eurofinas

SPECIALISED CONSUMER CREDIT PROVIDERS IN EUROPE

Preliminary Observations
Interest Rate Restrictions

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ABOUT EUROFINAS

Eurofinas, the European Federation of Finance House Associations, is the voice of the specialised consumer credit providers in the EU. As a Federation, Eurofinas brings together associations throughout Europe that represent finance houses, specialised banks, captive finance companies of car, equipment, etc. manufacturers and universal banks. It is estimated that together Eurofinas members financed over 320 billion euros worth of new loans during 2009 with outstandings reaching 720 billion euros at the end of the year.

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INTRODUCTION

The Institut Für Finanzsienstleistungen (the IFF) was commissioned by DG MARKT to undertake a study on interest rate restrictions in view of identifying the different forms these ones may take, the Member States that apply them, and their economic, financial, and social impacts on identified stakeholder groups and on the functioning of the Single Market. On the basis of the findings of the study, the Commission will examine whether it is necessary to take any action on the EU level.

Against this backdrop, and in parallel of the contributions provided directly by the industry, we would like to stress a number of points which we deem essential in the context of a European study on interest rate restrictions[1].

1. Diversity of mechanisms in place: objective & subjective controls

Several EU Member States such as Belgium, France or Poland impose a so-called “objective control” on credit interest rates charged to consumers through statutory rate ceilings. These ceilings are fixed and/or reviewed through administrative regulation or by law. In this context, we believe it is crucial to make a clear distinction between restrictions applying to interest rates or to APR.

1.1 Objective Controls – Examples

Poland

In Poland, a specific regulation sets the interest rate ceiling for all credit contracts. Additional changes have been introduced to the consumer credit regulation which contains a restriction of the credit’s additional costs (up to 5% of the total amount of credit). The interest rate ceiling depends on the central bank’s reference rate (lombard) and is set at 4 times that rate. The interest rate ceiling changes every time the reference rate changes. If the reference rate is lowered all contracts which contain a higher interest rate have to be modified by the lender.

France

In France, interest rates ceilings exist for all credit to consumers (including real estate loans). Theses are calculated quarterly by the National Bank on the basis of the market rates for different categories of credits (revolving, linked credit, personal loans etc). No distinctions are made for credits of less than 1524 Euros. The ceilings correspond to market rates multiplied by 1,33. Sanctions in case of non compliance are penal. The system is currently being reviewed by the French regulator.

In the absence of such mechanism, local jurisdictions are in charge of assessing *in concreto* the usurious/extortionate characteristic of an interest rate/credit agreement.

Therefore, implying that the absence of a statutory rate ceiling entails the inexistence of limits or controls whatsoever on credit interest rates would not only be wrong but absolutely misleading.

[1] These observations are restricted to rate ceilings and do not include restrictions to interest rate variability or compound interest rates.

1.2 Subjective controls – Examples

Germany

Germany has no statutory requirements relating to interest rates ceilings. However according to the Federal Court of Justice the morality of a credit contract should be assessed at court. When the interest rate is twice as much as the average interest rate applied on the market (for a defined period), the contractual conditions shall be considered as excessive.

United Kingdom

The UK Consumer Credit Act 2006 provides the courts with powers to determine whether a relationship between the creditor and debtor is unfair on the latter. Unfairness is not defined *per se*, though the Office of Fair Trading issued in March 2010 irresponsible lending guidance which sets out factors contributing to an unfair relationship. These go more widely than just the cost of credit.

Objective controls ease regulators' monitoring of lenders' practices and are usually associated to administrative and/or criminal sanctions. Equivalent sanctions may as well be found in subjective controls systems. Objective controls do not impact *per se* the validity of extortionate credit agreements. In all cases borrowers must contest at court the legality of a credit agreement.

This is why objective and subjective controls of credit interest rates must be analyzed in the wider context of consumer protection both through European and national regulations addressing unfair commercial practices, unfair contract terms and, information and pricing transparency[2].

Significant research has been undertaken on interest rate restrictions across Europe and beyond. Much of it has either been funded or undertaken by stakeholders and/or networks explicitly favorable to price controls.

Against this background, the Federation would like to highlight that the economic principles underlying an operational consumer credit market are equivalent as those that apply for other types of goods or services. This notably implies that i) quantity of credit demand by consumers responds to the price of credit (i.e. the cheaper the credit, the more demand), and, ii) markets generating profit for credit providers stimulates competition through market entry by new competitors and development of innovation.

2. Competitive and fair credit pricing arises from profitable supply and sustainable demand

2.1 Interest rate ceilings have an impact on the number of credit providers active in a market. This means that i) large firms are better able to preserve a profitable activity than smaller competitors under such regulatory restrictive market conditions and ii) new entry by competitors is limited as new providers might face difficulties in offering alternatives to historical players.

[2] See Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market, Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts and, Directive 2008/48/EC of 23 April 2008 on credit agreements for consumers.

As in all sectors of the economy, the benefits of full and effective competition in the consumer credit markets are enhanced efficiency, the provision of tailored products to consumers, constant innovation, and lower prices. Market structure and the intensity of competition can be assessed in terms of **the role of specialised consumer credit providers** and level of concentration in consumer credit markets.

In this context, we believe that the consequences of past introduction of statutory interest rate restrictions in some industrialized economies should be taken into consideration.

2.1.1 Statutory interest rate restrictions have a direct impact on lending institutions strategic business orientations such as location or type of activities

In 1978, the US Supreme Court ruled in *Marquette National Bank vs. First of Omaha Corporation* that “the National Bank Act, authorizes a national bank based in one State to charge its out-of-state credit-card customers an interest rate on unpaid balances allowed by its home State, when that rate is greater than that permitted by the State of the bank's nonresident customers”[3].

The removal of limits on bank card finance charges by several US States led to the influx of credit card operations into those States without restrictions. It is believed that statutory restrictions on APR and fees continue to drive corporate location decisions.

This demonstrates that statutory interest rate restrictions have a direct impact on lending institutions strategic business orientations such as location or type of activities[4].

2.1.2 The introduction of statutory interest rate restrictions necessarily impact on the number of providers and weaken the smallest firms

In January 1977, the Small Loans Regulatory Board of Massachusetts reduced rate ceilings significantly, especially on loans of less than $2,200 to $2,500 (depending upon maturity). The rates that licensed lenders in Massachusetts could charge were lower than those of almost all other States. Between the ends of 1975 and 1979, the number of small loan licences in Massachusetts fell from 266 to 172 (one licence is required for each office). Small local companies were more adversely affected by the low rate ceiling than the national chains of consumer finance companies[5].

The 2004 Policis report on *the effect of interest rate controls in other countries* for the UK Department of Trade and Industry, mentions as well the example of Florida where rate ceilings for Auto Title lenders (Cash loans are secured by the deposit of title to a car) were imposed at the end of 2000[6]. According to the report, the number of Auto Title lenders dropped from 600 pre legislation to 58 in the year following.

This demonstrates that the introduction of statutory interest rate restrictions necessarily impact the overall number of active providers in a given market, affecting particularly the smallest firms.

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[3] See Marquette National Bank vs. First of Omaha Corporation*, 439 U.S.299 (1978). For an analysis, see also M. Staten & R. Johnson,* The case for deregulating interest rates on consumer credit*, Credit Research Center, 1995, p. 20*

[4] See M. Staten*, The case for deregulating interest rates on consumer credit, op. cit., p. 20-23*

[5] See Robert W. Johnson and A. Charlene Sullivan*, Restrictive effects of rate ceilings on consumer choice: the Massachussets experience,* Working Paper 35, Credit Research Center, 1980

[6] See Policis Report for the Department of Trade and Industry*, The effect of interest rate controls in other countries,* July 2004, p. 16

2.1.3 Interest rate restrictions may adversely affect specialised credit providers

In 2006, Japan's Financial Services Agency sharply reduced the ceiling on consumer loan interest rates. The reform had a major impact on local specialised providers.

The drop in the overall new production and outstandings could not compensate for the increased funding costs. In this context several institutions required bankruptcy protection from their creditors and some foreign players simply withdrew from the market. The overall decrease in values of specialised consumer credit providers forced the creation of alliances with mainstream institutions in turn leading to higher market concentration[7].

2.2 Applicant borrowers' risk of default influences the price of credit. This means that the credit provider adjusts interest rates charged according to the borrowers' risk of default. A competitive market ensures that pricing reflects borrowers' repayment risk. Interest rate restrictions have an impact on the ability of credit providers to adapt their pricing to borrowers' repayment risk. In turn, restrictions may have an impact on the availability of credit.

As a direct consequence of the Japanese reform mentioned above, a decrease of more than 30% of the loan acceptance ratio was observed between years 2006 and 2007. The consumer loan market was hardly hit as market interest rates continued rising while ceilings were lowered.

The reform led to the review of lenders risk policy and lending criteria resulting in a sharp drop of approval rates followed by significant decrease of credit applications[8].

In Massachusetts, the number of loans made below $500 declined by 32 percent between years-end 1975 and 1979, and the large, national finance companies dramatically increased their investment in large second mortgage loans. This led to a situation where "on the whole it was the high-risk customers who were most adversely affected, and many were 'protected out' of the credit market"[9].

As reported by the French Ministry of Finance in 2009, sharp interest rate restrictions explain the relatively low development of consumer credit in France in the eyes of the industry. As it stands, no official estimates are available to measure the real extent of credit exclusion in France. However, a recent report indicates that between 4.5 to 5 million people would benefit of a reform of ceiling rates in France. Rate ceilings would be particularly damaging for small cash loans[10].

The Dutch market is a further example of this situation. In the eyes of the industry, the tight interest rate ceilings in force in the Netherlands do not allow for a proper coverage of all operational and risk costs associated to the supply of consumer finance. In this context, smaller credit amounts are simply not profitable. Hence most suppliers do not offer revolving of fixed term credit amounts below EUR 1.000 or even below EUR 2.500 anymore.

[7] See Project Associates, *Briefing note on interest rate ceilings*
[8] *Ibid.*
[9] See E. Kempson and C. Whyley, *Extortionate credit in the UK,* Personal Finance Research Center for the DTI, June 1999, p. 34
[10] See J-L. Lépine et F. Laloue, *Rapport sur les modalités de fixation du taux de l'usure,* Inspection générale des Finances et Inspection générale des affaires sociales, février 2009

The Dutch consumer credit market (excl. home loans) is, in relation to GDP, much smaller than in other EU countries. The impact of interest rate restrictions on the supply of lower credit amounts has clearly contributed to the lower development of the market.

The examples mentioned above show that the introduction of statutory rate ceilings lead to the decrease in the overall number of lending transactions. The provision of small cash loans is particularly affected by such mechanism.

2.3 Recall that another key element of market competitiveness lies in comprehensible information provided to borrowers. In this context, the new Consumer Credit Directive (the CCD) imposes transparency requirements on advertising, pre-contractual and contractual information and cost of credit[11]. Market conditions must therefore be analyzed taking into account the impact of these requirements on comparability of products conditions and pricing discipline.

The Federation therefore wishes to highlight the importance of an economic analysis of market conditions unconstrained by rate ceilings before any conclusions are drawn on the impacts of statutory interest rate restrictions.

Additionally, the Federation wishes to highlight the importance of conducting a thorough analysis of the concrete impacts of the introduction of statutory interest rate restrictions on product diversity, structure and size of the market, profitability of the lending business and, costs of regulatory intervention[12].

3. Interest Rate restrictions impact on the availability of credit for those most in need

Deciding upon acceptable levels of risk is a business decision. The higher the risk posed by an applicant borrower, the higher the cost for lenders to grant them credit. If credit providers are not allowed to charge a sufficient rate to cover certain levels of risk, lending will consequently be restricted to those consumers for which lenders are able to cover associated costs and exclude the provision of small cash loans. In this context, major development banks and agencies such as The World Bank, the Asian Development Bank and CGAP (the Consultative Group to Assist the Poor) advise strongly against rate ceilings as damaging to the interests of those most in need[13].

Countries with ceilings show lower levels of recorded credit use. The reason for such low use of credit does not reflect a lack of demand but constrained credit options. Households on very tight budget usually cannot qualify for one[14]. This is notably reflected in the recent findings of the UK Office of Fair Trading's (OFT) review of high cost credit. The OFT found

[11] See OJEU L 133/66 of 22.05.018, Directive 2008/48 EC on credit agreements for consumers and repealing Council Directive 87/102/EEC

[12] See for example on the costs of interest rate ceiling regulation, P. Bialowolski, *Report on the economic effects of the interest rate ceiling regulation in Poland, op.cit.* p. 27

[13] See for example N. Fernando, *Understanding and dealing with high interest rates on microcredit*, Asian Development Bank, May 2006. See also A.Duval, *The impact of interest rate ceilings on Microfinance,* CGAP, May 2004

[14] See Policis Report, *The effect of interest rate controls in other countries, op.cit.* quoted by F. A. Hayek Foundation, *The relevance of Cash loans on the loan and credit market in Slovakia,* p.9-10

See also, J. Shwarz , *The role of interest and the effects of its regulation on the credit market*, Liberalni Institut, p 12-16

that significant groups of people would be denied access to licensed credit in the UK if these markets did not exist [15].

As reported in several academic works, ceilings can act to exclude people for whom the costs of providing credit are higher than the ceiling[16]. This is particularly true for those who need to borrow small sums of money for short periods of time. Though we appreciate that any potential effects of statutory interest rate ceilings shall be interpreted carefully in light of market characteristics, we believe that direct consequences of interest restrictions on the demand side should be analysed. This is particularly important where no alternative social funding/lending systems have been put in place[17].

In light of the elements mentioned above, we believe it essential to take borrowers' characteristics into account when analysing the impact of interest rate restrictions[18].

We believe that a thorough analysis of the economic and social impact (including on over-indebtedness) of interest rate restrictions which encompasses both beneficial and detrimental effects is needed before any conclusions are drawn[19]. In this context, we raise the particular importance of measuring the impact of statutory restrictions on consumption levels[20].

4. Increase/decrease of interest rates charged to consumers does not necessarily follow absence/existence of ceilings

Regardless of the level at which they are set, interest rate ceilings represent a judgment that no consumers should want or need to borrow at a rate that exceeds a certain level. **In this context, it should be recalled that outcomes in markets show that following the imposition of a rate ceiling, lenders do not lower the price of credit but rather refuse more applications from high risk borrowers**. In addition, arguing that ceilings are the only safeguards preventing lenders from rising interest rates reflects a failure to understand or to voluntary ignore the dynamics of demand and supply as mentioned above and remains empirically undemonstrated.

5. Impact of interest rate ceilings on the Single Market

Statutory interest rate restrictions along with subjective controls of credit contracts by local jurisdictions diverge across EU Member States. We believe that these divergences can largely be explained by distinct national cultural preferences. Fundamentally it corresponds to different cultural approaches towards access, use of credit products and regulation of lending activities.

In this context, it is worth highlighting that consumer credit markets are some of the most dynamic markets in financial services. While consumer credit borrowers across EU27 might

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[15] See OFT review of the high cost credit sector, June 2010 http://www.oft.gov.uk/OFTwork/credit/review-high-cost-consumer-credit/

[16] B. Bayot, L. Disneur & E. Kempson, *Working Paper on Legislative action by Government to promote financial inclusion*

[17] See on the development of a black consumer credit market, P. Bialowolski*, Report on the economic effects of the interest rate ceiling regulation in Poland, op.cit. p. 27*

[18] See Policis Report for BERR*, Transitioning high risk low income borrowers to affordable credit, p. 4-7*

[19] See on potential negative social effects, P. Bialowolski, *Report on the economic effects of the interest rate ceiling regulation in Poland, op.cit.*, p. 29

[20] See for example comments by N. Doumarshkin (one author of the ORC Macro for DG Sanco) at World of Credit and Counselling Symposium 28-30 September 2003*:* "There is a group which has no loans but which still have problerms making ends meet. These under-indebted households have even lower levels of consumption" – " Where there is a lack of […] credit service, overindebtedness is higher*"*

share some common characteristics, differences in local regulatory frameworks, cultural approaches to credit and savings, households' levels of consumption make it difficult to draw a uniform picture of European consumer credit markets.

As recently confirmed in GHK's final report for the European Commission on *the Establishment of a Benchmark on the Economic Impact of the Consumer Credit Directive*, consumer credit direct cross-border lending is insignificant in the EU and where it exists is restricted, in the main, to border areas[21]. Direct cross-border lending concerns a limited number of institutions and, in all cases, an extremely small proportion of overall outstanding consumer credit.

However, indirect cross border lending through mergers/acquisitions and establishments of branches or subsidiaries has played and is still playing a key role in the development of a European wide consumer credit market.

Divergences in interest rate restrictions have to be taken into account by providers when expanding their activities across borders. However we believe that rate restrictions are only one of the characteristics that have to be taken into account by lenders. Other factors include differences in languages, currencies, cost of risk, cost of funding, consumers needs, contractual standards and, regulatory frameworks for debt recovery (including transparency of debtors' assets).

Clarity of regulations and legal certainty are the key drivers of credit providers' business policy across the EU. Therefore, we do not believe that the diversity of policy of interest rate restrictions has a decisive impact on lenders' cross-border trade strategy.

CONCLUSION

In conclusion, Eurofinas wishes to highlight the importance of providing a complete analysis of the impact of interest rate restrictions on market conditions such as the number of players and the diversity/availability of consumer credit products before any conclusions are drawn on this issue.

The Federation remains available to engage in further discussions on the subject matter with the consultants and the European Commission.

[21] See GHK's final report on *the 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 consumer protection*, 5 November 2009