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# RESPONSIBLE LENDING

## OVERVIEW OF REGULATORY TOOLS

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## BACKGROUND

1. **This paper provides an overview of key regulatory actions a government may implement to support responsible lending.** It covers a range of possible interventions, including the provision of information, developing consumers' ability to use that information, formal requirements for responsible behavior of the lenders, and regulatory limits for loans.
2. **Because the research on the effectiveness of the responsible lending policies is limited, the paper focuses on literature overview and empirical evidence when available and uses case studies to describe key policies.** As most regulatory rules are applied countrywide, there is a lack of a "control group" to compare the effects of the regulation and the regulator introducing any responsible lending rules must thus look at changes in the patterns of borrowing and overindebtedness without being able to precisely quantify the impact of these changes.
3. **A regulator seeking to develop a responsible lending framework must cover all areas of the responsible lending regulatory and educational mix.** No single solution may be applied universally. The regulators must ensure they understand the retail credit markets. They must also test the effects the lending rules will have on lending markets to ensure that well-meant policies do not lead to financial exclusion or increases in the price of retail credit. The testing should be based on the Regulatory Impact Analysis methodology<sup>1</sup> used to assess the impact of regulatory measures.
4. **The paper identifies main policy options and areas for further research.** Better data on lending markets before and after the rules are introduced and more detailed understanding of consumer behavior helps in identifying effective regulatory rules and supervisory actions that help ensure more responsible lending while not limiting financial inclusion and the growth of the credit market.

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<sup>1</sup> For further details, see for example recommendations and country examples prepared by OECD at <http://www.oecd.org/gov/regulatory-policy/ria.htm>

## THE ORIGINS OF RESPONSIBLE LENDING

5. **Access to credit is sometimes considered by national authorities a crucial measure of financial inclusion.** Many international comparisons such as the Financial Access Survey of the International Monetary Fund<sup>2</sup> use the number of retail loans as one of the key statistics when evaluating financial inclusion. Availability of credit in general provides the population with more options to realize their economic plans<sup>3</sup> but the authorities need to keep in mind that overindebtedness of consumers will have negative effects, stemming from irresponsible provision and use of retail credit products.

*Case study: reckless or predatory lending: what is it and what to do about it?*<sup>4</sup>

*Reckless or predatory lending can take many different forms, with the result that law makers and regulators in various countries have struggled to define it adequately in a way that prohibitions or penalties can be enforced.*

*In the U.S., the definition used by the Federal Deposit Insurance Corporation (FDIC), which regulates and supervises member banks, is “the lack of a fair exchange of value or loan pricing that reaches beyond the risk that a borrower represents or other customary standards.”<sup>5</sup> This definition is quite general, however. The Stop Mortgage Fraud campaign of the US Mortgage Bankers Association has suggested a checklist of ten warning signs of predatory lending. These include process indicators such as missing or blank signed documents, as well as outcome indicators, such as higher than anticipated payments or costs, or a loan amount larger than the amount of the collateral.<sup>6</sup> In response to rising concerns over predatory lending, the FDIC policy statement of January 2007 states that lenders will be subject to heightened supervision and, in terms of enforcement: “When examiners encounter loans with predatory characteristics, the lending practices will be criticized as unsound. When the FDIC finds practices that violate consumer protection, fair lending and other laws, including applicable state laws or the Federal Trade Commission (FTC) Act*

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<sup>2</sup> See <http://fas.imf.org/> for the most current data as well as historic data sets.

<sup>3</sup> See for example Beryl Y. Chang (2005), Greater Access to Consumer Credit: Who Benefits and How?

<sup>4</sup> Source: David Porteous, Policy Focus Note 2: Consumer Protection in Credit Markets, 2009, The Financial Access Initiative (The Initiative is a consortium of researchers at New York University, Harvard, Yale, and Innovations for Poverty Action).

<sup>5</sup> See <http://www.fdic.gov/news/news/financial/2007/fi107006a.html>

<sup>6</sup> See <http://www.stopmortgagefraud.com/signs.htm>

*prohibition against unfair or deceptive practices, the FDIC will take appropriate action... Actions range from commitments to formal enforcement actions under Section 8 of the FDI Act.”*

*South Africa's National Credit Act of 2005 prohibits credit providers from entering reckless credit agreements. An agreement is defined as reckless if, at the time of entering it, the provider failed to conduct an affordability assessment; or if, having done the assessment, the preponderance of evidence suggested either that the borrower did not understand the agreement or that it would make the borrower over-indebted. If a court finds an agreement to be reckless, then it may set aside or suspend it. However, if it can be shown that a consumer has failed to fully and truthfully respond to the lender's requests for information during the decision process, this provides a full defense against recklessness by the lender. Courts are therefore left to enforce the definition of reckless lending.*

*The 2006 Consumer Credit Act in the UK, introduces a broad new level of protection against what is called ‘an unfair relationship’ between a borrower and lender, replacing the term ‘extortionate credit bargain’ in earlier legislation. The Act does not define this other than by setting out circumstances which a court should consider, such as the terms of the agreement and the way the creditor has acted. Some guidance has been issued by the Office of Fair Trading, which also has expanded powers and a broader range of sanctions which it can take against lenders*

6. **Many issues can negatively influence customers’ ability to make responsible borrowing decisions, leading to overindebtedness.** For example, research<sup>7</sup> on mortgage and consumer credit decision making suggests that consumers systematically underestimate their future borrowing because of issues such as imperfect self-control, optimism bias, hyperbolic discounting and the possibility to build up debt slowly by borrowing small sums each time (using a credit card).

## **Reasons of overindebtedness**

7. **A primary reason for households to borrow is the need to have steady living conditions over the years.** Since income generally increases at the beginning of a person's active economic life and decreases in the period following retirement, debt is the means that allows households to smooth their expenses over their lives; young families

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<sup>7</sup> See for example Oren Bar-Gill, Seduction by Plastic, Northwestern University Law Review 98 (2004), or L. Ausubel, The Failure of Competition in the Credit Card Market, American Economic Review 81 (1991), and Adverse Selection in the Credit Card Market (1999).

expect their future income to grow and spend more than they earn, thus accumulating debts that they plan to repay when they are more mature and their disposable income is higher<sup>8</sup>. However, many households tend to accumulate more debt than they can afford, becoming overindebted.

8. **The first driver of over-indebtedness is financial imprudence.** The imprudence – or poor financial decisions-making – is primarily caused by an inadequate understanding of the real cost of repaying a loan. This may be linked to transparency of lenders' terms and conditions as well as to borrowers' financial literacy and ability to manage their finances correctly, i.e. adequately plan expenses and income<sup>9</sup>. The imprudence may also derive from psychological biases and mental shortcuts that affect consumers' decisions and predictions about borrowing, such as the over-confidence bias, i.e. the tendency to underestimate the probability of suffering an adverse event<sup>10</sup>.
9. **The second driver of overindebtedness is the occurrence of unexpected events<sup>11</sup> that modify the initial conditions in which the contract between a creditor and a debtor was concluded.** An unexpected reduction in income (e.g. a job loss), an unforeseen expense (e.g. expensive medical care, damage to an uninsured house in a natural disaster), an increase in the cost of debt (e.g. a rise in interest rates or exchange rate in the case of foreign currency denominated loans) can all lead to over-indebtedness. Unexpected changes in family structure (e.g. divorce or the birth or death of a family member) may also affect the ability to repay.
10. **The third driver of overindebtedness is poverty which pushes individuals incapable of coping with their expenses to take on loans that have little chance of being repaid.** This usually happens when creditors have difficulties identifying the right debtors due to a lack of information on credit history and current financial situation. Included in this group is the situation when the need for a loan arises from overindebtedness itself, thus continuing a vicious debt cycle

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<sup>8</sup> For more details on the debt use under the life-cycle economic theory, see for example Betti G., N. Dourmashkin, M. Rossi, Y. P. Yin, (2007), Consumer over-indebtedness in the EU: measurement and characteristics, *Journal of Economic Studies*, Vol. 34 Issue: 2, pp. 136 - 156.

<sup>9</sup> See for example Lusardi A. e P. Tufano (2009), Debt Literacy, Financial Experiences and Overindebtedness, NBER Working Papers 14808, National Bureau of Economic Research, Inc.

<sup>10</sup> See Kilborn J. J. (2005), Behavioral economics, overindebtedness and comparative consumer bankruptcy: searching for causes and evaluating solutions, *Emory Bankruptcy Developments Journal*, July.

<sup>11</sup> See research by Jonathan Morduch, such as Morduch J., Income Smoothing and Consumption Smoothing, *The Journal of Economic Perspectives*, Vol. 9, No. 3 (Summer, 1995), pp. 103-114.

## Definitions and indicators of overindebtedness

11. **There is no single generally accepted measure of overindebtedness.** There are many definitions and tools to measure overindebtedness<sup>12</sup>. The European Commission in a 2008 study<sup>13</sup> examined and compared definitions and measures of over-indebtedness in the European Union countries, identifying the following four common features:

- economic (amount of debt to repay);
- temporal (the relevant horizon is the medium-long term);
- social (the basic expenses that have to be met ahead of the repayment of the debts); and
- psychological (the stress that over-indebtedness causes).

12. **In developing a definition of overindebtedness, a combination of several criteria should be applied to evaluate whether a person is overindebted.** A 2010 European Commission study<sup>14</sup> endeavored to develop a common overindebtedness definition across the EU that would be applicable in varying economic circumstances within the EU and could thus be useful also in other countries. Based on the analysis of information provided by the EU member states on their national policies (if any), the study has proposed that a household would be considered overindebted when its existing and expected resources are insufficient to meet its financial commitments without lowering its standard of living, which might mean reducing it below what is regarded as the minimum acceptable in the country concerned, which in turn might have both social and policy implications. To empirically measure the level of possible overindebtedness, the study has identified the following set of criteria:

- the unit of measurement should be the household because the incomes of individuals are usually pooled within the same household;

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<sup>12</sup> For an overview, see for example Bridges S., R. Disney (2004), Use of credit and arrears on debt among low-income families in the United Kingdom, "Fiscal Studies, Institute for Fiscal Studies, vol. 25(1), pages 1-25, March or Kempson E., S. McKay and M. Willitts (2004), Characteristics of Families in Debt and the Nature of Indebtedness, Corporate Document Services, DWP Research Report.

<sup>13</sup> European Commission (2008a), Towards a common operational European definition of overindebtedness.

<sup>14</sup> See European Commission (2010), Over-indebtedness: New evidence from the EU-SILC special module, Research note 4/2010.

- indicators need to cover all aspects of households' financial commitments: borrowing for housing purposes, consumer credit, to pay utility bills, to meet rent and mortgage payments and so on;
- over-indebtedness implies an inability to meet recurrent expenses and therefore should be seen as a structural rather than a temporary state;
- it is not possible to resolve the problem simply by borrowing more;
- for a household to meet its commitments, it must reduce its expenses substantially or find ways of increasing its income.

**13. Policy makers often need a practical tool to evaluate possible overindebtedness.**

Therefore, recent studies<sup>15</sup> have converged on a common set of indicators, while noting that there is no universal agreement on which indicator best captures true over-indebtedness (BIS, 2010, Keese, 2009). The indicators used broadly reflect four aspects of over-indebtedness and are summarized in table 1.

**Table 1: Overindebtedness indicators**

<b>Category</b>	<b>Indicator</b>
Cost of servicing debt	Households spending more than 30% (or 50%) of their gross monthly income on total borrowing repayments (secured and unsecured)
	Households spending more than 25% of their gross monthly income on unsecured repayments
	Households whose spending on total borrowing repayments takes them below the poverty line
Being in arrears	Households more than 2 months in arrears on a credit commitment or household bill
Number of loans – heavy use of credit	Households with 4 or more credit commitments
Subjective perception of burden	Households declaring that their borrowing repayments are a "heavy burden"

*Source: Giovanni D'Alessio and Stefano Iezzi (2013), Household Over-Indebtedness: Definition and Measurement with Italian Data, Bank of Italy Occasional Paper No. 149*

<sup>15</sup> Such as Keese M. (2009), Triggers and Determinants of Severe Household Indebtedness in Germany, SOEP papers 239, DIW Berlin, The German Socio-Economic Panel (SOEP) or BIS – Department for Business, Innovation and Skill (2010), Over-indebtedness in Britain: Second follow-up report.

14. **Low-income countries where microfinance is a key contributor financial inclusion may use similar measures.** For example, a recent paper<sup>16</sup>, which analyzed over-indebtedness of microborrowers in Ghana, considered borrowers over-indebted if they continuously struggled with repayment and experienced unacceptable sacrifices related to their debt. It found that poorer microborrowers were more likely to be overindebted. The risk of over-indebtedness further increased with the occurrence of adverse economic shocks to a borrower's income or expenses. The likelihood of overindebtedness was higher for borrowers with low returns on their investment and if borrowers used loans, at least in part, for non-productive purposes. It was also higher for borrowers with a low, debt-specific financial literacy.

15. **The negative effects of overindebtedness impact not only the individual concerned but also the society.** From the society's perspective, overindebtedness has the following four impacts<sup>17</sup>:

- economic: overindebtedness slows economic growth and development by limiting future access to credit, impacts local businesses as indebted individuals face curtailed free cash flows;
- social: overindebtedness and the ensuing drops in available cash flow bring increased social stratification as well as worsening opportunities for the poor;
- political: regulatory failure to limit overindebtedness may discredit political process as well as financial supervisors if the overindebtedness issue becomes widespread and politicized;
- perception of justice: predatory lenders may be seen as immune from prosecution when overindebted clients fail to get protection in courts.

16. **Therefore, a policy focused on access to consumer credit should ensure that the credit is offered and used responsibly.** The policymakers should strive to balance four distinct financial sector policy objectives: financial inclusion, stability of the financial sector, integrity of the financial services providers and financial consumer protection (the

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<sup>16</sup> Schicks Jessica, Over-Indebtedness In Microfinance – An Empirical Analysis of Related Factors on the Borrower Level, 2012, Centre for European Research in Microfinance (CERMi).

<sup>17</sup> For further examples and more detailed discussion, see Porter, Katherine (2012), The Damage of Debt, 69 Wash. & Lee L. Rev. 979 or Goode Jackie (2012), Feeding the Family When the Wolf's at the Door: The Impact of Over-Indebtedness on Contemporary Foodways in Low-Income Families in the UK, Food and Foodways, 20 / 2012.

so-called I-SIP framework<sup>18</sup>). In the area of consumer credit, the I-SIP network may be understood as the need to ensure that:

- consumer credit is widely accessible (inclusion);
- consumer credit is offered sustainably and under well-functioning risk policies (stability);
- consumer credit is offered by properly licensed and supervised institutions (integrity);
- when choosing consumer credit, consumers are offered adequate information, are equipped to use the information to make an informed decision and are protected from unfair and aggressive business practices (consumer protection).

**17. Becoming overindebted is more likely for clients with limited financial capability<sup>19</sup> if there are no barriers to credit overuse.** Many clients in low financial capacity environment (in both lower- and higher-income countries) find using consumer credit appealing as it allows them to fulfill – at least in the short term – their needs and plans much faster than before. While some types of credit – such as microfinance or mortgages – should be at least in theory focused on improving the financial security of the borrowers by strengthening their future income or building up their assets, other types of credit are designed to support consumption with no potential upside for the client's future income or asset base. People with low financial capacity often do not understand the risks of the credit repayment obligation they are taking on<sup>20</sup> and tend to disregard the risks of losing their current income that allows them to repay the loans.

**18. There is also an issue of motivation for the lenders.** While many strive for a long-term presence in the market and responsible operations, some operators try to profit from limited financial capability of consumers as there is a potential to sell more expensive

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<sup>18</sup> For an example of the practical use of the I-SIP framework in the context of the financial sector policy development in South Africa see the *Financial Inclusion – A Pathway to Financial Stability? Issues Paper* prepared for the first annual GPMI Conference on Standard-Setting Bodies and Financial Inclusion hosted by the Financial Stability Institute at the Bank for International Settlements in Basel on October 29, 2012, <http://www.gpmi.org/knowledge-bank/publications/issues-paper-3-financial-inclusion-pathway-financial-stability-understanding-linkages>.

<sup>19</sup> Financial capability is the combination of knowledge, skills, attitudes and ultimately behaviors that translate into sound financial decisions and appropriate use of financial services.

<sup>20</sup> Even in a developed country such as France banks have been recently including a slogan "Loan is an obligation" into their advertising to remind customers there is a long-term risk they are accepting when taking out a loan.

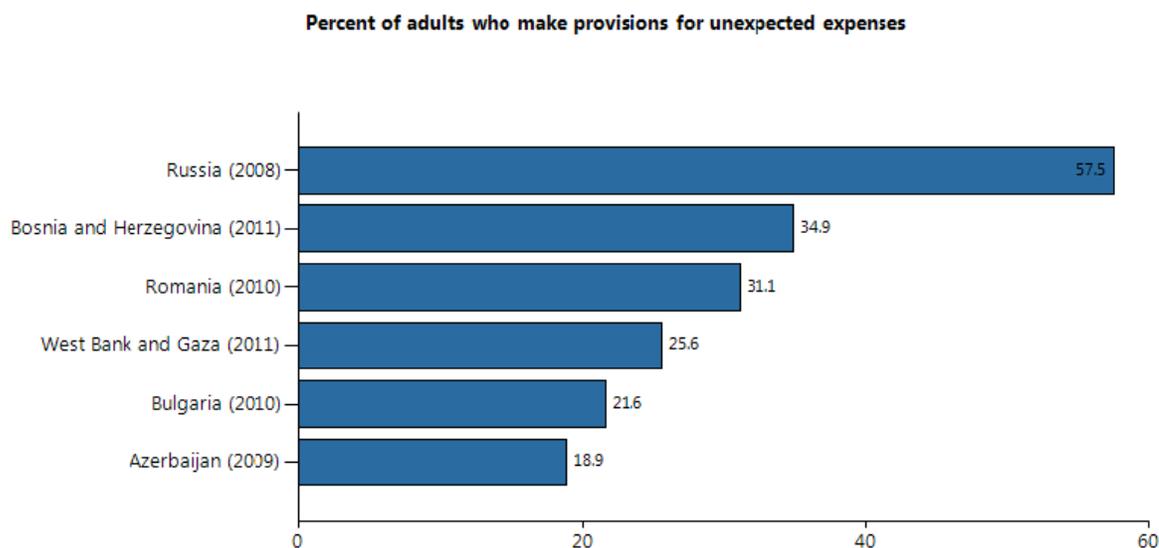
products to borrowers with limited understanding of financial products. This is true in both poor and rich countries<sup>21</sup> and the prevalence of these practices may be more dependent on the supervisor's ability to seek and prevent such behavior than on the income level of the country in question (with the level of financial capability being another major factor).

19. **Some individuals may need to borrow unexpectedly since they have no reserves.** Situations when an unexpected expense arises and the individual has no reserves to cover that expense may lead to a necessitated borrowing decision despite the fact that the debt may not be suitable or affordable. As illustrated by Figure 1 below, many adults do not build their reserves for unexpected expenses and may this be forced to borrow – often at high cost if they are considered having only limited creditworthiness.

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<sup>21</sup> For example, the US financial sector supervisors disregarded the sub-prime mortgage lending practices before the 2008 crisis. Besides allowing steady deterioration of credit standards in mortgage lending in general and allowing mortgages made solely against collateral and without consideration of ability to repay, the supervisors also disregarded mis-selling practices towards less experienced customers. There is evidence collected by the US Federal Reserve that some consumers who would have qualified for "prime" loans were steered into more expensive subprime loans. The Federal Reserve Board on July 18, 2011 issued a consent cease and desist order and assessed an \$85 million civil money penalty against Wells Fargo & Company of San Francisco, a registered bank holding company, and Wells Fargo Financial, Inc., of Des Moines. The order addresses allegations that Wells Fargo Financial employees steered potential prime-eligible consumers into more costly subprime loans and separately falsified income information in mortgage applications. In addition to the civil money penalty, the order requires that Wells Fargo compensate affected consumers. For more information see Federal Reserve Board statement at: <http://www.federalreserve.gov/newsevents/press/enforcement/20110720a.htm>

Figure 1: The share of adults that make provisions for unexpected expenses (which may include loan installments when the income of the borrower changes)



Source: World Bank financial literacy surveys in above listed countries

20. **While the need for responsible lending may seem to be most urgent in low-income, low-capacity environment<sup>22</sup>, even high-income countries need effective responsible lending rules.** The 2008 financial crisis is a case in point – it has started with the financial inclusion policy of expanding the availability of mortgages even to subprime borrowers that had no ability to sustain the mortgage in the long term, often did not understand the information provided about the products and the risks associated with the loans were hidden from the supervisors. Similarly, consumers in several Central European higher-income countries – Poland, Hungary, and Croatia – were heavily hit when their national currencies depreciated significantly after the 2008 crisis and the consumers were unexpectedly faced with harshly higher installments on their foreign-currency denominated mortgages.

21. **Due to the issues related to overindebtedness, many countries are adopting responsible lending rules.** In the World Bank's 2013 Global Survey on Financial Consumer Protection, most countries indicated that they have some form of responsible lending provisions (80 out of 114). Forty countries out of the 80 with some responsible lending provisions apply explicit lending limits such as maximum loan-to-value or debt

<sup>22</sup> For an example of the need for well balanced retail lending policy in a low-income, low-capacity environment, see the following overview of the microfinance crisis of 2010 in Andhra Pradesh, India, during which a number of Indian farmers committed suicide:

<http://trace.tennessee.edu/cgi/viewcontent.cgi?article=1137&context=pursuit>

service ratio<sup>23</sup>, double the number of countries that reported using these limits in the previous survey in 2010.

**22. Responsible lending is also featured prominently in many global industry initiatives.**

For example, the Smart Campaign, an initiative of the Center for Financial Inclusion at Accion and CGAP to develop and support responsible provision of microfinance, has featured the issue of responsible lending prominently, including it in its Client Protection Certification Standards:

*Case study: Smart Campaign's client protection principle 2: Prevention of overindebtedness*

- *The financial institution conducts appropriate client repayment capacity analysis before disbursing a loan;*
- *The financial institution incentivizes quality loans;*
- *The financial institution uses credit bureau and competitor data, as feasible in local context;*
- *The financial institution's management and board is aware of and concerned about the risk of overindebtedness;*
- *The financial institution's internal audit department monitors that policies to prevent overindebtedness are applied;*
- *The financial institution avoids dangerous commercial practices (i.e. avoids combining loan products to meet the same need, or restricting the loan use; sets prudent limits to allow for the renewal of a loan in case of early repayment; sets guidelines for appropriate rescheduling policies).*

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<sup>23</sup> The ratio of cash available for debt servicing to interest, principal and lease payments.

## RESPONSIBLE LENDING POLICIES

23. **Given the interest to prevent over-indebtedness, many regulators have been seeking ways to define rules of responsible lending.** As there are no internationally recognized standards on responsible lending, individual countries have used a wide range of regulatory approaches. Some rely primarily on regulating information disclosure, expecting consumers to be capable of making adequate decisions. Other countries place the burden for responsible lending primarily on lenders, requiring them to assess the suitability of the loan for each consumer. Others opt for more prescriptive solutions, defining interest rate ceilings, maximum debt-to-income or loan-to-value ratios or limits for penalties and late fees.
24. **When designing responsible lending policies, many regulators focus on a specific issue rather than the whole consumer lending process.** Understanding the whole market cycle is critical in developing a successful responsible lending regulatory framework that truly supports responsible use of credit and does not lead to two main potential negative effects of consumer credit regulations: (1) preventing those that might benefit from credit from using it and (2) moving significant share<sup>24</sup> of consumer lending into unregulated and unsupervised areas with its associated negative social effects. Any regulatory action should thus be tested and its impact regularly assessed to ensure that the action leads effectively to expected results.
25. **An effective responsible lending regulatory system needs to cover five key consumer protection areas: (1) institutional arrangements, (2) disclosure, (3) business practices, (4) consumer redress and (5) financial capability.** The relationship of each responsible lending regulatory tool to these five areas (as identified by the World Bank's Good Practices for Financial Consumer Protection<sup>25</sup>) and their impact on responsible lending environment will be discussed in the following chapters but the key lesson is that the tools should be combined to ensure that the regulatory environment reacts to each type of consumer and his needs.

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<sup>24</sup> There will always be illegal moneylenders but one of the regulators' goals should be to limit this activity to a minimum by supporting open consumer credit market while championing responsible behavior of both lenders and borrowers. For some effects of the responsible lending regulation, see paper by Robert Mayer, Loan Sharks, Interest-Rate Caps, and Deregulation, Washington and Lee Law Review, 2012.

<sup>25</sup> For the current (June 2012) edition of the Good Practices see the following link:  
[http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1339624653091/8703882-1339624678024/8703850-1340026711043/8710076-1340026729001/FinConsumerProtection\\_GoodPractices\\_FINAL.pdf](http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1339624653091/8703882-1339624678024/8703850-1340026711043/8710076-1340026729001/FinConsumerProtection_GoodPractices_FINAL.pdf)

26. **With regard to institutional arrangements, many countries face fragmented responsibilities for consumer protection in financial services which may provide opportunities for regulatory arbitrage and make responsible lending rules harder to enforce.** In many countries the responsibility for consumer credit regulation does not lie with the financial sector regulator but is handled by a general trade and industry regulator. This opens a gap – especially for non-bank credit providers – of uneven regulation that some credit providers may misuse. General consumer protection agencies – often responsible for enforcement of consumer credit rules – may also have limited supervisory capacity and consumer credit may not be their priority. Even if the resources are available, supervisors may prefer to focus on general rules (e.g. monitoring advertising or approving disclosure documents) rather than dealing with individual cases of misselling.
27. **As defined by the World Bank's Good Practices for Financial Consumer Protection, responsible credit disclosure should be understandable, complete and comparable.** Understandability should be tested by the regulator designing the disclosure rules with the literacy level of typical consumers in mind. While the disclosure should provide all relevant information, it should do so while presenting the key facts prominently. Comparability is also important as it helps consumers shop around and allows them to compare available offers to find the most suitable product.
28. **The rules regarding business practices should look not only who sells the loans and how but also what the motivation is.** Some regulators define the entry conditions for loan distributors in terms of age, education or through tests, some focus on detailing the sales process, including how the sales person should verify suitability of the loan. However, there is also the issue of motivation, both to the individual sales person and the financial institution. Badly structured incentives may actually support overindebtedness and the interest of financial institutions to offer credit to individuals that are highly likely to come into arrears<sup>26</sup>.
29. **When dealing with overindebtedness, the regulatory framework needs to allow for effective redress mechanism not only to address individual complaints but also to allow the regulator to identify emerging consumer issues.** Supporting consumers' ability to effectively protect their rights tends to motivate financial institutions to play within the field as the benefits of breaking the rules are limited. Moreover, consumer complaints may serve as an effective early warning system for the regulator and identify potential threats in specific market segments, from specific institutions or by specific business practices.

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<sup>26</sup> Details to be described later in the paper through a case study.

30. **Financial capability building activities should teach people to make informed decisions and understand the impact of their choices.** Especially in the area of consumer credit where there are many product varieties and where wrong choices may have significant long-term negative effects on the well-being of the consumer and his family, empowering consumers to understand the issues involved and to make informed decisions is of crucial importance. However, regulators need to keep in mind that financial capability building is a long-term endeavor and that there is a lack of evidence of general effectiveness of these programs.
31. **The key to truly successful responsible lending regimes is the ability of the supervisory agency to monitor and enforce the rules.** Many countries have well designed rules and the supervisors have wide formal powers – but they rarely use them due to limited personal capacity or the supervisors' capability to enforce the rules. According to the World Bank's recent Bank Regulation and Supervision Survey (Čihák and others 2012), many countries have consumer protection regulations on the books but only a small fraction of these actually take enforcement actions. For example, one of the larger countries in the Europe and Central Asia region has rules against deceptive advertising. However, when the World Bank's Consumer Protection Diagnostic Team inquired in 2011 how the responsible supervisory agency enforces these rules, the supervisor conceded that there was no formal process to monitor the advertising consistently and that any supervisory activity with regard to advertising was only based on what the supervisors happened to see while commuting to work, reading newspapers or watching TV – and being personally active enough to pursue the issue.
32. **The following chapters describe the types of regulatory and supervisory interventions governments may use to develop and support responsible lending policies and limit the danger of overindebtedness.** Each chapter starts with the description of the intervention and is followed with the options for enforcement of the intervention.
33. **When discussing the impact of each intervention, it is important to keep in mind that there is a lack of rigorous data for many of the available interventions.** Moreover, if an intervention is applied, it is usually applied across the whole country (possibly with the exception of internal risk scoring of potential clients) so there is a lack of a control group to compare impacts of the intervention. Besides, effectiveness of each type of interventions will also be influenced by wider socio-economic factors as well as by the ability of the supervisors to enforce existing rules. Any evaluation of the regulatory options is thus based on case studies, at least until more research is conducted in the area of overindebtedness prevention.

## MACROPRUDENTIAL REGULATION

34. **Many countries face a dilemma of balancing the support of their economy through low interest rates and the danger of excessive risk-taking.** As a response, they try to implement a macroprudential policy<sup>27</sup> of using regulatory and supervisory authority to stamp out excesses in specific market segments while using the monetary policy to address the general issues of inflation and economic growth.
35. **The key constraints of an effective macroprudential policy are regulatory arbitrage and political pressure.** A recent<sup>28</sup> working paper by Elliott, Feldberg and Lehnert, *The History of Cyclical Macroprudential Policy in the United States*<sup>29</sup>, points out that an effective macroprudential policy must cover all providers of substitute lending products and be applied consistently by all relevant regulators.
36. **A macroprudential policy may try to control the supply of credit through supervisory pressure, reserve requirements or interest rate ceilings.** However, as the Elliott, Feldberg and Lehnert paper points out, analysis of these policies that were supposed to suppress bank lending in the United States only led to other lenders filling the void, be it non-bank credit institutions or even non-financial corporations attracted by high returns<sup>30</sup>. However, macroprudential policy frameworks are currently undergoing changes around the world, especially with the focus on tradeoffs in these policies and improved understanding that tightening the macroprudential policies may lead to increased “leakage” to outside the perimeter.
37. **Demand control measures may be more effective than the supply measures to limit retail lending.** When governments seek to restrict specific areas of consumer credit, they

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<sup>27</sup> See for example the 2011 paper from the International Monetary Fund, *Macroprudential Policy: An Organizing Framework*, prepared by the Monetary and Capital Markets Department of the IMF or the World Bank's 2013 Policy Research Working Paper 6575 *The Foundations of Macroprudential Regulation: A Conceptual Roadmap* by Augusto de la Torre and Alain Ize.

<sup>28</sup> May 2013

<sup>29</sup> Published as a working paper nr. 2013-29 in the Finance and Economics Discussion Series of the US Federal Reserve Board.

<sup>30</sup> For example, when the US Federal Reserve tried to suppress bank lending to stockbrokers in 1929 in reaction to the speculative lending surge on Wall Street, non-financial corporations started lending to stockbrokers promptly, using their cash reserves for financial speculation rather than to invest into their core businesses. While bank lending to stockbrokers dropped due to the Fed's limits, total loans to stockbrokers still rose.

may set limits on maturities, loan-to-value ratios and other measures and make them more restrictive for specific purposes or for bigger loans. However, these controls may have significant side effects if designed too vaguely. .

## **INFORMATION DISCLOSURE AND ADVERTISING**

38. **Models of information search in economics posit that consumers perfectly rational consumers will seek product information and comparison shop as long as they perceive a marginal benefit from these activities.** Benefits can take the form of lower prices or better value, as each consumer defines it.<sup>31</sup> In an ideal marketplace, if complete information were available at no cost to all participants, fully informed and rational consumers would make decisions that are optimal for their financial situations and lifestyles and, at the same time, enable markets to function efficiently<sup>32</sup>. While engineering this ideal marketplace is not feasible in the real world, disclosures that make product pricing and features more transparent and easier to understand can reduce search costs, potentially improving outcomes for those consumers who shop around. Furthermore, search on the part of some consumers may lead to a more competitive marketplace as financial service providers adjust product features and reduce prices to attract informed customers.
39. **There are two aspects of effective disclosure of credit information – what is disclosed and how it is disclosed.** While the content of disclosure should ensure that consumers get all relevant information that is truthful, the method of disclosure should ensure that the information is presented in a way that is relevant and does not manipulate the consumer.
40. **Many national regulators have developed rules for what information should be disclosed about consumer credit and when.** These information sheets (often called Key Fact Statements) show key information about the loan, such as the volume of credit, interest rate, total cost of credit, and installment payments. The regulators usually require that these sheets be provided to the consumer at the point of sale. Design of the key fact statements is important as the way how the information is presented substantially influences the understanding of the consumer and helps inform his decisions.

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<sup>31</sup> George J. Stigler (1961) "The Economics of Information," *Journal of Political Economy*, vol. 69 (June); Pauline M. Ippolito (1988), "The Economics of Information in Consumer Markets: What Do We Know? What Do We Need to Know?" in E. Scott Maynes, ed., *The Frontier of Research in the Consumer Interest* (Columbia, MO: The American Council on Consumer Interests)

<sup>32</sup> See for example Durkin and Eliehausen, *Truth in Lending: Theory, History, and a Way Forward*.

41. **There are also regulations setting rules for other consumer credit disclosure in many countries, especially for advertising.** Many consumers rely on advertising as their first source of information about financial products. Misleading advertising can thus lead consumers to wrong choices (even if they receive correct information later in the sales process). The reliance on advertising is even more pronounced in rural settings where consumers usually have less experience with financial services – and are thus more susceptible to misleading information. For example, World Bank financial capability studies<sup>33</sup> in Romania and Azerbaijan found that more than one-third of rural consumers (38 percent and 34 percent, respectively) relied on advertising for their financial product information compared to only 17 percent and 25 percent in urban areas.

*Case study: examples of typical practices of unfair advertising and marketing*

*What constitutes unfair advertising and marketing always depends to some extent on individual circumstances, but some practices are considered almost universally unfair and deserving close supervisory attention. According to the “Summary of Responses to the Public Consultation on Responsible Lending and Borrowing in the EU”, published by the European Commission in November 2009, such practices (as identified by responders to the survey) include:*

- *disregard for or failure to calculate APR or any other approved measure of disclosing the total cost of credit*
- *the promotion of 0 % introductory interest rates or interest free credit*
- *the advertising of a lower starting rate – called the "rate of entry" or "teaser rate" – which is employed only for the first few months of consumer credit or the first few years of mortgage*
- *a lack of interest rate ceiling for variable interest rate loans*
- *floating rate mortgages with unclear rules for interest rate changes*
- *"buy now, pay later" advertisements that do not indicate that it concerns a credit or loan*
- *advertisements of easy and direct access to credit (often with "no questions asked / no credit history verification" messages)*
- *failure to mention administrative costs*
- *inadequate information on terms and conditions*
- *the possibility open to the lender to unilaterally change conditions*
- *unsolicited increases in credit limits*

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<sup>33</sup> For full survey data see <http://responsiblefinance.worldbank.org/>

- *sending direct advertising to already overindebted borrowers involved in collective debt settlement procedures*
- *consolidated loans and equity release products targeting customers with limited financial literacy*
- *irresponsible mortgage products such as self-certification mortgages*
- *credit cards secured on borrowers' homes*
- *costly revolving credit with ballooning interest charges*
- *cross-selling of loans and insurance products with hidden 'kick-back' provisions*
- *transformation of fixed-rate loans into variable rate loans prior to increases in interest rates or loans on misleadingly advantageous introductory terms*
- *short-term lending extended on terms that can trap the borrower into lifelong commitments and dependency*
- *open-ended and variable rate credit instead of installment credit*
- *pyramiding of existing debt with further credit*
- *interest-only mortgages.*

42. **Oral disclosure is at least as important as written disclosure.** Therefore, any design of disclosure should ensure that there are not only requirements for what information should be provided in writing but also what must be presented to clients face to face. Establishing clear and specific rules for what information must be orally presented to consumers during the pre-contractual stage of the sales process should both reinforce and expand upon written disclosure. However, the regulators need to keep in mind that verifying the provision of oral disclosure is harder and more resource-intensive. Also, the growing use of internet and mobile-based distribution channels means that the face-to-face interaction may not be necessary to conclude a credit contract – and the disclosure requirements should reflect the existence of these emerging distribution channels.

## **Enforcement options**

43. **When the regulator lacks formal mandate to set the disclosure rules, the disclosure of information may be standardized through an agreement of the credit providers.** The agreement may be either ad hoc among (some of) the market participants or formalized through an agreement of all members of an association of financial institutions, through a code of conduct or another self-regulatory document. If possible, the agreement should be consulted with the supervisory agency. The effectiveness of any self-regulatory measures is also significantly dependent on the prevailing culture and is not effective when there are institutions disregarding the agreed rules or opting out of the self-regulatory arrangement altogether.

44. **Information should be provided in a standardized way so that all providers use the same way to describe their products.** There are several areas where standardization may help consumers in better understanding of consumer credit features as well as their rights and obligations:
- Standardization of vocabulary – credit providers may agree to use the same term for the same aspect of the loan instead of several terms covering the same issue;
  - Standardization of formulas and calculations – credit providers may agree on using the same formulas and rules to compute the cost of credit;
  - Standardization of content and format of the disclosure documents so that consumers receive easily comparable information.
45. **Industry-based self-regulatory agreements should include an enforcement mechanism to provide certainty of the rules' application by all parties.** The "keeper" of the voluntary code (such as an industry association) should ensure that members adhere to the agreed rules and should have a power to investigate any alleged breaches of the code and sanction any confirmed breaches. To promote a level-playing field, the supervisory agency should preferably support a self-regulatory arrangement only if it is accepted by all financial institutions.

***Case study: Self-regulation of the UK banking sector***

*The UK Banking Code that was implemented until 2009 (when the Financial Services Authority was created to supervise market conduct of financial institutions) was sponsored by three trade associations: the British Bankers Association (representing banks), the Building Societies Association (representing the mutual building societies) and the Association of Payment Clearing Systems (APACS – representing credit card issuers). All retail banks, credit card issuers and building societies that offered consumer credit in the UK were signatories of the Banking Code and between them covered about two thirds of UK unsecured lending.*

*The Banking Code required an undertaking to lend responsibly and was accompanied by detailed Guidance for Subscribers, which provided details of how they were expected to interpret and implement this in practice. The commitments in the Banking Code and its Guidance were subject to independent review every three years. The latest review was held in 2007 as a result of which the Guidance was further strengthened in 2008 to require lenders to check both positive and negative data held at a credit reference agency and take into account one of three sources of data on the customer's financial circumstances. These were: income and financial commitments; how the customer has handled existing accounts and the lender's internal credit scoring techniques. These checks were to be made when raising limits on credit cards and overdrafts as well as when new credit was granted.*

*The Banking Code had an independent monitoring body – the Banking Code Standards Board whose primary role was to monitor compliance with the Code. This was done through a range of methods that were very similar to those used by the statutory regulator in other areas. All subscribers were required to file a detailed annual statement of compliance. In addition, BCSB staff undertook general compliance monitoring and themed investigations. Both involved visits to financial institutions, scrutiny of files and sitting in while staff did their jobs, including taking calls from the public; mystery shopping was also used in themed reviews.*

*When any breaches of the code were discovered, detailed discussions were held with Code subscribers who were not fully compliant with the Code, with a view to putting things right. Serious breaches were referred to the disciplinary committee of Board members (with independent directors in the majority) that had an independent chair who did not sit on the Board. There was a right of appeal to the full Board. The BCSB did not have the power to fine, but it could require a subscriber to compensate customers. It could also ‘name and shame’, which was considered to be a very powerful sanction as breaching your own Code of Practice has often been seen in the UK as worse than breaching a rule externally imposed by the regulator. Very serious breaches would result in a subscriber being ‘expelled’ from the Code and the public informed about this step.<sup>34</sup>*

**46. Disclosure documents may also be defined by law with a varying level of detail.** There are three general options the regulator may use to define rules on disclosure:

- Define only general rules (that disclosure must be complete, truthful, etc.);
- Define content of the disclosure, often including formulas that must be used to calculate any information regarding costs of credit, such as the Annual Percentage Rate or Total Cost of Credit;
- Define both content and format of the disclosure documents.

**47. When defining disclosure rules, the regulator needs to pay attention to the financial literacy of average consumers for the given product.** Regulators may tend to include as much information as possible in the key disclosure documents (often called Key Fact

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<sup>34</sup> Adapted from the European Commission: Towards a Common Operational European Definition Of Over-Indebtedness

Statement<sup>35</sup>) which may lead to information overload and worsen the ability of consumers to use the information provided for understanding the product and for informed decision making.

*Case study: European Standard European Consumer Credit Information*

*As part of the EU Consumer Credit Directive, a Standard European Consumer Credit Information (SECCI) sheet was developed and financial institutions in the EU required to use the SECCI information sheet to disclose information about the features of the consumer credit offered to clients.*

*While there is a good website operated by the European Commission to explain SECCI<sup>36</sup>, there have been only three national campaigns (by Ireland, Malta and Spain) to inform consumers about the new disclosure regime and the consumers' new rights with regard to consumer credit.*

*Some EU member states raised concerns that the SECCI is too complicated, as illustrated by the following resolution<sup>37</sup> of the European Parliament accompanying the approval of the Consumer Credit Directive while on the other hand noting that the Directive fails to ensure that consumers are also provided with the information of costs on tied products, such as insurance required by the credit provider:*

*[The European Parliament] takes note of the concerns raised in some Member States about the way pre-contractual information is presented to consumers through the Standard European Consumer Credit Information (SECCI) form and which is of such technical nature that it affects consumers' capacity to understand it effectively; considers that the efficiency of the SECCI form should be an important aspect in the assessment of the impact of the Directive carried out by the Commission;*

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<sup>35</sup> Examples include the EU's Standard European Consumer Credit Information, the US' Schumer Box for credit cards, Peru's Hoja Resumen (Summary Sheet), South Africa's Pre-Agreement Statement & Quotation for Small Credit Agreements, Ghana's Pre-Agreement Truth in Lending Disclosure Statement.

<sup>36</sup> See [http://ec.europa.eu/consumers/citizen/my\\_rights/consumer-credit/standardised-form-explained/index\\_en.htm](http://ec.europa.eu/consumers/citizen/my_rights/consumer-credit/standardised-form-explained/index_en.htm)

<sup>37</sup> European Parliament resolution of 20 November 2012 on the implementation of the Consumer Credit Directive 2008/48/EC (2012/2037(INI)), for full text see: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2012-0418+0+DOC+XML+V0//EN>

*[The European Parliament] notes that more comprehensive provisions do not always make for more effective consumer protection and that, in the case of inexperienced consumers in particular, too much information can serve to confuse rather than help;*

*[The European Parliament] calls for consumers to have a right to be informed about the cost of additional services, and about their right to buy auxiliary services such as insurance from alternative suppliers; considers that financial institutions should be required to distinguish such services and related charges from those pertaining to the basic loan, and to make clear which services are essential to the extension of a loan and which are entirely at the discretion of the borrower.*

**48. Simplicity and understandability should be the main aims of disclosure regulation.**

Regulators should ensure that a typical consumer may use the information provided easily and meaningfully to compare product offers and understand the real costs of the product. The disclosure should also target what the regulator considers the main issue (e.g. understanding the total amount the consumer will repay compared to the originally borrowed sum, the comparative cost of some types of credit, the impact of paying down only the minimum payments, etc.).

*Case study: a single number to describe credit features in Chile*

*Making consumers understand all costs associated with consumer credit is very hard and even measures such as the Annual Percentage Rate do not cover all aspects of the product's "costs" such as ability to repay early, extend the loan or penalties for late payments.*

*Therefore, the new consumer credit regulatory framework prepared by SERNAC, Servicio Nacional del Consumidor (the national consumer protection agency), requires that the lending terms and conditions be boiled down to a two-digit number, and that that number be prominently displayed for the consumer.*

*The law creates a structure under which credit-issuing institutions must combine various aspects of terms and conditions into one simple number so that consumers can interpret and compare different credit offers. This number must be displayed in bold highly visible numbers in the top right corner of the first document that a consumer receives regarding the loan as well as on subsequent monthly statements (see Figure 2 below).*

*SERNAC's goal was to provide consumers (especially those with low financial capability as consumer credit grows quickly<sup>38</sup> with a single measure of the "quality" of the loan without the need to understand concepts like the Annual Percentage Rate or compare varying repayment structures. With the single quality measure the consumer should get an adequate understanding of all of the critical pros and cons of the product relative to other options he has. On the other hand, distilling all product features into a single number may diminish the motivation of consumers for learning about product features and for detailed consideration of the appropriateness of the product for their individual circumstances.*

*The effectiveness on this new measure and its impact on financial capability and decision making would still need to be assessed. In the assessment, the regulator may consider the results of the recent World Bank studies<sup>39</sup> conducted in Mexico by Xavier Gine (Senior Economist, Development Research Group, the World Bank) and Rafael Mazer (Financial Analyst, Consultative Group to Assist the Poor). The first study aims to understand the quality of information and products offered to potential low-income customers. Trained "shoppers" visited financial institutions, expressing interest in credit and savings products. Results suggest that clients are not offered the cheapest product that fits their needs, and they are provided with only little information voluntarily. Upon probing, they often receive disinformation about key characteristics of the products which illustrates the challenges of disclosure policies that go against commercial interests of financial institutions. In the second study, low income individuals participated in a lab experiment, in which they were presented with various informational formats about terms of savings and credit products. The study assessed the efficacy of each format.*

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<sup>38</sup> Chile's total consumer credit has nearly tripled in GDP terms in the past two decades, from 3.6% in 1992 to 10% of GDP in 2012, with loans outstanding now exceeding US\$25bn. The whole of the fourth quintile of the population by income and as much as 77% of the poorest quintile enjoy access to the local financial market, according to the government's Fondo de Solidaridad e Inversión Social (Fosis, the solidarity and social investment fund).

<sup>39</sup> For the presentation from a seminar discussing the preliminary results of the studies see the following: <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTGLOBALFINREPORT/0,,contentMDK:23362528~pagePK:64168182~piPK:64168060~theSitePK:8816097,00.html>

Figure 2: Example consumer credit contract summary sheet, complete with a placement marking (CAE: XX%) for the terms and conditions number.

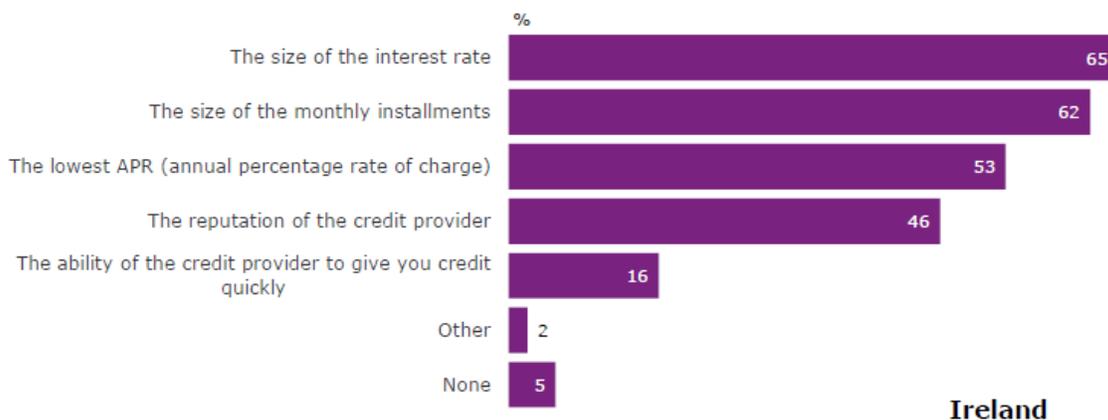
Hoja Resumen de Cotización o Contrato Crédito de Consumo	
SELLO SERNAC (si aplica)	
<b>CAE: XX%</b>	
Nombre titular	-
Fecha	-
Plazo de vigencia cotización	-
<b>I. Producto Principal</b>	
Monto Líquido del Crédito (pesos)	-
Plazo del Crédito (meses)	-
Valor de la Cuota (pesos)	-
Costo Total del Crédito (pesos)	-
Carga Anual Equivalente (CAE)	xx%
<b>II. Gastos o Cargos Propios del Crédito</b>	
<b>Gastos o Cargos</b>	
Impuestos	-
Gastos Notariales	-
Monto Bruto del crédito	-
Garantías asociadas	Si/No - ¿Tipo de garantía?
<b>Gastos o Cargos por Productos o Servicios Voluntariamente Contratados</b>	
Valor Cuota Referencia (pesos)	-
Seguro xxx	-
Costo mensual (pesos)	-
Costo total (pesos)	-
Cobertura	-
Nombre proveedor del servicio asociado	xxx
Seguro yyy	-
Costo mensual (pesos)	-
Costo total (pesos)	-
Cobertura	xxx
Nombre proveedor del servicio asociado	-
<b>III. Condiciones de Prepago</b>	
Cargo Prepago (%)	-
Plazo de aviso para pago anticipado o prepago	-
<b>IV. Costos por Atraso</b>	
Interés Moratorio (%)	-
Gastos de Cobranza (%)	-
<b>Advertencia</b>	
"El Crédito de Consumo de que da cuenta esta Hoja Resumen, requiere del Consumidor contratante, NN patrimonio o ingresos futuros suficientes para pagar su costo total de \$ xx, cuya cuota mensual es de \$ xx, durante todo el periodo del crédito".	
* Los créditos con periodo de gracia o la posibilidad de traslado de cuotas podrían estar asociados a un costo.	

49. **Disclosure documents should be tested by the regulator before any regulation of their form and content is issued.** Many consumers – even in developed countries with probably higher overall financial literacy – tend to use wrong metrics for choosing credit products. It is also not clear how many consumers understand how to shop in financial markets or even what they should look for or how to correctly use the information available<sup>40</sup>. Therefore, the regulators should ensure that any compulsory disclosure is

<sup>40</sup> See for example Jinkook Lee and Jeanne M. Hogarth (1999), "The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates," Journal of Public Policy and Marketing, vol. 18 (Spring).

understandable and provides the average consumers with all relevant information in a way that allows them to arrive to an informed decision. For example, an opinion research<sup>41</sup> (see Figure 3 below) conducted by TNS Opinion in April 2013 to measure awareness about consumer credit rights in Ireland identified that the Annual Percentage Rate (i.e. the rate that describes the true cost of consumer loan) is less important for consumers' decision-making than the size of the interest rate (thus allowing lenders to add fees to the loans and increase the loan profitability without negatively impacting their sales prospect) or the size of the monthly installment (as borrowers focus on immediate "affordability" of the loan rather than its total costs).

*Figure 3: If you needed consumer credit, which of the following would be the most important factors to decide which credit to take out?*



Source: TNS Ireland, April 2013

### *Case study: consumer testing of credit card disclosure in the United States*

*Between 2007 and 2011, the US Federal Reserve Board conducted extensive consumer testing of credit card, mortgage and banking services disclosure information in order to develop an easily understood format that would help consumers better understand the cost and product features of various financial products. The Fed published a detailed report on the results of both qualitative and quantitative studies it has conducted, as well as providing a detailed summary of its findings and analysis<sup>42</sup>.*

*The key findings from the Fed's research revealed several potential best practices for consumer disclosure content and presentation, and highlighted challenges involved in*

<sup>41</sup> Other findings available at [http://ec.europa.eu/consumers/citizen/my\\_rights/consumer-credit/documents/130522\\_ec\\_ccd\\_tns\\_ie\\_en.pdf](http://ec.europa.eu/consumers/citizen/my_rights/consumer-credit/documents/130522_ec_ccd_tns_ie_en.pdf)

<sup>42</sup> See <http://www.federalreserve.gov/pubs/bulletin/2011/articles/DesigningDisclosures/default.htm>

*crafting effective disclosures for financial products. The following are key findings from the testing:*

- ***Disclosure language should be plain but meaningful.** When reading disclosure documents, consumers are best served by terms that are straightforward. Small wording changes can significantly improve consumer understanding, but for some content, communicating the intended meaning may be difficult even with the use of plain language.*
- ***Thoughtful design can make disclosures more usable.** Carefully designed visual elements in disclosures, such as titles, headings, tables, charts, and typography can increase consumers' willingness to read disclosures and can aid their ability to navigate and understand them.*
- ***Contextual information can improve comprehension and usability.** Context, or a "frame," for information on a disclosure can help readers understand both the specific content in the disclosure as well as its overall message. It can also help consumers better comprehend how to use the information.*
- ***Achieving a neutral tone can be challenging.** Although disclosures often strive for a neutral tone to avoid "steering" consumers in one direction over another, achieving neutrality is difficult.*
- ***Creating disclosures may involve creating a choice structure.** In some cases where choice options are not specified in the law, establishing the structure may be part of creating the disclosure.*
- ***Standardizing disclosure can be challenging.** Standardization can be beneficial, but finding terms that are truly standard across all contexts can be difficult, and consumers may need to be alerted when a "standard term" has a different meaning than the one they may be familiar with.*
- ***What works in print may not work online.** Disclosure design needs to take into account the possibilities and limitations of alternative delivery channels.*
- ***"Less is more" often remains true.** Too much information can overwhelm consumers or distract their attention from key content.*

**50. Since oral presentation may have significant impact on what information consumers actually use and how they use that information, rules for oral disclosure also need to be set up.** The rules for oral disclosure should build on written disclosure documents, ensure that attention of the consumers is focused on the most important issues and verify whether the consumer understands the disclosed information well enough to use it for his decision-making process.

**51. Lenders should be required to explain certain material terms and concepts to customers that require more detailed explanation than a key facts statement can convey.** This can include rights such as cooling-off periods and recourse mechanisms, and information regarding how any bundled services work. Product features that are triggered

by future events (such as variable interest rates, prepayment penalties, late fees and penalties) should also be more fully explained through face-to-face interaction, including providing details on the conditions that trigger these events and how such penalties are applied. However, all such disclosure should be backed up by written disclosure so that the customer may have a permanent record of the information provided.

*Case study: oral disclosure regulation in the United Kingdom*

*Before a consumer credit agreement is made, creditors in the United Kingdom must "provide the debtor with an adequate explanation" of the following five matters either orally or in writing "in order to place him in a position enabling him to assess whether the agreement is adapted to his needs and his financial situation":*

- *Features of credit agreement which may make the credit unsuitable for particular types of use;*
- *How much the debtor will have to pay periodically and the total cost of credit;*
- *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;*
- *The principal consequences for the debtor arising from a failure to make payments under the agreement at the times required; and*
- *The effect of the exercise of any right to withdraw from the agreement and how and when this right may be exercised.*

*Moreover, the rules<sup>43</sup> require that:*

- *Where this information is disclosed in person to the debtor, that the debtor is able to take it away;*
- *The creditor must provide the debtor with an opportunity to ask questions about the agreement; and*
- *The creditor must advise the debtor how to ask for further information and explanation.*

**52. Supervisors should verify the disclosure requirements through all the tools they have at their disposals.** Off-site verification should include verification of the disclosure documents as well as of the sales process and sales staff training to ensure that all sales agents are adequately equipped with knowledge and materials to implement required

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<sup>43</sup> The Consumer Credit (EU Directive) Regulations 2010, section 55A.

disclosure. On-site verification should include verification of how the procedures are implemented in the reality of the lender's operations. Finally, mystery shopping may be used to verify how disclosure is made when the sales staff believes it is interacting with a client rather than knowing their sales conduct is monitored by an inspector during a formally announced on-site supervisory visit.

## **PUBLISHING PRICE COMPARISONS AND PRODUCT SELECTION ADVICE**

**53. A specific type of disclosure is a supervisor-backed credit price comparison website.**

While there are many private activities that seek to compare prices of financial products, the ability of the financial sector supervisor to obtain correct data in regular intervals makes these price comparison websites an appealing tool to inform the public about average cost of credit and teach them to seek several offers from various credit providers rather than rely on a single credit source. The comparison websites also usually attract media attention which might have positive influence on financial literacy of the population.

**54. Supervisors usually define several types of loans and require credit providers to report average price of the extended loans for each of the predefined types.** While there are many individual circumstances that influence the riskiness of an individual and his ensuing cost of credit, being able to see how the offer relates to an industry-wide average may help consumers discuss the offer or motivate them to seek other alternatives.

**55. One of the main challenges when designing these price comparison websites is the effective presentation of the results.** In a financial system with hundreds or thousands of credit providers, providing a full comparison would be very challenging if not impossible, both from the data collection and result presentation perspectives. Showing only a subset of providers is also challenging because it should not be done in a way that favors certain (e.g. larger) providers. Showing only market averages for each type of product may be an option to overcome the issue.

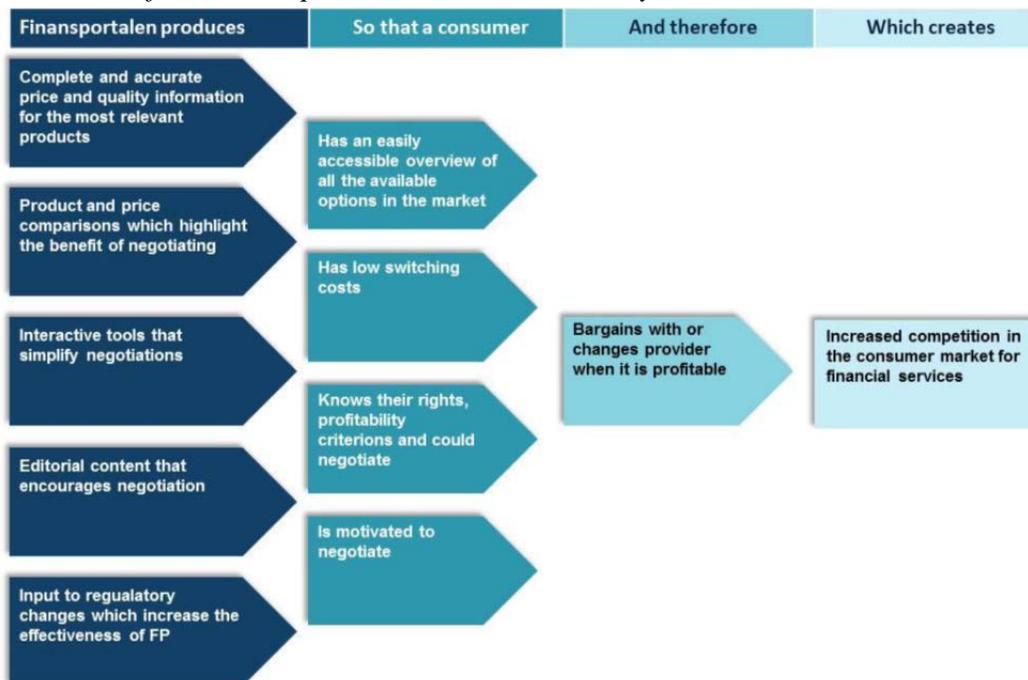
**56. Price comparison websites may aim to provide information on prices or also try to facilitate product selection<sup>44</sup>.** The basic type of a price comparison website will focus on price comparison (either through an Annual Percentage Rate or Total Cost of Credit) and

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<sup>44</sup> For an overview of various approaches, see the paper by Jennifer Chien, Public Sector-Operated Price-Comparison Websites: Case Studies and Good Practices, the World Bank, June 2013

usually present comparative tables ordered according to user-specified filters. Some countries (see Figure 4 with the example of Norway below) may go further and develop websites that not only provide information on product prices but also are more interactive and guide users towards products appropriate for various life situations, inspiring consumers to actively switch to the best provider or product available.

Figure 4: Goals of the Finansportalen website in Norway



Source: *Public Sector-Operated Price-Comparison Websites: Case Studies and Good Practices*, Jennifer Chien, the World Bank, June 2013

57. **Price-comparison websites also have certain limits to their effectiveness.** Price comparisons are most useful for comparing standardized, commoditized products and are less appropriate for sophisticated products or products with pricing dominantly dependent on individual circumstances. Price-comparison tools may operate effectively only if there are standardized metrics for conveying product pricing and if the operator has sufficient powers to compel providers to report these prices. Data on product prices also need to be reliable and regularly updated, as well as independently verified by the operator.

58. **There are also activities monitoring and comparing credit prices across countries.** For example, Mix Market<sup>45</sup> collects financial and social performance data from over 2,000

<sup>45</sup> See <http://www.mixmarket.org/> for more information and available data.

microfinance institutions and provides access to the data to allow better understanding of microfinance markets around the world. While typical microfinance consumers may not use such a database, it is a valuable tool for regulators and the industry on one hand as it allows them to better understand their domestic market development and for the media and consumer organizations on the other as they seek to compare product prices and features on their home market with situation in other countries.

## Enforcement options

59. **To make the price comparison website useful, the supervisor needs to strike a balance between relevance of listed products and usability.** The users must be able to find price comparison information that is relevant to them – therefore, the website should cover all typical lending products. However, the segmentation should not be overwhelmingly detailed so that a complicated identification of the most relevant product does not discourage potential users.
60. **The supervisor needs to ensure the information presented by each provider is correct.** As the website depends on how the lenders report average prices for each featured product, the supervisor needs to regularly verify that the reported data reflect actual loan pricing. The supervisor may conduct themed inspections or use regular on-site inspections to verify how the reported data is calculated and verify the calculation on a randomly selected group of loans.
61. **The comparison results should be communicated regularly as an integral part of financial capability building activities.** Besides operating the price comparison website and continually working on attracting users, the supervisor should also regularly promote comparison results to show the practical value of the website and attract public attention to the site. Such regular communication may be attractive for the media and also use the public that shopping around and comparing prices may have attractive financial benefits for consumers.
62. **The operator of the price comparison website should share the data with the competition authority.** Besides using the collected data for publishing prices charged by individual providers, the database may also be used for monitoring of the general level of competition among financial institutions by the competition authority.

## INCOME, CREDIT HISTORY AND CREDITWORTHINESS VERIFICATION

63. **When assessing the riskiness of a potential client – and his ability to repay the loan – income verification is the primary tool most lenders use.** In more formalized economies, most lenders require formal confirmations of borrower's income (employer's confirmation, tax returns for self-employed, etc.) while less-documented countries or countries with higher share of shadow economy use other sources of information to confirm the creditworthiness of the borrower as well, including witnesses, neighbors or assessment of borrower's property.
64. **Sometimes the lenders' policies regarding income (non)verification clash with the government's plans to combat shadow economy and tax evasion.** As they try to combat shadow economy, governments may seek ways to motivate citizens to declare their income – and pay income taxes. For example, in Moldova (the poorest country in Europe according to per capita GDP) 57% of Moldovans do not report their full salary according to the Ministry of Labor<sup>46</sup>. Many banks thus automatically expect a certain level of unreported income in their customer scoring models and provide loans that would not be sustainable if the customer only had the officially reported income.
65. **Some governments prescribe the minimum information lenders must collect from customers to ensure comparability and allow for verification of borrower's creditworthiness.** For example in Ireland, the government in cooperation with banks and the Money Advice and Budgeting Service (a network of government-sponsored advisors for people who need advice managing their money or are overindebted) developed a Standard Financial Statement that all lenders must use to collect information about the client's financial situation<sup>47</sup>. Knowing what data lenders collect, the Central Bank of Ireland as the financial sector supervisor may then develop its own scoring models and verify how well banks work with the collected data for loan scoring.
66. **Credit history is an important factor for most credit scoring systems where a reliable credit history is available.** Each financial institution has its own policies of varying

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<sup>46</sup> For further details see the World Bank's Moldova Retail Electronic Payments: Diagnostic Review & Action Plan by Tomas Prouza, May 2012.

<sup>47</sup> The Standard Financial Statement was developed for situations when the client is in arrears and seeks loan restructuring. However, the same principle and the same form could be used to evaluate loan requests if the government wanted to verify whether lenders lend responsibly and adequately verify clients' creditworthiness. The Irish government's interest in this case was to ensure that banks offer sustainable mortgage restructuring and do not apply an "extend and pretend" approach of continuous postponing of the bad loan's resolution without providing a restructuring option that the client may be reasonably expected to abide to based on his financial situation and assets.

formality and varying rules – and many financial sector supervisors (especially banking supervisors as part of the overall risk management assessment) tend to assess the robustness of the creditworthiness assessment system. Having a history of reliably using credit helps consumers get further or larger loans and if a country has a reliable credit bureau, most lenders verify credit history of potential borrowers as part of the client assessment process.

*Case study: Unsecured credit legislation in Belgium*

*Following a law of 9 July 1957, the law of 12 June 1991 on consumer credit had the aim of preventing over-indebtedness among consumers. It covers all types of credit including loans, retail installment plans, and the opening of credit facilities or a lease contracts. It does not, however, cover short-term credit (up to three months), credit of less than €1,250 and loans granted on an occasional, not-for-profit basis.*

*Before making a consumer credit offer, this law requires lenders to consult the Central Individual Credit register (la Centrale des Crédits aux Particuliers) managed by the National Bank of Belgium. In addition, lenders and credit intermediaries must collect full and precise information about the financial situation of potential borrowers in order to assess their ability to make the repayments. It is, therefore, the responsibility of the lender and credit intermediary to identify the information that is needed to assess a consumer's financial situation, including existing credit commitments, and repayment abilities and to ensure that the borrower provides full information supported by documentary evidence. The consumer, in turn, is bound to provide exact information when requested. It is then the lender's responsibility to decide whether to grant the credit and how much to lend, based on this information. Any guarantees (such as a surety) required for the credit offer can only be taken into consideration on a secondary basis.*

*Moreover, the lender and credit intermediary must identify the most suitable type from their portfolio, taking into account the consumer's financial situation when the contract is signed and the purpose of the requested finance.*

*Any failure to make these checks can result in the court writing off all or part of the money borrowed.*

*The law of 1991 provides a further spur to responsible lending exists in the form of the "Fonds de Traitement du Surendettement". This Fund is supported financially by payments made by creditor organizations, with an individual firm's level of*

*payments being determined by the ratio of negative credit reports on the central credit register divided by the number of positive ones. It finances the cost of the central credit database and also meets the cost of judicial procedures where the borrower would otherwise have insufficient funds to meet the required payments to creditors. In such cases, debt advisers representing the borrower can apply to the judge for payments from the Fund<sup>48</sup>.*

67. **Many credit information sharing systems<sup>49</sup> have recently also started collecting data on the use of and payment reliability for other services provided on credit, such as utilities or phone service.** While many consumers may be aware of the negative impact of being late with loan installments and try to pay on time if at all possible (sometimes also because of high and immediately applied penalties), they may not know that credit information sharing systems may also cooperate with non-financial institutions. In many countries, lenders thus may have access to information about consumer's failure to cover his mobile phone or utility bill on time and make lending decisions based on this information as well.
68. **Even when there are no credit history providers or when financial institutions are not required to report to them, financial institutions seek information about a client's credit history.** Especially microfinance institutions that often lack resources to both report to and seek information from a credit information sharing system often base their lending decisions on a credit history of the client with the institution. New clients are thus eligible only for smaller loans while customers with a proven track record may apply for higher loans. Similarly, banks may increase overdraft or credit card limits based on the client's history with the institution.
69. **The ultimate goal of the creditworthiness assessment should be the verification that the borrower has sufficient assets or income to pay back the loan.** Lenders must make the determination that the borrower can repay the loan by looking at both the borrower's income and any assets he has on hand and either (i) may be used to cover the installments in case his income diminishes and is not sufficient to cover the installments or (ii) may be used as collateral to the lender. The creditworthiness assessment is thus a "creditor-focused" test, looking at the probability that the creditor will be repaid in full.

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<sup>48</sup> Case study quoted from the European Commission: Towards a Common Operational European Definition Of Over-Indebtedness.

<sup>49</sup> In usually applied terminology, "credit bureau" refers to a privately operated credit history provider (often operating under a specific law) while "credit registry" refers to a credit history provider operated usually by the banking supervisor or another state body. In general, institutions collecting and sharing information about credit history are called "credit information sharing systems".

70. **This repayment ability test – also called affordability test – looks at the borrower's capacity to repay the loan.** Unless the regulator provides specific guidance on cut-off limits (discussed later in the chapter *Explicit Debt Limits*), it may implement at least some guidance to the lenders, including what should be taken into consideration besides the loan payment itself. For example, a 2007 predatory lending law of the US state of North Carolina addressed the issue of the mortgage payments together with other immovable property ownership costs by requiring<sup>50</sup> that the lender assesses whether the borrower:

*...has the ability to repay the loan according to its terms and to pay applicable real estate taxes and hazard insurance premiums.*

71. **Affordability test is used to verify the ability of the consumer to repay the debt, not only service it.** Especially in recent years of economic downturn many consumers have been unable to pay off their debts (particularly on credit cards) and only manage to make the minimum monthly repayments. Therefore, any regulatory guidance or rules on affordability testing should make clear (as for example the UK Office of Fair Trading Guidance for Creditors<sup>51</sup> does) that credit should not be considered affordable merely because the borrower is able to service the debt over a period of years by making the minimum payments.

72. **While collateral is an important aspect in quantifying (and lowering) the riskiness of the client, the repossession of the collateral is not considered a positive result from the point of view of responsible lending.** While repossessing a collateral may help the lender lower its losses from an unpaid loan, it usually has long-term negative consequences for the borrower. If a lender has to resort to an above-average number of repossessions compared to its peers, it will often be a sign of a failure of responsible lending behavior of the lending institution.

## **Enforcement options**

73. **Under its responsible lending policies, the regulator may require that any credit provider assesses credit history of the client and any other relevant information.** To allow for proper supervision of the requirements, the supervisor should be as specific as possible in defining the list of information the lenders should request when assessing a

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<sup>50</sup> See North Carolina General Statute § 24-1.1F(c) (2007).

<sup>51</sup> Office of Fair Trading, Irresponsible Lending – OFT Guidance for Creditors, 2009

loan application. For example, the Central Bank of Ireland issued a letter<sup>52</sup> to supervised financial institutions in February 2013, reminding them that:

*In order to fully assess a borrower's ability to repay the loan, the Central Bank's expectation is that you will avail of at least one of the following:*

1. *Employ the services of a suitable credit bureau or credit reference agency.*
2. *Require the borrower to obtain confirmation from the private dwelling mortgage lender on the payment status of their mortgage.*
3. *Require the borrower to provide an up to date mortgage statement covering a 12 month period.*
4. *Such other process employed by you to determine if the borrower is in arrears on their mortgage in non-permanent forbearance.*

*The borrower should also be required to provide any other additional supporting documentation required to assess creditworthiness (e.g. proof of income, current account, credit card and other mortgage statements).*

**74. When regulators see significant risky behavior of financial institutions, they may forbid specific business practices.** For example, as part of the *Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act*<sup>53,54</sup> the US Consumer Financial Protection Bureau outlawed the "no-doc" or "low-doc" loans, otherwise known as "Alt-A" loans, where some lenders made quick sales by not requiring documentation of income, ability to repay, or sometimes even of legal status, then offloaded these risky mortgages by selling them to investors.

**75. The law or regulation relevant for retail credit provision may require that the creditor adequately assesses the borrower's creditworthiness.** For example, the European Union<sup>55</sup> defined the requirement as follows (Article 8.1 of the EU Consumer Credit Directive):

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<sup>52</sup> Full version available at: <http://www.cscu.ie/wp-content/uploads/2012/10/Central-Bank-Letter-on-Prudent-Lending.pdf>

<sup>53</sup> For full text of the Regulation Z see <http://www.gpo.gov/fdsys/pkg/FR-2013-06-12/pdf/2013-13173.pdf>, for full text and further background information see <https://www.federalregister.gov/articles/2013/06/12/2013-13173/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z>

<sup>54</sup> Also known as "Regulation Z".

<sup>55</sup> The rule has also an impact on many non-EU countries in Europe and Central Asia as they strive to bring their legal framework more in line with the EU legislation.

*Member States shall ensure that, before the conclusion of the credit agreement, the creditor assesses the consumer's creditworthiness on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of a consultation of the relevant database. Member States whose legislation requires creditors to assess the creditworthiness of consumers on the basis of a consultation of the relevant database may retain this requirement.*

**76. Credit history verification requirement may be a part of an internal policy of the financial institution or required by the regulatory framework.** In higher-income countries with functioning credit bureaus, the requirement may be defined by regulatory rules at least for banks and possibly for larger loans from non-bank credit institutions. In lower-income or lower-capacity environment without sufficient credit history data the supervisor may list specific options the credit providers may use to verify creditworthiness of the client. The list needs to be specific to allow for supervisory verification and ensure that all options are relevant for the goal of the assessment – gauging the ability of the consumer to take on and repay the loan.

**77. Supervisors may also set rules on what they expect as a minimum verification of the consumer's creditworthiness and how they see the assessment process.** In another letter<sup>56</sup> sent to all moneylenders in March 2013 as a feedback to thematic inspections, the Central Bank of Ireland stressed that:

*The Central Bank is concerned with how firms are assessing the creditworthiness of consumers and that firms may be using information gathered from consumers, without verifying the information, in order to assess creditworthiness. Firms are reminded that the responsibility rests with the firm to ensure compliance and maintain evidence in order to demonstrate how they have complied with the Regulations. ... Furthermore, all conclusions made during the assessment of creditworthiness should be documented by the firm for each loan issued.*

**78. The US Consumer Financial Protection Bureau (CFPB) has defined in 2013 eight underwriting standards the mortgage lenders must implement.** According to the CFPB's Regulation Z, lenders must look at a consumer's financial records and verify them – i.e. the lenders are responsible for the validity of the information they use to make

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<sup>56</sup> For full text of the letter see:

<http://www.centralbank.ie/regulation/industry-sectors/money-lenders/Documents/Industry%20Letter%20re%20Themed%20Inspection%20of%20Moneylenders-1%20March%202013.pdf>

lending decisions. At a minimum, a US mortgage lender must consider eight underwriting standards:

- Current income or assets;
- Current employment status;
- Credit history;
- The monthly payment for the mortgage;
- The monthly payments on any other loans associated with the property;
- The monthly payment for other mortgage related obligations (such as property taxes);
- Other debt obligations; and
- The monthly debt-to-income ratio<sup>57</sup> or residual income the borrower would be taking on with the mortgage.

79. **The supervisor should make clear that it will monitor compliance with the rule – and do so regularly.** Financial institutions need to know that there is a high probability of the lending files being inspected by the supervisor and that they need to keep proper documentation of the clients' creditworthiness assessment or face supervisory enforcement action. To further quote the Central Bank of Ireland's February 2013 letter<sup>58</sup>:

*We expect that all credit applications will be supported by adequate evidence to illustrate that appropriate credit assessment has taken place and that such evidence will be retained on file and be available to us in the event of an inspection.*

80. **Failure to conduct an adequate affordability checks should have an impact on the lender.** In countries where the affordability check is required, the impact may come in the form of a supervisory action against the financial institution. Other countries may define the impact as a worse position of the lender in the case the borrower defaults. For example, Norway leaves it to the lender to decide how to assess the borrowers – but if the lender fails to make adequate checks, it will receive only a reduced dividend if the borrower subsequently defaults and enters the debt settlement procedure.

81. **Any creditworthiness evaluation must take into account the borrower's ability to repay the loan in full.** Before the 2008 mortgage crisis in the US, many mortgage

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<sup>57</sup> Debt-to-income ratio is a consumer's total monthly debt divided by their total monthly gross income.

<sup>58</sup> Full version available at: <http://www.cscu.ie/wp-content/uploads/2012/10/Central-Bank-Letter-on-Prudent-Lending.pdf>

providers assessed repayment ability only on the introductory teaser rates<sup>59</sup> that were substantially lower than the conditions for the rest of the mortgage. According to the 2013 Regulation Z of the Consumer Financial Protection Bureau, mortgage lenders will have to determine the consumer's ability to repay both the principal and the interest over the long term to prevent the continuation of this aggressive lending practice. The repayment ability is usually tested under the normal conditions but some regulators require more strenuous testing to account for possible protracted periods of economic problems, using scenarios such as 2% higher interest rates or significant fluctuation in the exchange rate for foreign currency mortgages.

82. **As part of the overall risk management requirements, the supervisor may want to verify that the financial institution has adequate risk identification policies in place and verifies the documents themselves.** When the income or credit history assessment is based on information provided by the consumer, the financial institution should have policies and processes in place that will verify that the information is true and correct – and ensure that any falsification is adequately prosecuted.
83. **The supervisors may also support the use of credit history and income verification through rules for loan provisioning.** The provisioning rules may stipulate that provisions for loans where the financial institution verified the borrower's income and / or credit history (if applicable in the country) may be lower than if such verification has not taken place. However, supervisors must ensure that the credit history information is relevant and provides the lender with necessary information to adequately assess the borrower's creditworthiness.
84. **If there are provisioning advantages based on credit history verification, the credit history must be relevant for the decision making; if there are several credit bureaus, they need to exchange information between them or that lenders utilize information from all of them if the credit history of the borrowers is not shared.** The supervisory agency needs to avoid a situation where credit history verification is conducted for the reason of lower provisioning requirements rather than for the reason of adequately verifying a borrower's credit history. For example, Ukraine offers lower provisioning for loans where credit history was verified. However, there are currently<sup>60</sup> six credit bureaus

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<sup>59</sup> For example, the client would pay only 2% interest rate for the first two years and 7% interest rate for the remaining 38 years, or the client would pay only interest for the first two years without any principal payment. Customers were expected to refinance the mortgage before the teaser rates ran out – which they have been unable to do after 2008 and defaulted on their payments as they were unable to cover the full payments.

<sup>60</sup> Information based on the November 2011 Consumer Protection and Financial Literacy Diagnostic Review of Ukraine, conducted by the World Bank.

in Ukraine, two large ones with wide membership, two established by an individual bank (Privat Bank and Russkij Standard Bank) and two smaller ones. The credit bureaus do not exchange information among themselves – but if a bank checks a borrower's credit history with its own or one of the small credit bureaus, it may still use the lower provisioning rule even though the credit history check has probably failed to provide a true and complete credit history of the borrower.

85. **Information disclosure should help consumers understand the impact of negative credit history, possibly even above the issue of credit provision.** Besides financial institutions checking consumer's credit history, assessing creditworthiness and pricing the loan based on the credit history records, there is a growing trend in some countries to evaluate credit history as part of the employee selection process. Responsible use of credit thus may have wider impact on consumers and any credit history disclosure should make consumers aware of this impact.
86. **Any falsification of documents presented as part of the income and credit history verification should be prosecuted actively.** Some clients – and some employees of lenders – may be tempted to change presented documents to ensure a loan approval. Should such a behavior be discovered, it should be prosecuted actively and the penal code should allow for adequate penalties to discourage this type of credit fraud.

## **SUITABILITY TESTING**

87. **The creditworthiness assessment looks at the borrower's ability to repay the loan.** With a long history of financial institutions assessing consumers' creditworthiness, any loan provider may easily develop a scoring system to verify borrower's creditworthiness. It is also sufficiently easy for the supervisor to verify whether the borrower meets reasonable income and credit history requirements and should thus be eligible for the loan. However, it is ultimately only the borrower's decision whether to take the loan on or not – assuming he was provided with adequate information and is able to make an informed decision.
88. **Understanding the limits in reasonable decision-making, some regulators go further and require that the financial institution ensures the offered product is not only affordable but also suitable for the client.** In the case of credit products, the suitability concept looks at the lending issue from the borrower's perspective rather than from the lender's perspective when the creditworthiness test primarily assesses the risk of the loan not being repaid in full and on time. Suitability test always needs to look at the individual borrower's circumstances, his life situation and how the loan will impact his financial security.

### *Case study: Compulsory debt repayment recommendation in the United Kingdom*

*The suitability concept is primarily used in the retail investment business but regulators seeking to build responsible financial markets expand the concept across the boundaries to ensure that financial institutions tailor their advice to the best interest of consumers.*

*The UK Financial Services Authority has been developing a Conduct of Business Sourcebook since 2007 (the sourcebook now being further developed by the new Financial Conduct Authority) to provide the financial industry with guidance on how the supervisor expects the industry to treat customers.*

*The Sourcebook lists the rule that the financial institution needs to act in the client's best interest as the first among its requirements that the financial institution acts honestly, fairly and professionally<sup>61</sup>:*

*The client's best interests rule COBS 2.1.1*

*(1) A firm must act honestly, fairly and professionally in accordance with the best interests of its client.*

*Many other regulators interpret this requirement, based on the EU's Markets in Financial Instruments Directive, only to apply to the sale of investment products. However, the UK authorities insist that the requirement needs to apply across financial sectors.*

*To illustrate their point, the Financial Services Authority (FSA) conducted a mystery shopping exercise Assessing the quality of investment advice in the retail banking sector published in February 2013. In 13% of mystery shops the FSA had concerns with the suitability of recommendations for customers' financial circumstances and needs. The two main problems in this area the FSA identified have been:*

- that the advisers failed to gather enough information about customers' income, assets and financial commitments to ensure the recommendation was suitable for their financial circumstances; and*
- that the advisers failed to recommend that customers repay existing unsecured debts, such as credit cards and loans, where this would have been in the customers' best interests.*

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<sup>61</sup> See <http://fshandbook.info/FS/html/handbook/COBS/2/1> for further details

*As part of the mystery shopping's feedback the FSA also published examples of behavior it considers as not in line with consumer's best interest:*

***Example of an adviser failing to recommend repaying unsecured debts***

*One adviser identified that the customer had around £9,000 of credit card debt. The customer was only making the minimum repayment amount each month and the outstanding balance was accruing a significant level of interest.*

*The adviser failed to recommend that the customer repay this credit card debt and instead recommended an investment within a collective investment scheme. The customer was likely to be worse off, as the interest on the credit card debt was likely to be higher than the investment returns (and paying off the credit card would not have involved any investment risk).*

*We considered that the adviser's recommendation was not in the customer's best interests and was unsuitable for his financial circumstances and needs.*

**89. Generally, a credit product's suitability should be evaluated by three tests – consumer's best interest, understanding of the product and long-term affordability.**

In the interest of an effective and enforceable responsible lending regime, all three of these tests should be combined and the results adequately documented to allow for verification, both by the lender's internal compliance team and by the relevant supervisory agency.

**90. The test of best interest verifies whether the lender adequately understands the borrower's situation and his future plans.**

As such, the financial institution needs to look at the consumer's whole financial portfolio and understand how the loan may interact with the consumer's financial stability and long-term goals (sometimes called "Know your customer principle"<sup>62</sup>). While the final decision will always remain with the customer, the lender should be able to evaluate the consumer's situation and advise which product – if any – is the most suitable to fulfill the specific needs of the consumer.

**91. The test of consumer's understanding looks at whether the consumer understands all product features, benefits and risks.**

It combines the need for adequate information disclosure (discussed above in the disclosure chapter) with the need for adequate

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<sup>62</sup> The same term is used in the anti-money laundering context where it applies to the need of the financial institution to know the identity of the client. In the consumer protection context, the term applies to the need of the financial institution to know the situation and understand future goals of the client sufficiently to be able to select an appropriate financial product from the available options.

explanation and guidance provided by the sales staff as the oral presentation may significantly influence how the borrower understands and uses presented information.

92. **The test of long-term affordability looks at how long-term risks the consumer may face could influence his ability to repay the loan.** As such, it goes beyond the creditworthiness assessment (that focuses on the immediate ability to repay the loan based on momentary circumstances) conducted by the lender before the sale. While the first two tests – of best interest and consumer understanding – are rather straightforward, the test of long-term affordability needs the lender to make various assumptions about the customer's future as well as consider potential impact of general economic development on the borrower's ability to repay the loan.

## Enforcement options

93. **Requiring suitability testing by law – and supervising the requirement – is a complex issue and may require a detailed supervisory guidance.** Even the European Union in its 2008 Consumer Credit Directive shied away from the requirement (that it had no problem introducing for investment products four years earlier via the Markets in Financial Instruments Directive). Instead, the Consumer Credit Directive keeps the burden of suitability assessment fully with the client, only requiring that the client is given sufficient information and that the information is explained if necessary:

*Article 5.6: Member States shall ensure that creditors and, where applicable, credit intermediaries provide adequate explanations to the consumer, in order to place the consumer in a position enabling him to assess whether the proposed credit agreement is adapted to his needs and to his financial situation, where appropriate by explaining the pre-contractual information to be provided..., the essential characteristics of the products proposed and the specific effects they may have on the consumer, including the consequences of default in payment by the consumer. Member States may adapt the manner by which and the extent to which such assistance is given, as well as by whom it is given, to the particular circumstances of the situation in which the credit agreement is offered, the person to whom it is offered and the type of credit offered.*

94. **For adequately testing suitability of loans, the lenders need a framework with which they can model typical customers.** Some lenders rely on historical data which might be risky if the institution enters new market segments or when overall economic situation significantly changes (for example after a global or regional economic crisis), some rely on general statistical information released by national statistical offices or private analysts.

However, national-level data tends to be too general and lacking the details to allow for adequate segmentation. Therefore, the supervisor may support collection and distribution of more detailed (and anonymized) data or development of models lenders could use with sufficient confidence.

*Case study: Reference budgets used by Dutch banks*

*When Dutch banks started introducing responsible lending policies, they faced the issue of developing sufficiently detailed guidance for understanding the debt capacity of Dutch households. Lacking the necessary data and capacity, they piloted an alternative approach of using an independent third party, Nibud (National Institute for Family Finance Information<sup>63</sup>), to develop reference budgets all banks would use to test the borrower's debt capacity.*

*These reference budgets (later developed also for other European Union countries<sup>64</sup>) contain a list of goods and services that a family of a specific size and composition needs so that it is able to live at a designated level of well being, along with the estimated monthly or annual costs thereof. Given the flexibility of the concept, the reference budgets may also be specifically related to a specific social class or occupational group, thus representing individual households based on the household's composition, income category, etc.*

*The important factor of using the reference budgets in the Netherlands is that they are used by all credit providers. The agreement provides for a level playing field for credit institutions and allows them to compete on price or product features but **not** on willingness to accept more risk without adequately pricing it.*

*As the reference budgets are also available online, they serve as a reliable and relevant "reality check" for potential borrowers and help them understand the effects of taking on the debt burden.*

- 95. Adequate suitability testing needs to take into account where the product is sold and implement behavioral psychology insights.** Especially when credit is sold to finance a specific purchase to be made on the spot, many borrowers may focus on acquiring the underlying product and disregard information provided to them about the loan. Especially in the situations where attention of the consumer is limited, insights from behavioral

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<sup>63</sup> For details see <http://www.nibud.nl/over-het-nibud/organisatie/about-nibud.html>

<sup>64</sup> See <http://www.referencebudgets.eu/>

psychology should be given specific attention to help find tools to communicate credit-related information effectively.

## EXPLICIT DEBT LIMITS

96. **One of the options to limit overall debt burden of the customers is to set explicit debt limits.** These limits look at the overall debt burden, measured by total monthly installments, and compare them to the customer's (or customer's family) income or value of the property being bought with the loan. The regulator then defines maximum limits for these ratios.
97. **These explicit debt limits make the assessment of affordability simpler for the lender to process but need to be set up flexibly so that they do not exclude clients that could benefit from new borrowing.** While the explicit debt limits allow lenders to formally assess affordability of the new loan easily through a simple process, there is a potential danger that the limits will exclude clients that would benefit from a new loan and could afford it. If the explicit limits are the only measure that is evaluated and are evaluated too narrowly, they may disregard options a potential consumer may have to cover his obligations (e.g. by pooling family resources, developing a new source of income through the loan, etc.).
98. **Loan-to-value (LTV) limits compare the loan with the value of the purchase that the loan will finance.** Primarily used for mortgages where it measures the loan against the value of the real estate property, LTV limits are primarily seen as a risk-management tool for the lender (assessing the lender's ability to recoup losses in the case the loan is not repaid) rather than a responsible lending tool. On the other hand, LTV limits also support responsible lending, especially if the regulator does not allow mortgages over 100% LTV (i.e. where the value of the property does not cover the loan if the property is sold and the borrower would thus remain indebted even after surrendering the property used as collateral<sup>65</sup>).
99. **Loan-to-income (LTI) or debt-to-income (DTI) limits compare the loan with the income of the debtor, either as an individual or as a household.** LTI/DTI is used as an assessment of the borrower, providing the lender with information on the ability of the borrower to repay the loan with current income. The ratio should help the lender evaluate the additional burden debt payments will put on a household, with recommendations usually set between 30-50% of household income as the cut-off point. However, any

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<sup>65</sup> Unless the country has a regime similar to the US where the borrower may give up the property and is no longer responsible for any remaining debt if the lender fails to cover the debt through the sale of the property.

number should be seen only as guidance and should take into account both the type of credit (for secured loans a higher DTI might be acceptable) and the use of the borrowed funds (for loans that serve the purpose of strengthening future income of the household a higher DTI might be acceptable).

## Enforcement options

100. **LTV and DTI limits may be set as firm limits that do not allow lenders extend any loans beyond the ratios.** Firm limits prescribe cut-off points beyond which a prospective borrower may not be offered a loan. To enforce these rules, the lender should be required to record all relevant information acquired from independent sources (such as a credit bureau) and the borrower. Information on income provided by the borrower should be verified with the employer or through a copy of a tax return if available, as income self-certification should not be allowed for larger loans.
101. **LTV and DTI limits may also be set as overall guidance for responsible lending policies but financial institutions may be given flexibility to provide loans even above the recommended thresholds.** However, the lenders should preferably document why they went over the threshold and how the loan above the LTV/DTI threshold may be in line with the best interest of the consumer. The supervisor should focus on these cases and follow the viability of these above-the-limit loans in the long term to ensure that they do not create significantly higher stability risks compared to loans of similar type but below the LTV/DTI thresholds.
102. **Another way to nudge lenders into preferring loans with lower LTV/DTI is requiring progressively higher reserves for loans with higher LTV/DTI or setting overall limits of share of various types of loans.** This might help focus the attention of the lenders away from loans with high LTV/DTI ratios but the regulator also needs to address the issue of the additional cost being simply passed to the borrower.
103. **Failing to follow the LTV/DTI limits or conducting adequate assessment should have an impact on both the lender and borrower.** The lender may be subject to a supervisory action (including a penalty, especially for repeated or large-scale breaches) while the borrower could benefit from application of a lower interest rate or prohibition of penalties or late fees if the borrower enters into arrears. Lenders could also be deemed responsible for defaults of overindebted clients.
104. **Special care needs to be taken for foreign-exchange loans or in a multicurrency environment.** If lenders provide foreign currency (FX) denominated loans, the LTV/DTI limits may be set lower for these loans to address the risk of significant fluctuation of the

exchange rate and thus an increase in the monthly installment. The supervisor should also carefully monitor any major use of FX loans and ensure that the additional risks are adequately disclosed and explained (or may even consider banning these loans for retail customers if it believes the consumers do not understand the risks as for example Armenia has done after the 2008 crisis brought a significant shift in the Armenian dram / US dollar exchange rate and thus a significant raise of the installments of USD denominated loans). Special attention to the issue of loan vs. income currency mismatch needs to be paid in countries that operate with several currencies<sup>66</sup> or with a pegged exchange rate when the peg may move.

## CEILINGS ON THE COST OF CREDIT

105. **Interest rate ceiling – also called usury ceilings – are used in some countries to limit maximum interest rates of consumer loans.** The ceilings are usually implemented with the intention to protect consumers from usurious behavior of some lenders. The primary target group consists of those lenders that serve fringe client segments that do not qualify for loans by banks and mainstream non-bank lenders because of their riskiness (insufficient income, other existing loans, sociodemographic profile, etc.) or negative credit history.

### *Case study: Experience with interest ceilings in the United States*

*Extensive research has identified three negative consequences of introducing interest rate ceilings.*

*First, they tend to displace costs so that lenders can avoid including them in the APR. So the extent of credit linked to goods sold at above market prices tended to increase when an interest rate ceiling was introduced in Massachusetts<sup>67</sup>. Pawnbrokers also tended to lend smaller amounts against the value of the goods pledged compared to the loan vs. goods value situation before the limits were introduced<sup>68</sup>.*

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<sup>66</sup> An example might be West Bank and Gaza where people have income in one or several of the three typically used currencies – US dollar, Jordanian dinar and Israeli shekel.

<sup>67</sup> See Johnson, R.W. and Sullivan A.C. (1980), Restrictive effects of rate ceilings on consumer choice, West Lafayette: Credit Research Center.

<sup>68</sup> See Johnson, R.W. and Johnson, D.P.(1998), Pawnbroking in the U.S: a profile of customers, West Lafayette: Credit Research Center.

*Secondly, interest rates tend to creep up to the ceiling. This is a particular problem when ceiling rates are deliberately not set too low.*

*Thirdly, ceilings tend to displace markets. When Massachusetts introduced a ceiling, the number of small loans (\$500 dollars or less) decreased by a third, while the number of secured loans increased. On the whole it was the high-risk customers who were most adversely affected, and many were 'protected out' of the credit market. Conversely, the de-regulation of interest rates increased access to credit of all kinds<sup>69</sup>.*

106. **Implementation of usury ceilings usually sparks a political debate.** Proponents of the ceiling use the argument of protecting consumers against excessive charges and misuses of their low financial literacy while opponents of the usury ceilings usually point out the dangers of market distortions and increased financial exclusion for more risky customers. However, as any regulation is usually implemented country-wide, there is a lack of analytical evidence and the debate is often based on political aspects of the issue. Specific market segments such as microfinance may be negatively influenced by the debate, as they charge higher rates due to their low-volume high operating costs business model<sup>70</sup>.
107. **Any discussion of usury ceilings needs to consider their costs and benefits in comparison with other available options described in this paper.** The issue of forcing some types of customers outside of the formal financial sector and towards the informal unregulated lenders is the most important as it may raise most harm<sup>71</sup>.

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<sup>69</sup> See Caskey J (1994), *Fringe banking*, New York: Russell Sage Foundation, and Staten, M.E. and Johnson, R.W. (1995), *The case for deregulating interest rates on consumer credit*, West Lafayette, Credit Research Center, Purdue University.

<sup>70</sup> See for example CGAP (2004), *The impact of interest rate ceilings on microfinance: Donor brief No. 18*, Washington: Consultative Group to Assist the Poor, warning that "Despite good intentions, interest rate ceilings generally hurt the poor by making it hard for new microfinance institutions to emerge and existing ones to stay in business... [They] often drive clients back to the expensive informal market where they have no or little protection."

<sup>71</sup> As examples, see a study by Porta and Masciadaro, that argues that in Italy the interest ceilings mean that people perceived to have a high risk of default are refused credit by mainstream providers and are therefore prey to informal and illegal lenders (Porta, A., Masciadaro, D. (2006), *L'usura in Italia*, Milano: EGEA). Another paper by Policis suggests that the interest rate ceilings in Germany and France have led to higher levels of unregulated lending than in the UK, where there is no ceiling (Policis (2005), *Economic and social risks of consumer market regulation*, London: Department of Trade and Industry).

108. **Regulations setting ceilings on cost of credit usually covered only the maximum interest rate.** The development is based on historical way of providing loans where the only cost was the interest rate. As the competition in the retail lending market grew, lenders started decreasing nominal interest rates – while recovering the profit via additional fees they started to charge.

*Case study: interest rate ceilings in Poland*

*Interest rate ceilings were introduced in Poland in 2006. The restrictions concern two elements. Firstly, the maximum amount of interest charged in any legal contract cannot exceed four times the Lombard credit interest rate of the National Bank of Poland. Then, the total amount of all costs cannot exceed 5% of the total amount of credit.*

*Unlike the ceilings in other countries the Polish regulation only applies to the interest and default charges not to the total cost of credit (and therefore the APR). As a response, many lenders have restructured their charges to formally comply with the new law. A lender specializing in small loans, with repayments collected in the home has, for example, separated the collection charge from the interest on the loan and now sells insurance alongside the loan to cover the rescheduling that was previously covered in the total cost of credit, thus bypassing the intended goal of the regulation.*

*In other words, the interest rate ceiling has not achieved a price reduction for users as planned but merely a change in the way that the various parts of the loan's price are presented to consumers. This change has added complexity to the price disclosure and resulted in a loss of transparency and comparability.*

109. **A modern regulatory ceiling on cost of credit needs to address the total cost, taking into account all relevant fees associated with the loan.** The total credit needs to be calculated through a standardized and generally applied methodology that ensures that all non-interest costs related to the loan are included into the calculation. For a detailed debate on calculating the total cost of credit and various measures to be used see for example CGAP Focus Note 78, Designing Disclosure Regimes for Responsible Financial Inclusion (2012).
110. **As the disclosure rules for the total cost of credit improve, some providers may try to move some of the costs into other products bundled with the loan.** A banking lender may thus require the borrower to open a current account with the bank and charge above-average cost for the current account. Any lender may require the borrower to purchase insurance coverage (life, property, payment protection, etc.) from a related insurance company and profiting from the arrangement through a commission or a profit-

sharing arrangement with the insurer. Some lenders may even include the cost of the insurance payments into the loan installments without disclosing how much of the payment goes towards the insurance coverage – and not allowing the customer to seek a cheaper insurance option.

## Enforcement options

111. **The first decision when designing usury ceilings is the decision on whether to apply an absolute or a relative limit.** With an absolute limit, the regulator sets a specific maximum rate either for all loans or for each specific type of retail loans. The regulator should also ensure it may change the maximum rate quickly to respond to any major market changes, such as increased inflation (driving nominal interest rates up) or improved competition (driving interest rates down).
112. **Relative ceilings are benchmarked against a benchmark rate and set the maximum add-on (or multiple) relative to this benchmark.** The benchmark may be the central bank's repo rate, LIBOR or its local variant or a regularly published industry average for specific types of loans. The regulator may thus specify that the maximum mortgage rate may be triple-LIBOR or LIBOR plus x%. Alternatively, the regulator may collect prices of all newly provided loans, calculate and publish averages and then specify that a credit card APR may not exceed double the industry average.
113. **Cooperation with the competition authority may help ensure that these limits do not have negative impact on the level of competition.** As research shows, interest rates tend to creep up to the ceiling, especially if it is set too high<sup>72</sup>. The competition authority would also want to see whether there is sufficient spread in credit prices for various client segments or whether the pricing is too similar for a competitive market.
114. **As the starting supervisory action, supervisors should regularly verify whether lenders calculate the total cost of credit properly.** When a formula is prescribed, the supervisor needs to ensure that it has the capacity to verify calculation of a sufficient number of loans to ensure compliance with the rules.
115. **When the lender breaches the maximum ceiling, there should be administrative sanctions from the supervisor.** The supervisor should have the full scale of supervisory interventions at its disposal – and use it adequately.

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<sup>72</sup> See Caskey J (1994), Fringe banking, New York: Russell Sage Foundation, and Staten, M.E. and Johnson, R.W. (1995), The case for deregulating interest rates on consumer credit, West Lafayette, Credit Research Center, Purdue University.

116. **If the breaching of the maximum ceilings is repeated often and with purpose, there should also be criminal sanctions against the lender.** Especially if the administrative sanctions are low or the supervisory agency unable or unwilling to apply them sufficiently, criminal proceedings may be a more effective deterrent of stepping over the usury lines. The criminal proceedings should also be brought when there is an evidence of the lender misusing the inability of its consumers to make an informed decision either due to low financial literacy, critical life situation or misleading sales practices.
117. **When a customer is a victim of a usury ceiling breach, he should be compensated.** The compensation may include lowering the interest rate for example to a central bank's repo rate, not being charged any late fees or penalties, etc.
118. **Besides setting outright usury ceilings, countries may also empower courts to reopen contracts with terms deemed usurious.** While this power to reopen contracts with usurious terms may have a limited impact (unless the legal system permits class action lawsuits, it always deals with a single case and many borrowers are not willing or able to take creditors to court) this legislation may be helpful when borrowers are taken to court for non-payment or when they seek either debt advice or assistance with debt settlement. To make the legislation more effective, it needs to refer to all terms and conditions and all charges associated with the credit. Courts may also benefit from guidance on what would be considered usurious, given the relatively small numbers of cases that usually come to court.

## **CEILINGS FOR SANCTIONS AND PENALTIES**

119. **Originally, late fees and penalties were used to penalize customers not keeping the agreed repayment schedule and cover any costs lenders face due to the repayment failure.** The late fees and penalty interest rate would thus serve as a motivation for the borrower to repay the loan on time while providing additional income to lenders (if the fees are collected in the end or when a collateral is sold by the lender) to cover costs with collection of late loans.
120. **Some lenders also use non-financial penalties to motivate timely repayment.** Used especially in microfinance that relies on personal collection of repayments, some lenders would build their penalty system on late fees as well as public shaming of the borrower, a powerful tool in some cultures.

121. **However, some lenders may also build their business case around lending unsustainably and recouping their "investment" through the sale of collateral and significant late fees and penalties.** Especially if there is an interesting collateral available with a value significantly higher than the loan amount (such as real estate securing a consumer loan) and the lender has the ability to increase the amount owed through significant penalties and then quickly repossess the collateral, rogue lenders may seek customers in financial difficulties, lending them with securing a collateral and then profiting on repossessing and selling the collateral.
122. **Additional fees and penalties the lender and associated companies may charge might provide a profitable business even without any collateral involved.** If the lender and associated companies (law firms, private arbiters, collection firms, etc.) are able to charge high fees without any limits or if the limits are set too high, it might be more profitable to support overindebtedness and intentionally create new debtors in arrears rather than lend responsibly.

*Case study: profiting from high penalties in the Czech Republic*

*When a borrower goes into arrears in the Czech Republic and the loan contract includes an arbitration clause (as most non-bank loan contracts would do until about 2012, with the arbiter being selected by the lender), the lender either sells the receivables to a specialized collection agency or tasks an external attorney with the collection of the loan. The same proceedings may also be used by other bodies with outstanding receivables, such as utility companies or city transport companies that caught the person riding without a valid ticket.*

*The attorney either requests a payment order from a court within civil proceedings or (more typically) requires a decision from the arbiter as defined in the loan contract. The attorney charges fees for his services and the receivable also grows either by a court fee or a fee for the arbitration service. Once an enforceable decision is made and if the client does not pay, the outstanding receivable (increased by attorney fees and court / arbitration fees) may be collected through a writ of execution. The Czech Republic uses a system of court appointed private bailiffs that charge fees for their collection services – and the lender's attorney charges further fees for processing the request for a writ of execution. When the bailiff collects from the debtor, the money collected first goes to covering the bailiff's costs and only once the bailiff's costs are covered, the remaining collected money is used to cover other parts of the outstanding debt.*

*Until cancelled by the Constitutional Court in April 2013, attorney fees were set by a regulation of the ministry of justice. While the regulation originally assessed the fees*

on the expectation that each transaction is conducted separately, specialized law firms developed automated processes to handle collection proceedings electronically for the fraction of the maximum allowed fee.

Moreover, the collection-related fees were set significantly higher than in any neighboring countries, not to mention much stricter limits of countries such as Great Britain where there are no attorney fees for small claims until about USD 7,500 (unless the court decides to award the fees). The following chart compares fees for a collection of a debt of CZK 1,020 (about USD 55) in the Czech Republic and Germany – with the attorney and bailiff's fees 10-13 times higher in the Czech Republic.

<i>Comparative debt burden for a collection of CZK 1,020 (USD 55)</i>			
<i>Type of fees Czech Republic (in CZK)</i>	<i>Czech Rep.</i>	<i>Germany</i>	<i>Fee ratio CZ/GE</i>
<i>Debt</i>	1 020	1 020	1,00
<i>Court fee</i>	800	575	1,39
<i>Attorney - civil proceedings</i>	7 920	744	10,65
<i>Attorney - writ of execution proceedings</i>	4 320	372	11,61
<i>Bailiff's fees</i>	7 800	595	13,11

*Source: Foundation Clovek v tisni (Man in Need), fees for the Czech Republic based on the regulation valid until February 2012.*

Additional profits by lenders focused on profiting from the high fees were ensured by splitting up the loan into several smaller loans. For example, a client would approach a lender that would agree to provide a loan of CZK 10,500 – but in reality would provide the borrower with three loans of CZK 3,500 from three legally distinct but related companies. The need to repay loans to three lenders increased the chance of going into arrears for a low-income borrower – and allowed the lending group with associated arbiters and collectors charge all attorney and arbiter fees three times<sup>73</sup>. With tripling of the fees due to the loan's split, the lender(s) would be able to gain a writ of execution for CZK 78,987, i.e. 7.5 times the value of the original loan of CZK 10,500.

<sup>73</sup> The government responded to this widespread practice by amending the private bailiff law and requiring that all receivables of an individual must be grouped together and enforced at the same time within a unified proceeding.

## Enforcement options

123. **If the regulator decided to set limits for penalties and late fees, it needs to assess true costs of debt collection to the industry.** Late fees and penalties should serve to both motivate consumers to pay their installments on time and compensate lenders with additional costs of their capital not being returned on time and of needing to invest into the collection of late payments. However, these fees should reflect fair costs to the lenders and should not be set so high that it is profitable for lenders to support overindebtedness.
124. **Similar to usury ceiling enforcement, both administrative and criminal sanctions should be available against those that breach the limits.** The sanctions should be high enough to ensure that any potential profits are taken away by the sanctions. Taking advantage of low capacity customers and their financial distress should also be viewed as a dangerous act and prosecuted actively as many potential victims would find it hard to protect themselves.
125. **Some regulators have designed the rules so that fees or penalties above the set limits are automatically invalid and lenders trying to charge these penalties may lose their right to any compensation.** This arrangement provides an additional level of protection for consumers as they do not have to assert their rights individually through courts but are provided the protection against illegal practices automatically. With regard to individual contractual relationships, any agreement between the lender and the borrower consenting to fees or penalties above the limit should be deemed as null and void. Stepping over the limits could also mean an automatic forfeiting of any reimbursement of the lender if the borrower goes into arrears.
126. **Supervisors should also verify that reasons for applying any penalties are specific and understandable to the client.** Vaguely defined penalties<sup>74</sup> should be invalid and the supervisor should actively communicate examples of invalid penalties to both guide the lenders towards adequate definitions and help borrowers protect their rights.

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<sup>74</sup> For example, a penalty of 40% of the borrowed sum for "not informing the lender about any negative change in the borrower's situation" should not be acceptable unless the loan terms specifically define what these "negative changes" are, how the borrower should inform the lender, and within what timeframe (the size of the penalty is another issue to be considered as it would seem out of proportion to any potential harm to the lender).