced by MFIs are described in Regulation (EC) No. 63/2002 of the ECB of 20 December 2001 (ECB, 2001, "MIR Regulation"). This regulation defines the statistical standards according to which MFI interest rates should be collected and produced.¹⁹¹

The interest rates data presented in this section are collected from the National Central Banks (NCBs) and the European Central Bank (ECB). The interest rates data available from these sources refer to new business and outstanding amounts. The new business is defined as all financial contracts, terms and conditions that specify for the first time the interest rate of the loan, and all new negotiations of existing loans. Outstanding loans cover all loans used and not yet repaid by customers in all the periods up to and including the reporting date, although excluding bad loans and loans for debt restructuring at rates below market conditions (ECB, 2003b). In the present section we provide the data on the interest rates in reference to the *new business*.

Depending on the choice of NCBs, the interest rates are either annualised agreed rates (AAR) or narrowly defined effective rates (NDER) and compiled either as a snapshot of end-month observations or as implicit rates referring to the average of the month. The interest rate that is individually agreed between the reporting agent and the household or non-financial corporation for a deposit or loan, converted to an annual basis and quoted in percentages per annum. The AAR covers all interest payments on deposits and loans, but no other charges that may apply. The NDER refers to an annual basis and is defined as the interest rate that equalises the present value of all commitments other than charges (deposits or loans, payments or repayments, interest payments), future or existing, agreed by the credit institution or other institutions and the household or non-financial corporation. The NDER is equivalent to the interest rate component of the APRC, *ie.* it does not take into account the component of other charges (ECB, 2003a).¹⁹²

Interest rate statistics for the euro-area refers to instrument categories rather than to individual products. These categories (in case of new business statistics which is relevant for this section) are presented in Table 37 below.

Table 41: Lending to households: MFI interest rates (AAR/NDER) on new business

Type of Instrument	Initial rate fixation
Bank overdraft	
Lending for consumption	- Variable rate and up to 1 year initial rate fixation
	- Over 1 and up to 5 years initial rate fixation
	- Over 5 years initial rate fixation

¹⁹¹ This regulation is explained in detail in the "Manual on MFI interest rate statistics" (ECB, 2003a), which clarifies and illustrates the statistical requirements.

¹⁹² As the data coverage differs substantially across AAR/NDER and APRC, we provide data on the former two types of interest rate.

Lending for house purchases	- Variable rate and up to 1 year initial rate fixation
	- Over 1 and up to 5 years initial rate fixation
	- Over 5 and up to 10 years initial rate fixation
	- Over 10 years initial rate fixation
Lending for other purposes	- Variable rate and up to 1 year initial rate fixation
	- Over 1 and up to 5 years initial rate fixation
	- Over 5 years initial rate fixation

Source: ECB (2003a).

2.3.4.2 Overview

Table 42 provides a snapshot of the interest rates charged on the various types of housing loans and consumer credit in the 27 countries of the European Union. It should be pointed out that the data in the tables need to be treated with caution due to differences in the levels of macroeconomic risks (such as default risk, currency risk, inflation risk, economic growth risk) and cost of capital across the EU countries. For example, both level of risks and cost of capital are usually higher in the New Member States and some particular earlier members of the EU. This fact results in higher levels of interest rates charged on credit products in these countries, including the consumer credit products. However, it should be noted that the interest rates are not fully comparable due to different rates of inflation in these countries. Bearing this reservation in mind we present below selected descriptive statistics for the nominal interest rates in these countries. The following tables also contain data on the level of long-term interest rates and inflation rates for the EU 27 countries in order to illustrate the differences in the cost of capital and inflation levels across the European countries.

2.3.4.2.1 Interest rates on credits for house purchases

As Table 42 shows, the median nominal interest rates in the EU 27 for housing loans of variable (1-year initial fixation), 1-5 years initial fixation and over 5 years initial fixation stood at 3.45%, 5.17% and 5.07% respectively. The corresponding figures for New Member States were almost double these and were 7.59%, 10.43% and 9.23%.

Table 42: Interest rates on lending for house purchase across the EU 27; new business; December 2009; %

Country	Lending for house purchase (by initial period of fixation):			Long-term interest rates (***)	Inflation rate (****)
	Floating rate up to 1 year	Over 1 and up to 5 years	Over 5 years		
Austria	2.91	2.94	4.90	3.29	0.4
Belgium	2.92			3.61	0

Bulgaria*	13.24	10.67	9.93	6.61	2.5
Cyprus	-	-	-	4.6	0.2
Czech Republic*	5.96	5.68	5.07	3.98	0.6
Germany	3.36	3.76	4.29	3.14	0.2
Denmark				3.53	1.1
Estonia*	7.59	16.00	-		0.2
Greece	3.08	4.60	4.06	5.49	1.3
Spain			7.17	3.81	-0.3
Finland	1.92	3.47	4.18	3.46	1.6
France	3.38	3.8	3.74	3.48	0.1
Hungary*	10.27	10.99	15.05	7.69	4
Ireland		2.61	2.68	4.88	-1.7
Italy	2.24	3.35	4.05	4.01	0.8
Lithuania	8.55	10.43		9.1	4.2
Luxembourg	2.03			3.8	0
Latvia*	13.19	7.18	-	13.75	3.3
Malta	3.52			4.41	1.8
Netherlands	3,84	4,87	5,26	3.44	1
Poland*	6.85	7.43	8.53	6.22	4
Portugal	2.22			3.91	-0.9
Romania*	12.97	11.60	6.65	8.66	5.6
Sweden	1.52	3.02	4.63	3.24	1.9
Slovenia	3.36	5.17	6.28	3.91	0.9
Slovakia	5.92	11.43	14.37	4.12	0.9
United Kingdom*	3.69	4.84	5.68	3.6	2.2
Median EU 27	3.45	5.17	5.07	3.95	0.90
St. Dev.	3.67	3.92	3.69	2.54	1.76

Median States	New Member	7.59	10.43	9.23	6.22	2.15
St. Dev. States	New Member	3.68	3.63	3.68	3.07	1.87

Sources: National central bank statistics, unless indicated otherwise. The reported rate is the Annual Agreed Rate (AAR)/Narrowly Defined Effective Rate (NDER), unless indicated otherwise. Missing values indicate that the data is not available. NMS stands for "New Member States". * Interest rates for domestic-currency-denominated loans. ** ECB Statistics: <http://www.bundesbank.de/statistik/>. *** ECB Statistics: <http://www.ecb.int/stats/money/>. The rates are secondary market yields of government bonds with a remaining maturity close to ten years. ****Source: ECB Statistics: <http://epp.eurostat.ec.europa.eu/>.

2.3.4.2.2 Interest rates on consumer credit for different maturities

Table 43 shows the median interest rates for consumer credit for variable rates/1-year initial fixation, 1-5 years initial fixation and over 5 years initial fixation loans. The corresponding interest rates in the EU were 7.54%, 8.28% and 7.69% respectively. The corresponding figures for New Member States were almost double as high and were 13.85%, 13.94% and 14.09%.

Table 43: Interest rates consumer credit across the EU 27; new business; December 2009; %

Country	Consumer credit (by initial rate of fixation):			Consumer credit other purposes (by initial rate of fixation):			Long-term interest rates (***)	Inflation rate (****)
	Floating rate up to 1 year	Over 1 and up to 5 years	Over 5 years	Floating rate up to 1 year	Over 1 and up to 5 years	Over 5 years		
Austria	4.26	4.44	3.74				3.29	0.4
Belgium	5.27	6.50	5.29				3.61	0.0
Bulgaria*	15.45	13.94	13.33	13.30	11.51	11.69	6.61	2.5
Cyprus	-	-	-				4.60	0.2
Czech Republic*	15.05	13.58	14.09	6.69	5.97	5.36	3.98	0.6
Germany	6.38	4.83	7.57				3.14	0.2
Denmark	8.448	6.17	7.036				3.53	1.1
Estonia*	11.70	20.73	19.40					0.2
Greece	8.18	8.95	9.75	7.00			5.49	1.3
Spain	9.72	8.08	9.08				3.81	-0.3
Finland	3.04	4.76	4.73				3.46	1.6
France	6.91	6.15	5.74				3.48	0.1

Hungary*	17.77	26.15	30.57	16.50	10.67		7.69	4.0
Ireland	3.63	2.61	3.90				4.88	-1.7
Italy	9.85	8.28	6.96	4.01	4.91	5.28	4.01	0.8
Lithuania	13.85	17.65		8.99	11.11		9.10	4.2
Luxembourg		5.17	4.76	1.77			3.80	0.0
Latvia*	21.13	25.04	7.81				13.75	3.3
Malta	6.02			5.56			4.41	1.8
Netherlands	8.76	-	-				3.44	1.0
Poland*	10.78	13.71	18.88				6.22	4.0
Portugal	5.53	12.17	6.08				3.91	-0.9
Romania*	17.21	18.28	14.53	14.08	27.40	10.58	8.66	5.6
Sweden	4.20						3.24	1.9
Slovenia	4.99	7.35	7.40	5.32	6.03	6.04	3.91	0.9
Slovakia	5.26	5.57	8.87				4.12	0.9
United Kingdom*	2.72	11.78	7.87				3.6	2.2
Median	7.54	8.28	7.69	6.77	10.67	6.04	3.95	0.9
St. Dev.	5.26	6.97	6.64	4.75	8.44	2.53	2.54	1.8
Median NMS	13.85	13.94	14.09	8.99	10.67	8.31	6.22	2.2
St. Dev. NMS	5.44	7.13	7.15	4.53	7.62	3.03	3.03	1.8

Source: National central bank statistics, unless indicated otherwise. The reported rate is the Annual Agreed Rate (AAR)/Narrowly Defined Effective Rate (NDER), unless indicated otherwise. Missing values indicate that the data is not available. NMS stands for "New Member States". * Interest rates for domestic-currency-denominated loans. ** Source: ECB Statistics: <http://www.bundesbank.de/statistik/>. *** Source: ECB Statistics: <http://www.ecb.int/stats/money/>. The rates are secondary market yields of government bonds with a remaining maturity close to ten years. ****Source: ECB Statistics: <http://epp.eurostat.ec.europa.eu/>

2.3.4.2.3 Interest rates on consumer credit by credit type

Table 44 shows that credit cards and overdrafts appear to be the most expensive type of credit (in terms of interest charges), with the credit cards commanding 12.37% and bank overdrafts commanding 10.51% median rates respectively. The corresponding interest rates in the New Member States were again higher, with the median credit card rates being as high as 16.07% and overdraft rates being 16.51% for these countries.

Table 44: Interest rates on overdrafts, credit cards and overrunning across the EU 27; new business; December 2009; %

Country	Overdrafts	Credit cards	Overrunning the bank account(**)	Long-term interest rates (***)	Inflation rate (****)
Austria	5.89		5.89	3.29	0.4
Belgium	9.81		6.95	3.61	0
Bulgaria*				6.61	2.5
Cyprus			7.25	4.6	0.2
Czech Republic*				3.98	0.6
Germany	10.38			3.14	0.2
Denmark				3.53	1.1
Estonia*	16.51				0.2
Greece	14.08	15.17	14.08	5.49	1.3
Spain	12.34			3.81	-0.3
Finland	7.83		7.83	3.46	1.6
France	10.28		10.28	3.48	0.1
Hungary*	27.52			7.69	4
Ireland	12.6		12.6	4.88	-1.7
Italy			6.6	4.01	0.8
Lithuania	17.02			9.1	4.2
Luxembourg				3.8	0
Latvia*	24.86			13.75	3.3
Malta	6.44		6.45	4.41	1.8
Netherlands	5.76			3.44	1
Poland*	11.59	16.07		6.22	4
Portugal	10.64			3.91	-0.9
Romania*	21.43			8.66	5.6
Sweden	3.72			3.24	1.9

Slovenia	8.64		8.64	3.91	0.9
Slovakia			14.35	4.12	0.9
United Kingdom*	7.74	17.76		3.6	2.2
Median EU 27	10.51	12.47	7.83	3.95	0.90
Standard deviation	6.55	6.68	3.17	2.54	1.76
Median NMS	16.51	16.07	7.25	6.22	2.15
St. Dev. NMS	7.58	4.95	1.11	3.07	1.87

Source: National central bank statistics, unless indicated otherwise. The reported rate is the Annual Agreed Rate (AAR)/Narrowly Defined Effective Rate (NDER), unless indicated otherwise. Missing values indicate that the data is not available. NMS stands for "New Member States". * Interest rates for domestic-currency-denominated loans. ** ECB Statistics: <http://www.bundesbank.de/statistik/>. *** For convergence assessment purposes, Source: ECB Statistics: <http://www.ecb.int/stats/money/>. The rates are secondary market yields of government bonds with a remaining maturity close to ten years. ****Source: ECB Statistics: <http://epp.eurostat.ec.europa.eu/>.

2.4 Case Studies

2.4.1 Introduction

The aim of this section is to provide a comprehensive overview and international comparison of relevant aspects of the functioning of consumer credit markets in the six selected European countries. It provides the necessary background for the discussion of the hypotheses in the subsequent chapters of this study. We focus on the following six countries which serve as case studies in this report: Germany, France, the Netherlands, Poland, Sweden and the UK. The reasons behind this choice include diversity in terms of economic characteristics, financial cultures, size and attributes of the consumer credit markets, as well as the heterogeneity of the legal framework of interest rate restrictions in these countries. It is this heterogeneity in the chosen countries which allows us to draw conclusions with regard to the effect of interest rate regulation on consumer credit markets and over-indebtedness.

The six countries selected represent more than half (54.3%) of the population of the EU 27. Furthermore, they account for nearly two-third of the volume of total credit to households and consumer credit to households in EU 27 countries at the end of 2008, as can be seen from Table 45. Thus focusing on these countries allows us to perform a *comprehensive overview* on the European consumer credit market by capturing an important share of it in the first place. Heterogeneity among their national consumer credit markets in all relevant aspects ensures further *representativeness* of the case studies for the European consumer credit market. The six countries included in our study differ considerably in market size and market structure: half of the selected countries – the UK, Germany and France represent the countries with the largest national consumer credit markets. They alone make up nearly sixty percent (57.1%) of the European consumer credit market and account for more than half (50.5%) of the total credit to households in EU 27 countries. The rest of the countries included in the study – Poland, Sweden and the Netherlands make comparatively small contributions to the overall volume of credit to households in Europe. As a typical representative of the New Member States from CEE, Poland exhibits high growth of per capita credit to households, as indicated in Chapter 2.3. The northern European countries the Netherlands and Sweden typically exhibit large mortgage markets which make up almost ninety percent (89.2%) and roughly seventy percent (65.2%), respectively, of the total volume of credit to households in both countries, as indicated in Chapter 2.3.3.7. Its large mortgage market makes the Netherlands the country with the fourth-highest rate of per capita housing loans in Europe. In contrast, Germany and France are among the countries with the lowest level of per capita housing loans, with exception of the New Member States.

Table 45: Market size and structure of the consumer credit market in selected countries

	Population (millions of people)	Total Credit, EUR billion	Total Credit (% of EU27)	Consumer Credit, EUR billion	Consumer Credit (% of EU27)	Housing Loans, EUR billion	Housing loans (% of EU27)
DE	82.12	1406.30	21	224.05	20	787.34	17
FR	62.28	921.17	14	155.73	14	687.22	15
NL	16.70	428.69	6	23.77	2	382.19	8
PL	38.10	88.90	1	32.80	3	46.37	1
SE	9.18	196.87	3	13.30	1	128.41	3
UK	61.07	1095.52	16	245.22	22	797.94	17
			61		63.53		60.81
EU 27	495.92	6781.88		1093.85		4653.34	

Source: ECRI (2009), "Lending to Households 1995-2008".

Furthermore, the dimensions of diversity in the selected countries include different demographic structures and characteristics of financial behaviour. The most populous countries in Europe – Germany, France and United Kingdom are included in the survey alongside with smaller countries.

As can be seen from Table 46, both Germany and France exhibit above-average standards of living measured by GDP per capita (EUR 30.35 thousand and EUR 31.27 thousand in Germany and France respectively) and slightly more equally distributed income and wealth (Gini index of 30 and 28 for Germany and France respectively) than the EU 27 average. However, there are differences among both countries in terms of their levels of indebtedness and over-indebtedness. In Germany the total credit to households as a percentage of GDP lies slightly above average, a comparatively low proportion of borrowers experience arrears in payments on mortgage or rent, utility bills or hire purchases. Despite the notably lower total credit to GDP ratio (47%) France experiences a notably higher proportion of borrowers experience arrears in payments as compared to Germany.

The total credit to GDP ratio is higher in the northern European countries Netherlands, Sweden and United Kingdom. Over-indebtedness measured by the percentage of people experiencing arrears in payments is relatively low in all three countries compared to the EU 27 average and compared to Germany and France. However, UK exhibits relatively low standards of living indicated by comparatively low GDP per capita (EUR 29.67 thousands) and an at-risk-of-poverty ratio above average (19%) when compared to the high GDP per capita in Netherlands (EUR 35.35 thousands) and Sweden (EUR 35.78 thousands) and their considerably low at-risk-of-poverty ratio (11% and 12% respectively). Furthermore, the Netherlands and Sweden experience higher income equalities (with a Gini index of 28 and 24, respectively) than the United Kingdom where the income inequality (Gini index of 34) is above EU 27 average.

Different financial behaviour and demographic structure are also observed in CEE Member States represented by the most populous country in this category – Poland. Poland experiences significantly lower standards of living (GDP per capita of EUR 9.47 thousands) and a high at-risk-of-poverty ratio (17%). Consequently, despite the low total-credit-to-GDP ratio (25%) a significant part of the population (11%) also experiences arrears in payments.

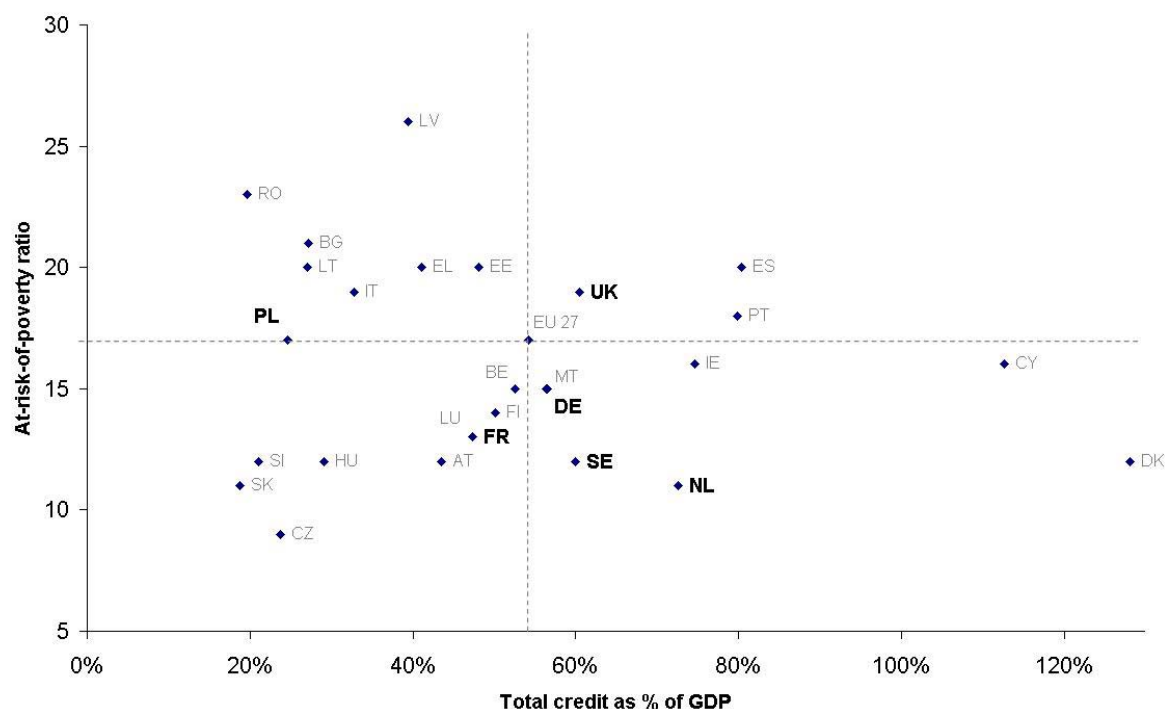
Table 46: Indicators of demographic structure and financial behaviour in selected countries

	GDP per capita (000's EUR)	Total credit (as % of GDP)	Gini Index	At-risk of poverty ratio*	Proportion of population facing arrears in payments***
DE	30.35	56%	30	15	6%
FR	31.27	47%	28	13	10%
NL	35.35	73%	28	11	4%
PL	9.47	25%	32	17	11%
SE	35.78	60%	24	12	6%
UK	29.67	72%	34	19	5%
EU 27	25.21	54%	31	17	10%

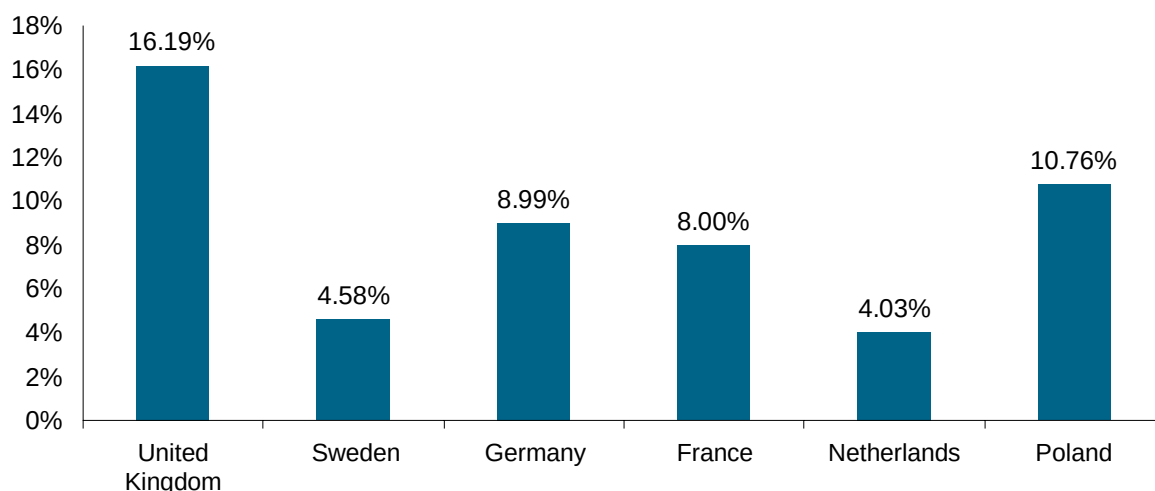
Sources: ECRI (2009), "Lending to Households 1995-2008", Eurostat, European Survey of Income and Living Conditions (EU-SILC). **Notes:** * Measured as a proportion of population whose income after social transfers is below the poverty threshold. The annual national at-risk-of poverty threshold in the EU is set at 60% of the national median income per equivalent adult (Eurostat, <http://epp.eurostat.ec.europa.eu/>). ** Measured in % of total population experiencing heavy financial burden from housing costs; *** Measured by % of total population facing arrears in payments on mortgage or rent, utility bills or hire purchase.

Figure 32 compares the selected countries with respect to their level of indebtedness and proportion of the population living below the poverty threshold. As can be seen from the figure, in most of the European countries less than one-fifth of the borrowers live below the respective country's poverty threshold. Thereby, the volume of total debt relative to GDP varies among European countries from less than 20% to more than 120% (in Luxembourg). Figure 32 further illustrates that the countries' level of indebtedness is not related to the share of the population being at-risk-of poverty. Furthermore, the figure illustrates the heterogeneity of the case study countries with regard to both measures. This heterogeneity allows for meaningful comparison of the impact of interest rate restrictions while accounting for relevant economic aspects.

Figure 32: Heterogeneity among relevant economic factors



Finally, the selected countries have different consumer credit regulation and, in particular, different levels and forms of IRR. Included in the study are Sweden and UK. Both of these countries have neither general usury limits nor interest rate restrictions. In contrast, in Germany and France regulations of consumer credit interest rates have been in effect for a long time. In Germany a court-based jurisprudence limits the interest rate charges on contractual interest for all consumer credits. Charging more than twice a certain benchmark rate or a premium of more than 12 percentage points above the benchmark rate (whichever is lower) is considered usurious. There is also a variable ceiling on default rates which lies at 2.5 percentage points above a published base rate for mortgage credits and 5 percentage points above the base rate for consumer credits. In France the ceilings are fixed at 133% of the 12 respective reference rate, which are differentiated by credit type and size. Despite their abovementioned similarities in financial behaviour, the Netherlands and Sweden experience different level of regulation. Whereas there are no IRR in Sweden, in the Netherlands a variable ceiling is set at 12 percentage points above a reference rate. Thereby a "legal interest rate" is implied which reflects the maximum rate to be charged in case the debtors are in arrears. In Poland interest rate caps were introduced in 2005. The ceilings are variable and are at the level of four times the National Bank of Poland's Lombard rate.

Figure 33: Consumer credit per GDP in a cross-country comparison

Source: ECRI (2009), "Lending to Households 1995-2008".

As can be seen from Figure 33, there is no obvious correlation between the existence of interest rate restrictions (red-coloured countries) and the aggregate volume of consumer credit relative to the country's GDP. Between both case study countries without existing interest rate regulation the difference is most obvious as UK has the highest and Sweden one of the lowest level of consumer credit indebtedness. That is why for the purposes of gaining an insight on the impact of interest rate restrictions the following in-depth analysis on the selected individual credit markets should be helpful.

2.4.2 Credit markets

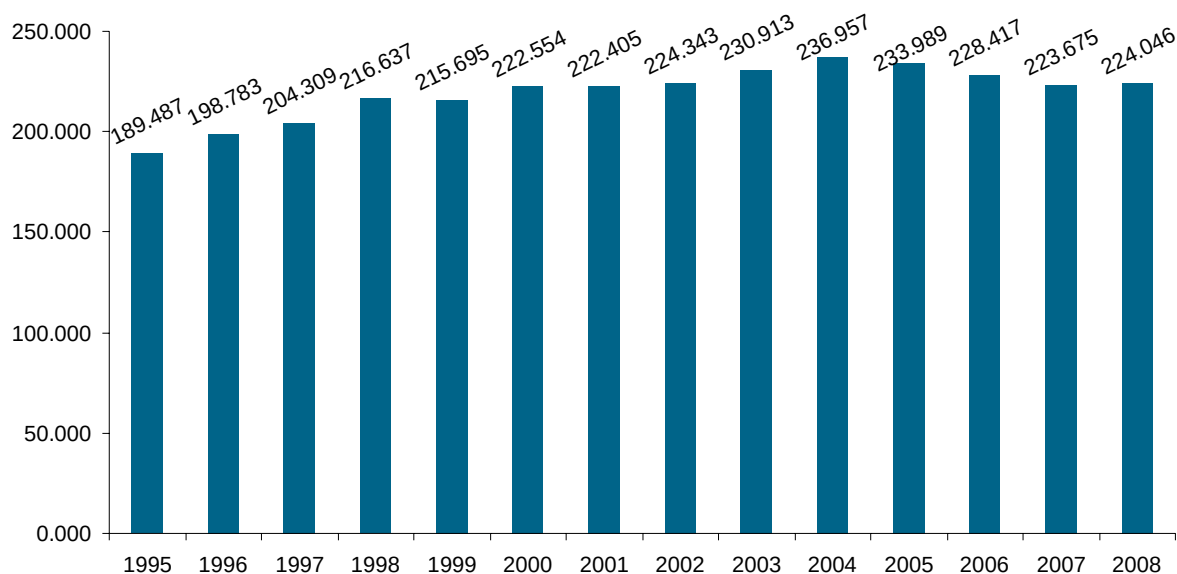
2.4.2.1 Germany

At the end of 2009, the German credit institutions lent EUR 227.5 billion to consumers for their consumption purposes.¹⁹³ This represents an increase of 1.5% compared to the previous year. In 2009 instalment credit grew for the first time since 2004. The volume of instalment credit grew by 7.5% to EUR 142 billion. Revolving credit, which includes overdrafts and credit cards, grew by 7.1% to EUR 85.4 billion.

¹⁹³ Housing loans are excluded.

2.4.2.1.1 Overview

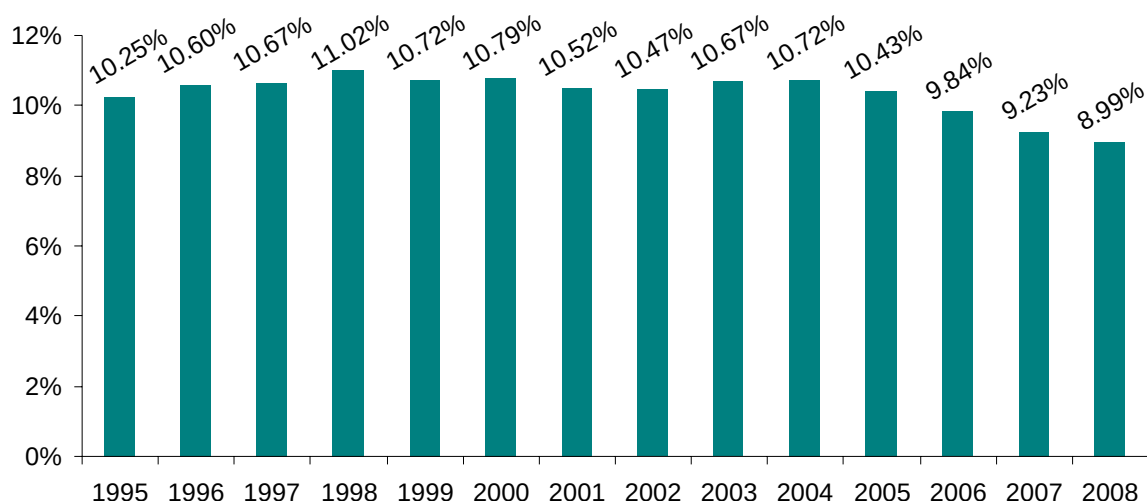
Figure 34: Consumer credit outstanding; Germany, EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

Between 1995 and 2008 consumer credit in Germany grew from EUR 189.5 billion to EUR 224 billion (ECRI (2009), Figure 34), although the growth slowed down somewhat during 2006-2008. In 2009 the German credit institutions lent to consumers EUR 227.5 billion for consumption purposes (Börsen-Zeitung, 2010), 1.4% more than in the previous year. In 2008 consumer credit in Germany was almost 9% of GDP (Figure 35), which is slightly above the European average of 8.75% (ECRI, 2009).

Figure 35: Consumer Credit as % of GDP, Germany



Source: ECRI (2009), "Lending to Households 1995-2008".

Figure 36 shows nominal growth rates of consumer credit in Germany. The growth rates vary from 6% in 1998 to -2.3% in 2006. Years 1999, 2001, and 2005-2007 saw negative growth rates in the volume of consumer credit outstanding.

Figure 36: Growth of consumer credit, Germany; % p.a.



Source: ECRI (2009), "Lending to Households 1995-2008".

Private consumption, which forms the basis for the consumer credit market, stood at EUR 1,414.7 billion and grew by about 0.4%. This amounts to about 9.0% of GDP and suggests significantly lower levels of consumer debt than in the USA and the UK where this figure stood in 2008 at 18.2% and 16.2%, respectively. More than half of the consumer credit is directed to the purchase of cars. In 2009, new and used cars accounted for EUR 17.3 billion. In second place with 36% are cash loans in the form of instalment or revolving credit intended for free use by the consumer. In third place with 9% are loans on furniture, home appliances, and consumer electronics. Other vehicles such as mobile homes and motorcycles make up 2%.

2.4.2.1.2 Types and dynamics of consumer credit

Information in this section is drawn on the annual reports of Bankenfachverband (various issues), unless indicated otherwise and relates to the segment of consumer credit market covered by its participating institutions. The 58 credit banks of the Bankenfachverband finance private consumption and commercial investments, above all, motor vehicles.¹⁹⁴ The banks represented by Bankenfachverband account for about 48% of the overall consumer instalment credit (Bankenfachverband, 2009).

Credit banks that are members of Bankenfachverband finance private consumption by means of instalment credit (93%) and revolving credit (7%). While the volume of instalment loans in 2009 grew by 14.4%, the volume of revolving credit declined by 19.0%. The number of new contracts has increased by 15.5% in 2009 to 9.1 million. Contracts for instalment loans grew by 37.7%, driven largely by car-dealerships and consumer-electronics stores. The number of revolving credit contracts declined by 16.1%.

According to the research conducted by the Bankenfachverband and GfK Financial Market Research more than one in three households uses instalment loans, overdrafts (*Dispokredit*) or other form of financing in order to acquire consumer goods such as cars, furniture or household appliances. In September 2009, 38% of households took

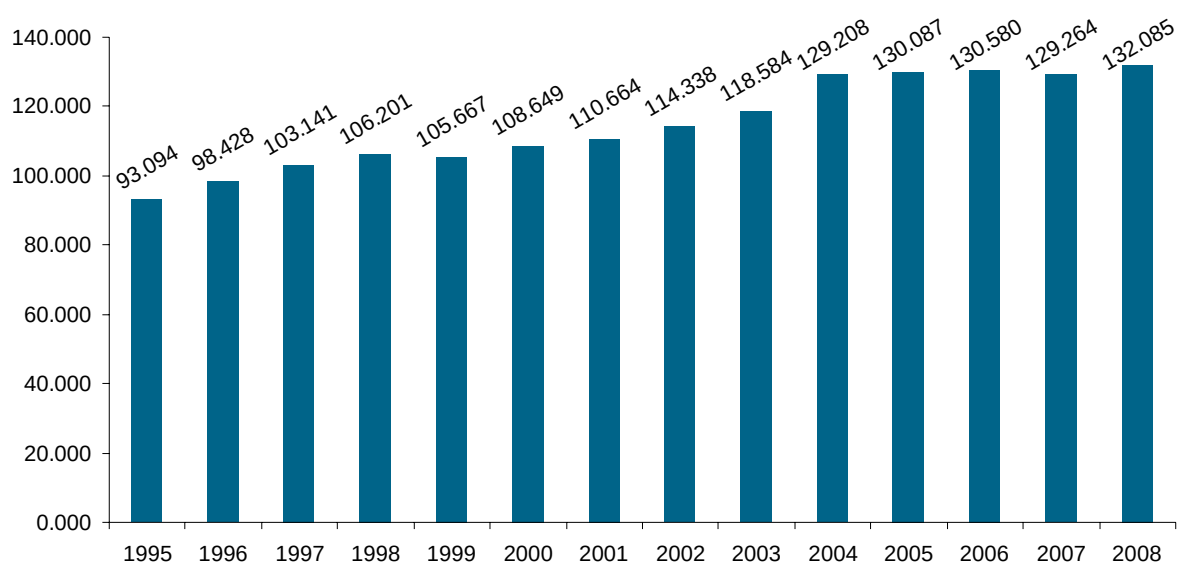
¹⁹⁴ <http://www.bfach.de>.

advantage of at least one type of financing. The volume of consumer credit for purposes such as furniture, electronic equipment, washing machines etc. constituted EUR 33.5 billion and increased by 11.3% in comparison with the previous year. The point-of-sale financing (*Finanzierungen am Verkaufspunkt*) constituted EUR 21.4 billion. This form of consumer credit has shown the highest growth rate of 22.9% in comparison to the previous year (Börsen-Zeitung, 2010).

Instalment credit. The most popular form of the consumer credit is instalment credit. About 28% of consumers make use of an instalment credit to finance private consumption.¹⁹⁵ On average, German consumers pay monthly instalments of around EUR 250 to repay their loans. Ten percent of consumers choose other forms of financing such as the overdraft (Dispokredit), revolving credit (*Rahmenkredit*, eg. credit cards) or leasing.

During the period between 2004 and 2008 instalment credit grew slowly (Figure 18). In 2009 instalment credit has grown for the first time since 2004. In 2009 the volume of instalment credit grew by 7.5% to EUR 142 billion.

Figure 37: Instalment credit; Germany; EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

Automotive credit. Nearly one in three private cars is financed entirely or partially by credit. Accordingly to a survey conducted by GfK Financial Market Research more than two-thirds of customers who purchase goods on credit would not be able to finance their purchase otherwise. This suggests that about 20% of private cars would not be sold without customers having access to credit. As car prices represent anything but insignificant amounts (the average price of a new car is about EUR 21,000 and the average price of a used car is about EUR 11,200), a growing number of car buyers recourse to credit. Two-thirds of all consumers who plan to acquire a car until 2011 can imagine purchase it on credit. Instalment credit is again the first choice of the financing mode. 18% of consumers would use leasing or choose another form of third-party financing. In the case of used cars instalment credit with a share of 84% is by far the most important form of financing. The volume of automotive finance for acquisition of

¹⁹⁵ The cost of a consumer good is divided into instalments that can be repaid monthly. The consumer can secure credit either directly at a bank branch or online. Additionally, consumer can access credit in form of financing deals from car dealers.

private vehicles in 2009 stood at EUR 17.9 billion and grew by 19.2% in comparison with the previous year (Börsen-Zeitung 2010).

Point-of-Sale Financing. Point-of-sale (POS) financing represents an important segment of consumer credit. Besides the financing vehicles, the POS transactions included goods such as furniture and consumer electronics. The volume of POS transactions stood at EUR 21.4 billion at the end of 2009 and grew by 22.9% in comparison to the previous year. Two-thirds of the goods bought on credit at the point-of-sale are instalment credits, the rest are cash loans from the banks. In 2009, the average amount of a cash loan was EUR 8,350 (EUR 8,200 in 2008) with an average duration of 50 months (53 months in 2008).

Table 47: Consumer credit market; Germany; 2009

	EUR billion	Change to previous year, %
New Business	33.5	11.3
Instalment Credit	31.3	14.4
Point-of-Sale Financing	21.4	22.9
Cash loans	9.9	0.6
Other Credit	2.2	-19
Revolving credit	1.8	-20.5
Credit cards	0.4	-20.2
New contracts (million)	9.1	15.5
Stock (at 31.12.2009)	73.9	11

Source: Bankenfachverband (2009). The data relates to the segment of consumer credit market covered by institutions participating in Bankenfachverband.

As Table 47 shows, the crisis situation observed in the other credit market segments did not appear to have significantly affected the instalment credit granted by the credit banks participating in Bankenfachverband, which grew by 14.4% in 2009. Figures presented in Table 43 reflect the broader trend observed in the German consumer credit market. The instalment credit in Germany showed robust growth of 7.5% in 2009 (Börsen-Zeitung 2010).¹⁹⁶

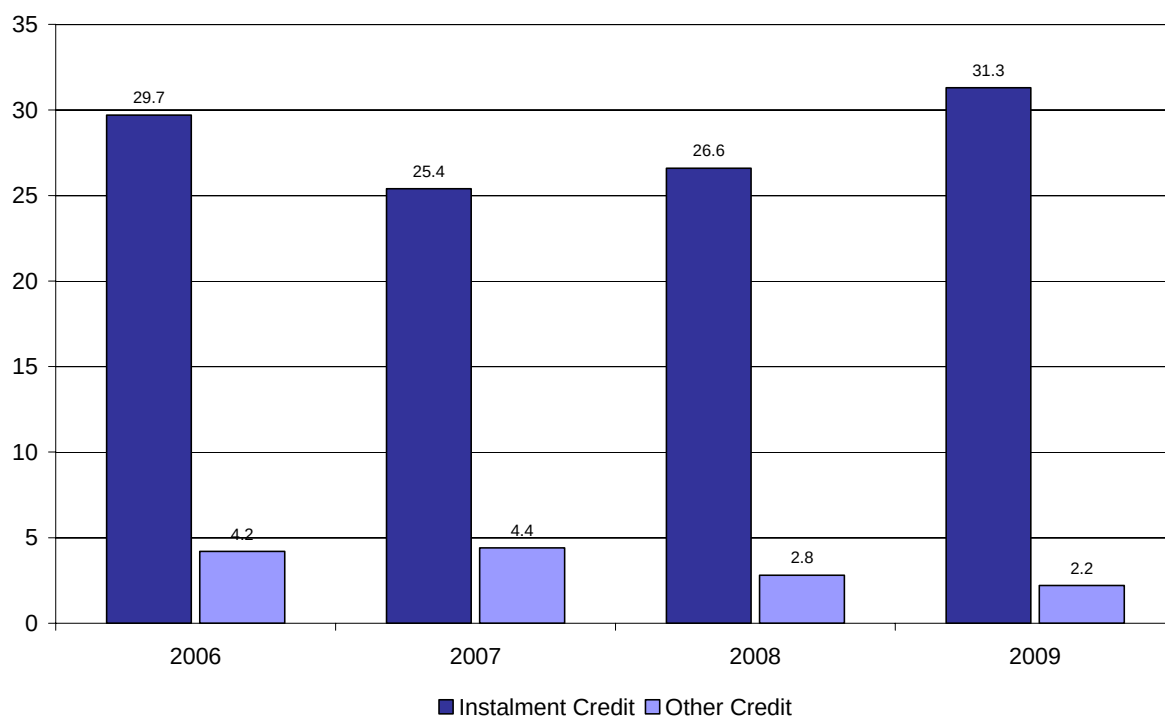
Figure 38 to Figure 40 below show information about the segment of consumer credit market served by the credit banks which are members of the Bankenfachverband. The data show the dynamics of this segment of the consumer credit market from 2006-2009 and a break-down into the instalment and revolving credit categories. As we can see from Figure 38, the majority of consumer credit granted by banks takes the form of instalment credit (93.4% of the overall new business volume at the end of 2009). Within instalment credit, which at the end of 2009 stood at EUR 31.3 billion, EUR 21.4 billion or 68.3% is accounted for by point-of-sale credit (Figure 39). The fraction of point-of-sale financing in the overall volume of instalment consumer credit fluctuated between 72.4% (2006) and 64.4% (2008). Finally, the volume of other credit between 2006 and 2009 declined from EUR 4.2 billion to EUR 2.2 billion (Figure 38). The other credit is dominated by the

¹⁹⁶ Revolving credit includes overdrafts and credit cards.

revolving credit (*Rahmenkredit*), which in 2009 accounted for 81.8% of the overall other credit.

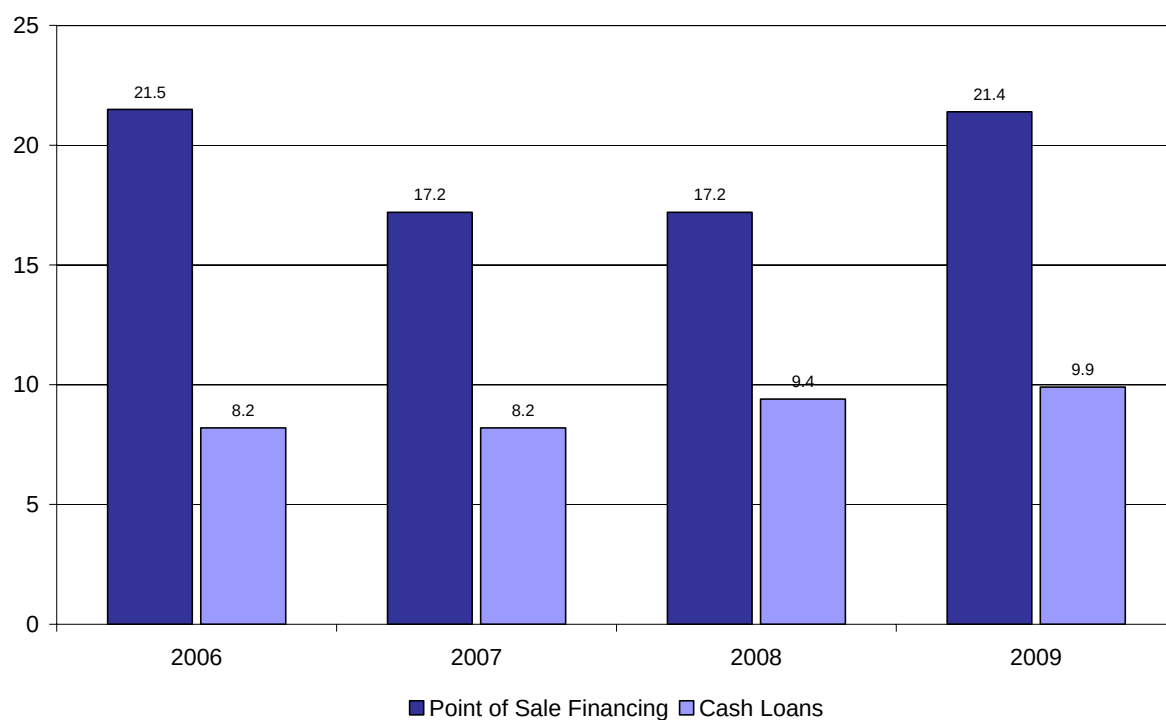
It should be pointed out that the volume of new business for credit cards has been declining steadily in the last four years. While in 2006 the credit card new business volume stood at EUR 1.7 billion, in 2009 it declined to only EUR 0.4 billion.

Figure 38: Consumer credit in Germany; Dynamics of instalment credit vs. other credit; 2006-2009; new business; EUR billion



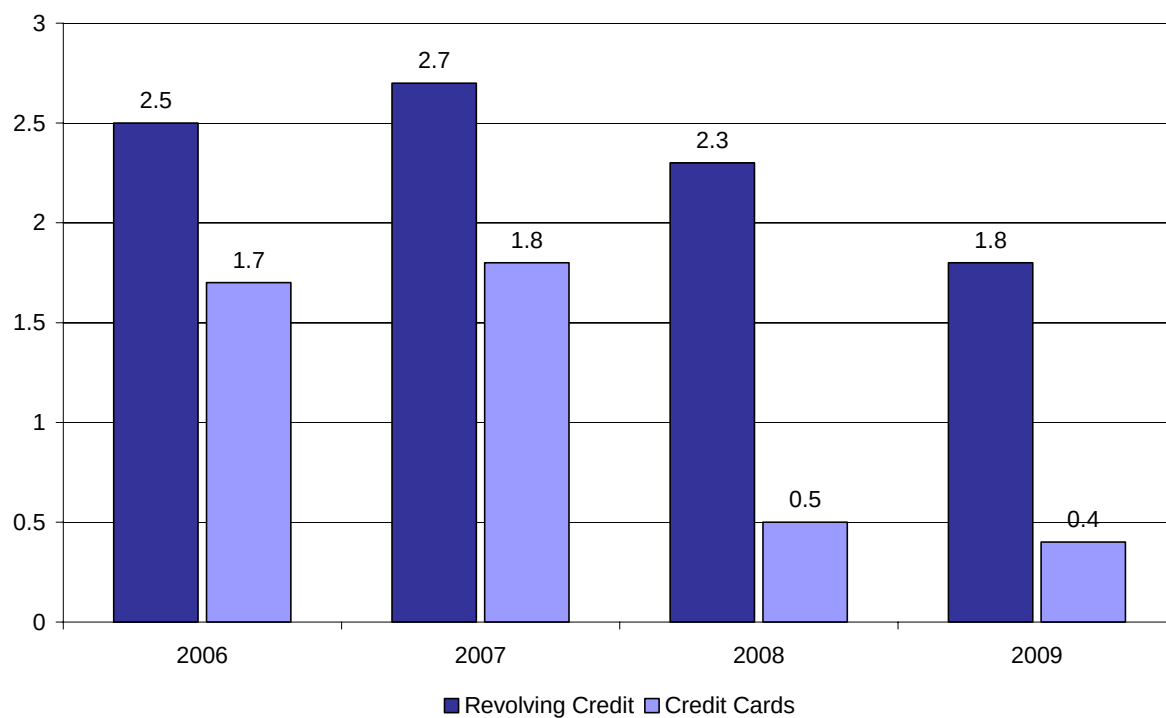
Source: Bankenfachverband Annual Reports, various issues, <http://www.bfach.de>.

Figure 39: Consumer credit: Dynamics of instalment credit; Germany; 2006-2009; new business
EUR billion



Source: Bankenfachverband Annual Reports, various issues, <http://www.bfach.de>.

Figure 40: Consumer credit: Dynamics of other credit; Germany; 2006-2009; new business,
EUR billion



Source: Bankenfachverband Annual Reports, various issues, <http://www.bfach.de>.

2.4.2.1.3 Pawn Broker Credit

Pawn broker credit in Germany is provided by around 200 entities, members of the German Association of Pawn Brokers (ZDP, 2009). According to Dischinger and Mögel (2004), in 2003 1.9 million contracts for a value of EUR 450 million were issued by the 230 pawn broking entities. The volume of pawn broking credit amounted to about only 0.2% of the total consumer credit in Germany in that year. The reported number of customers in 2000 was 160,000 or about 2% of indebted households in that year (Dischinger and Mögel, 2004).

Pawn broking credit has grown in popularity in the recent years due to a number of factors, including quick and easy process of granting credit (only a personal ID or passport is required); creditworthiness of the customer need not to be checked; values of credit can range from quite small (EUR 50) to relatively large (EUR 10,000); the duration of credit is flexible and is determined by the customer; the credit can be extended on the wish of the customer upon payment of the due interest and fees; there are no penalties for early repayment of credit.

After evaluation of the collateral by the pawn broker a credit that typically amounts to about 80% of the resale value of the collateral is granted. In 2002 an average value of the pawn broker credit was EUR 230 (Dischinger and Mögel, 2004). Interest rate amounts to 1% per month. Additionally, a customer pays a fee for storage, insurance and administration in accordance with the regulation. Dischinger and Mögel (2004) report that in 2002 the interest and fees for an average credit of EUR 230 amounted to 36% per annum.

2.4.2.1.4 "Kredite ohne SCHUFA-Auskunft"

"Kredite ohne SCHUFA(-Auskunft)" also known as "SCHUFA-frei" credit is unsecured credit granted by non-bank credit providers without check of the borrower's credit record with SCHUFA.¹⁹⁷ Consumers are often those, who were not able to obtain credit from mainstream banks. Some credit providers in Switzerland focus specifically on clients with already existing debt. High default risk associated with such credit is compensated by higher costs. Since opportunity to charge extremely high level of interest is limited in Germany due to legal provisions against usury interest rates, providers compensate for their risks by charging additional fees, such as commission and administrative fees. Often these fees are charged upfront, before the decision about granting credit is taken. In case an agent visits customer at home, an additional fee is charged for this service. Some companies resort to communicating the decision about granting of credit via phone, using the high-cost numbers 0190/0900. This results in customer incurring additional costs even if credit is not granted.¹⁹⁹ While we do not have data on the precise number of consumer using "SCHUFA-frei" credit, Der Spiegel (2007) reports that the number of enquiries regarding granting a credit stands at 400,000 customers per year.

2.4.2.1.5 Summary statistics

Summary statistics on the distribution of consumer credit in Germany by type are presented in Table 48. The figures refer to the overall German consumer credit market. However, provided figures in the table should be treated with caution, since in a number

¹⁹⁷ SCHUFA stands for *Schutzgemeinschaft für allgemeine Kreditsicherung*. The company was founded in 1927 (www.schufa.de). Nowadays SCHUFA is one of the leading credit information agencies in Germany.

¹⁹⁸ However, Grote (2007) states that despite credit providers advertise otherwise, credit checks with SCHUFA or other assessment of consumer creditworthiness are made nevertheless.

¹⁹⁹ Grote (2007), Der Spiegel (2007). In one case phone call cost a customer who was refused credit about EUR80.

of cases they are based on estimates, due to absence of official statistics. The aim of the table is to provide information about the relative importance of the various types of credit existing on German market.

Table 48: Distribution of consumer credit; Germany, 2008

Type of credit	EUR billions	% of Total Credit	% of Consumer Credit
Total credit (including mortgages)	1406.30	100.00	
Mortgages	787.30	55.99	
Consumer credit, out of which...	224.05	22.15	100.00
...Installment credit, out of which...	132.09	13.06	58.95
... .. Point-of-sale financing*	85.86	8.49	38.32
... Automotive credit**	15.02	1.48	6.70
...Debit balances on wage, salary and pension accounts	17.06	1.69	7.61
...Other (residual)***	74.90	7.41	33.43
...Revolving Credit****	79.74	7.88	35.59
... ..Credit Cards (new business), 2009*****	0.40	0.03	0.13

Source: ECRI (2009) unless indicated otherwise.

Notes: Percentages for consumer credit do not add up to 100 due to differing sources of the data.

* Estimate based on Bankenfachverband (2009).

** Estimate based on data in Börsen-Zeitung (2010).

*** Estimate based on data in Bankenfachverband (2009).

**** Estimate based on Börsen-Zeitung (2010).

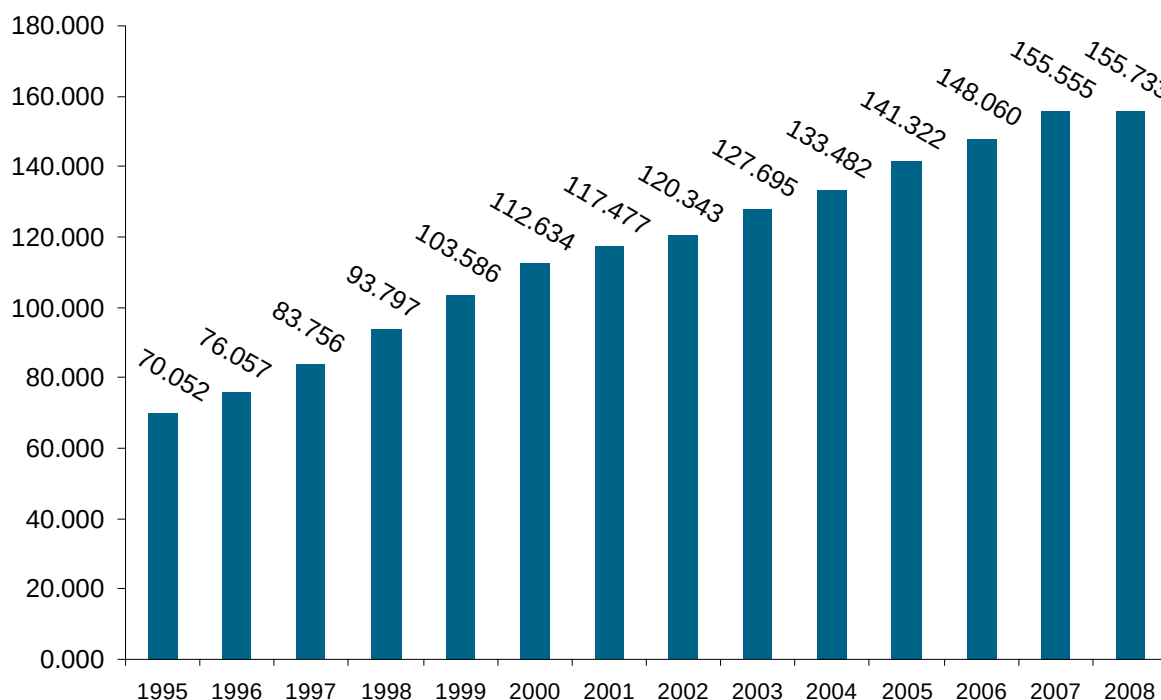
***** Estimate based on projected total credit to households for 2009.

2.4.2.2 France

2.4.2.2.1 Overview

The volume of consumer credit outstanding more than doubled during the last fourteen years. It grew from slightly more than EUR 70 billion to EUR 156 billion in 2008 (Figure 41). In 2008 French consumer credit market was the third largest market in the EU in terms of volume of consumer credit outstanding (see Table 6 above).

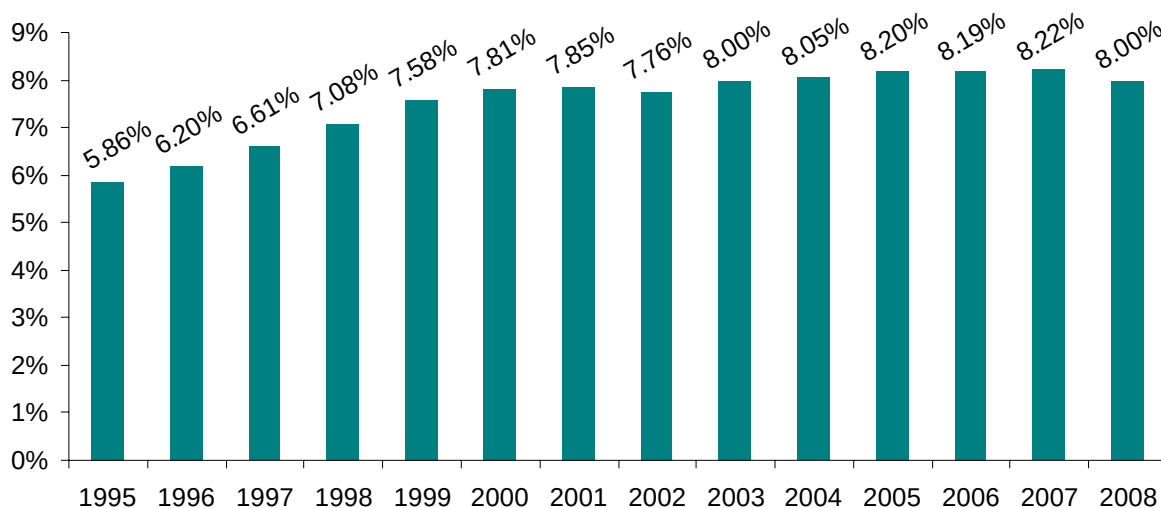
Figure 41: Consumer credit outstanding; France; EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

In relation to GDP volume of consumer loans grew from 5.9% of GDP to 8% of GDP (Figure 42). Thus in 2008 consumer credit as a fraction of GDP in France was slightly below the EU 27 average, which was 8.75% (ECRI, 2009).

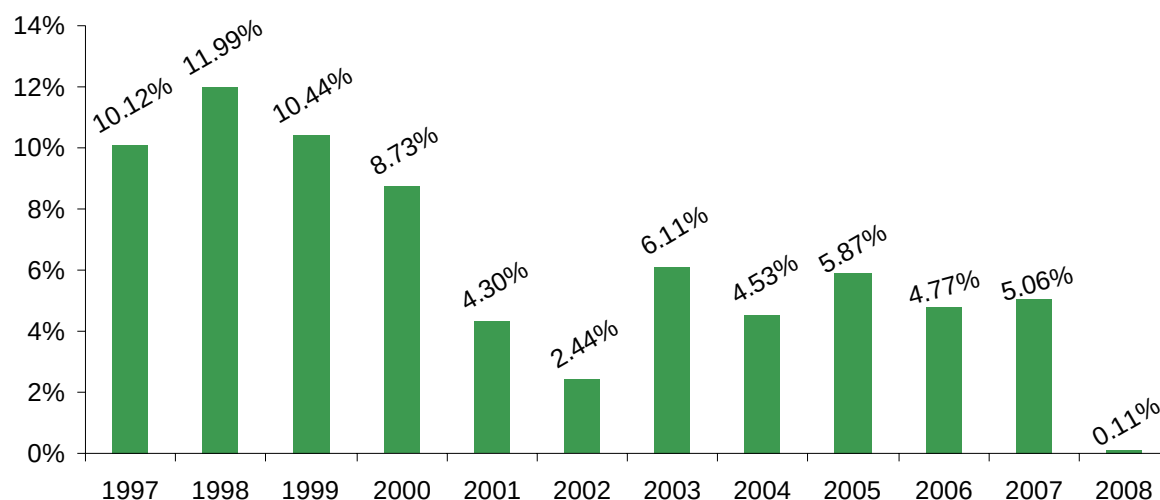
Figure 42: Consumer credit as % of GDP; France



Source: ECRI (2009), "Lending to Households 1995-2008".

Consumer credit grew rapidly in France between 1998 and 2000 (Figure 43). In 2001 growth slowed down sharply and continued showing lower rates until 2008 when it virtually was at zero level. This is in line with the situation among the EU 15, which saw a decline in consumer credit by about 5% in 2008.

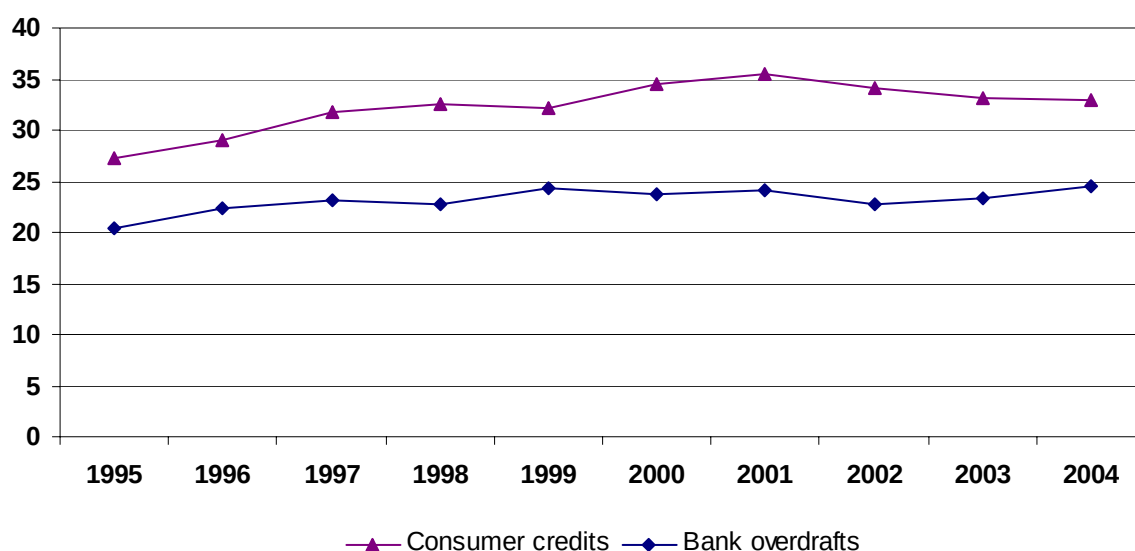
Figure 43: Consumer credit growth rates; France; %



Source: ECRI (2009), "Lending to Households 1995-2008".

According to BIPE (2006), in 2004 outstanding consumer credit to households in France accounted for around 18% of their total liabilities, which is expected to be close to the European average. Between 1995 and 2000, there was an increase of the share of credit consumption in total household liabilities of about 15% to 20%. Figure 44 shows the use of consumer credit and bank overdrafts by French households. Between 1995 and 2004 the fraction of French households using consumer credit fluctuated between 27% and 33%. The fraction of consumers using bank overdrafts remained within a 20%-25% range.

Figure 44: Evolution of the use of consumer credit and bank overdraft; France; % of total households

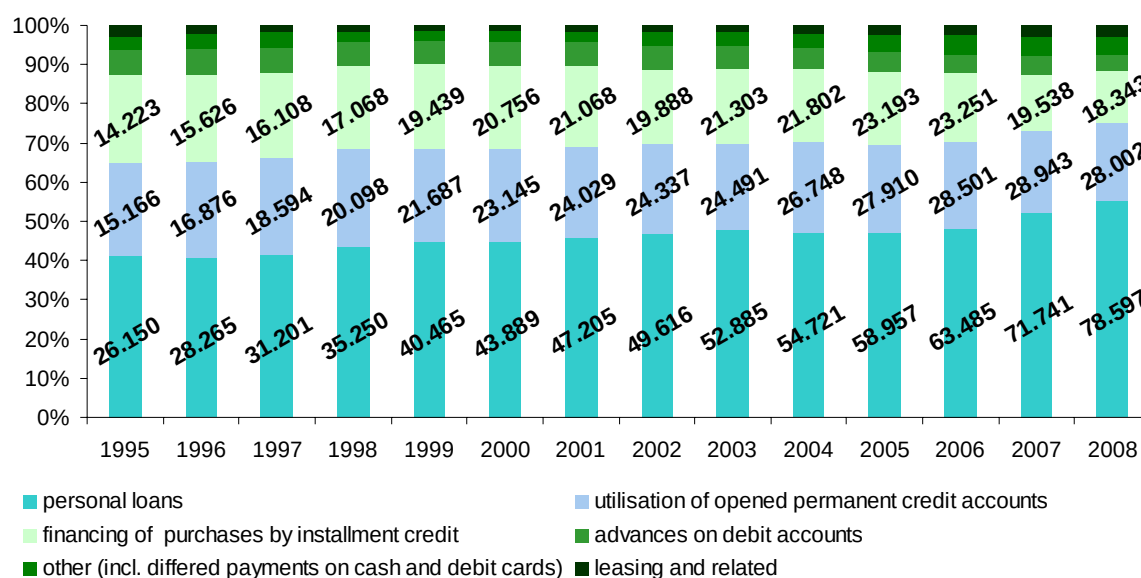


Source: BIPE (2006).

2.4.2.2.2 Types and dynamics of consumer credit

As we can see from Figure 45, the share of personal loans is very important. In 2008 personal loans constituted 55% of the total volume of consumer credit. Personal loans are followed by the credit accounts (20%) and instalment credit for financing of purchases (13%). Leasing and advances on debit accounts remain much less important forms of consumer credit in France (4% and 3% respectively). Estimates provided in BIPE (2006) suggest that the average duration of consumer credit in France is between 18 and 24 months. The comparable estimate for the the United Kingdom and Germany are 12 months and over 5 years, respectively.

Figure 45: Consumer credit by type; France; 1995-2008; EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

Accordingly to BIPE (2006), despite the growth of household debt, the debt burden (repayment of principal and interest relative to disposable income) during the past decade has only moderately increased. The reason is that increasing repayments were partially offset by lower interest rates (Table 49).

Table 49: Total debt burden of households; France

Type	1995	2004
Capital repayment	9.2	11.1
Housing loans	4.5	4.7
Consumer credit	4.7	6.4
Interest paid	4.2	3.2
Total debt burden	13.4	14.3

Source: BIPE (2006). Debt burden is measured as a repayment of principal and interest relative to disposable income.

Most popular uses of consumer credit in France are car purchases, house equipment, consumer bills and other expenses. At least 30% of purchases of new cars would be financed via credit (this may be an underestimation since this figure does not include

personal loans used to finance new cars). The average length of credit on new cars would be a little more than eighteen months, which is close to the average of all consumption loans (BIPE, 2006).

2.4.2.2.3 Summary statistics

Summary statistics on the distribution by type of consumer credit in France is presented in Table 50 which provides information about the relative importance of the various types of credit existing on French market.

Table 50: Distribution of consumer credit; France, 2008

Type of credit	EUR billions	% of total credit to households	% of consumer credit
Total credit (including mortgages)	921.17	100.00	
Mortgages	687.22	74.60	
Consumer credit of which...	155.73	16.91	100.00
...financing of purchases by installment credit	18.34	1.99	11.78
...advances on debit accounts	5.99	0.65	3.84
...personal loans	78.60	8.53	50.47
...utilisation of opened permanent credit accounts	28.00	3.04	17.98
...leasing and related	4.23	0.46	2.71
...other (incl. differed payments on cash and debit cards)	6.57	0.71	4.22

Source: ECRI (2009).

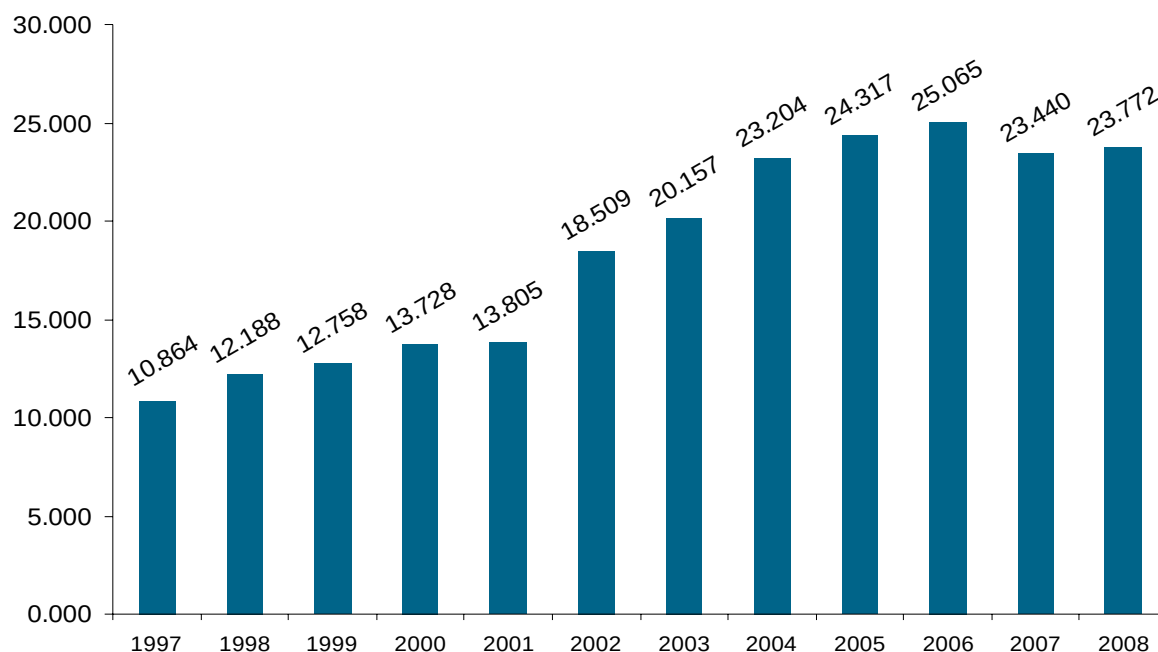
Notes: Percentages for consumer credit do not add up to 100.

2.4.2.3 Netherlands

2.4.2.3.1 Overview

The volume of consumer credit outstanding in the Netherlands in 2008 stood at the level of EUR 23.8 billion (Figure 46). This made Dutch consumer credit market the ninth largest in the EU. In nominal terms, the market has grown from EUR 10.9 billion in 1997 at nearly 120%.

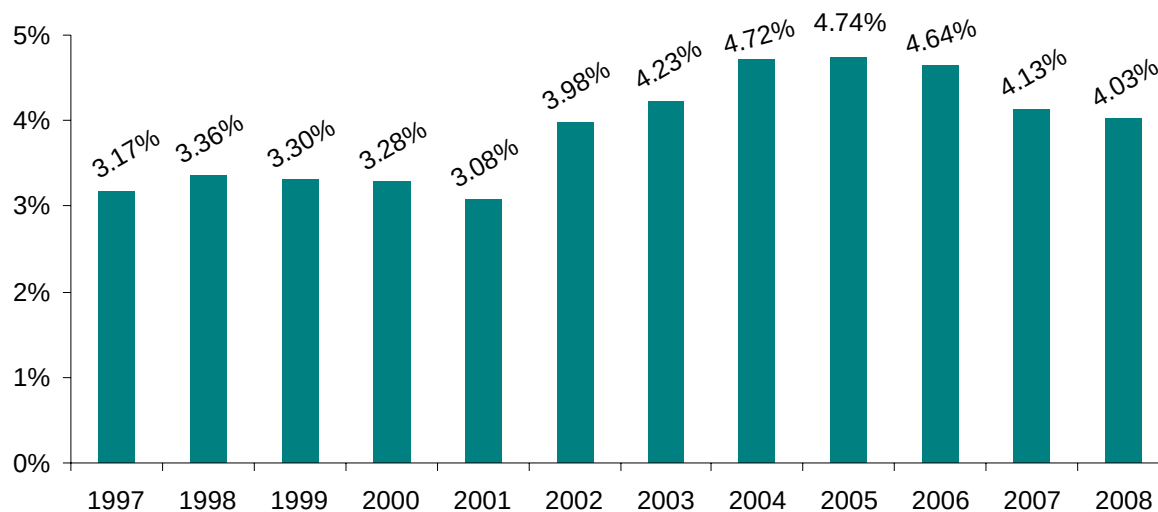
Figure 46: Consumer credit outstanding; Netherlands; EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

Loans to consumers in the Netherlands represented about 4% of the country's GDP (Figure 47). This is somewhat lower than the EU average of 8.75% in that year. It should be born in mind that consumer credit in this country accounts for only 5.6% of the overall lending to households. Loans to households are dominated by the housing loans which account for 89% of the overall household borrowing (see Figure 31 above). Accordingly, in 2008 Netherlands was the country with the highest proportion of housing loans (89%) and the lowest proportion of consumer credit (5.6%) in total credit to households in the EU.

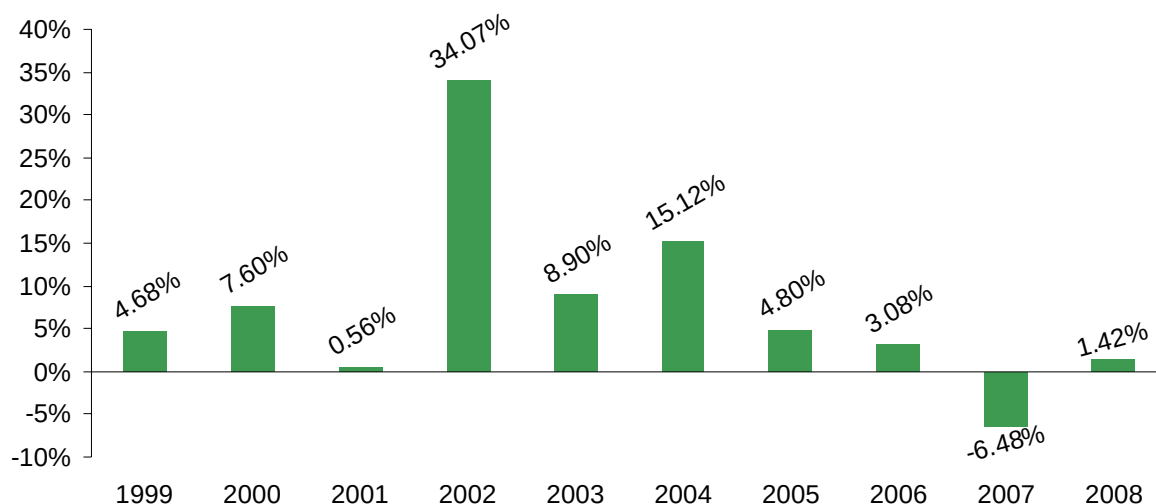
Figure 47: Consumer credit; the Netherlands; % of GDP



Source: ECRI (2009), "Lending to Households 1995-2008".

Figure 48 illustrates growth of consumer credit in the Netherlands during 1999-2008. As is the case of Germany and France, growth rates fluctuated during this period. Like in the other two countries, growth has slowed down starting from 2005 and was negative in 2007 (-6.5%).

Figure 48: Consumer credit growth; the Netherlands; % of GDP



Source: ECRI (2009), "Lending to Households 1995-2008".

2.4.2.3.2 Flitskrediet

In 2007 a new form of consumer credit was introduced in the Netherlands, the so-called Flitskrediet (Flash credit), which is represented by loans of less than one month maturity.²⁰⁰ Due to its short maturity, Flitskrediet was until recently not legally covered by any interest rate restrictions. A distinction of Flitskrediet is the short notice on which money is lent: a new customer can receive credit in less than 24 hours, a known customer even within 10 minutes.

Providers grant only 10% to 20% of all requests for loans. In 2007, the volume of Flitskrediet granted is estimated at 25.000 contracts with a total sum of EUR 6.0 million. This amounts to about 0.025% percent of the Dutch consumer credit market. The average loan size is 230 Euro, whereas most contracts have a loan sum of 100 Euro. The average maturity of the loan is 24 days.

According to the providers, customers are mostly employed persons with yearly or permanent employment contracts, who face unexpected expenses such as traffic fines or want to treat themselves to something special, who repay their debt after receiving their next salary. In this respect, this loan type is most similar to payday loans in the UK (Chapter 2.4.2.6) or SMS loans in Sweden (Chapter 2.4.2.5). According to branch organisations, its high costs make Flitskrediet a down-market product for consumers who have already depleted their other liquidity sources or have no other possibilities of credit access.

Table 51 shows the cost structure for Flitskrediet loans.²⁰¹ For example, the effective annual interest rate of a loan of 400 Euro for a period of 30 days amounts to 1200%. In

²⁰⁰ The information in this subsection is taken from IOO (2009).

²⁰¹ According to IOO (2009), this lower bound estimate, as some providers also charge eg. the costs of SMS that are received from the credit provider.

case of arrears, the customer usually has to pay an average of 10 Euro per reminder and all of the debt collection costs.

Until June 2009 five competitors entered the market. According to IOO (2009), providers do not yet break even. One of the reasons is the high startup costs of the young business, but mostly the high costs for employees' salary, write-offs and advertising. At the current demand for loans, the incurred fees per loan would have to be at 37% per loaned Euro to break even. IOO (2009) points out that the extension of existing interest rate restrictions to Flitskrediet would likely close down this market.²⁰² The government has announced that the maximum interest rates will apply also to flash credits.

Table 51: Cost structure of Flitskrediet

		Fee in Euro			Fee as percentage of loan		
Maturity(days)		15	21	30	15	21	30
Loan, EUR	100	20	19	25	20	19	25
	200	40	38	50	20	19	25
	300	60	57	75	20	19	25
	400	80	76	95	20	19	23.8
	500		95	125		19	25
	600		114			19	
	750		142.5			19	

Source: IOO (2009).

2.4.2.3.3 Summary statistics

Summary statistics on the distribution of consumer credit in the Netherlands by type is presented in Table 52. The aim of the table is to provide information about the relative importance of the various types of credit existing on Dutch market.

Table 52: Distribution of consumer credit; the Netherlands, 2008

Type of credit	EUR billions	% of total credit to households	% of consumer credit
Total credit (including mortgages)	428.693	100.00	
Mortgages	382.190	89.15	
Consumer credit, out of which...	23.772	5.55	
Flitskrediet	0.0004	0.001	0.002

Source: ECRI (2009), IOO (2009).

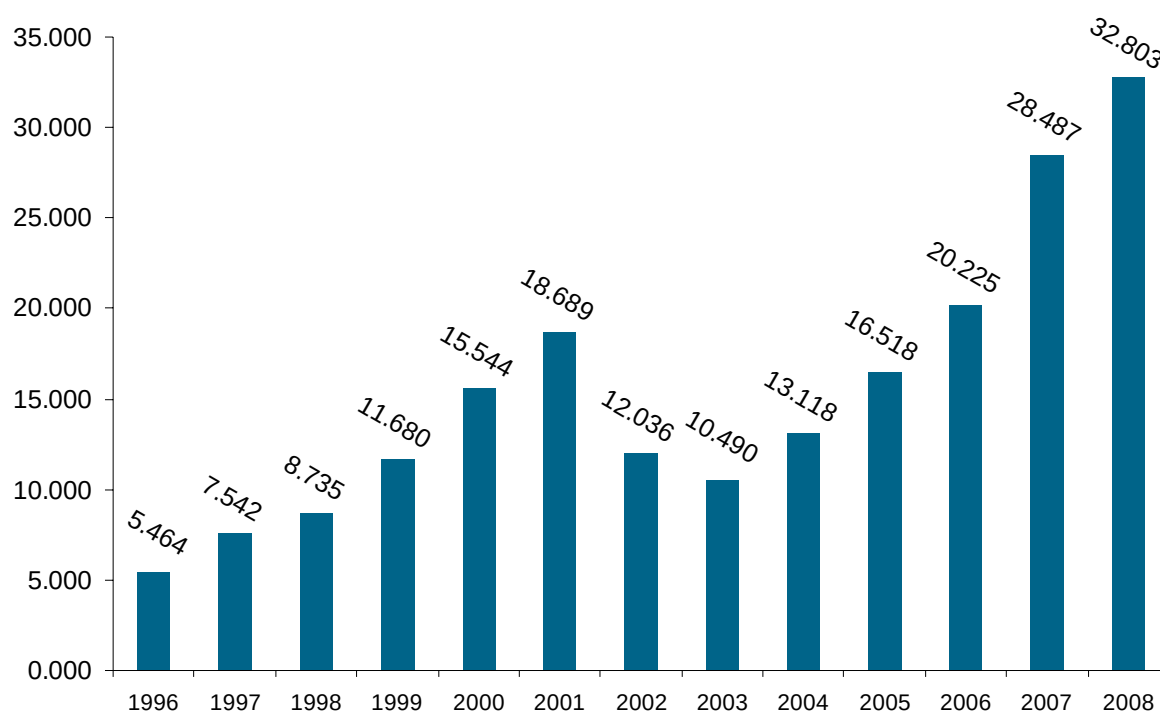
²⁰² It points out that an interest rate cap of 18 % translates into a maximal fee of 1.37 euro for a 30-days loan or 0.68 Euro for a 15-days loan, which can hardly cover the providers' communication costs.

2.4.2.4 Poland

2.4.2.4.1 Overview

During the period from 1996 to 2008 volume of consumer credit in Poland increased six-fold from EUR 5.5 billion to EUR 32.8 billion (Figure 49). This remarkable growth propelled Poland to the sixth largest consumer credit market in the EU in 2008.

Figure 49: Consumer Credit Outstanding; Poland; EUR billion

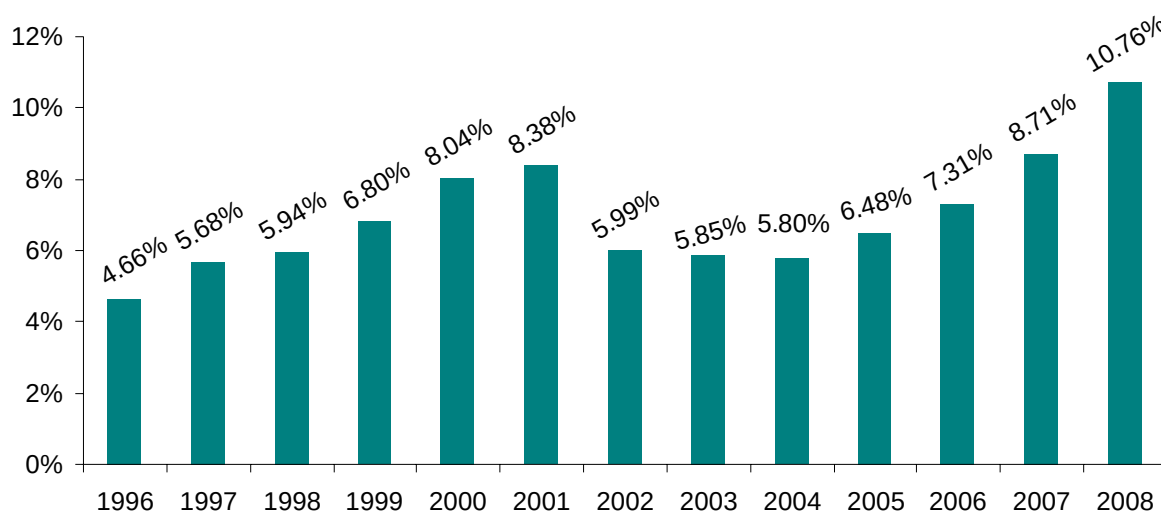


Source: ECRI (2009), "Lending to Households 1995-2008".

Consumer credit has also been rapidly increasing in proportion to Poland's GDP: from about 4.7% in 1996 to about 10.8% in 2008 (

Figure 50). The latter figure is above the EU average of 8.75%.

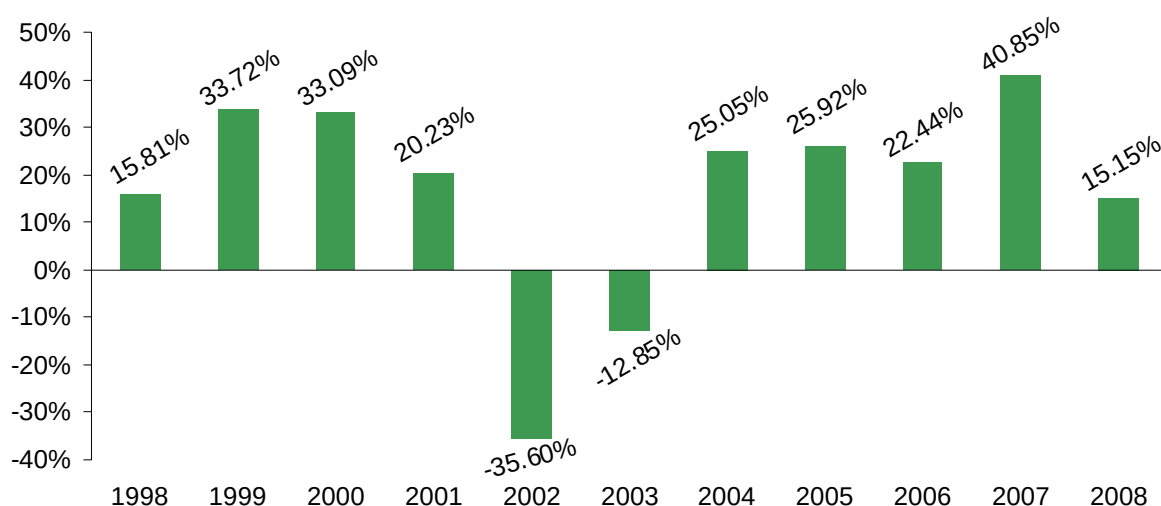
Figure 50: Consumer credit; Poland; % of GDP



Source: ECRI (2009), "Lending to Households 1995-2008".

With the exception of two years (2002 and 2003), annual growth of consumer credit in Poland has been high, always above 15% with the exception of the aforementioned two years when growth was negative (Figure 51). The growth rate in 2008 was well above the EU 27 average and somewhat below the average of the New Member States, which were -5% and 17.9%, respectively. Pruski and Zochowski (2006) cite increased creditworthiness of individuals due to higher disposable income, upward adjustment of income expectations and favourable interest rate environment as demand-side reasons for the growth of credit to households in Poland. On the supply-side, easing of bank lending policies due to increased competitive pressures, development of additional loan distribution channels by banks and attractive profit margins contributed to the growth of credit to households.

Figure 51: Consumer credit growth; Poland; % p.a.



Source: ECRI (2009), "Lending to Households 1995-2008".

2.4.2.4.2 Types and dynamics of consumer credit

Białowolski (2009) reports that the volumes of cash loans, credit card and installment credit in Poland are PLN33 billion (EUR 8.4 billion), PLN14 billions (EUR 3.5 billion) and PLN10.5 billions (EUR 2.7 billion) respectively. Figure 52 highlights the rapid increase in the use of two forms of credit in Poland: loans on current accounts and credit card credit. In particular, credit cards credit in Poland grew from virtually zero in 1996 to EUR 3 billion in 2008.

Figure 52: Types of consumer credit; Poland



Source: ECRI (2009), "Lending to Households 1995-2008".

2.4.2.4.3 Home Credit in Poland²⁰³

In contrast to the UK, where home credit is primarily targeted at credit impaired customers, in Poland the most important customer base for home credit are people without a bank account and hence no credit score. To evaluate the scope of home credit in Poland, one may take 857,000 customers of the dominant provider (early 2010) as a lower bound.

The average size of a home loan in Poland is EUR 385, which is higher than the average loan size in other Central and Eastern European countries where Provident operates (EUR 349). Loans can be granted for 26, 39 or 52 weeks (which correspond to 6, 9 and 12 months respectively). To qualify for a loan, customers must receive an income from employment, which includes income from being self-employed, and every type of other self-reported income. New customers may not obtain a loan exceeding EUR 150-200. Customers may be granted a maximum of two loans at a time with the total amount outstanding not exceeding EUR 500. The average interest rate is about 20%. The customer may choose to either service the loan through their bank account or through cash repayments returned to an agent visiting them at home. These two options entail different pricing structures. In case of collecting repayments at home, a convenience fee is charged for calling at customer's home when collecting weekly payments. No default charges are applied and the repayment schedule is usually flexible in that it is easy for a customer to postpone a payment. In case a loan is serviced through the customer's bank

²⁰³ The information in this section is drawn from an interview with Provident Polska, the main provider of home credit in Poland (http://www.ipfin.co.uk/pages/key_milestones), unless indicated otherwise.

account, no convenience fee is charged, but default charges apply in case of arrears. The home collection convenience fee and default charges in case of a loan serviced through the bank account were introduced subsequently to the introduction of the interest rate ceilings on borrowing rates in Poland in 2005. Most of customers (75%) are reported to come back for the next loan within one year.

2.4.2.4.4 Summary statistics

Summary statistics on consumer credit distribution by type is presented in Table 53. The aim of the table is to provide information about the relative importance of the various types of credit existing on the Polish market.

Table 53: Distribution of consumer credit; Poland, 2008

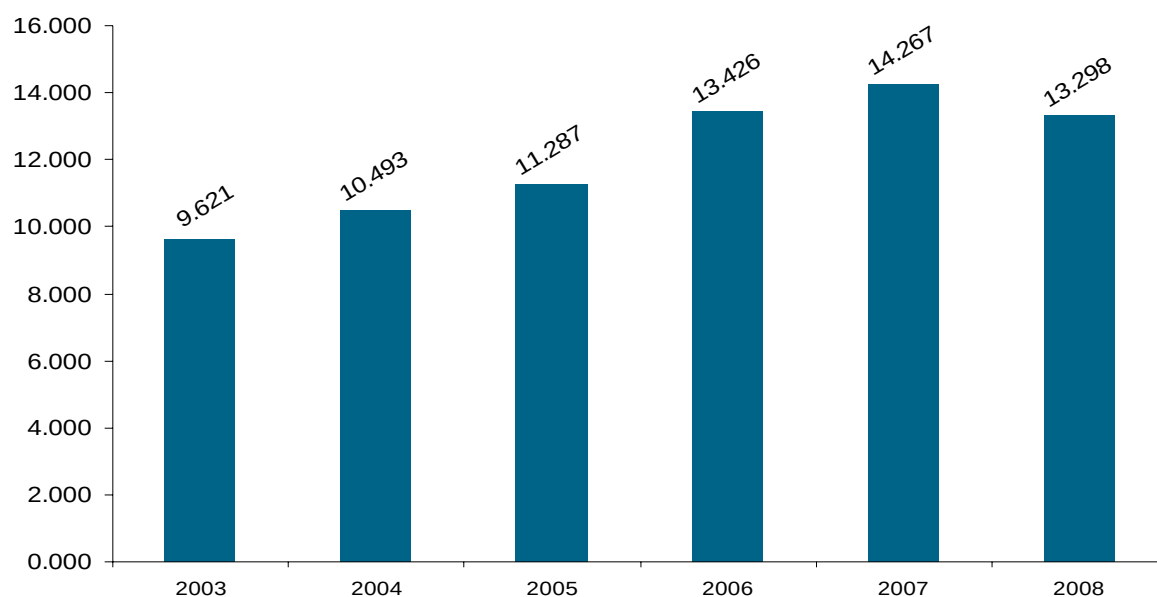
Type of credit	EUR billions	% of total credit to households	% of consumer credit
Total credit (including mortgages)	88.90	100.00	
Mortgages	46.37	52.16	
Consumer credit of which...	32.80	36.90	100.00
...loans on current accounts	4.99	5.61	15.22
...loans related to credit cards	3.05	3.43	9.29
...other (including hire purchases)	24.76	27.85	75.49

Source: ECRI (2009).

2.4.2.5 Sweden

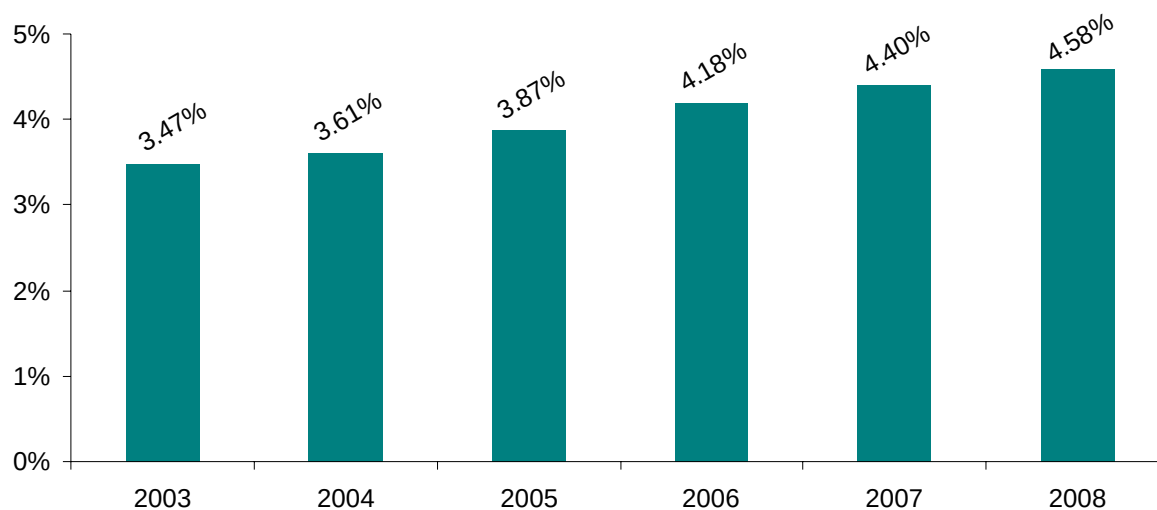
2.4.2.5.1 Overview

The volume of consumer credit in Sweden in 2008 stood at EUR 13.3 billion, making it a medium-size market, ranked 15 among the EU 27 countries. Like in other EU countries, the volume of consumer credit in Sweden grew during the last decade: in 2003 the volume outstanding was EUR 9.6 billion.

Figure 53: Consumer credit outstanding; Sweden, EUR billion

Source: ECRI (2009), "Lending to Households 1995-2008".

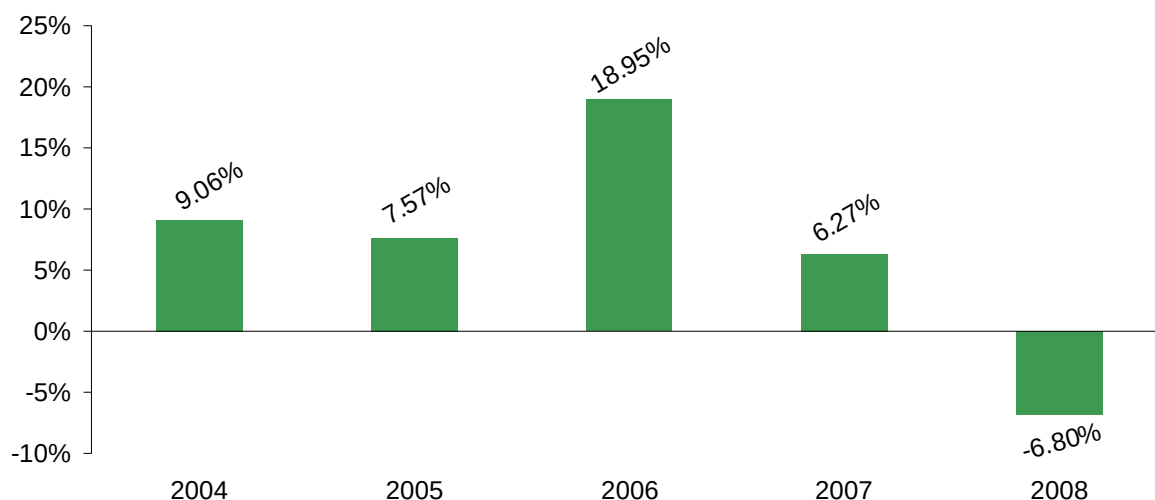
Consumer credit in Sweden is less important for the economy than in other EU Member States. The ratio of the volume of consumer credit to GDP stood at 4.6% in 2008, which is well below the EU average of 8.75% (Figure 54). Since 2003 the importance of consumer credit remained roughly the same: in 2003 the ratio had a value of 3.5%.

Figure 54: Consumer credit; Sweden; % of GDP

Source: ECRI (2009), "Lending to Households 1995-2008".

Figure 55 shows growth rates in consumer credit between 2004 and 2008. Like in case of other European countries, we observe a declining credit growth in 2007 (from almost 19% in 2006 to 6.3% in 2007) and even negative growth in 2008 (-6.8%).

Figure 55: Consumer credit growth; Sweden; % p.a.



Source: ECRI (2009), "Lending to Households 1995-2008".

2.4.2.5.2 SMS loans

Spring of 2006 saw an introduction of a new form of consumer credit in Sweden, SMS loans. Companies that offer SMS loans do not have to perform a credit check which extends easy credit access to low-income individuals. Accordingly to some estimates, many SMS loans are below EUR 200. Another source reports that the loans on average amount to 3,000 kronor (EUR 313). The loans come with average fees of 500 kronor (EUR 52) and interest payments of 50 kronor (EUR 5.2). The loans are usually repaid during a rather short period of time, such as 30 days. SMS loans quickly became popular among younger groups of population.²⁰⁴

2.4.2.5.3 Summary statistics

Summary statistics on the distribution of credit to households in Sweden by type is presented in Table 54. The aim of the table is to provide information about the relative importance of the various types of credit existing on the Swedish market.

Table 54: Distribution of consumer credit; Sweden, 2008

Type of credit	EUR billions	% of total credit to households
Total credit (including mortgages)	196.87	100.00
Mortgages	128.41	65.22
Consumer credit	13.30	6.75

Source: ECRI (2009).

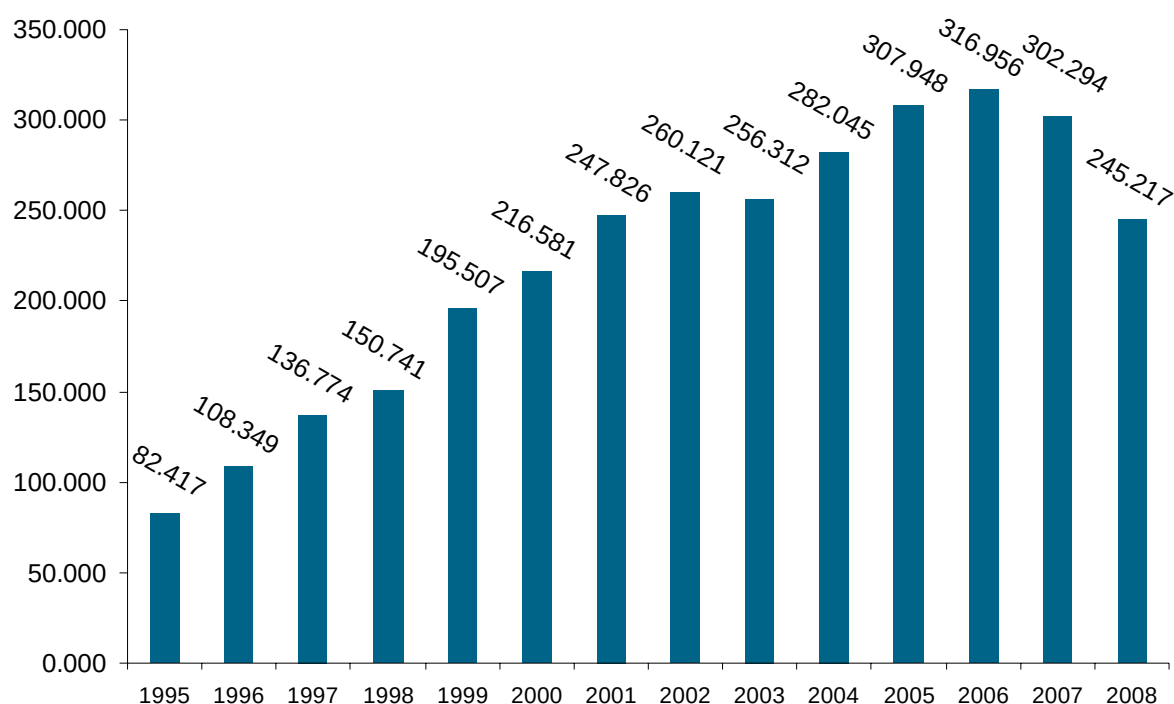
²⁰⁴ <http://www.thelocal.se/>.

2.4.2.6 United Kingdom

2.4.2.6.1 Overview

The UK has experienced a very dynamic development of its consumer credit markets over the last decades: the consumer credit in the UK has grown from EUR 82.4 billion in 1995 to EUR 245.2 billion in 2008, thus increasing nearly three-fold in the last fourteen years. In terms of consumer credit volume, UK market was the largest market in the EU in 2008. At the end of 2008 the volume of consumer credit outstanding was EUR 245.2 billion (Figure 56). Like in other European countries, market volume declined: it dropped from its maximum of EUR 302.3 billion in 2006.

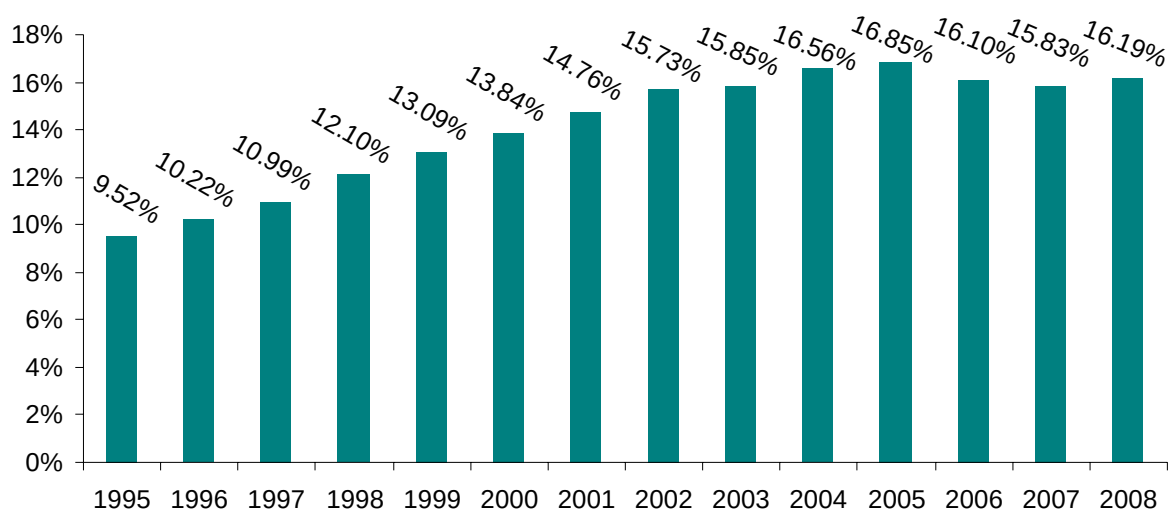
Figure 56: Consumer credit outstanding; UK; EUR billion



Source: ECRI (2009), "Lending to Households 1995-2008".

Consumer credit represents an important element of the UK economy. In 2008 consumer credit outstanding was about 16.2% of the UK GDP (Figure 57). This is nearly double the EU average of 8.75%. This ratio has grown from 13.8% in 2000, albeit there was a slight decrease in 2006 and 2007.

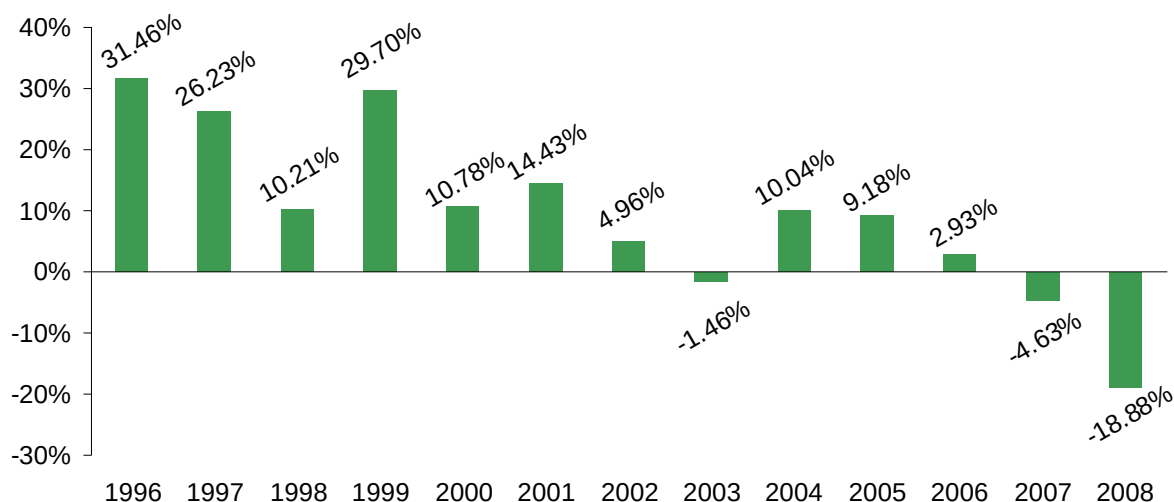
Figure 57: Consumer credit; UK; % of GDP



Source: ECRI (2009), "Lending to Households 1995-2008".

Figure 58 illustrates growth rates of consumer credit volume. During the period 1996-2000 the market saw double-digit growth rates ranging from 11% to 31%.

Figure 58: Consumer credit growth rates; UK, % change p.a.



Source: ECRI (2009), "Lending to Households 1995-2008".

2.4.2.6.2 Types and dynamics of consumer credit

The consumer credit market in the UK comprises the following segments:

- Secured lending other than first charge mortgages;
- Credit cards;
- Loans, including short-term small-value loans (including home credit and pawnbroking loans);
- Mail order, hire purchase and store cards.
- Credit Unions.

2.4.2.6.3 Secured credit

In September 2003 secured lending accounted for GBP737 billion or 81% of the total consumer credit (DTI, 2003). Table 55 demonstrates the development of the different categories of consumer credit as a proportion of household liabilities and also represents typical amounts owned on specific forms of loans. As we can see from the table, by 2002 the importance of credit card debt in the overall household debt had increased to almost 20%, while the importance of other categories had somewhat declined. In 2008, credit card credit accounted for 23% of total consumer credit. After credit card debt, the most important form of credit is mail orders and loans. Overdraft accounted only for 9% of the household debt in 2002.

Table 55: Composition of consumer debt over time; UK

	Proportion of Households with Current Commitments (%)		Average amount owed by households (GBP, adjusted to 2002 prices)	
	2002	1989	2002	1989
Credit cards	19	15	1570	565
Mail order	17	23	240	na
Loans	15	16	5000	2190
Hire purchase/Credit	13	17	3800	*
Overdraft	9	12	450	1676
Store cards/accounts	8	7	210	197

Source: DTI (2003).

2.4.2.6.4 Home credit

Home credit is represented by small-value, short-term loans. Home credit loans are usually repaid over a period of around one year or less, in weekly instalments which are collected from the customer by the agent calling for this purpose to the customer's home. According to estimates by the Department of Trade and Industry (DTI), this segment of consumer credit market has about 3 million customers (DTI, 2003). Collard and Kempson (2005), citing several sources, report a more modest figure between 2 million and 2.5 million people. There are around 30,000 agents working in the home credit industry. The sums advanced are usually small, typically below GBP500, with a repayment period in the range of 26 to 52 weeks. A later study by the Competition Commission (2006) suggests that about 70% of home credit loans are for less than GBP500. Around 90 per cent are for less than GBP1,000. The mean repayment period is 43 weeks. Compared to the costs of credit from the mainstream credit providers, costs of home-collected credit are much higher, with APRs ranging between 100% and 400% or more (Collard and Kempson, 2005). OFT (2010) report slightly higher APR between 150% and 500%. The charges are fixed and 'all-in'. That is, they include costs of home collection and the costs of late payment (DTI, 2003; Corr, 2007). It should be pointed out, however, that the direct comparison of the costs of mainstream and high-cost credit is hindered by the differences in the values of principal amount and risks characterising these two types of lending.

Accordingly to the estimates provided in the Competition Commission (2006), in 2005 the outstanding volume of home credit amounted to GBP1.3 billion. The Competition Commission also provides an alternative estimate for this market derived by

Datamonitor, which suggests that the size of the market was GBP2 billion in 2003. As estimated by OFT (2010) the total value of loans in 2008 lies between GBP1.2 billion and GBP1.3 billion. Among the reasons for taking out a home loan, customers cite both urgent needs for money and special occasions, such as birthdays or Christmas (Competition Commission, 2006). In 2005 the home credit market in the UK was dominated by four companies (Provident, Cattles, London and Scottish Bank (LBS) and S&U). Recently two of them, Provident Financial and S&U, have increased their customer base and market share because the two others, LBS and Cattles, have reduced their exposure.²⁰⁵ Provident, the largest of the four providers, controlled about 50% of the market as reported by Collard and Kempson (2005). OFT (2010) estimates the recent figure to be higher as Provident was able to increase its market share following the difficulties faced by LBS and Cattles.

2.4.2.6.5 Pawnbroker loans

Pawnbroking is a form of secured lending in form of small cash loans secured by property, usually jewelry. According to the estimates from the DTI, about 0.1% of households admitted having a loan from a pawnbroker. This may be an underestimate due to reluctance to admit use of credit in general and pawn-broking credit in particular (Collard and Kempson, 2005). Corr (2007) provides an estimate of ca. 750 thousands users of pawn loans.

The National Pawnbroking Association estimates that there are about 1,200 pawn broking outlets in the UK. There exist two national chains: Albermarle and Bond and Harvey and Thompson. Each has about fifty outlets. The rest of the industry consists of small companies operating at local or regional level (Collard and Kempson, 2005).

According to the estimates by the National Pawnbroking Association, the volume of pawnbroking loans in the UK is about GBP576 million (new business).²⁰⁶ However, this estimate is based on a number of assumptions and should be treated with caution. The average loan in the UK is believed to be about GBP120-GBP150 and the average term is about 3.5 months. The average pledge book per outlet is around GBP160,000. According to OFT (2010) the value of the annual loan book for 2008 was between GBP500-GBP600 million. With a reported number of 1200 pawn broking outlets this would suggest, that the average annual book per outlet amounts to GBP417,000-GBP500,000. Collard and Kempson (2005) report that APRs charged on pawn loans range from 70% to 200%. The typical APR as reported by OFT (2010) is 100%. Like in case with home credit, the small scale of lending, small values and short period for which pawn loans are granted make the comparison of costs of mainstream and pawn loans less straightforward.

2.4.2.6.6 Payday Loans

Payday loans are a form of unsecured small-amount, short-term lending. To access this form of credit, borrowers must have regular income, usually from paid employment; have a bank account and a cheque book. Customers write a cheque to the company, which in return for a fee agrees not to present the cheque for up to 30 days. They are generally available for amounts between GBP100 and GBP1,000.²⁰⁷ The customer receives a loan in the amount indicated on the cheque less the fee. OFT (2010) report that the total charge of credit (TCC) for payday lending is varying between 10% and 20% for high-street borrowing. TCC for borrowing online is generally higher. It is estimated that

²⁰⁵ LBS went into administration at the end of 2008 and Cattles stopped lending to customers shortly afterwards (OFT 2010).

²⁰⁶ Based on the information obtained from the National Pawnbroking Association (2009).

²⁰⁷ See www.moneysupermarket.com.

about 1500 outlets in the UK provide payday loans (Collard and Kempson (2005), OFT (2010)²⁰⁸). This type of lending is often associated with cheque cashing services which advance funds on a post-dated cheque. Payday loans are not only used to cover immediate personal needs by individuals who cannot obtain credit elsewhere but also because of the ease of the transaction and because of the higher transparency in the charges as compared to the bank charges levied for unarranged overdrafts (OFT 2010). It is reported to be predominantly used by younger working male, unmarried with no children, but also by low-income families struggling to make ends meet or in case of an emergency (Collard and Kempson, 2005; Finlay, 2009; OFT, 2010). Dominy and Kempson (2003) report that an average outlet issues about 50-60 payday loans a month, with larger outlets issuing 150-200 payday advances a month. The estimated number of customers of payday industry in 2003 was approximately 300,000 (Dominy and Kempson, 2003). They estimate that slightly less than one million advances are issued in the industry per year. OFT (2010) estimate that for 2008 the value of total payday loans granted was between GBP700-GBP900 million.²⁰⁹ Considering the reported typical loan size of GBP300 this would suggest that the number of advances issued in the industry was between 2.3 and 3 million – well above the number estimated in Dominy and Kempson (2003).

2.4.2.6.7 Credit cards

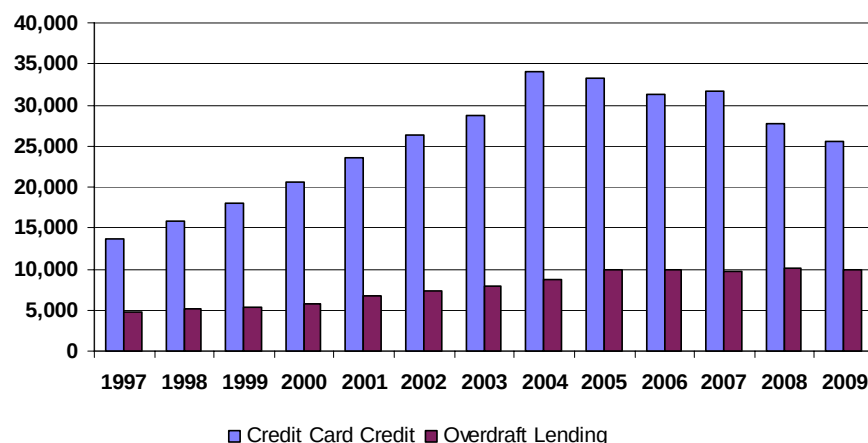
In 1971 there was only one type of credit card (Barclaycard) available in the UK. In 2003 there were around 1,300 types. The amount of money owed on credit cards has increased substantially from GBP32m in 1971 (DTI, 2003) to over GBP25bn (BBA, 2009) today. Accordingly to DTI (2003), the credit card market in the UK is the most developed in Europe, accounting for about a third of all EU transactions, with many consumers now using credit cards as their preferred payment medium. After the US, the UK has the largest number of credit cards per capita with GBP63 million credit cards in circulation (Department for Business Innovation and Skills, 2009). A major driver for the take-up and usage of credit cards, in recent years, has been the rapid development in e-commerce.

Figure 59 presents development in the credit card credit and comparison with the use of overdrafts from 1997 to 2009 based on the data provided by the British Bankers' Association (BBA). Accordingly to BBA, the volume of credit card credit amounted to at least GBP25.5 billion at the end of 2009. While debt on credit cards declined somewhat during 2007-2009, it remained an important source of credit for consumers as other forms of lending dried up due to funding constraints faced by financial institutions.

²⁰⁸ However, the number is believed to have increased to 2000 outlets in 2009 as reported in OFT (2010).

²⁰⁹ However, this estimate should be treated with caution as OFT (2010) is lacking publicly available data to underpin the value.

Figure 59: Consumer credit outstanding: Cards and overdrafts; UK; GBP million



Source: British Bankers Association (BBA), www.bba.org.uk

About 69% of consumers pay off their outstanding balances on credit cards every month or most months while at the same time a significant number of customers carry high level of unsustainable debt on one or sometimes more than one credit card. Customers who sought advice from the consumer Credit Counselling Service (CCCS) in 2008 had average credit card debts of nearly GBP15,000, with 90% of such customers having an income less than GBP 30,000. For customers with income less than GBP 10,000 per year, the average credit card debt was GBP 8,000. (Department for Business Innovation and Skills, 2009)

2.4.2.6.8 Mail order, hire-purchase and store cards

Mail order credit provides consumers with an opportunity to make purchases that can be paid off over an agreed period of time. The credit is paid off during regular periods of time, such as on a weekly basis. DTI (2003) reports that mail order credit is used by about 20.8 million users. *Hire purchase agreements* allow individuals to finance the purchase of expensive assets, such as a car. The agreement is usually structured in a way that the consumer pays a deposit, a number of monthly instalments and a final payment to secure ownership of the asset. *Store cards* allow consumers a form of running-account credit to purchase goods from a particular store. The cards are usually store-branded, but the credit will usually be provided by a finance company. Often store cards have incentives attached, such as participation in promotions and discounts (DTI, 2003). Department for Business Innovation and Skills (2009) estimates that as of December 2008 the market for store cards had approximately 1.9 billion of outstanding balances. This makes it a much smaller market than the credit card market. While the use of store cards was on the rise until about 2006, since then it saw a decline, since stores increased their offering of credit card products.

2.4.2.6.9 Summary statistics

Summary statistics on the distribution of consumer credit in the UK by type is presented in Table 56. The figures refer to the overall UK consumer credit market. However, the provided figures in the table should be treated with caution since, in the absence of official statistics, in a number of cases they are based on estimates drawn from various sources. The aim of the table is to provide information about the relative importance of the various types of credit existing in the UK market.

As the table shows, high-cost credit, including money lending, payday loans and pawn broker loans account for about 0.8% of the total consumer credit in the UK.

Table 56: Distribution of consumer credit; UK, 2008

Type of Credit	EUR billion	% of Total Credit	% of Consumer Credit
Total credit	1 095.52	100.00	
Mortgages	797.94	72.84	
Consumer credit out of which...	245.22	22.38	100.00
...credit cards	56.58	5.16	23.07
...other	188.64	17.22	76.93
Other credit of which...			
...money lending*	0.89	0.08	0.36
...pawn broker loans**	0.52	0.05	0.21
...payday loans***	0.5	0.05	0.20

Source: ECRI (2009) unless indicated otherwise.

Notes:

*Estimate for 2005 (Competition Commission (2006); ECB).

**Estimate for 2009 (National Pawnbroking Association (2010); ECB).

*** Estimate for 2003, based on Dominy and Kempson (2003).

Percentages for consumer credit do not add up to 100 due to differing sources of the data.

2.5 Discussion of the hypotheses

This part of the report discusses the hypotheses we have derived from our theoretical considerations in Chapter 2.1. In this discussion, we make use of a variety of sources. We reconsider existing literature (partly already mentioned in Chapter 2.2) to discuss previous evidence on these issues. Where deemed necessary, we point at shortcomings of these reports and discuss their plausibility. We also make use of the data we have already introduced in the overview of the credit markets in Chapter 2.3, and in the case study descriptions provided in Chapter 2.4. Additional data sources such as the EU-SILC and the Eurobarometer are also employed to obtain a more complete picture. One has to note, however, that in many cases these macroeconomic data can only give rough evidence on the hypotheses; a more exact identification of causal effects would require micro data, which are not available at all or do not allow international comparisons to a sufficient degree. To improve the evidence base, we also make use of particular stakeholders' experience in the consumer credit market, such as regulators, consumer associations, providers and provider associations. This experience is predominantly taken from the Stakeholder Questionnaire (SQ) attached in the Appendix. There is also a stakeholder questionnaire sent exclusively to individual providers (PQ), which is considered complementary to the SQ. This approach enables us to learn from stakeholders' experience with regard to the effect of interest rate restrictions (or lack of thereof) on the credit markets in the respective countries. It also allows a comparison of the answers from stakeholders in countries *with* IRR with the answers of those from countries *without* IRR and a qualitative discussion of the differences. The inclusion of heterogeneous stakeholders (regulators, consumer agencies, supplier associations) will enable us to consider potentially divergent perspectives about issues in question in a balanced way. Based on the entire set of information discussed above, we derive a final judgement about the validity of each hypothesis. The brief evaluations "plausible", "inconclusive" or "unlikely" are given upfront in the overview parts.

As the quality of information from all sources differs across hypotheses (eg. for some hypotheses we subsequently point to shortcomings of data to set the effect of interest rate restrictions apart from other effects), a purely mechanistic weighting scheme of potentially conflicting findings from different points of view (eg. 30 % literature review, 30% stakeholder assessment, 40% collected data) is not feasible. Rather, the evaluation of each hypothesis requires a judgement of the credibility and usefulness of the different information sources. Specifically, we base our evaluation on the following classification:

Plausible: A hypothesis is found to be "plausible" if there is sufficient evidence in favour of it, and only little counterevidence to it. Such evidence may be based on convincing analyses in previous studies, the data we have collected or the overall impression of stakeholders in the market. We conjecture that a "plausible" hypothesis should contain at least *some* relevance in different national settings, irrespective of the economic and institutional circumstances. However, as market outcomes are a mixture of various aspects of an economy, we will be careful to discuss the limitations of "plausible" hypotheses.

Inconclusive: A hypothesis is evaluated to exhibit "inconclusive" results if there is conflicting evidence from various information sources (without a dominance of either favouring or opposing evidence), or if the available data are insufficient for an evaluation. We will point to such data limitations in our discussion. Conflicting evidence suggests that interest rate restrictions may have an effect as postulated by the theoretical considerations, but that this effect does not necessarily materialise in an economically significant way under all circumstances in all countries. For example, observed developments might be caused by interest rate restrictions under the institutions (or, eg. consumer preferences) of one country, while this need not hold in other countries.

Unlikely: A hypothesis is found to be "unlikely" if there is no evidence (or even substantial counterevidence) for it. A judgement of "unlikely" to a hypothesis suggests

that even theoretically convincing effects of interest rate restrictions are not expected to materialise in an economically meaningful way, as the scope of the effect is too little or it is washed out by other simultaneous developments in the market.

2.5.1 H1: IRR reduce credit access, in particular for low-income borrowers.
2.5.1.1 An overview

Based on findings from previous literature, the Eurobarometer survey and the Stakeholder Questionnaire, we find **H1** to be *plausible*. This result has to be seen in the context of the following remarks which underline its limitations:

- **H1** is unanimously **confirmed** by the existing literature which analyses or comments interest rate restrictions. While the identification of the effects of interest rate restrictions appears to be solid, one has to keep in mind that the analysed interest rate caps (eg. 12%) are rather low compared to the typical levels in some countries of the European Union. It is therefore questionable whether the interest rate caps in the Member States have similar effects on, eg. auto loans, as it has been found in the US studies.
- In contrast, comparing data from the Eurobarometer survey on households holding neither a credit card nor having an overdraft facility in five of the case study countries, **H1 cannot be confirmed**. Conflicting findings from the literature and survey data might stem from the different influences interest rate restrictions have on the access to mainstream and high-cost credit. Due to the relatively high levels of interest rate caps operated in most EU countries, **H1** may thus solely hold in the context of high-cost credit, while access to mainstream credit products is rather unaffected.
- One has to be careful, however, interpreting the *incidence* of credit to be equivalent to the *supply* of credit, assuming the *demand* for credit to be constant across countries. The *attitude to credit* differs substantially, explaining both the existence of interest rate restrictions and differences in the prevalence of different credit facilities.
- Even if **H1** holds with regard to high-cost credit, it does not imply that consequences of reduced credit access are purely *negative*. The majority of stakeholders does not see a need for increasing credit access to low-income borrowers.
- The stakeholders in countries *with* IRR see a slightly stronger need in increasing credit access to low-income borrowers. This is an (albeit weak) confirmation of **H1**.
- The stakeholders unanimously express their view that **H1** is likely to hold.

2.5.1.2 Literature

Chapter 2.2.6 has summarised a consensus of existing studies that interest rate restrictions may limit credit access to some groups of customers. Villegas (1982) finds that lower interest rate caps increase the rejection probabilities in automotive credit markets. Zinman (2008) investigates the effect of the interest rate cap on payday loans in Oregon and documents that payday credit access is strongly reduced compared to Washington State, where no such cap exists. The view that credit access is reduced in the presence of interest rate restrictions is also taken by Policis (2004), Białowolski (2009), and OFT (2010) in their studies on high cost credit or interest rate restrictions in Member States of the European Union. IGF/IGAS (2009) confirm this view, but point out that the reduction of credit access may be seen as an objective of interest rate restrictions.

Some argue that if providers cannot charge the levels of interest rates necessary to cover higher risk, they will restrict credit access accordingly. This argument has also been made by Fernando (2006) in the context of microcredit for developing Asian countries: he points out that microcredit is a personal, intensive, costly (on a per-unit basis) business, such that high effective interest rates are required to maintain the lenders' activity to serve poor people. Helms/Reil (2004) argue that interest ceilings discourage commercial banks from expanding into higher-cost rural or microcredit markets in developing countries.

Overall, the literature contains strong arguments that credit access to specific groups of the population may be reduced, which is broadly in line with **H1**. However, as detailed in Chapter 2.2.6, the US studies consider the case of much lower interest rate caps (eg. 12%), and are thus only partly transferable to European countries.

2.5.1.3 Cross-Country Comparison

Issue 1: Perception of difficulty of credit access

Facts and Figures

If **H1** holds, one can expect credit access to be more complicated in countries with interest rate restrictions, in particular for low-income borrowers.

Figure 60 depicts the fractions of households agreeing on the question from the Eurobarometer survey (60.2, 2003)²¹⁰ asking: "*Do you tend to agree or tend to disagree on the statement: You can borrow as much as you like, there are no real checks?*". Overall, these responses indicate that households can borrow as much as they like in only a minority of all countries. Interestingly, the highest fractions of households agreeing on the statement are found in Germany and Sweden, whereas the lowest fractions agreeing on the statement are from the Netherlands and the UK.

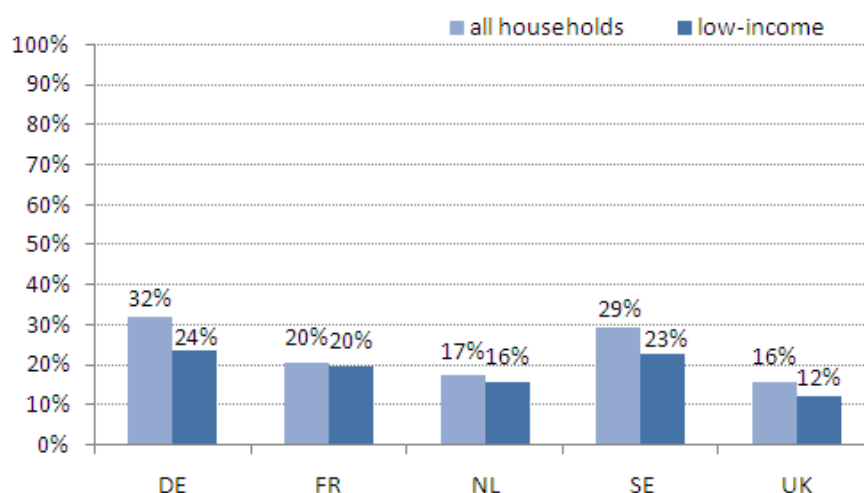
It seems plausible that Swedish households feel to have easy access to credit because the level of credit exclusion²¹¹ is low among the total population (Figure 61). However, it is surprising that households in Germany, where the level of credit exclusion is highest, feel to have easy and unlimited credit access, while households in the Netherlands, where the level of financial exclusion is lowest and overdraft facilities and credit cards are widely spread do not feel to have easy access to credit.²¹²

²¹⁰ The Eurobarometer survey is collected on behalf of the European Commission. Relying on this cross-national survey avoids incomparability emanating from lacking harmonisation. For more information about the survey and the special module analysed in this part of the study, see the Appendix. Since information on household income is not included in the more recent Eurobarometer 63.2. (2005), the analysis on H1 has to rely on the data from 2003.

²¹¹ Credit exclusion is defined on the basis of Eurobarometer data. Those households are regarded as excluded from short-term credit that do not have access to neither credit cards, nor other cards or overdraft facilities.

²¹² The incidence of different short-term credit facilities (overdraft facility, credit card, other card) has been analysed on the basis of the Eurobarometer question "Do you personally have...?". Venn diagrams showing the prevalence of multiple and single holdings of the different credit instruments are included in the Appendix.

Figure 60: Perception of easy and unlimited credit access



Source: Eurobarometer 60.2, Variables Q20.3, D29.

Discussion

Credit access is not judged to be easier in countries without IRR, **which might be seen as evidence against H1.**

Issue 2: Access to short-term credit (overdraft, credit cards, other cards)

Facts and Figures

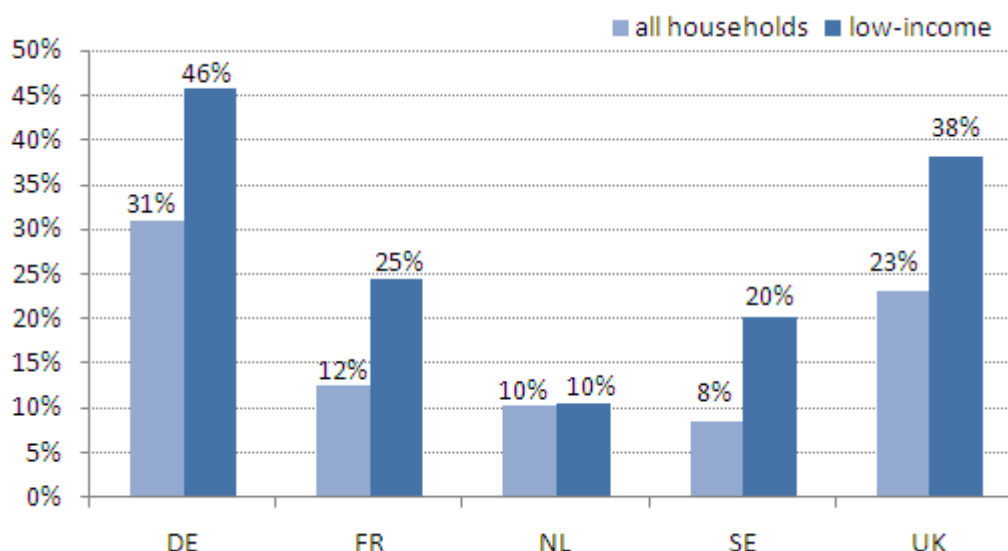
We conduct a cross-country comparison of the case study countries to investigate whether there are differences in access to credit cards and overdraft facilities which may be due to interest rate restrictions.

The proportions of households excluded from short-term credit are depicted in Figure 61 for the entire population and for the group of low-income households.²¹³ Figure 61 reveals that there are countries with high levels of credit exclusion from short-term credit such as Germany (where there are IRR in place) and the UK (where there are no significant interest rate restrictions). The case of the Netherlands is interesting, as credit exclusion from short-term credit is very low in this country and levels of exclusion from short-term credit are equal between low-income households²¹⁴ and the overall population. This could be a sign that households are *not being excluded* but simply *do not demand* short term credit.

²¹³ Since it cannot be ruled out that *credit cards* and *other cards* are pure *debit cards*, considering those households to have access to at least one of the three facilities rather overestimates the fraction of households that have access to short-term credit. Looking at the opposite is therefore a tentative estimate of the percentage of households which are excluded from short-term mainstream credit.

²¹⁴ Households are considered to live on a low income if their monthly total income lies below 60% of the median income.

Figure 61: Households without access to short-term credit



Source: Eurobarometer 60.2.

Discussion

First, as expected, low-income households have less access to short-term credit facilities. However, **it is not possible to draw the conclusion that differences in credit access (irrespective of households' income) are due to interest rate restrictions, as H1 suggests.** One explanation is that these figures of the non-existence of particular credit sources do not reflect credit constraints, but simply the lack of willingness to obtain credit. Also, one has to note that the Eurobarometer survey only captures mainstream credit facilities, which seem to be influenced less by interest rate restrictions than is high-cost credit.

Issue 3: Is credit useful?

Following from the literature finding that interest rate restrictions seem to reduce access to high-cost credit it is worthwhile examining whether reduced credit-access is perceived as a *shortcoming* at all. To shed more light on this latter point, we discuss different attitudes in the case study countries. These attitudes are derived from the Eurobarometer 60.2 question: "Do you tend to agree or tend to disagree on the statement: *Buying on credit is more useful than dangerous?*".

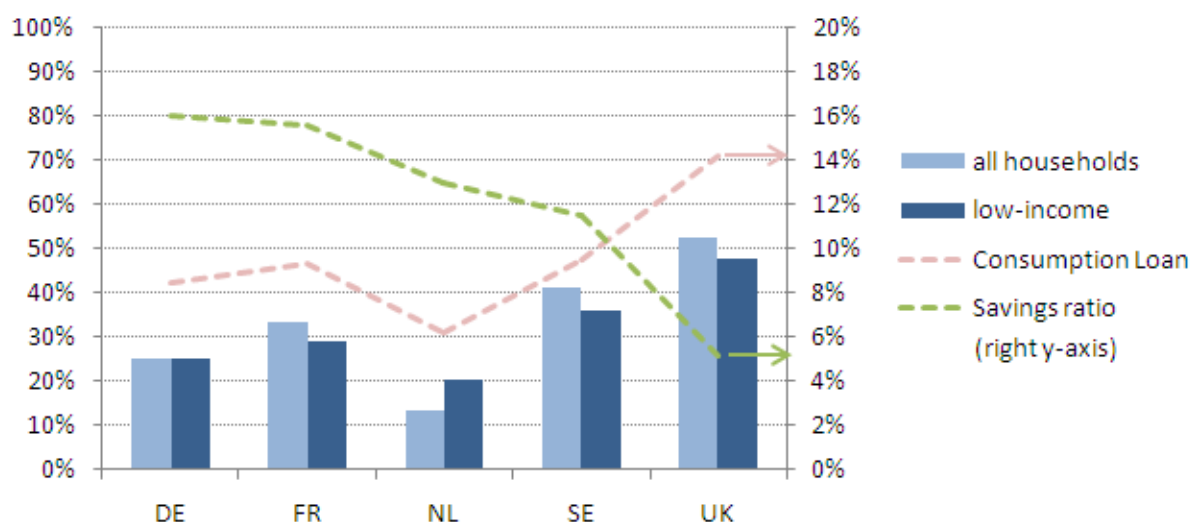
Facts and Figures

The fractions of households which tend to agree on the statement that credit is more useful than dangerous are depicted in Figure 62. It can be seen that, among the case study countries, the statement is only shared by a majority in the UK. Sweden is second, while, in contrast, there are low support rates for this statement in Germany, France and the Netherlands²¹⁵. Figure 62 also shows the prevalence of consumption loans²¹⁶ and savings ratios in the different countries. There is a clear relationship in a sense that, in countries where credit is rather perceived useful than dangerous, households borrow more often and save less.

²¹⁵ Poland is not included in the Eurobarometer survey. However, a major home credit provider operating in the country shares experience of general "debt reluctance" of the society compared to the borrowers in UK.

²¹⁶ Loans with a maturity of more than 12 month which are not used for car or house purchases.

Figure 62: Households considering credit to be useful



Source: Eurobarometer 60.2, Variables Q20.2, Q11, D29; BIS, Savings ratio.

Note: The percentage of households indicating to hold a consumption loan and the savings ratio relate to the right hand axis.

Discussion

It appears that the public opinion about the nature of credit is able to explain the existence or non-existence of interest rate restrictions. More than that: there is higher incidence of credit in countries where credit is more widely accepted than in countries where public support for credit is lower. It therefore seems that it is not only *credit access* but also to a substantial degree *credit demand* which influences the number of households relying on different sources of credit.

2.5.1.4 Views of Stakeholders

Issue 1: Is there a need to increase credit access for low-income borrowers?

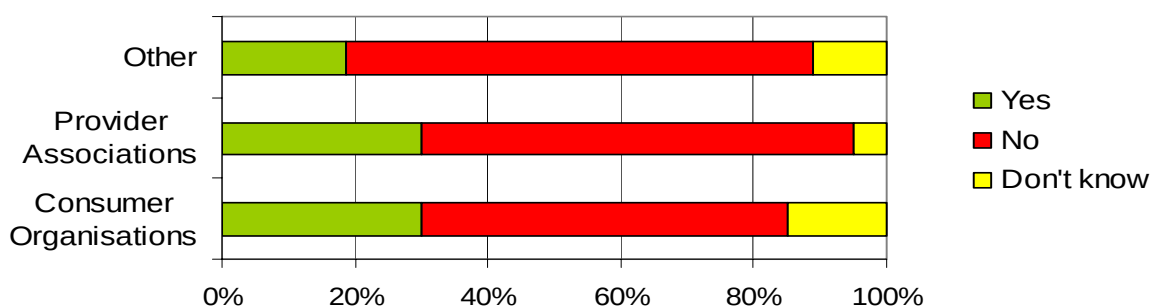
H1 suggests that there is a lack of credit access for low-income borrowers in countries with IRR. This paragraph therefore discusses whether or not stakeholders in countries with IRR see a higher need for increasing the level of credit access (compared to the present level) than stakeholders in countries without IRR.

Facts and Figures

As Figure 63 shows, more Stakeholders are *against* an increased access to consumer credit for low-income borrowers than *in favour* of it. In written comments, consumer organisations and government officials point out that credit access is a necessary condition for over-indebtedness. Interestingly, the share of proponents of increased credit access for low-income borrowers is similar for provider and consumer associations. Yet, in repeated feedback credit card providers and home credit providers²¹⁷ from UK and Poland regard credit exclusion as a macroeconomically and politically *undesired* effect of interest rate regulation.

²¹⁷ eg. Credit card providers from UK as well as a home credit lender from Poland

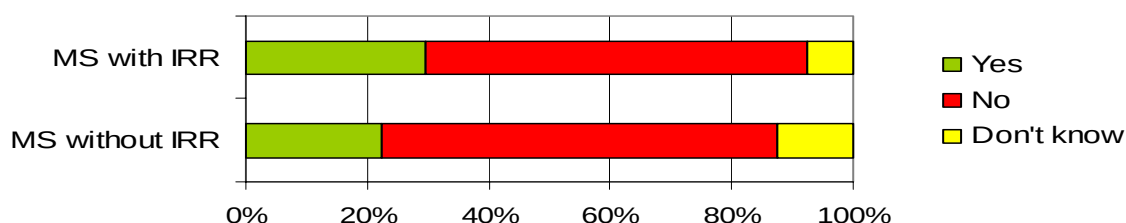
Figure 63: Desirability of Credit Access for low-income borrowers, by Stakeholder Type



SQ Question: In your view, should low-income borrowers be given any greater access to credit than they are given at present?

Figure 64 reveals that there is no strong difference in the responses by stakeholders from Member States *with* IRR and Member States *without* IRR. It appears that the share of proponents of an increased credit access of low-income borrowers is slightly larger in countries with IRR. However, the number of its opponents is equally large in both types of countries.

Figure 64: Desirability of Credit Access for low-income borrowers, by Type of Country of Origin



SQ Question: In your view, should low-income borrowers be given any greater access to credit than they are given at present?

Discussion

If **H1** holds, one would expect respondents to report insufficient credit access for low-income borrowers particularly in countries *with* IRR, while credit access should pose no problem in countries *without* IRR. Overall, the need for further credit access for low-income borrowers is found to be at comparable levels for both types of countries. As the results above document, **there is only a slight tendency in favour of H1, if any.**

However, one has to note that these answers do not reveal anything about the *absolute level* of credit access in these two types of countries: it may well be that the level of credit access is higher in countries *without* IRR, but that stakeholders in both regulatory regimes consider their respective status quo level of credit access appropriate to the same extent. This would imply that the politically desired level of credit access should be heterogeneous across Member States, depending on the respective financial culture.

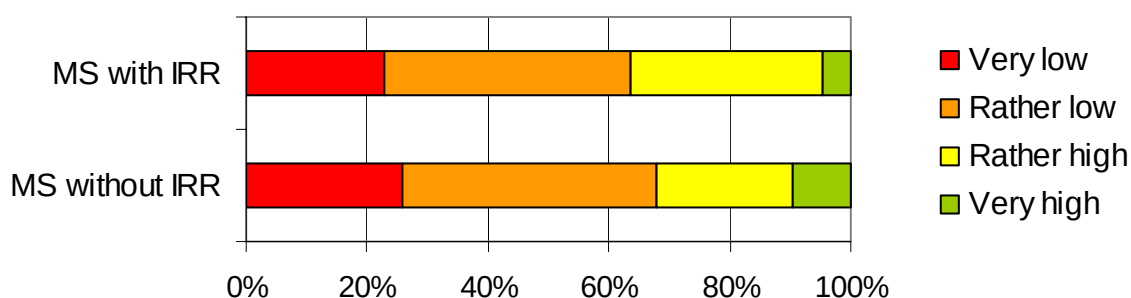
Issue 2: Differences in Credit Options for low-income borrowers

H1 suggests that, in countries with IRR, low-income borrowers have fewer options to obtain credit than in countries without IRR. The following paragraphs collect the stakeholders' views on this issue.

Facts and Figures

Figure 65 shows that low-income borrowers are perceived to have access to *rather few* or *very few* credit options, as indicated by the majority of respondents (66%). The evidence is consistent for both Member States *with* IRR (with 64% of respondents in this category indicating the latter) and Member States *without* IRR (with 68% of respondents in this category indicating the latter).

Figure 65: Level of Credit Options to low-income borrowers



SQ Question: How would you describe the level of credit options available to low-income consumers to choose from? (Very low/rather low/ rather high/ very high/)

Discussion

Unlike implied by **H1**, the stakeholders' responses about the levels of credit options for low-income borrowers do not differ substantially between countries *with* and *without* interest rate restrictions. **These finding contradicts the validity of H1.**

Issue 3: Effect of the introduction of interest rate restrictions on credit access

The following paragraph discusses the views of stakeholders responding to the Stakeholder Questionnaire on the introduction of interest rate restrictions in a hypothetical country which has had no IRR before.²¹⁸ For purposes of comparison, we suggested two alternative ways of interest rate restrictions: a relative one, defined as twice the average rate prevailing in the market, as well as a fixed interest rate cap of 30% p.a.

Facts and Figures

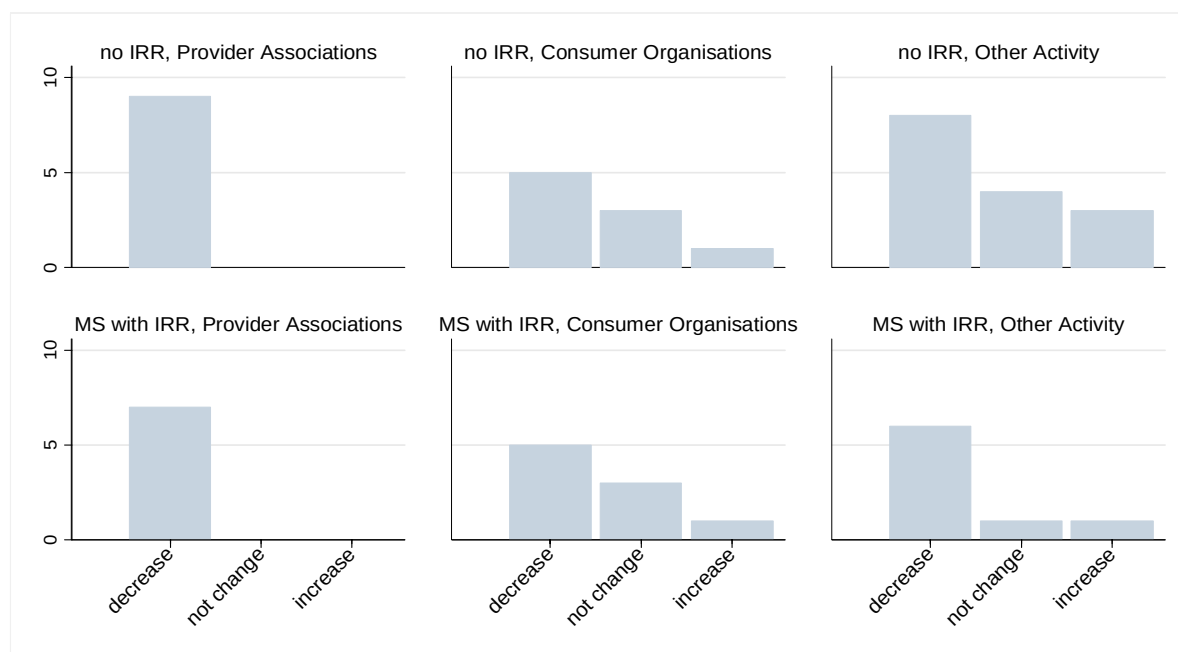
Figure 66 provides separate graphs for the different stakeholder types analysed before (provider associations, consumer associations and a third category "other activity" which includes financial regulators, banking authorities, government officials and others). It also distinguishes between these groups in countries *with* IRR and those *without*.

Figure 66 illustrates that 70% of stakeholders expect the introduction of a floating interest rate restriction (ie. a relative rate ceiling) to lead to *reduced* credit access of low-income borrowers. Thereby, provider associations from both Member States *with* IRR and Member States *without* IRR are unanimous in their expectations. There is a slight disagreement among respondent from consumer organisations, as 11% of them would even expect an *increase* in credit access following an introduction of IRR. The percentage

²¹⁸ However, we cannot be sure at this point that the stakeholder did not misunderstand the question and give an answer which is appropriate for their own country instead of the suggested hypothetical country.

of respondents expecting an increase (20%) is at largest among “other” stakeholders such as financial regulators and banking authorities from countries *without* IRR.

Figure 66: Effects of IRR (2x average) on credit access, for low-income borrowers

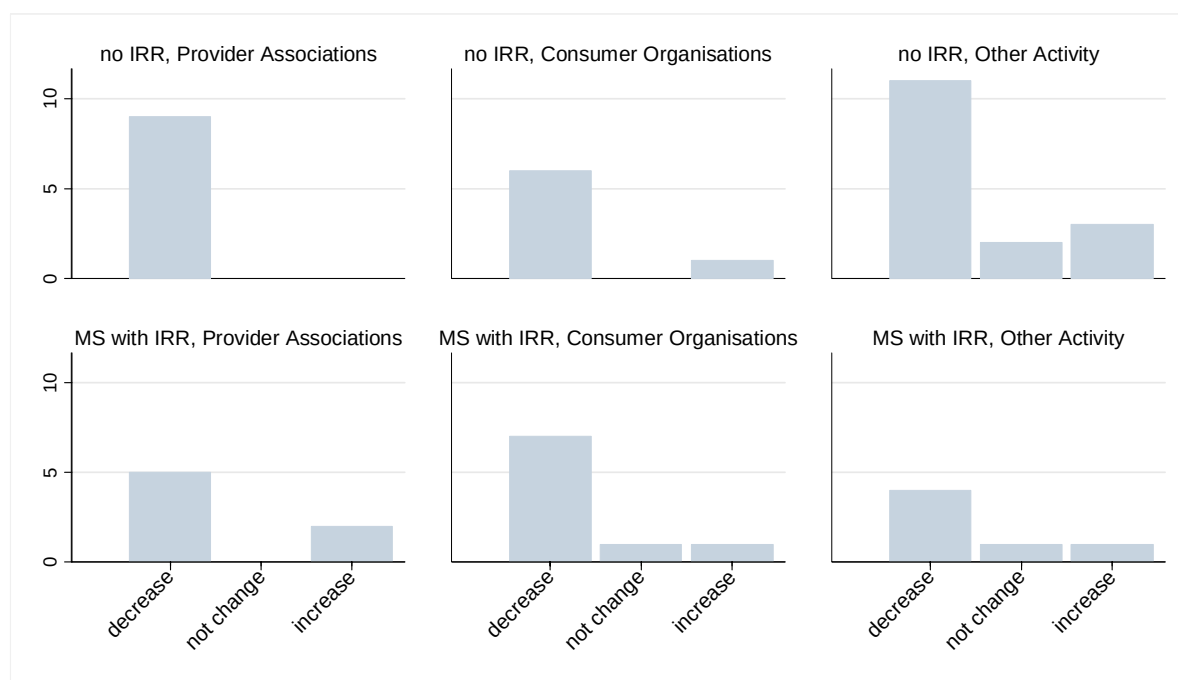


SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was **double the average** of the interest rates offered on the entire credit market access to credit of the low-income consumers would... (decrease(-1)/stay same(0)/increase(1))?

Figure 67 shows that the results for a hypothetical introduction of a fixed interest rate cap of 30% APR differs from the results above. Part of the difference (especially in Member States *without* IRR) is based on the different *initial* average interest rates in the distinctive countries which makes the fixed absolute ceiling of 30% *differently restrictive* as compared to relative interest rate restrictions.²¹⁹ Interestingly, (despite of repeated feedback that the level of 30% APR is rather high and unlikely to be binding) a large majority of stakeholders (78%) claim that a fixed ceiling introduction would lead to a *decrease* in credit access of low-income borrowers. Unlike for the relative ceiling discussed above, “other” stakeholders from Member States *without* IRR tend to agree on this.

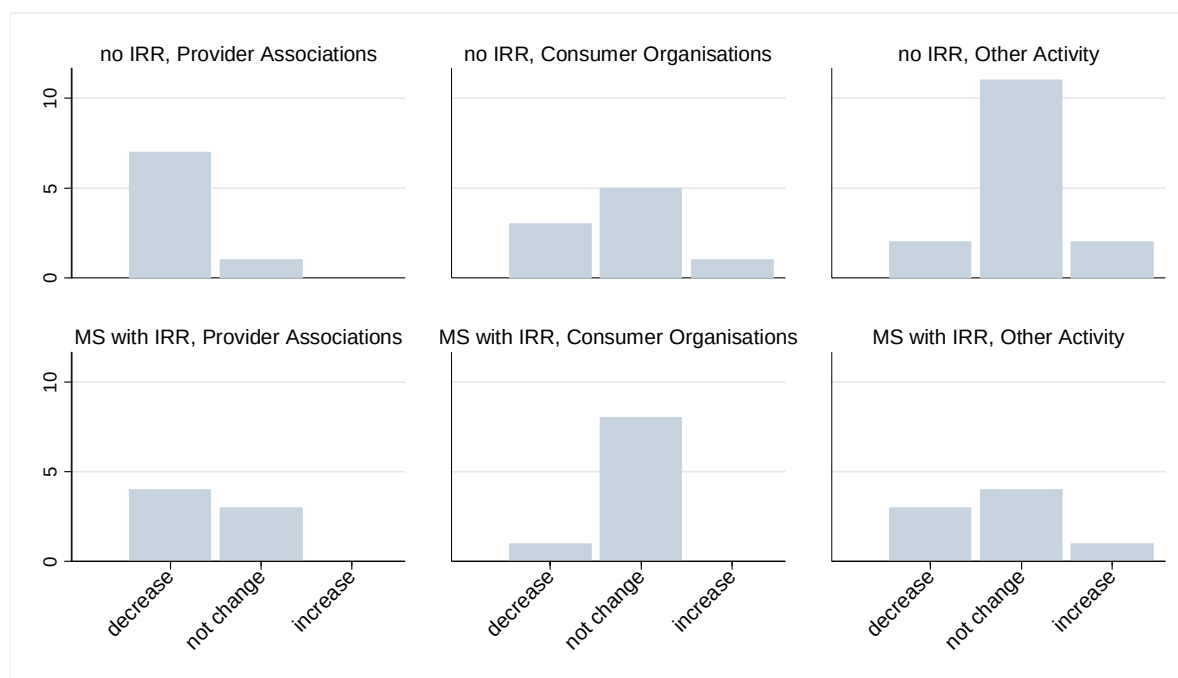
²¹⁹ All respondents to the Provider Questionnaire from the Netherlands, Sweden, Germany and some respondents from the UK indicate that a fixed ceiling set at 30% would not be binding for their institution (PQ Question: In your view, what minimum level of interest rate ceiling (as calculated by the annual percentage rate of charge (APRC)) would have a significant impact on the volume of consumer credit granted BY YOUR INSTITUTION?). It should further be noted that the level of 30% would not be binding for these institutions. In UK the level would only be binding for pawnbrokers, payday lenders and moneylenders. On the other hand, when analogically asked about the level of a relative interest rate ceiling, some respondents from the UK (among others a major commercial bank, an important building society as well as a credit card provider) also indicated that a level of two times the market average would even be binding for a broad range of loans, particularly general instalment loans, credit cards, overdrafts and even mortgage loans.

Figure 67: Effects of IRR (max. of 30%) on credit access, for low-income borrowers



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that fixed at 30% APR for all credits, access to credit of the low-income consumers would... (decrease/no change/increase)?

Figure 68: Effects of IRR (2x average) on credit access, for average borrowers



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market access to credit of average consumers would... (decrease/no change/increase)?

So far, we have discussed how, according to the views of different stakeholders, interest rate restrictions are likely to affect credit access for *low-income* borrowers. In contrast, there are diverging assessments with respect to credit access for *average* borrowers, as

Figure 68 documents that the provider associations from countries *without* IRR expect negative effects not only for low-income, but also average-income consumers. This view is not shared by the majority (63%) of the shareholders in countries *with* IRR, which rather foresees an unchanged situation for average consumers.

In the Provider Questionnaire, loan providers were asked about their expectations on the impact of a hypothetical introduction of a more restrictive, relative interest rate ceiling on the credit access of high-risk borrowers.²²⁰ Most of the respondents would expect an IRR to be followed by a higher credit exclusion to high-risk borrowers. Given that low-income borrowers are often associated with high-risk, the evidence is in line with the results from the Stakeholder Questionnaire. However, it should be noted that some providers expressed their view that the terms "low-income" and "high-risk" should be kept apart as they consider risk to be a function of the *loan size* rather than of *the borrower's income*.²²¹

Discussion

These graphs document that **H1** is attributed a substantial degree of plausibility by virtually all groups of stakeholders: when asked for a hypothetical introduction of interest rate restrictions, the respondents point to decreasing levels of credit access for low-income borrowers. An equivalent effect even for average consumers is only expected by provider associations (and providers) who are primarily operating in countries without IRR.

The finding that low-income customers are assumed to be more affected than average consumers also supports the thesis that the influence of interest rate restrictions differs for *mainstream* and *high-cost credit*.

Issue 4: What is the effect of different regulatory measures on credit access of low-income borrowers?

If **H1** holds, interest rate restrictions would be an obstacle to credit access for low-income borrowers. If regulators have a choice between different measures (including IRR) for a specific policy goal (eg. reduce over-indebtedness, see Chapter 2.5.6, page 274), they may take this potentially adverse effect into consideration. The following paragraphs discuss the importance of this problem compared to adverse effects of other measures on credit access.

Facts and Figures

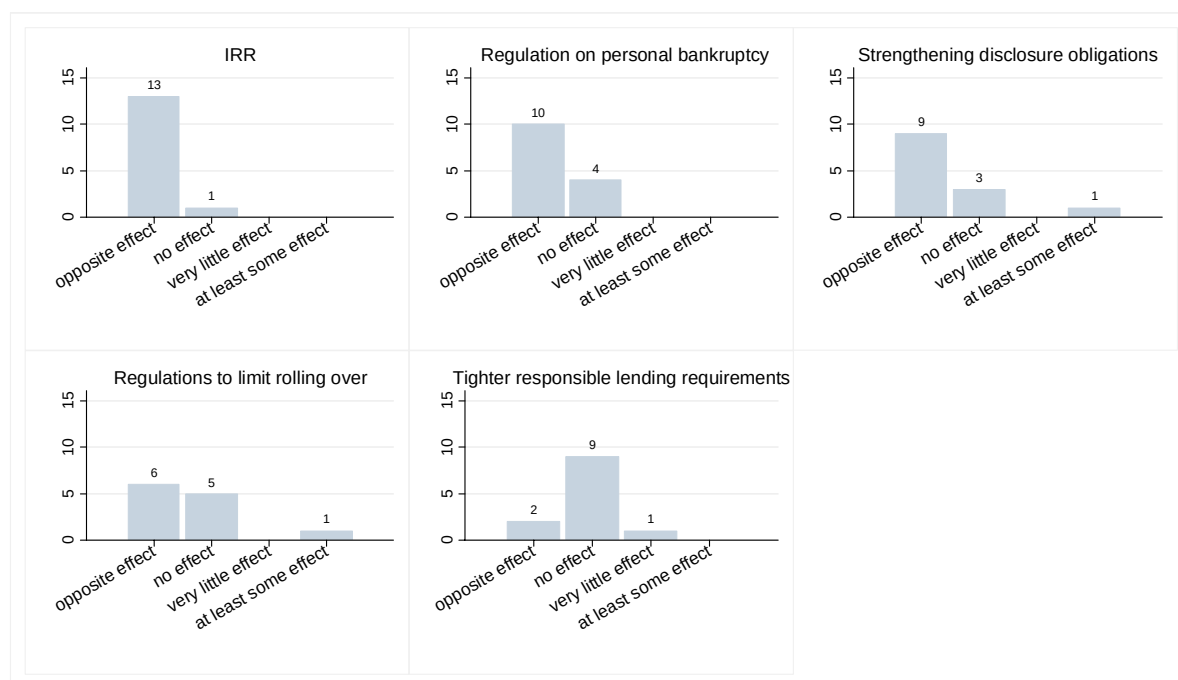
As revealed in Figure 69 and Figure 70, almost all respondents from provider associations (93%) and half of the respondents from consumer organisations assert that interest rate restrictions would reduce credit access.²²² Compared to other regulatory measures, interest rate restrictions are expected to have the most pronounced effect in this respect. In contrast, consumer organisations even expect policy measures which limit rolling over of existing credit and which set tighter responsible lending standards are to increase the level of credit (Figure 70). Provider associations, in contrast, do not expect any of the listed policy measures to be effective in reducing credit access (Figure 69).

²²⁰ PQ Question: In 2009 PORTUGAL introduced rate ceilings capping the authorised interest rate on consumer credit. Since the second quarter of 2010, the ceiling has been set as the average market APR (annual percentage rate) charged in the previous quarter times 1.33. How, in your view, will this measure affect the proportion of highrisk borrowers able to obtain credit (...) Assume that the same interest rate ceilings, as those introduced in Portugal in 2010, were introduced IN YOUR COUNTRY. What do you think will be the effects of this measure on the proportion of high risk borrowers able to obtain credit IN YOUR COUNTRY?

²²¹ Eg. home credit providers from UK and Poland as well as a provider association from UK.

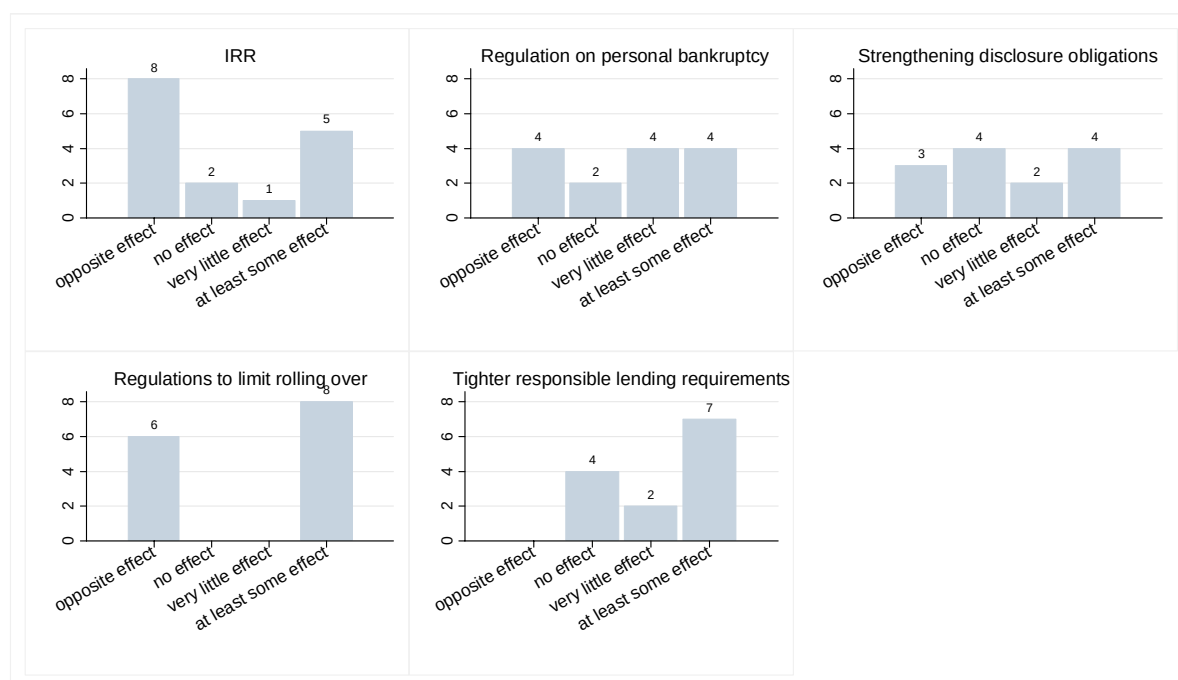
²²² This effect of reduced credit supply in the presence of interest rate restrictions is also highlighted by Eurofinas (2010).

Figure 69: Effectiveness of different measures to increase credit access for low-income borrowers, views of provider associations



SQ Question: Which of the following regulatory activities would have the most pronounced effects on improved credit access? [the opposite effect/no effect/ very little effect / some effect /strong effect/ very strong effect]

Figure 70: Effectiveness of different measures to increase credit access for low-income borrowers, views of consumer organisations



Discussion

It appears that, among other potential measures, interest rate restrictions are seen as a particular obstacle to credit access for low-income borrowers. According to the stakeholder's views, **H1 is thus plausible**. It should be noted, however, that the improvement of credit access is not a sensible policy target in the opinion of the majority of stakeholders (see Figure 63).

2.5.2 H2: IRR lead to a decline in the volumes of consumer credit granted.

2.5.2.1 Overview

Overall, it appears *unlikely* that the presence of IRR has the effect of substantially shrinking the consumer credit market volume.

- This hypothesis is potentially important because it is directed towards *macroeconomic* implications: if there is evidence that the entire credit market is impaired by interest rate restrictions, this will have consequences for the economic development.
- Earlier literature has compared credit market sizes in France, Germany and the UK, concluding that this difference arises, among other factors, from different interest rate regulation. **This view is in favour of H2.**
- Comparing a larger number of countries *with* and *without* interest rate restrictions, the details above document a heterogeneous pattern of the level as well as the growth rates of consumer credit across countries. **These findings are against H2.**
- After the introduction of interest rate restrictions in Poland and Germany, these countries have experienced higher subsequent credit market growth, which is against H2. In contrast, in the Dutch case, credit volume declined after a tightening of interest rate caps. With respect to **H2, these are mixed results.** However, since there are many other influencing factors in all cases, these results have to be interpreted with caution.
- As revealed in Chapter 2.4.2, the high cost credit market segments (which are supposed to be the most sensitive to interest rate restrictions, such as home credit providers, payday lenders and pawn brokers) only represent a minor share of the total credit volume. An example is the UK, where non-mainstream lending represents about 1% of the total consumer credit volume.

2.5.2.2 Introduction

The claim made in **H2** is bold in the sense that it addresses the *entire* market for (at least non-mortgage) consumer credit. It is not concerned with *specific* market segments which might be particularly sensitive to interest rate restrictions. As a consequence, this hypothesis is not so much directed towards *microeconomic* questions (eg. credit access of a particular household), but rather to *macroeconomic* questions (eg. the role of credit for economic growth): as described in Chapter 2.2, it has been argued that the level of consumer credit has an impact on domestic spending and, ultimately, on economic growth. This “multiplier effect”-type argument is also made by practitioners in the credit market industry. The following paragraphs will therefore discuss the plausibility of **H2**.

2.5.2.3 Existing literature

For the Member States of the European Union, it is primarily the study by Policis (2006a) which claims that interest rate restrictions are associated with lower levels of consumer credit in the respective countries. To illustrate this point, Policis (2006a) compares the size of the consumer credit markets in the UK, France and Germany and finds that the UK (without IRR) has the largest, whereas Germany (with stricter rules) has the smallest consumer credit market among these three countries. They consider these findings evidence in favour of **H2**. Eurofinas (2010) claims that the low levels of consumer credit per GDP in the Netherlands were caused by its regime of interest rate restrictions.

The expectations of declining volumes of consumer credit following an introduction of an interest rate ceiling are largely shared by credit providers participating in our provider survey.²²³ With only a few exceptions, participants expect the total volume of lending to decrease.

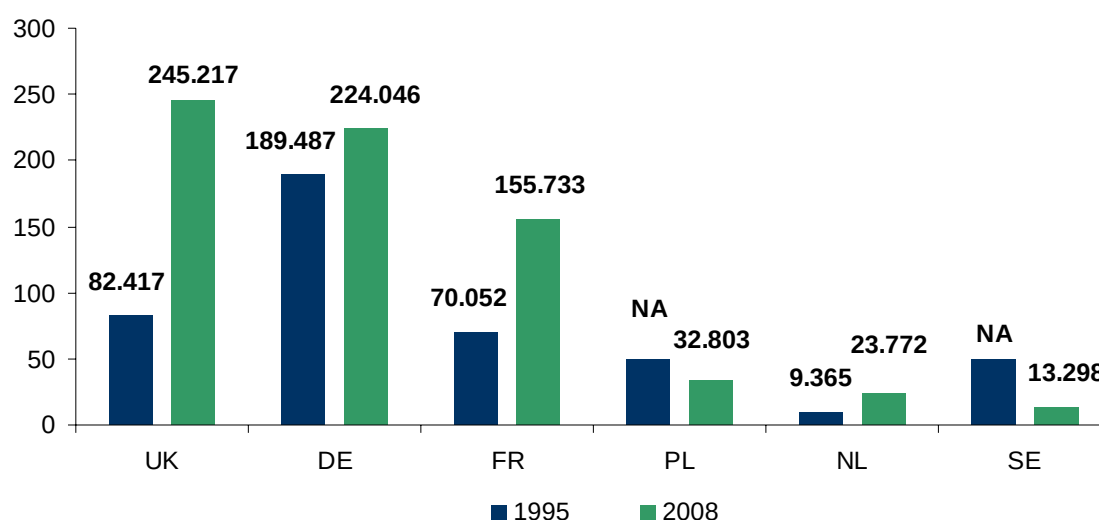
Policis (2006a) even goes one step further and attributes the higher UK *growth rates in GDP per capita* between 1995 and 2005 to the stronger growth in consumer credit (compared to Germany and France). We find it doubtful that the main distinctive driver between GDP growth in the UK and in Germany can be found in the prevalence of consumer credit. Rather, it is a multitude of influencing factors differing across these countries, in particular the sectoral composition of their economy, labour market institutions, and the timing of business cycles. Even the housing price bubble in the UK until the financial market crisis (while there was none in Germany) has impacted the consumer spending behaviour. It also needs to be noted that in the years after the ones considered by Policis (2006a), real GDP growth rates tended to be more favourable in Germany than in the UK, although no substantial changes in consumer credit regulations occurred.

As described in the following sections, the picture of the consumer credit market is much more multi-faceted than Policis (2006a) suggest. This becomes apparent when considering several countries beyond the ones considered by Policis (2006a), as is done in Chapter 2.5.2.4.

2.5.2.4 Cross-Country comparison

Figure 71 indicates the size of the consumer credit markets (without mortgages) of the selected six countries: Germany, France, the Netherlands, Poland, Sweden and the UK. It becomes apparent that the largest market in this group is the UK market with a consumer credit volume of EUR 245.2 billion. It is followed by Germany and France with EUR 224 billion and EUR 155.7 billion. Notably, Poland's consumer market already surpassed those of the Netherlands and Sweden in absolute terms in 2008.

Figure 71: Consumer Credit in EUR billion, current prices



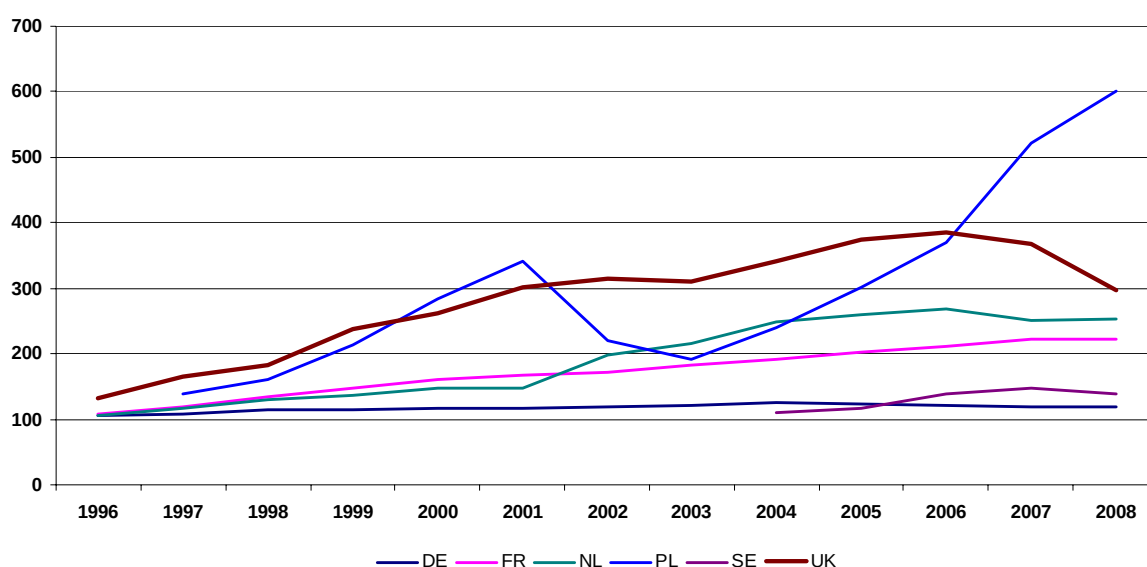
Source: ECRI (2009), "Lending to Households 1995-2008".

²²³ Among the participants are commercial banks, credit card providers, home credit providers, pawnbrokers and a building society from the Netherlands, the UK, Germany, Sweden, Poland and the Czech Republic.

Figure 72 shows the trends in consumer credit in the period 1996-2008, with the year 1995 as base year. In all countries, with the exception of Germany, we observe growth rates in the stock of consumer credit during this period. With the exception of Poland, growth in all six countries slowed during the period of financial turmoil of 2007-2008.

In the context of interest rate restrictions, it is interesting to note that the country with the fastest growth is Poland, where interest rate restrictions have been in place since 2005. Poland experienced the highest annual real growth rate of 13.2% during the period from 1997-2008. After the introduction of IRR in Poland in 2005, real growth rates stood at impressive 25.2%. Of course, we do not know what growth rates would have been observed in this country had interest rate restrictions *not been introduced*. France and the Netherlands, where interest rate restrictions are also in place, have enjoyed a stable growth in the volume of consumer credit, albeit not as strong as in the UK.

Figure 72: Trends in Consumer Credit, End-of-Period Stocks, 1995=100%



Source: ECRI (2009), "Lending to Households 1995-2008".

Regarding the market share of **non-mainstream lending** in the six case study countries, it seems that its importance compared to conventional credit is limited: For Provident Polska, the main home credit provider in Poland, we estimate a market share of less than 1% of the whole consumer credit market. The Dutch market for flash credits (Flitskrediet) is tiny with an annual volume of EUR 6 million²²⁴ estimated, which accounts for less than 0.03% of the consumer credit market. Even in UK, where the volume of non-mainstream credit such as pawn broking, payday lending and home lending are comparably high, their market share is slightly more than 1% of total consumer credit.

Discussion

The details above document a heterogenous pattern of the level as well as the growth rates of consumer credit across countries. When looking at several countries with diverging forms of interest rate regulation (instead of only UK, France and Germany), it is apparent that this pattern cannot solely be explained by interest rate restrictions. As other factors dominate relative size and growth of the consumer credit markets, **it appears unlikely that H2 holds.**

²²⁴ With an annual volume of EUR 6,000,000 and an average maturity of 24 days, the average outstanding credit would amount to only EUR 400,000.

2.5.2.5 Evidence from the past

In this section we provide an illustration of the development of the volumes of consumer credit after the introduction of interest rate restrictions in **Germany** and **Poland** in 1981 and 2005, respectively, and a change in interest rate regulations in the **Netherlands** in 2006. A brief summary of the results is given in Table 57.

Table 57: Evidence from the past – volume of credit (H2)

Country	Year	Event	Observation	Tendency	Alternative Explanation
Poland	2005	Introduction of IRR	Strong increase in consumer credit volume	Evidence against H2	Strong consumer credit growth in all New Member States; convergence to EU 15 levels
Netherlands	2006	Legislative Change: Decrease in interest rate cap	Decrease in consumer credit volume	Evidence in favour of H2	Financial market crisis; similar development in, eg. Germany; cyclical downturn.
Germany	1981	Introduction of IRR	Increase in total consumer credit volume; increase particularly for longer maturities, decrease for shorter maturities	Evidence against H2	Secular upward trend for consumer credit in the 1980s in Europe

Example 1: Poland

Background

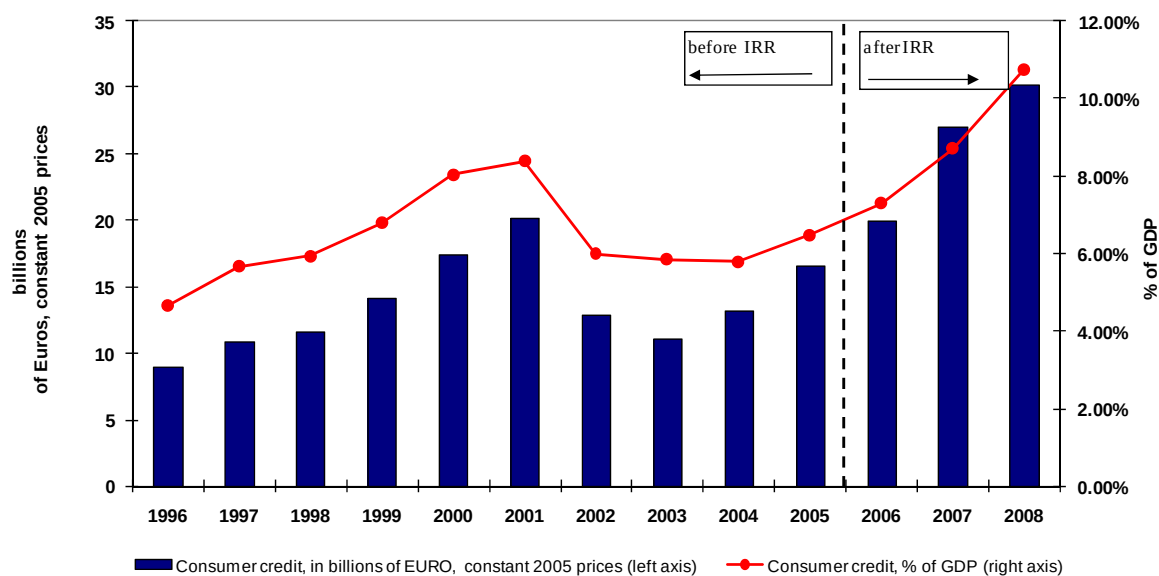
As described in Chapter 1.2.1.3.8, Poland introduced interest rate restrictions in 2005. These restrictions refer to the borrowing rate and not to the total cost of credit (ie. APR), and are defined as four times the central Lombard rate. In addition, restrictions were imposed on the fees and additional charges related to granting a loan, which must not exceed 5% of the amount of credit.

Facts and Figures

Figure 73 shows the dynamics of the volume of consumer credit in Poland in absolute terms and relative to GDP for the period from 1996 through 2008: the volume of consumer credit has been steadily increasing since 2003 and we observe no decline in the volume of consumer credit in the three years after 2005. Notably, the average annual growth rate of consumer credit during 2005-2008 was 22.5%. This is higher than the

average annual growth rate for the period 1996-2008, which constituted 18.2%. As a percentage of GDP, consumer credit has grown from 6.5% in 2005 to 10.8% in 2008.

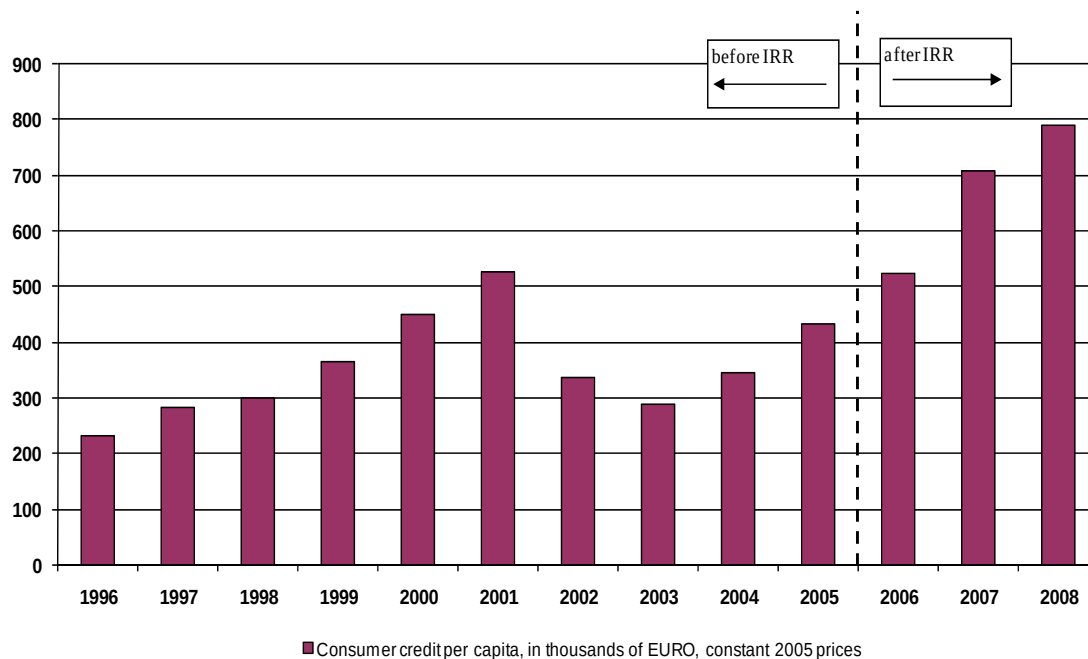
Figure 73: Consumer Credit in Poland, 1996-2008



Source: ECRI (2009), "Lending to Households 1995-2008".

Figure 74 presents consumer credit per capita. Likewise, after 2005 consumer credit per capita has grown from EUR 433 to EUR 790, an increase of 83%.

Figure 74: Consumer Credit per Capita in Poland, 1996-2008, in EUR.



Source: ECRI (2009), "Lending to Households 1995-2008".

Discussion

These observations do not support the view that the introduction of interest rate restrictions has led to a decline in the overall volume of credit granted, as suggested by **H2**. Instead, the volumes continue to increase even after the introduction of interest rate caps in 2005. However, one has to be cautious to draw general conclusions from these data: it is impossible to tell whether or not the increase of consumer credit volume would have been even more pronounced in the *absence* of such regulation. As Figure 25 through Figure 28 demonstrate, the growth in the Polish consumer credit market (in the considered time span) is rather typical for new EU Member States (which face heterogeneous forms of interest rate regulations), and reflects a convergence in living standards and GDP per capita in comparison to the EU 15 countries as well as the development of financial services provision to households (consumer credit practically did not exist in the country until ca. 1996 (ECRI, 2009)). These figures in the Polish case demonstrate that the introduction of IRR does not appear to have been a severe obstacle in this process of convergence to EU 15 standards, as it does not result in lower total consumer credit volumes.

Example 2: The Netherlands

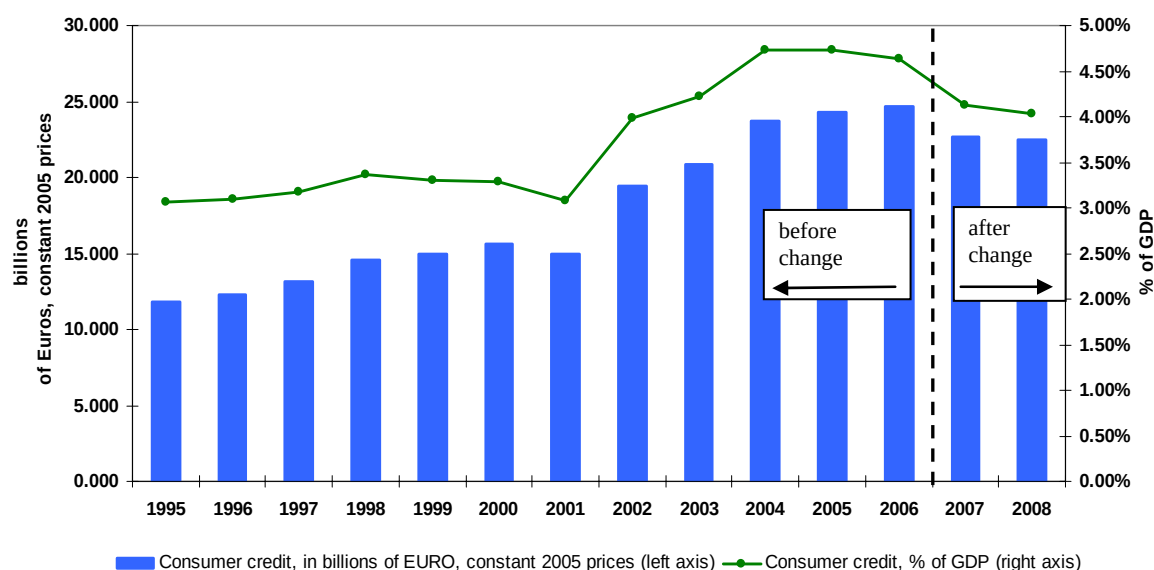
Background

Unlike Poland, where interest rate restrictions were introduced in the recent past, the Netherlands have decreased the level of *existing* interest rate caps from an allowed spread of 17% to 12% above the legal rate in 2006. See Chapter 1.2.1.3.7 for details on the interest rate ceiling in the Netherlands.

Facts and Figures

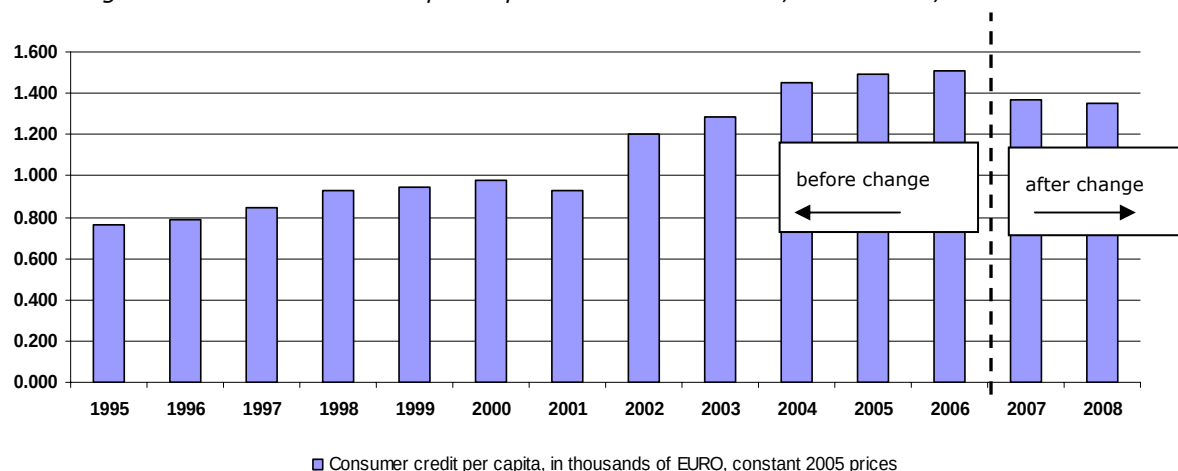
Figure 75 shows the development of consumer credit in absolute terms and as a percentage of GDP in the Netherlands from 1995 to 2008. Consumer credit declined by about 8.9% between 2006 and 2008. Consumer credit per capita declined from EUR 1,508 to EUR 1,348, which represents a 10.6% decline (Figure 76).

Figure 75: Consumer Credit in the Netherlands, 1995-2008



Source: ECRI (2009), "Lending to Households 1995-2008".

Figure 76: Consumer Credit per Capita in the Netherlands, 1995-2008; in EUR 000s



Source: ECRI (2009), "Lending to Households 1995-2008".

Discussion

These observations suggest that the Netherlands experienced a decline in consumer credit after the tightening of interest rate regulations, which would be in line with **H2**. However, it appears advisable not to overstress these findings for several reasons: first, it has to be noted that the years 2007 and 2008 were overshadowed by the financial market crisis, which is likely to have impaired the ability of the financial institutions in the Netherlands to provide credit to households.²²⁵ Second, it is unclear whether or not the decline would also have occurred had there been no changes in regulation. In this context, it has to be noted that in Germany (which had not seen a change in its regulation at this point in time), the years 2007 and 2008 were also those with the lowest consumer credit volume since 2002 (see Figure 34). Third, the time span of only two years after the event is too short to allow firm conclusions: as the consumer credit market has experienced relatively high growth rates in the Netherlands in the years prior to 2006, the decline can also be seen as a cyclical downturn.

Example 3: Germany

Background

In Germany, interest rate restrictions have been introduced by courts since 1981. According to these, it is not allowed to charge more than double the average interest rate. (For more detail, see Chapter 1.2.1.3.1.) While the process of the introduction required several court decisions over a time span of several years, we consider the year 1981 the starting point of the regulation for the purpose of this analysis. However, one should also have a closer look at the subsequent years, in which interest rate restrictions became increasingly effective.

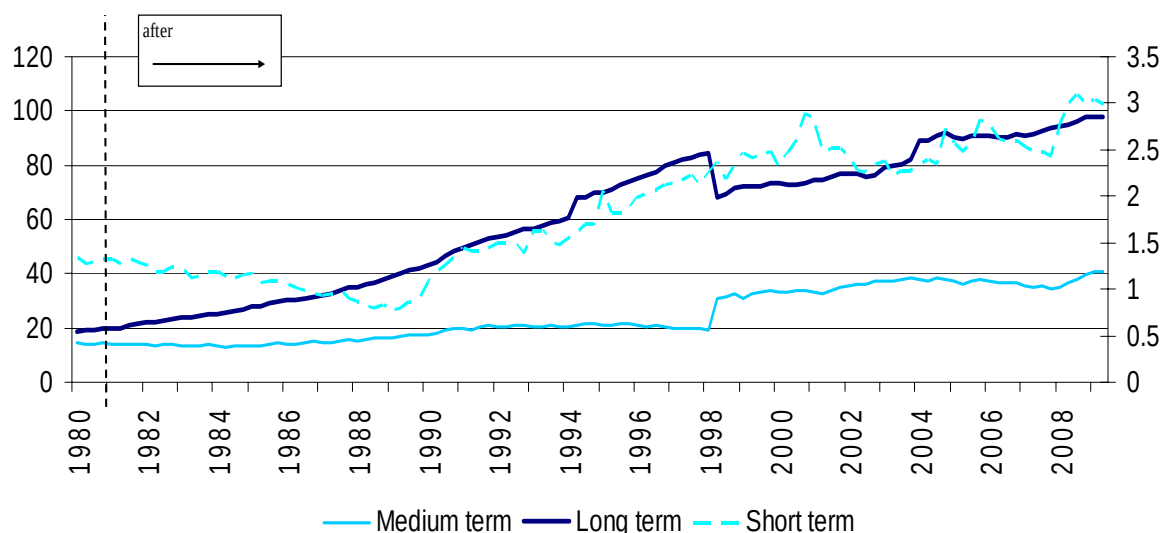
Facts and Figures

The analysis of this less recent event is more cumbersome than the others due to the lack of data availability. As the Bundesbank reports, the categorisation of consumer loan contracts in different subgroups was entirely different before 1980 and is thus not comparable to the figures from the post-1980 period. As a consequence, Figure 77 is only able to capture the final stage of the pre-regulated period in Germany.

²²⁵ See Netherlands Bureau for Economic Policy Analysis, 2009. The Credit Crisis and the Dutch Economy 2009-2009, (http://www.cpb.nl/eng/pub/cepmev/cep/2009/pdf/summary_uk.pdf).

Figure 77 reveals the following: Germany experienced an increase in consumer credit during the 1980s. Just before the implementation of interest rate restrictions in 1981, the levels of volumes for *medium-term* and *long-term* credit were similar. In the following years during the 1980s, however, Germany experienced a steady increase of long-term instalment credits, while there was a modest decline in medium term instalment credit contracts in the first half of the 1980s (and a rebound afterwards). Also, the volume of short-term instalment credit (which is on a much lower level) declined during this decade.

Figure 77: Volume of Instalment Consumer Credit in Germany, different maturity groups, in bn. Euros



Source: www.bundesbank.de, own calculations.

Note: Interest rates used are effective annual interest rates (new business). "Short term" captures <1yr., "Medium term" captures 1-5 yrs., "Long term" captures >5 yrs.; the right y-axis displays the monetary values for short term contracts only, while the left y-axis captures the values for the medium term and long-term contracts.

Discussion

The overall instalment credit volume does not decrease, **as H2 would suggest**. It is likely that there is a strong secular trend for consumers to finance part of their expenditures by credit underlying this development. Again, it is impossible to quantify whether or not this trend would have been even stronger *without* IRR.

We see a differentiated pattern for different maturity types of consumer credit: the growth of consumer credit is most pronounced for long-term maturities, while there is a decline in short-term and medium-term credit in the first half of the 1980s. This might be a reaction to the introduction of interest rate restrictions: long-term contracts might give lenders the opportunity to cover operational costs, as well as to lower the APR while maintaining a given level of upfront administrative fees. These factors could help maintain interest rates below the interest rate cap.

2.5.3 H2a: Without IRR, more product types exist in the market.

2.5.3.1 An Overview

Comparing the incidence of credit and especially high-cost credit in countries with and without IRR, we conclude that **H2a** is *plausible*.

- Countries *without* interest rate restrictions tend to have a higher prevalence of personal loans/auto loans than countries *with* interest rate restrictions. **This observation supports H2a.** However, the relationship between interest rate restrictions and the level of credit is unlikely to be purely mechanistic. Rather, both the lower levels of consumer credit and the tougher regulation of credit (including interest rate restrictions) *are consequences* of a country's attitude towards credit.
- The prevalence of mortgages can be expected to depend on a variety of factors, such as the demand for owner-occupied housing or lending standards of banks. In contrast, they are likely to be rather unaffected by typical interest rate caps, as they have usually relatively low interest rates.
- **It is likely that interest rate restrictions prevent market entry of one or some forms of high-cost credit, as H2a suggests.** On the other hand, it is probably also common that (in countries with IRR) providers tailor the products such that existing interest rate legislation does not apply.
- Higher-cost small-volume credits tend to be more important in countries without IRR. This is revealed by the stakeholders, **and confirms H2a.**
- Evidence from the stakeholder questionnaire reveals that countries without IRR tend to have higher levels of coverage with (true) credit cards; there is mixed evidence for overdraft facilities. It is likely that the acceptance of credit card credit is again closely related to the country's credit culture.
- According to the views of the **provider associations responding to the Stakeholder Questionnaire**, it is likely that the introduction of interest rate restrictions would lead to a reduction of available credit types. **This would support H2a.** The critical credit types are those which are most suitable for low-income customers.

2.5.3.2 Evidence from the Past / Perception of Stakeholders

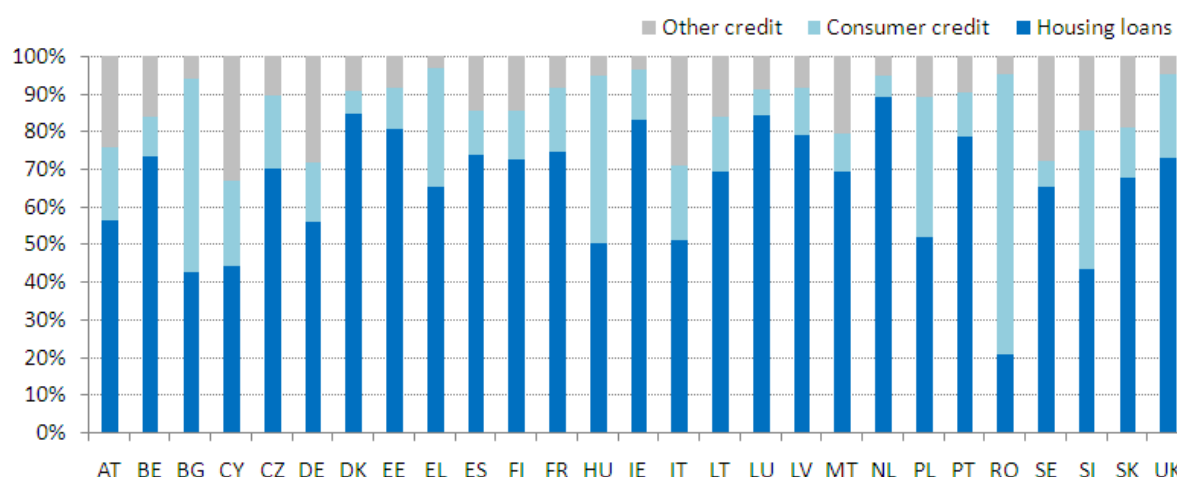
Issue 1: How common are different credit types?

Credit markets are heterogeneous across EU Member States. To obtain a broad picture about the product variety in a large set of countries, we attempt to characterise the importance by consulting data from different sources: the Eurobarometer Survey from 2005, data from Oliver Wyman referring to the year 2006 and, where appropriate, we return to data from ECRI as summarised in the Chapters 2.3.3 and 2.4. Furthermore we consider the more recent *perceived relative importance of different credit types* as reported by the surveyed stakeholders in the EU 27 countries. Along the line of these findings, we discuss hypothesis **H2a** with respect to the individual types of credit.

a) Mortgages

Facts and Figures

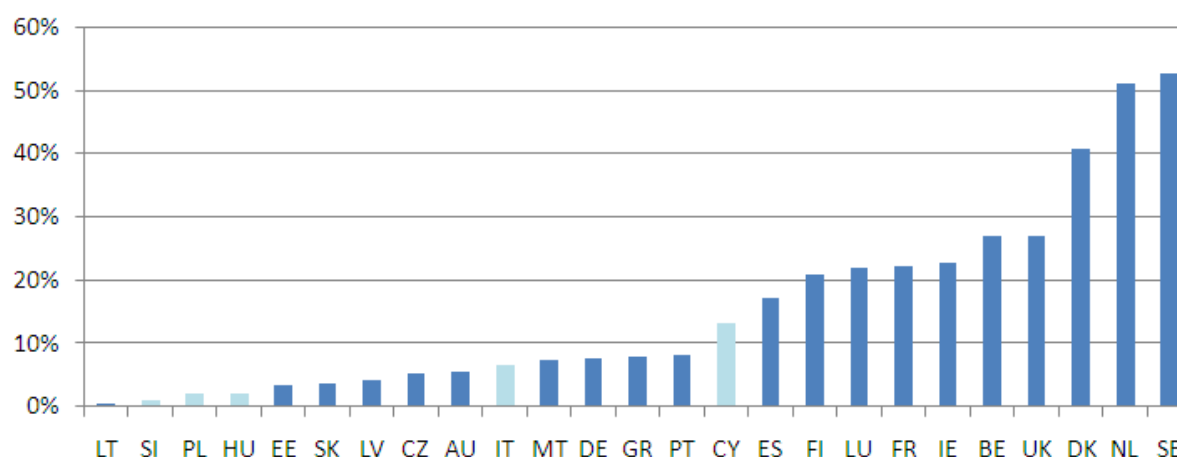
Figure 78: Distribution of loans in EU 27 Member States, 2008



Source: ECRI (2009), "Lending to Households 1995-2008".

As Figure 78 shows, **mortgage loans** amount for the highest shares of credit volumes compared to other loans in most countries.²²⁶ Still, this does not directly tell how widespread mortgage loans are in the different countries. Therefore, Figure 79 shows the prevalence of mortgages which can be deduced from Eurobarometer data. The survey asked households whether they hold a mortgage. The figure reveals, that even in countries in which mortgage credit amounts for high shares of total credit, only small fractions of households actually hold a mortgage loan (for example, this is the case for Estonia, where 80% of total credit are mortgage loans, but only 4% of households hold a mortgage). Altogether, data from ECRI and Eurobarometer match in a sense that most countries, in which mortgage credit accounts for a high fraction of total credit, the proportion of households holding a mortgage is high as well (examples are the Netherlands, Denmark and the UK). The opposite shows true as well, since Slovenia, Poland and Hungary (with low percentages of households holding a mortgage loan) are among the countries in which mortgage credit accounts for less than (or around) 50% of total credit.

Figure 79: Prevalence of mortgages among EU-25 households, 2005



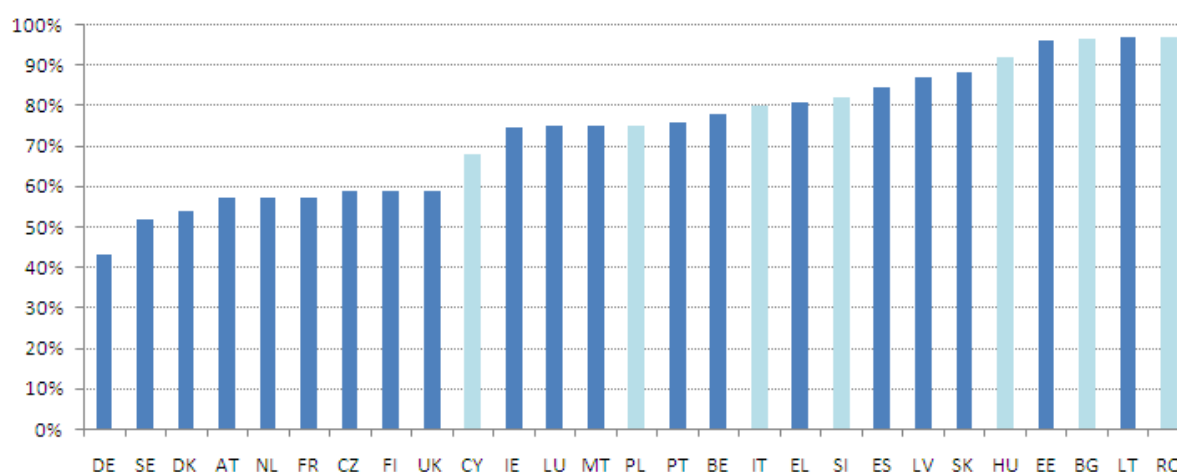
Source: Eurobarometer 63.2, Variable: QB 11.

Note: Countries in which mortgage credit amounts to less or equal 50% are highlighted.

²²⁶ There are some exceptions of some south and east European countries.

These findings largely coincide with the results from the Stakeholder Questionnaire. To characterise the importance of credit types in the different countries, we asked stakeholders to evaluate the importance of specific products in their countries according to the scale (0: not existent, 1: uncommon, 5: widespread). The median stakeholder responses are displayed in Table 58. Mortgage loans are also subjectively perceived to have the highest prevalence compared to other loans in most countries. An exception is, eg. Germany, which exhibits the second lowest figure for mortgage loans after Slovakia (the result for Slovakia is plausible comparing them to the figures from ECRI and Eurobarmoter). The relatively low value for Germany is consistent with the low owner-occupation rate for housing in Germany (Figure 80). It is also in line with the relatively low (compared to other EU 15 countries) level of housing loans per capita, as documented in Figure 17 and the low prevalence of mortgage debt which is documented by Eurostat. However, one has to note that even for Germany, the volume of housing credit amounts to more than half (55.99%) of the entire volume of credit to households (Table 48, p.203). This is lower than the share of mortgages to total credit in France (74.6 percent) or the UK (72.84 percent).

Figure 80: Owner-occupation rates for the EU 27 Member States, 2008



Source: Hypostat (2008). Countries in which mortgage credit amounts to less or equal 50% are highlighted.

Figure 80 demonstrates that the highest shares of ownership rates are found among the New Member States of the European Union. This observation is the outcome of a massive privatisation process in the transition to market economies in those countries.²²⁷ Still, as Figure 17) reveals, the typical level of mortgage *volume per capita* in the New Member States is rather low, and mortgages only account for 52.2 percent of total credit to households. Nevertheless, with the exception of Slovakia, the stakeholders assess mortgages to be relatively widespread in the New Member States. Note that the Netherlands has the largest share of mortgages to total credit (89.15%), and stakeholders accordingly perceive it to have a very strong importance.

²²⁷ For more details on the housing markets in Poland, see Kierzenkowski (2008).

Table 58: Prevalence of different product types across countries

	Mortgage loan	Auto / vehicle loan	Other personal loans	Point-of-sale / Mail-order loans	Overdraft facilities	Credit-card credit	Pawnbroker loans	Home loans	SMS loans	Payday loans
Austria	4	2	4	3	5	3	2	1	1	1
Belgium	4.5	0	2.5	2	2.5	2.5	0	0	0	0
Bulgaria	4.5	1.5	4	1.5	2.5	3	2	1	1	1
Cyprus	5	5	4		4	5				
Czech Republic	4	5	4	3	4	4	3	2	0.5	0
Denmark	5	5	5	5	5	5	2	0	3	0
Estonia	2.5	2.5	2.5	1	2	2.5	2.5	0.5	2.5	0.5
Finland	5	5	5	5	4	5	4	2	5	0.5
France	4	4	4	3.5	4	4	2	0.5	1	1
Germany	3	4	4	3	4	3	1	1	0	0.5
Greece	5	5	5		5	5	1			
Hungary	5	4	4	0	2	3	2	3	0	0
Italy	5	5	5	4	3	4	1	2	1	1
Latvia	5	5	4	0.5	4	4.5	2.5	2	4.5	4
Lithuania	0	0	0	0	0	0	0	0	0	0
Luxembourg	5	5	4.5	3.5	3.5	4.5	1			1
Malta	5	5	5		3	5				1
Netherlands	4.5	4	3.5	3	5	3.5	2	2	2	2.5
Poland	4	3	4	1	4	4	1	2	0	0
Portugal	5	5	5	3	4	5	2	1.5	1	2
Romania	5	5	2.5	3.5	3.5	3.5	4.5	2		
Slovakia	4	4	4.5	1	2.5	3	0.5	1.5	0.5	0.5
Slovenia	4	4	4.5	2.5	4	2.5	1.5	2	2	2
Spain	5	5	5	3	3	5	2	1	1	2
Sweden	5	3	3	3	1	3	1	1.5	2	0.5
United Kingdom	5	5	5	4.5	5	5	3	3	1	2.5

Source: Stakeholder Questionnaire, median values where multiple answers.

Scale for selection was 0: not existent, 1: uncommon to 5: widespread

Discussion

Mortgages are unlikely to be affected by a general interest rate cap applying to all different forms of consumer credit:²²⁸ as demonstrated by Table 42 (p. 185), the typical levels of mortgage interest rates (depending on the fixation period) are lower than other forms of consumer credit,²²⁹ ie. only few percentage points above long-term government bond yields in those countries. In this context, note that the demand for *owner-occupied housing* (and as a result for mortgages) depends on a variety of factors, such as the availability of high quality rental dwellings as an attractive substitute to owner-occupied housing, possibilities of tax deduction of mortgage interest rates, as well as the lenders' collateral standards.

b) Overview on Consumer Credit

Facts and Figures

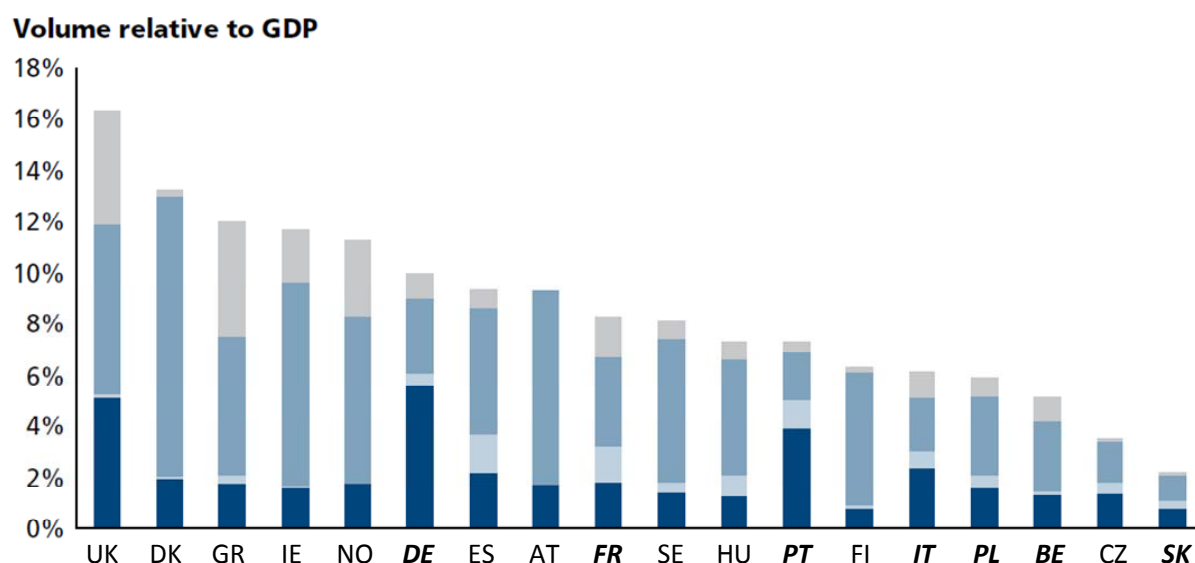
Consumer credit can itself be split in several sub-groups such as personal loans, auto/vehicle loans, point-of-sale credit and revolving credit. An overview of the relative importance of different forms of consumer credit, measured by each forms volume relative to the national GDP is given in Figure 81. The results are taken from a report of Oliver Wyman (2008) which relies on different institutional sources. It reports findings for 2006. The analysis will then focus on specific forms of consumer credit: personal loans and auto / vehicle loans, revolving credit and non-conventional forms of credit.

Figure 81 shows an overview of the outstanding volumes of different credit forms in relation to national GDP (labelled "market penetration"). These vary widely across Europe. Concerning different regulatory regimes on interest rates (countries with IRR are given in bold letters), there are higher volumes of the different credit forms outstanding in countries without IRR.

²²⁸ Effects on mortgage markets may be more relevant in countries with *different* ceilings for different forms of credit with comparably low levels for caps on mortgage interest rates. However, one should note in this context that even for the French case (with separate IRR on mortgage credit), it has still been argued that interest rate restrictions have a negligible effect on the mortgage markets (IGF/IGAS 2009, p.4/17).

²²⁹ As described in Section 4.5.4.2.1., the EU 27 median for 2009 is 3.52%- 5.38% for mortgage rates, 7.54%- 7.69% for consumer credit rates and 18.97% for overdrafts.

Figure 81: Market penetration for different consumer credit products, 2006



Source: Oliver Wyman (2008). Countries with IRR in place are given in bold, italic letters.

Discussion

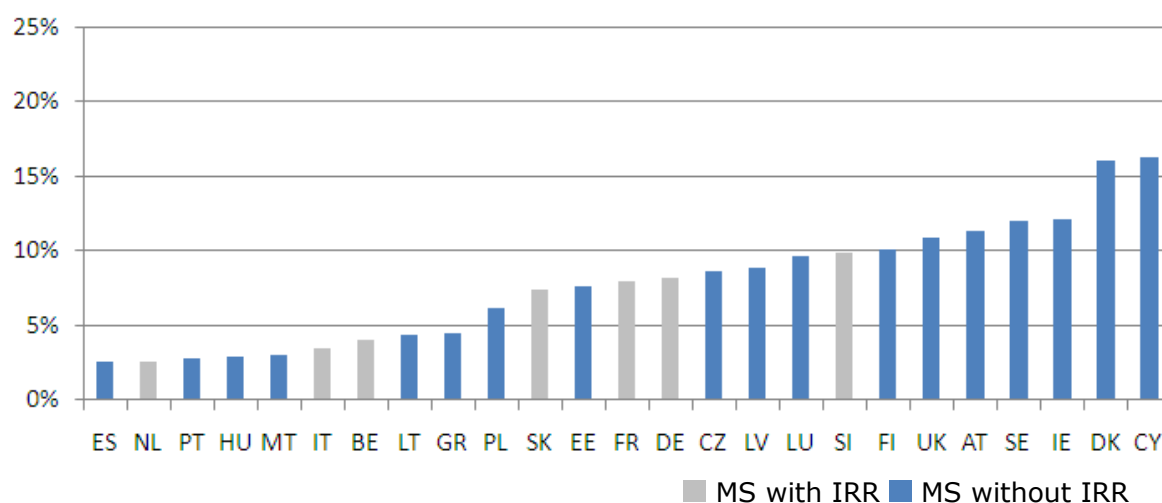
There is a tendency that countries *without* IRR display higher volumes of different forms of consumer credit than countries *with* IRR. **This would support H2a.** However, as specified in the report by Oliver Wyman (2008), it is likely that penetration levels in practice frequently coincide with countries' attitudes towards credit in general and different forms of consumer credit in particular. For example, it is specified, that Belgium has always been culturally adverse to consumer credit which leads to lower levels of penetration with consumer credit in total compared to other equally developed markets (eg. Austria). On the other hand low market penetration in Slovakia and the Czech Republic can be explained by the fact, that the markets are still very young. An example for the dominance of a specific form of consumer credit can be given by Nordic markets which are highly concentrated on personal loans as a consequence of their predominant banking distribution channel.

c) Personal loans or auto loans

Facts and Figures

Personal loans and **auto/vehicle loans** are types of credit to finance major household investments. We first refer to the Eurobarometer (2005) survey responses of interviewed households. These objective figures are then cross-validated with the subjective prevalence of the credit forms as reported in the Stakeholder Questionnaire.

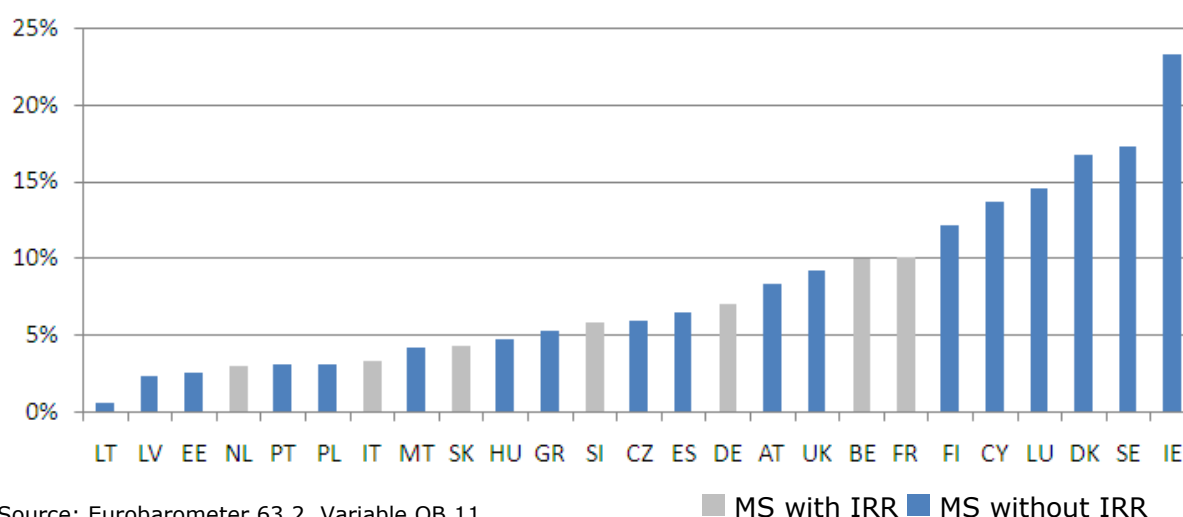
Figure 82: Prevalence of personal loans across EU 25 Member States, 2005



Source: Eurobarometer 63.2, Variable QB 11.

Note: Since regulations on interest rates in Poland and Portugal have been introduced in 2005 and 2009 respectively, they are not included in the group of Member States with IRR.

Figure 83: Prevalence of auto / vehicle loans across EU-25 Member States, 2005



Source: Eurobarometer 63.2, Variable QB 11.

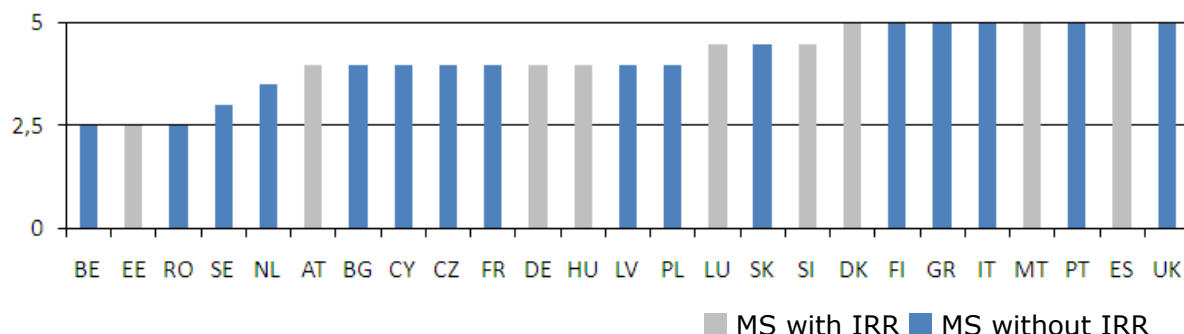
As Figure 82 and Figure 83 demonstrate, the prevalence of these types of credit is different across countries. It appears that the households from countries with IRR (grey colour) tend to report lower importance of this type of credit as the respondents from countries without IRR (blue colour): there is a clustering of "blue" colour on the right hand side of Figure 82 and Figure 83

In line with this, Denmark, one of the countries *without IRR*, belongs to the countries in which personal loans and auto/vehicle loans appear to be very common. This picture corresponds with the description in Figure 21 (p. 176), which details that Denmark is among the countries with the highest consumer credit per GDP. Same holds true for Ireland, Sweden and the UK, although auto loans are less prevalent in the latter. As opposed to these, the case study countries *with IRR* the Netherlands, France and Germany appear to be below the average in terms of importance of personal or auto loans.

The findings from the Eurobarometer survey can be validated with the up to date perceptions of the respondents to the Stakeholder Questionnaire. Their subjective

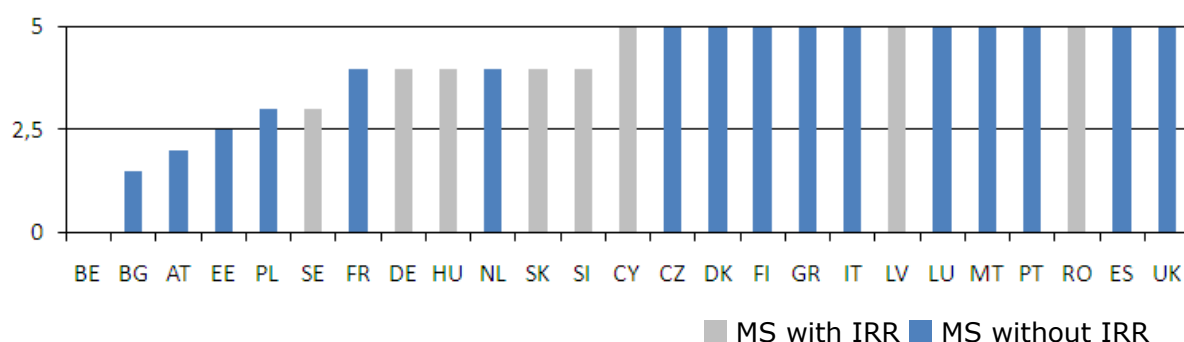
perception how important personal loans and auto / vehicle loans are in their home countries are displayed in the following figures. Again, the results for Member States with IRR in place are shown in grey colour.

Figure 84: Prevalence of personal loans across countries
(0: not existent, 1: uncommon - 5: widespread)



SQ Question: Please indicate which of the following forms of consumer credit exist and to what extent they are used.

Figure 85: Prevalence of auto/vehicle loans across countries
(0: not existent, 1: uncommon - 5: widespread)



SQ Question: Please indicate which of the following forms of consumer credit exist and to what extent they are used.

Note: Cross categorical mean of the median response within a category.

Although Figure 84 and Figure 85 differ in some respects from the statements made above for individual countries, it can be seen that countries *without* IRR tend to be among those with the highest share of credit. This finding is slightly more pronounced in the case of loans which are used to finance a vehicle.

Discussion

It appears that countries *without* IRR tend to have higher prevalence of personal loans/auto loans than countries *with* IRR. One reason could be that low-income borrowers (who have to accept differing conditions to compensate the lender for risk) cannot be offered credit at prices below the cap. **This would support H2a.** However, typical interest rates of personal loans (EU median 7.54%-7.69%) are usually well below the restricted levels. Therefore, it is likely that tougher interest rate restrictions in practice frequently coincide with other types of regulation which all have the purpose of *discouraging lending* to impaired households. Hence, it is plausible to assume that both lower levels of consumer credit and tougher regulation of credit (including interest rate restrictions) *both* are *consequences* from the *preferences* in the society of the respective country (see also the discussion about Figure 62 on the attitude to credit).

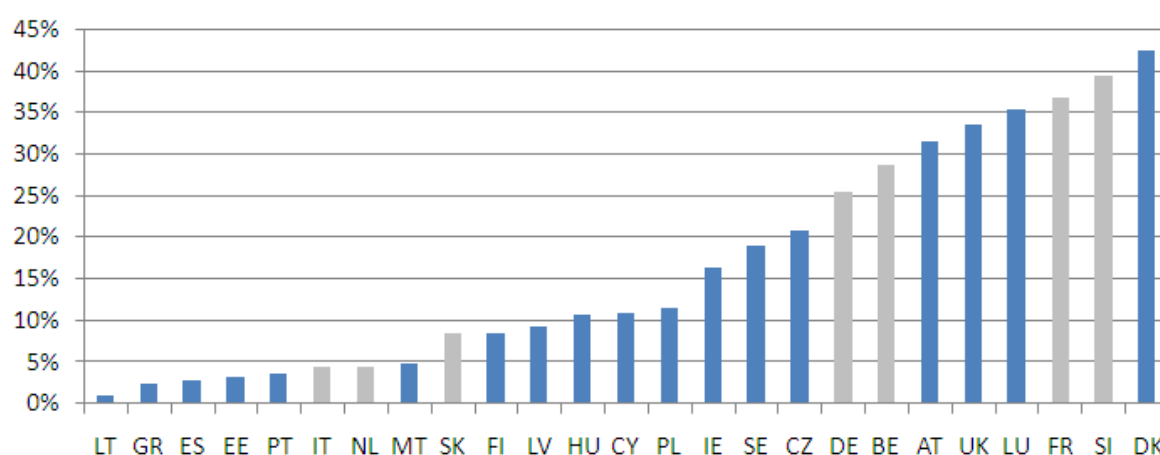
d) Revolving Credit

Facts and Figures

Overdraft credit and *credit card credit* are *revolving credit products*. Overdraft facilities are linked to a current bank account, and permit to borrow money spontaneously when the account's credit balance turns negative. Credit cards grant credit up to a specified limit. For both types, the *amount* borrowed and the *date to pay off the debt* can be chosen flexibly. Compared to personal loans, however, credits from overdraft facilities and credit cards are thought to be of *smaller amounts* and *shorter durations*. One has to note that the mere existence of an overdraft facility does not imply that the consumer actually makes use of it; there are also credit cards which are only used as a payment device rather than as a device of credit.

To judge the prevalence of **overdraft facilities** it is useful to consider first the share of households in the Eurobarometer (2005) survey who indicate that they have such a facility.

Figure 86: Prevalence of overdraft facilities across EU-25 Member States, 2005



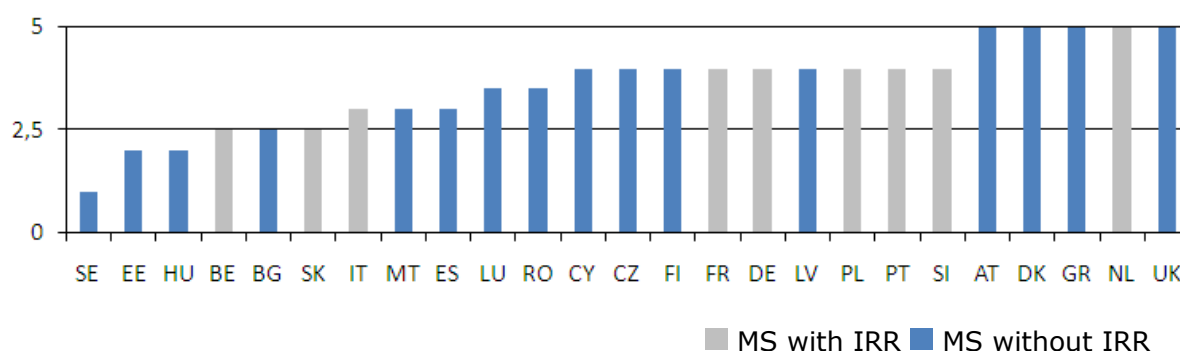
Source: Eurobarometer63.2, Variable: QB 11.

■ MS with IRR ■ MS without IRR

Figure 86 indicates these values for the year 2005 for the then 25 Member States. Again, countries *with* IRR are coloured in grey, while those *without* significant restrictions are shaded in blue. The UK is reconfirmed to have a *highly developed* credit market (while having no IRR), with high importance also of overdraft facilities. In contrast, however, Sweden (another case study country without IRR) is found to have only little prevalence of overdraft facilities. Broadly there is no clear clustering of countries with or without IRR on any end of the scale.

Comparing the importance of overdraft facilities as perceived by the respondents to the Stakeholder Questionnaire across countries, Figure 87 demonstrates that countries *with* IRR (grey colour) tend to be above average. Although the picture differs in some respects from the statements made above for individual countries, the overall impression is unchanged: No clear statement can be made about whether overdraft credit is more prevalent in countries *with* or *without* IRR.

Figure 87: Prevalence of overdraft facilities across countries
(0: not existent, 1: uncommon - 5: widespread)

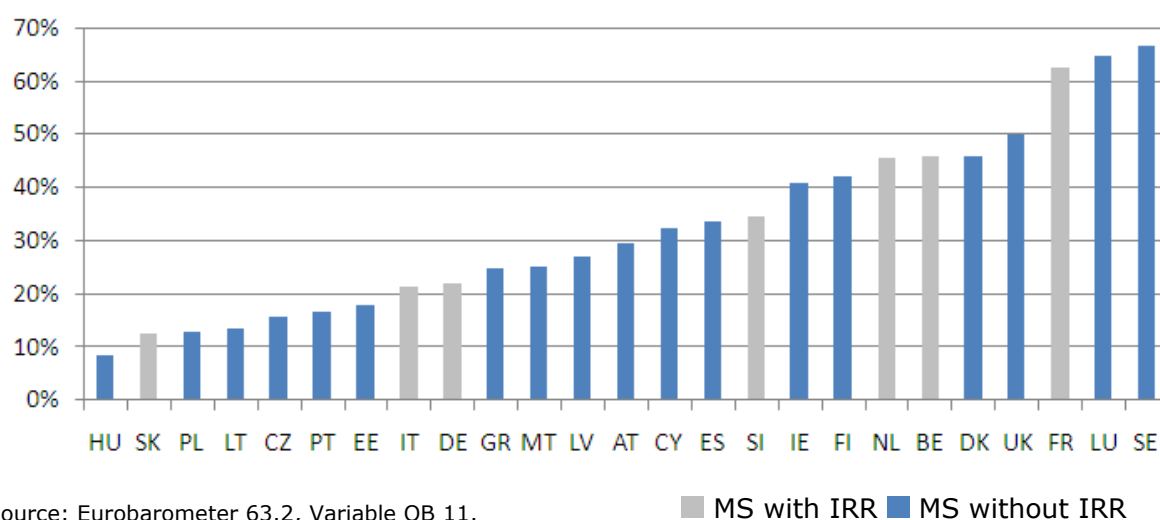


SQ Question: Please indicate which of the following forms of consumer credit exist and to what extent they are used.

Note: Median of the responses within a category

However, these figures should be interpreted with caution. When stakeholders indicate that overdraft facilities are “widespread”, it is not clear whether they judge a coverage rate of 20%, 60% or 90% of the total population. In some sense, respondents may consider all these figures to be characterised as “widespread”, as they are not asked to compare them with corresponding figures from *other countries* (as we do in this text), but with *other types of credit* in their own country.

Figure 88: Prevalence of credit cards across EU-25 Member States



Source: Eurobarometer 63.2, Variable QB 11.

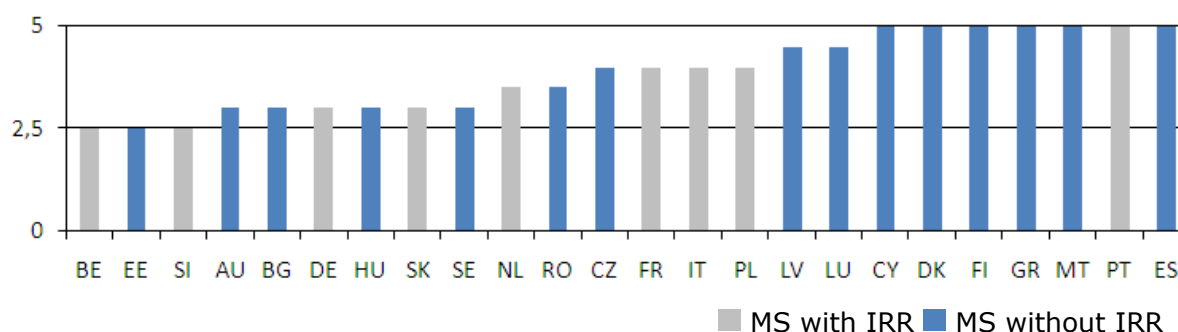
It can be seen in Figure 88 that **credit cards** are least frequent in young credit markets and in Portugal. It is striking that Eurobarometer respondents report high levels of credit card usage in Sweden whereas only limited importance of credit card credit is found when asking the stakeholders (see Figure 89 below). This can be explained as follows: while stakeholders assess the importance of credit card *credit*, Eurobarometer asks whether respondents *hold* a credit card. In Sweden, however, a pure debit function is about twice as frequent as a delayed debit or credit function, which means that there is no true credit involved in credit card payments. Another example is Germany where there are relatively few *pure credit cards* (3 million)²³⁰ compared to *delayed debit cards* (18.1 million), which are both counted as *credit cards* in the Eurobarometer survey.

²³⁰ Figures are from BIS (2009).

Therefore, we consider the Eurobarometer (2003) data on credit cards to be poorly suitable to measure the occurrence of credit card credit.

Judging from stakeholders' perceptions of the importance of credit card credit (Figure 89), it appears that there is only a limited number of countries *with* IRR in which credit card credit is perceived to be important. Only in Portugal (which has introduced the restrictions only recently) credit card credit is perceived to be very important. Again, the UK belongs to the countries with high levels of importance, whereas Sweden shows low levels.

Figure 89: Prevalence of credit card credit across countries
(0: not existent, 1: uncommon - 5: widespread)



SQ Question: Please indicate which of the following forms of consumer credit exist and to what extent they are used.

Note: Median of the responses within a category

Discussion

It appears that *credit card credit* is more frequently used in countries *with* IRR. For overdraft facilities, we obtain rather mixed evidence. We expect that parts of these differences across countries are originating from a different credit culture and different attitudes with respect to credit or the maturity of credit markets.

e) Pawnbroking loans, Home loans, SMS loans, Payday loans

This paragraph discusses different **non-conventional forms of credit**. They have in common that they are granted for *very short or short time spans*, and that the credit amounts are typically very small. As can be seen from the relatively low numbers indicated in Table 58, these types of credit are perceived to be less important than other forms of credit. This assessment corresponds to the relatively small share of these credit types compared to the overall consumer market. Eg. as discussed in Chapter 2.4.2.6 the volume of payday lending in the UK in 2008 is estimated at £ 700-900 million. This amounts to only less than 1% of total consumer credit in the UK.

In general, it is obvious from the legal part of the study and the relatively low interest rate ceilings in operation across the EU (see Table 8 on p63) that high priced doorstep credit according to the terms as observable in the UK, would not be possible in these countries where IRR exist. However, this does not answer the question of whether such credit would not be equally available at much lower cost in these countries. The existence or non-existence of each individual non-conventional credit product appears to be rather idiosyncratic for each country: **Home loans** are perceived to be relatively widespread in the **UK** and in the New Member States **Czech Republic, Hungary, Latvia, Romania, and Slovenia**. As discussed in more detail in the case study section (p. 213), home loans

also exist in **Poland**. It appears that these loan types are particularly successful in serving unbanked customers in Eastern European countries.²³¹ In contrast, **Payday loans** are found to be most important in the **UK**, in **the Netherlands** and in **Latvia**. **SMS loans** are reported to play a role in the Northern countries of **Latvia**, **Finland**, **Estonia** and **Denmark**. In the case studies, we have also discussed the existence of SMS loans in **Sweden** (p. 216) and that of the related *Flitskrediet* in the **Netherlands** (p. 209).²³²

Pawnbroking is a non-conventional source for credit which appears to be existent in a majority of countries. It is not apparent that the degree of its importance is significantly related to the regime of interest rate restrictions. However, the importance of pawnbroking is perceived to be particularly high in the Finland, Romania, the UK and the Czech Republic, which are countries without interest rate restrictions. However, one has to keep in mind that pawnbrokers are frequently subject to regulatory regimes differing from those applying to other types of lenders.

Discussion

Overall, it appears that the existence of these non-conventional credit types is idiosyncratic to a specific country and the economic and the prevailing institutional circumstances. Nevertheless, **it is perceivable that interest rate restrictions do prevent market entry of one or the other form of high cost credit, as H3 suggests**. On the other hand, it is probably also not uncommon that providers tailor the products to the regulatory needs, such as the (very short-term) *Flitskrediet* in the Netherlands, which has made use of a loophole in the legislation which is currently being closed.

2.5.3.3 Perception of Stakeholders

Issue 2: Prevalence of high cost small volume credit

If **H2a** holds, one would expect countries with IRR to have a lower prevalence of, eg. higher-cost small-volume credit. The following paragraphs therefore compare the stakeholders' answers from Member States with and without interest rate restrictions.

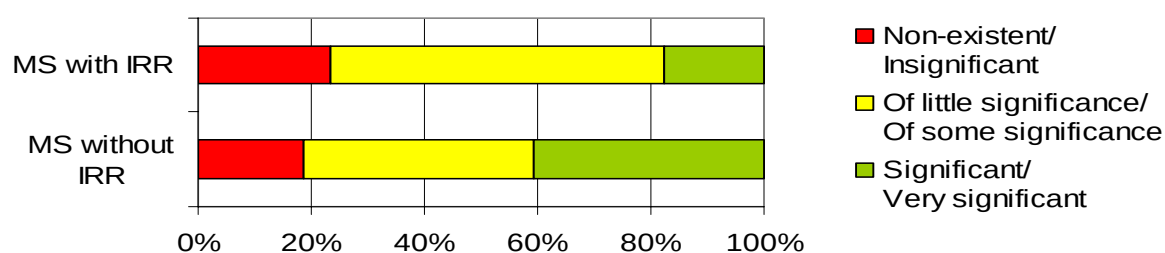
Facts and Figures

Figure 90 shows that higher-cost small-volume credit is regarded as an unimportant or only moderately important credit source by 80% of the responses from Member States *with* IRR. In contrast, more than two-fifths of the respondents from Member States *without* IRR indicate that high-cost small-volume credit is an important or very important source of credit in their countries. The share of respondents indicating that high-cost small-volume credit holds a significant or very significant importance is twice as high in countries without IRR.

²³¹ In the UK, however, home credit serves primarily customers with a bad credit score.

²³² For the Netherlands, it is perceivable that the Stakeholders were referring to *Flitskrediet* when answering in the category of "Payday loans".

Figure 90: Importance of alternative lending (higher cost small volume credit) as % of total lending activities



SQ Question: What is the importance of alternative lending (higher-cost small credit)? (in EUR/local currency and % of total activities if possible) [non-existent/insignificant/of little significance/of some significance/significant/very significant]

Discussion

This confirms H2a: The stakeholders report lower levels of high-cost small-volume credit in Member States *with* IRR.

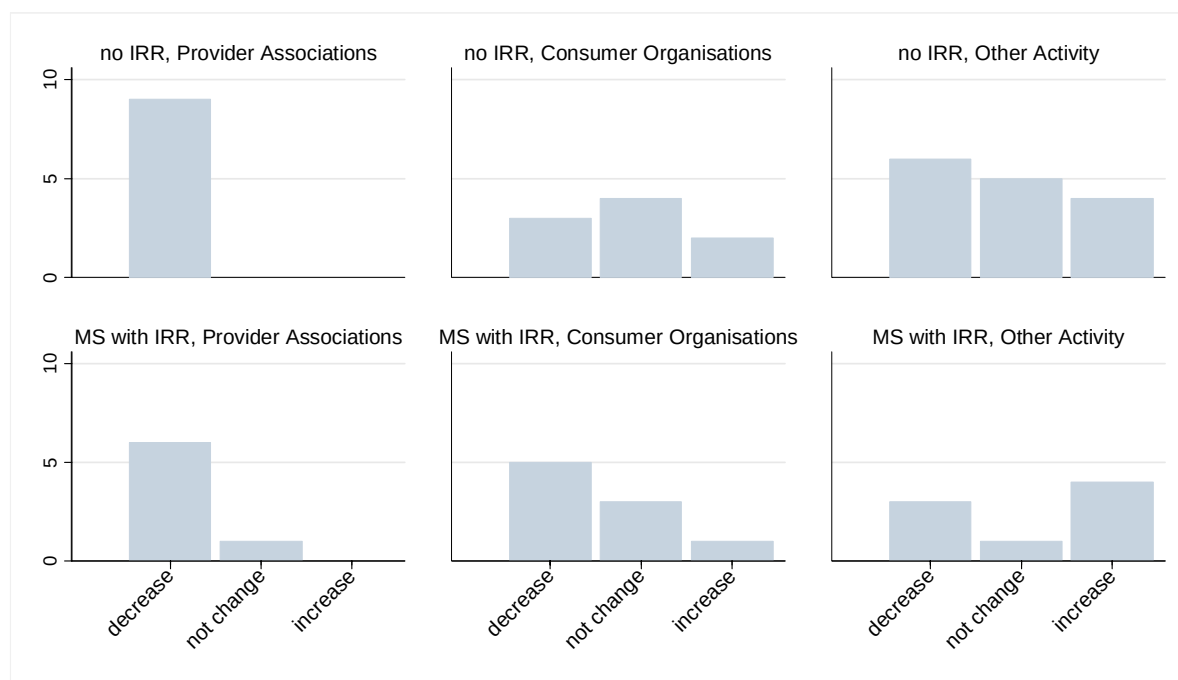
Issue 3: Effect of the introduction of interest rate restrictions

The following paragraph discusses the views of stakeholders on the introduction of interest rate restrictions in a hypothetical country which has had no IRR beforehand. For purposes of comparison, we suggested two alternative ways of interest rate restrictions: a relative one, defined as double the average rate prevailing in the market, as well as a fixed interest rate cap of 30% p.a.

Facts and Figures

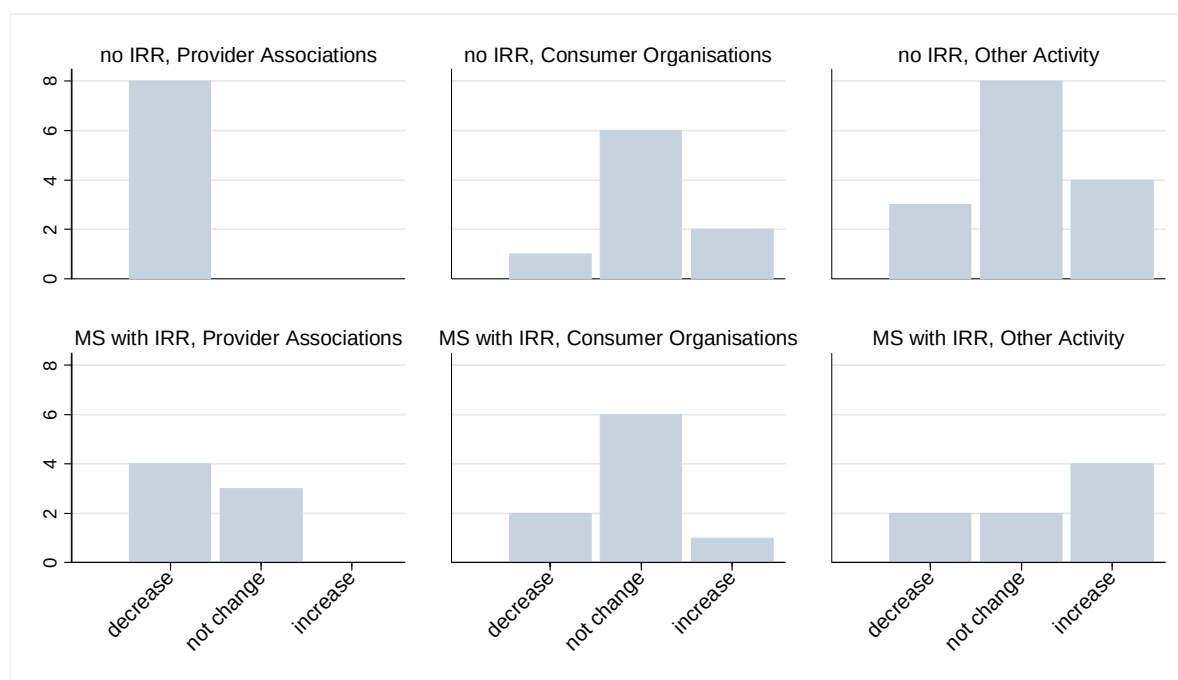
Figure 91 shows that stakeholders' opinions clearly diverge with regard to the impact of interest rate restrictions on product variety available to *low-income borrowers*. A large majority of *provider associations* (94%) expects an introduction of a ceiling to *decrease* the range of products available to low-income borrowers. It should be noted that respondents from provider associations from Member States with IRR agree on the matter with provider associations from countries without restrictions. In a separate question regarding their assessment of the access of low-income borrowers to credit options, stakeholders from countries without IRR indicated less credit options available to low-income borrower than in countries with an existing ceiling (see Chapter 2.5.1.4). Among consumer organisations and other stakeholders, such as banking authorities and financial regulators, opinions on the impact of IRR on product variety seem to diverge.

Figure 91: Impact of a relative/floating IRR (2x market average) on the product variety available to low-income borrowers



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market, for the low-income consumer variety of products would...[decrease/not change/increase]?

Figure 92: Impact of a relative/floating IRR (2x market average) on the product variety available to an average borrower.



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market, for average consumers variety of products would...[decrease/not change/increase]?

Regarding the product variety available to *average-income* borrowers, *provider associations* from Member States *without* IRR appear to be also sceptical (Figure 92). In contrast, among provider associations from Member States *with* existing interest rate restrictions there is a higher tendency (43%) to think that a zero-impact is possible. A tendency towards expectations of a zero-impact on *average* borrowers can also be observed in the majority (54%) of the responses from other stakeholder categories.²³³

Discussion

According to the views of the provider associations, it is likely that the introduction of interest rate restrictions leads to a reduction of available credit types. This would support **H2a**. The credit types affected by this reduction are those which are most suitable for low-income customers.

Issue 4: Which regulatory activities could increase the product variety?

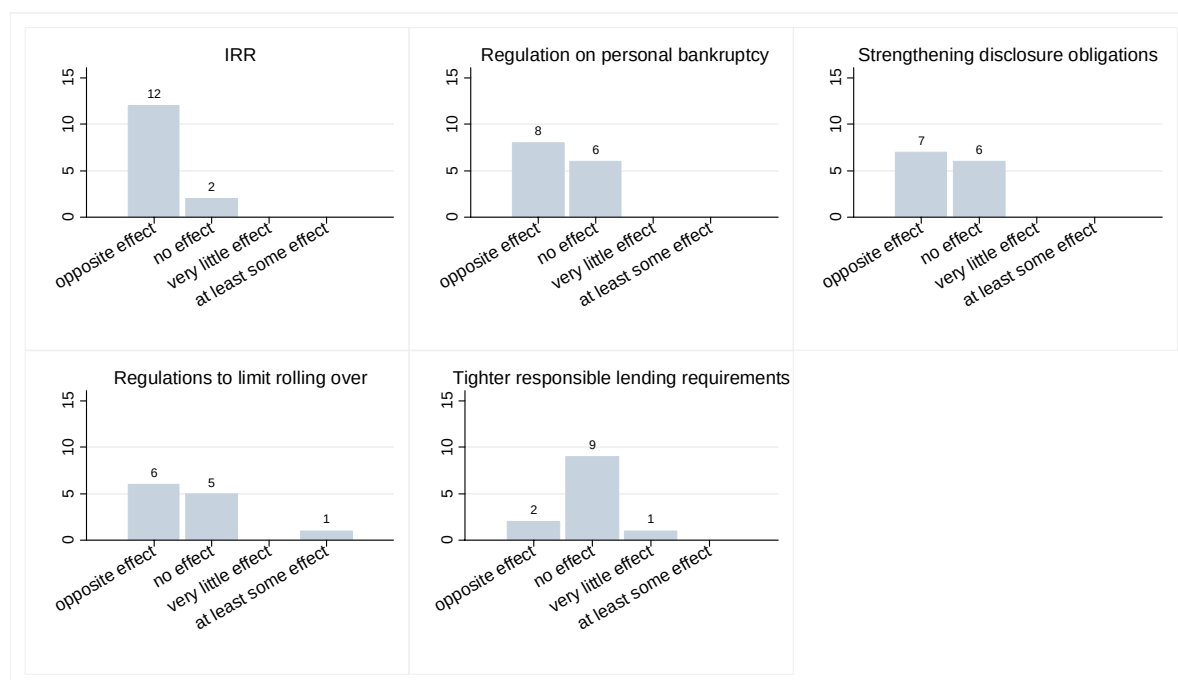
If **H2a** holds, interest rate restrictions would reduce product variety. If regulators have a choice between different measures (including interest rate restrictions) for a specific policy goal (eg. reduce over-indebtedness, see Chapter 2.5.6, page 274), they might take this potentially adverse effect into consideration. The following paragraphs discuss the importance of this problem compared to adverse effects of other measures with respect to product variety.

Facts and Figures

Figure 93 displays the results from the *provider associations* only: between 92% and 100% of the respondents expect either an adverse effect or no effect of all listed regulatory measures. This effect appears most pronounced for interest rate restrictions. In the case of an introduction of an interest rate ceiling, most of the provider associations (86%) even assert that the effect would be strictly adverse.

²³³ These results are similar to stakeholders' responses with regard to the impact of a fixed interest rate cap at 30%.

Figure 93: Effectiveness of different regulation measures with respect to wider product variety (responses from provider associations)



In a separate questionnaire sent to *individual providers* almost all respondents indicate that the “offering of consumer credit products” would decrease if an interest rate restriction was introduced in their country (respectively increase if an existing interest rate ceiling was abolished).²³⁴ From a written feedback from home credit providers in the UK²³⁵ it appears that an interest rate restriction based on the APR would lead to a decrease in the offering of short-term products (or even more so – exclusion from very short-term products) and increase in the offering of long-term products (**loan maturity extension**).

²³⁴ PQ Question: Assume that interest rate ceilings capping the authorised interest rate on consumer credit set as the average market APR charged in the previous quarter times 1.33 were introduced/were abolished IN YOUR COUNTRY. What do you think will be the effects of this measure on the various aspects of consumer credit markets IN YOUR COUNTRY?

²³⁵ See eg. home credit lenders from UK

Figure 94: Effectiveness of different regulation measures with respect to wider product variety (responses from consumer organisations)

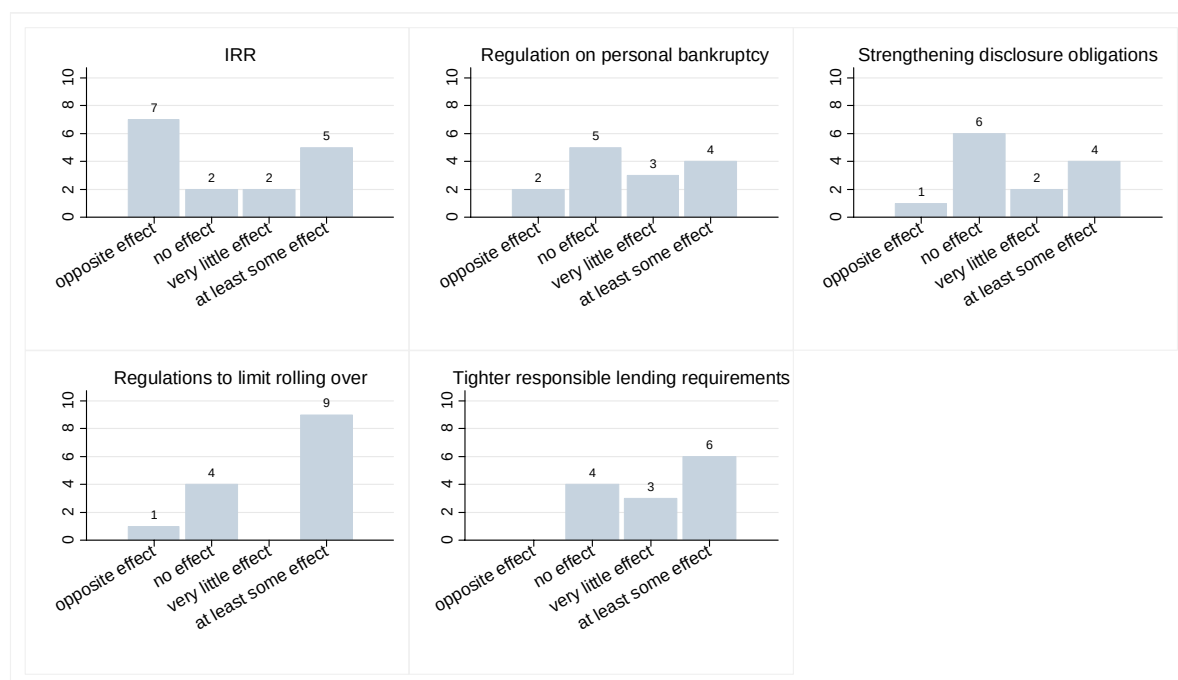


Figure 94 shows that the consumer organisations come to similar conclusions with respect to the effect of IRR: (44%) agree with the opinion of provider associations that an interest rate ceiling would lead to a decrease in product variety. However, as noted in a written comment by consumer organisations, in a longer term there still may be a positive impact on product variety because a ceiling introduction may give rise to a “positive product innovation”. Unlike provider associations, consumer organisations recognise a non-negligible positive effect of regulations limiting rolling over of existing credit.

Discussion

The answers reveal that respondents take the plausibility of *H2* for granted.

2.5.4 H3: IRR lead to credit from non-bank sources, such as paying bills late.

2.5.4.1 An overview

With respect to **H3**, our results remain *inconclusive*.

- Looking at *arrears to utility providers*, we do not find evidence that households in countries *with* IRR show stronger tendencies to take credit from these sources; the data rather suggest otherwise. **This contradicts H3.**
- Historical examples deliver mixed evidence on **H3**: Poland has seen a *decrease* in arrears on utility bills after the introduction of interest rates, whereas there are *increases* for low-income households in the Netherlands. Overall, one has to be careful with the interpretation because of cyclical macroeconomic trends around the event.
- The Stakeholders do not report significant differences between countries with and without IRR with respect to the level of *informal lending*; **this again contradicts H3.**

2.5.4.2 Cross-country comparison

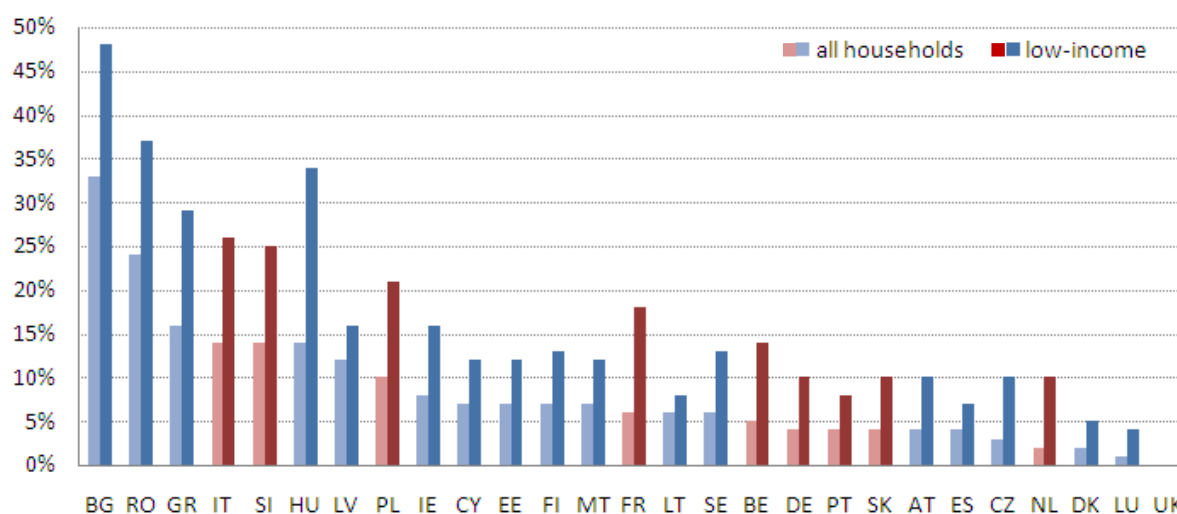
It is frequently argued that households need *access to credit* to enable them to pay their bills even if they face negative income shocks; if they are denied credit (eg. due to interest rate restrictions), they are assumed to make use of alternative ways of “credit”, such as paying bills late. If H3 holds, we expect arrears on bills to be higher in countries *with* IRR.

In Figure 95 countries are compared by the incidence of households who are in arrears on *utility bills*. The data is taken from the EU-SILC, which is a pan-European panel survey that collects data on living conditions, including social exclusion and poverty on an annual basis.²³⁶ Countries *with* IRR are depicted in red colours, countries with no significant restrictions are coloured in blue shades. Light colours are used to show the overall prevalence of households in arrears, while darker shades indicate the fractions of low-income households.²³⁷ Countries are sorted by descending prevalence of arrears in the overall population.

²³⁶ More information on the EU-SILC is included in the Appendix.

²³⁷ Households with a monthly income below 60% of the median income are considered low-income.

Figure 95: Cross-country comparison of households in arrears on utility bills (2008)



Source: EU-SILC; Variable: "Arrears on utility bills"

It first appears that southern and eastern European countries are those in which 10% or more of the households are late on their payment obligations. Among these countries, there are three countries *with* IRR and five countries *without* significant restrictions in place. There are slightly fewer countries *with* IRR where the percentages of households with payment arrears are particularly high and slightly more of them at the lower end. Therefore, the average percentage of households in arrears in countries *with* IRR is a little lower than in their counterparts *without* significant restrictions (7% compared to 9% for the overall population).

Discussion

There might be many other factors influencing households' evaluation of the importance to pay in time in the different countries. For example there can be pre-payment meters in use, which render late payments impossible. Also, private utility providers might collect debt more quickly compared to public utilities. **The evidence contradicts H3. Still, this seems to be too weak evidence to refute H3.**

2.5.4.3 Evidence from the Past

To study the effect of the introduction of interest rate restrictions, it is possible to analyse the case of Poland and the Netherlands, which have already been discussed for the evaluation of H2.²³⁸ The results are summarised in Table 61.

²³⁸ Unfortunately, data has only been available since 2005. Therefore the introduction of an interest rate restriction in Germany cannot be studied at all.

Table 59: Past experience with arrears on utility bills

Country	Year	Event	Observation	Tendency	Alternative Explanation
Poland	2005	Introduction IRR	Declining fraction of households in arrears on utility bills	Evidence contradicting H3	Improvements in households' financial standing
Netherlands	2006	Legislative Change: Decrease of the interest rate cap	Constant fraction of households in arrears for the overall population, slight increase among low-income households in arrears	Mixed evidence	

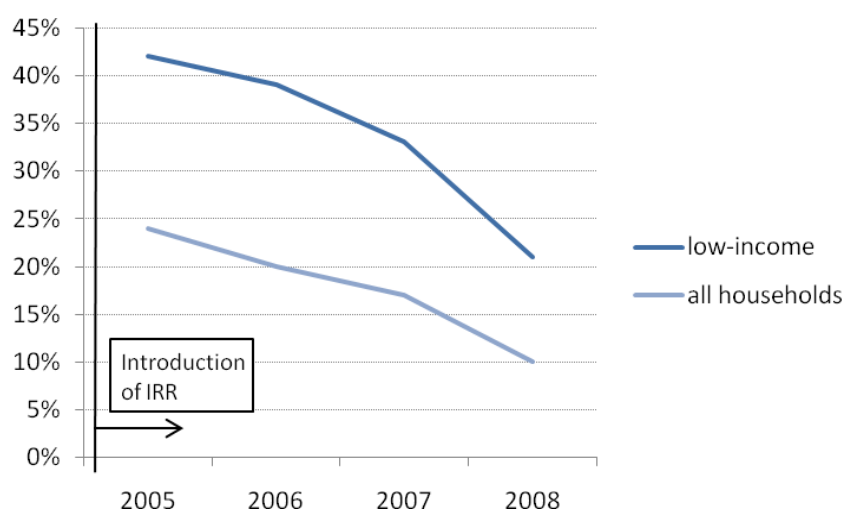
*Example 1: Poland**Background*

The case of Poland is described in closer detail in Chapter 1.2.1.3.8 and has been consulted before to draw conclusions on *H2*. The interest rate restrictions were introduced in 2005 and refer to the borrowing rate and not to the total cost of credit (ie. APR). Additionally, restrictions were imposed on the fees and additional charges related to granting a loan.

Facts and Figures

The fractions of Polish households in arrears on utility bills for the years after the introduction of the rate ceiling 2005 to 2008 are depicted in Figure 96. The number of households in arrears on utility bills follows a steady downward trend for the *overall population* as well as for *low-income households*.

Figure 96: Polish households in arrears on utility bills, development 2005-2008



Source: EU-SILC; Variable: "Arrears on utility bills"

Discussion

This downward trend clearly contradicts **H3**, which would predict the percentage of households that are forced to rely on alternative sources of credit – such as paying utility bills late – would *increase* after the introduction of an interest rate cap. Still, this counter-evidence has to be taken with caution since this development might be due to improvements in households' financial standing, which can be read from high and stable growth rates of the real GDP for the same time horizon.

Example 2: The Netherlands

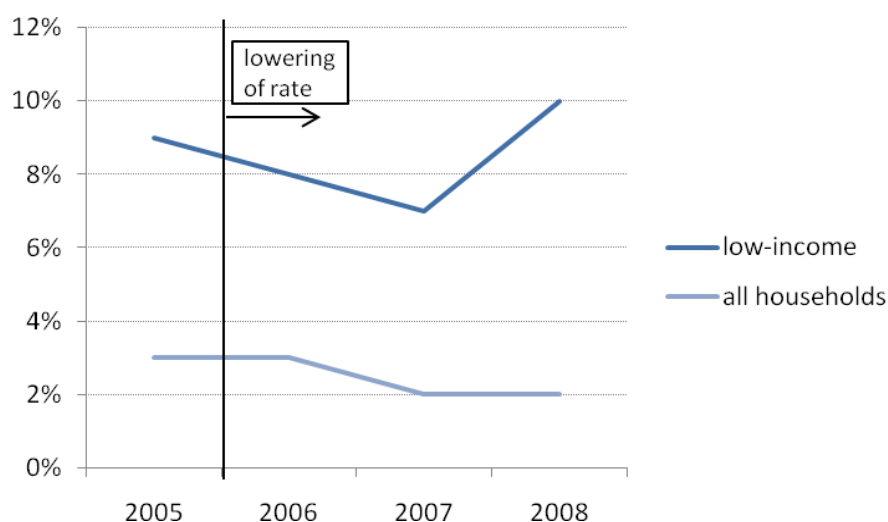
Background

In the Netherlands the existing interest rate caps were lowered in 2006. Interest rate restrictions therefore decreased. More detailed information can be found in Chapter 1.2.1.3.7.

Facts and Figures

Respective data for the Netherlands is depicted in Figure 97. While the fraction of the overall population in arrears on utility bills stayed largely constant (decrease of one percentage point) for the full time horizon, the fraction among low-income households changed. First, the lowering of the maximum rate was followed by a decrease in the proportion of low-income households in arrears, but this decrease was followed by an increase in the following year which resulted in a higher level of households in arrears in the year 2008 compared to all preceding years.

Figure 97: Dutch households in arrears on utility bills, development 2005-2008



Source: EU-SILC; Variable: "Arrears on utility bills"

Discussion

Although the unchanged level of the overall population in arrears on utility bills speaks against **H3**, the increased fraction of low-income households falling into arrears might be in favour of **H3**, since especially low-income borrowers might only have access to higher cost credit, which will be affected first by the lowering of the interest rate ceiling.²³⁹

2.5.4.4 Views of Stakeholders

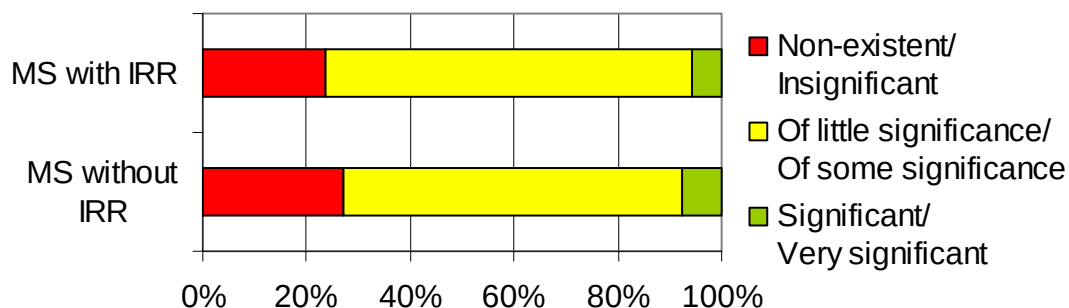
If **H3** holds, we expect that non-bank sources of lending are more prevalent in countries *with* IRR, since households have less access to official credit sources. We therefore ask the stakeholders how important they perceive the existence of informal/community lending activities to be.

Facts and Figures

Figure 98 documents that informal lending sources are generally regarded as credit sources of *little to some* importance by the majority of the respondents. This holds true in both Member States *with* IRR and Member States *without* IRR. In both groups of countries, a significant proportion of responses indicate that lending from informal sources is *insignificant* or *non-existent*, while there is only less than one-tenth of the stakeholders assigning significant importance to informal lending.

²³⁹ This may be enfeebled by the argument that interest rate caps do not apply to some forms of high-cost credit (eg. very short-term loans like Flitskrediet). Since these forms of credit are usually granted by non-banks, this is rather a further point in favour of H3.

Figure 98: Importance of community/informal lending as % of total lending activities



SQ Question: What is the importance of community/informal lending (family, social banks, welfare)? (in EUR/local currency and % of total activities if possible) [non-existent/insignificant/of little significance/of some significance/significant/very sign]

Discussion

As there are no systematic differences across countries with and countries without IRR, the findings above are in contradiction to **H3**.

2.5.5 H4: IRR lead to a substantial illegal market in lending.

2.5.5.1 An Overview

The results on **H4** are *inconclusive*, in particular as there is –unlike previous studies suggest– no reliable data to evaluate this hypothesis.

- There is an influential report claiming that the level of illegal lending is higher in countries with interest rate restrictions, which is favour of **H4**. However, the empirical base of these results is controversial.
- The Stakeholders expect levels of illegal lending to increase after a hypothetical introduction of interest rate restrictions. This is in line with **H4**.
- In contrast to this, the Stakeholders report even higher levels of importance of illegal lending from countries without IRR, which contradicts **H4**.
- To our knowledge, the question if and to what extent customers enter the illegal market due to interest rate restrictions has not yet been empirically answered.

2.5.5.2 Existing literature

To describe potential differences between EU countries *with* and *without* IRR, Policis (2004) compares the UK (as a country *without* interest rate caps) with France and Germany (as countries *with* interest rate caps). The report claims that the rate of low-income households in Germany and France being in contact with illegal lenders is twice or three times as high as in the UK. Policis (2004) interprets this as a confirmation of **H4**.

While Policis' (2004) report has been frequently cited in policy discussions to illustrate drawbacks of interest rate caps, the validity of its empirical base is controversial: the empirical results in this study are based on a panel of poor households conducted by TNS exclusively on behalf of Policis. nef (2009) criticises that Policis does not indicate how the sample of about 2,700 respondents was chosen and how many people replied in the individual countries. Furthermore, nef (2009) points out that neither the questionnaire nor information about how the questions were asked is provided by the authors of this study, which raises concerns about the external validity of the survey results.

Policis (2004) assumes that credit *demand* is uniform in all countries, irrespective of the economic and social circumstances. nef (2009) points out that this assumption is unlikely to hold since countries differ in terms of social inequality as well as credit institutions. In Chapter 2.5.1.4, we demonstrate different levels of *credit acceptance* across countries; to our understanding, this should also be a reason for different levels of credit demand in different countries.

Policis (2004) also understands credit demand as entirely *inelastic to interest rates*. While this might hold true for a subsection of low-income households, there may be others who are sensitive to interest rates when formulating their credit demand. Perhaps even more important in the context of **H4**, it is also questionable whether or not the demand for credit remains constant when official credit access is denied. As with other prohibited goods, there are two ways of *responding to denied access* to official credit: the illegal market or coping *without* credit at all. It is perceivable that the anticipated non-existence of official credit sources alters the behaviour of consumers in the first place: people might help each other more within the family and the neighborhoods, or simply save more for a rainy day.

We conclude that, from a theoretical point of view, it is possible that a reduced (official) credit supply increases illegal lending; however, the scope of this phenomenon is an open question and (due to the weaknesses of the empirical grounds of that study) not yet reliably quantified by the considerations in Policis (2004).

2.5.5.3 Views of Stakeholders

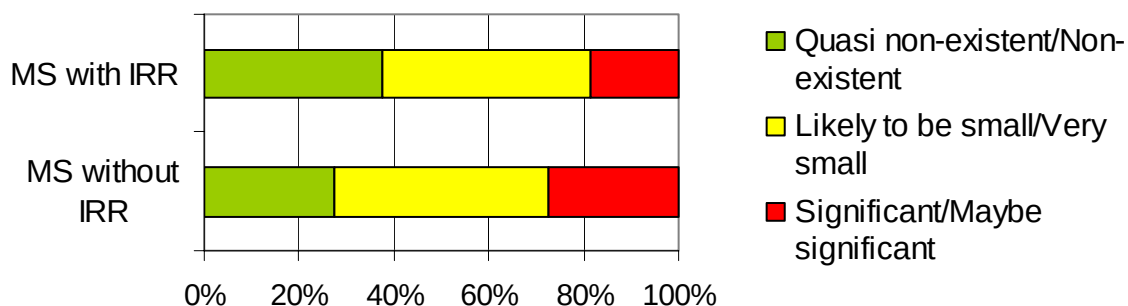
Issue 1: Presence and importance of an illegal market

If **H4** holds, one would expect illegal lending practices to be a more severe problem in countries with IRR. We therefore ask the stakeholders in all countries how they evaluate the presence of illegal lending to low-income households.

Facts and Figures

Figure 99 demonstrates that a majority of respondents acknowledges that illegal lending may happen in their countries. Interestingly, this view is even more pronounced in countries *without* IRR. In those countries, less than 30% report that illegal lending is (quasi) non-existent, while this is reported for almost 40% in countries *with* IRR. Similarly, there is a larger fraction of stakeholders from countries *without* interest rate restrictions indicating that the presence of illegal lending is more significant than in countries *with* IRR.

Figure 99: Presence of illegal lending



SQ Question: How would you describe the presence of an illegal market in lending money to low-income households? (Significant/ May be substantial/ Likely to be small/ Very small/ Quasi non-existent/non-existent)

Discussion

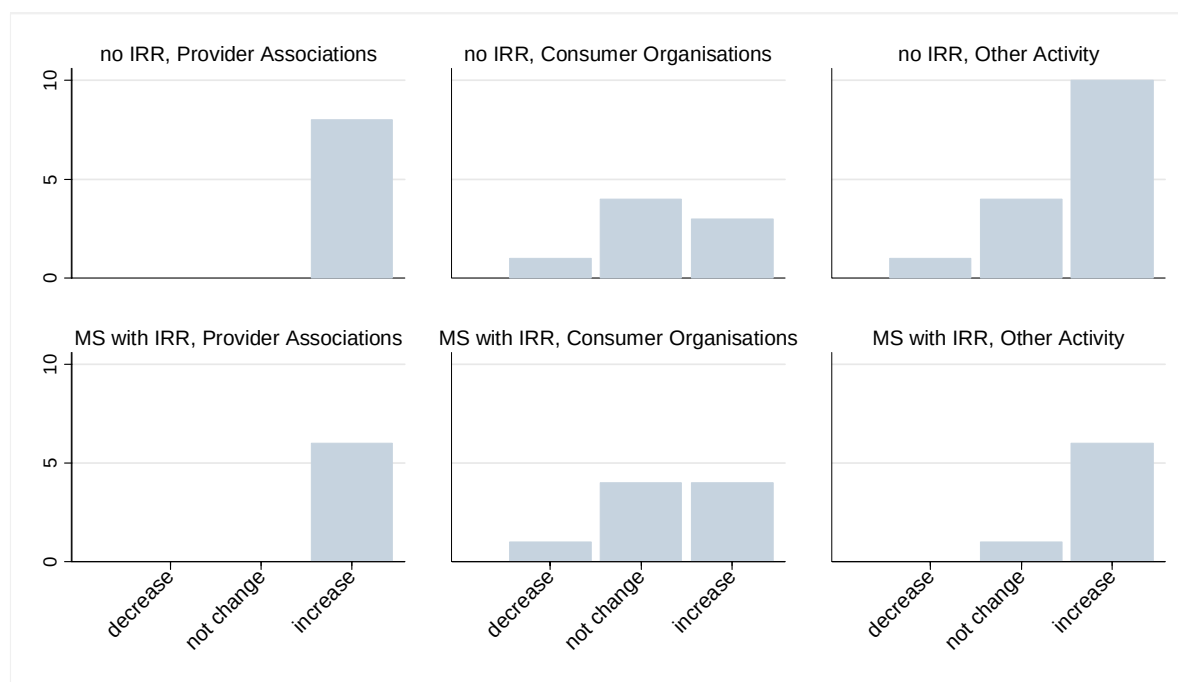
The findings above suggest that the level of illegal lending is even more pronounced in countries *without* IRR. This is evidence against **H4.** However, the evidence should be interpreted with caution because a comparison of Member States *with* and *without* IRR does not depict the isolated impact of interest rate restrictions alone on the extent of illegal lending. Countries with *effective* interest rate restrictions may also be assumed to have effective institutions prohibiting illegal lending.

Issue 2: Impact of IRR on illegal money-lending

The following paragraph discusses the views of stakeholders on the introduction of interest rate restrictions in a hypothetical country which has had no IRR beforehand.²⁴⁰

Facts and Figures

Figure 100: Impact of relative/floating IRR (2x market average) on illegal lending to low-income borrowers



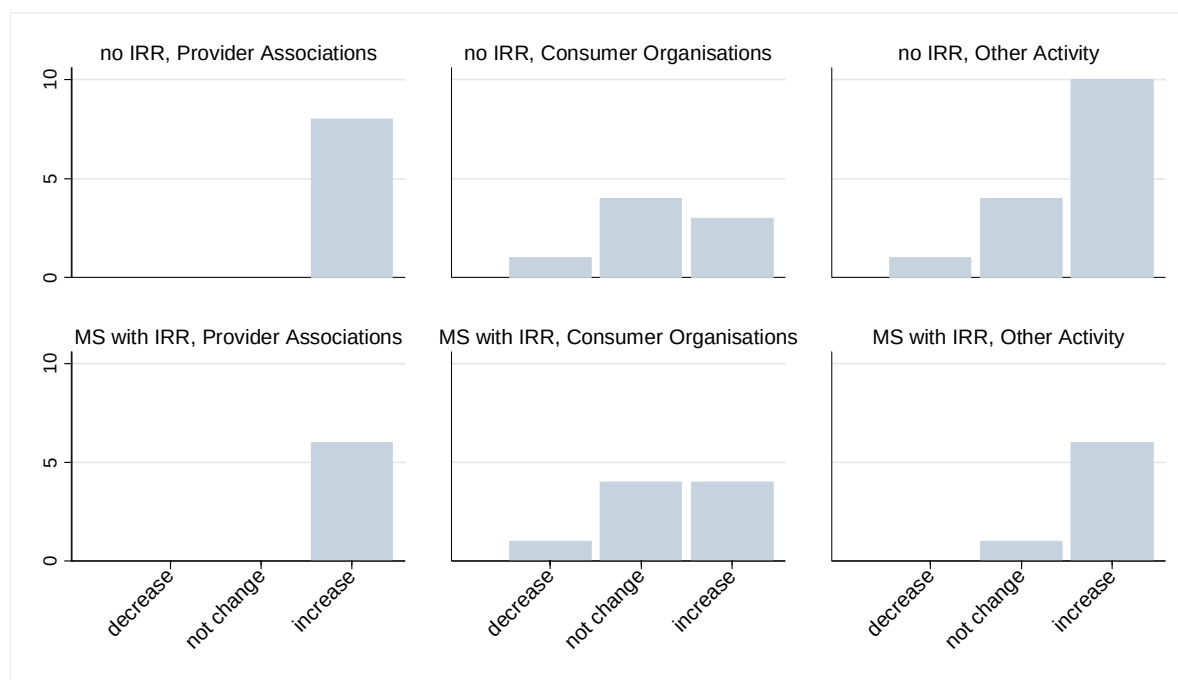
SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market, for low-income consumers the number of individuals resorting to the illegal credit market would...[decrease/not change/increase]?

A majority of the respondents (80%) fears that an introduction of an interest rate ceiling would lead to an increase in the level of illegal lending to *low-income borrowers*. This opinion is held even unanimously by all responding *provider associations*.²⁴¹

²⁴⁰ While we discuss the answers with respect to interest rate restrictions of twice the average interest rate, the answers for a hypothetical introduction of interest rate caps of 30% are very similar.

²⁴¹ It should be noted that several Provider Associations from UK give the report from Policis (2004) as a reason for their assertion in written comments. Furthermore individual home credit providers and a commercial bank from UK repeatedly refer to this report when claiming that the level of illegal lending will rise as a result of an interest rate restriction.

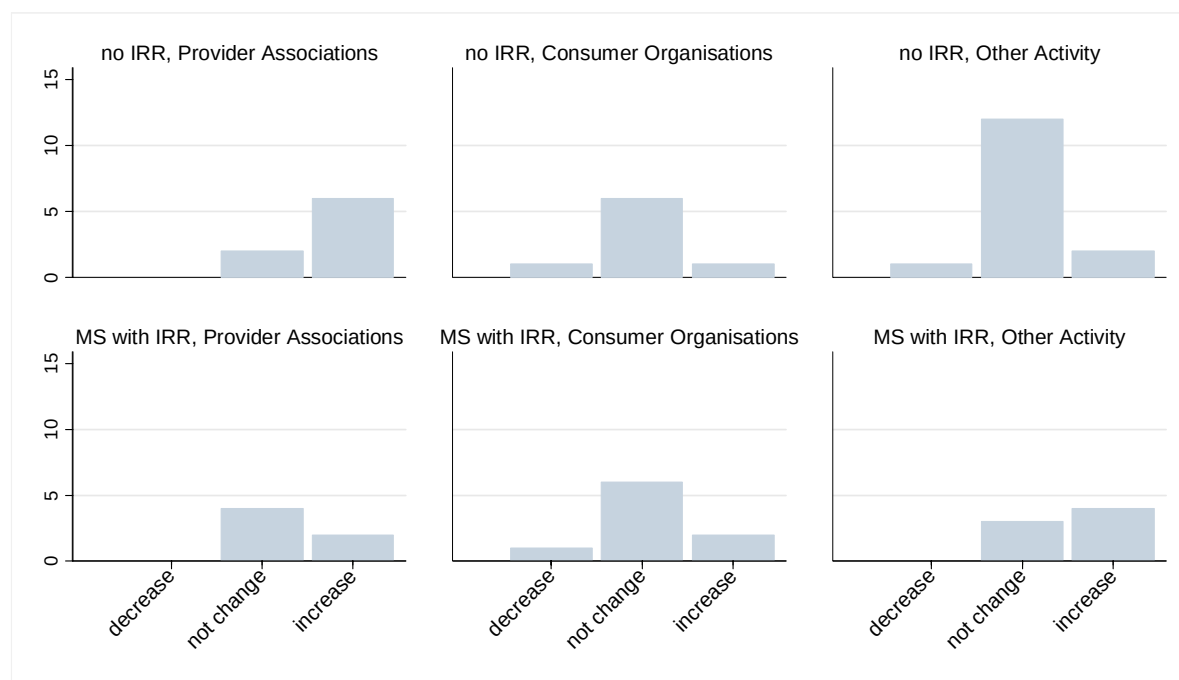
Figure 101: Impact of relative/floating IRR (2x market average) on illegal lending to low-income borrowers



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market, for low-income consumers the number of individuals resorting to the illegal credit market would...[decrease/not change/increase]?

While *provider associations* in Member States *without* IRR claim that illegal lending will increase for *average borrowers* as well, the majority of other stakeholder categories assert that an introduction of interest rate restrictions will not change the level of illegal lending to the *average borrower* (Figure 102). The evidence does not change significantly when considering fixed interest rate restrictions.

Figure 102: Impact of relative/floating IRR (2x market average) on illegal lending to an average borrower



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market, for average consumers the number of individuals resorting to the illegal credit market would...[decrease/not change/increase]?

Discussion

According to the stakeholders' views, H4 is plausible with respect to illegal lending to low-income borrowers.

2.5.6 H5: The lack of IRR leads to a higher level of over-indebtedness.
2.5.6.1 An overview

Comparing evidence from different countries and taking into account the answers from the Stakeholder Questionnaire, **H5** is **unlikely to hold**:

- Comparing different countries with respect to the prevailing level of over-indebtedness according to two different measures, it does not appear that over-indebtedness is predominantly related to the regime of interest rate restrictions. **These findings do not confirm H5.**
- Looking at the time after the introduction of IRR in the Netherlands and Poland, **we find weak evidence in favour of H5**, ie. the introduction of IRR seems to lead to a lower level of over-indebtedness. However, we argue that one should not over-stress these findings as other cyclical factors may drive the results.
- The problem of over-indebtedness is perceived almost equally strong among stakeholders from the same category in countries *with* and *without* IRR, which **does not support H5 in general.**
- The Stakeholders' views on the expected effects of a hypothetical introduction of IRR are heterogeneous and suggest that **H5 is unlikely to hold.**
- Stakeholders from countries *without* IRR predominantly expect *increasing* levels of over-indebtedness after the introduction of IRR, while this is not the case for stakeholders from countries *with* this kind of regulation. It appears that stakeholders who do not experience IRR in their daily business attribute adverse consequences to them, which are ultimately not observed in countries in which IRR are in place.

2.5.6.2 Cross-Country comparison

If **H5** holds true, the absence of IRR should be reflected in statistics on over-indebtedness. The following paragraphs therefore discuss the importance of over-indebtedness in various countries.

Despite the growing awareness on over-indebtedness,²⁴² there is no common definition of the term which is accepted and applied throughout the European Union. Therefore national data sources are not applicable for cross-country comparisons. Furthermore the problem of heterogeneous definitions is regarded as one of the reasons why there are no comprehensive comparable statistics that provide insights about the current state, extent and past development of over-indebtedness in the individual EU Member States.²⁴³ To verify hypotheses concerning over-indebtedness, a working-definition of the term was established: Generally over-indebtedness is a state in which consumer's current assets and prospective income streams no longer suffice to cover the present value of his or her payment obligations.²⁴⁴ The consumer is forced to cut back on his accustomed standard of

²⁴² Compare for example the recent report from the British Department for Business, Innovations and Skills, BIS (2010) or the report EUC (2008) seeking for a common definition of over-indebtedness throughout the European Union.

²⁴³ See EUC (2008).

²⁴⁴ Compare Betti et al. (2007), p. 140.

living in order to meet his obligations.²⁴⁵ In such a situation, the previously chosen consumption path is no longer sustainable.

Based on this definition, the usability of alternative data sources was judged. In previous studies on over-indebtedness several measures of over-indebtedness have been adopted amongst which payment arrears and self-assessed indicators seem to be most promising identifying over-indebted households.²⁴⁶

It therefore seems all the more reasonable to rely on EU-SILC (Survey on Income and Living Conditions), which provides comparable data on all EU countries. In the following we use a subjective indicator of over-indebtedness (households' ability to make ends meet) as well as an objective measure (households in arrears).

Facts and Figures: Total Arrears

Table 60 displays households in arrears in different Member States. Countries with significant interest rate regulation in place are marked in grey shades.²⁴⁷ The highest fractions of over-indebted households are found in Bulgaria, Romania and Greece. There seems to be some kind of geographical clustering, as percentages of households in arrears are similar for some geographically close countries (such as Greece and Romania; Spain and Portugal; Hungary and Slovenia; Estonia and Lithuania).

*Table 60: Percentages of households in arrears
(on mortgage or rent, utility bills or hire purchase), 2008*

Country	level of over-indebtedness among ...		significant IRR in place?
	all households	low-income households	
AT	7%	17%	no
BE	7%	18%	yes
BG	35%	49%	no
CY	13%	15%	no
CZ	4%	16%	no
DE	6%	14%	yes
DK	4%	9%	no
EE	9%	13%	no
ES	7%	11%	no
FI	10%	20%	no
FR	10%	25%	yes
GR	24%	42%	no
HU	16%	37%	no
IE	11%	20%	no
IT	16%	29%	yes
LT	8%	10%	no

²⁴⁵ Indicators of over-indebtedness based on administrative measures such as defaults rates or legally declared bankruptcy omit people forced onto a lower consumption path.

²⁴⁶ For a discussion on the possible measures of over-indebtedness and their suitability to measure over-indebtedness in general and in particular for the purpose of verifying hypotheses by a cross-country comparison please refer to the Appendix.

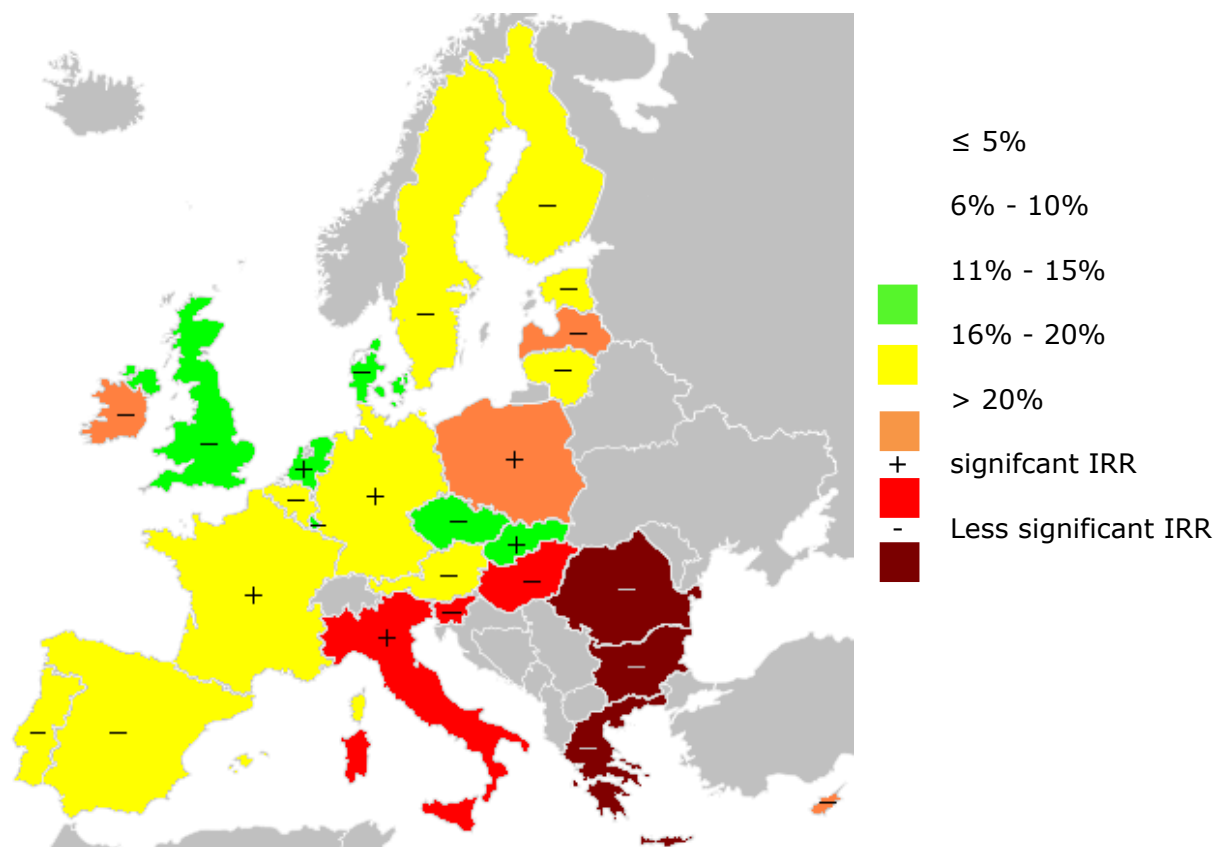
²⁴⁷ Since Portugal introduced regulation only recently (in 2009) we consider it to be unregulated when analysing data from 2008, the period before the IRR became effective.

LU	2%	8%	no
LV	14%	19%	no
MT	8%	14%	no
NL	4%	14%	yes
PL	11%	23%	yes
PT	6%	13%	no
RO	25%	38%	no
SE	6%	15%	no
SI	16%	29%	yes
SK	5%	12%	yes
UK	5%	11%	no

Source: EU-SILC. Objective indicator: "Arrears on mortgage or rent, utility bills or hire purchase".

Figure 103 depicts this potential geographical relation. Its pattern is surprising since there are also *neighbouring* countries with *similar* over-indebtedness problems and *different* regimes concerning IRR: while France (10% over-indebted households) has a strict regulation on interest rates, there is only weak regulation in Spain (7%). While France and Italy both have strict regulatory regimes, over-indebtedness is a more severe problem in Italy (16% over-indebtedness) than in France.

Figure 103: Over-indebtedness in the EU in 2008



Source: EU-SILC. Objective indicator: "Arrears on mortgage or rent, utility bills or hire purchase". Graph: ZEW.

Discussion

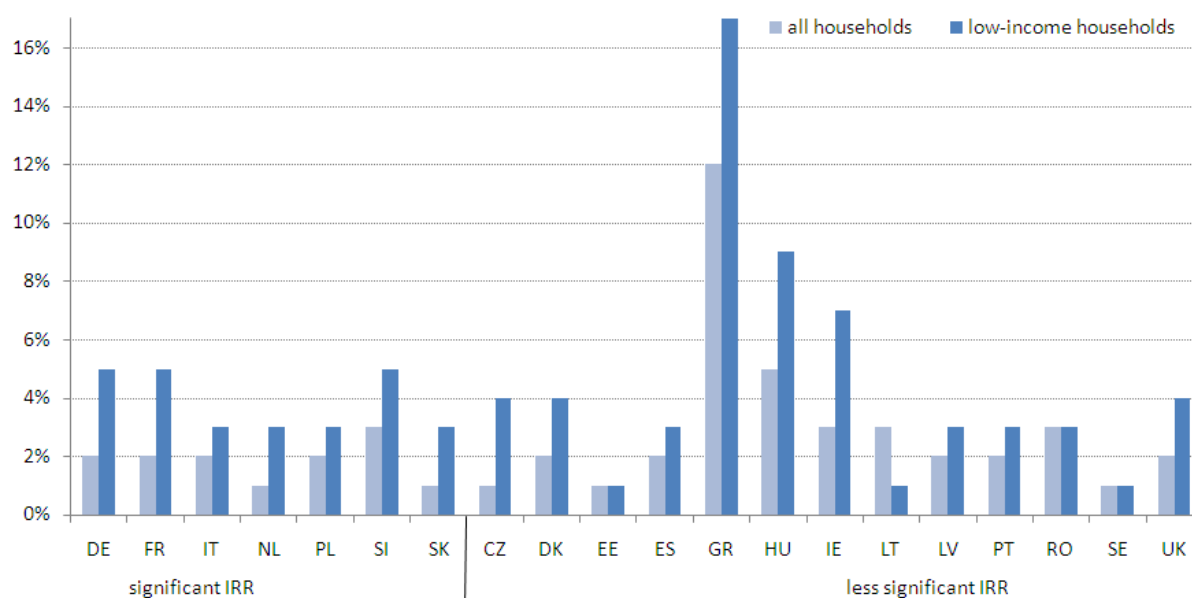
Evidence stemming from households in any kind of arrears is mixed and does not support **H5**. Among the strictly regulated countries are populations with high fractions of over-

indebted households (Italy) as well as very low fractions (the Netherlands). The same is true for weakly regulated countries with the Czech Republic as an interesting example of a lax regulatory regime and few over-indebted households as opposed to Hungary, where regulation is weak as well but over-indebtedness poses a serious problem.

Facts and Figures: Specific types of arrears, different population groups

Instead of considering the entire set of potential arrears of a household (credit obligations, utility bills, mortgage or rent payments), one can also look at specific types of arrears, which are most likely to be linked to consumer credit. However, the *arrears on credit obligations* (hire purchases or loans) of EU Member States do not provide a clearer picture (see Figure 104): the most frequent incidences of arrears on hire purchases or loans appear in Greece (12% of all households) and Hungary (5%). But again, different types of interest rate regimes are found in various categories of over-indebtedness due to *arrears on credit obligations*.

Figure 104: Prevalence of arrears on hire purchases or loans, comparison of overall population and low-income households in 2008



Source: EU-SILC. Objective indicator: "Arrears on hire purchases or loans"

Compared to the case of arrears on all obligations, the levels of arrears on financial commitments differ less across countries and are generally less prevalent among the population. Except for Greece no more than 10% of households in each Member State report arrears on their obligation from hire purchases or loans.

It is also impossible to obtain a more clear-cut picture by regarding only low-income households instead of the entire population (in Figure 104 fractions of low-income households are depicted by dark blue bars).

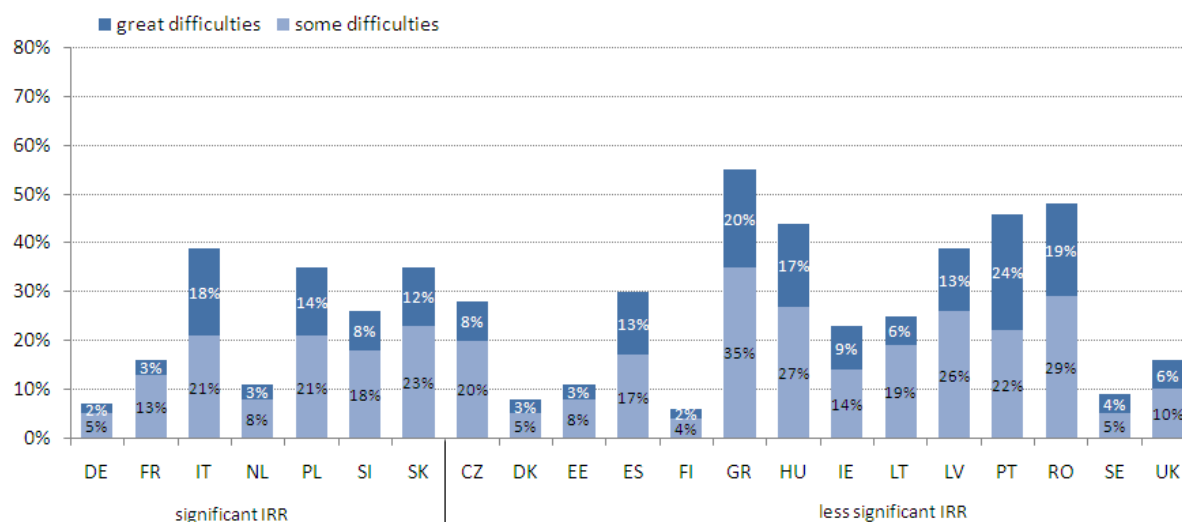
Facts and Figures: Subjective over-indebtedness

Figure 105 and Figure 106 present a *subjective* measure of over-indebtedness (the "ability to make ends meet").²⁴⁸ They, again, group countries according to the prevailing

²⁴⁸ Although it cannot be controlled whether these households are indebted at all (a household not holding debt that indicates its inability to make ends meet could rather be considered to "struggle on a low income")

degree of interest rate regulation. As Figure 105 indicates, the highest levels of subjective over-indebtedness of the population appear in Greece, Romania, Portugal and Hungary. In Greece more than half of all households experience difficulties or great difficulties to make ends meet. In Portugal nearly one in four households has great difficulties making ends meet. The lowest percentages of households feeling over-indebted are found in Finland, Germany, Denmark and Sweden. It appears that over-indebtedness is a less severe problem in northern- and central- European countries and more severe in southern European countries and the New Member States.

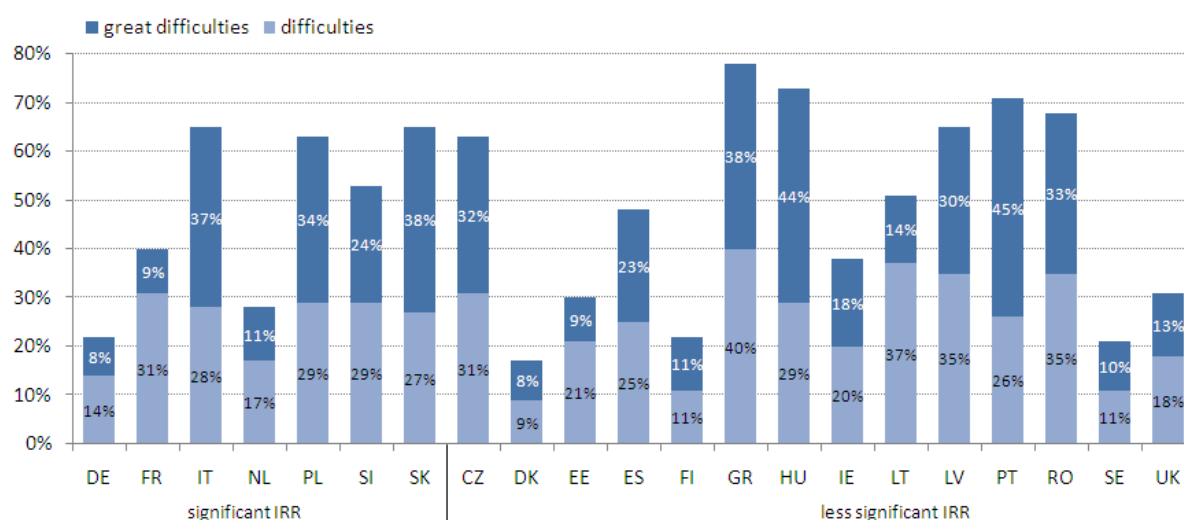
Figure 105: Households' ability to make ends meet in 2008



Source: EU-SILC; Subjective indicator: "Ability to make ends meet"

Figure 106 focuses on low-income households in the different countries. These households might be especially affected if interest rate regulations lead to credit exclusion of certain customer groups. Figure 106 supports the assumption that over-indebtedness is influenced by other factors than interest rate restrictions. First of all, percentages of households experiencing problems to make ends meet are notably higher across all countries, while low-income households in Greece, Hungary, Portugal and Romania still face the greatest problems making ends meet.

Figure 106: Low-income households' ability to make ends meet in 2008



Source: EU-SILC; Subjective indicator: "Ability to make ends meet"

Discussion

It does not appear that the level of over-indebtedness (as measured by two different proxies) is predominantly related to the regime of interest rate restrictions. This does not reveal anything about whether a particular country would exhibit higher or lower over-indebtedness if it had a different regime of interest rate restrictions. Overall, however, these findings do not confirm **H5**.

2.5.6.3 Evidence from the Past

To study the effect of the introduction of interest rate restrictions it is possible to analyse the case of Poland and the Netherlands, which have already been discussed for the evaluation of **H2**.²⁴⁹ The results are summarised in Table 61.

²⁴⁹ Again, data is only available from 2005 onwards. So the introduction of an interest rate restriction in Germany cannot be studied.

Table 61: Evidence from the past - over-indebtedness (H5)

Country	Year	Event	Observation	Tendency	Alternative Explanation
Poland	2005	Introduction IRR	Declining fraction of over-indebted households	Evidence in favour H5	Increased competition amongst credit providers, decreasing interest rates, improvements in households' financial standing ²⁵⁰
Netherlands	2006	Legislative Change: Decrease of the interest rate cap	Declining fraction of over-indebted households	Evidence in favour of H5	Long-term downward trend

*Example 1: Poland**Background*

The case of Poland is described in closer detail in Chapter 1.2.1.3.8 and has been consulted to draw conclusions on **H2**. Interest rate restrictions were introduced in 2005 and refer to the borrowing rate and not to the total cost of credit (ie. APR). Additionally, restrictions were imposed on the fees and additional charges related to granting a loan.

Facts and Figures

Figure 107: Polish households in arrears, development for entire population 2005-2008

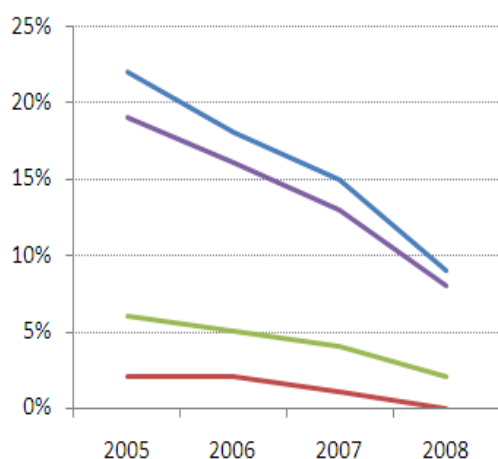
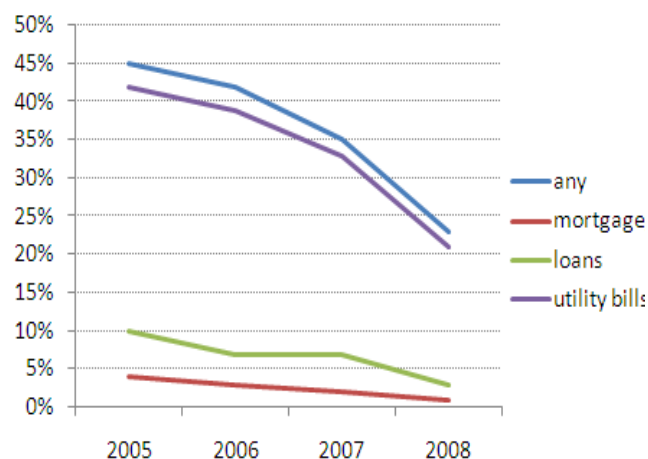


Figure 108: Polish households in arrears, development for low-income households 2005-2008



Source: EU-SILC; Objective indicator: "Arrears on payment obligations"

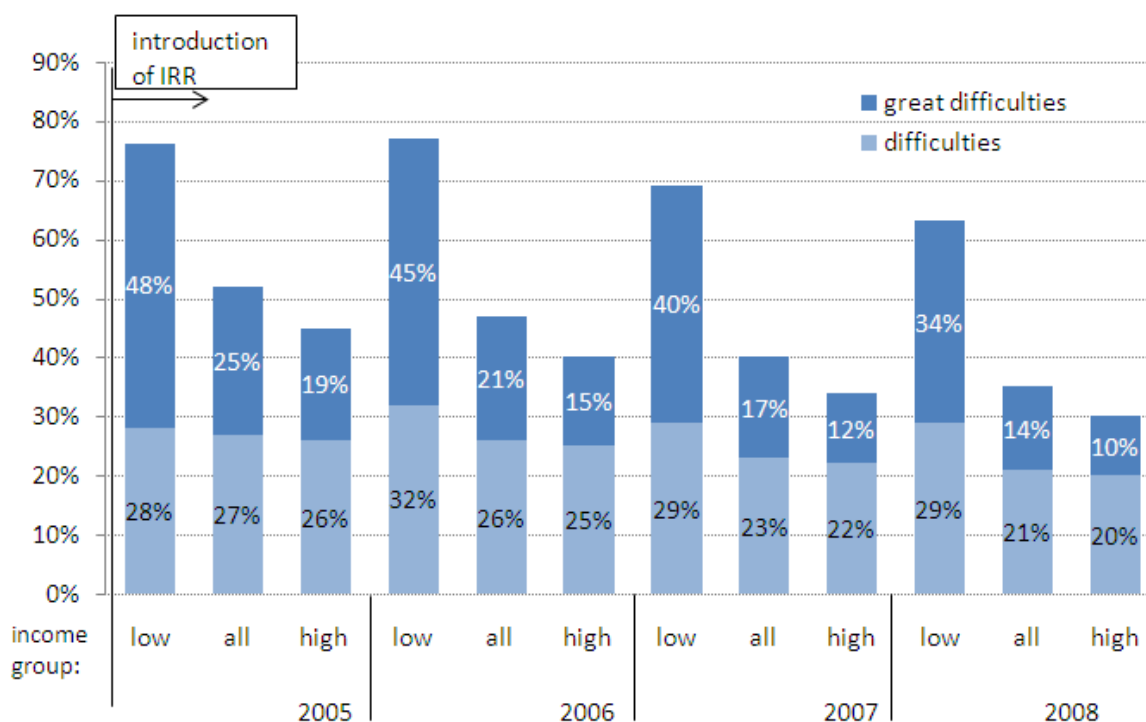
Figure 107 and Figure 108 depict the development of the fraction of Polish households in arrears on different commitments. The left hand panel shows the development for the

²⁵⁰ See Pruski, Żochowski (2006).

entire Polish population, while the right hand panel sheds light on the situation for low-income households. Albeit on different levels (the y-axis of Figure 108 spans double the scale of Figure 107) the developments are similar: arrears of low-income households on *all commitments* decreased by 22 percentage points (-50%) from 2005 to 2008. The respective figure for the overall population amounts to 13 percentage points (this equals an even higher relative decrease of -59%). Arrears on *hire purchases and loans* were seldom, compared to arrears on utility bills, and have become less prevalent. The decrease is 7 percentage points for low-income households and 5 percentage points for the overall population. The development for arrears on *mortgages or rents*²⁵¹ is comparable.

As in the earlier argumentation it is worth considering households' subjective assessment of over-indebtedness measured by households' ability to make ends meet.

Figure 109: Development of over-indebtedness amongst Polish households 2005-2008



Source: EU-SILC; Subjective indicator: "Ability to make ends meet"

Discussion

Although the findings from data on subjective and objective over-indebtedness support **H5**, there could be other reasons for an ongoing downward trend in objective over-indebtedness and therefore a decreasing level of over-indebtedness. In Poland credit supply has eased since 2003 due to different reasons:²⁵² Inflation stabilised and interest rates decreased. Furthermore, competition increased due to stagnating lending to corporate and international banks that entered the Polish market after Poland's accession to the EU. The increase in lending was also influenced by demand-side factors such as the expectations of property price increases following Poland's accession to the EU and a

²⁵¹ The European Mortgage Federation reports an owner-occupation rate of 75% for Poland for the year 2004. The numbers stated by eurostat lie considerably higher at 95% in 2005 and 97% in 2008. Still, no clear statement is possible on whether arrears on mortgage repayments or rents are more frequent. Arrears on mortgage repayments remain very scarce.

²⁵² The argumentation follows Pruski, Żochowski (2006).

more open attitude towards credit in general²⁵³. Objective and subjective over-indebtedness might therefore have decreased.

Example 2: The Netherlands

Background

In the Netherlands the existing interest rate caps were lowered in 2006. Interest rate restrictions therefore decreased. More detailed information can be found in Chapter 1.2.1.3.7.

Facts and Figures

Percentages of Dutch households in arrears are displayed in Figure 110 and Figure 111. The development does not exhibit a constant trend as in the Polish case described. Regarding arrears on all obligations, the fraction of households in arrears is low and decreased slightly from 4% in the years 2005-2006 to 3% in 2007-2008. The fraction of households falling behind on their obligations on hire purchases or loans stayed constant since 2005.

Figure 110: Dutch households in arrears, development for entire population 2005-2008

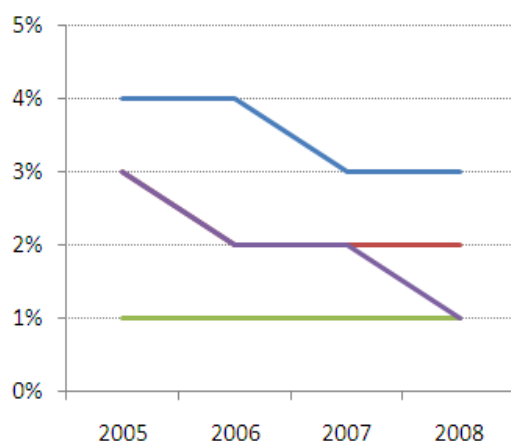
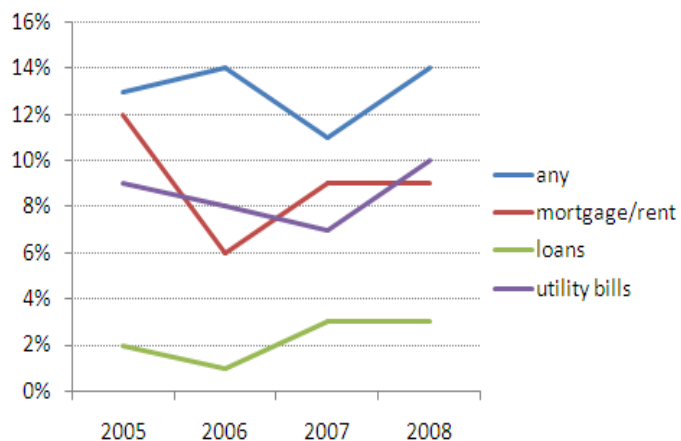


Figure 111: Dutch households in arrears, development for low-income households 2005-2008



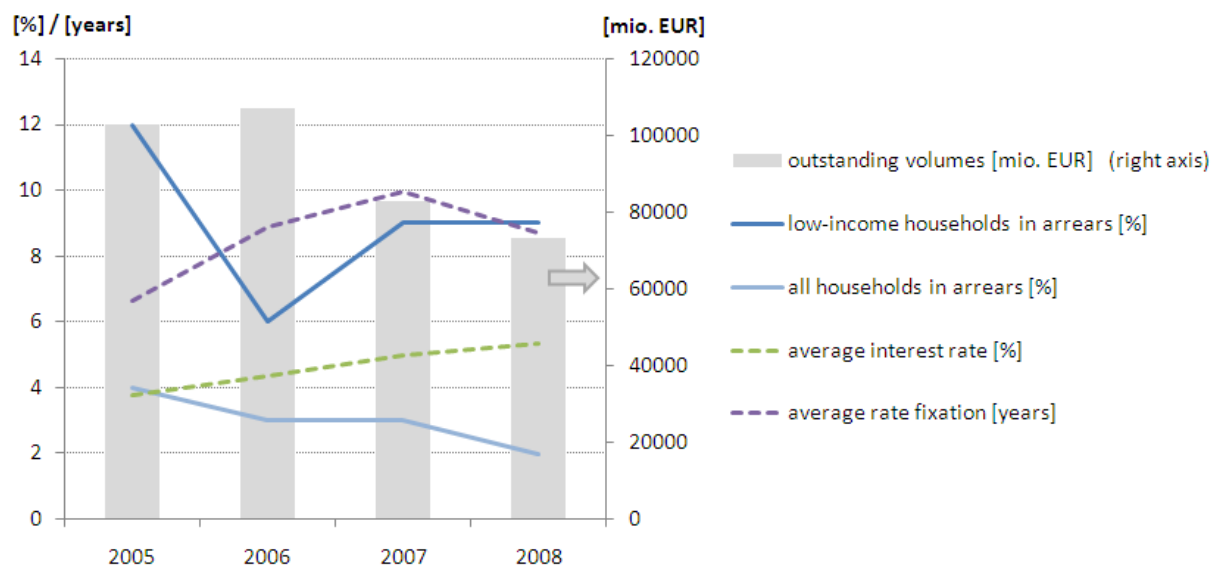
Source: EU-SILC; Objective indicator: "Arrears on payment obligations"

Only considering the group of low-income households changes the picture, showing a slight increase in the prevalence of arrears when comparing 2008 to 2005. While percentages of households in arrears on all three groups of obligation decreased from 2005 to 2006 they became more prevalent in the consecutive years. Regarding different obligations the prevalence of arrears on hire purchases and loans run in co-movement with the development of arrears in mortgage repayments or rent with the difference that percentages stabilised at a higher level compared to the year 2005 (up 1 percentage point). The fraction of households in arrears on utility bills reached a slightly higher level, too, (up 2 percentage points respectively) when comparing 2008 to the year 2005. Most interesting are the numbers of low-income households in arrears on mortgages or rent. Their fraction dropped markedly by 6 percentage points (a 50% decrease in relative terms) in 2006, it increased in 2007 and stabilised at the level of 9%. This development might²⁵⁴ be explained by mortgage market characteristics (see Figure 112).

²⁵³ See Żochowski, Zajączkowski (2006).

²⁵⁴ No clear statement is possible on whether arrears on mortgage repayments or arrears on rents are more frequently reported in this subgroup. The European Mortgage Federation reports an owner-occupation rate of

Figure 112: Development of the Dutch mortgage market and mortgage repayment arrears 2005-2008



Datasource: Bank of the Netherlands, EU-SILC, Graph: ZEW

From 2001-2008, the Netherlands experienced an increase in housing prices of 4 to 5% per year.²⁵⁵ Since 2005, net residential lending has slowed down; this decline continued into 2008, from 36,539 loans approved in 2007 to 30,550 in 2008. As shown in Figure 112 average interest rates on mortgages were lowest in 2005 and experienced a steady rise till 2008 (overall increase of more than 1.5 percentage points). In the same time volumes of floating rate or short term initial fixed rate contracts went down. Interestingly volumes of outstanding mortgages developed inversely compared to the fraction of low-income households in arrears on mortgage repayments or rents, peaking in 2006. This might be an indicator that low-income households experience less repayment problems in times of eased credit access.

Furthermore, the subjective indicator for over-indebtedness is taken into account and is depicted in Figure 113. Once more it is not possible to preclude an ongoing downward trend because data from earlier years is lacking. Still, the decline of perceived difficulties in 2005-2008 was accompanied by a favourable employment environment. Unemployment rates declined from 4.8% in 2005 to 2.8% in 2008²⁵⁶, with slow GDP growth²⁵⁷. With the employment rates already very low in EU comparison, they are hardly the main source of better perceptions on financial distress. The improvement does not stem, however, from financial markets, with interest rates for household credit staying in the range of 2005 and volumes decreasing.²⁵⁸

57% for the Netherlands for the year 2008. The numbers stated by Eurostat for the same year are again considerably higher at the 68% level.

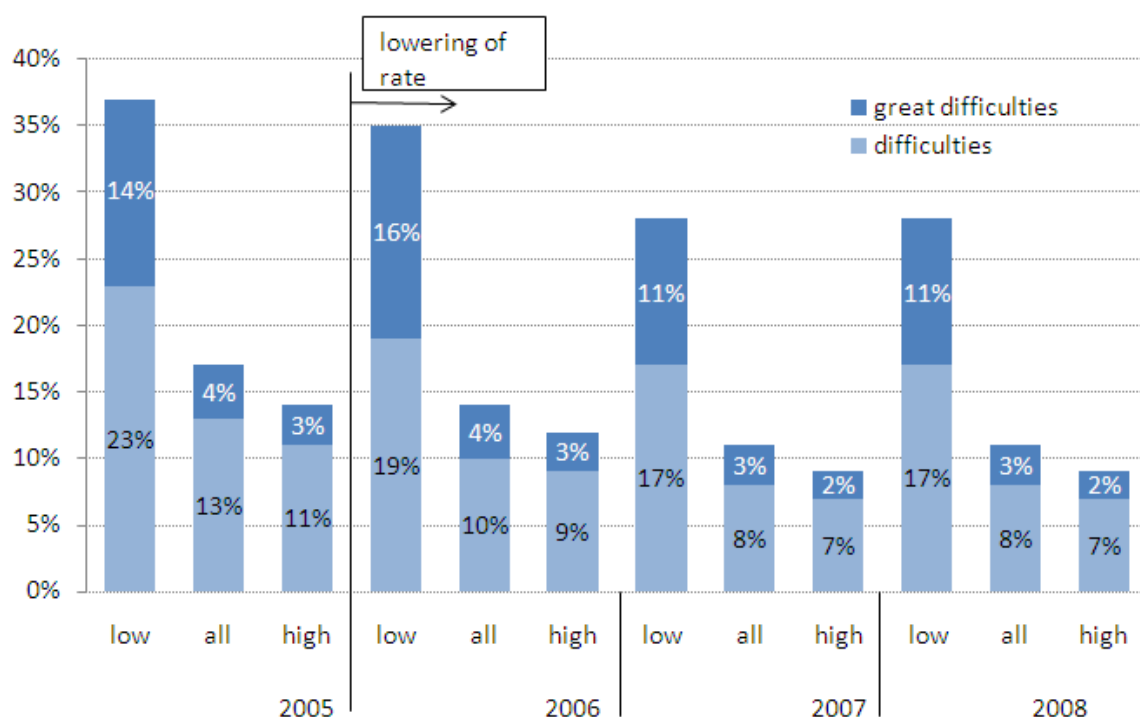
²⁵⁵ The European Mortgage Federation reports an owner- occupation rate of 57% for the Netherlands for 2008. The numbers stated by Eurostat for the same year are again considerably higher at the 68% level. Still, no clear statement is possible on whether arrears on mortgage repayments or rents are more frequent.

²⁵⁶ Unemployment rates according to Eurostat.

²⁵⁷ ECRI Statistical Package 2009.

²⁵⁸ De Nederlandsche Bank; ECRI Statistical Package 2009.

Figure 113: Development of over-indebtedness amongst Dutch households 2005-2008



Source: EU-SILC; Subjective indicator: "Ability to make ends meet"

Discussion

Regarding objective over-indebtedness indicators it seems most reasonable to consult the overall (non-)development with regard to arrears on hire purchases to judge **H5**. Changes in the prevalence of arrears cannot clearly be attributed to changes in the interest rate regime.

Concerning the subjective over-indebtedness indicator, however, tells a different story: As for the other case study countries (France, Germany, Sweden and the UK), the picture of the development of subjective over-indebtedness is heterogeneous: subjective over-indebtedness has stayed fairly constant in France and the UK, it decreased in Germany and Sweden from the years 2005-2007 but increased in 2008. The downward trend in the Dutch data should therefore not be attributed to an overall European trend.

While there have been major changes to the credit market in Poland, the same is not true for the Dutch credit market, so that the case of the Netherlands might constitute a better basis to argue in favour of H5, since the level of over-indebtedness decreased after the lowering of the interest rate cap in the Netherlands.

2.5.6.4 Views of Stakeholders

Issue 1: Is over-indebtedness a problem?

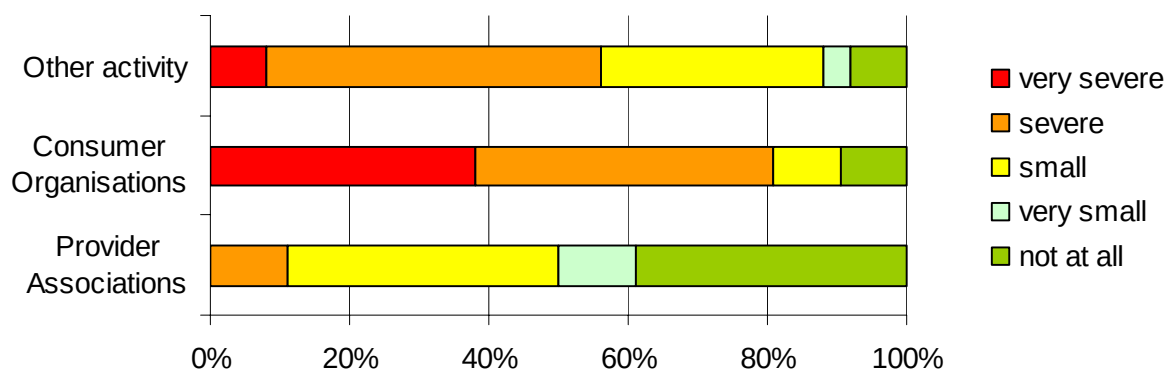
Facts and Figures

Whether or not one should consider the role of IRR for over-indebtedness obviously depends on the relevance of over-indebtedness in a society. In our questionnaire, we asked stakeholders if over-indebtedness is a severe problem in their respective countries.

Figure 114 reveals that the stakeholders' views on this issue are mixed: half of the respondents (52%) indicate that over-indebtedness is either a "severe" or a "very

severe” problem in their country. *Consumer organisations* attribute stronger importance to this problem (81%) than other stakeholder categories. In a written comment, some respondents point out that in certain countries over-indebtedness might be a small problem on an aggregate level but a relatively severe problem on an individual level.

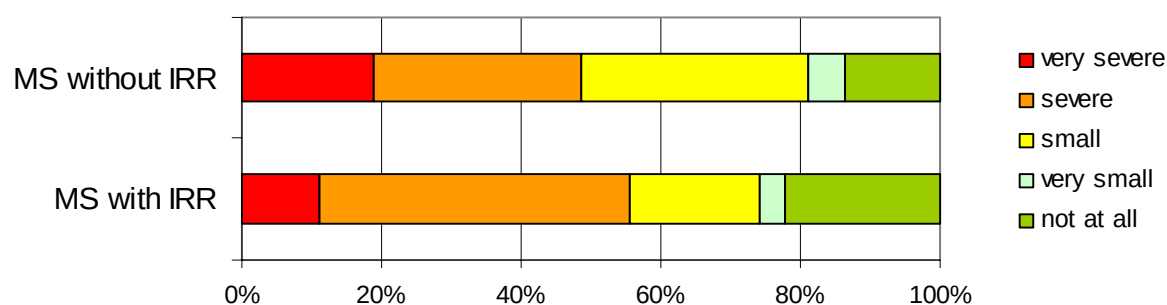
Figure 114: Severity of over-indebtedness, by type of respondent.



SQ Question : Do you think that private over-indebtedness is a problem in your country?

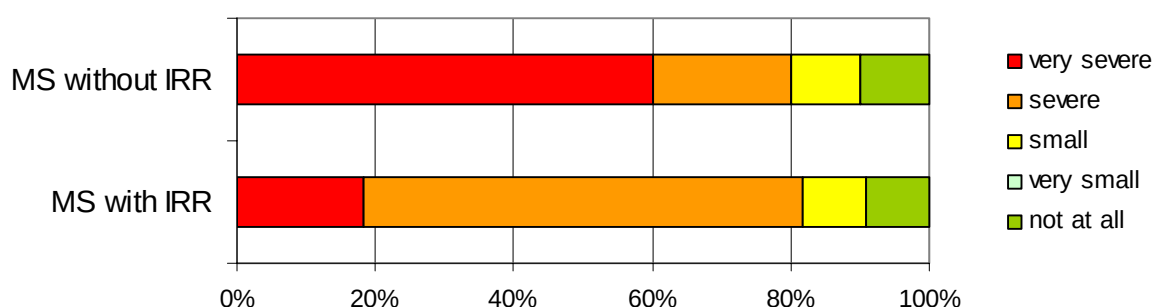
The fraction of respondents answering that over-indebtedness is a “very severe” or a “severe” problem in their countries is approximately equally large for countries both *with* and *without* IRR. This finding is documented in Figure 115: there is a slightly higher proportion of respondents from MS with IRR considering over-indebtedness a severe problem, which is related to the differences in the answers of subgroups of respondents from consumer organisations. The majority of consumer organisations (63%) from MS with IRR indicate a “severe” problem of over-indebtedness. In contrast, the majority of consumer organisations in countries without IRR (60%) indicates a “very severe” problem of over-indebtedness (Figure 116).

Figure 115: Severity of over-indebtedness, by country of origin with respect to interest rate regulation



SQ Question: Do you think that private over-indebtedness is a problem in your country?

Figure 116: Severity of over-indebtedness, responses from consumer organisations



Discussion

It appears that, overall, the problem of over-indebtedness is perceived almost equally strong among stakeholders from the same category in countries with and without IRR, which **does not support H5 in general**. However, there is a tendency that, if there are problems of over-indebtedness, these are perceived in a more pronounced way by consumer organisations in countries without IRR.

Issue 2: Which regulatory activities could reduce over-indebtedness?

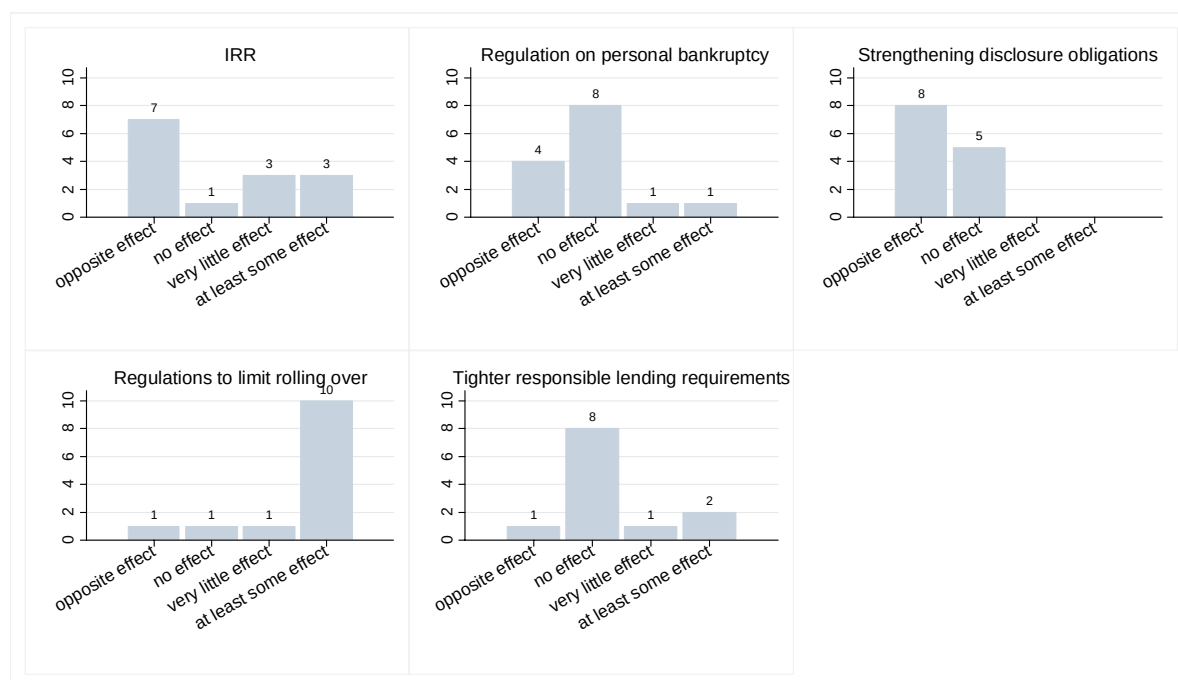
Governments may pursue multiple strategies to try to prevent over-indebtedness. While the evaluation of these different approaches is beyond the scope of this report, it is crucial to determine how important various stakeholders perceive interest rate restrictions to be compared to other potential measures.

Facts and Figures

Figure 117 and Figure 118 discuss different potential government actions directed at reducing the level of over-indebtedness. These include interest rate restrictions (upper left, "IRR"), regulations to limit the rolling-over of credit contracts, regulations on personal bankruptcy, tighter responsible lending requirements as well as strengthened disclosure obligations for lenders. As regulation affects providers and consumers differently, we take into consideration that both groups may provide strategic answers to these questions by looking at the answers of both subgroups separately. The charts in Figure 117 and Figure 118 can be interpreted as follows: the bar charts represent the number of respondents who chose a specific category. We consider one category for those who respond that a specific regulatory measure would have some effect, a strong effect, or a very strong effect on the reduction of over-indebtedness, another category for those who see little effect, a third category for those who see no effect and a fourth category for those who would even expect an adverse effect on the reduction of over-indebtedness.

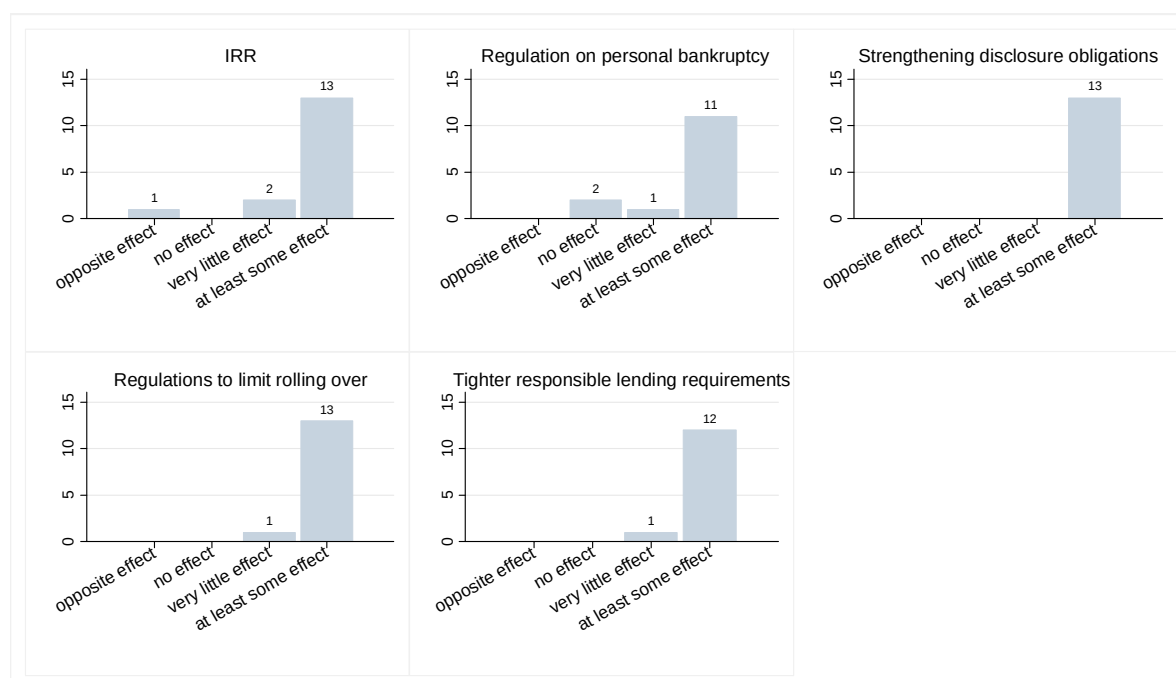
With respect to provider associations, Figure 117 documents controversial views on the effectiveness of interest rate restrictions to reduce over-indebtedness: while most respondents show support for the idea that IRR would reduce over-indebtedness to some extent, there are two-third who claim that IRR either have no effect or even lead to an increase in over-indebtedness. Interestingly, the majority of respondents from this stakeholder category even assert that from the listed regulation measure, the only alternative which might be effectively applied against over-indebtedness would be a regulation towards limiting the rolling-over of existing credit.

Figure 117: Effectiveness of different measures to reduce over-indebtedness
(view of providers)



SQ Question: Which of the following regulatory activities would have the most pronounced effects on reduced level of over-indebtedness?

Figure 118: Effectiveness of different measures to reduce over-indebtedness
(view of consumer organisations)



SQ Question: Which of the following regulatory activities would have the most pronounced effects on reduced level of over-indebtedness?

From the consumer associations' perspective, however, the role of interest rate restrictions to reduce over-indebtedness is only seen in positive light: they almost

unanimously (94%) assert that IRR have a *positive* effect on the reduction of over-indebtedness, whereas 81% of the respondents further expect more than just a little positive effect. Compared to provider associations, the majority of consumer organisations even assess all listed policy measures as particularly effective instruments against over-indebtedness.

Discussion

According to the views of consumer organisations, **H5** appears plausible. The views of provider associations on this differ, with a tendency to disagree with this hypothesis. Provider associations see other regulatory measures to be more effective to reduce the level of over-indebtedness.

Issue 3: Hypothetical case: effect of the introduction of IRR

The following paragraph discusses the stakeholders' views on the introduction of IRR in a hypothetical country which has had no IRR beforehand. For purposes of comparison, we suggested two alternative ways of interest rate restrictions: a relative one, defined as double the average rate prevailing in the market, and a fixed interest rate cap of 30% p.a.

Facts and Figures

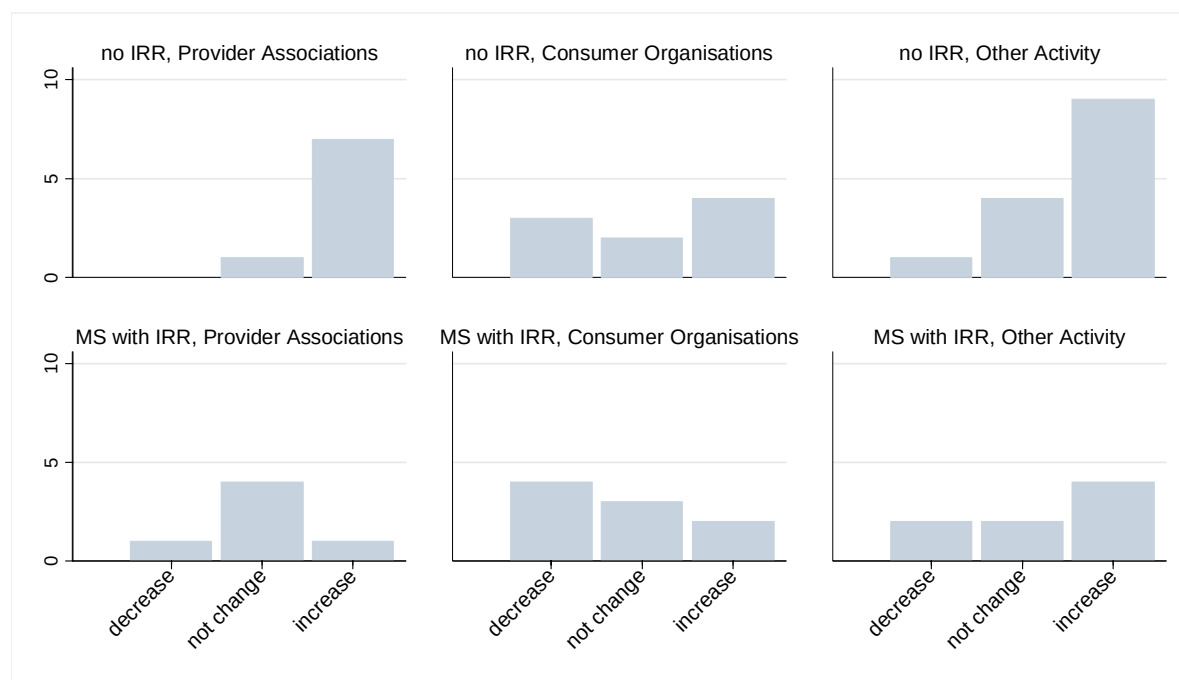
Figure 119 provides separate graphs for different respondent types (provider associations, consumer associations and a third category, "other activity", which includes financial regulators, banking authorities, government officials and others). It also distinguishes between these groups in countries *with* IRR and those *without*.

Interestingly, the expected effects of the introduction of an interest rate restriction of twice the average rate differ substantially across countries *with* and *without* IRR. In countries *without* IRR, there is very little support for the view that interest rate restrictions could *reduce* the level of over-indebtedness for low-income *consumers*. This view is equally pronounced for provider associations, the "other activity" category and consumer associations. Instead, the prevailing opinion even suggests that an introduction of interest rate restrictions would *increase* the level of over-indebtedness.

The responses from countries *with* IRR on these issues are different:²⁵⁹ here, a majority of the consumer associations (44%) expect the level of over-indebtedness to decrease after the introduction of interest rate restrictions. Also, the position of the provider associations and the "other activity" category is more heterogenous than that of the countries *with* IRR.

²⁵⁹ In some cases respondents from MS with IRR refer to the case of their own country instead of a hypothetical country.

Figure 119: Effects of IRR (2x average) on over-indebtedness, for low-income borrowers



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market (ie. set at 200% of the average calculated price for all credit products in a previous period) over-indebtedness of the low-income consumers would... (decrease/stay same/increase)?

Figure 120 shows that the results for a hypothetical introduction of a *fixed* interest rate cap of 30% APR differs from the results above. Nearly 80% of respondents argue that the interest rate ceiling should have a nonzero impact on the level of over-indebtedness of low-income borrowers. However, opinions are almost equally split between an *increase* (41%) and a *decrease* (39%). The same is also true for the responses of consumer organisations. In contrast to responses from Member States *with* IRR, 88% of the responding provider associations from Member States *without* IRR claim that a fixed IRR introduction would lead to an *increase* in the level of over-indebtedness of low-income borrowers.

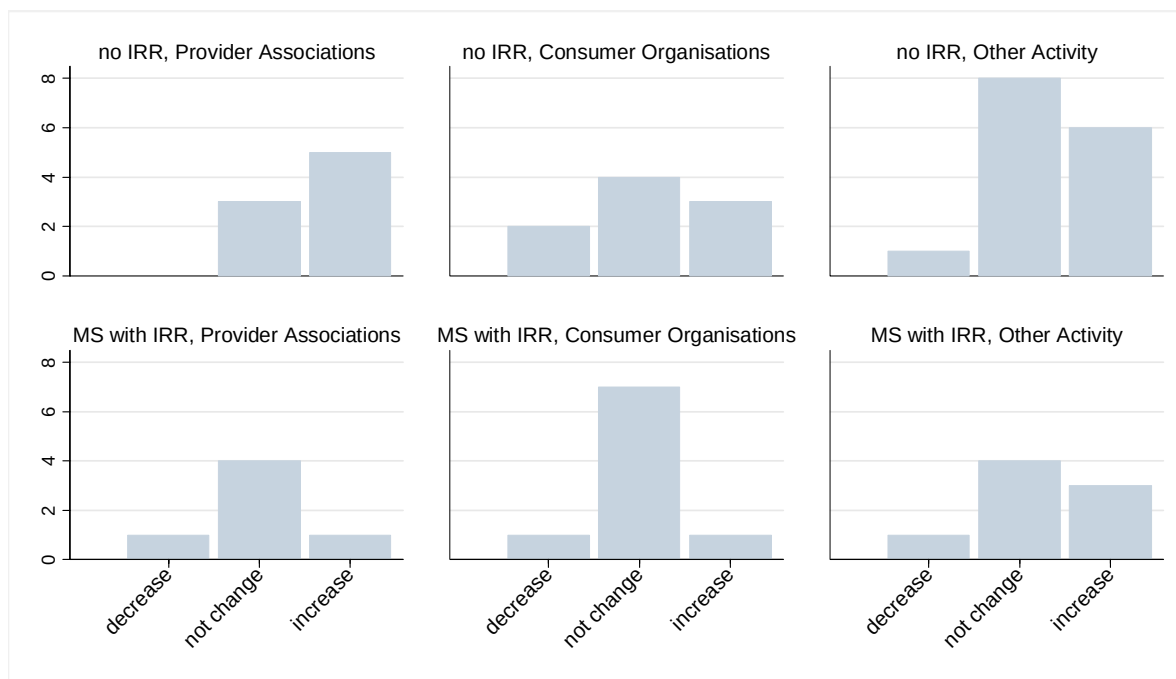
The findings in Figure 119 and Figure 120 appear to be slightly contradictory. However, verbal comments of stakeholders in the questionnaires reveal that at the given levels the relative (floating) ceiling and the absolute (fixed) ceiling are to a different extent binding in the different countries. Stakeholders who perceive an interest rate restriction of “twice the average rate” to be more binding than an interest rate cap at 30% slightly prevail. We therefore expect the results in Figure 119 to be more informative with respect to the views of the stakeholders on effectively binding interest rate restrictions.

Figure 120: Effects of IRR (max. of 30%) on over-indebtedness, for low-income borrowers



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that fixed at 30% APR for all credits, over-indebtedness of the low-income consumers would... (decrease/stay same/increase)?

Figure 121: Effects of IRR (2x average) on over-indebtedness, for average-income borrowers



SQ Question: Imagine a country with no IRR at all. If IRR were introduced and effective and set at a level that fixed at 30% APR for all credits, over-indebtedness of average consumers would... (decrease/stay same/increase)?

While the results in Figure 119 and Figure 120 concern the role of interest restrictions on over-indebtedness of *low-income* consumers, the heterogeneity of survey responses documented in Figure 121 suggest that there is no clear effect on the over-indebtedness of *average* consumers: the majority of provider associations (50%) and consumer organisations (61%) do not expect any impact on the over-indebtedness of an average borrower. The same is true for 48% of “other” stakeholders dominated by banking authorities and financial regulators.

Discussion

Overall, the responses on the expected effects of a hypothetical introduction of interest rate restrictions are heterogenous and suggest that **H5 is unlikely to hold**. Strikingly, respondents from countries *without* IRR predominantly expect even increasing levels of over-indebtedness after the introduction of interest rate restrictions, while this is not the case for respondents from countries *with* this kind of regulation. It appears that respondents who do not experience interest rate restrictions in their daily business attribute adverse consequences to it, which are ultimately not observed in countries in which interest rate restrictions are in place.

2.5.7 H5a: The lack of IRR has particularly adverse effects on default rates/over-indebtedness in the presence of negative shocks (eg. recessions) to the economy.

2.5.7.1 An overview

Since there are not yet enough data available covering the financial crisis no concluding judgment can be made about the validity of **H5a**. Evidence is therefore **inconclusive**:

- For the financial market crisis until 2008, cross-country comparisons do not reveal that countries *without* interest rate restrictions experience higher growth rates of over-indebtedness than countries *with* interest rate restrictions **This observation does not support H5a**. However, one has to keep in mind that the time period for the years 2009 and 2010 is likely to be more informative, as the crisis has only gradually affected private consumers in those countries.
- To partly fill the gap of lacking external data on over-indebtedness for the most recent years, we also consider the views of the stakeholders on recent developments in their countries. These views reveal that there has been an upward tendency of defaults by credit households in the time since 2008. **This effect appears to be slightly more pronounced in countries without IRR.** These findings might be seen as a confirmation of the hypothesis, although this evidence base might be too weak to draw final conclusions. We therefore recommend verifying these impressions at a later stage when objective (and internationally comparable) data on over-indebtedness for those years are available.
- There is no direct evidence from the literature, since the development of over-indebtedness after a negative shock has not been examined with regard to prevailing interest rate regimes. Still, other significant factors have been found, which might have a stronger impact on over-indebtedness than restrictions on interest rates.

2.5.7.2 Evidence from the past / Views of Stakeholders

There is reason to assume that the financial market crisis has had an impact on the financial situation of households and ultimately on over-indebtedness. Creditreform (2010) report a double digit number of increases of private insolvencies in Europe between 2008 and 2009, with particularly pronounced increases in the UK and France. As private insolvencies are not comparable on a cross-country basis,²⁶⁰ it appears promising to study whether there has been an increase in percentages of households in payment arrears after the financial market crisis.

Unfortunately, data covering the year 2009, when the impact of the crises may be fully mirrored in payment difficulties of households is not available. With respect to the EU-SILC data, we are therefore only able to discuss the development until 2008. Responses from the Stakeholder Questionnaire²⁶¹ will be reported to get an idea of possible recent developments (which are not yet reflected in the data).

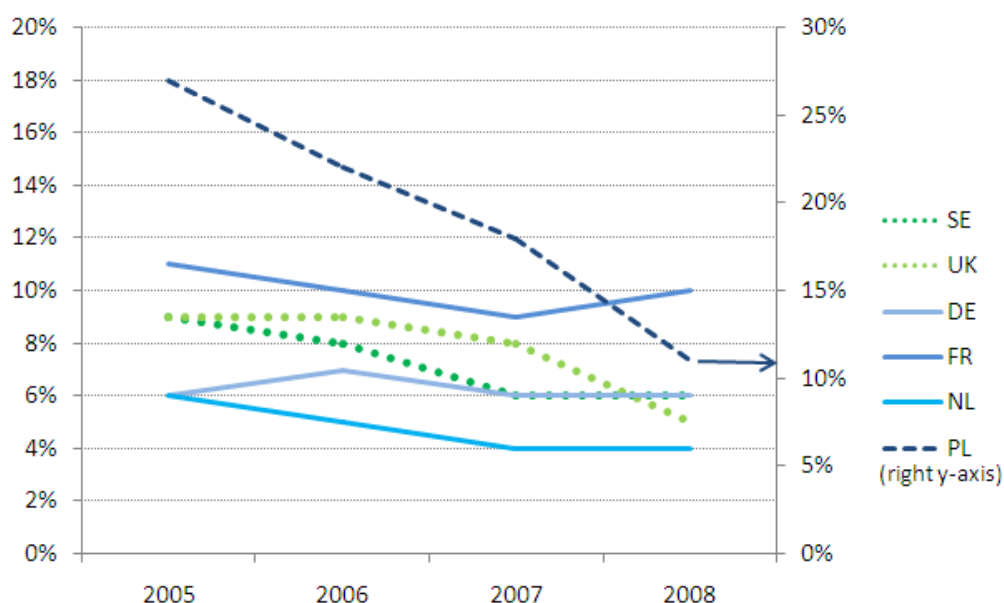
²⁶⁰ For a more detailed reasoning on that point, see the Appendix discussing measures for over-indebtedness (in particular administrative measures).

²⁶¹ In a separate questionnaire, providers were also asked: "Since the start of the financial market crisis in 2007, how would you characterize the changes to customer defaults in your institutions". However, given the fact that mostly respondents from the UK have answered the question, no comparison can be made and

Facts and Figures: The financial market crisis

Figure 122 presents the objective indicator “Arrears on mortgage or rent, utility bills or hire purchase”. It depicts the percentages of households (*all households*) in arrears in the six case study countries. In all countries but France the share of over-indebted households stayed constant or decreased. It is impossible to differentiate the development of over-indebtedness in the year 2008 on the basis of different interest rate regimes.

Figure 122: 6-Country comparison of households in arrears 2005-2008



Source: EU-SILC; Objective Indicator: “Arrears (utility bills, mortgages, loans)”

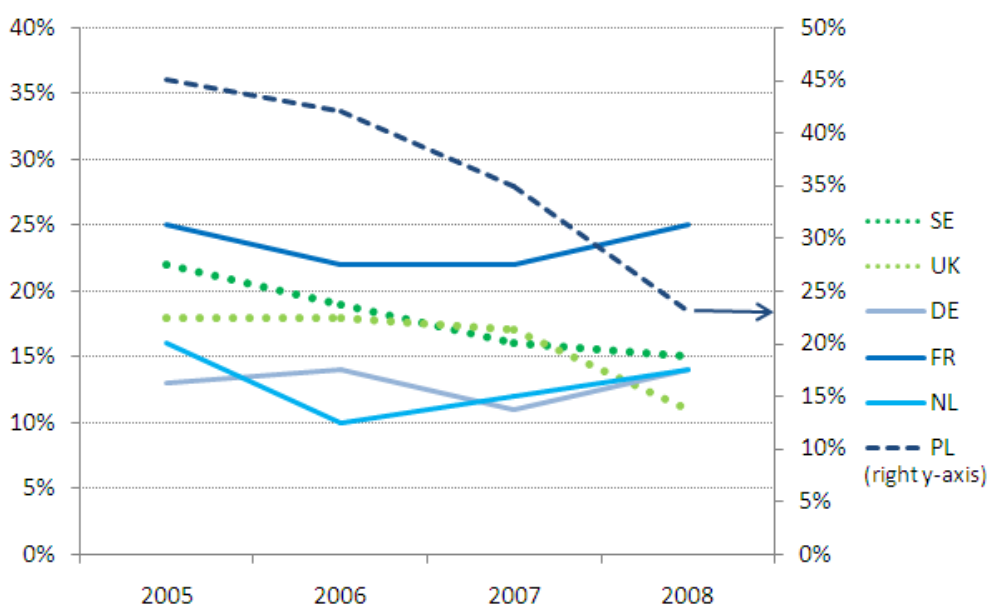
Note: All countries, with the exception of Poland, relate to the left hand y-axis. Countries without or with only insignificant IRR are depicted with green shaded dotted lines (Sweden and UK) and countries with IRR are depicted in blue shaded continuous lines except for the development of Poland which is displayed by a dashed line.

Figure 123 takes a closer look at *low-income* households, as they can be presumed to be the first to be affected by negative shocks.²⁶² It shows the development of fractions of low-income households falling in arrears in different countries. Not very surprisingly, payment difficulties on different obligations (utility bills, mortgages or rent, hire purchases or loans) are much more prevalent among *low-income* households compared to the overall population. Interestingly, percentages of over-indebted households increase in countries *with* IRR (with the exception of Poland) and decrease in Sweden and the UK.

hence no conclusion can be drawn regarding the differences between Member States *with* and *without* interest rate restrictions.

²⁶² Eg. low-income households might have to rely on two incomes to cover their obligations. Therefore, an increase in unemployment rate might quickly lead such households into payment difficulties as opposed to households that can meet their obligations by the earnings of just one of the household's members.

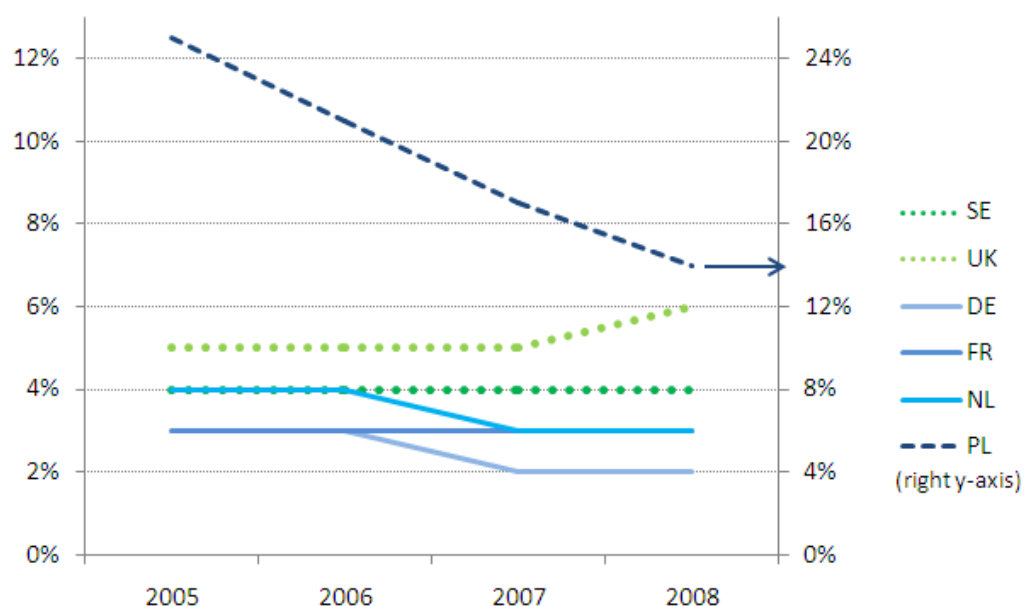
Figure 123: 6-Country comparison of low-income households in arrears 2005-2008



Source: EU-SILC; Objective Indicator: "Arrears (utility bills, mortgages, loans)"

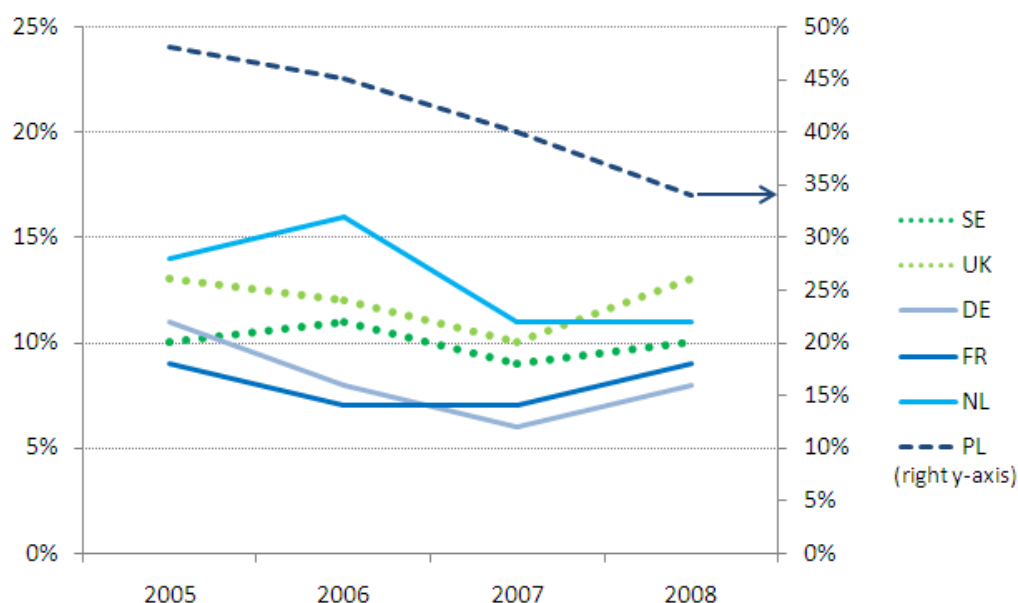
As subjective burden indicators might mirror difficulties more promptly, corresponding data from EU-SILC (indicator: "Households experiencing great difficulties to make ends meet") is analysed for possible effects of the financial market crises on over-indebtedness. As before, we consider all households and low-income households separately. But again, no statements can be made on the connectedness of over-indebtedness and interest rate restrictions in the case of a negative shock comparing the entire populations of the countries: as Figure 124 shows, there have not been notable developments of over-indebtedness in any countries (except Poland) in the period from 2005 to 2008. There is more movement in the data for low-income households (Figure 125). In four countries low-income households more often experience great difficulties making ends meet, which could be interpreted as an effect of the crisis: however, two of them have interest rate restrictions while in the remaining two there are no significant regulations on interest rates. There is thus, again, a mixed pattern.

Figure 124: 6-Country comparison of subjective over-indebtedness 2005-2008



Source: EU-SILC; Subjective Indicator: "Experiencing great difficulties to make ends meet"

Figure 125: 6-Country comparison of subjective over-indebtedness among low-income households 2005-2008



Source: EU-SILC; Subjective Indicator: "Experiencing great difficulties to make ends meet"

Discussion

The evidence from the objective indicators provided above is not in line with H5a, as there is no observable effect (for all households) or an opposing effect (for low-income borrowers) for 2007/2008. Likewise, the information from the subjective indicators points to the same direction. Summing up, the results from subjective and objective indicators of over-indebtedness rather disprove **H5a**, as IRR do not seem to have any impact on over-indebtedness in the event of a negative shock or a rather

negative effect in the sense that more low-income households reported problems keeping up with their obligations in countries with IRR.

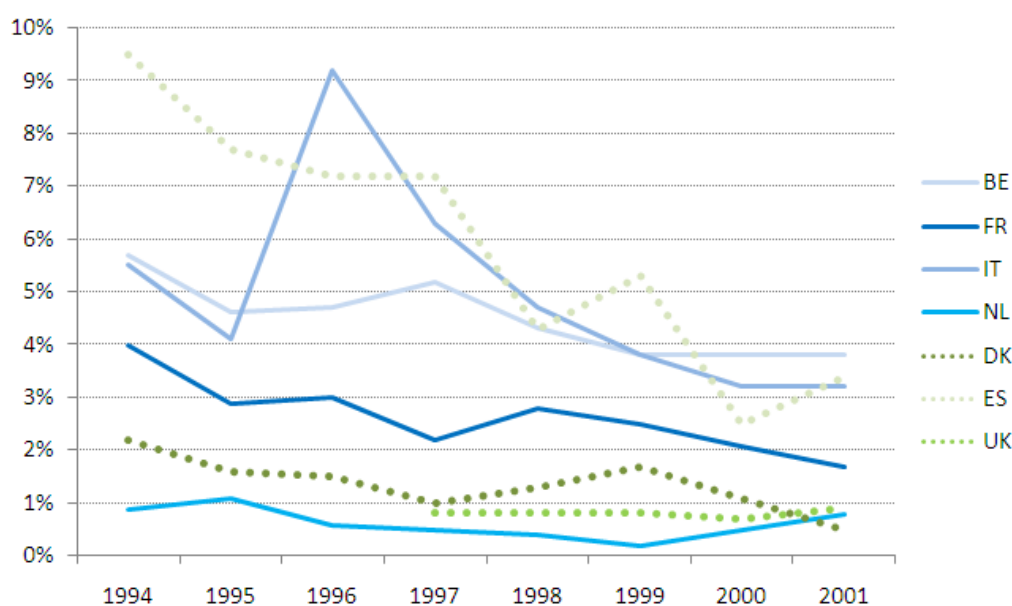
However, as data for 2009 and 2010 are lacking, these results are not yet conclusive. It is therefore recommended to re-evaluate the impact of the financial market crisis and its impacts on the real economy upon availability of EU-SILC data.

Facts and Figures: The burst of the dotcom bubble

To shed further light on **H5a**, the ECHP (European Community Household Panel)²⁶³ offers data from 1994-2001 that will be used to analyse developments after the burst of the dotcom bubble. Unfortunately, data is again not available for a longer period of time after the negative shock.

Figure 126 shows the fraction of households holding a mortgage and behind on their payment obligations. It is possible to grasp a slight increase in percentages of households with repayment difficulties for the Netherlands, Spain and the UK in the year 2001. It has to be noted, though, that interest rate regimes differ among these countries: while we consider the UK and Spain to have no effective interest rate restrictions in place, the regulatory regime in the Netherlands is rather strict. Interestingly, there are also countries in which the rate of households in payment arrears on their mortgages decreased in 2001 (Denmark and France).

Figure 126: Cross-country comparison of households falling behind on their mortgage repayments 1994-2001



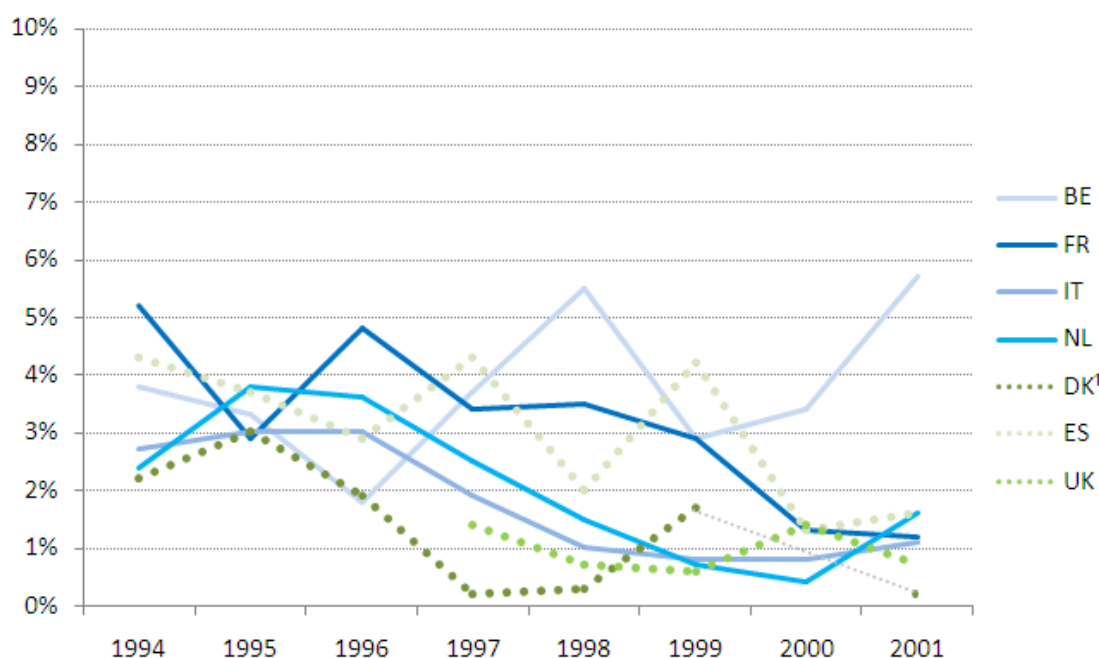
Source: ECHP; Objective Indicator "Households with mortgages in payment arrears"

Again, we will examine the development of arrears on mortgage repayments among low-income households separately (Figure 127). First, and somewhat surprisingly, arrears on mortgage repayments are much less prevalent amongst low-income households compared to the overall population. Concerning the analysis of low-income households' mortgage repayment difficulties, the majority of countries exhibiting a rise in the percentage of over-indebted low-income households are countries with IRR. However,

²⁶³ The ECHP can be considered the predecessor of EU-SILC. The discontinuity between ECHP and EU-SILC not only concerns the years 2002-2004, which are not covered by the surveys, but also variable definitions.

development of arrears on mortgage repayments in Belgium and Spain rather seem to follow cyclical movements with up and down-swings strengthening the aforementioned reservation that other factors may have greater impact on repayment problems than interest rate restrictions.

Figure 127: Cross-country comparison of low-income households falling behind on their mortgage repayments 1994-2001



Source: ECHP; Objective Indicator "Households with mortgages in payment arrears"

¹ For Denmark there is no data for the year 2000. The development is therefore depicted only exemplarily in tiny grey dots.

Discussion

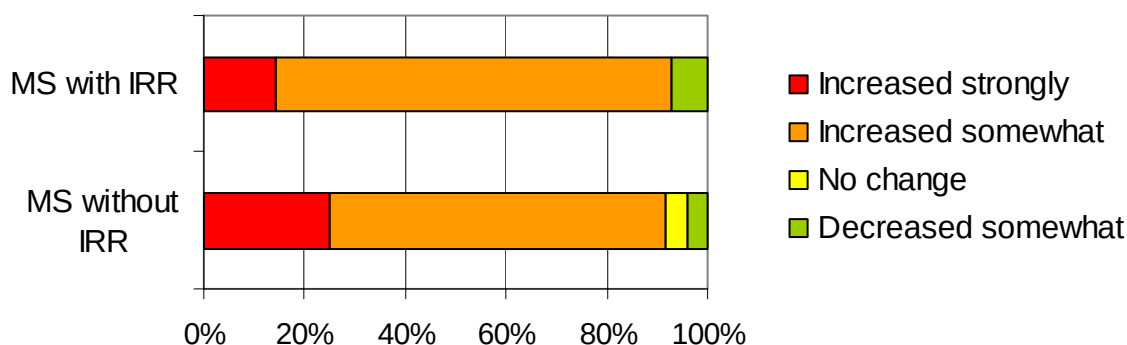
There is again no clear pattern in the results above which argues in favour of the validity of **H5a**. However, one has to be cautious using this finding as an argument in favour of **H5a**: it is probable that differences in developments of arrears on mortgage repayments are related to mortgage market characteristics and not to interest rate regulatory regimes.

Facts and Figures: Stakeholders' responses

As described above, the most recent data from SILC does not yet enable us to effectively evaluate the (potentially) different impact of the financial market crisis. To fill this gap, we consider responses from the Stakeholder Questionnaire about current developments in the respective countries. In particular, we ask stakeholders whether there has been a trend in consumer credit business with respect to credit defaults by private households after the financial crisis (since 2008).

The fraction of respondents answering that over-indebtedness "increased strongly" or "increased somewhat" in the course of the financial crisis is nearly equally large for countries both *with* and *without* IRR. This can be taken as a sign that, in fact, the financial market crisis has had an impact on over-indebtedness which became apparent only in the time after 2008. It is also important to notice that there is a larger share of respondents reporting "strong increases" in over-indebtedness from countries *without* IRR. In line with this, the share of those responding that there has even been a decrease in the level of over-indebtedness is slightly higher in countries *with* IRR.

Figure 128: Trend in credit defaults by private households after the financial crisis



SQ Question: Did you notice a trend in consumer credit business with respect to credit defaults by private households after the financial crisis (since 2008)

Discussion

The findings highlight the importance of looking at the financial market crisis with data on the years 2009 and 2010, which are not yet available. We therefore recommend to revise this analysis once the data are accessible. Although we interpret the stakeholders' responses only as a first indication of a tendency that needs to be verified later with objective data, we see that there appears to be a more pronounced increase in over-indebtedness from countries *without* IRR. This **observation supports H5a**.

2.5.7.3 Evidence from the literature

There are some studies and reports examining the vulnerability of households in case of economic shocks such as interest rate increases, fuel price increases or exchange rate changes. The findings from literature can shed light on other factors, besides IRR, impacting the level of over-indebtedness in case of negative shocks to the economy. Furthermore there is research examining the risk of over-indebtedness on the level of the individual household into which an insight will be given at the end of the paragraph.

Negative shocks to the economy

For the *Netherlands*, Brouwer (2008) expresses the concern that, since the loan-to-value ratios are very high,²⁶⁴ a downturn in the economy may have serious consequences for borrowers' ability to meet their payment obligations. While the average LTV ratio on outstanding loans amounts to over 40%, for new contracts it is often higher than 110%.²⁶⁵ This might be a particular concern, as many new borrowers are first-time house buyers, with relatively low incomes, low job security and in many cases dependence on two incomes. They are therefore particularly vulnerable.

²⁶⁴ Strictly speaking loan to foreclosure values (LTFV) are high. The foreclosure values refer to the estimated sum that can be realised in a forced sale and usually amount to 85%-95% of the market value of the property. As LTFV can reach up to 125%, the LTV can be calculated to range between 85-115%. Compare Standard & Poors (2005). High loan-to-value ratios are motivated by tax deductibility of mortgage interest payments.

²⁶⁵ Furthermore, tax deductibility leads borrowers to maximise the outstanding principal balance on their mortgages for as long as possible, thereby increasing the tax benefits over the duration of the loan. Compare Standard & Poors (2005).

Although the level of aggregate indebtedness in *Poland* is low compared to other EU countries, Zajączkowski and Żochowski (2006) express the concern that Polish households may still be more vulnerable to shocks to the economy because of the higher share of basic living costs in total consumption expenditure. In Poland, new loans, and especially mortgages, are often denoted in Swiss francs.²⁶⁶ Furthermore, mortgage debt-service ratios in lower-income groups are increasing. Zajączkowski and Żochowski (2006) therefore analyse the effects of a foreign exchange or interest rate shock. They hold the opinion that the debt-service ratio level, at which one of the risks may prove crucial for the financial system's stability, is lower than in EU 15 as the proportion of fixed expenditure in the budgets of Polish households is higher. The safety income buffer within which the debt may freely rise as a result of different shocks without a risk to stopping debt repayment is therefore lower in EU 15 countries.

Johansson and Persson (2006) study the possible consequences of increases in interest rates or unemployment rates households' ability to pay in *Sweden*. According to their analysis of 5 different income quintiles, debt is backed by sufficient collateral in all quintiles. They find the most vulnerable households in the lowest income group. Although this income quintile holds only 2% of total household debt, more than half of the losses incurring in case of default would stem from this category.²⁶⁷ They find the effect caused by an interest rate hike to be stronger compared to an only very moderate effect of rising unemployment. They explain their findings with the fact that large amounts of debt are concentrated in the highest income quintile where households are presumed to have dual incomes and high unemployment benefits.

For the *UK* Kempson and Atkinson (2006) investigate the impact of two areas of expenditure increase – fuel bills and mortgages – on households' ability to make ends meet. For the expenditure on fuel bills they find that price increases have the greatest impact on poor people and those aged over 70, but that they do not have a major effect on most households' ability to make ends meet. Regarding mortgages, concerns have been raised questioning the ability of some mortgagors to keep up with repayments should interest rates rise against the background of increases in the sums of money that have been borrowed. In contrast, to fuel bills, mortgages absorb a far higher proportion of household income (on average 20% of net monthly household income, at the time of the baseline survey of financial capability in the year 2005, while fuel bills absorb only an average of 4.1% of net household income). Kempson and Atkinson (2006) assess the impact of interest rate increases considering a subjective indicator as well as a statistical analysis. They show that far fewer people would actually experience payment difficulties than expected. While more than 20% of mortgagors anticipated financial difficulties following a rise in monthly payment obligations by 10%, according to the statistical analysis only one in a hundred seemed likely to experience these difficulties.

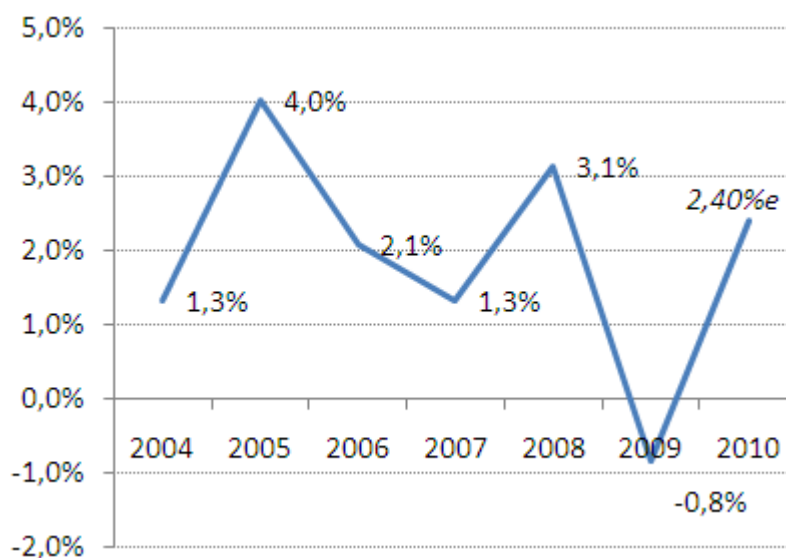
Their findings are consistent with previous research which has shown that, across the population as a whole, increases in expenditure are not a major cause of financial difficulties. However, price increases have been found to be a contributory factor (Ford, Kempson and Wilson, 1995; Herbert and Kempson, 1995).

²⁶⁶ According to Zajączkowski and Żochowski (2006) the majority of new loans (70% - 90%) are loans denominated in foreign currencies, usually in Swiss francs. Housing loans are usually extended at a floating interest rate, where fixed interest rate is generally used for a short promotional period – up to two years from the date of loan contract. Brown and al. (2009) find that while foreign currency residential housing loans accounted for up to 60% of all foreign currency loans they are much less widespread in consumer lending and corporate finance. In 2007, less than 6% of CHF lending was ascribed to consumer credit and corporate credit.

²⁶⁷ Johansson and Persson (2006) express the suspicion, that households in this income category may have incomes and assets not reported to the tax authority providing the analysed data.

Creditreform (2009) judge the risk of over-indebtedness to be lowest for *German* households, as compared to their US or UK counterparts. They base their analysis on different economic indicators such as unemployment rate, GDP growth and the lower ratio of consumer credit to GDP. Creditreform (2009) underline that the default rate on consumer credit in Germany amounts to only half of the rate in the US or the UK – 3% versus 6% respectively. Schufa (2010) find the default rate in Germany to be fairly constant for the years 2007-2009. Furthermore, they publish an index assessing the risk of over-indebtedness and predicting its future development. This index (called PVI – Private Indebtedness Index) showed a slight decrease from 2008 to 2009, signaling a decrease in critical signs of over-indebtedness²⁶⁸ but for 2010, an increase is expected. The development of PVI growth rates is depicted in Figure 129.

Figure 129: Growth rates of PVI (Germany) 2004-2009



Source: Schufa.

Negative Shocks on the level of the individual household

Theoretically, it is major events which force households into over-indebtedness. Such circumstances may lead households into an economically destabilised situation, either because of lower household income or higher need for household expenses. However, in practice there are other reasons for over-indebtedness such as over-commitment or bad management of households' finances. A great part of the analysis of potential causes relies on self-reported reasons and may therefore be biased.

For *Germany* there is data reported by debt counselling agencies. Although this data is not representative, it can give some insights into which triggers might have lead households into over-indebtedness, according to the assessment of counsellors. In the view of counsellors, the main triggers are unemployment or an income reduction of another type (30%), family breakdowns (13%), illness (7%), avoidable behaviour such as unsustainable consumption behaviour or bad housekeeping (17%), and failed attempts of self-employment (12%).²⁶⁹

According to Kempson (2002), a loss of income is the most frequently stated reason (45% of households) by people who have fallen into arrears in the previous 12 months or

²⁶⁸ Such as personal insolvency (Privatinsolvenz).

²⁶⁹ See Statistische Bundesamt (2009).

who are experiencing financial difficulties in the *UK*. This loss of income was often a result of dismissal. The second and third reasons were relationship breakdowns and long-term sickness. This result is confirmed by a later analysis which finds drops in income to be strongly associated with the risk of arrears.²⁷⁰ Low income as such was reported by 14% of households in the study of Kempson (2002). Over-commitment, overlooking or withholding payments were only mentioned in around one tenth of the cases. As some people prefer to give reasons which relate to external factors, rather than admitting that they are personally responsible for their indebtedness,²⁷¹ Kempson et al. (2004) expect that over-commitment and overlooked or withheld payments account for a larger fraction of actual reasons for debt problems. Trying to evaluate which events significantly affect self-assessed over-indebtedness, Disney et al. (2008) identify divorce and a decrease in income as the major changes in personal circumstances which induce a household's perception to feel over-indebted. In another analysis they try to determine changes causing households to fall into arrears. Among them are previous relationship breakdowns and an increase in the number of credit commitments. Taking a closer look at the effect of family dynamics, Kempson et al. (2004) find that family changes have a greater impact on the likelihood of arrears on unsecured credit commitments than they do on household bills. Interestingly, changes in current income and loss of employment are not found to have a direct impact on a change in arrears. Disney et al. (2008) argue that the 'life cycle' model does not suggest that income changes always affect indebtedness, but that it is adverse shocks to income, possibly coupled with high debt commitments, which cause problems.

Jentzsch and Riestra (2006) examine reasons for repayment difficulties in *Austria, Belgium, France and Spain*. Unemployment is blamed for repayment difficulties in all countries, with a fraction as large as 42% in France to a relatively low 21% in Austria and 19% in Belgium. Divorce is also a widespread factor, mentioned by a fifth of Austrian, Belgian and French households. In Spain 58% give a reduction in income (due to unemployment, divorce or other factors) as reason for a default on payment obligations. Interestingly, the reason most commonly reported in Austria is poor household management. Similarly, 12% of Spanish households admit bad financial management to have caused their payment problems. Excessive charges or unexpected charges (as mentioned by 16% and 3% of Belgian households, respectively) may as well be indicators of poor financial management, as can be the lack of information reported by 26% of Spanish debtors.

Conclusion/Discussion

Literature finds that different factors influence the risk of over-indebtedness on the macro and the micro level: Most cited are a rise in unemployment and changes in the family structure. Even so, there are contradicting opinions on which of the factors has the highest impact. This may be due to differences in credit markets. Literature shows that there is a range of factors besides interest rate restrictions which can lead to adverse effects on default rates/over-indebtedness in case of negative shocks to the economy.

²⁷⁰ See Kempson et al. (2004), p. 32.

²⁷¹ Compare Dominy and Kempson (2003).

2.5.8 H6: The average consumer (or even more so: low-risk consumer) would be granted cheaper credit in the presence of IRR.

2.5.8.1 An Overview

A necessary condition for **H6** to hold would be a decline in the average interest rate after the introduction of restrictions. Since in general no data on individual credit cost before and after the introduction of IRR are available, aggregate data are taken into account. Drawing on these data and findings from the Stakeholder Questionnaire, we find **inconclusive** results with respect to **H6**.

- The cross-country comparison of interest rates is difficult due to differing loan values and maturities of the loans as well as differing market structures, taxation and the cost of funding by lenders. **A cross-country comparison of the case study countries does not deliver patterns which can be explained by interest rate regulation.**
- Based on the data on interest rates presented above we **find some evidence in favour** of the decreased average rates immediately after the introduction of interest rate restrictions in **Poland**. The observations from the year 2006/2007 in the **Netherlands** suggest that one **cannot expect a decline** in *average* interest rates on instalment loans after lowering interest rate restrictions, as **H6** implies.
- The German example in the 1980s suggests that interest rate restrictions may lead to a **lower degree of heterogeneity** of charged interest rates: this means that the most expensive loans offered are closer to the average interest rates than before; this does not, however, necessarily confirm **H6**.
- Stakeholders report their view that interest rate restrictions are likely to make credit more expensive than without; this is the opposite of **H6**.

2.5.8.2 Introduction

When banks apply risk-adjusted pricing, there is a broad range of different interest rates in the market. In theory, interest rate caps may reduce the scope of risk-adjustment, potentially driving higher-risk groups out of the market (see Chapter 2.5.1). As a statistical consequence, the average interest rate after the introduction of interest rate restrictions is lower. This does not necessarily imply that an individual borrower (who remains in the market) gets better rates as before. In addition, as discussed in Chapter 2.1.3, there are also theoretical arguments that credit should be cheaper for the customers remaining in the market.

Unfortunately, data limitations do not permit to distinguish whether a drop in *average* rates is due to the statistical effect, or whether an individual borrower ultimately faces lower credit costs.²⁷² To evaluate the hypothesis (which has the latter effect at its core), we thus consider the drop of average rates to be necessary (but not sufficient) condition for the validity of the hypothesis.

2.5.8.3 Cross-country comparison

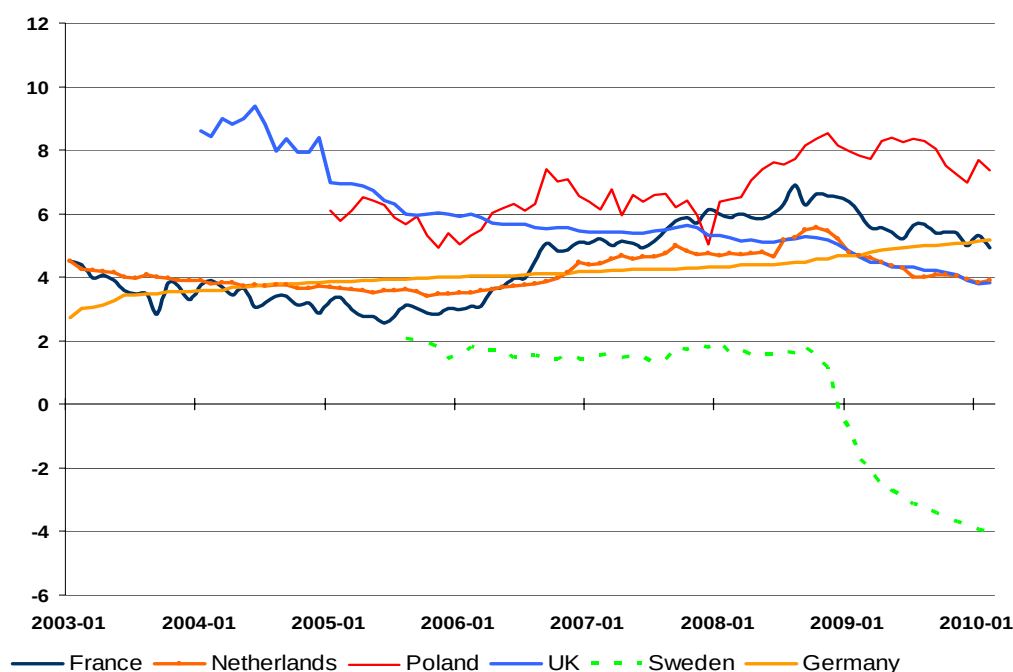
Interest rates are difficult to compare across countries. Differing loan values and maturities of the loans as well as differing market structures and taxation of interest

²⁷² This would only be possible based on micro data which records not only the credit positions of households, but also the prevailing credit conditions before and after the introduction of interest rate restrictions.

rates between countries make it very difficult if not impossible to draw conclusions with regard to relative interest rate levels (Guardia, 2002). Casolaro et al. (2006) briefly describe dynamics of interest rates in Italy. They find a continuous reduction in the level of both nominal and real interest rates in Italy starting in 1995, which they attribute to the decrease in the interest realised to achieve Maastricht criteria for admission to the single currency, worldwide reduction in the interest rates during the 1990s, as well as financial liberalisation. Casolaro et al. (2006) also find a decline in the spread in the long-term interest rates *vis-à-vis* average interest rates on long-term bank funding from 5% in 1996 to 2% in 2000. The authors state that the decline may be attributed to the increased completion brought about by the financial liberalisation. Except for Hartmann-Wendels and Spörk (2008), we are not aware of studies analysing consumer credit interest rates in the six case study countries. However, Hartmann-Wendels and Spörk (2008) focus on German consumer credit interest rates only and their discussion is centered on comparability of the interest rates reported after the introduction of the EMU guidelines for interest rate statistics in 2003.

Below we illustrate the dynamics of the consumer credit interest rates in the selected six EU countries. Figure 130 presents real interest rates on consumer credit with initial fixation of up to 1 year. Due to lack of data for Sweden, Poland and the UK in the early 2000s, the time period for which data for all six countries are available is limited to August 2005 to January 2010. As we can see from Figure 130, for most of this period, the highest real interest rates are observed in Poland while the lowest interest rates are found in Sweden. Interest rates in France, Germany and the Netherlands remained below those in the UK until the period of the recent financial turmoil. French, German and Dutch interest rates exceeded those of the UK in 2007, 2008 and 2009, respectively. Notably, after the start of the recent financial crisis in 2007, the interest rates on consumer credit declined somewhat in all countries except for Germany.

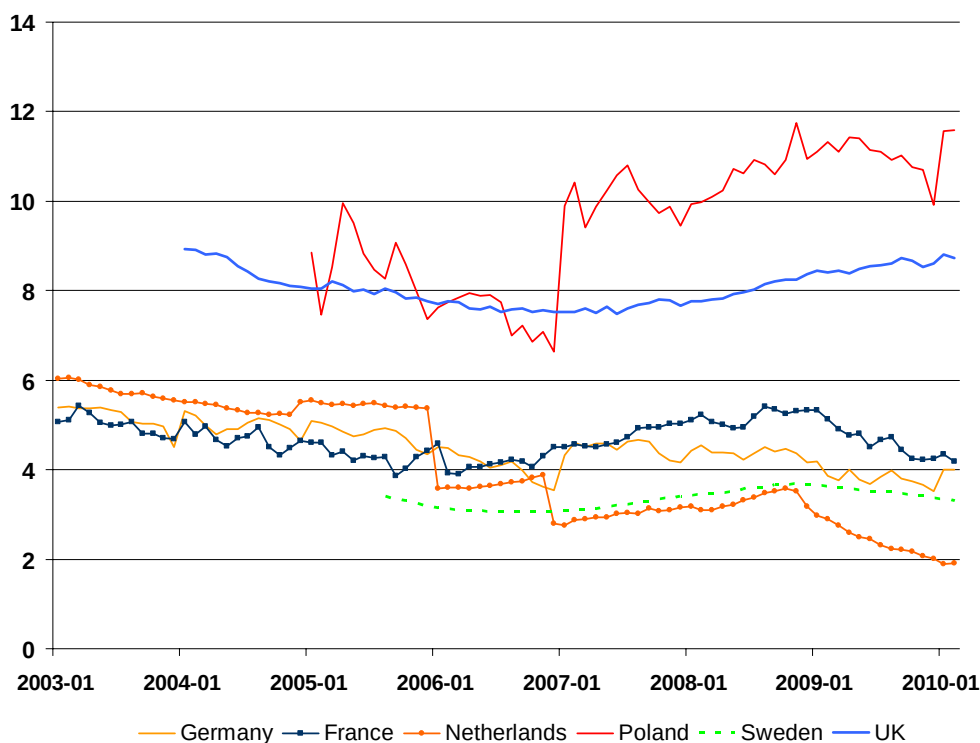
Figure 130: Real interest rates on consumer credit with initial fixation of up to 1 year in the six EU countries, 2003-2010, in percent.



Source: National Central Banks, Eurostat, own calculations. Notes: Interest rates are for new business, except for Sweden.

A similar picture is observed in case of interest rates with an initial fixation of more than 1 and less than five years (Figure 131). The highest and lowest interest rates were observed in Poland and Sweden until 2007 and in the Netherlands since 2007. German and French interest rates remained well below those of the UK for the whole period.

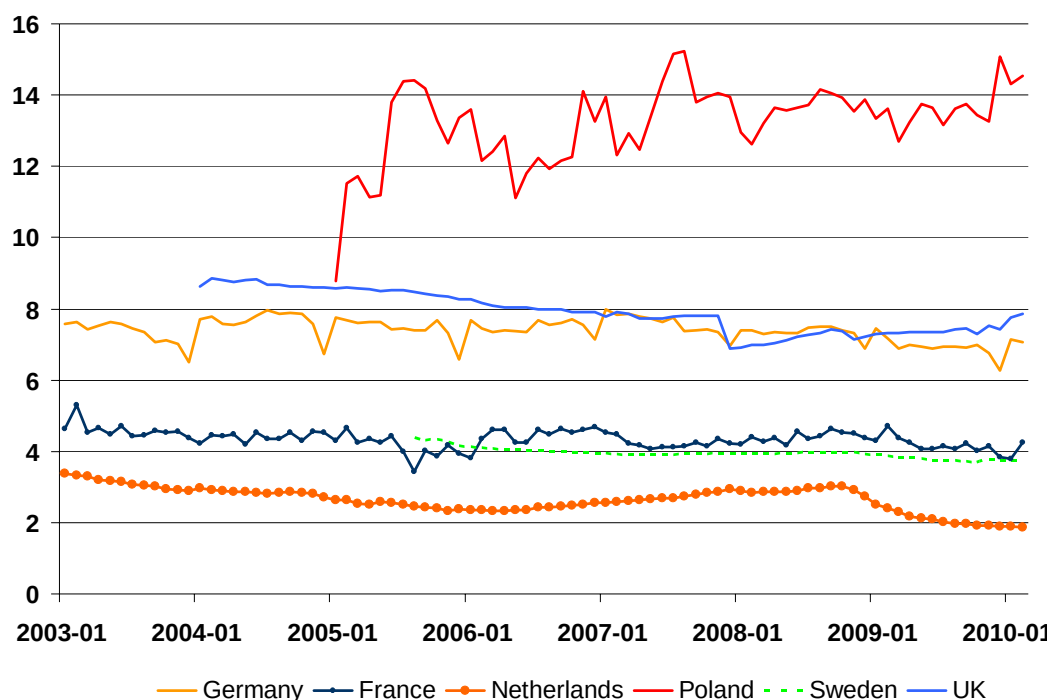
Figure 131: Real interest rates on consumer credit with an initial rate fixation of more than 1 year and less than 5 years in the six EU countries, 2003-2010, in percent.



Source: National Central Banks, Eurostat, own calculations. Notes: Interest rates are for new business, except for Sweden.

Finally, Figure 132 shows interest rates with the initial fixation of more than five years. As in the case with the two previous interest rates, Poland showed consistently higher interest rates than other countries. UK interest rates are similar to those of Germany and Swedish interest rates are somewhat below those of France. The lowest interest rates for this type of credit are observed in the Netherlands.

Figure 132: Real interest rates on consumer credit with an initial rate fixation of more than 5 years in the six EU countries, 2003-2010, in percent.



Source: National Central Banks, Eurostat, own calculations.

Notes: Interest rates are for new business, except for Sweden.

Discussion

Based on the facts above, **we conclude that the evidence with respect to the interest rate levels in the countries with and without IRR is mixed.** Two issues should be borne in mind. First, the case of Poland is special since this is the only new Member State in the group of the considered six EU countries. As a country with a relatively new and fairly concentrated banking system, where competition may still remain in a nascent state, it is not surprising that relatively high interest rates are observed. Second, the recent financial crisis resulted in a decline in interest rates internationally which means that the observed figures for 2007-2009 reflect not only the interplay between demand and supply factors, but also broader macroeconomic situation.²⁷³ Finally, as interest rates may be affected by a number of the above-mentioned factors, it is difficult to identify whether and to what extent the observed changes result from differences in interest rate regulation. Therefore observations presented here should be treated with caution.

2.5.8.4 Past experience

In this section we provide an illustration of the development of the levels of interest rates for consumer credit following the introduction of interest rate restrictions in Poland in 2005 and the change in interest rate regulations in the Netherlands in 2006. A brief summary of the results is given in Table 62: Evidence from the past.

²⁷³ In addition to real interest rates we also considered spreads between interest rates and rates on government bonds (as a proxy for bank cost of funding). The results are largely the same.

Table 62: Evidence from the past – average prices (H6)

Country	Year	Event	Trend in interest rates one year after change	Summary
Poland	2005	Introduction of IRR	Decrease in three out of four considered rates	Evidence in favour of H6
Netherlands	2006	Lowering of the legal allowed rate	No decrease in two out of three rates	Evidence against H6

Furthermore, the introduction of interest rate restrictions in **Germany** in the years after 1981 allows an assessment of the development of the *average* interest rate compared to the *5% most expensive* interest rates at each point in time. This investigation reveals that the *heterogeneity* of consumer credit with respect to the offered interest rate declines after the introduction of interest rate restrictions.

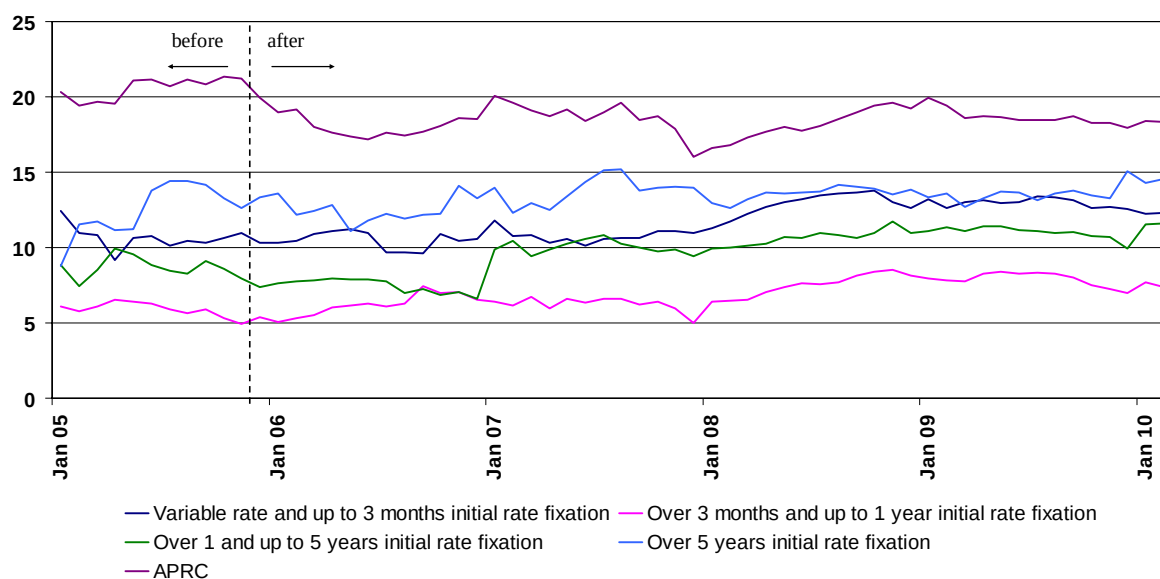
Example 1: Poland²⁷⁴

Facts and Figures

As Figure 133 shows, during 2006, the year after the introduction of interest rate restrictions in Poland, we do not observe an increase in interest rates. In fact, average interest rates in 2006 were slightly lower than those of 2005, with the exception of the interest on consumer loans with an initial rate fixation of over three months and up to 1 year. Interest rates on loans with an initial fixation of more than 1 year and less than 5 years decreased by 1.12 percentage points; loans with an initial period of fixation of more than five years decreased by 0.04 percentage points. APRC showed the most dramatic decline of 2.51 percentage points. It should be pointed out, however, that this decline in interest rates observed in 2006 could be a continuation of the downward trend in consumer credit interest rates that has been observed since at least 2002 (Pruski and Zochowski, 2006).

²⁷⁴ The background of the event, here for Poland as well as later for the Netherlands and Germany, is described in Section 2.5.2.5 on page 241ff, where the events are also studied with respect to the influence on the development of credit volume.

Figure 133: Selected consumer credit interest rates in Poland, 2005-2010, in percent.



Source: National Bank of Poland, www.nbp.pl

Note: interest rates provided are agreed annual rates (AAR), unless indicated otherwise, in real terms. Loans are denominated in Polish Zloty, new business.

Discussion

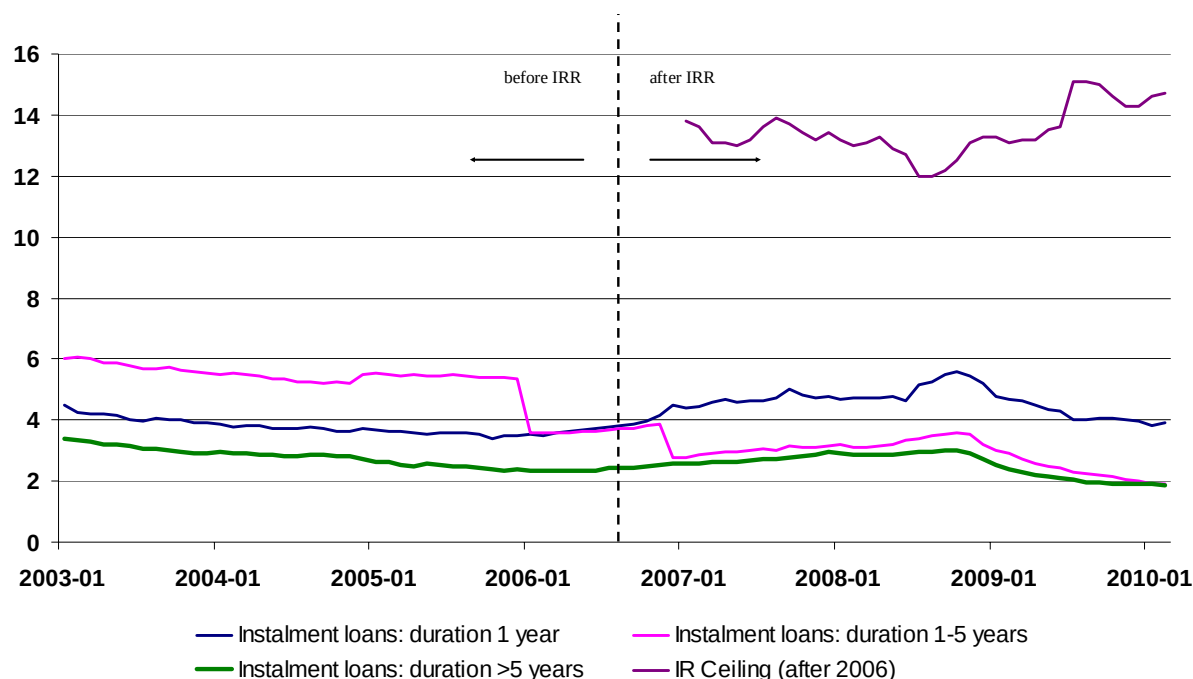
Based on the data on interest rates presented above we find some evidence in favour of the decreased average rates during the immediate aftermath of the introduction of interest rate restrictions in Poland. However, it should be pointed out that since no adjustment for the bank cost of capital is done, it is difficult to deduce to what extent this decline might be driven by the prevailing macroeconomic climate.

Example 2: The Netherlands

Facts and Figures

Figure 134 depicts real interest rates on consumer credit loans with initial period of fixation of less than 1 year, more than one year and less than five years and more than five years. As we can see, interest rates have increased slightly between 2006 and 2007. Interest rates on loans with an initial rate fixation of less than one year increased by 0.9 percentage points, rates on loans with an initial rate fixation of more than five years increased by 0.30 percentage points. Interest rates on loans with more than one and less than five years initial fixation declined by 0.6 percentage points during this period.

Figure 134: Selected consumer credit real interest rates in the Netherlands, 2003-2010



Source: <http://www.statistics.dnb.nl/index.cgi?lang=uk&todo=Rentes>

Note: interest rates provided are agreed annual rates (AAR), in real terms. Loans are in Euro, stocks. The interest rate ceiling of 15% presented on the graph is the ceiling which came into effect in 2006 (see Chapter 1.2.1.3.8 for details). An earlier, higher ceiling which existed before 2006 is not depicted.

Discussion

These observations suggest that one cannot expect a decline in average interest rates on instalment loans after lowering interest rate restrictions, as **H6** implies. While these interest rates do not cover the entire consumer credit market (as they apply to instalment credit), this finding is still important for an important fraction of the consumer credit market.

Example 3: Germany

Unlike the considered events in the Netherlands and Poland, where interest rate caps were introduced or tightened in a single-point-in-time legislative decision, the introduction of interest rate caps in Germany took place as a direct consequence from a sequence of judicial decisions starting in 1981. As this took time to become effective, it is impossible to identify only one "relevant" year to look at. Instead, we will consider how the spread between the *average* and the *most expensive credit contracts* evolve in the years after the introduction of interest rate restrictions compared to the situation before.

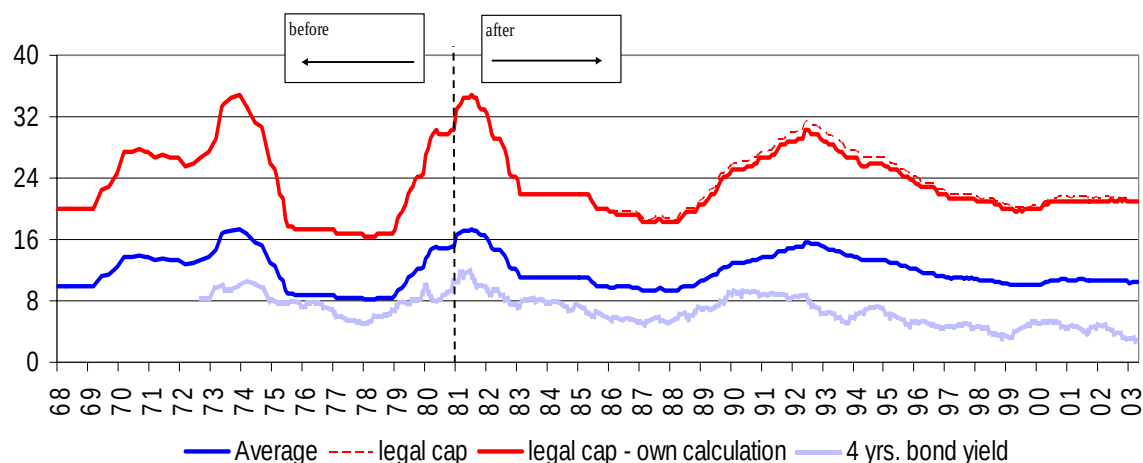
Facts and figures

The following graphs depict effective annual interest rates on instalment credit (excluding mortgages, new business) from March 1968 to June 2003.²⁷⁵ The legal cap rate was calculated as two times the current average interest rate.

²⁷⁵ The data is taken from "Erhebung über Soll- und Habenzinsen" by Deutsche Bundesbank, which was suspended in 2003. The unweighted average interest rate was calculated after excluding the highest and the lowest 5th percentile of interest rates. The value of the surveyed contracts changed twice during the surveyed period: from 2000 to 5000 DM in 1968 and from 5000 to 15000 Euro in 2003.

Since effective annual interest rates are only available from June 1986, we estimated them from monthly interest rates where necessary.²⁷⁶ As can be seen from Figure 135, our estimate of the interest rate ceiling lies slightly below the ceiling provided by Bundesbank.²⁷⁷ The difference is relatively constant and rather small at 0.3 percent.

Figure 135: Instalment consumer credit interest rates in Germany, average cap and bond yields (in percent), 1968-2003.



Source: www.bundesbank.de, own calculations. Interest rates used are effective annual interest rates (new business).

Note: "Average" stands for unweighted average interest rates calculated after excluding the bottom and the top 5th percentile of interest rates. "Legal cap" stands for interest rate ceiling as provided by the Bundesbank. "Legal cap – own calculation" stands for the interest rate ceiling based on own calculations. 4 yrs. bond yield reflect the yield of a government security.

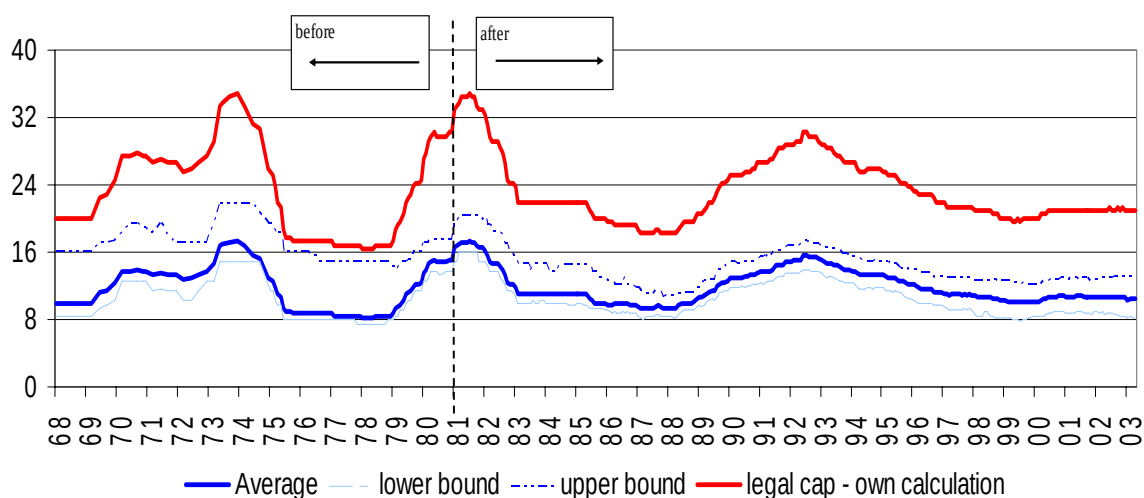
Figure 135 shows substantial fluctuations in average interest rates on instalment consumer credit over time. Most of these fluctuations originate from the general level of interest rates (which directly affects refinancing costs of lenders), as captured by the line "4yrs bond yield". Note that the spread between the average instalment interest rate and the bond yield had already widened before the introduction of interest rate restrictions in 1981.

The German data not only includes the average rate of instalment credits, but also the level of the 5% lowest and highest interest rates, respectively. Accordingly, Figure 136 allows a comparison of the interest rates of the 5% most expensive credits with double the average interest rate, which has been defined as interest rate restriction by court decisions after 1981.

²⁷⁶ Until 1986, interest rates were only given as monthly rates on the initially borrowed amount. In the time period under consideration, the conversion of these monthly rates to effective annualised rates was mostly carried out using calculation tables. Interest rate conversion tables recommended by the "Bund-Länder-Ausschuss" were used in calculations. Based on Bundesbank data, we assumed a contract fee of 2.1%. See also Sievi et al (1980). To compute the effective rates, one requires information about the maturity of the considered contracts. Unfortunately, the surveyed maturities changed over time, starting from an interval of 12 and 24 months in 1968 and ending with an interval of 36 and 60 months in 2003. Sievi, F., G. H., and C. R. Sievi, 1980. *Effektivzinssätze für Ratenkredite mit monatlichen Raten* (Gillardon-Verlag, Bretten). For the sake of comparability, we assume alternative average maturities of 24 and 48 months, respectively. The results of both specifications are qualitatively similar.

²⁷⁷ This graph reflects the findings obtained when assuming an average maturity of 48 months. Assuming an average maturity of 24 months, the approximation is even closer.

Figure 136: Instalment consumer credit interest rates in Germany, in percent, 1968-2003.

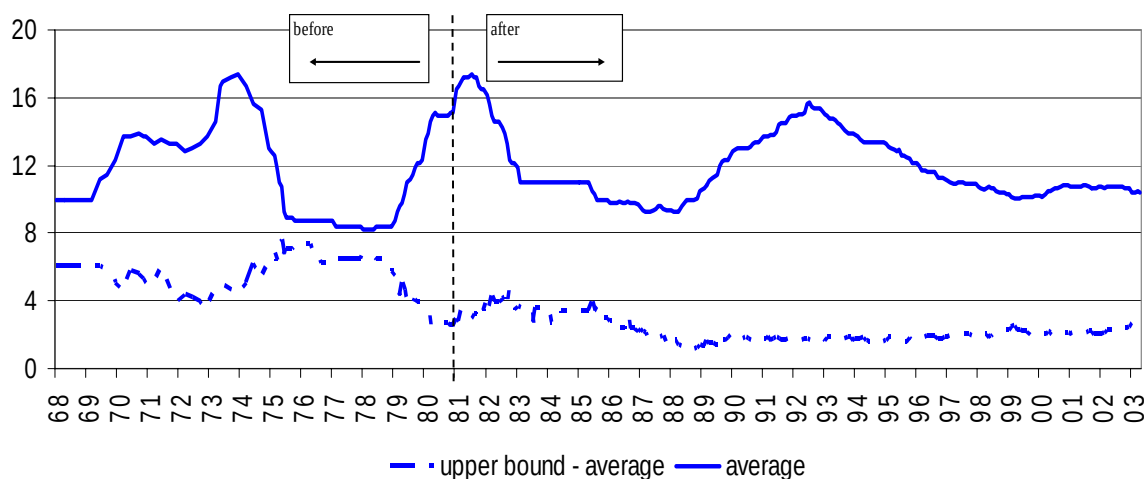


Source: www.bundesbank.de, own calculations. Interest rates used are effective annual interest rates (new business).

Note: "Average" stands for unweighted average interest rates calculated after excluding the bottom and the top 5th percentile of interest rates. "Lower bound" and "Upper bound" stand for the bottom 5th and the top 5th percentile of interest rates, respectively. "Legal cap - own calculation" stands for the interest rate ceiling based on own calculations.

It is striking that, after 1981, the 5 percent most expensive credits have constantly been substantially lower than the interest rate ceiling. Before the introduction of the rate caps, however, the upper bound of interest rates was at some points in time (in particular in time periods with lower average levels) very close to double the average rate. This implies that before the introduction of interest rate restrictions, the heterogeneity among credit interest rates was higher than after. Figure 137 points to the same direction: as we can see, the "upper bound - average" spread, which is calculated as a difference between the 5 percent most expensive credits and the average interest rates, is substantially lower in the post-1981 than in the pre-1981 trend.

Figure 137: Consumer credit interest rates in Germany, spreads and interest rate cap, in percent, 1968-2003.



Source: www.bundesbank.de, own calculations. Interest rates used are effective annual interest rates (new business).

Note: "Upper bound – average" stands for a spread calculated as a difference between 95% percentile of interest rates and the average interest rates. "average" stands for the average interest rate.

Discussion

We are not able to find a clear pattern with respect to **H6**: we demonstrate that the heterogeneity of credit contracts (with respect to their interest rate) was reduced after 1981. This could have various alternative reasons:

- More homogeneity in credit contracts could imply *less risk-adjusted pricing* and less particular (eg. small amount) credit. This would exclude specific consumer groups and confirms **H1**.
- IRR could bring the level of interests charged by, eg. local monopolists down to a "more competitive" level. This would be to the benefit of their debtors, which could make a point in favour of **H6**.
- Providers could have *abandoned* the interest rate as an instrument to differentiate between different consumer types, and could have introduced alternative sources of revenue which are not captured by IRR. These sources could, for example, include insurances. This strategy would imply that lenders do not necessarily exclude specific consumer groups, but charge their margin by other means than interest.

2.5.8.5 Views of Stakeholders

Due to the problems to identify the causal effect of interest rate restrictions on the price of credit for consumers, we also collect the stakeholders' views on this issue.

Figure 138 demonstrates this view with respect to credit for average borrowers: A large majority of stakeholders (95%) does not expect the cost of credit for the average borrower to decrease, which contradicts hypothesis **H6**. In contrast, 77% of the responding provider associations further claim that interest rate restrictions would definitely lead to an increase in the costs of credit even to the average borrower.

Figure 138: Impact of a floating IRR on the cost of credit for the average borrower



Source: SQ Question: Imagine a country with no IRR at all. If interest rate restrictions were introduced and effective and set at a level that was double the average of the interest rates offered on the entire credit market for average consumers cost of credit would...[decrease/not change/increase]?

In line with these results, the majority of provider associations (77%) expect an introduction of interest rate restrictions to be largely ineffective in reducing cost of credit, leading to an increase in the latter instead (see Figure 138). The majority of respondents further considers all listed alternative regulation measures as ineffective or even having the opposite effect with regard to a reduction in the costs of credit. Notably, consumer organisations show inconsistencies in their abovementioned opinion by unanimously claiming that interest rate restrictions will have more than just a little positive effect in reducing costs of credit.

Discussion

Stakeholders express their view that H6 does not hold, since, in their opinion, interest rates will either remain constant or increase.

2.5.9 H7: IRR lead to increased charges as providers will try to compensate the reduced interest revenues by increased charges.

2.5.9.1 An Overview

H7 is *plausible* and confirmed by several examples in selected countries. Still, one should note that there are no comprehensive data available.

- There is a variety of additional charges which are generally not affected by existing interest rate regulations. Furthermore, complementary agreements such as life insurances until credit maturity can be applied to compensate for decreasing interest revenues caused by the interest rate regulation.
- Interest rate restrictions are expected to increase the price complexity of credit products.
- Experience from the UK, Germany and Poland confirms the expectations that a ceiling on interest rates or on specific fee components will lead to an introduction of new charges and fees by credit providers.
- Stakeholders who favour the introduction of interest rates restrictions hold the opinion that charges and fees should be regulated as well.
- It is obvious that the degree to which **H7** has relevant consequences depends on the way the interest rate restrictions are formulated: eg. an interest rate cap based on APR covers more cost components than an interest rate cap based on an interest rate (without taking account of fees).

2.5.9.2 Introduction

Existing theoretical literature suggests that, depending on the price elasticity of credit demand, interest rate regulation would lead to an increase in or introduction of charges, not captured by the interest rate cap, or to the signing of additional agreements in connection to the credit. This would imply that, credit contracts are more complicated in countries *with* IRR, as these need to incorporate more elements (charges, complementary agreements) than those captured by the regulation on interest rates. The increased price complexity would damp down the decrease in credit supply and thus an expected credit exclusion of low-income borrowers (according to **H1**) as well as a decrease in volumes of credit granted (according to **H2**).

There are different **types of charges** which are not captured by the interest rate regulation in most of the Member States:

- upfront interest payments
- fees for issuing a card (Białowolski 2009)
- current account fees (IFF Research 1998, Białowolski 2009, DG SANCO 2009)
- charges attached to specific **payment behaviour** such as
 - o late payment fees on credit cards (OFT 2006, Białowolski 2009)
 - o unarranged overdraft charges (OFT 2010b)
 - o low-activity fees (PwC 2008)

- o connected fees for issuing notices for delayed payments or low activity (Białowolski 2009).

Complementary agreements include

- additional insurances such as life insurances,
- payment protection insurances (IFF Research 1998)
- savings agreements capturing repayment amounts of the credit (IFF Research 1998)
- currency swaps (Białowolski 2009)
- etc.

It is apparent that circumvention is more difficult when interest rate ceilings are applied to the APR rather than an interest rate excluding fees and charges. Although charging of non-mandatory costs (those not included in the APR such as voluntary insurance) can still take place, the problem of circumvention is of concern primarily to high cost credits like home credit where separate costs can be identified and extracted from the interest rate ceiling and justified by associating the additional fee with an additional service (such as home collection, direct debit).

2.5.9.3 Literature Review

To our knowledge, there is no comprehensive data on the change in pricing behaviour of suppliers as a response to the introduction of interest rate restrictions. However, there are some cases which underline the potential importance of the hypothesis.

In **Germany**, an alternative to *upfront interest payment* has been documented by IFF Research (1998): a zero interest credit provided by banks owned by automobile companies. Thereby, although no explicit upfront payment is collected, consumers granted a zero interest credit do not benefit from discounts made to cash-paying customers. This strategy is **also a way to circumvent interest rate restrictions**, as the interest payments are not declared as such; rather, they formally are a component of the price charged on a product.

Since the EU regulation on the APRC has been implemented in Germany also for usury ceilings after 1998 (Art. 1A CCD), banks have increasingly cross sold *insurance products* with hidden bank provisions. The extra price for these insurances lead to credit contracts with costs beyond the interest rate ceiling. With these practices lately accepted by OLG Hamburg Dec. 12.5.2010 13 U 21/09, the rate ceiling **was de facto lifted and gradually circumvented in practice**. This evidence also speaks in favour of **H7**. In this context, interest rate ceilings may further set an incentive for a constant refinancing of existing credit contracts, as they do not reimburse the hidden provision in the cancelled insurance contracts in early repayment cases.

In the **UK**, unarranged *overdraft charges on personal bank accounts* account for one-third of the banks' revenues (OFT 2010b). Furthermore, in a different statement, the OFT addresses the issue of fairness of *default charges* on credit cards (OFT 2006) in a survey of major credit card issuers. Thereby, the level of default charges is considered unfair if it exceeds a reasonable estimate of the marginal administrative costs in case of default. OFT (2006) conclude that the level of credit card default charges in the UK was unfairly high. Subsequently to the report, some credit card issuers have decided to reduce the credit card default charges to the suggested threshold of GBP12 (see PwC 2008). As argued by PwC (2008), credit card issuers have attempted to replace the income thereof by introducing fees in other areas, for example on dormant or low-activity accounts. The report advocates that direct price regulation applied on specific charges will have a

“waterbed effect” (PwC 2008) on other charges. From this, we learn the following: **there is a variety of charges even in the UK, a country *without* IRR.** This variety of charges offers sufficient room for an efficient **adaptation of the pricing structure to any kind of political pressure or regulation**, including interest rate restrictions. This makes it likely that providers react with the introduction or strengthening of unaffected income sources when interest rate restrictions are introduced, **as suggested by H7.**

Since the introduction of the ceiling in Poland, the products for home lending have had to be reworked in a way that a separate optional convenience fee was introduced (Chapter 2.4.2.4.2, p.213). The evidence is, again, **in line with H7.** It should be noted that in Poland administrative fees and charges are additionally capped at a level of 5%. The convenience fee, however, is not captured by the definition of administrative fees and charges.

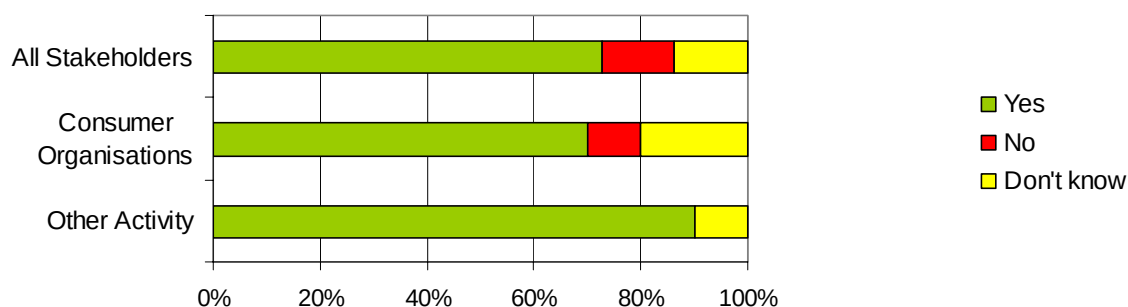
DG SANCO (2009) focuses on the simplicity and transparency in the charges on bank accounts and conducts a cross-country comparison of the EU Member States. Unfortunately, it does not consider credit contracts explicitly. For the bank accounts, its evidence shows that the level of transparency and simplicity of charges²⁷⁸ on personal bank accounts **do not depend on the interest rate regulation of the country.** For example, **France** and **Poland** are distinguished by both *above average intransparency* and *above average complexity* of the charges on personal bank accounts, whereas in **Germany** and the **Netherlands** the opposite is true. All these are countries *with* IRR. The Netherlands is even reported to be the country with the highest level of both transparency and simplicity of charges. The report suggests that there are factors other than interest rate restrictions influencing the structure and assessment of bank account charges such as the level of the bank account charges themselves. It is an open question, however, whether these findings can also be transferred to credit markets. We thus recommend to evaluate the transparency and complexity of consumer credit contracts in an international comparison.

2.5.9.4 Views of Stakeholders

Among the stakeholders participating in the survey who claim that interest rates should be capped, 73% hold the opinion that charges and fees should be capped alongside interest rates (Figure 139). It should be noted that 91% of the stakeholders who are in favour of interest rate restrictions represent consumer organisations and “other” activities such as banking authorities, financial regulators and government officials. The few responses from provider associations in favour of an interest rate cap unanimously argue against an additional cap on charges and fees. However, the tight connection between a desire to regulate interest rates on the one hand and fees and charges on the other highlights the importance of a potential restructuring of pricing schemes by providers in case of an introduction of interest rate restrictions. This finding is also in line with H7.

²⁷⁸ Transparency is measured by the need for an in-depth search in order to fully identify the total price of credit paid by the customer. Simplicity captures the number of components of a bank account tariff.

Figure 139: Acceptance of regulation of fees and charges



Source: SQ Question: Level of fees and charges should be regulated. [Yes/No/Don't know]. Note: A separate category showing provider associations responses was not meaningful seeing as too few responses to this particular question were received from them.

Also, the majority of respondents to the PQ agree that interest rate restrictions would lead to an increase in the level of administrative and other fees, as implied by **H7**.

Exceptions are commercial banks from Germany and the Netherlands who argue that the level of fees would not change as a result of the regulation.

Home credit providers participating in the survey further note that, as there are no administrative fees charged in home lending, an interest rate ceiling would far more lead to a maturity extension of the products.²⁷⁹ In a personal interview a major home credit provider from Poland further claims that the regulation would increase the intransparency of the products. In connection with the evidenced negative correlation between transparency and the level of charges on bank accounts (see DG SANCO 2009), this expectation would be **in line with H7**.

²⁷⁹ In case the restriction (regardless of whether absolute or relative) is set based on APR.

2.5.10 H8: IRR represent barriers to consumer credit market integration.**2.5.10.1 An Overview**

Given the multitude of factors determining cross-border market entry or international diversification of credit companies, the evidence on **H8** is *inconclusive*.

- It is not the interest rate restrictions as such, but the **variety of different interest rate regulations which may be a barrier to consumer credit market integration** in Europe. However, since there are multiple differences in credit regulation, it is likely that barriers will remain despite a potential harmonisation of interest rate regulations.
- The Stakeholder questionnaire shows that provider associations support H8. Consumer associations are more critical of this point. From provider associations, however, there are also voices deemphasising the role of interest rate restrictions for cross-border activity, saying that the variety of interest rate restrictions is deeply rooted in the cultural background and the national attitude towards credit.

2.5.10.2 Literature

Several studies have argued that the *variety of regulatory measures* across the EU has lead to lower levels of credit market integration. In the context of mortgage suppliers, CEC (2007) points at the legal *"costs of adapting the products and producing different materials in accordance with different national frameworks"* as a limitation to enter markets in different Member States. CEC (2007) acknowledges that many of these legal institutions are created as devices of consumer protection and calls for *"balancing the benefits of product diversity with the need to protect consumers"*. In this context of consumer credit, one may also make this argument with respect to interest rate restrictions, for which we have extensively demonstrated the heterogeneity in the first part of this report. In the same vein, CEC (2002) sees *"a lack of adequate harmonisation as regards national legislation"* as one of the causes for the *"sluggish development of the European cross-border credit market"*. In line with this, DG SANCO (2008) sees the *"Lack of harmonisation of relevant MS legislation or absence of EU legislation"* to be a *"very significant barrier"* for all retail financial services. In line with this view, DG Internal Market and Services (2006) report that financial institutions overwhelmingly express that usury rules have a negative impact on integration. In that report, which summarizes the contributions provided to the Commission in the context of the consultation on its Green Paper on Mortgage Credit (2005), it is also apparent that other stakeholders, such as consumers or Member State authorities, provided an unclear pattern of responses. This report concludes that the main message of the stakeholders was that there is *"no need to introduce any usury rules at the EU level"*.

On the other hand, one has to acknowledge that interest rate restrictions are only a small part of the overall regulation which is meant by the remarks above. For this reason, it is likely that barriers to integration will still persist even if interest rate restrictions are harmonised. In this vein, EUROFINAS (2010)²⁸⁰ therefore deemphasise the importance of interest rate restrictions by pointing out that they *"do not believe that diversity of policy of interest rate restrictions has a decisive impact on lenders' cross-border trade strategy"*. They also acknowledge that the divergence of interest rate restrictions across the EU Member States *"can largely be explained by distinct national cultural preferences"*, which *"[...] correspond to different cultural approaches towards access, use of credit products and regulation of lending activities"*.

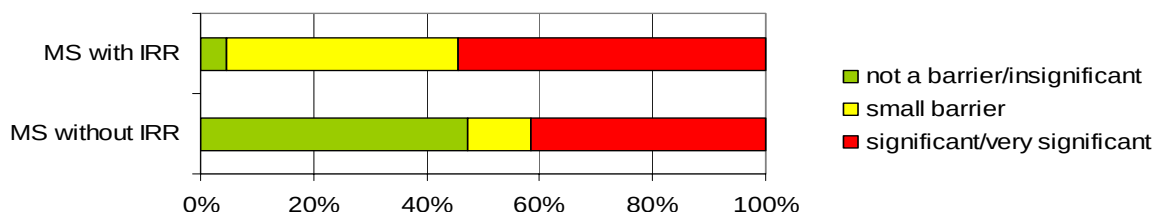
²⁸⁰ Note that EUROFINAS is the association of specialised consumer credit providers in Europe and is thus to be seen as a particular stakeholder, which makes these insights above inherently relevant from a practitioners' perspective.

2.5.10.3 Views of Stakeholders

Facts and Figures

As demonstrated in Figure 140, stakeholders' responses substantially differ among Member States *with* IRR and Member States *without* IRR. As can be seen from Figure 140 stakeholders from countries *with* IRR expect these to be stronger barriers (55%) to market integration than stakeholders from countries *without* IRR.

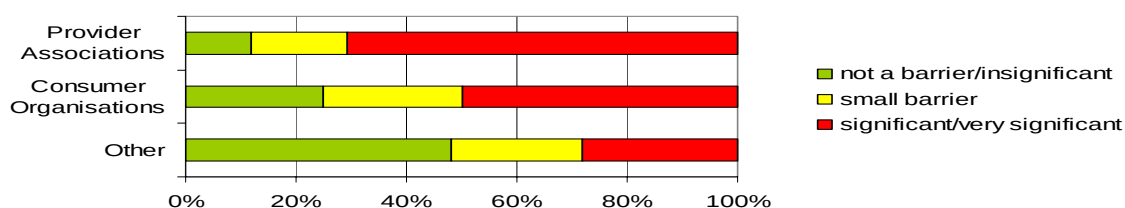
Figure 140: IRR as a barrier to the cross-border provision of consumer credit



SQ Question: In your view, how important are interest rate restrictions (incl. restrictions on fees) as barriers to the cross-border provision of consumer credit in the EU? [not a barrier/insignificant/small barrier/ significant/ very significant]

Interestingly, as can be observed from Figure 141, provider associations assign a greater importance to interest rate restrictions in the discussed context than consumer organisations and "other" stakeholders such as financial regulators and banking authorities.²⁸¹ In the case of the latter, a majority of 72% even assert that IRR are at most only a small barrier to the cross-border provision of credit. The majority of them further indicates that consumer preferences for local creditors as well as foreign providers' lack of information about customers and language barriers are significant or very significant barriers to the cross-border provision of credit.

Figure 141: IRR as a barrier to the cross-border provision of consumer credit (divergence of opinion among stakeholder categories)



Discussion

The Stakeholders (in particular provider associations) support *H8*.

²⁸¹ In a written feedback individual providers from UK and Poland even indicate considerations a cross-border market entry in the past. They indicate that existing interest rate restrictions in the foreign country were among the main reasons to refrain.

2.5.11 H9: IRR lead to lower levels of competition in the consumer credit industry.
2.5.11.1 An Overview

Comparing markets *with* and *without* interest rate restrictions with respect to competition, stakeholders' concerns that tough regulation might lead to less supply and therefore lower competition **cannot be confirmed**. **H9** is thus **unlikely** to hold:

- A recent study has reported concerns that specific segments of the high-cost credit market do not function competitively due to limitations of the *demand* side. As this has been found in the UK, a country without interest rate restrictions, **this finding deemphasizes the role of interest rate restrictions** in the context of competition: the absence of interest rate restrictions does not appear to be sufficient to come to competitive prices.
- There are also concerns that tougher regulation (including interest rate restrictions) could lead to an additional reduction of the supply side, making the problem even worse.
- While we are not able to quantify the degree of competitiveness of specific market segments due to data limitations, we discuss the competition in the banking sector in various countries. We argue that from this sector, players could easily enter any part of the consumer credit market if excessive returns were to be earned there.
- **There is no evidence** that different approaches to regulate or not regulate interest rates in credit markets affect the degree of competitiveness of the banking segment, **as H9 suggests**.

2.5.11.2 Introduction

OFT (2010) expresses concerns that the market of high cost credit in the UK does not function in a competitive manner due to limitations of the demand side in shopping for best prices. As a consequence, this finding could imply that consumers pay excessively high prices when taking out high cost credit. This argumentation refers to the low elasticity of demand, which allows suppliers to engage *in non-competitive pricing*. This holds despite the fact that there are no interest rate restrictions in the UK. One can therefore conclude that, in specific markets, the absence of interest rate restrictions is not sufficient to come to competitive prices. This is no direct evidence against the hypothesis, but deemphasizes the role of interest rate restrictions in the context of competitive pricing.

Another argumentation stresses that the presence of interest rate restrictions even worsens this problem: interest rate restrictions could lower the profitability of providing services in specific segments of the consumer credit market, which may drive competitors out of the market. As a result, the remaining suppliers would face too little competition to keep prices at competitive levels. This reasoning refers to the *concentration of the credit supply side*, which is a traditional way of thinking about competition in markets.

H9 postulates that competition is lower in countries with IRR. In the following paragraphs, we therefore discuss various measures of market competitiveness in the banking sector.²⁸²

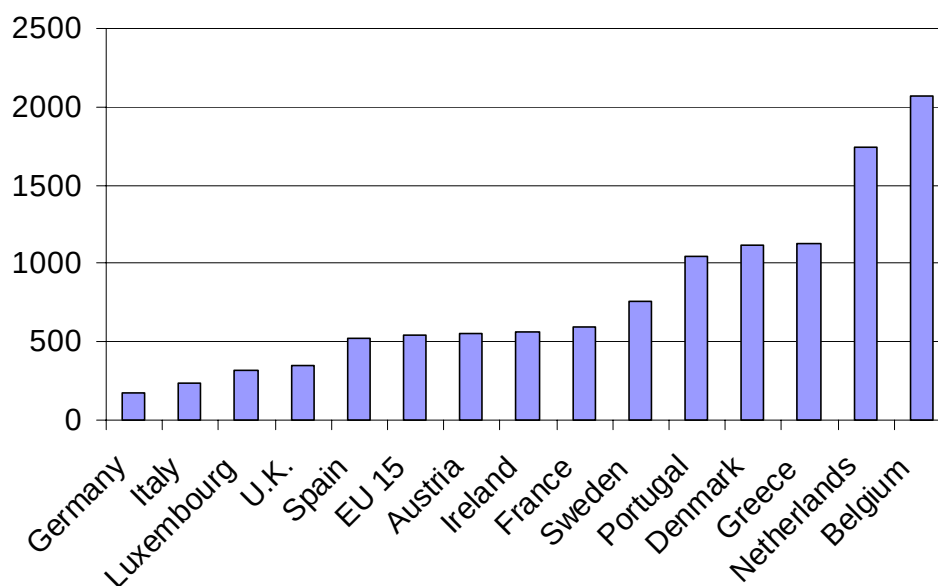
2.5.11.3 Cross-country comparison

Facts and Figures

A traditional measure of competition is the *Herfindahl-Index*. It is a weighted *concentration* measure which over-weights large players.²⁸³ Figure 142 depicts the ECB (2004) estimates of this measure for different Member States. According to the *Herfindahl-Index*, Germany is ranked the country with the highest level of competition in the banking sector, as it exhibits low market concentration. At the other end of the ranking is Belgium, with the highest Herfindahl-Index and thus the lowest competition.

Interestingly, countries with IRR are very dissimilar in terms of their market concentration: Germany and the Netherlands, countries *with* IRR, are found at different ends of the ranking in Figure 142. France (another country *with* IRR) and Sweden (a country *without*) are relatively close in their Herfindahl-Index.

Figure 142: Competition measures by the Herfindahl-Index



Source: ECB (2004), p.36.

However, concentration measures are problematic to determine competition in the banking sector when there is limited connection between regional markets within a country.²⁸⁴ This is the case for, eg. Germany, where public banks and cooperative banks are restricted to specific geographical units. As a consequence, different measures are

²⁸² The banking sector may be too broad to capture the competition in a specific segment of the credit market. However, the banking sector can be assumed to include sufficient agents who could easily enter a specific market if excessive profits were to be earned in it. The exact determination of competition in specific segments requires econometric analyses and extensive data input, which is beyond the scope of this study.

²⁸³ See, eg. Sachverständigenrat (2008).

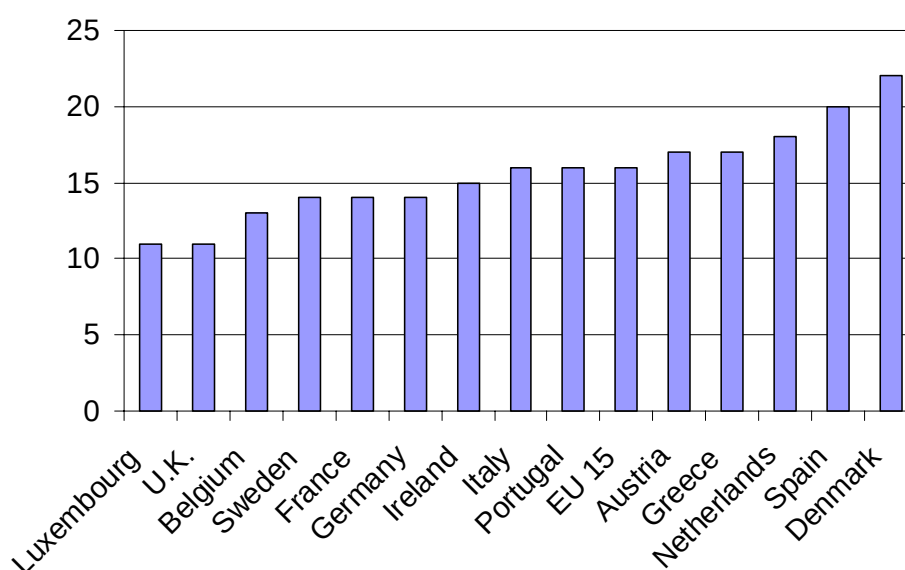
²⁸⁴ See Sachverständigenrat (2008).

applied to determine the mark-up banks can charge over their marginal costs. This idea is reflected by the *Lerner-Index*, which depends on the price elasticity of demand.²⁸⁵

The numbers presented in Figure 143 capture the banking business in a broader sense, since they include interest and non-interest income. A low *Lerner-Index* reflects a high level of competition. According to this measure, the UK is ranked second concerning competition and Sweden is ranked fourth across the European countries considered. While these two countries have no interest rate restrictions in place, one has to note that also Germany and France are also above the EU 15 average. The Netherlands, in contrast, exhibits a relatively high level of market power of its banks.

Another measure, the *H-Statistic* is frequently being used as a measure of market power in the banking industry.²⁸⁶ It reflects the relationship between input prices and revenues prevailing in a market: if changes of costs transmit efficiently into prices, the market is considered to be competitive.²⁸⁷ The *H-Statistic* is unity under perfect competition, between zero and one for monopolistic competition, and smaller than zero under monopoly. Figure 144 illustrates that the *H-Statistic* provides a different picture about the competitiveness in the banking sector in different countries. In this ranking, the Netherlands (country with IRR) is found to be a rather competitive country, whereas Sweden (a country *without* interest rate restriction) is found to have the least competition across countries. However, the UK (without IRR) is ranked above average, while Germany and France (with IRR) are ranked below average.

Figure 143: Competition measured by the Lerner Index



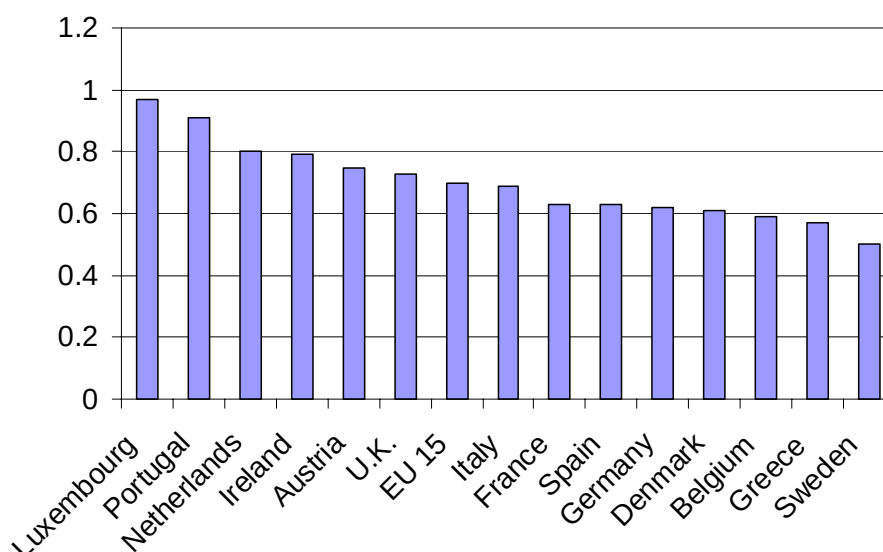
Source: Carbó et al. (2009).

²⁸⁵ If the price elasticity of demand is infinitely large, the Lerner Index converges to zero and implies perfect competition (Sachverständigenrat, 2008).

²⁸⁶ See Sachverständigenrat 2008.

²⁸⁷ For a more detailed discussion, see Carbó et al. (2009).

Figure 144: Competition measured by the H-Statistic



Source: Carbó et al. (2009).

Discussion

The paragraphs above demonstrate that different competition measures lead to different conclusions about the relative competitiveness in different markets. The UK is consistently found to have a relatively competitive banking industry. Other countries show more diverse patterns across different measures.²⁸⁸ Looking at these other countries, **there is no evidence that different approaches to regulate or not to regulate interest rates in credit markets affect the degree of competitiveness of the banking segment**, as **H9** suggests. Rather, it appears that other factors (banking regulation, the role of state-owned banks, historical developments) are more important in determining the competitiveness of those markets.

²⁸⁸ Carbó et al. (2009) also emphasise this point.

2.5.12 H10: IRR lead to a convergence of all consumer credit interest rates at the level of the interest rate cap.**2.5.12.1 An Overview**

Considering findings from the literature and the analysis of the development of interest rates in the Netherlands and Poland where IRR were introduced, does not allow drawing clear-cut conclusions, since there are opposing findings. The results on **H10** are therefore “*inconclusive*”.

- Theory argues that certain types of interest rate caps may be used by competitors to collude on prices.
- Other studies have documented that **H10** holds for some market segments in France.
- It does not appear that the introduction or lowering of an interest rate cap in Poland or the Netherlands, respectively, has lead to an increased clustering at the level of interest rate cap. This evidence speaks against **H10**.
- We stress the point (already mentioned on p.152) that the possibility of a convergence to the level of the interest rate caps is only given for specific forms of interest rate caps, such as exogenously determined rates. Thus, the problem implied in **H10** could be avoided by the right design of interest rate caps.

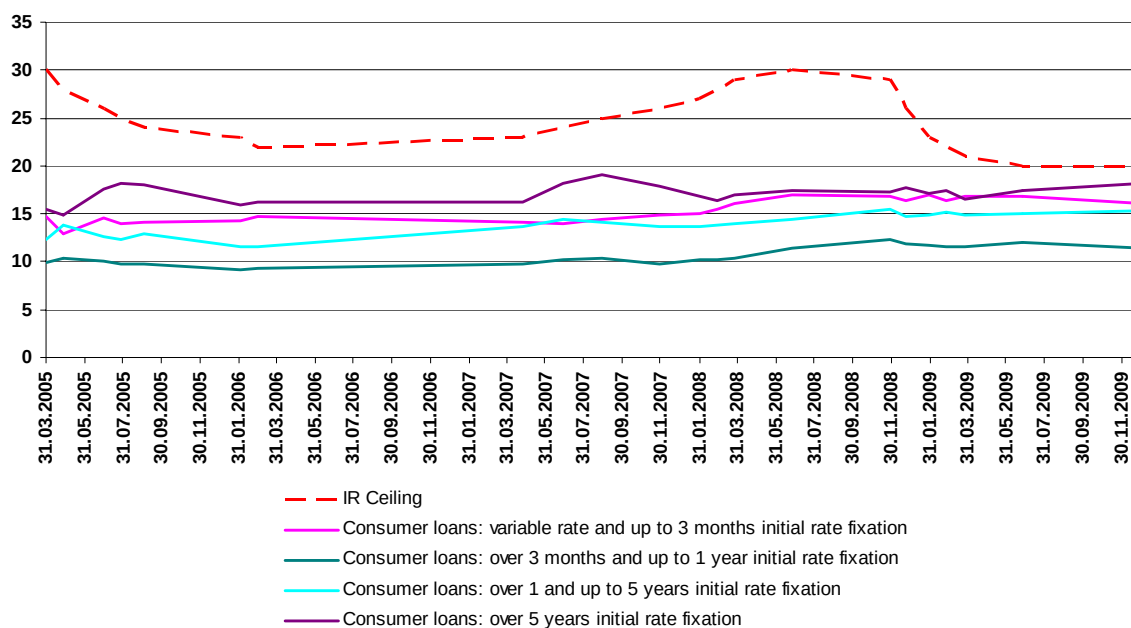
2.5.12.2 Literature

IFG/IGAS (2009) analyses the distribution of interest rates of different credit types in the French consumer credit market. With respect to small revolving credits and overdraft loans (<EUR 1524), they demonstrate a clustering of interest rates slightly below the legal ceiling. With respect to revolving credit and overdrafts of higher amounts (>EUR 1524), they document a clustering of interest rates at this level for special-purpose banks, but not for general banks. These findings suggest that the consequences described in **H10** may, in fact, become reality.

2.5.12.3 Past experience

Figure 145 shows the development of consumer credit interest rates in **Poland** in relation to the interest rate ceiling during the period from 2005 to 2010. As can be seen from the graph, we do not observe a convergence of interest rates to the ceiling until 2009, as **H10** implies. The convergence observed in 2009 is more likely to be due to an abrupt reduction of the ceiling rather than to an increase in interest rates.

Figure 145: Consumer credit interest rates and ceiling in Poland, 2005-2010



Source: National Bank of Poland, www.nbp.pl

Note: interest rates provided are agreed annual rates (AAR). Loans are in Polish Zloty, new business. Interest rate ceiling is calculated as four times the Lombard rate. Due to gaps in the Lombard rate data, all rates are presented for those dates only for which Lombard rate is available.

Similar findings can also be made in the **Netherlands**: it can also be seen from Figure 134 on page 308 that the interest rate ceiling of 15% applied to the interest on consumer credit in the Netherlands after 2006 is well above the shown interest rates, none of which exceeds 9% at any time after 2006. This contradicts the hypothesis that interest rate restrictions are used as a reference point for implicit collusion, which would imply that interest rates converge to the rate cap (**H10**).

Discussion

While findings from France suggest that **H10** is likely to hold in some market segments, it does not appear that the introduction or lowering of an interest rate cap in Poland or the Netherlands, respectively, has lead to an increased clustering at the level of interest rate cap. **There is thus mixed evidence.**

In this context, it has to be noted that clustering at the level of the interest rate ceiling is only **given for specific forms of interest rate caps**, such as **exogenously determined rates**. For interest rates caps tied at an average of the targeted interest rates (eg. twice the typical consumer loan interest rate), the cap would keep increasing when all actors are rising their rates towards this level. This is unlikely in a market structure with several players, as they are threatened to be underbid by competitors easily.

2.5.13 Summary H1-H10

2.5.13.1 Introduction

For most of the above-mentioned hypotheses, theoretical reasoning comes to rather clear-cut conclusions. In contrast, collecting evidence which can be observed in the reality of European markets (as done in the paragraphs above) reveals that, for many hypotheses, the impact of interest rate restrictions may be less obvious than postulated by theory. The above subchapters thus carefully analyse to what extent theoretical considerations can be confirmed or rejected. In fact, there are three out of the twelve hypotheses and sub-hypotheses which can be broadly confirmed to be *plausible* by our investigations. Three different hypotheses are found to be relatively *unlikely*. In six more cases, conflicting evidence or the lack of data leads to *inconclusive* results.

2.5.13.2 Summary of the hypotheses

The first hypothesis (**H1**: *IRR reduce credit access, in particular for low-income borrowers*) is generally found to be *plausible*: High-risk borrowers requesting small-amount credit can only be served when a certain threshold interest rate is exceeded. Hence, they may not be served credit in the presence of interest rate restrictions. However, one needs to keep in mind that, due to the relatively high levels of interest rate caps in most European countries, the scope of the interest rate restrictions is not expected to be equivalent to the ones documented in the US a few decades ago. Rather, it is likely that access to mainstream credit (including overdrafts and revolving credit) remains rather unaffected by IRR, while there may still be missing credit options to low-income borrowers which are served in the high-cost credit segment in some countries. Note that the *desirability* of such credit access to this specific population group is subject to political controversy.

In the light of our analysis, a second hypothesis (**H2**: *IRR lead to a decline in the volumes of consumer credit granted*) appears *unlikely* to hold in an economically significant way. This may be explained by the fact that the relevant market segments of high-cost credit (which are most affected by interest rate restrictions) only constitute a relatively small fraction of the entire consumer credit market in which they exist. A lack of these market segments is unlikely to lead to an economically significant drop in the volume of credit markets, as the latter is affected by a multitude of other factors, as well. This finding implies that economic activity is unlikely to be significantly supported by the presence of high-cost credit (ie. the absence of interest rate restrictions). In contrast, hypothesis **H2a** (*Without IRR, more product types exist in the market*) appears *plausible*: Countries *without* interest rate restrictions tend to have a higher prevalence of personal loans/auto loans than countries *with* interest rate restrictions. It is also likely that interest rate restrictions prevent the market entry of one or more forms of high-cost credit. Note in this context, however, that a relationship between the importance of certain credit types and interest rate restrictions is unlikely to be purely mechanistic. Rather, lower levels of consumer credit and the tougher regulation of credit (including interest rate restrictions) may both be consequences of a third factor- the country's attitude towards credit.

With respect to another hypothesis (**H3**: *IRR lead to credit from non-bank sources, such as paying bills late*), our results remain inconclusive. Some argue that the existence of high-cost credit helps households to avoid obtaining credit from (potentially expensive) non-bank sources, such as utility providers. However, it does not appear that there are systematic differences in lending from non-bank sources between countries with and without interest rate restrictions. A related claim in the context of interest rate restrictions is addressed in **H4** (*IRR lead to a substantial illegal market in lending*). There

is no convincing comprehensive data to evaluate this hypothesis. Due to this lack of data, we evaluate the evidence on **H4** to be *inconclusive*.

The related hypotheses **H5** and **H5a** address the effect of interest rate restrictions on the level of over-indebtedness and on its *growth rate* after an economic shock, respectively.²⁸⁹ We conclude that a direct influence of interest rate restrictions on the level of over-indebtedness, as **H5** suggests, is *unlikely*. With respect to **H5a**, we obtain *inconclusive* results: the most current figures do not reveal a particularly pronounced increase of over-indebtedness in the aftermath of the financial market crisis. However, there are no official data covering the years 2009 and 2010, and the views collected from our stakeholders indicate that there might be a link as postulated by **H5a** in those years. We therefore recommend re-evaluating this issue in the next year when the relevant data are available.

With respect to the hypothesis **H6** (*The average consumer - or even more so: low-risk consumer - would be granted cheaper credit in the presence of IRR*), we find *inconclusive results*. Due to the lack of micro data on individual credit cost before and after the introduction of IRR, we focus on average interest rates. Drawing on these data and findings from the Stakeholder Questionnaire, there is no unambiguous evidence that average rates are declining, as **H6** postulates. In contrast, it appears *plausible* that **H7** holds (*IRR lead to increased charges as providers will try to compensate the reduced interest revenues by increased charges*). There are examples from different countries illustrating that providers react to regulation by charging fees for which the regulation does not apply.

The evidence on **H8** (*IRR represent barriers to consumer credit market integration*) is *inconclusive* for two reasons. Firstly, it appears that not the mere presence of an interest rate restriction, but rather the *variety* of interest rate restriction is potentially an impediment to market entry. Secondly, the institutional setting is also diverse across countries along several other dimensions, such that it is hard to assess how important interest rate restrictions are in this environment. Hypothesis **H9** (*IRR lead to lower levels of competition in the consumer credit industry*) is found to be unlikely to hold, as the level of competition differs (according to several criteria) across countries regardless of the presence of interest rate restrictions. It has also been documented in other studies that there is a low level of competition in high cost credit markets in the UK, a country without interest rate restrictions in these segments. This also deemphasises the role of interest rate restrictions in the context of competition.

The last hypotheses (**H10**: *IRR lead to a convergence of all consumer credit interest rates at the level of the interest rate cap*) implies that providers use an exogenously given interest rate cap to coordinate their (non-competitive) price setting at a rate just below the cap. Other studies have found some evidence on this issue. We demonstrate that the results on this hypothesis are inconclusive: whether or not the phenomenon captured in **H10** occurs crucially depends on the market structure and the exact way in which interest rate restrictions are implemented.

2.5.13.3 Concluding remarks

In summary, we find that there are less clear-cut implications of economic significance of interest rate restrictions than it is sometimes argued. However, it is apparent that interest rate restrictions do shape the supply side of the consumer credit market in three respects: Firstly, it is likely that the existence of interest rate restrictions excludes some

²⁸⁹ (**H5**: *The lack of IRR leads to a higher level of over-indebtedness*; **H5a**: *The lack of IRR has particularly adverse effects on default rates/ over-indebtedness in the presence of negative shocks (eg. recessions) to the economy*).

customer groups from credit access (which might or might not be an explicit *objective* of the introduction of interest rate restrictions). Secondly, there might be a reduced set of credit types, as some credit types with very high interest rates are not offered in the presence of interest rate restrictions. Thirdly, one needs to keep in mind that suppliers can (to some extent) structure their credit product in a way so that the existing interest rate regulation does not apply.

We also conclude that many observations on credit markets are not only driven by regulatory conditions (affecting the *supply side*), but also by the actual behaviour of the *demand side*. This aspect is important as typical strategies of *quantification* of the effects of interest rate restrictions on the basis of cross-country comparisons rely on the bold assumption that demand patterns are identical across countries. In contrast, as particularly explained in our discussion of **H1** and **H2a**, it is more realistic to assume that there are clear patterns in the attitude towards credit across countries which may explain both the preferences for strict interest rate regulations prevailing in some countries and, eg. reduced incidence of credit of their consumers.

3 What can the European Commission learn from this study?

1. IRR in general do not affect ordinary car loans, mortgage loans, home improvement loans, ordinary overdraft for short-term liquidity because
 - a. Their interest rates are by definition far removed from the ceiling between 33% (France), 50% (Italy), 100% (Germany), 300% (Slovenia) because ceilings are defined by average interest rates for these products.
 - b. Borrowers can exercise a certain amount of choice (sufficient competition).
2. IRR do shape the supply side of the credit market in the sense that they affect high-cost credit.
 - a. Credit types operating with high annualised interest rates are not able to operate in an environment of interest rate caps.
 - b. The lack of high cost credit reduces credit access to those parts of the population which are considered to be high-risk and which demand small-amount credit. This reduction of these subgroups' credit access may or may not be an *objective* of a government's policy.
 - c. Credit providers may tend to offset these effects by designing credit contracts or additional service contracts charging fees which are not captured by the interest rate regulation.
3. The mere existence of certain credit types or differential volumes of credit in different countries is not a sufficient indication about the restrictiveness of credit (including interest rate) regulation. Rather, these also reflect different attitudes towards credit.
 - a. A country in which the population is more sceptical with respect to consumer credit is likely to have lower total volumes of credit simply because of low demand.
 - b. A country with these properties is more likely to opt for stricter legislative measures to reduce the level of credit.
4. However, in these market segments we are increasingly confronted with "invisible high interest credit" for consumers, the effective cost of which are much higher than disclosed in the APRC, which is also the basis for comparison with the Usury Ceiling.
 - a. Credit and payment protection insurance contain high kick-back provisions and take unusual forms, such as long-term prepayment of premiums to facilitate their financing, relative short-term of risk coverage, unfavourable early repayment conditions where much of the premium is withheld
 - b. Endowment credit, where additional borrowing is necessary in order to fund an investment or savings
 - c. Credit card fees on, for example, cash withdrawal which adds invisible interest
5. If the internal market favours increased competition and choice, the following differentiation could take place

- a. Ordinary investment credit is not affected by IRR – there is no need for the harmonisation of such rules to further transborder commerce
 - b. Circumventions with the effect of high-price credit in this segment occur irrespective of the existence of IRR – improved EU regulation on price disclosure including all price elements which burden the borrower would help to clarify the impacts
 - c. Since it appears that short-term credit is often extended under conditions of little or no competition, removal of IRR would not be conducive to consumer benefit and confidence.
6. If regulation is deemed necessary it should be modern and adequate for market conditions.
 - a. Instead of criminal law with moral and subjective rules, private law with objective market-related ceilings specific to certain products would be more self-executing.
 - b. Rules should carefully observe the impact on the distribution of certain regulated products. Differentiation by marketing practice, product, life-time and amount is more promising than unified approaches.
 - c. Rules should be immune to circumvention. IRR require an objective consumer view of the amount payable, irrespective of the purposes to which these payments are attributed by the supplier side.
 - d. Sanctions should also be clear and easy to understand and develop enough threat to provide the underlying rules with sufficient deterrent effect
7. IRR need a common ground which develops the traditional concept of usury and good morals into a market-driven concept. It could be derived from the new market-related concepts of relative rate ceilings, which replace the subjective and moral principle of exploitation by a more objective concept of market dysfunction, possibly developed from cartel law. The EU could play a special role in providing a framework for such a concept, leaving its operational form for the Member States, to determine according to their different traditions and stage of market development as indicated in the opinion of the Attorney General in ECJ Case C-484/08.
 - a. Art. 101 (1) (a) of the Lisbon Treaty creates the idea of unfair prices because of a lack of competition through the creation of monopolies and cartels. State agencies intervene with “as-if-prices”, representing prices from markets which are still functioning, in a manner which is comparable to interest rate ceilings derived from average market rates.
 - b. The concept of unfairness should cover all forms of distorted competition with regard to prices, and include both opaque pricing and extortionate pricing in consumer credit.
 - c. Such propositions could be made within the actual process of proposing a Common Frame of Reference for EU consumer contract law.

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Annex II: Mandate of the European Commission and objectives

This study is intended to broaden the European Commission's knowledge of interest rate restrictions in place across Member States, and help it to form an assessment of the economic, financial, and social impacts of these.

According to the terms of reference of the study, the objectives are to:

- Identify the different forms that interest rate restrictions may take
- Provide an inventory of the Member States that apply them
- Assess the economic, financial, and social impacts on identified stakeholder groups and on the functioning of the single market

There are a wide range of possible forms of interest rate restrictions that fall within the scope of the study, including:

- Rate ceilings (caps),
- Limits on interest rate variability, and
- Restrictions on the use of compound interest rates.

The stated objective of the application of interest rate restrictions by a number of Member States is to protect borrowers against exorbitant charging by lenders that could make repayment of loans difficult or impossible for some of them. Rate ceilings are perceived to prevent the charging of unreasonable or excessive interest rates, while the restrictions on interest variability aim to shield borrowers from large shifts in interest rates. The rules on compound interest rates are often designed to impose restrictions on the application of compound interest²⁹⁰. In this sense, rate restrictions are designed to protect consumers, either in general or specific sets of consumers who have a weak bargaining position.

However, the existence of interest rate restrictions may constitute an impediment to product innovation, product diversity, and cross border activity of lenders. Certain products, such as equity release products, may become more difficult to market given that they are based on (regular) interest compounding. In addition, certain borrowers with high risk profiles, including many self-employed and SMEs, may theoretically be prevented from having access to credit as lenders are unable to charge them risk-based rates, since doing so would exceed the rate ceiling.

Furthermore, the existence of interest rate restrictions in some Member States could also theoretically dissuade lenders from other Member States from offering their services in those countries. It follows that interest rate restrictions may therefore limit, at least in theory, the range of customers served, consumer choice, and cross-border activity.

Interest rate restrictions may therefore have negative impacts on the businesses, credit markets themselves, and wider economic interests.

In the White Paper on the Integration of EU Mortgage Credit Markets and its accompanying Impact Assessment, the Commission identified interest rate restrictions as an issue that warrants further examination, and for an assessment to be undertaken which includes the impacts on both consumer and provider stakeholders including the wider social and economic environment.

²⁹⁰ Study on Equity Release Schemes, p. 111, at http://ec.europa.eu/internal_market/finances-retail/credit/mortgage_en.htm#studies.

On the basis of the findings of the study, the Commission has stated that it will examine whether it is necessary to take any action on the issue at the EU level.²⁹¹

The conduct of the study is divided into two main parts, a legal part, and an economic part, the objectives for which have been set out by the Commission as below.

Objectives of Task 1: Legal part

Task n°1: Identify the different types of interest rate restrictions, the Member States that apply them, and their reasons for doing so.

- 1) Identify all the different forms that interest rate restrictions may take and the levels at which they are set and how they function, including interest rate ceilings (caps), interest rate variations, and compound interest;
- 2) Identify those Member States that apply statutory or administrative provisions, case law, or have self regulation or other instruments that constitute interest rate restrictions or have an effect equivalent to interest rate restrictions;
- 3) Inquire for the reasons and concerns that led the competent authorities to adopt such provisions, particularly any data relating to abusive interest rate charging in the past.

Objectives of Task 2: Economic part

Task n°2: Analyse the economic, financial, and social impacts of interest rate restrictions on various stakeholders.

- 1) The study will analyse all the existing and potential economic, financial, and social impacts (in quantified terms) of provisions on interest rate restrictions existing in the Member States on: consumers in general, and specific classes of consumers such as the self-employed, microenterprises, and SMEs; credit providers and, where relevant, credit intermediaries.
- 2) The study must further analyse the economic, financial, and social impact that provisions on interest rate restrictions have on: the pursuit of cross-border business by credit providers; access to credit products and product diversity; the price paid by consumers; the functioning of the Single Market.
- 3) Finally, the study shall provide an analysis of how the different types of interest rate restrictions identified in the 27 Member States compare to each other in terms of efficiency and effectiveness.

²⁹¹ As stated in the European Commission's terms of reference. To see a summary of the Commission's Call for Tender (MARKT/2009/08/H) see [Contract notice](#). (In order to facilitate the finding of material underlying this research iff has developed a blog where relevant materials can be found under <http://irr-blog.responsible-credit.net/>).

Annex III: Methodology of the research

Tasks, existing literature and stakeholders

Approach to the literature, data review and stakeholder meetings

Direct contact with stakeholders was an integral part of the research and covers a broad range of stakeholders as identified in the next Annexes of this report.

The research has taken into account existing studies completed at both international and EU level, and has reported on all existing research, which it and its stakeholders are aware of at the national level. Despite some informative research on national details on the subject in countries such as France, Poland, the Netherlands Slovakia or the UK, there is an evident shortage of existing research on the issue of interest rate restrictions from the rest of the EU Member States. While the subject has featured in much literature on price controls on credit in the US and in the context of the microfinance agenda in the area of development economics, there is as of yet no such report for the EU. One significant concern with the state of the research on this issue, is that one particular forerunner for investigation of the issues, with very affirmative statements and conclusions with regard to the effects of IRR generally and in several specific EU countries, has managed to contaminate the objectivity of subsequent research. Empirical studies have a lot of clout and policy makers should base their decisions on arguments backed by evidence and scientific research. However, the danger of too little such research is that the results of the few existing ones are increasingly referred to without questioning the validity of the results. The prior absence of such studies at the national level makes the current research more difficult, however, our survey of stakeholders in all Member States has provided us with valuable material to assess the impact of IRR on credit markets and stakeholder groups.

A variety of different data sources has been used, first to comprehend the idiosyncrasies of each Member State's credit market and to assess the possible impact IRR may have had and the potential effects these restrictions could have when applied to other Member State markets. We have restricted the selection of data to reliable industry and public sources that allow for comparison across the Member States and have also incorporated some national sources for specific phenomena which are measurable.

We have also reviewed the wider literature. This is primarily focused on the historical tradition of usury laws, and there is also a significant literature on the operation of usury ceilings within the U.S, where there has been a long running debate over the past 30 years on this issue. Material found from the various scientific and regulatory websites has been downloaded and collated within a bespoke research blog.

Telephone interviews with certain stakeholders were conducted and a number of face-to-face meetings were organised with certain specific stakeholders. While stakeholders vary as to the usefulness and knowledge of the subject matter that they have been willing to contribute to the research, stakeholder involvement with the issue of IRR and its potential usefulness and limitations etc.. are a worthwhile endeavour in itself. In addition to the bilateral communication with stakeholders, part of the research team has presented the study to the Forum of users experts in the area of financial services (FIN-USE) set up by the European Commission in order to alert them to the study and seek their involvement. This meeting was held on 4 May and attended by Sebastien Clerc-Renaud from iff and by Damon Gibbons from the UK's Centre for Responsible Credit, who is one of the national experts supporting the study. Both explained the nature and details of the study and FIN-USE members were encouraged to participate by contributing a survey response for themselves.

Methodology

In the first phase of the study the research team, which comprises both an economic team and a legal team, has:

- Conducted a search of, and examined the, existing literature and data sources
- Undertaken initial interviews and discussions with specialists, which has helped to determine the relevant areas for further investigation and helped to define the categories of credit and forms of IRR that lie within the scope of the project
- Designed a survey for the collection of legal detail from the selected legal experts in all Member States
- Developed a number of hypotheses concerning the economic and social impacts of IRR
- Designed surveys for stakeholders to obtain their views on these hypotheses and to seek any further evidence that they may have on these issues.

The core of the empirical evidence in this project is therefore derived from an international survey based on questionnaires sent to the following stakeholders:

- Individual credit providers (Provider Questionnaire - PQ)
- Credit provider trade associations, regulators and supervisors, consumer organisations and other interest groups (Stakeholder Questionnaire - SQ)
- and Legal expert questionnaire.

A particular focus of the initial work was on understanding and collecting the details of the legal and regulatory underpinnings, techniques, and mechanisms behind the different forms that IRR can take. Subsequently full research attention was dedicated to collecting the views of stakeholders through the designed survey and telephone conversations.

Individuals and organisations interviewed

Legal experts

Overseeing the legal work on this project were Prof. Udo Reifner together with attorney at law Michael Knobloch with the collaboration of Prof. Iain Ramsay from the University of Kent. In addition, additional national legal experts participated in the study. These have been selected on the basis of their prior contributions to national research on consumer credit issues, and their efficient collaboration in previous European research projects.²⁹²

Individual providers

A Provider Questionnaire was designed and sent to credit providers in order to assist with the economic analysis in this project. The questionnaire was designed to collect insights about the experience of individual players in the consumer credit market with regard to the effects of the interest rate restrictions, or lack of thereof, on the different segments of the market.

²⁹² The list of legal experts that have contributed their expertise on their country is available in the Annex.

The questionnaire was first sent to providers in the six chosen case-study countries, and was subsequently distributed to other providers from different Member States through the main EU level provider associations who disseminated the Provider Questionnaire to their own national association members, who past these on to their own members, the individual providers themselves. The introduction of the questionnaire was tailored to the country in which the providers were operating and the Provider Questionnaire can be found in the Annex.

Provider associations and consumer organisations

In order to collect more general provider opinions on IRR, the research team has also approached trade associations for the different credit market providers through the use of the Stakeholder Questionnaire.

We have asked national as well as European associations for their views. At the European level, we have asked the European Mortgage Federation (EMF) as well as Eurofinas to complete a questionnaire on behalf of their members, and the research team met with the EBIC Consumer Credit Working Group on the 3rd of June to explain the aim of the study and the reasons why provider involvement was important. The members of the working group agreed to encourage their members (provider associations themselves) to complete a Stakeholder Questionnaire, as well as asking them to forward the Provider Questionnaire to their own members.

In addition, the Stakeholder Questionnaire was also sent to consumer associations and other stakeholders associated with the user side, and, as mentioned previously, we have also engaged FIN-USE in the study.

Public authorities - Government and regulators

We have sent the Stakeholder Questionnaire to all identified public authorities in each Member State. There is significant differentiation in the national regulatory structures across the EU, although there is now also a clear trend towards the consolidation of supervisory authorities²⁹³. As a result, we have had to take into account three main systems of regulation:

The widespread '**sectoral model**' is used in 11 Member States (Greece, Spain, Cyprus, Lithuania, Slovenia, Bulgaria, Romania and with some variations in France, Portugal, Finland and Luxembourg) and is based on a separate authority for each sector (banking, securities and insurance).

The so-called '**single regulator model**', preferred by the UK and some of the smaller new EU Member States. The single regulator may, however vary. For example, all the financial supervision functions can be transferred to the national central bank, as in the case of the Czech Republic and Slovakia, or a new single authority separate from the central bank can be created, as in the UK, Estonia, Latvia, Hungary, Malta, and now Poland). In fact, although the term 'single regulator' is used, this can be misleading. For example, the UK, which is most associated with the term, still separate banking, insurance, and mortgage regulation (Financial Services Authority) from consumer credit regulation (Office of Fair Trading).

In between these two models, the '**twin peaks model**' (practiced in the Netherlands and to some extent in Italy) allocates responsibilities according to supervisory objectives (ie. prudential supervision and conduct of business regulation are the responsibility of

²⁹³ European Central Bank, Recent Developments in Supervisory Structures in EU and acceding Countries 2006; ibid. EU Banking structures: The impact of ageing on EU banks 2006.

two different authorities). Elements of this model are also present in the French and Portuguese supervisory structures.

Questionnaires

We present a short section on the process, which may assist in understanding the questionnaires.

Legal Expert Survey

In order to obtain a legal inventory of existing IRR in the EU, iff designed a questionnaire for its legal experts. The Legal Questionnaire (LQ), not reproduced in the Annex to avoid confusion with the Stakeholder Questionnaire, contained questions broadly structured by IRR starting with direct restrictions on the interest rate (Sections A to C), indirect restrictions on other credit parameters with an equivalent effect to IRR (Sections D to E) ending with a set of questions on sanctions and control mechanisms (Sections F to G).

In more detail, the introductory questions concerned the economic (Q1-5), political and social background (Q6-16); Section A) restrictions regarding contractual interest rates through direct ceilings and strict "usury ceilings"/"rate caps" on borrowing rate or Annual Percentage Rate of Charge (APR) (Q17-34); B) restrictions on default interest and penalties (Q35-44); C) limitations to the variability of rates (Q45-48); D) restrictions regarding other cost elements emerging in connection with the credit contract (Q49-54); E) indirect ceilings concerning other contractual conditions, calculation methods, size, time, amortisation of instalments and other credit terms (Q55-77); F) sanctions and control mechanisms (Q78-85); G) restrictions affecting the SME and micro-lending market beyond the core consumer markets reported on until then and summary views (Q86-92).

The legal results were subsequently sent to the public authorities for verification and some minor adjustments and corrections were received from them.

The Stakeholder Questionnaire

The results of these surveys were received at different times and the deadline given to respondents was extended twice in order to allow for the maximum of stakeholder responses to be taken into consideration in the analysis of IRR for this report. The approach behind the design of the questionnaires and details of how the different questions from the survey relate to the hypotheses of interest to the study were explained to the European Commission at the interim stage of the research.

By conducting the stakeholder survey, we were able to obtain insights about the practical effects of IRR, in both the formal rules and regulations and also other less formal mechanisms that moderate consumer credit prices (for example moral consensus or ethical practice). The targeted stakeholders include associations of providers of consumer credit at the national and European level, consumer protection organisations and public authorities including government officials and regulatory bodies. The respondents were asked both closed and open questions. In the case of the latter they were given an opportunity to write their detailed responses in the entry fields provided (reproduced in part in the following annexes). Responses also helped the study by providing references and links to information and data sources.

The Stakeholder Questionnaire was structured in four sections. The first one starts with questions concerning details and views on the forms and features of IRR (Part A: Q1.1-1.36). This section aimed at strengthening our understanding of the regulatory framework of those markets. It also asked questions which are targeted at the effectiveness of interest rate restrictions of both prevailing rates as well as hypothetical legal rates.

The second section dealt with issues related to the extent of private over-indebtedness (Part B: Q2.1-2.5). While some questions asked about determinants of over-indebtedness in more detail, other questions targeted current trends in the respective country. The latter questions being useful in a cross-sectional comparison across countries with different legal situations on interest rate restrictions.

The third section addressed access to consumer credit (Part C: Q3.1.-3.6). Several aspects centred on the level of credit access (this could then be compared in a cross section of countries) and evidence of possible credit exclusion due to interest rate restrictions.

The fourth section included a set of questions on the characteristics of the different credit markets (Part D: Q4.1-4.14). It allowed us to better understand whether there are different market structures, including international integration, competition as well as market vulnerability in times of crisis in a cross-country comparison in our case study countries.

The Provider Questionnaire

Since filling out such questionnaires can be very burdensome for providers, there was a general risk that more information will originate from those with a political interest in EU policies. The letter from the Commission accompanying the questionnaire demonstrated the political importance of responding. More details on the survey of providers including the questionnaire itself is available in Annex XII: Provider Questionnaire.

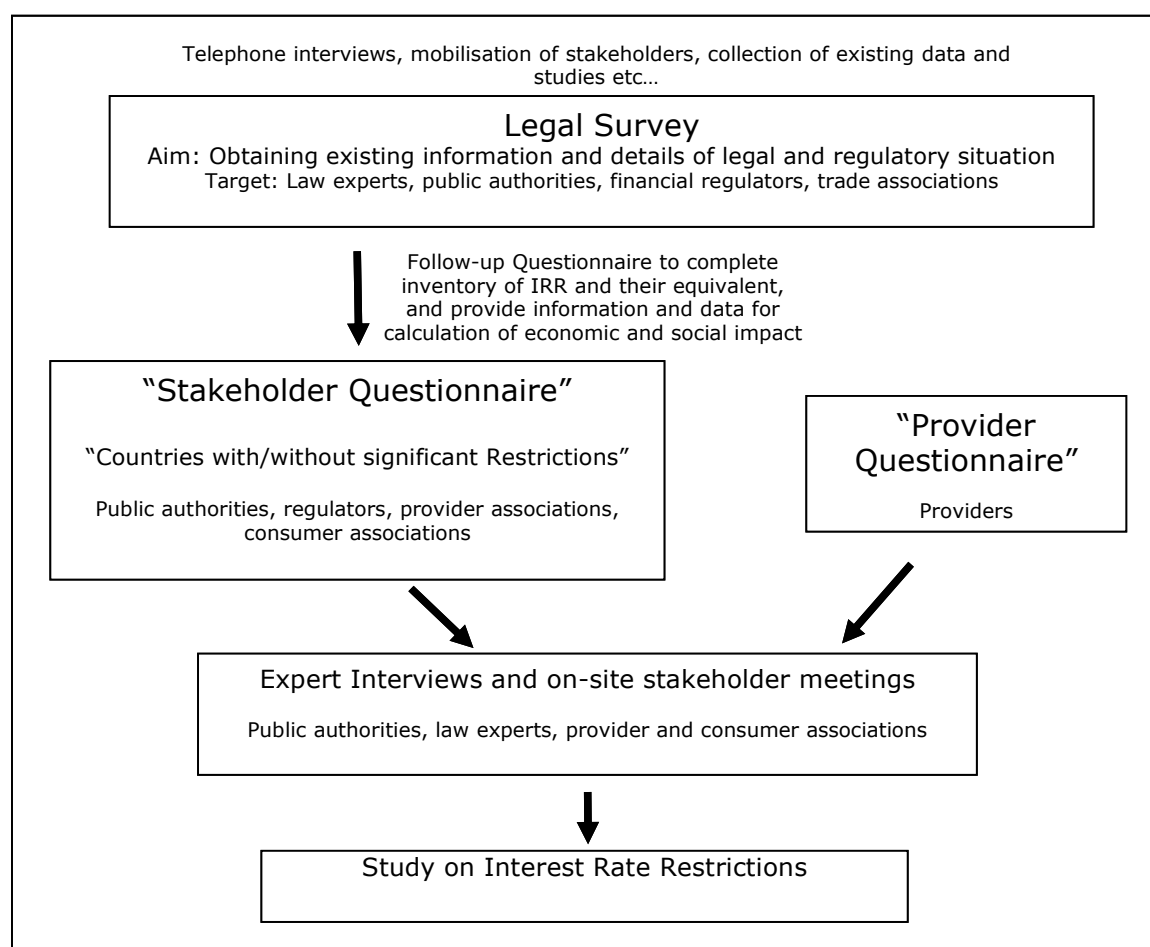
Development of the questionnaires and testing

The questionnaire was developed along the following steps:

1. In the first stage, IRR were defined theoretically and the key research questions were drawn up.
2. In a second step, hypotheses concerning the possible outcome of this research in relation to dissemination, barriers, incentives, features, risks, etc., were discussed with economists, sociologists and lawyers based at or cooperating with iff.
3. These hypotheses were operationalised into research dimensions and sub-dimensions.

The questionnaire was tested first in Germany and then discussed with experts from the UK and the Netherlands.

The chart, below, provides an overview of the methodology for the study.

Figure 146: Process of the surveys for the empirical work

Annex IV: Stakeholders contacted

Country	Regulator, Authorities, Government agencies
Austria	Oesterreichische Nationalbank; Bundesministerium für Finanzen; Finanzmarktaufsicht
Belgium	Banque Nationale de Belgique; Commission Bancaire, Financière et des Assurances; Fonds de Traitement du Surendettement
Bulgaria	Bulgarian National Bank; Ministry of Finance
Cyprus	Central Bank of Cyprus; Ministry of Finance; Authority for the Supervision and Development of Cooperative Societies; Ministry of Commerce, Industry and Tourism; Authority for the Supervision and Development of Cooperative Societies
Czech Republic	Ministry of Industry and Trade; Ministry of Finance; Czech National Bank
Denmark	Danish Financial Authority (Finanstilsynet); Danish Mortgage Credit Complaint Board; National Bank of Denmark; Ministry of Justice
Estonia	Bank of Estonia; Consumer Protection Board of Estonia; Financial Supervision Authority of Estonia; Ministry of Finance; Ministry of Justice
Finland	Ministry of Justice; Financial Supervisory Authority; Bank of Finland
France	Ministry of Justice; French Treasury and Economic Policy Directorate General; Banque de France; Commission bancaire; Comité consultatif du secteur financier; Direction générale de la concurrence, de la consommation et de la répression des fraudes
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Deutsche Bundesbank; Bundesministerium der Justiz; Wettbewerbszentrale
Greece	Bank of Greece
Hungary	National Bank of Hungary; Hungarian Financial Supervisory Authority; Ministry of Finance
Ireland	Irish Department of Finance; Irish Financial Services Regulatory Authority
Italy	Ministry of the Economy and Finance; Banca d'Italia
Latvia	Ministry of Economy; Bank of Latvia; Financial and Capital Market Commission
Lithuania	Bank of Lithuania; State Consumer Rights Protection Authority; Ministry of Finance
Luxembourg	Banque de Luxembourg; Ministère des Finances
Malta	Central Bank of Malta; Ministry of Finance & Economic Affairs; Malta Financial Services Authority (MFSA)
Netherlands	Netherlands Authority for the Financial Markets (AFM); Ministry of Finance; De Nederlandsche Bank
Poland	Office of Competition & Consumer Protection (OCCP); National Bank of Poland; Ministry of Finance
Portugal	Banco de Portugal
Romania	National Bank of Romania; National Authority for Consumers Protection
Slovakia	National Bank of Slovakia; Ministry of Finance
Slovenia	Ministry of Economy of Slovenia; Bank of Slovenia; Ministry of Finance
Spain	Banco de España
Sweden	Swedish Financial Supervisory Authority; Ministry of Integration and Gender Equality; Ministry of Finance; Kronofogden; Sveriges Riksbank
United Kingdom	Financial Services Authority (FSA); Office of Fair Trading; Financial Services Authority (FSA); Department for Business, Innovation & Skills; HM Treasury; Competition Commission UK; Bank of England; Scottish Government

Country	Provider Associations
Austria	Verband Österreichischer Banken & Bankiers; Verband der österreichischen Landes-Hypothekenbanken; Österreichischer Genossenschaftsverband (ÖGV)
Belgium	Febelfin - Fédération belge du secteur financier; Union Professionnelle du Crédit (UPC); PBA - Private Bankers Association Belgium
Bulgaria	Association of Banks of Bulgaria; Bulgarian Association of Leasing
Cyprus	Association of Cyprus Commercial Banks; Cyprus Banks Association
Czech Rep.	ACSS - Asociace českých stavebních spořitelien; Czech Banking Association (CBA); Czech Leasing and Finance Association (CLFA)
Denmark	Realkreditrådet (Association of Danish Mortgage Banks); Association of Danish Finance Houses (Finans og Leasing); Realkreditrådet (Association of Danish Mortgage Banks); Danish Bankers Association
Estonia	Estonian Banking Association
Finland	Federation of Finnish Financial Services
France	Association française des sociétés financières (ASF); Fédération Bancaire Française (FBF); Caisse nationale des Caisses d'Épargne (CNCE)
Germany	Verband deutscher Pfandbriefbanken (vdp) e.V.; Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR); Verband der Privaten Bausparkassen e.V.; Bankenfachverband e.V.; Bundesverband Öffentlicher Banken Deutschlands e.V. - VÖB; KfW Bankengruppe; Verband deutscher Pfandbriefbanken (vdp) e.V.; Gesamtverband der Deutschen Versicherungswirtschaft e.V. (GDV); Rheinischer Sparkassen- und Giroverband; Bankenfachverband e.V.; KfW Bankengruppe; Bankenfachverband e.V.; Deutscher Sparkassen- und Giroverband (DSGV); Bundesverband Deutscher Banken; Verband der privaten Bausparkassen (vdpb); Zentraler Kreditausschuss (ZKA); Zentralverband des Deutschen Pfandkreditgewerbes e.V.; Deutscher Sparkassen- und Giroverband (DSGV)
Greece	Hellenic Bank Association (HBA)
Hungary	Association of Hungarian Mortgage Banks; Hungarian Banking Association; Hungarian Real Estate Association
Ireland	Irish Banking Federation; Irish Mortgage Council (IMC); Irish Finance Houses Association; Irish League of Credit Unions
Italy	Italian Association for Consumer Credit and Mortgages (ASSOFIN); Associazione Bancaria Italiana (ABI); Associazione Italiana del Factoring - ASSIFACT; Unione finanziarie italiane (UFI); Associazione Italiana del Leasing - ASSILEA; Unione Nazionale Imprese Recupero crediti e informazioni Commerciali
Latvia	Ombudsmen of the Association of Latvian Commercial Banks; Association of Commercial Banks
Lithuania	Lithuanian Bankers' Association; Association of Lithuanian Banks; Lithuanian Credit Unions
Luxembourg	Luxembourg Bankers' Association (ABBL)
Malta	Malta Commercial Banks Association (MCBA); Finance Malta
Netherlands	Nederlandse Vereniging van Banken (NVB); Nederlandse Vereniging van Volkskrediet (NVVK); Dutch Banking Association; Vereniging van Financieringsondernemingen in Nederland (VFN)
Poland	Conference of Financial Companies in Poland (KPF); Polish Bank Association; Mortgage Credit Foundation; Conference of Financial Companies in Poland (KPF); Polish Cooperative Bank Association
Portugal	Associação Portuguesa de Bancos; ASFAC; Associação Portuguesa de Bancos
Romania	Romanian Banking Association; ALB
Slovakia	Slovak Banking Association
Slovenia	Bank Association of Slovenia
Spain	€uroMontepio; Asociación Nacional de Establecimientos Financieros de Crédito (ASNEF); Asociación Hipotecaria Española (AHE); Confederación Española de Cajas de Ahorros; Asociación Española de Banca
Sweden	Swedish Bankers' Association (Svenska Bankföreningen) AFINA; Swedish pawnbrokers association; Finansbolagens Förening; Swedish Bankers' Association (Svenska Bankföreningen) AFINA
UK	The UK Cards Association Limited; British Cheque Cashers Association (BCCA); British Bankers' Association (BBA); Consumer Finance Association (CFA); Building Societies Association; Council of Mortgage Lenders; Consumer Credit Trade Association (CCTA); Consumer Credit Association UK; Finance & Leasing Association (FLA); ABCUL (The Association of British Credit Unions Limited); National Pawnbrokers Association (NPA)
EU	European Savings Banks Group; Eurofinas (The European Federation of Finance House Associations); European Banking Federation; EBIC European Banking Industry Committee; Austrian Savings Banks Association; European Federation of Building Societies; European Mortgage Federation; European Financial Services Round Table (EFR)

Country	Consumers Associations
Austria	Arbeiterkammer Wien; Verein für Konsumenteninformation (VKI)
Belgium	Test Achats; Centre de recherche et d'information des organisations de consommateurs (CRIOC); Verbruikerssateljee vzw - Beweging voor de kleine consument ;
Bulgaria	Bulgarian National Consumer Association; Consumer Center for Information and Research; Federation of Consumers of Bulgaria
Cyprus	Cyprus Consumer Association
Czech Republic	Consumers' Defence Organisation of the Czech Republic; Czech Consumers Association (SCS); Debt Advisory Center
Denmark	Forbrugerradet (Danish Consumer Council)
Estonia	Estonian Consumers' Union
Finland	Kuluttajaliitto; Kuluttajavirasto Konsumentverket; National Consumer Research Center
France	UFC-Que Choisir; Association Léo Lagrange pour la Défense des Consommateurs (ALLDC); Organisation Générale des Consommateurs - OR.GE.CO; Association française des usagers des banques (AFUB); ANIL (Association Nationale pour l'Information sur le Logement); Consommation, Logement et Cadre de vie (CLCV); Fédération des Associations Indépendantes de défense des Epargnants pour la retraite (FAIDER); SOS Familles Emmaüs; Association de consommateurs Union féminine civique et sociale (UFCS); Secours Catholique; INDECOSA CGT; Confédération Syndicale des Familles (CSF); Institut National de la Consommation (INC)
Germany	Verbraucherzentrale Bundesverband (vzbv); Verbraucherzentrale Hamburg e.V.; Stiftung Warentest
Greece	EKPIZO Consumers' Association "Quality of Life"; Hellenic Ombudsman for Banking-Investment; KEPKA - Consumers Protection Centre
Hungary	National Association of Consumer Protection in Hungary; Association For The Hungarian Consumers (AHC/FOME)
Ireland	Financial services ombudsman; Consumers' Association of Ireland (CAI); Free Legal Advice Centres Ltd. (FLAC)
Italy	Altroconsumo; Adiconsum; ADUSBEP; Associazione Conciliatore Bancario Italia; Consumatori Associati;
Latvia	Consumer Rights Protection Center; Latvian National Consumers' Association
Lithuania	Lithuanian Consumer Institute (LCI); Lithuanian National Consumer Federation
Luxembourg	Union Luxembourgeoise des Consommateurs (ULC)
Malta	Ghaqda tal-Konsumaturi; Maltese consumer association
Netherlands	Consumentenbond; NIBUD (National Instituut voor Budgetvoorlichting)
Poland	Polish Consumer Federation National Council; Association of Polish Consumers
Portugal	DECO - Ass.Portuguesa para a Defesa do Consumidor; Centro de Arbitragem De Conflitos de Consumo de Lisboa; Associação Portuguesa de Direito do Consumo (APDC)
Romania	Association for the Protection of Consumers (APC)
Slovakia	Association of Slovak Consumers (Zdruzenie slovenskych spotrebiteľov)
Slovenia	Slovene Consumers Association
Spain	Organización de Consumidores y Usuarios (OCU); Spanish Independent Financial Advisors' Association; Confederación de Consumidores y Usuarios (CECU); ADICAE
Sweden	Swedish Consumers' Association; Swedish Consumer Agency (Konsumentverket)
United Kingdom	Community Development Financial Association; Advice UK; Consumer Credit Counselling Services; Consumer Focus; Citizens Advice Scotland; Citizens Advice; Credit Action; Money Advice Trust; The Financial Inclusion Centre; Money Advice Scotland; Financial Services Consumer Panel; Community Finance Solutions; Which?
EU	BEUC; ANEC

Country	Other stakeholders
Finland	Guarantee Foundation
France	CSC Commission de la Securite des Consommateurs; CLERSÉ; Association d'économie financière; Conseil économique et social (CES); Association Française des Intermédiaires Bancaires (AFIB); Audencia Nantes - School of Management
Germany	Zentrum für Europäische Rechtspolitik an der Universität Bremen (ZERP); Creditreform; SCHUFA Holding AG; Finpolconsult; GP Forschungsgruppe
Ireland	Law Society of Ireland
Italy	Unione Nazionale Imprese Recupero crediti e informazioni Commerciali
Luxembourg	Ligue Medico-Sociale
Netherlands	Dutch government; BKR (Dutch Bureau of Credit Registration)
Portugal	Observatório do Endividamento dos Consumidores (OEC); Universidade de Coimbra (FEUC)
Romania	Credit Bureau
Spain	FinanzKontor; Instituto de Crédito Oficial (ICO)
Sweden	Skatteverket
United Kingdom	Fair Finance Ltd; Personal Finance Research Centre; Confederation of British Industry (CBI); Unite the union; ACCA The Association of Chartered Certified Accountants; Toynbee Hall; New Local Government Network (NLGN); NIACE (National Institute for Adult Continuing Education); Lending Standards Board; London Rebuilding Society; UK Financial Inclusion Taskforce; UK National Housing Federation; National Association of Credit Union Workers; Bassac; Barnardos; New Economics Foundation; ACEVO - Association of Chief Executives of Voluntary Organisations
EU	Association of Consumer Credit Information Suppliers (Accis); European Trade Union Confederation (ETUC); CEPS (Centre for European Policy Studies)

Annex V: Legal Experts

Country	Legal Expert
Austria	Prof. Dr. Michael Gruber (University Salzburg)
Belgium	Prof. Dr. Evelyne Terryn (Univ. Leuven)
Bulgaria	Ass. Prof. Ivan Mangatchev (New Bulgarian University)
Cyprus	Ass. Prof. Nikitas Hatzimihail (University of Cyprus)
Czech Republic	Petr Müller (Lawyer in Prague)
Denmark	Susanne Nielsen (Danish Mortgage Credit Complaint Board)
Estonia	Mark Butzmann (Lawyer in Tallin)
Finland	Riitta Kokko-Herrala (Kuluttajavirasto)
France	Masset Denevre (Institut National de la Consommation)
Germany	RA Michael Knobloch (iff)
Greece	Melina Mouzouraki (Lawyer in Athens)
Hungary	Csongor Buzády (Lawyer in Budapest)
Ireland	Mel Cousins (Lawyer in Dublin)
Italy	Prof. Diana Cerini (Milan University)
Latvia	Theis Klauberg (Lawyer in Riga)
Lithuania	Frank Heemann (Lawyer in Vilnius)
Luxembourg	Elise Poillot (Université du Luxembourg)
Malta	Dr. Grazio Mercieca (Consumer Affairs Council Malta)
Netherlands	Tamara Madern (NIBUD), Prof. Dr. Nick Huls (Univ. Erasmus)
Poland	Prof. Dr. Włodimierz Szpringer (Warsaw School of Economics)
Portugal	Joao Espanha (Espanha associados)
Romania	Dr. Rodica Diana Apan (North University Baia Mare)
Slovakia	Prof. Maria Patakyova (Comenius University Bratislava)
Slovenia	Dr. Meta Ahtik (Ljubljana University)
Spain	Dr. Elena Perez Carrillo (Universidade Santiago de Compostela)
Sweden	Ann-Sofie Henrikson (Umea University)
United Kingdom	Prof. G.A. Williams (University of Kent)

Annex VI: ECRI (2009) Dataset main definitions

The following definitions need to be mentioned in relation to the ECRI dataset (ECRI, 2009).

1. *Credit to the non-financial business and household sector.* Credit to the non-financial business and household sector comprises all loans to households and NPISH (non-profit institutions serving households) and credit to non-financial corporations.
2. *Total credit to households and NPISH.* According to the European System of Accounts 1995, the household sector covers individuals or groups of individuals as consumers, but also as entrepreneurs (ie. sole proprietorships and partnerships). Non-profit institutions serving households are a separate institutional sector, although often reported together with households. Unless stated otherwise, loans to NPISH are included in the various categories of loans (consumer credit, housing loans and other loans).
3. *Consumer credit.* Consumer credit corresponds to the outstanding amounts (stocks) of loans at the end of the year granted by the resident MFI sector to resident households and NPISHs for consumption purposes. Consumer credit notably includes loans related to credit cards as well as overdrafts. Consumer credit by lender or by type is not necessarily comparable across countries, as various country-specific classifications and definitions apply.
4. *Housing loans.* Housing loans correspond to the outstanding amounts of loans at the end of the year granted by the resident MFI sector to resident households and NPISHs for housing purposes. The data series comprise loans on dwellings both secured and unsecured. Breakdowns by maturity and currency are provided where available.
5. *Gross domestic product (GDP).* Gross domestic product is the final result of the production activity of resident producer units.
6. *Final consumption expenditure.* The final consumption expenditures of the household sector correspond to the value of the consumption goods and services acquired through purchases (social transfers in kind receivable from other institutional units are excluded). According to the international principles of national accounting, final consumption expenditure may take place on the domestic territory or abroad.
7. *Gross disposable income.* The gross disposable income of the household sector is intended to measure the monetary income which can be used for consumption and saving. It is a balancing item of the current income in the secondary distribution income account of households and NPISH and derived from the balance of primary incomes by adding or subtracting all social transfers (except social transfers in kind).

Annex VII: Databases used in the analyses of over-indebtedness

In this Annex, data bases which cover indicators for over-indebtedness on the European level are described more closely. It refrains from using national data sources because of various statistical problems. These problems include: statistical categories and definitions are not the same across countries; the methodology applied varies and the frequency of data collection varies as well. These are strong arguments for using an international EU survey to collect comparable statistics. Two surveys provide rare sources of comparable information about levels of over-indebtedness across Europe.

EU SILC

The EU SILC is a pan-European panel survey collecting data on living conditions, including social exclusion and poverty on an annual basis. The collected indicators play a major role in tracking developments in individual Member States as well as in the fight against poverty. Some of the questions in the EU-SILC survey can be classified as objective questions, such as whether the household has been in arrears over the past 12 months, whereas others are based on households' own assessments of their situation, such as their ability to make ends meet. It mainly focuses on income and detailed income components are collected mainly at personal level although a few components are included in the household part.

Data collection for EU-SILC started in 2004. The survey then covered twelve EU 15 countries (Belgium, Denmark, Greece, Spain, France, Ireland, Italy, Luxembourg, Austria, Portugal, Finland and Sweden) as well as Estonia, Norway and Iceland. The remaining EU-25 countries joined the EU SILC in 2005. Bulgaria, Romania, Turkey and Switzerland have launched SILC in 2006.

As EU SILC is based on the idea of a common "framework" and not a common "survey" as was the case for its predecessor - the European Community Household Panel (ECHP) – there are harmonised lists of annual variables, which are transmitted to Eurostat. This setup is aimed at maximising comparability of the information produced. This way problems with harmonisation of national data are largely avoided.

Measures that can be drawn from EU SILC to evaluate the over-indebtedness of households are numerous: they comprise arrears, debt ratios as well as subjective measures. Data from EU SILC will be used at an aggregate level for the analysis of probable impacts of regulatory decisions on over-indebtedness. Relying on an EU-wide survey such as the EU SILC has the advantage that all countries are covered, the data survey is run with the same frequency and that results are harmonised, allowing for a high comparability of the results across countries. The indicator reflects repayment problems and is generally judged to be good in terms of information content and reliability.

The Survey on Household Finance and Consumption, discussed in chapter 4.5.2 might provide further valuable insights.

Eurobarometer

The Eurobarometer survey is collected on behalf of the European Commission. Relying on this cross-national survey avoids incomparability emanating from lacking harmonisation. The Standard Eurobarometer survey series is a longitudinal study, designed to compare and gauge trends within Member States of the European Union. Each survey consists of approximately 1000 face-to-face interviews per Member State. Besides, special irregularly repeated modules investigate topics such as environment, gender roles, family, or financial services in a European perspective. Such a special Eurobarometer

module from Eurobarometer 60.2 and 63.2 will be used in the following to analyse credit access.

The Eurobarometer 60.2 was conducted in fall 2003, the 63.2 in spring 2005. This round diverged from the standard measures and queried, among others, the use of and attitudes towards financial services. Respondents were asked about the type of bank accounts they personally had. Demographic and other background information provided include respondent's nationality and household income.

Annex VIII: Measures of over-indebtedness

For the analysis of the hypotheses it was necessary to determine an appropriate measure for over-indebtedness. The following paragraphs discuss and classify possible measures from which two indicators on the aggregate level– a subjective burden indicator (households ability to make ends meet) and an objective over-indebtedness measure (households in arrears with their payment obligations) – were chosen for the analysis.

Data

Data generally used to identify situations of financial difficulty can be classified into two groups:²⁹⁴ *Aggregate data* provide indications regarding the pervasiveness of financial difficulties amongst a particular population and are usually collected by national central banks. Aggregate indicators of over-indebtedness quantify the size of the phenomenon and can thus be helpful in temporal or cross-country comparisons. The disadvantage of these data is that they do not always correctly identify situations of over-indebtedness and that they are not available for all countries or can be derived consistently across different countries. Furthermore, aggregate data have the problem of not capturing well the individual circumstances of consumers:²⁹⁵ To determine the sustainable amount of debt a household can bear, lending institutions draw on numerous characteristics of the future borrower. In contrast, aggregate indicators establish thresholds to determine over-indebtedness for all consumers. Such general measures fail to allow for the different needs of consumers. People of different ages have different requirements for borrowing depending on their time preferences and possibilities to consume out of current income or accumulated wealth. Since an aggregate consumption/saving pattern cannot be stipulated, Betti et al. (2007) conclude that there is *"no simple aggregate measure of "normal" or "excessive" consumer indebtedness for the economy as a whole. A simple aggregate measure of consumer indebtedness that covers all age groups does not contain much absolute information about how much consumers as a whole are indebted."*²⁹⁶

Individual data enable the identification of socio-demographic and economic profiles of individuals or households experiencing situations of financial difficulties and can give useful insights into the most frequent causes of over-indebtedness. Furthermore, individual data may serve for the evaluation of measures undertaken to prevent and manage over-indebtedness. Individual data is collected via surveys, conducted by national statistic institutes, central banks or research institutes. These surveys can include questions referring to objective as well as subjective indicators of over-indebtedness. Especially answers to subjective questions can be influenced by respondents' socio-cultural context and their perception of economic and financial fragility and difficulty in a certain moment. Again, unfortunately, individual data is usually not homogeneous for different countries.

Measures determining over-indebtedness

Specific measures of indebtedness can again be grouped into three categories: administrative, objective and subjective measures. An overview of these measures is given in Table 63, they are discussed in more detail in the following.

²⁹⁴ See Vandone (2009), p. 71.

²⁹⁵ See Betti et al. (2007), p. 143.

²⁹⁶ Betti et al. (2007), p. 143.

Table 63: Overview of measures determining over-indebtedness

Administrative measures	Objective measures	Subjective measures
Court arranged solutions	Debt ratios:	Inability to make ends meet.
Cases of approaches to counselling agencies	- Consumption/income ratio	Perception of heavy payment burden
	- Debt/asset ratio	
Debt write-offs by banks	- Debt/disposable income ratio	
Mortgage repossessions	- Debt-servicing ratio	
	Arrears	
	Financial coping strategies:	
	- Overdraft use	
	- Extended credit card facilities	
	- New credit to pay off debts	

Administrative measures

Administrative measures comprise the number of court-arranged solutions to debt (legal measure), cases of debt problems reported to debt advice agencies or debt write-offs by lending institutions. They are a by-product of official functions and take into account only those cases where payment difficulties have been registered officially in some way.

Legal measures depend on the legislation of the respective countries, which complicates international comparison. A further obstacle to using such indicators is that some European countries (Bulgaria, Greece, Italy and Lithuania) do not even have a law on personal bankruptcy.²⁹⁷ More fundamentally, another drawback of legal measures is that they include only the severe cases in which indebtedness has already led to consumer bankruptcy. The indicator thus grasps only a small fraction of over-indebted households and disregards cases of severe disruption to the established consumption pattern. Thus, legal debt settlements can at best paint a picture of the outcome rather than the situation of indebtedness. Keeping in mind that debt settlement procedures are hardly comparable between different countries, they serve at best as a partial measure of indebtedness.

²⁹⁷ For a comparison of the insolvency statutes of countries in the EU see Brennecke, Otépková (2009).

The drawbacks of legal measures apply even more to data regarding households approaching debt agencies. Recorded numbers of *people seeking advice* will depend on the pervasiveness of counselling agencies, the size of their staff and hence on the funding available to them. Paradoxically, rising numbers of over-indebtedness may therefore be caused by an increased commitment of debt agencies instead of a change in the advice-seeking consumers' initial situation.²⁹⁸ Thus, the informational content of figures from debt agencies is low.

Data on *debt write-offs* by lending institutions is collected only in some countries. Still, if the information is recorded by credit reporting agencies it is usually not publicly accessible. In countries where data on write-offs is collected by central banks, the data is aggregated, which leads to a low informational content for mapping over-indebtedness. Besides the accessibility of debt write-off data, it is difficult to assess what causes might induce changes in the write-off rates: write-off rates are linked to the policies of individual borrowing institutions, which may vary over time. So a rising level of write-off rates is not necessarily a symptom of growing excessive debt loads of households.²⁹⁹

Indicators depicting *mortgage possessions* share the same drawbacks as debt write-offs. There are even two more reasons why information relating to properties taken into possession may not be an accurate measure of households' debt burden:³⁰⁰ first, there are potentially significant time lags involved in the possessions process (up to a year), such that properties taken into possession today may result from actions related to repayment problems in the past. Secondly, actual repossession may not be accomplished, as the involved parties may agree on a different arrangement. Therefore, only part of the consumers who experience problems paying their mortgages will end up having their property repossessed.

Altogether, administrative measures tend to indicate problems with a delay, they capture only a fraction of over-indebted households and they are hardly comparable in cross-country analysis due to different national frameworks.

Objective measures

Most of the existing *objective indicators* of over-indebtedness are based on the notion of unsustainable consumption behaviour of the households.³⁰¹ To determine when a household's debt becomes unaffordable, commonly applied indicators are concerned with a household's spending behaviour, level of debt, or ability to service outstanding debt. High debt levels do not necessarily lead to over-indebtedness, as long as households manage to meet their obligations. However, it puts them into a potentially vulnerable position. Adverse shocks, such as unemployment, price increases or changes in interest rates can push such vulnerable households into serious financial difficulties. The above-mentioned indicators thus help to form views about the extent to which households exposed themselves to potential economic shocks because of their credit obligations.

One way to assess unsustainable spending behaviour is by looking at the *consumption-to-income ratio*. High values of the ratio (eg. above 100 percent) can be perceived as an indication of over-indebtedness. However, drawing conclusions from the permanent

²⁹⁸ See EUC (2008), p. 44.

²⁹⁹ See BERR (2007), p. 18.

³⁰⁰ See BERR (2009), p. 24.

³⁰¹ See Betti et al. (2007), p.142.

income hypotheses, younger households who have to acquire durable goods and retirees who deplete their savings are expected to exhibit high consumption to income ratios.³⁰²

The level of household debt can be measured by the *debt to asset ratio*. The ratio compares the overall stock of debt to the household's total stock of assets. It can indicate how well consumers are potentially able to cover debt out of their stock of assets, while this ability is likely to depend on the liquidity of the asset compared to the payment date of debts.³⁰³ However, the ratio gives no indication of this relative liquidity of assets owned compared to debts and potential difficulties of households in servicing the debt in each period using their available resources at the time.

The aggregate household *debt to disposable income ratio* is not as such a measure of over-indebtedness. However, comparing debt to income facilitates an assessment of households' real exposure to debt, which is not possible by judging from levels of debt only.³⁰⁴ Moreover, the debt to income ratio can indicate whether income readily covers current obligations. A clear advantage of the measure is that it can be used for cross-country comparisons within the EU, as the data is either collected by the national central banks or statistical authorities, which use a harmonised methodology.³⁰⁵

However, not all possible financial commitments are covered by the debt-income ratio as only credit related to the financial sector is reported in official statistics in all countries. The credit to income ratio cannot directly be used to infer the burden of debt for the households as only part of the outstanding amount is payable in the near term. Rather, the monthly percentage of income devoted to financing commitments can be deemed an adequate indicator of the current payment burden.

The ratio of debt payments to disposable income (after tax) can be regarded as a measure of the *debt-servicing burden* to households. Credit-service ratios are not collected in all Member States and sometimes only raw data series are provided (such as disposable income and credit service) from which the ratio must be calculated. But where the data is collected, the definition is consistent among countries in the EU. As usually only aggregate information is available, the information content regarding the burden to individual households is low and hence the usefulness of the indicator with regard to over-indebtedness limited. An even more important drawback of the indicator is that it typically includes only debt payments (on mortgages and consumer credit) and no other monthly payment burdens such as utility bills or rent payments.

Deducting indications of over-indebtedness from the measures described above requires defining their critical levels.³⁰⁶ However, there is no established methodology for determining the critical level of these ratios beyond which a household can be regarded to be over-indebted. According to the permanent income hypotheses, thresholds would vary with households' characteristics, as has already been discussed in the example of a debt-to-income ratio, which varies with age. It might therefore be sensible to incorporate a household's absolute income level in order to decide whether a high debt-servicing ratio leaves the household with enough money to cover its basic needs.

³⁰² On the contrary, Betti et al. (2007) argue that over-indebtedness is more likely to be observable by a low ex-post consumption-to-income ratio than a high one ex-ante, p. 140 f.

³⁰³ See BERR (2009), p. 13.

³⁰⁴ See BERR (2007), p. 12.

³⁰⁵ See EUC (2008), p. 45.

³⁰⁶ Critical levels have been defined in major empirical studies on over-indebtedness, such as Oxera (2004), MORI (2005), ECRI and PFCR(2008). The combination of objective indicators and subjective measures suggested by MORI (2005) have become the benchmark and a convention for subsequent evaluations of 'over-indebtedness' in the UK. A more exhaustive compilation of concepts of over-indebtedness can be found in Anderloni and Vandone (2008).

An indicator not depending on a certain threshold refers to the financial *arrears* of households. Indicators on arrears capture all forms of debt and household bills for which a household is behind in payments for longer than a specified period of time. This cut-off time period is important, otherwise households which simply forgot to pay a bill or debt once would be considered over-indebted. Data on financial arrears is collected in all countries. Most data (and often more precise data relating to individuals) is collected by private credit bureaus and is not in the public domain. In some countries it is primarily the central bank accumulating the data through a public credit register. It is also common that both types of institutions gather the information.

Another group of objective indicators deals with strategies households may adopt to cope with financial stress. *Financial coping strategies*³⁰⁷ comprise households constantly in overdraft, the use of extended facilities on credit cards to pay for everyday living expenses and to draw cash, and the need to take out additional credit in order to pay off debts.

Subjective measures

Subjective measures also try to grasp the extent of how stressed households are because of their financial obligations. Unlike for the other measures, in this approach individual households are considered to be the best judges of their own financial well-being. All households who claim to be unable to repay their debts without substantially lowering their standard of living are regarded to be over-indebted. There is no doubt that subjective measures also need to be considered with some caution: as the data is survey-based, it is necessary that consumers be honest in the report of their financial situation. Survey responses may also differ across households due to different perceptions and reactions, although the financial circumstances may be identical.³⁰⁸ Furthermore, respondents may feel urged to report at least some kind of 'financial difficulties' in an interview concerning over-indebtedness, especially when credit and debt problems are continually discussed in the media. It has to be presumed that the more vague the question concerning 'financial difficulties', the greater the likelihood that the interviewer is capturing self-reflective attitudes and responses rather than the underlying debt position of the household. Despite these limitations, the important advantage of subjective measures is that they give a direct indication of over-indebtedness by capturing not only those households that are in arrears but also those that are currently managing their credit commitments but are vulnerable to falling behind.

Conclusion

Because of the lack of models from economic theory³⁰⁹, lack of data on household income and asset, and lack of robustness in the results from an "objective" approach, we decided to rely in this study on a broadly undisputed objective measure – the fraction of households in payment arrears as well as a subjective indicator – households being unable to make ends meet.³¹⁰

³⁰⁷ See ECRI and PfRC (2008), pp. 6 ff. for studies drawing on financial coping strategies.

³⁰⁸ Compare Disney et al. (2008), pp. 19 and 51 for the mentioned drawbacks.

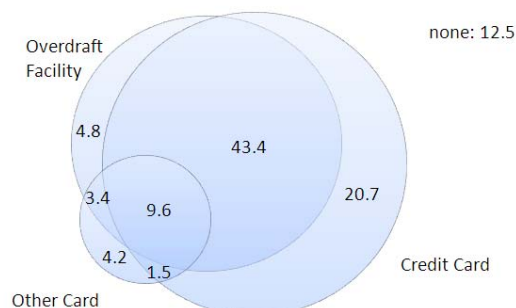
³⁰⁹ Studies from the UK constantly identify a lack of overlap between the indicators. According to MORI "this demonstrates the need to consider several measures when conducting analyses in this area" while Disney et al (2008) conclude that by considering multiple indicators it is rather probable that the sub-set of 'over-indebted' households will not be identified correctly as almost all families might satisfy one or more criteria. They suggest considering "a more 'structural' and life cycle-based approach to the issue of 'over-indebtedness', while acknowledging that specific indicators and self-reported perceptions are important components of the over-indebtedness phenomenon."

³¹⁰ As some recent studies focus more on a subjective approach to determine and analyse over-indebtedness; eg. Betti et al. (2007).

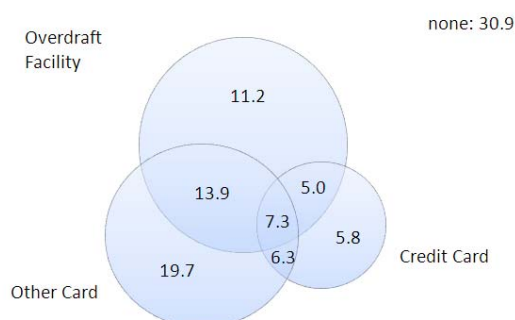
Annex IX: Incidence of short-term credit facilities

The following Venn-diagrams adumbrate the pervasiveness of different forms of short-term credit facilities measured by the percentages of households indicating to hold none, one or more of the categories overdraft facility, credit card or other card. However, households holding credit cards and other cards with pure debit functions cannot be distinguished and are therefore considered having access to short-term credit. Therefore the complement, the fraction of households without access to any of these forms of short-term credit (credit excluded households) shown by the categorie "none" underestimates the true prevalence of households without access to short term credit.

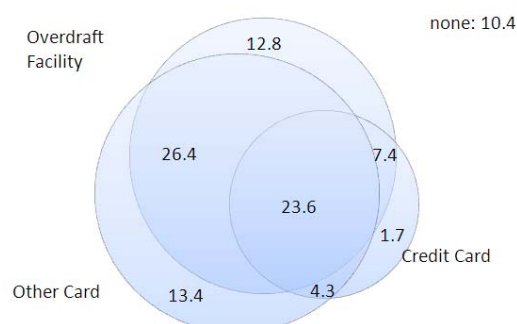
France



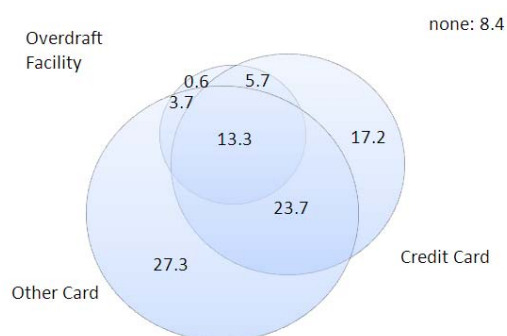
Germany



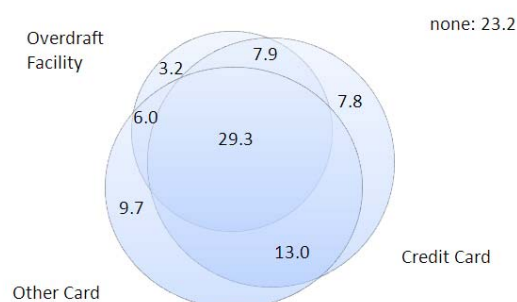
The Netherlands



Sweden



UK



Source: Eurobarometer 60.2, Variable Q11 ("Do you personally have...?")

Annex X: Stakeholder Questionnaire

Your details as Respondent		
0.1	Your country	Country A-K Country L-Z
0.2	Your activity	Please select from the dropdown menu Other:
0.3	Your name: Name of your institution: Address, telephone and email:	
PART A: Interest Rate Restrictions (IRR)		
1.1	Has the role of interest rate restrictions been discussed among regulators, providers or consumer organisations in your country in the past five years?	Select Please give details:
1.2	Are you aware of studies that have been undertaken regarding interest rate restrictions? Are there any plans in your country to do so?	☐ Yes ☐ No ☐ Don't know Please give details:
1.3	Do any of the following terms appear in a legal context and how are they defined: "mainstream credit", "fringe lending", "money-lenders", "last resort loan", "prime", "sub-prime", "payday loans", "usurious rates" etc..? [please give translated word in your own language]	
1.4	What does " usury " (ie. the respective word in your language) refer to (generally and, where applicable, in your legislation)?	

1.5	Which forms of interest rate restrictions currently exist?	☐ Absolute or relative contractual interest rate ceilings (fixed administratively by statute) ☐ Absolute or relative contractual interest rate ceilings (fixed by court rulings) ☐ Capped default interest rates ☐ Laws designed to prevent exploitation and unfair competition with effects on credit cost ☐ Restrictions on the compounding of interest ☐ Restrictions on the variability of variable interest rates ☐ Other forms of restrictions to the level or rate of interest including moral consensus ☐ Anti-Trust regulation or laws designed to improve levels of competition ☐ Regulations concerning early repayment fees Please give detail:
1.6	To what extent are interest rates regulated?	Scale: 1 (not at all regulated) to 5 (very significantly regulated) Select Please give detail:
	If IRR in the form of ceilings exist in your country, please comment on the following:	
1.7	What were the reasons for introducing controls on the cost of credit?	
1.8	To what extent are those reasons still valid?	
1.9	What were the reasons for choosing the particular form of the restriction and the level at which the ceiling was set?	
	If IRR in the form of ceilings do NOT exist in your country, please comment on the following:	
1.10	What policy concerns have contributed to the decision not to introduce ceilings and what alternative controls on the cost of credit exist?	

1.11	Are there any plans to review the position on the introduction of ceilings?	☐ Yes ☐ No ☐ Don't know Please mention any circumstances or criteria identified, which if satisfied, could lead to a change in policy:
	If IRR do NOT exist in your country, please skip the next 6 questions and [go to Question 1.18]	
1.12	Have consumers benefited from the introduction/retention of interest rate ceilings?	☐ Yes ☐ No ☐ Don't know Please give details and mention whether consumers are sufficiently aware of the existence of the IRR:
1.13	How easily have credit providers circumvented the interest rate restriction rules mentioned?	Scale: 1 (not at all) to 5 (very easily) Select Please give detail (eg. on compliance in case of IRR in the form of a ceiling):
1.14	To what extent are the interest rate restrictions effective ?	Scale: 1 (not at all) to 5 (very significantly effective) Select Please give detail:
1.15	What are the compliance costs of the different forms of IRR? Has a regulatory impact assessment been conducted?	
1.16	To what extent is compliance with the IRR monitored by the regulator?	Scale: 1 (not at all) to 5 (very closely monitored) Select Please give detail (eg. on steps that regulatory agencies take to monitor compliance and/or to enforce the IRR):
1.17	If IRR in the form of ceilings, has experience with the ceiling demonstrated any loopholes or other practical problems with the legislation? What steps have been taken to address these issues?	
1.18	What changes to the current IRR regulatory apparatus would you suggest to improve the effectiveness of existing IRR?	

1.19	What have you learnt from experience in other EU Member States and other countries that have introduced IRR (caps or other controls)?																			
	Imagine a country with <u>no IRR</u> at all. If interest rate restrictions were introduced and effective and set at...																			
1.20	...a level that was double the average of the interest rates offered on the entire credit market (ie. set at 200% above the average calculated price for all credit products in a previous period)...																			
		<table border="1"> <thead> <tr> <th></th> <th>for average consumers?</th> <th>for the low-income consumers?</th> </tr> </thead> <tbody> <tr> <td>....access to credit would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>....cost of credit would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>....over-indebtedness would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>....variety of products would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>.... the number of individuals resorting to the illegal credit market would</td> <td>Select</td> <td>Select</td> </tr> </tbody> </table>		for average consumers?	for the low-income consumers?	access to credit would	Select	Select	cost of credit would	Select	Select	over-indebtedness would	Select	Select	variety of products would	Select	Select	 the number of individuals resorting to the illegal credit market would	Select	Select
	for average consumers?	for the low-income consumers?																		
....access to credit would	Select	Select																		
....cost of credit would	Select	Select																		
....over-indebtedness would	Select	Select																		
....variety of products would	Select	Select																		
.... the number of individuals resorting to the illegal credit market would	Select	Select																		
1.21	...a level that was fixed at 30% APR for all credits...																			
		<table border="1"> <thead> <tr> <th></th> <th>for average consumers?</th> <th>for the low-income consumers?</th> </tr> </thead> <tbody> <tr> <td>....access to credit would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>....cost of credit would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>....over-indebtedness would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>....variety of products would</td> <td>Select</td> <td>Select</td> </tr> <tr> <td>.... the number of individuals resorting to the illegal credit market would</td> <td>Select</td> <td>Select</td> </tr> </tbody> </table>		for average consumers?	for the low-income consumers?	access to credit would	Select	Select	cost of credit would	Select	Select	over-indebtedness would	Select	Select	variety of products would	Select	Select	 the number of individuals resorting to the illegal credit market would	Select	Select
	for average consumers?	for the low-income consumers?																		
....access to credit would	Select	Select																		
....cost of credit would	Select	Select																		
....over-indebtedness would	Select	Select																		
....variety of products would	Select	Select																		
.... the number of individuals resorting to the illegal credit market would	Select	Select																		
	Please elaborate on each of your answers here:																			
1.22	Which credit forms/types/products would especially be affected by interest rate restrictions in that hypothetical country?																			
		<table border="1"> <thead> <tr> <th></th> <th>for average consumers?</th> <th>for the low-income consumers?</th> </tr> </thead> <tbody> <tr> <td>Mortgages (for property purchase)</td> <td>☐</td> <td>☐</td> </tr> <tr> <td>2nd charge mortgages (for consumption)</td> <td>☐</td> <td>☐</td> </tr> </tbody> </table>		for average consumers?	for the low-income consumers?	Mortgages (for property purchase)	☐	☐	2 nd charge mortgages (for consumption)	☐	☐									
	for average consumers?	for the low-income consumers?																		
Mortgages (for property purchase)	☐	☐																		
2 nd charge mortgages (for consumption)	☐	☐																		

	Auto/vehicle loans	☐	☐	
	Other personal loans	☐	☐	
	Other point-of-sale/mail-order loans	☐	☐	
	Overdraft facilities	☐	☐	
	Credit card credit	☐	☐	
	Pawnbroker loans	☐	☐	
	Home (collected) loans	☐	☐	
	SMS loans contracted at a distance	☐	☐	
	Payday loans	☐	☐	
	Other:	☐	☐	
	Other:	☐	☐	
	Please elaborate on each of your answers here:			
1.23	Which of the following regulatory activities would have the most pronounced effects on the four desired outcomes shown below? [Scale: 0 (the opposite effect) to 5 (very strong effect)]			
	Reduced level of over-indebtedness	Reduced cost of credit	Improved credit access	Wider variety of credit products
Interest rate restrictions	Select	Select	Select	Select
Tighter responsible lending requirements (<i>in general</i>)	Select	Select	Select	Select
Regulations to limit rolling over/consolidating existing credit	Select	Select	Select	Select
Strengthening of disclosure obligations	Select	Select	Select	Select
Regulation on personal bankruptcy (<i>in general</i>)	Select	Select	Select	Select

	<i>More specifically: to make insolvency easier</i>	Select	Select	Select	Select
	<i>More specifically: to enable earlier discharge</i>	Select	Select	Select	Select
	Please elaborate on each of your answers here:				
1.24	How would you describe the adequacy of the actual level of regulation of IRR faced by the following different credit forms/types/products <u>in your country</u> ?				
	Mortgages (for property purchase)	Select			
	2 nd charge mortgages (for consumption)	Select			
	Auto/vehicle loans	Select			
	Other personal loans	Select			
	Other point-of-sale/mail-order loans	Select			
	Overdraft facilities	Select			
	Credit card credit	Select			
	Pawnbroker loans	Select			
	Home (collected) loans	Select			
	SMS loans contracted at a distance	Select			
	Payday loans	Select			
	Others:	Select			
	Others:	Select			
	Please elaborate and identify specific products here:				
1.25	How would you describe the adequacy of the actual level of regulation of IRR faced by the following types of credit institutions?				
	Banks	Select			
	Non-bank lenders	Select			

	Finance companies/mortgage specialists	Select
	Moneylenders and payday lenders	Select
	Home credit (collected at home)	Select
	Others:	Select
	Please elaborate:	
1.26	With regard to IRR in your country, are you in favour of IRR? How important is this regulation?	
	Interest rates should be capped.	☐ Yes, the regulation is Select. ☐ No, the deregulation is Select. ☐ Don't know. Please give reasons why/why not:
	Variability of interest rates in variable rate credit contracts should be regulated.	☐ Yes, the regulation is Select. ☐ No, the deregulation is Select. ☐ Don't know. Please give reasons why/why not:
	Default interest should be capped.	☐ Yes, the regulation is Select. ☐ No, the deregulation is Select. ☐ Don't know. Please give reasons why/why not:
	Level of fees and charges should be regulated.	☐ Yes, the regulation is Select. ☐ No, the deregulation is Select. ☐ Don't know. Please give reasons why/why not:
1.27	If controls are to be introduced or retained, what do you think would make for an effective regime? Eg. what form should such controls take and at what level should ceilings be set?	

1.28	Should caps be fixed or floating ?	☐ Fixed ceiling ☐ Floating ceiling ☐ Neither Please explain:
1.29	Should caps differ according to type of loan ?	☐ Different ceiling levels ☐ One unique level Please explain:
1.30	To what extent should fees and charges be included in the cap?	☐ Borrowing rate ☐ APR ☐ Other Please explain:
1.31	How have regulations of the unfair terms in consumer contract (as per Directive 2005/29/EC on Unfair Commercial Practices) been used to control high cost credit and default charges?	[Please mention if there have been any problems]
1.32	Where controls exist in court based rules concerning unfairness more generally, are the rules sufficiently clear and how have courts implemented these? Is there evidence that courts have been willing to intervene to limit the cost of credit?	[Please provide citations for key cases where possible]
1.33	Are there any regulatory actions you can think of which would increase levels of access to credit for low income consumers?	
1.34	What are the regulatory measures currently being planned with regards to consumer credit regulation?	
1.35	Are there any regulatory actions you can think of which would limit future levels of over-indebtedness ?	
1.36	Micro credit: Are there special regulations with regard to micro-lending which set interest rate restrictions or gives relief from it? (please give details)	
PART B: Over- Indebtedness		
2.1	Do you think that private over-indebtedness is a problem in your country?	[See definition on page 2] ☐ Yes, it is a Select problem. ☐ No ☐ Don't know Please explain:

2.2	Do you think that this problem has improved or worsened over the last five years?	Select Please explain:
2.3	Are there any statistics regarding over-indebtedness of private households?	☐ Yes ☐ No ☐ Don't know If yes, please provide a link to such data:
2.4	In your view, what are the main driving forces behind over-indebtedness ?	
2.5	Which of the following changes have occurred within the last three years? How have they influenced over-indebtedness?	
	Aspects	Evolution Influence on over-indebtedness
	Situation of the labour market	Select Select
	Level of financial literacy/competence	Select Select
	Standards of "responsible lending"	Select Select
	Access to credit for vulnerable consumers	Select Select
	Prices of real estate property	Select Select
	Entry of new providers in the credit market	Select Select
	New insolvency legislation	Select Select
	Consumer propensity of demand	Select Select
	Level of restrictiveness of IRR rules	Select Select
	Please elaborate on each of your answers here:	
PART C: Access		
3.1	How would you describe the following aspects of the level of credit access	
	Access to...	...for average consumers? ...for low-income consumers?
	 banking services in general	Select Select
	 mortgage credit (for property purchase)	Select Select
	 mortgage credit (for consumption)	Select Select
	 non-mortgage consumer credit	Select Select
	 credit card credit	Select Select
	 overdraft credit	Select Select

	 credit provided by non-banks (retail, leasing, moneylenders, pawnbrokers etc.)	Select	Select
	Please elaborate on each of your answers here:		
3.2	In your view, should low-income borrowers be given any greater access to credit than they are given at present?	☐ Yes ☐ No ☐ Don't know Please give reasons why/why not:	
3.3	If yes, to which forms of credit?	☐ Mortgages (for property purchase) ☐ 2 nd charge mortgages (for consumption) ☐ Auto/vehicle loans ☐ Other personal loans ☐ Other point-of-sale/mail-order loans ☐ Overdraft facilities ☐ Credit card credit ☐ Pawnbroker loans ☐ Home collected loans ☐ SMS loans ☐ Payday loans ☐ Others:	
3.4	If IRR in the form of a ceiling exists in your country, is there evidence that low-income consumers have been excluded from the credit market following the introduction of this ceiling? (If so, please tell us whether or not this is a deliberate policy intention or an unintended effect)	When answering, please give details on the availability of credit options and extent to which consumers have turned to illegal lenders:	
3.5	What kind of political and legal discussions are presently ongoing to make credit more affordable ?		
3.6	Is affordability a concept in your legislative or regulatory frameworks?	☐ Yes ☐ No ☐ Don't know Please give details:	
PART D: Credit Markets			

	Other personal loans						
	Other point-of-sale/mail-order loans						
	Overdraft facilities						
	Credit card credit						
	Pawnbroker loans						
	Home (collected) loans						
	SMS loans						
	Payday loans						
	Others:						
	Others:						
Please elaborate on each of your answers here:							
4.3	How would you assess the different credit forms/types/products with regard to the attributes/market features below: [From a scale of 1 (insignificant) to 5 (very significant)]						
		Incidence of high cost credit 1 2 3 4 5	Incidence of consumer debt problems 1 2 3 4 5	Transparency of pricing 1 2 3 4 5			
	Mortgages (for property purchase)	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐			
	2 nd charge mortgages (consumption)	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐			
	Auto/vehicle loans	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐			
	Other personal loans	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐			

	Other point-of-sale/mail-order loans	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Overdraft facilities	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Credit card credit	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Pawnbroker loans	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Home (collected) loans	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	SMS loans contracted at a distance	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Payday loans	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Others:	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Others:	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐	☐ ☐ ☐ ☐ ☐
	Please elaborate and identify specific products here:			
4.4	Is there a need for controls on the cost of credit to protect low income and vulnerable consumers?	☐ Yes ☐ No ☐ Don't know Please give reasons why/why not:		
4.5	Which type of credit cards are commonly held by consumers?	[See definitions on page 2] ☐ Mostly single function cards (eg. debit cards) ☐ Mostly double function cards (ie. used as a payment device <u>and</u> as a source of credit) ☐ Both types of credit cards are equally common (single and double function credit cards) ☐ Credit cards are not popular at all ☐ Don't know Comments:		
4.6	Do you see a trend towards using credit cards as a regular source of credit (ie. increased use made of the credit facility of the double function card)?	Select Please explain:		

4.7	How would you describe the presence of an illegal market in lending money to low-income households?	Select Comments:	
4.8	What is the importance of the different credit markets ? (in EUR/local currency and % of total lending activities if possible)	[See definitions on page 2; From a scale of 0 (non-existent) to 5 (very significant)] Mainstream lending (typical bank loans and non-bank credit): Select Alternative lending (higher cost small credit): Select Community/informal lending (family, social banks, welfare): Select Illegal lending: Select Please give detail and specify source or basis for any figures or estimates:	
4.9	In general would you say that your country's credit markets are price competitive ?	Scale: 1 (not competitive) to 5 (very highly competitive): Select Please give details (see also next two questions):	
4.10	Have you observed problems in specific sub-markets?	☐ Yes, ☐ No. ☐ Don't know. Please give details:	
4.11	Have you observed examples of sales practices which appear designed to make it more difficult for price competition to operate?	☐ Yes, ☐ No. ☐ Don't know. Please give details:	
4.12	Did you notice a trend in consumer credit business with respect to any of the following areas in the period 2002 to 2007 and since 2008?		
		... before the financial crisis (2002–2007)	... after the financial crisis (from 2008)
	Level of interest rates	Select	Select
	Use of fees outside the scope of the APR calculation	Select	Select
	Use of default charges	Select	Select
	Cross selling of ancillary products (eg. insurance)	Select	Select
	Productivity within firms	Select	Select
	Costs of operation, including capital	Select	Select

	Volume of consumer credit (incl. mortgages, and from all sources)	Select	Select
	Refusal rates for consumer credit applications	Select	Select
	Credit defaults by private households	Select	Select
	Please elaborate and explain what you think were the main causes of the trends mentioned:		
4.13	How would you describe the level of the following:		
		...for average consumers?	...for low-income consumers?
	Understanding of consumer credit products	Select	Select
	Level of financial literacy	Select	Select
	Credit options available to choose from	Select	Select
	Please elaborate here:		
4.14	In your view, how important are the factors below as barriers to the cross-border provision of consumer credit in the EU? [From a scale from 1 (not at all) to 5 (very significant)]		
	Different language	Select	
	Different currency	Select	
	Different approach to consumer protection	Select	
	Lack of information about the customer	Select	
	Consumer preference for local creditors	Select	
	Different legal frameworks for debt recovery	Select	
	Interest rate restrictions (incl. restrictions on fees)	Select	
	Extra costs of doing business abroad unrelated to those above	Select	
	Other factor:	Select	
	Please elaborate here:		

Annex XI: Tables of stakeholder responses

The tables with stakeholder answers to some of the survey questions are provided as illustrative examples of stakeholder responses. Not all answers have been reproduced.

Selection 1: “Has the role of IRR been discussed among regulators, providers or consumer organisations in your country in the past five years?” and “Are you aware of studies that have been undertaken regarding IRR?” (SQ 1.1 and 1.2)

MS	Level of discussion	Details	Studies on IRR exist
AT	Somewhat discussed	Currently concerns regulation of default interest rates only.	Yes but restricted to default interest.
BE	Somewhat discussed	By parliament (Conseil de la Consommation) and at several meetings with representatives of the financial institutions, the government and the consumer organisations.	Révision du mode de fixation des taux annuels effectifs globaux en matière de crédit à la consommation (2006) at http://statbel.fgov.be/fr/binaries/354_tcm326-41864.pdf .
BG	Somewhat discussed	After the financial crisis the banks raised the rates and the consumers were not happy as they had to pay more, and some media reports on usury within the illegal sector.	Yes
CY	Somewhat discussed	A usury bill (not involving ceilings) has been drafted and IRR was discussed ahead of the CCD transposition set for October 2010.	Yes (a central bank study compared ceilings in different EU Member States incl. Malta)
CZ	Intensively discussed	A draft aimed at introducing IRR was raised by a group of MPs in the lower Chamber of the Czech Parliament ahead of the elections but proposals were not put to vote. The draft was not supported by the Government. Drafting of CCD implementation brought the matter into discussions.	Ministry of the Interior of the Czech Republic - Prevention of indebtedness study. Some criticise that the draft laws were proposed without any data based studies. A report was also published by the Liberalni Institut (Schwartz, 2007) see http://www.responsible-credit.net/index.php?id=1980&viewid=45753 .
DK	Intensively discussed	Discussed in connection with implementation of the CCD 2008. A proposal from the Danish opposition parties of a ceiling of aprox. 17% APRC was rejected.	The Ministry of Economy and Commerce are currently undertaking a study of the market for consumer loans as a part of the discussion of IRR. Such a cap has been proposed by different political parties in parliament, but so far without a majority of MEP's behind it. As a result the government established a ministerial working group in the beginning of 2009 that were to analyze the effect of APR-ceilings in other countries and publish a report by the end of 2009. The report has not yet been published and is expected in the Summer of 2010, but was influential in implementation of the CCD 2008 as many problems were postponed to the publication of the report.

EE	Somewhat discussed	The discussions have mostly focused on problems with micro credit (especially SMS-loans) with an extremely high APRC.	No study, but a legal article "Protection of Consumer Rights in SMS Loan Agreements" (in English) was published in the European Review of Private Law 2010 (18) by K.Saare, K.Sein, M.A. Simovart. See http://www.responsible-credit.net/index.php?id=1980&viewid=45754
FI	Somewhat discussed	The introduction of IRR has been discussed due to problems relating to increase of SMS loans and the issue has been raised by the consumer ombudsman. However, at least for the time being other regulatory options to reduce problems have been chosen.	No. Though reports in the 1980ies on the subject were made.
FR	Intensively discussed	During the 2 years of debates on the bill concerning the credit reform, the role of IRR has been strongly discussed. Principalement à deux occasions : 1) Les difficultés éprouvées par les accédants ayant souscrit des prêts au logement à taux variables dont ils n'avaient pas compris les clauses de révision 2) Pour une réforme des taux d'usure en crédit à la consommation. Although the modalities of fixing the ceiling and the credit categories were discussed (with changes made by parliament in 2010), the principle of IRR was never questioned. This subject has been discussed in 2010 during household overdebtedness bill and a government report about bank charges which is going to be published may also mention this subject.	Rapport sur les modalités de fixation du taux de l'usure", General Inspectorate of Finance & General Inspectorate of Social Affairs, February 2009. See http://www.responsible-credit.net/index.php?id=1980&viewid=45728
DE	Somewhat discussed	In the context of statistical changes to reported data due the change in competence from the Bundesbank to the European Central Bank	No, at least not specifically. Only the statistics problems discussed on the new ceiling of usury after court chosen indicator ceased to be published by Bundesbank. See the report by the Bundesbank concerning the change in statistics and the Report on its implications by Hartmann-Wendels/Spörk in 2006. See: http://www.responsible-credit.net/index.php?id=1980&viewid=45755
GR	Not at all discussed	n.a.	No
HU	Somewhat discussed	Interested in experience of EU peers.	Yes
IE	Not at all discussed	n.a.	No
IT	Somewhat discussed	Debate has been going on in connection with the reform of Italian Usury Law	No
LV	Not at all discussed	n.a.	No

LT	Somewhat discussed	The question of IRR is usually raised during various discussions.	No
LU	Not at all discussed	n.a.	No
MT	Not at all discussed	n.a.	No
NL	Somewhat discussed	The maximum interest rate has been lowered in 2006 and 2009. The Netherlands has IRR on consumer credit only (not on mortgage credit). The level has been subject of discussion. Loans with a duration shorter than 3 months had initially been exempt, but will be covered by the restrictions later in 2010.	A study on SMS-credit and pawn-brokers was done in 2009. See Report from "Research voor beleid". http://www.responsible-credit.net/index.php?id=1980&viewid=45753 .
PL	Somewhat discussed	IRR were introduced in Poland in 2006 following an intensive debate. Before the maximum percentage, tests were conducted mainly by representatives of the banks. Since the adoption of the regulation the issue has not been widely discussed, although the government had plans to amend the present regulations in 2010.	KPF commissioned a study evaluating the impact IRR have had on the market. The report was published in March 2009 (English translation available). A barometer Rynku Consumer Finance (BAROMETR KPF-IRG) has also been published (see http://kpf.pl/raporty/barometr-kpfirg/)
PT	Intensively discussed	A legal document has been adopted (Decreto-Lei nº 133/2009, de 2 de Junho) which establishes a ceiling for interest rates in consumer credit (personal loans; auto loans; credit cards; etc.). There has been some legal uncertainty regarding the way the ceilings were introduced, some debate is expected.	No
RO	Not at all discussed	n.a.	No
SK	Intensively discussed	Public discussion is high due to recent introduction and debate following this.	Ministry of Finance internal analyses on credit market in 2008. A report was also published by the Hayek Foundation see http://www.responsible-credit.net/index.php?id=1980&viewid=45753
SI	Somewhat discussed	Draft Act amending the Consumer Credit Act (issued in the Slovenian Official Gazette No. 77/2004 and 111/2007). IRR for non-banking credit providers have been introduced in Slovenia before. The discussions in the last 5 years have focused around how to make the IRR more effective and prevent evasion.	No
ES	Somewhat discussed	Mostly in the context of floors to variable mortgage credit, but also due to planned changes in existing IRR on overdrafts.	No

SE	Somewhat discussed	Interest rates on SMS -loans have led to some discussions	No
UK	Intensively discussed	Previously considered by the government and ruled out in 2004. The discussions are focussed on the consumer credit industry and there hasn't been an active discussion in the context of mortgages. There has been consistent lobbying for interest rate controls over many years and opponents of IRR and the Government have dismissed the views that consumer benefits could outweigh consumer detriment.	Most have been Government sponsored studies. The Policis study "Interest Rate Controls in other Countries" for the Department of Trade and Industry in 2004 and the study on the effects of interest rates have been disseminated world-wide. More recently, the issue was referenced within the Report by the Financial Inclusion Taskforce on Access to affordable credit (2010) and the OFT study on High Cost Consumer Credit (2010). A further study was conducted in 2010 by the New Economics Foundation (Doorstep Robbery) which provided counterbalancing findings compared to the 2004 report mandated by the Government. We are not aware of studies in regard to mortgages, or of any plans to undertake such studies.

Note: Discussions at the EU level on these issues were reported by several respondents with regard to the EU level and the Study on mortgage policy options which although focused more on mortgage markets in general, nevertheless concerned in parts the issue of IRR and was discussed in some detail. Regarding the fourth column on IRR studies, though not all empirically based, studies on interest rate restrictions have been made in 11 Member States and these have been taken into account in this report for the European Commission. Of these 11 Member States, the Czech Republic and the UK appear to be the only countries without an interest rate ceiling that have done some research into IRR. Italy is the Member State that particularly stands out by the fact that it is a major country with ceilings in place which does not appear to have produced a report on the issue (made publicly available in any case).

Selection 2: "To what extent are interest rates regulated?" (SQ 1.6)

MS	Extent of IRR regulation	Comments and distinguishing features
Belgium	4 - significantly	Ceilings but also limits to the authorised changes in interest rates sold at variable rates
Cyprus	2 - very little	Only the compounding of interest rate is regulated. The Cyprus legal environment is characterized by liberalization of interest rates and usury is not qualified as a criminal offence. A usury bill has been drafted to change this leading up to the transposition of the CCD which is expected to be transposed into national Law in October 2010.
Czech Republic	2 - very little	Judgements by court rulings based on breach of good morals cover all types of interest rates. Though the Supreme Court ruled that the interest rate 4 times higher than usual interest rate offered by banks is in violation of good morals, court rulings are not generally binding and as such regulation through the consideration by courts is not seen to be exercising significant control. Interest rates are regulated in some specific areas, such as building savings where a relative ceiling exists that limits loans from exceeding the maximum rate on deposits by 3 percentage points. The only way of direct regulation is related to the late payments or default interest rates.

Denmark	2 - very little	Current provisions have no effect. Loans with APR's of 40-50-60% and SMS-loans with APR's of several thousand percent exist. Regarding the interest all credit agreements are covered by the Danish criminal code (the usury restrictions). Apart from short-term credits (less than 3 months) and certain credit buys of securities all consumer credit agreements have to comply with the consumer credit agreement act. Accordingly the lenders have to give certain information on the credit. (For credits lower than EUR 200 (DKK 1,500), there is no legal obligation for the credit provider to give such credit information). Furthermore any agreement (credit or otherwise) has to comply with the regulation in the Danish agreement act, which contains provisions regarding unfairness etc. If the interest rate is considered flagrantly unfair (by the courts or by the complaint boards) it can be overridden. Distance selling and agreements entered outside the usual place of business of the supplier are covered by the Danish act on certain consumer agreements.
Estonia	3 - partly	According to Estonian Civil Law Act § 86(4) the consumer credit contract is void when cost of the credit is more than three times higher than average credit cost, published periodically by central bank. Restrictions mainly apply to consumer credit. (But we would like to point out that the scope of consumer credit regulation is broader than the scope provided in art 2 of Directive 2008/48 and art 2 of Directive 87/102. For example consumer credit regulation applies also to mortgage credit and micro credit.)
Finland	3 - partly	Default interest rates are regulated in detail, contractual interest rates are not.
France	4 - significantly	The legal usury rate is not an absolute ceiling but varies with the average APR measured from the market. Therefore, the level of interest rates is only regulated in so far as a money-lender would like to exceed the market average by more than 33%. Also, it reduces the speed of an increase in interest rates, but does not entirely prevent it. Also significant are the penal sanctions involved and the long experience with administration of ceilings by the central bank. The rest of the regulations that affect interest rates indirectly are mainly designed to protect consumers from insufficient information and understanding of credit products. All in all, the strongest restriction to the level of interest rates is the competition between banks, whose strategy is to use mortgage loans as a loss leader. The legal usury rate is probably more of a constraint for consumption credit.
Germany	4 - significantly	A number of strict regulations apply as well as further rules on missing or inadequate statement of credit costs.
Greece	3 - partly	Pricing of the banking services and products are not regulated.
Ireland	2 - very little	Although there are some ceilings in place (Credit Unions and money lenders) these are not extensive.
Italy	4 - significantly	The ceiling applies to the APR and is comprehensive of all commissions and expenses (excluding taxes). The ceiling is based on provider offered rates on the market and not regulated through exogenous sources. Some respondents argue that Italy has only partial regulation because the regulator only sets the threshold beyond which rates are considered usurious and does not control them as such.

Latvia	2 - very little	Interest according to Art.1753 of the Civil Law is defined as compensation to be given for granting use of, or for lateness relating to a sum of money or other fungible property, proportionate to the amount and the duration of use thereof. Therefore it is assumed that interest should be proportionate to the amount of money borrowed and time of contract. In addition to this, Cabinet regulations No.692 Regulations Regarding Consumer Credit Agreement state, that a consumer has a duty to pay only the payments indicated in the credit agreement as well as consumer has a duty to pay interest and other charges only for the time period up to which the consumer has settled his or her credit obligations. This limits percentage rates to the amounts that are stated in the credit agreement.
Malta	2 - very little	Effectively the ceilings that exist do not apply and the regulation is thus very weak.
Netherlands	4 - significantly	The maximum interest rate concerns all consumer credit but not mortgage credit. However the exogenous method of fixation of the level means that regulation can be constraining for a sustained period of time.
Poland	4 - significantly	The ceiling based on an exogenous source affects all consumer credits and is accompanied by regulation of other costs of consumer credit (excluding the interest rate, collateral and premium for insurance coverage) which cannot be higher than 5% of the credit amount.
Portugal	4 - significantly	The law sets ceilings for specific credit contracts differentiating by type (normal, car or credit card). Definitions based on the purpose of the credit could regulate the market even more significantly.
Slovakia	3 - partly	Ceilings affect consumer credit only.
Slovenia	4 - significantly	Verbraucher Kreditgesetz: Der effektive Jahreszinssatz in den zwischen den Verbrauchern und Nichtbanken abgeschlossenen Kreditverträgen darf nicht 200% des zuletzt seitens der Slowenischen Zentralbank veröffentlichten durchschnittlichen effektiven Jahreszinssatzes für Verbraucherkredite überschreiten. Der durchschnittliche effektive Jahreszinssatz für Verbraucherkredite wird seitens der Slowenischen Zentralbank ermittelt und zweimal jährlich veröffentlicht.
Spain	2 - very little	Only overdrafts face ceilings limited to 2.5 times the legal interest rate, this may change as a result of transposition of the CCD. In addition, there are some court ruling applying the anti-usury law and others which apply this 2.5 times limit to other forms of credit by analogy, therefore IRR is somewhat regulated.
UK	2 - very little	Although credit unions may face a ceiling and store cards may be subject to a ceiling of some form in the future, it has not been deemed necessary to regulate interest rates in the UK. Mortgage regulation especially does not directly address the level of the interest rate charged. The CCA does define the total cost of the credit to the consumer which includes all mandatory fees. It also governs the calculations of APRs as does the CCD 2008. The UK consumer credit market is highly competitive which in turn generates intense competition on interest rates charged. Consumer behaviour demonstrates that customers are willing to shop around on a regular basis to benefit from lower interest rates charged by other lenders. Although rates per se are not specifically regulated there are provisions to deal with unfair relationships, unfair terms and competition failures.

Note: Scale for answers ranged from 1 (not at all regulated) to 5 (very significantly regulated).

Selection 3: Some answers to the question: "What policy concerns have contributed to the decision not to introduce ceilings and what alternative controls on the cost of credit exist?" (SQ 1.10)

Member State	Stakeholder	Reasons for <u>not</u> introducing ceilings
MS with no plans to review IRR position		
Bulgaria	Public Authority	The main policy concern was the potential distortion of the free market principles in pricing credit products by banks. The risk premium over the market interest rates, charged by banks, is calculated on the basis of the current economic situation and reflects the credit quality of the customers. If there is IR ceiling, quite significant amount of bad" customers would be charged with administrative rate, which is lower than the rate they will pay if no IR ceiling existed. This would eventually lead to unfair treatment of good customers, which repay their debts but still are charged with interest rate closer to the administrative one. Another major policy concern was, that the practise evidences that banks will transfer the final effect of the decreased rates to customers in form of additional hidden taxes and penalty fares.
Cyprus	Public Authority	The Law Regulating the Liberalisation of the Interest Rate and Related Matters was issued in 1999 in order to abolish the existing ceiling on lending interest rate with the aim to promote free competition.
Finland	Public Authority	Reasons not to introduce ceilings relate mainly to fear that vulnerable consumers would fall outside the normal credit market and a black market would emerge.
Germany	Consumer Organisation	A main objection is the general attitude that price are to be influenced by the market not the law. Rules and court rules on fees can always refer to inadequate and one-sided influence on pricing, which market rules do not do or do not adequately apply.
Hungary	Public Authority	Professional viewpoint was not to introduce IRR because the interest rate would have gathered around the maximum amount (as is observed with capping of early repayment fee).
Latvia	Public Authority	Latvia has so far stuck to approach of market self-regulated interest rates accompanied with requirements to give clear information on rates to consumer in advertising and contracts. Until present no need to control interest rates by stating ceilings has been discovered. Cost of credit is not presently controlled, but information on costs has to be clearly provided to consumer.
Lithuania	Other	The loan market is comparably new in Lithuania so it is poorly regulated. There was no common consensus to impose IRR.
Luxembourg	Public Authority	Loans are granted to consumers almost exclusively by a limited number of well-known banks. The problem of charging excessive interest rates has not materialised in these cases. Therefore the need was not felt to introduce IRR.
Malta	Public Authority	The decision to lift IRR on credit and financial institutions was implemented by way of a provision in the central bank legislation in 2002 and while this was subsequently removed, it has been inserted by way of secondary legislation in 2009 through the Interest Rate (Exemption) Regulations L.N. 142 of 2009.
Romania	Provider Association	Ceilings have not been introduced in commercial agreements because they could restrict access to credit and financial inclusion. There are also concerns that such introduction will damage the broader economy by limiting consumer spending, as has happened in Japan.
Spain	Public Authority	Credit institutions should compete freely under transparent market conditions.

MS with plans to review IRR position		
Czech Republic	Provider Associations	Establishment of ceilings will not lead to usury extermination. Legal bans do not prevent subjects/entities willing to behave in such a way from usury and any other kind of immoral behaviour in general. Effective supervision over the entire credit market and appropriate enforcement of existing regulation on the national level would do the trick. Restrictions of access to credit, financial inclusion. Concerns that it will damage broader economy by limiting consumer spending, as has happened in Japan. Drive up illegal lending, loan sharks, personal security issues, credit into non taxable environments.
Czech Republic	Consumer Organisation	There is lack of interest of the lawmakers. Recently a bill aimed at setting the ceilings was proposed, but the Parliament did not manage to discuss it before the elections.
Czech Republic	Public Authority	Mainly contractual freedom - interest rate represents the risk a credit provider is taking when granting a credit. A well informed debtor could be thus prevented from being granted a credit, even when the interest rate would be appropriate to the risk. Ceilings also give way to black economy. Credit providers usually find other means to maintain the level of profit which is not less burdening to debtor than a high interest rate. We have evidence that the regulation in Slovakia is evaded.
Czech Republic	Other	Czech society used to be relatively low-stratified. There was not strong need of introduction of instruments of this kind. The current attempts to introduce the ceilings are related to significant increase of over-indebtedness and debt traps.
Denmark	Provider Association	The consumer is all ready protected to a very large scale eg. pre-contractual information requirements, right of withdrawal, the concept of responsible lending where the creditor should asses the consumers ability to pay down the loan. Interest rate ceilings will not ensure that consumers are not becoming over-indebted but can instead lead to consumers taken bigger/longer running loans than they need so that APRC is legal. Interest rate ceilings might lead to exclusion of some consumers from the regulated lending market and may push them out on the non-regulated lending market. Interest rate ceiling can be counterproductive for the competition among lenders - the ceiling can be seemed as a signal to the market to use a rate just below the fixed rate.
Denmark	Consumer Organisation	Two main arguments were used by opponents to APR-ceilings: 1) An APR-ceiling will become the price-norm and thus drive up APR's on cheaper loans 2) an APR-ceiling will lead to financial exclusion - poor people will no longer be able to get loans when a high risk premium can no longer be included in the interest rate. In effect there are no alternative controls on the cost of credit.

United Kingdom	Consumer Organisation	Decision not to back calls from some consumer groups for an interest rate ceiling in the UK include: - Interest rate ceilings would possibly lead to a reduction in access to credit for some borrowers. There is some evidence to suggest that this could create a welfare loss as consumers face reduced options for income smoothing/absorbing income shocks; - There is also a concern that a rate ceiling would merely lead lower income consumers to migrate to other forms of credit or para credit (mail order goods, buy back stores) or take more credit requiring security, which may not be suitable for needs and which creates a different risk exposure; - At the extreme is the fear that some consumers may resort to illegal lenders (loan sharks); - Arguments that rate caps would have any significant effect on over-indebtedness in the UK are not convincing. The sort of high cost credit likely to be covered by a rate cap only accounts for around 5-10 per cent of the credit debts. Instead, the significant challenge for tackling over-indebtedness in the UK is to ensure responsible lending practices by mainstream lenders whose agreements make up the large bulk of the debt problems; - UK rate cap advocates have argued that such a policy is needed to protect the poorest and most vulnerable consumers from falling into a cycle of debt dependency using high cost credit. While this is a problem, a rate cap alone may not resolve the issue, given the underlying problem of poverty and the issues raised above on money management and migration to possibly more expensive alternatives. Evidence that the supply of alternative low-cost third sector credit (credit unions) is currently sufficient to pick up the slack is not convincing. Any rate cap policy would have to be accompanied by a policy of ensuring low income households have better access to credit at mainstream (or near mainstream) rates - this is after all the main hoped for policy outcome of a rate cap. There is scepticism that a rate cap that focuses on APR's will be effective, given that these are a poor cost comparator. Equally a rate cap that focuses on borrowing rates is not likely to be effective unless default charges are taken into account. For instance overdraft credit can be by far the most expensive credit product in the UK because of the structure of default charges, but the borrowing rates are relatively low compared to possible substitutes (such as payday lending). As a result a rate cap policy is not seen as the most effective and pressing solution for the problems in UK credit markets.
United Kingdom	Provider Association	Lack of consumer choice, lack of consumer access to relevant credit products, financial exclusion, restriction of competition and the opening up of unregulated markets. The UK Office of Fair Trading notes [A report by Europe Economics for the Office of Fair Trading International research: Case studies on Ireland, Germany and the United States December 2009 OFT 1150b] that in Germany it difficult for anyone without a Schufa rating to obtain a loan. This has led to the development of small scale lending from outside Germany (mostly based in Switzerland) which is not regulated (Kredite ohne Schufa). This illustrates a feature which is also apparent in the USA. Where there is demand for credit but regulations seek to control the supply, whether through interest rate caps or behavioural controls, market operators will seek to find ways round the regulations in order to supply the unmet demand.
United Kingdom	Provider Association	Concerns that the introduction of ceilings would impact on consumer choice, lead to an increased risk of financial exclusion and limit market competition. Existing consumer credit legislation and protection is considered to provide a sufficiently robust framework.

United Kingdom	Public Authority	Relevant considerations include: 1) the availability of other regulatory tools; 2) the concern that imposing a single figure would adversely impact on the wide variety of lending forms currently available; and 3) the risk rates in the market will migrate towards any ceiling.
United Kingdom	Provider Association	The UK approach is to allow prices to be set by the market (which is competitive and open). There are a series of policy concerns that sit behind this: (a) research (eg. POLICIS [2004]) indicates that price caps can operate to exclude certain groups of borrowers from access to commercial credit market. The characteristics of these groups are (i) they only want (and can only afford) small amounts of credit and/or (ii) they may be somewhat higher-risk because they are having to work to tighter budgets; b) research (eg. POLICIS [2006]) has shown that consumers excluded in this way are much more likely to use illegal, unregulated sources of credit. Such illegal markets are not benign and debt recovery is routinely based on fear, intimidation and control. (c) rate caps restrict the diversity of credit products available to consumers (eg. Staten and Johnson [1995]; eg. POLICIS [2004]). This means that consumers may have to use products that are not suited to their needs (because they are the only ones on offer). For instance, a consumer having a pressing need for a £300 loan may have instead to borrow £1500 because that is the minimum loan available on the (rate-capped) market. In this type of case, borrowing more than is needed creates a greater risk of default (and the problems associated with it) for that person. (d) it is well-documented that rate caps cause the displacement of charges, to the detriment of consumers (eg. Staten and Johnson [1995]). So, for instance, the levels of (non-interest) charges payable if payments are missed tend to increase. The result is that consumers lose price transparency and consumers who (through no fault of their own) miss payments, can find that they are more heavily penalised and suffer increased detriment on top of the problems they already face. (e) rate caps also distort markets in another way by forcing more credit to be tied to the purchase of goods (eg. Staten and Johnson [1995]). If the credit charge (or part of it) is built into the cash cost of the goods, the price of those goods rises (coloured pricing). The eventual outcome (observed in US studies) is a two-tier retail system, which is, in effect, another form of price displacement. Consumers constrained by the price cap are forced to use those (higher-priced) stores or retailers willing to extend them credit on purchase of goods. In the meantime, those consumers who can access normal cash credit are able to drive much better bargains from a far wider range of stores.

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Selection 4: Some answers to the question: "What have you learnt from experience in other EU Member States and other countries that have introduced IRR?" (SQ 1.19)

MS	Stakeholder	Other EU lessons
Belgium	Provider Association	We learned that, compared to neighbouring countries, since the beginning of the nineties the Belgian legislator provided for a whole series of IRR which are stricter than in these countries. As a consequence, Belgian providers are suffering from competitive

		disadvantages compared to providers operating from a country with a less restrictive regulation.
Bulgaria	Public Authority	The main thing learnt is that the situation in every country is unique and it is not possible to directly copy&apply IRR policy of other EU member states, without taking into account the different macro- and micro- economic factors
Czech Republic	Provider Association	Such measures are always based on a variety of reasons - cultural, historical, economic, legal... Therefore the main lesson is never to assume partial knowledge without knowing the context. Regulating through the licensing regime was seen by provider respondents as appropriate, drawing on the experience of the UK. Another respondent said that other EU experience has provided evidence that the regulation is evaded (eg. in Slovakia). A further respondent mentioned that without social / municipal / guided lending there is an increased likelihood that a ceiling would cause consumers to turn to illegality without any redress.
Denmark	Consumer Organisation	Subprime lending is reduced, or non-existent. SMS-loans are not possible in a number of Member States. In Denmark, with no effective controls, there are major problems with high-cost consumer credit.
Estonia	Public Authority	While drafting the regulation, practices from Germany, France, Sweden, Netherlands etc. were scrutinized.
France	Other	Apparently the countries that have no regulations do not seem to complain.
Germany	Consumer Organisation	We have actually been asked by colleagues and member-states on our usury rules a couple of times. We have furthermore learned that price caps are more eagerly applied in other countries than here eg. with early repayment fees. We see that European law is only introducing the concept now.
Hungary	Consumer Organisation	In countries where there is a welfare state, IRR works, but in case of an emerging country, introducing caps or other controls meets difficulties.
Latvia	Public Authority	So far Latvia has not evaluated experience of other EU member states in relation to IRR, since there have been no plans to introduce IRR in Latvia. If decision will be taken to do so, other states experience will be evaluated in search for best practice that could be incorporated in the Latvian market.
Netherlands	Consumer Organisation	Most states have not these strict rules, which leads to room for different interpretations about what is "too high" for credit prices.
Poland	Provider Association	Regardless of their form IRR seem to cause a decrease in credit availability for particular consumer groups. The effectiveness of the ceiling much depends on the supervisory authority in charge.
Portugal	Consumer Organisation	The ceilings released show that the Portuguese pay interest on consumer credit three or four points above the average of other European countries. Take the example of France where the maximum rate of the cards in the third quarter of 2009 was set at 21.4% (in Portugal was 32.8% in January).
Romania	Provider Association	EU experiences have only been look at for early repayment. In countries where there is not an organisation with direct oversight, a licensing regime would be appropriate. An example of good practice would be Great Britain which chose not to introduce such IRR
Slovakia	Provider Association	Licensing regime is the best way for all - consumers, regulators and providers. It sets up clear rules how to do the business, avoid mis-practices on the market and strongly limit illegal lending.
Spain	Consumer Organisation	EU studies from other countries constitute a good starting point. We have taken notice that in Belgium, mortgages are usually

		capped at the top and at the bottom.
UK	Provider Association	IRR are an old-fashioned idea and have been tried in many forms for many centuries. This includes the UK, where an Act of 1713 fixed the legally permitted maximum at 5% for both business and consumer loans. Crowther observed that 'there is a fair amount of evidence that during the eighteenth century the limitation was observed, although of course various evasion devices existed, such as the issue of annuities at 10%...and both evasion and avoidance became more commonplace in the fifty years before repeal [in 1854]'. So 'work around' techniques, described in our answer to Q1.10 above, are not new. These distort markets so that, as Robert Reich put it in 1979: 'Ironically, usury ceilings are most harmful to citizens they were apparently designed to protect - relatively poor credit risks.' There is a rapidly-growing body of data that is starting to capture the modern detail of the market distortions that price caps create. Looking, for example, at illegal lending, PFRC/POLICIS [2006] estimated from surveys that 165,000 households in the UK (with no price caps) were using illegal lenders. POLICIS [2004] estimated from surveys that Germany and France (both countries with price controls) had markedly higher illegal lending markets. The German illegal sector was two and a half times bigger (c.400,000) and the French illegal sector three times bigger (c.500,000). Japan is an example of a market where it is now generally accepted that credit price controls are creating serious societal harm, with growing criminalisation of illegal lending (see, for example, HSBC analysis of Japanese market 17 March 2003). Looking at displacement effects (for explanation, see our answer to Q1.10), OFT [2010] describes some of these at play in the German market. German consumers unable to access the mainstream market often borrow from Swiss and Luxembourg lenders (ie. geographic displacement, 'Schufafrei') and also use mail order credit (ie. price displacement into cost of goods). POLICIS [2004] notes that one side effect of French rate caps is that higher-risk borrowers tend to use mainstream lending models that they struggle to manage, and suffer default consequences as a result. Pawnbroking systems are often overlooked in these discussions, but are highly relevant to the debate. Commercial pawnbroking (as for instance in the UK) can only operate with fairly high APRs. A methodology found in continental Europe (where pawnbroking has been state-run) is to systematically under-value the pawned goods, so as to achieve a much lower headline rate of charge. In summary, there are many examples from across the world of the ways in which rate caps distort markets, to the detriment of consumers.

UK	Public Authority	Studies carried out for the Department for Business suggest that some countries that operate a cap on interest rates have increased levels of illegal/unlicensed lending. The FSA's Mortgage Market Review looks to draw on experience from mortgage markets around the world. What has been noted is the view, particularly from the industry, that the approach to IRR can have a marked effect on the diversity of products/choice in the market. We have no direct experience but believe that the introduction of IRR limits product offerings including the availability of short-term credit or credit facilities designed for those with thin credit files. Studies from US markets (in many ways similar to UK credit markets) present a mixed picture of the outcomes from rate cap policies and raise the 'winners and losers' question. A clear theme is many of these studies is the need to actively develop better lower cost products for lower income households and that rate caps are not necessarily a good 'protective' substitute for this. Where IRR exist, consumers do not have access to small sum short-term loans and have to use inappropriate long-term loans with high default charges and other fees and penalties. They not only are denied the type of credit they require, but they have to pay a very high price for the inappropriate products. Theoretically, the APR calculation within the EU is standardised. But in practice this is not the case. The APR in Ireland does not include collection charges for home credit loans, but in the UK it does. Purely because of this difference, the de facto interest rate ceiling of 200%APR allows home credit to operate in Ireland, but prevents all other small sum short term lenders from so doing. The only result is that consumer choice is limited. Not one consumer is actually advantaged by this policy. Despite an agreed APR formula throughout the EU, pawnbrokers in Germany are allowed to charge additional fees for administration, safe keeping and insurance of pawned objects, which do not appear to be included in interest rate calculations as they would be in the UK. Consequently pawnbrokers enjoy an almost complete monopoly in Germany in offering small loans to the exclusion of other lenders and the detriment of consumer choice. They are increasingly lending to middle and higher income earners. Standing and membership charges are not included in the APR in Germany even if membership is a condition of the loan. Consequently, in EU states where fees and charges can be excluded from the APR interest rate restrictions will have little or no effect on the actual cost paid by consumers for credit. But in those EU states where such charges have to be included in the APR calculation, interest rate restrictions will preclude small sum short term loans being offered at all. Customer choice and access to relevant credit products would be removed. See the Policis 2004 report.

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Selection 5: "If controls are to be introduced or retained, what do you think would make for an effective regime?" (SQ 1.27)

MS	Stakeholder	Comments from respondents on how to make for an effective regime for setting ceilings
Austria	Public Authority	You always have to take care that ceilings do not extent the demanded prices. We had to experience that with the ceiling of default interest rates. They are now always 5% over the agreed interest rates. Controls only are effective if a supervisory board has enough resources and the power of sanctions.
Belgium	Provider	Controls are already in place.

	Association	
Cyprus	Public Authority	A regime would be effective if it was principle based.
Czech Republic	Provider Association	Any form of regulation always allows providers to go around it (and thus made the system less transparent to the client). Regulation should not focus on the economic parameters (the rates of their structure, fees, etc.), but effective control will enable clients to easily determine the price at which they can buy (as in ordinary supermarket). The decision to purchase is already on the client.
Czech Republic	Other	1. ceiling should be set probably at the relative levels (ie. certain multiples (2 - 4) or excess over the market basic rate); 2. another crucial issue is - control of the creditors and instruments and practices they use.
Czech Republic	Public Authority	In our opinion on-site inspections would be effective. Moreover, if ceiling level should be introduced, we would prefer a certain percentage of an average rate set for different segments of the credit market. But generally we are not in favour of any ceiling.
Denmark	Provider Association	A general clause about unfair interest rates is enough and gives a good protection for the consumer together with the other consumer protections rules in the CCD 2008.
Denmark	Consumer Organisation	First of all we need to acknowledge that there are different credit markets and that they should be regulated differently. Ceilings should take into account the providers cost of funding (the market interest rate at a particular point in time), and the security of the loan. For example, in Denmark mortgage lending is very secure as you can evict your customers from their homes and sell it at current market price. Therefore it is possible to provide mortgage credit at the market rate (funding cost) + 0,5% (administration fee). In terms of an APR-ceiling for consumer credit it should probably be combined with a cap on the total cost of the credit in relation to the amount of the credit to avoid providers prolonging the repayment period in order to stay below the APR-ceiling. If a one-cap-fits-all solution is chosen the Danish Consumer Council have officially advocated that the ceiling be set at the Danish National Banks interest rate + 15%.
Estonia	Other	Strict rate caps and supervision authorities for all credit providers (also for non-banks) regulated by law.
Finland	Other	Should be in legislation. IRR level could be eg. compared to those in recovery proceedings
Finland	Public Authority	Regulations should be written in the law. We have no comment on pricing level.
France	Consumer Organisation	The controls already exist through the French Prudential Supervisory Authority (autorité de contrôle prudentiel)
France	Other	The issue is very important. The answer is YES but there is so much difference between the development of the theory and practice that means one should be realistic.
Hungary	Consumer Organisation	The best solution would be: Limit to variability of interest rates in variable rate credit contracts, and the level of fees and charges should be regulated as well.
Hungary	Public Authority	An impact assessment is needed.

Latvia	Public Authority	Effective regime would be a mixture of free market regulation for mainstream lending with some restrictions for loans that present risk to low-income consumers. However, this might be achieved also by restricting certain credit products instead of setting ceilings. It might be difficult to set one set of restrictions for all EU, since it is formed of countries with different economic situation.
Netherlands	Public Authority	Form: supervisory control; Level: market interest plus a ceiling.
Netherlands	Consumer Organisation	Some licensing system and punishments to withdraw the license.
Poland	Public Authority	Present regulations could be considered as appropriate.
Portugal	Consumer Organisation	More attention should be given to the non-observation of IRR; the existing sanctions do not seem sufficient or inhibiting.
Romania	Provider Association	We do not believe that these controls can produce an effective regime.
Slovakia	Provider Association	IRR or other price controls are not delivering the results they are aimed for. They do not help customers, they increase costs for legal lenders and do not limit illegal lending.
Slovenia	Public Authority	- Verbrauchercreditgesetz: Ueberwachung des Anzeigeninhalts, der Kreditangebote und -vertraege, der Gesamtkosten- und der APR-Ausrechnung sowie der Beruecksichtigung der fuer Kreditvermittler vorgegebenen Geschaeftsbedienungen; - Meldewesen (Regelmaessigkeit).
Spain	Consumer Organisation	A possible formula would be to proceed with the action raised, over the next two years, where the difference between the reference rate that is being applied (whether the Euribor or other) and the Bank rate European Central exceed 15% of the value of Euribor (in the case of EURIBOR) or 30% of the value of the index in question (in the case of other indices such as the ECSC).
Sweden	Provider Association	No further controls are needed.
United Kingdom	Consumer Organisation	A brief answer to this might be: Controls need to be focused at the detriment; Controls need to be part of a package of measures aimed at reducing over-indebtedness and increasing access to alternative forms of suitable credit for lower income consumers; Controls need to properly consider the likely effects on different groups of consumers - will there be winners and losers and if so who?; Controls should avoid a priori assumptions about any ceiling level.
United Kingdom	Provider Association	An effective regime results from a free, competitive market without restrictive barriers to entry. However, if a ceiling were to be set it would need to allow for products to continue to be offered ie. short term, low level lending is expensive to offer and the interest rate has to reflect this, otherwise creditors will withdraw and consumers will be pushed to less reputable forms of borrowing
United Kingdom	Provider Association	As the UK has demonstrated, the key is transparency and clarity, ensuring consumer choice. Other approaches would stifle competition to the detriment of the consumer.
United Kingdom	Provider Association	Consumers benefit from transparency, simplicity and fairness which is provided through a combination of statutory regulation and self-regulation. This is far more important than imposing market controls.

United Kingdom	Provider Association	Simplicity, transparency and fairness are of much greater benefit to consumers than simplistic rate or amount restrictions. Those three principles allow innovation, increased competition, increased choice and increased access for consumers that are otherwise stifled by rate and amount restrictions.
United Kingdom	Provider Association	We do not believe that controls should be introduced in the UK apart from those that already exist and which we have described.

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Selection 6: "Do you think that private over-indebtedness is a problem in your country?" (SQ 2.1)

Member States where Over-indebtedness is a <u>small</u> problem	
There is robust, statistically valid research (eg. Kempson [2002] and CCCS Statistical Yearbooks) which make very clear that, in the context of unsecured credit, the phenomenon of private over-indebtedness cannot be described as 'a problem'. There is a relatively small percentage of consumers who struggle to repay their credit debts, mainly as a result of unexpected life events. However, that percentage has remained fairly stable and may even have dropped in the last year. In this context, it is worth stressing that unsecured credit in the UK accounts for only about 15% of all credit outstanding. Also, assets and equity far outweigh levels of personal debt.(UK)	
Until 2008, the number of default was very low and even decreasing since 5 years. Of course, due to the financial crisis, there was an increase during 2009. Over-indebtedness remains however well monitored. (Belgium).	
Due to a lack of a consistent definition measuring the scale of private over-indebtedness is difficult. Different studies show different figures but all contain a conclusion that over-indebtedness is not as big an issue as in other EU Member States. (Poland)	
There is generally very low level of debt in Slovakia. However, there are a few communities - especially Roma communities, in which the over-indebtedness is serious problem due to illegal lending practices and local usurers. (Slovakia)	
Very strong self regulation which limits the maximum credit amount which can be offered based on income and financial obligations of the borrower. Although over-indebtedness concerns relatively few households, the problem for those households can be enormous. The group that is confronted with over-indebtedness is small but the problems for this group are big. (Netherlands)	
In general, the levels of household indebtedness are low in the Czech Republic compared to Western Europe (around 49 % of gross disposable income compared to 93.2 % of disposable income in the Euro zone). However, the pace of growth has been fast due to credit availability, higher living standards and very low base indebtedness levels (since 2000 household indebtedness increased 8-fold) - between 2000 and 2008 the annual increase of household loans over 30 %. Current risks are relatively low - levels of mortgage loans comparable to levels of term deposits. Due to the aggressive marketing (performed especially by some non-banking credit providers, who do not assess creditworthiness sufficiently, and offer sharking loans in some cases) in combination with insufficient financial literacy some groups in the Czech society already encountered over-indebtedness problems. The volumes of non-banking credit (based on approximations) have been going down since early 2009, levels of NPLs have been steadily rising - hitting 13 % of all non-banking credits (end 2009). Due to the crisis the consumer non-performing credits share hit 9.35 % (end March 2010) of all bank consumer credits and the volume up by 39 % y-o-y. Also the household insolvency started to rise (around 100 cases in January 2009 and 600 cases in January 2010) It becomes more and more important issue (currently not severe, nevertheless some data: eg. the total volume of household loans from banks in 2000 was CZK40bln, in 2009 it was CZK897 bln (source Czech Stat. Office report- bellow link). Hand in hand - the indebtedness in rapidly increasing, eg. according to Czech Credit Bureau was the total amount of personal declared bankruptcies in 2009 was 2500, while in 2008 the amount was 718. (Czech Republic)	
It would appear that to date the incidence in non-performing loans in the personal sector ie. Households and Individuals, is still relatively low in comparison with other economic sectors. This said, there will always be people who will enter into loan commitments that would be difficult to repay according to agreed terms. Banks are however being very cautious in their lending process and vet customers' ability to repay very carefully prior to agreeing to sanction any lending. (Malta)	

Structural over-indebtedness is an issue for a relatively small number of consumers. The UK has developed sophisticated debt relief and management structures, both statutory and voluntary (supported by the financial services sector) that provide beneficial assistance to all consumers who encounter structural debt problems. The UK is a sophisticated and well developed credit market and it is inevitable that there will be some level of over-indebtedness. However as studies have evidence this tends to be more as a result of unexpected lifestyle changes (eg. unemployment; divorce; children; etc.) and is therefore difficult to predict. (UK)

Member States where Over-indebtedness is a severe problem

According to the data published by the National Bank of Romania in December 2009, the percentage of overdue credit is 3,96%. However the Government announced that the budgetary staff (civil servants, teachers, physicians, police etc.) will have their salaries diminished by 25%. Problems with paying the instalments will expand. (Romania)

Because of historically low interest rates which encourage too big loans. (Finland)

15,2% of all lenders registered in Credit Register hold by Bank of Latvia have had at least one violation or delay of payment. (Latvia)

According to our studies 5-10% of the population are overindebted/in the risk of being overindebted. (Sweden)

The estimates of the severity of private indebtedness have changed. Based on a survey conducted by BNB almost all of the 5 largest banks (having a market share of 57.4%) estimate private indebtedness as high. (Bulgaria)

Member States where Over-indebtedness is a very severe problem

Over-indebtedness is regarded as a social risk, reflected on the known archetype indebtedness triangle risk," translated into 3 topics: i) serious employment problems, ii) multi-overindebtedness and iii) cost savings and / or weak social frameworks. These 3 vertices confess this phenomenon as a complex problem (from the standpoint of financial, social and psychological issues which involves the entire family): -It is costly to the financial system and to the public policy (justice, welfare, housing and health), -Social stigma and psychological difficulties in the financial recovery of the household, loss of social skills, decline in job performance, isolation and shame, physical and psychic disturbances - high risk of social exclusion and poverty -Urgent: how much longer it takes to be treated, the greater the breach of contract, plus interest, minus assets - a family can not close as a company. (Portugal)

Overindebtedness is a serious problem in the Swedish society of today. According to The Swedish Enforcement Authority there are 400 000 people that are over-indebted.(Report from 2008 about the causes and consequences of over-indebtedness). The report 2003:04 Överskuldssättning - omfattning, orsaker och förslag till åtgärder" (Over-indebtedness - extent, causes and measures proposals) content almost 150 pages about over-indebtedness. Some reasons for over-indebtedness that are mentioned are divorces, bankruptcies, sickness and unemployment. The reason why a person becomes over-indebt is however not often caused by one single reason. The report distinguishes debts related to the individual problems (such as sickness) and to the credit market (such as loans with high interest on a loan) and debts from the public sector (such as government subsidies or student grants). 17 proposals to decrease people in over-indebt are mentioned in the report. They are not evaluated yet. The two earlier mentioned national associations for people in debt have also recently published proposals to solve the problems with people in debt. "Eternity debtors" are a common word in the debate. Conclusion: over-indebtedness is an actual debate theme in Sweden, especially in media. Interesting is that fast loan with a high interest on the loan (because no security) is increasing in Sweden. SMS-loans (from companies that offer loans in minutes, simply by sending a text message) are a rather new occurrence (and problem) on the Swedish market. (Sweden)

The continuation of bad credits, "restructured credit", "delay in payments" grows. In April 2010, loan loss provisions in the banking sector overall increased by 2.3%, or 35.4 million lats (in March - by 11.9% or 166 million lats), totalling 1.6 billion lats, or 10.6% of total banking portfolio (at end-March - 10.3%). (Latvia)

The debt overhang is the result either of bad debt is an accident of life that causes a decrease in revenues. If the accident of life is unpredictable it is not the same for the bad debt. But nobody (state, consumer groups and especially not the commission's debt) does address the issue of restructuring. The problem of overindebtedness of individuals emerged in France two decades ago. A law was passed at the end of 1989 in order to provide solutions for individuals who were no longer able to meet their loan repayments. This initial mechanism has been amended three times , in 1995, 1998 and 2003. However, the number of over-indebted people remains, till today, relatively important. So a new Act has just been adopted by the French Parliament in order to improve the prevention and the resolution of such difficulties. According to the Banque de France barometer of the over-indebtedness of December 2009, 954,000 files were submitted to the commissions of over-indebtedness between January 2005 and December 2009, that is to say an average of 190,986 files per annum. It's a 15% growth in only one year. (France)

The household debt, whose main cause is the mortgage credit places us at the top of the international debt ranking family and has reached such severity that the threat of foreclosure housing usual payroll, property and other assets of families, hangs over hundreds of thousands of consumers. The latest analysis and existing data are already talking about more than 100,000 families in judicial mortgage enforcement procedures, figures that can bend in coming months, according to most analysts. Not surprisingly, the General Council of the Judiciary has expressed its concerns and has published recently that the number of foreclosures in the Spanish courts in the period between January and September 2008 was already 53.696 and that this figure would amount to 86.681 foreclosures in 2009 (three times in 2007) and even arrive in 2010 at 121.006 executions. (Spain)

A debt counselling service for low-income citizens has recently been established. Unfortunately resources are insufficient to help middle- or high-income citizens that are over-indebted, but the demand is there. The burst of the price-bubble on the real-estate market has left many unable to meet their contractual financial commitments because they have had to sell their home at a prize much lower than what they owe on their mortgage (due to divorce, unemployment or other reasons. (Denmark)

We have seen the level for debt problems brought to Citizens Advice Bureaux in England and Wales increase for over a decade. Credit debt problems were at a high level even before the recession and have now grown further. Personal insolvency levels are high and growing. (UK)

Selection 7: Some answers to the question "Do you think that this problem [private over-indebtedness] has improved or worsened over the last five years?" (SQ 2.2)

The table below shows extracts of a few responses for countries where the trend is seen as not having worsened significantly for consumers.

Czech Republic	It worsened for certain groups in the society, especially due to the influence of economic crisis (growth of unemployment) and low level of financial literacy (within 2009 the number of persons with delays with repayments increased by 16 %). Nonetheless, the new insolvency legislation improved the situation of households in the Czech Republic significantly. Also, banks, even more than before, run very thorough creditworthiness assessment before granting any credit. Recently most of the households became very cautious with getting new credits and/or increasing indebtedness.
Finland	In general, the trend is slightly negative. However, regarding small and short term credits, typically SMS loans, the situation has worsened significantly during the past 4 years.
Germany	There was a certain levelling, things are yet worsening, there are too few counselling services financed to meet the requirements given the number of people affected.
Hungary	More people have taken out loans which they might not be able pay back. Many people have even taken out more than one loan. The number of 'late payers' is significantly growing from day to day.

Malta	The problem of over-indebtedness has worsened marginally mainly due to the current local economic conditions brought about by the on-going world financial crisis, which resulted in increased unemployment and consequently somewhat increased defaults on borrowers' obligations.
Netherlands	Credit was tightened because of new regulations, but the economic crisis caused loss of income, resulting in overindebtedness. It is more depending to the social structure of the community then (acceptance of having debts is a social aspect). Problems occur in difficult circumstances, for example unemployment. The Netherlands have a high level of mortgage debt compared to other countries. Actual payment problems and forced sales of homes are relatively limited, but have increased slightly due to the economic crisis.
Poland	Most people already over-indebted have a problem now, so we assume that the problem is slightly worse. The financial crisis has affected Poland in the minimal compared with other EU countries.
Romania	Credit was introduced quite recently in Romania, just about 5 years ago. People had no experience to deal with the advertisements. Overindebtedness worsened for a small proportion of the population who were effected by the foreign currency lending issue. There has clearly been a swing to higher levels of saving since the 'credit crunch'.
United Kingdom	As a result of deteriorating economic conditions generally. However, there is a greater awareness of debt issues and the availability of support and assistance for those who find themselves in financial difficulties. As remedial assistance developed in the UK over the past 15 years, statistics concerning overindebtedness suggested a rising problem. However, it is most likely that greater awareness of remedies led to greater reporting of problems, not actually a significant increase in the problems themselves. Also, in March 2010, BIS published a report containing an assessment of over-indebtedness in Britain, based on a set of indicators (http://www.bis.gov.uk/assets/biscore/consumer-issues/docs/10-830-over-indebtedness-second-report.pdf), which attempted to compare evidence with previous analysis in this area. Although the data were not directly comparable in every case, it suggested a slight increase in the proportion of people who could be described as 'over-indebted'.

Annex XII: Provider Questionnaire



Provider Questionnaire

We would like to invite you to cooperate with us in a **study for the European Commission** (DG Internal Market) identifying economic and social consequences of interest rate restrictions in the context of European consumer credit markets (unsecured and secured credit, i.e. including mortgage credit) via participating in a survey on this subject. The survey consists of 14 short questions. It will take you no longer than 15 minutes to complete.

Your view is extremely valuable in informing the current debate on the role of regulation for consumer credit markets in the European Union. **Please answer these questions carefully to ensure that your opinion is considered in this debate.**

Thank you for your time and the effort you make to complete this survey.

This questionnaire is for individual credit providers.

A separate "Stakeholder Questionnaire" will collect the views of regulators, government, consumer organisations and provider associations, as well.

Please return the questionnaire to: irr-survey@zew.de

Background Information

What do we mean by the term *Interest Rate Restrictions* in this survey?

If not otherwise defined in the questions, we understand interest rate restrictions in the following way:

- It is a *maximum level* of interest rates charges which lenders may not exceed.
- It is enforced by *legislation* or by *court-based jurisprudence*.
- It may be an *absolute* ceiling (for example, an absolute percentage level) or a *relative* ceiling (for example, a multiple of a reference market interest rate).
- It applies to *contractual* interest rates.

Beyond the definition given above, does our study also cover different forms of interest rate restrictions?

Yes. Besides absolute rate ceilings and administrative rate caps, we also consider default interest rate caps, restrictions on interest compounding and the variability of rates, unfair exploitation rules as well as other cultural and/or institutional factors which may effects equivalent to those of legal interest rate restrictions. If you have any further comments on these issues, please do not hesitate to contact us using the contact details provided below.

Should you have further questions and/or comments please do not hesitate to contact us at:

Dr. Svitlana Voronkova,
Zentrum für Europäische Wirtschaftsforschung GmbH (ZEW)
L 7, 1 · D-68161 Mannheim
Tel.: ++49 (0)621 1235 379
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PART A. GENERAL QUESTIONS

1. To what extent has there been a public debate on the issue of interest rate restrictions in your country over the last 5 years? Please give a score from 1 (very little of an issue) to 5 (very intensely discussed issue).

2. In 2009 PORTUGAL introduced rate ceilings capping the authorised interest rate on consumer credit. Since the second quarter of 2010, the ceiling is now set as the average market APR (annual percentage rate) charged in the previous quarter times 1.33. The authorities distinguish between the following types of consumer credit when calculating the average market prices: 1) Personal loans; 2) Car loans; 3) Credit cards, lines of credit, bank accounts and overdraft facilities.

How, in your view, will this measure affect various aspects of the PORTUGUESE consumer credit market? Please tick appropriate box.

	increase significantly	increase somewhat	not change	decrease somewhat	decrease significantly	Don't know
Volume of consumer credit is most likely to...	☐	☐	☐	☐	☐	☐
The demand for consumer credit is most likely to...	☐	☐	☐	☐	☐	☐
The offering of consumer credit products on the Portuguese market is most likely to...	☐	☐	☐	☐	☐	☐
Level of interest rates is most likely to...	☐	☐	☐	☐	☐	☐
Administrative fees on credit products (penalty, set-up) are most likely to...	☐	☐	☐	☐	☐	☐
Other fees for ancillary services are most likely to...	☐	☐	☐	☐	☐	☐
Proportion of high-risk borrowers able to obtain credit is most likely to...	☐	☐	☐	☐	☐	☐
Number of domestic providers of consumer credit in Portugal is most likely to...	☐	☐	☐	☐	☐	☐
Number of international providers of consumer credit in Portugal is most likely to...	☐	☐	☐	☐	☐	☐

COMMENTS:

3. In your view, if an interest rate ceiling based on a multiple of the average market rates for the credit types listed below were introduced IN YOUR COUNTRY today, at what minimum multiple of an average market rate would this ceiling have to be set before it had a significant impact on the volume of consumer credit granted BY YOUR INSTITUTION?

Please tick appropriate box for the credit type(s) that apply to YOUR INSTITUTION.

	<2 x market rate	2-4 x market rate	5-10 x market rate	>10 x market rate	There would be no impact	Do not know
Installment credit (general-purpose credit)	☐	☐	☐	☐	☐	☐
Installment credit (specific-purpose credit, for example, auto loans)	☐	☐	☐	☐	☐	☐
Revolving credits (Overdrafts)	☐	☐	☐	☐	☐	☐
Revolving credits (Credit cards)	☐	☐	☐	☐	☐	☐
Mortgage consumer credit	☐	☐	☐	☐	☐	☐
Payday loans	☐	☐	☐	☐	☐	☐
Pawnbroker loans	☐	☐	☐	☐	☐	☐
Moneylender loans	☐	☐	☐	☐	☐	☐
Other (please indicate):	☐	☐	☐	☐	☐	☐

4. In your view, what minimum level of interest rate ceiling (as calculated by the annual percentage rate of charge (APRC)) would have a significant impact on the volume of consumer credit granted BY YOUR INSTITUTION? Please tick appropriate box for the credit type(s) that apply TO YOUR INSTITUTION.

	<5%	5-10%	11-20%	21-30%	31-40%	41-50%	>50%	Do not know
Installment credit (general-purpose credit)	☐	☐	☐	☐	☐	☐	☐	☐
Installment credit (specific-purpose credit, for example, auto loans)	☐	☐	☐	☐	☐	☐	☐	☐
Revolving credits (Overdrafts)	☐	☐	☐	☐	☐	☐	☐	☐
Revolving credits (Credit cards)	☐	☐	☐	☐	☐	☐	☐	☐
Mortgage consumer credit	☐	☐	☐	☐	☐	☐	☐	☐

Payday loans	<200% ☐	201-300% ☐	301-400% ☐	401-500% ☐	501-900% ☐	901-1200% ☐	>1200% ☐	Do not know ☐
Pawnbroker loans	<20% ☐	20-30% ☐	31-40% ☐	41-500% ☐	501-600% ☐	601-700% ☐	>700% ☐	Do not know ☐
Moneylender loans	<50% ☐	51-80% ☐	81-100% ☐	101-200% ☐	201-300% ☐	301-400% ☐	>400% ☐	Do not know ☐
Other (please indicate):	<5% ☐	21-50% ☐	51-100% ☐	101-200% ☐	201-400% ☐	401-500% ☐	>500% ☐	Do not know ☐

5. Assume that interest rate ceilings capping the authorised interest rate on consumer credit were abolished IN YOUR COUNTRY. What do you think will be the effects of this measure on the various aspects of consumer credit markets IN YOUR COUNTRY? Please tick appropriate box.

	increase significantly	increase somewhat	not change	decrease somewhat	decrease significantly	Don't know
Volume of consumer credit is most likely to...	☐	☐	☐	☐	☐	☐
The demand for consumer credit is most likely to...	☐	☐	☐	☐	☐	☐
The offering of consumer credit products is most likely to...	☐	☐	☐	☐	☐	☐
Level of interest rates is most likely to...	☐	☐	☐	☐	☐	☐
Administrative fees on credit products (penalty, set-up) are most likely to...	☐	☐	☐	☐	☐	☐
Other fees for ancillary services are most likely to...	☐	☐	☐	☐	☐	☐
Proportion of high-risk borrowers able to obtain credit is most likely to...	☐	☐	☐	☐	☐	☐
Number of domestic providers of consumer credit is most likely to...	☐	☐	☐	☐	☐	☐
Number of international providers of consumer credit is most likely to...	☐	☐	☐	☐	☐	☐

COMMENTS:

PART B. NON-MORTGAGE CONSUMER CREDIT

PLEASE ANSWER QUESTIONS 6 TO 8 IF YOUR INSTITUTION PROVIDES NON-MORTGAGE CONSUMER CREDIT. OTHERWISE PLEASE GO DIRECTLY TO QUESTION 9.

6. In your view, the proportion of high-risk borrowers (such as: low-income, unstable employment history, poor credit history) that are granted non-mortgage consumer credit by your institution is approximately (please tick appropriate box):

>80% ☐
 80-61% ☐
 60-41% ☐
 40-10% ☐
 <10% ☐
 Do not know ☐

7. Since the start of the financial market crisis in 2007, how would you characterize the changes to the following (as listed in the table below) in YOUR INSTITUTION? Please tick appropriate box.

	increased significantly	increased somewhat	not changed	decreased somewhat	decreased significantly	Don't know
Volume of non-mortgage consumer credit has...	☐	☐	☐	☐	☐	☐
The demand for non-mortgage consumer credit has...	☐	☐	☐	☐	☐	☐
The offering of non-mortgage consumer credit products has...	☐	☐	☐	☐	☐	☐
Interest rates charged to new borrowers have...	☐	☐	☐	☐	☐	☐
Interest rates charged to existing borrowers have...	☐	☐	☐	☐	☐	☐
Default interest rates and charges on outstanding credits have...	☐	☐	☐	☐	☐	☐
Refusal rates to prospective borrowers have...	☐	☐	☐	☐	☐	☐
Customer defaults have...	☐	☐	☐	☐	☐	☐
Administrative fees on credit products (penalty, set-up etc.) have...	☐	☐	☐	☐	☐	☐
Other fees for ancillary services have...	☐	☐	☐	☐	☐	☐

	increased significantly	increased somewhat	not changed	decreased somewhat	decreased significantly	Don't know
Proportion of high-risk borrowers (as defined in question 6) has...	☐	☐	☐	☐	☐	☐
Number of domestic providers of non-mortgage credit in your country has...	☐	☐	☐	☐	☐	☐
Number of international providers of non-mortgage credit in your country has...	☐	☐	☐	☐	☐	☐

8. Did you notice a trend in any of the following areas in the period 2002 to 2007 (before the financial market crisis) in YOUR MARKET?

	increased significantly	increased somewhat	not changed	decreased somewhat	decreased significantly	Don't know
The use of fees outside the scope of the APR calculation had...	☐	☐	☐	☐	☐	☐
The use of default charges had...	☐	☐	☐	☐	☐	☐
The cross-selling of ancillary products (e.g. insurance) had...	☐	☐	☐	☐	☐	☐
Productivity within firms had...	☐	☐	☐	☐	☐	☐
Costs of operation , including capital had...	☐	☐	☐	☐	☐	☐

Please tell us what you think were the main causes of the trends that you have mentioned:

PART C. MORTGAGE CONSUMER CREDIT

PLEASE ANSWER QUESTIONS 9 TO 11 IF YOUR INSTITUTION PROVIDES MORTGAGE LOANS. OTHERWISE PLEASE GO DIRECTLY TO QUESTION 12.

9. In your view, the proportion of high-risk borrowers (such as: low-income, unstable employment history, poor credit history) that are granted mortgage consumer credit BY YOUR INSTITUTION can best be described as (please tick appropriate box):

>80% ☐
 80-61% ☐
 60-41% ☐
 40-10% ☐
 <10% ☐
 Do not know ☐

10. Since the start of the financial market crisis in 2007, how would you characterize the changes to the following (as listed in the table below) in YOUR INSTITUTION? Please tick appropriate box.

	increased significantly	increased somewhat	not changed	decreased somewhat	decreased significantly	Don't know
Volume of mortgage consumer credit has...	☐	☐	☐	☐	☐	☐
The demand for mortgage consumer credit has...	☐	☐	☐	☐	☐	☐
The offering of mortgage consumer credit products by your institution has...	☐	☐	☐	☐	☐	☐
Interest rates charged to new borrowers have...	☐	☐	☐	☐	☐	☐
Interest rates charged to existing borrowers have...	☐	☐	☐	☐	☐	☐
Default interest rates and charges on outstanding credits have...	☐	☐	☐	☐	☐	☐
Refusal rates to prospective borrowers have...	☐	☐	☐	☐	☐	☐
Customer defaults have...	☐	☐	☐	☐	☐	☐
Administrative fees on credit products (penalty, set-up etc.) have...	☐	☐	☐	☐	☐	☐
Other fees for ancillary services have...	☐	☐	☐	☐	☐	☐

	increased significantly	increased somewhat	not changed	decreased somewhat	decreased significantly	Don't know
Proportion of high-risk borrowers (as defined in question 9) has...	☐	☐	☐	☐	☐	☐
Number of domestic providers of mortgage credit in your country has...	☐	☐	☐	☐	☐	☐
Number of international providers of mortgage credit in your country has...	☐	☐	☐	☐	☐	☐

11. Did you notice a trend in any of the following areas in the period 2002 to 2007 (before the financial market crisis) in YOUR MARKET?

	increased significantly	increased somewhat	not changed	decreased somewhat	decreased significantly	Don't know
The use of fees outside the scope of the APR calculation had...	☐	☐	☐	☐	☐	☐
The use of default charges had...	☐	☐	☐	☐	☐	☐
The cross-selling of ancillary products (e.g. insurance) had...	☐	☐	☐	☐	☐	☐
Productivity within firms had...	☐	☐	☐	☐	☐	☐
Costs of operation , including capital had...	☐	☐	☐	☐	☐	☐

Please tell us what you think were the main causes of the trends that you have mentioned:

PART D. BUSINESS ENVIRONMENT

12. How would increased regulatory activity in the following areas affect YOUR INSTITUTION? Please give a score from 1 (very little of an issue) to 5 (very much of an issue):

Area	Score 1-5
Restrictions on interest rates	
Restrictions on rolling over or consolidation of existing loans	
Restrictions due to responsible lending practices	
Restrictions on disclosure obligations on lending	

13. In your view, how will the business environment in which your institution operates be affected should interest rate restrictions be abolished? (please tick appropriate box):

More opportunities
for my business
☐

No effects
on my business
☐

More threats
for my business
☐

Don't
know
☐

14. One of the aims of the Single Market is to ensure smooth provision of cross-border financial services within the European Union. What barriers, in your view, are there to the cross-border provision of consumer credit in the EU? Please rank the importance of the factors listed below on the scale from 1 to 5 (1 – least important, 5 – most important)

Factor	Score 1-5
Different language	
Different currency	
Different approach to consumer protection in a foreign country	
Lack of information about the customer	
Lack of personal contact with the customer	
Consumer preference for local creditors	
Different debt recovery legal frameworks	
Interest rate restrictions (including restrictions on fees)	
Extra costs of doing business abroad unrelated to those above (please specify below)	
Any other? Please describe:	

Is there anything else you would like to add?

COMMENTS:

THANK YOU!

Annex XIII: Provider Questionnaire - Methodology and feedback

The survey consists of national providers of both secured and unsecured consumer credit. The list of contacted providers include commercial banks (mainstream), non-bank mortgage lenders, non-bank point-of-sale lenders, credit card companies, moneylenders such as payday lenders and door-to-door lenders, and pawnbrokers.

The questionnaire has been sent to individual providers directly in March and April after an initial invitation call/email and has been filled in by providers from 4 of the selected countries (UK, Germany, Netherlands and Sweden). In addition to that providers from Czech Republic and Norway have submitted a written comment on the study hypotheses and a personal interview has been conducted with a major home credit provider from Poland. Providers who have explicitly refused participation have been additionally asked to indicate their reasons. Unfortunately, the input we received for the different countries is not comprehensive enough to conduct quantitative analysis on the European data. However, it allows presenting some important insights on the hypotheses.

From a total of 137 credit provider companies contacted we have received a total of 18 responses, 3 submitted written comments on the hypotheses of the study and 31 explicit refusals. Thereof 14 providers have already refused when first being contacted by phone (before receiving the questionnaire) and 17 providers have refused to participate after having received the questionnaire. The response rate of 13% is comparably high by industry standards.

The providers in Germany and UK have filed most of the explicit refusals. In UK we have therefore also obtained a relatively high participation rate 33% in contrast to Germany where the response rate amounts to only 5%. All the request to French providers have been left unanswered and despite of repeated reminders sent by email (in French) and repeated phone calls we have not received any indication of reasons for choosing not to participate. In Sweden and Netherlands the response rate was respectively 7% and 12%.

Frequent reasons to refuse:

Country	Returned Questionnaires	# Refusals	Branch	Survey contents does not apply to company	Not authorized	Not interested	aire takes too much time /They are too busy	Hang up/ forward to nowhere	Language Barriers	Other	Do not participate in studies in general	No Reason
FR	0	4	commercial bank mortgage specialists - 2 pawnbroker					1		1		2
DE	1	9	commercial banks - 2 point of sale lenders - 3 mortgage specialists - 3 pawnbroker	2		1				1	2	3
NL	1	3	non-bank mortgage specialist pawnbroker point of sale lender			2	1					
PL	0	5	commercial bank pawnbrokers - 3 non-bank mortgage specialist			1		1	1			2
SE	1	3	point-of-sale lenders - 3 commercial bank	1						1	1	1
UK	11	8	commercial banks - 2 credit card companies - 3 pawnbrokers - 2	4	1		1	2		2		
	14	32		7	1	4	2	4	1	5	3	8

Most of the providers who have explicitly refused participation indicate that IRR are either not relevant for them or consumer credit is not their main activity. In particular, as indicated in the responses to the Stakeholder Questionnaire, in some countries, including

Germany, as well as in particular segments there is a little debate on this issue and thus little interest in participating in the survey.

Comparably large number of providers have indicated that as a part of their corporate policy they do not participate in surveys or do not provide prognosis-related numbers.

A further group of refusals is based on lack of interest or time (considering the length of the questionnaire). It appears to us that many providers do not see their advantage in taking the time to participate in a survey, as they are affiliated with associations which are supposed to do this kind of communication for them.

Further feedback on the PQ:

Concern has been raised regarding the ability of the survey to provide a meaningful comparison among different European countries and different market segments. Furthermore, the definition of different lender categories is considered too general. In particular, specifications of sub-groups of credits from the category “moneylenders” were omitted. As a result, respondents from the sector claim that the indicators use were either irrelevant or misleading. For instance the applied interest rate measure (APR) is considered to be a misleading indicator regarding short term/low value debt. Compared to other market segments, APR seems to adequately reflect the costs of credit in the home credit industry as it includes all fees associated with doorstep loans. In contrast, in other market segments administration fees and other fees associated with the loan are included in the APRC. We take account of this difference when interpreting the survey results. The critique on the use of APR can also be linked to the discussion on which interest rate should a possible restriction be applied. From the responses of home credit providers, it can be concluded that an interest rate restriction on APR instead of on interest only (as in the case of Poland) would result in an offering of longer-term home loans only due to the APR decreasing with maturity. In this regard the TTC (total costs of credit) has been suggested as an alternative measure.

Respondent from the home credit sector have been reluctant to answering questions regarding “high-risk” borrowers as they argue that the risk is a function of credit amount, not an individual. Furthermore, the request to provide an indication of average market rate for markets for which there is no such value publically available, such as the home credit sector, was met with criticism. The lack of publically available value makes it even more plausible to address the question on the average market rate exactly to the providers as they have the best insight on the market segment in which they are acting.

Finally, participants seem reluctant to give indication on the case Portugal as they do not have sufficient knowledge and experience on the market. Furthermore, respondents have reported that the question has raised confusion and led to initial misunderstanding of the aim of the study. Similar to the previous point this has been a reason for several respondents to initially ignore our request to fill in the survey questionnaire.

Annex XIV: Provider general feedback on IRR

Pawnbroker, UK, denied participation:

On the market mechanism:

My general opinion on interest rate caps is that they are a clumsy tool to address an issue which is already managed in a competitive market. Issues surrounding competition and unfair / misleading practices are already enshrined in law and protect the consumer.

There have been various studies that demonstrate internationally that rate caps have distorted the market and led to increased in unregulated credit and further financial exclusion. The OFT in the UK has already issued comments to this effect as part of its recent High Cost Credit Review.

Credit card issuer, UK, filled in PQ:

Any simple link between average rates in the credit card market and a fixed ceiling will restrict the ability for the industry to apply risk based pricing correctly and therefore cut off credit to the underserved market. In effect it will increase the population of the UK who will not be able to access credit through reputable lenders. This is inconsistent with UK policy

Commercial bank, UK, filled in PQ:

On the market mechanism:

The UK has a wide, varied and sophisticated credit market which is highly competitive. Access to credit is determined based on the customer's and lender's risk profile ie. ability to pay and appetite to lend. X believes that charging interest rates based on risk is a feature of prudential lending. The transparency of interest rate and charge structures offered by lenders and the ability of debtors to switch from lender to lender is a far better control on any possibility of unacceptable behaviour by lenders than IRR.

On costs of credits and illegal lending:

X believes that interest rate caps do not work and could lead more consumers into debt or force them to borrow from unscrupulous lenders who operate on or outside the fringes of regulation. In other countries which impose a maximum interest rate, the cap becomes the normal price for credit and rates that are lower than the cap all converge towards it. If the limit is set too high, consumers end up paying more, and if the limit is set too low, lenders will be forced to exit the market leaving vulnerable customers prey to loan sharks.

On the impact on supply:

The most likely impact of an IRR would be a reduction in supply and therefore consumer choice.

An IRR would be likely to result in adverse selection as the demand for credit from borrowers that would have been priced-out of the un-capped market increases. These borrowers are more likely to have been higher-risk borrowers and as such it is likely that levels of defaults would rise. As a result of this, lenders are likely to offset their additional losses by increasing the average interest rate for all customers. Both theory and evidence suggests that as the average interest rates rise, lower risk borrowers would borrow less while individuals of lower credit quality will either remain unaffected or increase their demand for credit. This will lower the average credit quality of a lenders book. At the extreme, only poor credit quality households would borrow, leading to market failure. To avoid adverse selection/deterioration in credit quality, lenders will tighten credit restrictions, for example by tightening score cards. This is likely to lead to a reduction in the total supply of credit.

Home credit provider, UK, filled in PQ:

On illegal lending:

The very real risk is that a price cap would cause this (illegal lending) to increase. The research by POLICIS for the UK Government said that France and Germany (with price caps) had higher levels of illegal lending than the UK.

Home credit provider, UK, filled in PQ:

Most groups realise that introducing a rate cap would cause companies to be more selective & offer longer term products which would make credit difficult to obtain for anyone wanting a short term product to help them with an unforeseen short term cash flow problem. The problem for small business is the difficulty of borrowing from the banks. A rate cap would reduce the choice customers have for short term products. Many customers do not want to take out a loan for say 2 years, as the APR may be lower but the total cost of credit could be higher, when they could take out a loan for 16 or 22 weeks with us & have it paid off in a short space of time.

On illegal lending:

The result of too much regulation could result in lenders pulling out of the market & increasing the market share of illegal moneylenders.

Home credit provider, UK, filled in PQ:On the impact on demand:

In our view, rate caps do not affect demand for credit (see for instance POLICIS [2004]). Instead, they affect supply of legal credit.

On illegal lending:

The result of too much regulation could result in lenders pulling out of the market & increasing the market share of illegal moneylenders...In fact, the reality is that if a price cap suppresses supply, that will mean more illegal lending.

On the impact on administration fees and other fees:

So, for instance, if the availability of legal cash credit is suppressed by means of the cap, one would expect to see more retail credit (where the credit charge is built into the cash price). When the credit charge is built into the cash price of the goods it is easy to circumvent any price cap (which will only apply to an explicit credit charge).

Credit card issuer, UK, filled in PQ:On international competition:

During the past 14 years we have also tested our business model in Spain, Italy and France (through a partnership agreement with a local Spanish bank). In each case we have decided not to pursue a consumer lending business. A number of reasons have contributed to this decision- they vary from the limitations on availability of information about consumers (data sharing is essential to our business model so that we can make responsible decisions about whether to grant credit to an individual); to restrictions on interest rates; to restrictions on our ability to collect on debts; to other regulatory requirements that make the business opportunity unattractive.

On credit access:

It is better to include rather than exclude consumers, who may otherwise have to resort to other, possibly unregulated, sources of credit.

Home credit provider, PL, in a personal interview:

IRR increase the intransparency in the charges and fees. IRR do not reduce the costs of credit because of hidden costs. IRR lead to reduced credit volume and from a macroeconomic perspective reduction on growth.

IRR harm competition. X considered a market entry in Germany but decided to refrain from entering because of the existing interest rate cap. Even if yet not binding an existing cap adds uncertainty to the providers as the cap level can be changed in future to a more restrictive one.

The level of over-indebtedness in a country is influenced by intercultural differences in the subjective perception of debt. In Poland there is a general reluctance to debt in contrast to UK.

Interest rate regulation should focus on stress testing the banking system.

Annex XV: Stakeholder general feedback on IRR

(Government official, Austria)

On the one hand a regulation concerning the level of fees and charges is welcome but on the other hand a regulation may minimize the competition. From consumer's view it would be important to regulate a maximum level of fees and charges.

(Provider Association, Czech Republic)

Regulation by the cap (usually relative) makes sense in some areas. Generally does not make sense.

In case of delay is necessary to ensure compliance with the conditions on which the debtor and the creditor agreed contractually. The solution is not a cap.

Level of fees and charges should not be regulated. Client must be able to easily obtain information about them.

The market is just the difference between the offered goods. Unification leads to a reduction in diversity of supply. The same applies to credit caps.

(Provider Association, United Kingdom)

There are no consumer benefits, only detriment, caused by regulated interest rates.

IRR lead to significant consumer detriment, lack of choice, lack of competition, lack of access and unregulated lending.

Caps are detrimental to consumers and, in NO jurisdiction where they are used, have resulted in cheaper, accessible loans. On the contrary they have led to circumvention, higher prices, inappropriate products and greater consumer indebtedness.

There should be no caps. If there are, any fee or charge that is excluded will simply be used to circumvent the cap. No jurisdiction has a cap that cannot be circumvented.

(Other Activity, Finland)

Because we don't have IRR at all in Finland, we have SMS loans with very high IR. IRR would vanish those.

If it were easier to get out of debts it would make it easier to have a fresh start. On the other side access to credit would be more difficult.

(Provider Association, Germany)

IRR exclude consumers with a lower creditworthiness from obtaining credit. This is because banks are not able to cover the actual costs of credit for those consumers due to IRR. If insolvency would be made easier, banks would have to face higher losses and would therefore have to compensate higher costs in their credit prices.

There should be different ceiling levels, since there are different credit products with different risks. Eg. a car credit has a lower risk than an unsecured loan.

Access to credit always depends on the individual creditworthiness of a customer that has to be thoroughly assessed when applying for a credit. The availability of credit products for low-income consumers increases, when using risk-based pricing. IRR at a low level are generally minimizing access to credit for low-income consumers, since banks are then not able to adjust their pricing to the risk of the borrower. Risk-based pricing generally raises credit access for low-income customers. IRR at a high level (eg. average times 3) are sufficient in order to avoid over-indebtedness. Limited access to credit is a vital mean in order to avoid over-indebtedness and an expression of responsible lending.

(Provider Association, Italy)

There have been phenomena of credit rationing and no direct benefits in term of fighting usury; consumers are aware credit providers simply abide to rules: NO CIRCUMVENTION.

Compliance costs are significant: no impact assessment has been conducted.

IRR are not effective to fight usury.

There is no evidence of a positive effect of rate restriction in the control of over-indebtedness. No understanding of responsible lending requirements and disclosure.

(Provider Association, United Kingdom)

Free market competition and a realization that imposition of IRR would restrict the market and reduce the availability of credit.

Research indicates that IRR results in less product diversity; and access to credit becomes restricted; and lenders withdraw from the market; and pricing is increased elsewhere eg. fees.

IRR would make it uneconomic to lend to some customers. This would impact on the pricing and availability of credit for the rest of the market.

Any regulatory action that restricts the ability to lend will limit future over-indebtedness

Alternatively, making consumers liable for borrowing irresponsibly.

(Provider Association, United Kingdom)

Rate caps are shown to create a series of adverse unintended outcomes and tend to harm those they are intended to protect.

(Provider Association, Romania)

In countries where there is not an organisation with direct oversight, a licensing regime would be appropriate. An example of good practice would be Great Britain which chose not to introduce such IRR.

IRR by their nature are an inappropriate and inadequate form of regulation.

Free market competition should establish prices. Improve access to credit. However, the underlying principles behind treating customers fairly should be applied in particular around transparency, fair market practice and clear customer communications.

All caps are a bad idea.

We do not agree with caps however there are clearly different sectors and different products within the market which would require different types of regulation.

(Banking Authority, Malta)

The capping of interest rates would spell the end for certain local licensed institutions.

(Provider Association, Slovakia)

Licensing regime is the best way for all - consumers, regulators and providers. It sets up clear rules how to do the business, avoid malpractices on the market and strongly limit illegal lending.

IRR generate big costs for legitimate lenders as they would need to take into account the added compliance costs. We do not believe that any IRR can provide effects, which are displayed above.

IRR are inappropriate as they do not respect different risks of different customers. It is highly ineffective and do not provide customers any value.

IRR or other price controls are not delivering the results they are aimed for. They do not help customers, they increase costs for legal lenders and do not limit illegal lending.

Caps should not exist at all.

(Other Activity, Estonia)

These restrictions will have effect only if higher interest rates and/or cost of credit are prohibited and punishable by law.

(Other Activity, France)

As stated above, we are rather for the removal of regulation on the rate of wear.

It takes freedom.

(Provider Association, Czech Republic)

Any form of interest rate restriction would have a substantial impact across all sectors of the market.

Free market should establish the level of interest rates.

An effective regime of controls was already introduced by CCD (Act. No. 145/2010 Coll.). No new controls would help to make the market more effective.

(Provider Association, Denmark)

A general clause about unfair interest rates is enough and gives a good protection for the consumer together with the other consumer protection rules in CCD 2008.

(Provider Association, United Kingdom)

Where they do not exist, this is primarily because they will: reduce access to credit; reduce consumer choice; increase financial exclusion; increase the cost of credit; force consumers into the unregulated credit market; they do not benefit consumers; it will have a number of unintended consequences.

Consumers benefit from transparency, simplicity and fairness which are provided through a combination of statutory regulation and self-regulation. This is far more important than imposing market controls.

(Consumer Organisation, United Kingdom)

We are open to the argument but remain to be convinced that a rate cap would, on balance, benefit to UK consumers. We are also unconvinced that rate caps are the most pressing credit issue for UK policy makers.

We believe that there is a need for a package of policy intervention, although we are not sure what role (if any) interest rate caps should play in this.

(Consumer Organisation, Portugal)

The law only sets ceiling on IRR and for certain credit contracts; this rates encourages institutions to extend credit risk and even mass advertising, encouraging consumers to unnecessary consumption starting a spiral of indebtedness.

(Government official, Latvia)

Regulation on default interest rates is important to prevent over-indebtedness of consumers. However, it should be general enough stating overall rules and boundaries and not numeral caps.

Fees and charges should be regulated by market to offer consumer competitive products for adequate price. However those charges should be adequate and justified.

If ceilings are to be set, they should be flexible enough to promote creating of new products and allowing consumers access to credit.

Caps should differ according to type of loan.

(Provider Association, United Kingdom)

It has not been deemed necessary to regulate interest rates. Rate restrictions would not enhance the UK's existing legislation but would potentially restrict the market, constrain competition and be to the detriment of the consumer.

The use of the IRR model does not exist in the UK. We believe that the focus should be on transparency and clarity ensuring that consumers can make informed choices and understand how the product works and the cost attached to it.

The introduction of IRR would distort the market and lenders would gravitate towards the cap.

As we have seen within the UK, increased regulatory burden results in additional cost for the credit market and this is, inevitably, reflected in the cost to the consumer and a reduction in competition.

As has already been stated, we do not believe that IRR deliver sufficient consumer benefit when viewed against the impact on the competition, product availability, and consumer choice.

(Provider Association, Czech Republic)

The main impact of the caps would be worsening of the access to credits. A rejection rate in the banks will increase just because of the individual cost of risk (of worse-profile clients) will not cover maximum rate.

Regulation of variability does not bring anything else than restricting to variety. It certainly would not protect consumers in any aspects; it would only limit them in their choices.

Regulation of prices does not mean that consumers are going to pay less, mostly quite contrary. It means neither wider access to credits nor wider range of products offered, again both quite contrary.

(Provider Association, Belgium)

A too restrictive regulation has counterproductive affects: closure of the market, less innovative products...

The caps must vary in relation with reference indexes of the market (either mortgage or consumer credit).

(Provider Association, Netherlands)

The effect of IRR is that potential interest margin for suppliers will be limited.

The limitation of interest rates will lead to a worsening of the profitability of small loans in particular. Micro Finance will thus be negatively affected by restrictions.

(Public Authority, Bulgaria)

The main thing learnt is that the situation in every country is unique and it is not possible to directly copy and apply IRR policy of other EU member states, without taking into account the different macro- and micro- economic factors.

Level of the interest rates depends on risk - a possible cap would stop credits towards risky but potentially profitable investments. Moreover entrepreneurs with no credit history would not be able to borrow as the bank would not lend at higher rates.

If IRR regime is introduced, it should be constantly monitored and changed according the pace of the development of economic cycle, in order not to restrict the economic growth.

(Government official, United Kingdom)

Concerns that introducing ceilings on interest rates could lead to a decrease in access to legitimate sources of credit and an increase in use of unlicensed sources of credit.

(Government official, Finland)

Reasons not to introduce ceilings relate mainly to fear that vulnerable consumers would fall outside the normal credit market and a black market would emerge.

Without any restrictions on default interest rates, these interest rates would be higher and thereby cause more problems to vulnerable consumers. Rules on default interest rates are fairly well-known among consumers.

If fees and charges are not included in the cap, rules will probably be very ineffective and easy to circumvent.

(Consumer Organisation, Germany)

A main objection is the general attitude that prices are to be influenced by the market, not the law. Rules und court rules on fees may yet always refer to inadequate and one-sided influence on pricing as market rules do not or do not adequately apply.

(Consumer Organisation, Denmark)

In effect there are no alternative controls on the cost of credit.

In relation to consumer credit there are major problems due to the lack of IRR. We have three distinct markets for consumer credit: 1) consumer credit obtained through banks are usually reasonably priced and the consumers ability to repay the loan is assessed 2) consumer credit obtained in retail stores or via the internet have APR's of 20-60% and the consumers ability to repay the loan is not assessed at all or not assessed in a responsible manner (hence we have many over-indebted low-income consumers) and 3) SMS-loans and Web-loans with APR's of several thousand percent (typically you borrow 1000 DKK and repay 1300/1400 DKK after 30 days). A cap of 30% APR would not have an impact on the first market where APR's are already below the cap and price competition puts (moderate) downwards pressure on prices. On the second market lenders would have to rethink their business models. Lower risk premiums on the individual loans means that they no longer could afford the same number of customers defaulting on their loans and (better) assessments of the consumers ability to repay the loans would have to be made. This means that prices would be lower and that some low-income consumers would be denied access to credit. This could be a good thing as 30% is still very high and anybody with a reasonable chance of paying back the credit would be able to borrow at this rate. In terms of the third market, a cap of 30% APR would be the end of SMS-loans and Web-loans in Denmark as the business model is premised on the ability of lenders to absorb a large number of defaults through high interest rates.

The common solution to reducing over-indebtedness relating to lending from the three distinct credit markets is to increase the providers financial risk when engaging in irresponsible lending. On the first market (as well as the mortgage market) more consumer friendly 'regulation on personal bankruptcy' and 'tighter responsible lending requirements' would have the most pronounced effects. On the second market (which contributes the most to over-indebtedness) interest rate restrictions would have the most pronounced effects. On the third market the loans are relatively small and are not as such causes of over-indebtedness.

First of all we need to acknowledge that there are different credit markets and that they should be regulated differently. Ceilings should take into account the providers cost of funding (the market interest rate at a particular point in time), and the security of the loan.

In terms of an APR-ceiling for consumer credit it should probably be combined with a cap on the total cost of the credit in relation to the amount of the credit to avoid providers prolonging the repayment period in order to stay below the APR-ceiling.

A sophisticated model for the setting of ceiling levels generally, could be that the National Banks of the member states regularly calculate 3 caps based on, for example, the market interest rates of 3-, 7- and 10-year repayment periods plus say 5% (to cover administration, reasonable profit and defaults/risk). The exact level could be calculated by analyzing average administration costs, reasonable profit and a risk premium/default rate that is politically acceptable.

(Financial Regulator, Netherlands)

Consumer credit interest rate should be capped to protect consumers. Mortgages don't need capping because there is enough other regulation for protection purposes.

(Consumer Organisation, Romania)

Why regulate the prices in the financial market and not also in the vegetables market?! Other types of regulations are needed for banks, that is when investing and speculating deposits; but not for the interest rate for credit. Better is to educate consumers not to spend money they haven't earned yet; save first, spend later. Of course, a special case is the mortgage credit. Here we have a misbalance in the present time: consumers had obtained a credit for a house whose price now has diminished.

If low-income people will be given greater access to credit (that is by imposing low interest rates), it will be unfair towards other people, with medium-income.

(Government official, France)

The credit market is much more competitive now than it was when the legal usury rate was introduced. Still, the financial crisis led the French government to consider that IRR are an effective protection against excessive risk-exposure by money lenders and borrowers. Indeed, sub-primes and near-primes do not exist in France. The interest rate of revolving credit is relatively lower than in other countries, though it nears the usury rate with an average APR around 16-17%.

All in all, consumers have benefited from the interest rate ceilings. On the one hand, this ensures that money-lenders will not use their market power to enforce abusive interest rates. On the other hand, it does prevent the riskiest consumers from accessing the credit market. The general consensus in France is that lesser access to credit is preferable to an increased risk of over-indebtedness for low-income consumers. The consequences of the development of sub-prime markets in other countries in the past years have strengthened this consensus.

Overall, the French government is satisfied with the IRR system.

(Banking Authority, Spain)

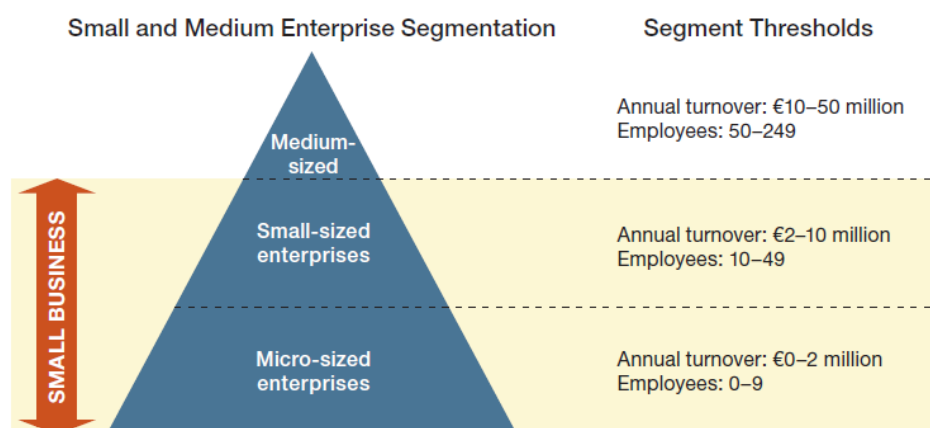
We do not favour introducing IRR, either caps or other types of controls.

Annex XVI: Observations on SME and microenterprise lending

As explained in the introduction and elsewhere (see Chapter 2.1 and subsection 2.1.5 on page 157), the study is primarily concerned with credit markets to consumers as IRR is primarily designed for reasons of consumer protection rather than for prudential reasons. Because the general purpose behind IRR to protect borrowers from the securing of excessive or abusive economic rent by the lender is also valid for the lender-borrower relationship for business loans to small and medium sized enterprises (SME), this Annex will outline some definitions with regard to business lending, market description for microcredit, and summarise some recent legislative changes with regard to IRR that have affected credit markets for businesses in France.

Small and medium size enterprises (SMEs) and microenterprise lending

SMEs are usually classified using methods based on the number of employees (headcount), annual sales (turnover) and value of assets and net profit (balance sheet). According to the European Commission's definition from its Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises³¹¹, enterprises qualify as micro, small and medium-sized enterprises if they fulfil the criteria shown in the graph below.



Source: European Commission Recommendation 2003/361/EC.

Though small enterprises, defined as enterprises which employ fewer than 50 persons and whose annual turnover or annual balance sheet total does not exceed €10 million, will also be affected by IRR, it becomes increasingly unlikely that firms will be significantly affected by these the larger they are. One reason is because the financing regimes become structurally very different as the firm's reliance on banking intermediation as a source of finance decreases and capital markets offer increasing financing possibilities. This is in strict contrast to small enterprises who are compelled to rely on bank financing and the existence of a sustainable commercial relationship with their banker. One reason this relational banking is so important for SMEs is because there is not the large quantity of public information available that comes with being a larger business, and as such bankers need to be well acquainted with the needs and appreciation of risks of its client's business ventures. Furthermore, statistically, firms with larger turnovers become less reliant on only one bank and are far more likely to

³¹¹ See <http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/>.

have multi-banking channels for loans. SME lending is also distinguished from corporate lending to larger firms by bank regulators in their assessment of risk.³¹²

A further distinction can be made between small businesses³¹³ (whether privately owned corporations, partnerships, or sole proprietorships) and micro-enterprises, this later category covering the smallest businesses, often located in private homes, single-family operated business with few (or no) employees other than the owners. There is also a notable trend to further segment different-sized microenterprises; for instance, the term Very Small Business is now being used to refer to businesses that are the smallest of the smallest, such as those operated completely by one person or by 1-3 employees. This attempt to define a microenterprise reflects recent EU entrepreneurial and employment developments and testifies the aims of the European Commission to encourage the adoption of measures addressing the specific problems micro enterprises face, especially during the start-up phase (see microcredit section on the following pages).

A differentiation between lending to SMEs and consumers is nevertheless common in the definition of banking based on the object of the lending activity ie. between those conducted by a commercial bank (also known as a business bank) which takes deposits and gives loans to businesses or corporations, and those by a retail bank which deals with individual citizens or consumers as opposed to companies or other banks (primarily handling savings and checking accounts, mortgages, and personal loans).³¹⁴ Banking provided to individuals, referred to as retail banking is thus distinct from business banking where loans are provided to SMEs.

IRR and its effects on credit markets for SME and microenterprises

The first observation is that EU SME financing is not subject to IRR to the same extent as consumer credit markets. Ceilings only exist in Italy and France (for overdrafts only). The study thus focused primarily on IRR with respect to consumer credit (mortgage and non-mortgage). Because similarities between SMEs and consumers exist, such as their dependency on the banks for their financing (unlike larger firms that can access capital markets) and vulnerability to tightening credit exposures by the banks as a consequence of stronger bank capital requirements as at the current time, the findings of the report can be extrapolated and are generally applicable to an assessment of IRR effects on credit markets to professional credit (business loans for commercial purposes). Nevertheless, some of the differentiating factors between the two distinct users of finance for economic activity are outlined below:

- **Overdraft facilities or credit lines can be far more substantial:** This facility with a stated maximum amount that an enterprise is entitled to borrow from a bank at any given time is of far greater relevance and necessity for businesses that have larger inflows and outflows affecting their liquidity or cash flow position.

³¹² The so-called Basel II rules where bank appraisal of ex-ante individual counterpart risk and credit risk in their portfolios, and where retail credit and loans to SMEs receive a different treatment to corporate loans which require more regulatory capital for given default probabilities. The main reason for this differential treatment is that small business loans and retail credit are generally found to be less sensitive to systematic risk. Their risk of default is thought to be largely of an idiosyncratic nature and, as a result, default probabilities are assumed to be more weakly correlated when compared with corporate loans. Another reason for the preferential treatment of retail credit lies in a technical assumption by the Basel Committee that maturities are shorter. See "Credit risk versus capital requirements under Basel II: are SME loans and retail credit really different?" BIS, Tor Jacobson, Jesper Lindé, Kasper Roszbach, August 2005.

³¹³ Examples of small businesses include: convenience stores and other small shops, hairdressers, tradesmen, lawyers, accountants, restaurants, guest houses, photographers, small-scale manufacturing etc.

³¹⁴ Note however that there is another common classification of credit banking based on the distinction between commercial banking (generally accessible to anyone with banking needs) and merchant banking (serving mainly large companies and very wealthy individuals), which include SME and household finance in both definitions.

- **Personal credit cards may be used for SME source of financing:** The more severe consequences of liquidity constraints, mean that entrepreneurs tend to resort to credit cards for financing when other sources of credit are unavailable. Credit cards offer the self-employed a convenient payment mechanism and easily accessible way to borrow. Whereas large firms are more likely to use business credit cards, the smaller firms will often only have their personal credit cards.
- **Credit standards may differ:** These internal guidelines or criteria reflect a bank's lending policy and written or not written define the types of loan a bank considers desirable and undesirable, its designated geographical priorities, collateral deemed acceptable or unacceptable, etc.
- **Credit terms and conditions are more varied:** The specific obligations agreed upon by the lender and the borrower may consist of more than the direct price or maximum size of the loan, as SME lending is also subject to other terms and conditions in the form of non-interest rate charges (ie. fees), collateral requirements (including compensating balances), and loan covenants.
- **Debt restructuring may be more common:** As more rational economic agents with repeated use of credit, enterprises may be more prone to use debt restructuring than households ie. to avoid defaulting on existing debt or to take advantage of lower interest rates or lower interest rate expectations.
- **Greater variety of non-interest rate charges:** Various kinds of fees that can form part of the pricing of a loan for SMEs are less relevant for credit to households, such as commitment fees on revolving loans, administration fees (eg. document preparation costs), and charges for enquiries, guarantees and credit insurance.
- **Greater product and service offering:** Among the additional services provided to businesses are more treasury services, revolving credit, merchant credit, cash management, group insurance, corporate cards and secure internet banking.
- **Differing profitability potential:** SMEs may be extended credit at lower rates of interest than households, since SMEs may bring in more money to the bank as compared to retail banking customers who tend to need more maintenance compared to their deposit sizes.
- **More alternative sources of financing:** Other than a bank start-up loan, an entrepreneur wanting to start a business can obtain financing from either their own personal savings, friends and family (with lower returns expectations), loans guaranteed by specific entities, hire purchase, factoring, and the possibility to obtain equity investments from venture capital firms or other investors if operating a more sophisticated business.
- **Timely interventions in times of crisis:** Because of the role SMEs play in terms of employment and investment spending for economic growth, businesses are more likely than consumers to receive help from the authorities as was seen in the recent financial crisis where the European Commission for example introduced an updated Late Payments Directive in April 2010 and the European Investment Bank made €30 billion available for SMEs.
- **Greater requirements for documentation:** Because lending to businesses is inherently risky (especially smaller businesses), providers will want assurances that their funds will be repaid. The documentation which banks generally require from an entrepreneur in order to assess a borrower's risk is far greater than for households. Eg. to obtain a bank loan, businesses must typically be prepared to provide several years of financial statements, information on existing debts along

with accounts receivable and payable, lease details, projected future income streams and signed personal financial statements. Microenterprises and potential borrowers from guarantee funds will also need to prove their good character as well as their expertise and commitment to business success (with expected contributions from their own funds).

These specific factors of SME lending may have a more or less determining role in upholding the conclusions of the report with regards to the hypotheses investigated with regards to the effects of IRR on aspects of the credit market. However, because the empirical work and quantitative and qualitative fieldwork was focused on credit to consumers, any deviations in the assessment of the validity of our set of hypotheses cannot be totally ignored.

Microcredit in the EU

Microcredit³¹⁵ is the extension of very small loans (micro loans) to the unemployed, to poor entrepreneurs and to others living in poverty that are not considered bankable. These individuals typically lack collateral, steady employment and a verifiable credit history, and therefore are unable to meet the minimal qualifications to gain access to traditional credit. Entrepreneurs often find it difficult to borrow small amounts, because many banks see microcredit as a high-risk, low-return activity, and their handling costs are high in relation to the lent amount.

Microcredit should not be confused with short-term or small-sized loans. Although there is some overlap, microcredit serves a specific purpose and is not associated with consumer credit as such. Neither should it be confounded with business loans for SMEs more generally as these will often be profitable ventures in themselves. Microcredit is considered in the EU as a way to encourage self-employment and the development of microenterprises. These microenterprises represent over 90% of all enterprises (of all sizes) in the EU. Though there is still no internationally accepted definition of "microcredit", it is generally defined as the provision of credit in limited amounts to lower income households and small, informal businesses. It is thus broadly viewed as a business line that can be carried out by a wide range of institutions providing a range of financial services, such as lending, deposit taking, insurance, payments and funds transfers.

The European Commission has launched a number of important initiatives to promote the development of microcredit in the EU including a definition which is that of a loan of up to €25,000. The Commission states that increasing the supply of microcredit is important for encouraging new businesses, stimulating economic growth (in line with the EU growth-and-jobs strategy) and opening doors to people who would not otherwise have such opportunities (EU policy on social inclusion). Microcredits are increasingly being used as a tool against poverty and exclusion in the EU and is increasingly seen by the authorities as a credible tool in promotion of social cohesion. Eg the European Union has launched the JEREMIE initiative (Joint European Resources for Micro to Medium Enterprises), in collaboration with the European Investment Bank (EIB) and the European Investment Fund (EIF) aimed at improving SME access to finance and venture capital.

In general terms, micro-credit in Europe addresses two groups: "micro-enterprises", defined as enterprises employing less than 10 people and "disadvantaged persons" (unemployed or inactive people, those receiving social assistance, immigrants, etc.) who

³¹⁵ Microcredit is a financial innovation which originated in developing countries where it has enabled extremely impoverished people (mostly women) to engage in self-employment projects that allow them to generate income and to begin to build wealth and ultimately to exit poverty. These microcredit borrowers are increasingly seen by traditional bankers as pre-bankable as microcredit gains credibility in the mainstream finance industry.

wish to go into self-employment but do not have access to traditional banking services. Micro-credit is of particular importance for rural areas and can play an important role in helping to integrate ethnic minorities, and immigrants both economically and socially. Over recent decades, the EU economy has evolved from one driven by large-scale industrial enterprises to a greater dependence on smaller businesses, including one-person business, mostly in services.³¹⁶ In Western Europe, microloans are largely given to individuals in poverty and to those excluded from the banking system. Given the size of the banking system in European countries, we are nevertheless talking about a very small percentage of the population.

As a result of EU and national initiatives, there are increasing numbers of statistics available to measure the characteristics of EU microcredit. The number of loans disbursed, the total value of loans outstanding, and the average size of a loan are thus available based on a survey conducted by the European Microfinance Network (EMN) which are reproduced below.³¹⁷ Though not a survey including the complete entirety of microcredit organisations, a total of 84,523 microloans worth €828 million were disbursed in the EU in 2009. With 26% and 40% of these respective values attributable to activity in the Eastern countries, the average loan value is higher in the Eastern countries as in the Western EU countries. The greatest number of loans disbursed by country is led by France (28,863)³¹⁸, which is also the country with the largest number of active clients (70,252) followed by Finland, Romania and Spain. The largest number of microcredit providers is found in Italy (via the large number of small social microcredit initiatives and anti-usury associations), Bulgaria (via commercial banks) and Hungary (savings cooperatives and Local Enterprise Agencies), followed by Spain (via savings banks) and the UK (via public, private and non-profit development finance agencies, CDFAs). The majority of these EU organisations work at a national (70%) or local level (32%), with only 6% operating cross-border.

The average microcredit loan size for the EU was €9,641 in 2009 and varied from €19,000 in Finland to €2,500 in Latvia with Finland, Sweden, Belgium, Hungary, Ireland and Germany all in the group of countries with loan amounts above the average. Caution in interpretation is nevertheless necessary because these averages do not reflect differences in standard of living or relative poverty levels, and may hide the real situation such as the case in France, where different organisations extend credit on different terms including loan size, namely ADIE representing 97% of the market with an average loan size of less than €3000. This example not only shows that the source for these figures (the EMN mentioned above) should perhaps have used the median rather than the mean for calculation of the average, but demonstrates that microenterprises may often be targeting different consumer segments. This is true in France, where ADIE is fundamentally geared towards the socially included, whereas other microlenders are financing the development of more economically robust microenterprises or businesses.

The regulatory and supervisory practices may differ across countries and institutional types ranging from: Banks (institutions licensed for taking deposits from the general public and subject to banking supervision), and Non-banks which are made up of Other deposit taking institutions (ODTIs, institutions that are authorised to collect deposits

³¹⁶ See: The European initiative to develop microcredit in support of growth and employment (2007), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0708:REV1:en:PDF>. On p6 of this document, it is stated that one aim of the initiative is to “....help micro-credit to become sustainable by relaxing interest caps for micro-credit operations”.

³¹⁷ See: Overview of the Microcredit Sector in the European Union (EMN 2008-2009, June 2010). Available at <http://www.money-advice.net/media.php?id=3910>.

³¹⁸ In France, two organisations, a not-for-profit organisation (France Initiative) and an NGO (ADIE) disbursed 14,050 and 13,997 loans respectively in 2009, with the difference that disbursement of funds by the former was in the form of zero-interest quasi-equity loans that allow beneficiaries to access significant complementary bank credits, as opposed to stand-alone interest bearing loans.

without necessarily being subject to the same regulation and supervision as banks eg. financial cooperatives³¹⁹ and Microcredit institutions (MCIs - institutions that lend for limited amounts, without being authorised to collect deposits).

Microcredit has a number of distinctive features such as product design, client profile and labour-intensive underwriting methodologies, four main features are³²⁰:

- **Microborrowers:** A microcredit provider usually caters to low-income clients, both the underemployed and the entrepreneur with an often informal family business. Borrowers are typically concentrated in a limited geographic area, social segment or entrepreneurial undertaking (eg. when socially motivated investors have a special interest in targeting a given region or social segment, such as women or immigrants). Loans are usually very small, short term, and unsecured, with more frequent repayments and higher interest rates than conventional bank loans.
- **Credit risk analysis:** Loan documentation is generated largely by the loan officer through visits to the borrower's business and home. The borrower's character and willingness to repay is also assessed during field visits. Credit bureau data are not always available for low-income clients or for all types of microfinance providers. Credit scoring, when used, complements rather than supplants the more labour-intensive approaches to credit analysis.
- **Use of collateral:** Microborrowers often lack collateral traditionally required by banks, and what they have to pledge is of little value for the financial institution but are highly valued by the borrower (eg TV, furniture). Where the lender does take some sort of collateral, it is for leverage to induce payment rather than to recover losses.
- **Progressively increasing lending:** Customers who have limited access to other financing are usually dependent upon ongoing access to credit. Because some microlending uses incentive schemes to reward good borrowers with preferential access to future, larger loans (sometimes with favourable repayment schedules and lower interest rates), this may increase the risk of over-indebtedness.

For these reasons, it is understandable that many providers require higher interest rates to offset higher operational costs involved in the labour-intensive microlending methodology (eg. in the absence of collateral, underwriting depends on careful analysis of the household's repayment capacity and the borrower's character). However, as covered in the main part of the report with respect to credit provision of small sizes more generally, high interest rates for sustainable microcredit are also the result of the fact that a portfolio of very small loans are usually more costly than the same total value of lending in larger amounts, as not all costs vary in direct proportion to the amount lent.

However, development of national microcredit sectors is not solely determined by the access or non-access to finance, and will largely depend on the desirability and prevalence of self-employment against a status of employee (whether motivated by opportunity or necessity). Statistics in this regard show that the status of self-employed is most preferred in countries like Italy and the UK. Italy incidentally, a country where business loans are subject to usury ceilings, suggests that these ceilings may not actually constitute a significant barrier to self-employment opportunities.

³¹⁹ A term that includes a diverse group of member-owned financial intermediaries referred to as credit unions, savings and credit cooperatives, cooperative banks etc.

³²⁰ See: "Microfinance activities and the core principles for effective banking supervision - final document", Bank of International Settlements, Aug 2010, at <http://www.bis.org/publ/bcbs175.htm>.

Because the issue of IRR and microcredit is a worldwide one, it may be useful to outline some suggestions from a recent industry report on responsible pricing in microcredit other than the most common option of using interest rate ceilings.³²¹

- **Interest rate ceilings:** Primary virtue of caps being their simplicity (easy to understand, and the same standard gets applied to all financial institutions) and their greatest weakness in the developing world is that interest rate caps apply the same standard to all financial institutions, regardless of their location, type of clients, loan size, or loan term (as we have seen, this is not the case in the EU). The potential negative effects of caps should they be set unrealistically low have been explored in main part of this report.
- **Margin Caps:** A ceiling on the difference between the underlying costs incurred by a financial institution and the amount it can charge its borrowers. This method takes differences in costs between providers into account eg. a version proposed by Nobel Prize winner Muhammad Yunus has a traffic light system based on the difference between an MFI's cost of funds and the interest rate it charges (Green Zone which he calls poverty focused institutions whose interest rates are 10% or less above their costs of funds, Yellow Zone between 10 and 15%, and a Red Zone of money lenders and loan sharks who charge 15% or more above their cost of funds). Again, this method has the advantage of simplicity. A person only needs to know two numbers in order to determine the reasonableness of a price, an institution's cost of funds and the interest rate it charges. However, this simplicity makes it very difficult to apply this standard across a wide range of locations and conditions (a study showing that 75% of all MFIs would land in the Red Zone, especially NGOs with small average loan sizes because the formula does not take into account differences in operating costs).
- **Return on Equity Policies:** This involves not looking at the price but to examine whether the financial institution is receiving excessive profits from the poor people it serves (ie. pricing structures that result in very high profits, high return on equity (ROE), could be made more affordable without endangering institutional sustainability). By deliberately setting an ROE target, MFIs hope to manage the tension between institutional profitability and institutional mission, however limiting profits would have little effect on the institutions with moderate interest rates, and the approach could obscure inefficiency in financial institutions.
- **Comparative Transparency:** Another approach to responsible prices avoids the setting of ceilings or limits and instead advocates for a public listing of the prices for all microfinance products in a country, using a common method for defining the price (APR and effective interest rate (EIR) on these products posting this information on a website (eg. MicroFinance Transparency has a graph depicting each loan product plotted by its APR and average loan size, which produces a market price curve and makes it easy to see which loan products carry prices that are far above the market average for those sizes of products - though the graph does not distinguish between loan purposes (education, housing, business, consumption etc.)). The idea being that the tool (common definition of price, providing information on each loan product rather than averages, showing the information differentiated by loan size, and collecting information on all loan products for a single country at one time) could lead to downward pressure on interest rates either through MFIs seeing their APRs compared to others, regulators will be able to identify those who charge significantly above the market for a given loan size and put pressure on them to lower prices, MFIs charging

³²¹ See "Responsible pricing: the state of the practice", the Smart Campaign and MicroFinance Transparency, July 2010) available at: <http://www.money-advice.net/media.php?id=3921>.

lower than market rates may advertise this fact. But weaknesses are the long and labour intensive process of collecting data, the uncertainty of frequency of updates and accuracy over time, microfinance clients will not have ready access to this data when purchasing, showing comparative data may not help much in markets where there are few providers who charge similar prices.

- **Promoting Competition:** This approach has worked somewhat so far where as microfinance has become more popular, a greater number of providers have entered the market putting downward pressure on average interest rates in developing countries.

A case study – France (legal changes in 2003 and 2005)

The issue of IRR is seen as particularly relevant to very small enterprises³²² presenting a level of risk greater than the average SMEs (eg. young enterprises or those in the creation phase). This was the case in France at the end of the 1990's when a period of low base rates meant that a number of these very small enterprises were not allegedly being served by banks due to the usury ceilings in place limiting the ability of banks to cover the costs of lending to them.

A study of the issues of IRR and discussions over the modernising and updating of the existing mechanism featured in length in the 2000-2001 annual report by the consultative committee of the French central bank.³²³ Back in 2000, the usury ceilings applied to business credit (which have a history of change³²⁴) were seen as particularly problematic because the economy was at a point in the cycle where average rates were low and the formula for setting the ceiling ($\times 1.33$) was seen as too constraining in comparison with its limiting effect when average rates are higher, and the time-lag between the date of capture of the data and subsequent period for which the ceiling is applied was seen as too unresponsive (ie. a delay of over 5 months could be constraining in periods of high volatility in rates). When rates are low, providers argued that the risks involved with small enterprises or specific phases of their development, could not be sufficiently covered when the rate differential was so small, leading to banks refusing these enterprises a credit. Providers also stressed that the APR definition used for the ceilings made this problem particularly acute in times of low rates. A further point raised by the providers was that interest rate ceilings were justified on the grounds of consumer protection and that this need for protection was greater for a consumer than a business - citing a European Commission communication making the distinction between an experienced (in this case the business) and non-experienced person (the consumer). Providers also challenged the legality of the ceiling on businesses on the grounds of the law of 1993 which transposed the stipulations of the law of 1966 into the consumer code (and thus outside the jurisdiction of businesses). During the debates, the enterprises interviewed made the following observations: small enterprises with a weak bargaining power vis-à-vis the providers justified protection; the rationing effects of the ceiling had no quantitative basis; the ceilings only had an effect on the very small enterprises and

³²² In France the term very small enterprise (très petites entreprises, TPE) is equivalent to the definition of the EU for microenterprise (less than 10 employees) however micro-enterprises is a more restrictive term in France. Microenterprises are almost exclusively sole-proprietorships (one-man business, called entreprises individuelles, EI), and their status confers them a specific tax regime (tax exonerations such as from VAT).

³²³ See: Rapport annuel 2000-2001 du Comité consultatif (former CCSF of the Banque de France), pp. 21-37, available at http://www.banque-france.fr/archipel/publications/ccsf_cc_ra/cc_ra_2000_2001.pdf.

³²⁴ A brief history of IRR affecting SMEs in France since the French revolution includes the law of 1807 reinstating a ceiling - but confusing the usury ceiling (taux d'usure) with the legal rate ceiling (taux légal) when setting these at 5% for civil matters and 6% for businesses; the law of 1886 which removed the rate ceiling for businesses (and then for civil matters as well in 1918 on economic grounds to promote reconstruction), before being reinstated in 1935 before reaching its contemporary regime through the laws of 28.12.1966 and 31.12.1989.

those starting-up or developing; those not being served by banks turned to other alternative methods of financing including approaching foreign banks for loans; certain business ventures would benefit from having a better quality of banking relation and provision of counselling and information.

When the conservative majority reached power in 2002, the authorities proposed a law to relaunch economic activity which included a revision of the usury ceilings applicable to businesses.³²⁵ Although the reform in its initial version was suggesting only an increase in the setting of the interest rate ceiling for businesses (ie. a relaxation by modifying the fixation method to the average APR plus 15 percentage points), the resulting law of August 2003 led to its removal altogether, albeit, not applicable to credit that was extended in the form of an overdraft nor to those credit contracts that concerned their non-commercial activities. While this 2003 law disappointed microcredit advocates by only concerning credit to moral persons, a subsequent 2005 law then also extended the exception from the usury ceilings to business credit extended to those individuals exercising a professional activity (eg. the self-entrepreneur). The result of the Dutruel laws of 2003 and 2005³²⁶ has been the removal of usury ceilings for credits to businesses and the self-employed, with the exception of overdraft credit which is still subject to the applicable usury ceilings, however with the notable exception that the sanctions for breaching of the ceilings set for overdrafts to businesses are no longer penal and only civil. Below is a description of some of the views expressed during the legislative process.

In the first reading, end 2002, the members of the parliament discussed the arguments put forward for the change in the regime of usury ceilings applicable to businesses (Article 17), namely that these ceilings excluded the enterprises displaying the highest level of risk from access to bank loans and that if the ceilings were to be set at a higher level this would enable banks to accept to finance more risky project ventures. This argument however, did not convince the parliamentary committee in charge because of its reservations that the efficiency of the suggested arrangements were difficult to measure and not sufficiently justified with regards to the risk of a hike in interest rates charged to existing businesses that could result from a less restrictive setting of the ceiling. At the time of the discussions, outstanding loan amounts to businesses were about €54 billion of overdrafts and €110 billion of loans of maturity less than two years. Although average interest rates for business start-up loans on the market were observed at 6.7%, more than 2 percentage points below the interest rate ceilings for business loans, the alleged credit rationing was subject to intense debate as was the observation that these very small enterprises not receiving access to credit were being forced to turn to other alternative sources of financing solutions that were more expensive than the classic business loans (eg. factoring, leasing of real property or personal property, hire-purchase etc..). Furthermore, those business creators unable to obtain a bank loan, were said to have tried to finance their venture through consumer credits, a credit category subject too much higher (looser) ceilings of over 18%. Though this resorting to consumer credit would likely be reduced as a result of the supply side reaction to the change in ceilings for business loans, the resulting balance between the additional loan volumes distributed to newly served borrowers and increase in income from existing businesses was discussed. While it was argued that the intensity of competition did not warrant fears that provider lending margins would rise, other arguments voiced included that in reality,

³²⁵ Leading to the Loi n°2003-721 du 1 août 2003 pour l'initiative économique (1). <http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000000414455&dateTexte=>. The reasoning behind the law for economic initiative was based on finding solutions to the creation, selling on and taking over of businesses, along 5 lines, of which one entitled "measures enabling a better financing of economic initiative" consisted of an investment fund (fonds d'investissement de proximité), fiscal advantages (tax deduction of up to €10,000), doubling of the loss deductability threshold, and facilitating credit access to businesses through the relaxing of the fixation rules of the interest rate ceilings.

³²⁶ Loi n° 2003-721 du 1er août 2003 pour l'initiative économique and the loi n° 2005-882 du 2 août 2005 en faveur des PME.

the conditions of a loan are primarily dependent on the guarantees which the business can bring to the table, and that demands for small amounts of credit entailed management costs that made bankers reluctant to lend. One suggested solution put forward put never actually discussed involved excluding from the interest rate ceiling the portion of costs related to the setting up of the loan.

As part of the reform, two and half years after adoption of the 2003 law, legislators mandated the Bank of France to evaluate its effects on lending to small businesses and to the expected spur to small business creation and development. This report³²⁷ was published in 2006, and notwithstanding some alleged improvements along the lines of the hypotheses put forward for reform, the overall findings were rather inconclusive, especially in the face of some criticism of the methodology applied in the surveys used and data interpretation.³²⁸ In the opening sections of its report, the French central bank writes that the setting of interest rate ceilings supposes implicitly that it is difficult to reach an economic "fair price" on credit markets, and that the assumptions of perfect competition, perfectly accessible information and no externalities, underlying a free market determination of rates, is particularly tenuous with regards to SMEs as opposed to larger firms. The report claims that deregulation and removing the ceiling on loans to businesses had the following favourable effects: It made the access to credit for SMEs easier especially for the very small businesses as well as those who had recently been created (with more than 20% of banks having increased the number of loans extended to the self-employed and SME in all sectors – increase in the number of risky enterprises served but also the amount extended - including less delays in granting of credit); Led lenders and borrowers to give up less favourable credit solutions in favour of traditional forms of credit; Favoured more access without increasing the default risks as it had been feared; Helped the creditors to better select their borrowers and to better price them by taking into account the true cost of the risks involved and reducing their reliance on additional guarantees.

However, from the reading of the report, the reform cannot be said with any certainty to have had the desired impact on access to credit. Firstly, the reform was actually one that was weakly noticed by the firms themselves, with the report establishing that there was in fact very little awareness by SMEs of either the pre-existing interest rate ceiling regime or knowledge about the reforms having taken place in 2003 and 2005. In addition, the reform was seen by the SMEs themselves as not having had any significant effect on their relations with their banks. Secondly, some other factors may have played a role in determining the effects outlined above, including heightened competition as a result of globalisation, e-banking, new microcredit institutions (which the report acknowledges), and unnoticed interest rate rises because the non increase in interest rates are observed in a context of general decline in rates in practice. Lastly, seeing that a decrease in lending was being witnessed Europe-wide and acknowledging the new orientation in bank lending towards risk-based allocation of credit, it seems difficult to agree with the main argument behind the political aims of deregulating interest rates at the time, which was that the conjectural decrease in lending was due to the existence of usury ceilings.

As seen previously, France is the most active European country for professional microcredit. Though this has been intentionally promoted by the above mentioned reforms, it is also due to the overwhelming success of Adie, which has been giving media coverage to microcredit for over 20 years, and to the more discreet field work of France Initiative. While both microfinance networks are different in their structures, their

³²⁷ See: "Les incidences de la réforme de l'usure sur les modalités de financement des petites et moyennes entreprises" (Rapport au Parlement, Banque de France, Décembre 2006) available at <http://www.responsible-credit.net/media.php?t=media&f=file&id=2441>.

³²⁸ See: <http://www.responsible-credit.net/index.php?id=1980&viewid=39376>.

philosophies and their targets, they nevertheless have the common feature of being not-for-profit associations. Since then, further reform helping microcredit and business creation includes the creation of a “self-entrepreneur” status (autoentrepreneur) in 2009, and the development of a new form of microcredit serving a different purpose to traditional microcredit for businesses. These personal loans rather than professional loans (called microcrédit social or microcredit personnel) may target the same target group with the same counselling functions, but are distinct because the funds are used for purposes that are the same as consumer credit, namely personal project financing such as for specific housing tasks, help with employment and skill development, mobility, and family events. A report by the French Government on microfinance from March 2010³²⁹ underlines the social and economic utility of microcredit and explains the different models of microcredit extension that exist in great detail, such as the bank guaranteed microcredit.

³²⁹ See: <http://www.economie.gouv.fr/services/rap10/1003rapmicrocredit.pdf>.

Annex XVII: Quantification of the implications of *H1* and *H2a*

Our discussion of *H1* and *H2a* reveals that an influence of interest rate restrictions on the existence of certain credit market segments is highly plausible. In particular, providers in high cost credit market segments such as home lending or payday lending, which rely on an interest rate and fee structure implying high levels of (annualized) interest rates, may not be able to operate their businesses. As a consequence, some groups of the population (those perceived to have high risk and demanding small-amount credit) may be excluded from regular credit access.

Given this concern, one may attempt to *quantify* the importance of lacking credit opportunity in countries with interest rate restrictions. However, transferring the experience of one country to another requires strict assumptions on the behaviour of both demand as well as supply side in the credit markets. In particular, one implicitly assumes that ...

- 1) ... the **demand side behaves equally across countries**. Relatively low levels of credit incidence in one country (compared to another) need to be attributed to the lack of *supply*, rather than to different attitudes toward credit or differing living conditions in the respective countries, which might otherwise influence the *demand* side.
- 2) ... interest rate restrictions are the **only institutional difference** between several countries. One needs to assume that, once interest rate restrictions are adapted to the standards of another country, the entire business environment of suppliers is perceived to be equivalent in those two countries.
- 3) ... interest rate restrictions **are fully effective in shutting down a specific market segment**. One needs to assume that lenders do not have the opportunity to structure contracts in such a way that interest rate restrictions do not apply.³³⁰
- 4) ... there are **no alternatives to high cost credit for a subgroup of consumers**. In particular, one needs to assume that lenders do not offer any kind of credit to some groups of the population when interest rate restrictions are in place nor are alternative options for these groups.

The UK is frequently taken as a benchmark country *without* interest rate restrictions. For the UK, OFT (2010) estimates an upper bound for the market size of home lending in 2008 of GBP 1,300 million (EUR 1,636.44 million).³³¹ This corresponds to a *per-capita* amount of home lending credit of EUR 26.79, and to a share of 0.67 percent of the total consumption credit market. This figure also corresponds to 0.09 percent of the Gross Domestic Product (GDP).³³²

Given that one is willing to accept the assumptions above, one may therefore take these ratios to determine projections for potential market sizes in other countries where the institutional environment (here: interest rate restrictions) still prevents high cost credit markets. In the following, we illustrate this idea based on the four case study countries with interest rate restrictions.

³³⁰ Note that this assumption is at odds with *H7*.

³³¹ The lower bound of GBP 1,200 is not much lower.

³³² The 2008 population of the UK is 61 million, the consumer credit market amounts to EUR 245,217 million and the GDP amounts to EUR 1,812,076 million.

Table 64 demonstrates the results of this approach. Take Germany as an example of a country in which interest rate restrictions prevent home credit lenders from operating as they do in the UK: assuming that every citizen would, on average, take the amount of home lending credit as it is observed in the UK (EUR 26.79), the expected market size for home lending would be EUR 2.2 billion. The estimate is rather similar when assuming that home lending would arise according to a similar share of the GDP as it is the case in the UK. In contrast, assuming that, in the absence of interest rate restrictions, home lending accounts for a comparable share of the *total consumer credit* market (excluding mortgages) as observed in the UK, the market size would be EUR 1.4 billion.

Table 64: Projection of potential home (collected) lending market size

	MS characteristics			Projected home lending volume in a NO ceiling scenario (EUR million)		
	Population (million)*	Consumer Credit (EUR million)*	GDP (EUR million)*	based on per capita value	based on % of consumer credit	based on % of GDP
Germany	82	224,046	2,492,000	2,200	1,495	2,250
Netherlands	17	23,772	590,427	448	159	533
Poland	38	32,803	360,639	1,021	219	326
France	62	155,733	1,947,210	1,669	1,039	1,758

* Values for 2008, Source: ECRI Statistical Package 2009, ZEW.

The comparison of the projections on different bases reveals that there is a higher similarity between the projections on the *per capita basis* and on the *per GDP* basis than on the basis of the *consumer credit market size* for Germany, the Netherlands and France. In contrast, the projections on the basis of *per-capita borrowing* and on the *per GDP* basis are very different in the Poland. This illustrates that there are large differences in GDP/per capita between the UK and Poland, while these values are more similar for the UK, Germany, the Netherlands and France. However, the size of the consumer credit market is again very different (on a per-capita basis) across all these countries. Recall that the results of all these projection strategies should be interpreted with caution as they are subject to the plausibility of the above-mentioned assumptions 1)-4).

In a similar vein, one may estimate the scope of payday lending in the four countries with interest rate restrictions. For the UK, OFT (2010) reports payday lending to amount to an upper bound of GBP 900 million (EUR 1,132.92 million).³³³ This corresponds to a per-capita use of payday lending of EUR 18.55, and to ratios of total payday lending amount of 0.46 percent of the total consumer credit market (without mortgages) and 0.06 percent of total UK GDP. Table 65 presents the estimates based on different ratios for potential payday lending markets in other countries. Note again that these estimates should be interpreted with caution as they are subject to assumptions 1)-4).

³³³ The lower bound is GBP 700 million.

Table 65: Projection of potential payday lending market size

	MS characteristics			Projected payday lending volume in a NO ceiling scenario (EUR million)		
	Population (million)*	Consumer Credit (EUR million)*	GDP (EUR million)*	based on per capita value	based on % of consumer credit	based on % of GDP
Germany	82	224,046	2,492,000	1,523	1,035	1,558
Netherlands	17	23,772	590,427	310	110	369
Poland	38	32,803	360,639	707	152	225
France	62	155,733	1,947,210	1,155	719	1,217

* Values for 2008, Source: ECRI Statistical Package 2009, ZEW.

While these estimates would make sense if the assumptions above hold, one needs to be aware of the fact that these assumptions are **overly restrictive and do not well reflect** the nature of credit markets in European countries: as demonstrated in several parts of Chapter 2.5 (eg. the discussion of **H1** and **H2a**), European countries show differing attitudes toward credit. It is therefore unlikely that demand is universal across countries, as assumption 1) postulates. Rather, one may expect that lower *incidence* of credit in some countries is not only due to a lower credit *supply*, but also due to a *less pronounced preference* for consumer credit. As there are different institutions (eg. consumer insolvency laws), but also different market structures, it is also questionable whether the assumption 2) holds. If assumptions 1) and 2) are implausible, however, the approach to making projections for other countries drawing on data from the UK would not be valid.

Interestingly, assumption 3) is at odds with the findings with respect to **H7** that providers raise those fees which are unaffected by the specific interest rate restriction implemented in a country. As a consequence, credit contracts are restructured in a way that allows the continuation of certain (high cost) credit practices, but under different formal conditions. If this is the case, the estimates above may be an estimation of the market share (and this is only the case if assumptions 1), 2) and 4) hold), but do not identify the effects of giving up interest rate restrictions: the targeted markets **already exist even though there are interest rate restrictions**. The only difference is that credit contracts are formulated in a different way. As a consequence, the effects of the (removal) of the interest rate restriction would be rather low.

To illustrate that this objection is realistic, consider the case of Poland, where a market of home lending does exist along *with* interest rate restrictions. Indeed, the Polish market for home lending is approximately EUR 330 million, which is not too far from the projection on the GDP basis made above. This example illustrates that a dismantling of interest rate restrictions would not lead to an increase of home credit by the amounts suggested in Table 64. Rather, one would expect the lenders to restructure typical loan contracts to cover their costs by the means of interest payments directly.

These considerations underline that any **quantification of the effects of interest rate restrictions requires relatively rigid assumptions**. We conclude that these figures

are inherently unreliable, as the necessary assumptions are unrealistic and do not capture the specific characteristics of consumer credit markets. However, based on the UK experience, it appears that the markets for high cost credit account for only a marginal share of total consumer credit market (about 1 percent). For the other countries, there is no reason to expect that the effect of abolishing interest rate restrictions could lead to a higher increase of credit volume.