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European Union Committee

36th Report of Session 2005–06

**Consumer Credit in
the European Union:
Harmonisation and
Consumer
Protection**

Volume I: Report

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NOTE:

The Report of the Committee is published in Volume 1, HL Paper No. 210-I
The Evidence of the Committee is published in Volume II,
HL Paper No. 210-II

FOREWORD—What this Report is about

The European Commission plans to replace the 1987 EU Directive on Consumer Credit, which lays down minimum standards of consumer protection that Member States are free to improve, as Britain has done.

The Commission's stated objective is to promote an internal market in cross-border consumer credit by enabling lenders in one country to offer credit to consumers in another. The Commission sees the differences in national laws as the main obstacle to developing that market. To overcome this, Member States would not be allowed to have national laws that gave consumers either less or more protection than was set by the new Directive.

Undoubtedly an internal market in consumer credit would offer consumers more choice. It would also present huge opportunities for British companies to make profits in other Member States, using the know-how gained in developing the largest and most sophisticated consumer credit market in Europe. But all our evidence shows that the focus on cross-border credit is misconceived, because consumer credit suppliers cannot penetrate a market in a foreign country without setting up or acquiring an establishment there, as several have done.

Contrary to its own established policy, the Commission has not carried out any study to verify the basic assumption on which its proposals are based. Nor has enough work been done to assess their effects. That matters in the UK where already high standards of consumer protection have been reinforced by the new Consumer Credit Act. The Directive would force some of those standards to be reduced. UK consumers would suffer and the flexibility to change UK laws rapidly through domestic regulation when needed would be lost.

What is more, some aspects of consumers' rights could be governed by laws other than their own, without them knowing that another country's laws would apply or being able to obtain local advice on those laws. At the same time, consumers' organisations say the scope of the Directive is too limited.

All in all, the drawbacks of the Commission's present approach seem to outweigh any advantages so far as the UK is concerned.

Consumer Credit in the European Union: Harmonisation and Consumer Protection

CHAPTER 1: INTRODUCTION

Purpose of the Inquiry

1. The 1987 EU Directive on consumer credit¹ contains various rules for the protection of the consumer in credit transactions. Except for the requirements for the computation and statement of the total charge for credit and the annual percentage rate of charge (APR), these rules set only minimum standards. That leaves Member States free to retain or introduce additional measures to enhance consumer protection.
2. The European Commission proposes to replace the present Directive with a new one with a different focus. As well as improving common standards of consumer protection to what they describe as a “high level”, the Commission aims to promote an internal market in cross-border credit by harmonising certain national rules which they regard as impeding the development of that internal market.
3. We wanted to examine whether that was a feasible and desirable aim and what the consequences might be for UK legislation and for British business and consumers. We did so against a background of the very diverse, sophisticated and profitable market in consumer credit which has developed in this country and the extensive framework of national consumer credit legislation which has been built up here over more than 30 years. We were also conscious of rising concern about consumer credit in this country, as reflected in the enactment of a major new Consumer Credit Act earlier this year to supplement the Consumer Credit Act 1974.

Conduct of the Inquiry

4. This Inquiry has been conducted by Sub-Committee G (European Social Policy & Consumer Affairs) of the European Union Select Committee. A list of the Members of the Sub-Committee who carried out the Inquiry, and their declared interests relevant to the Inquiry, is at Appendix 1.
5. We issued a call for evidence on the 8th November 2005 (Appendix 4) and received written and oral evidence. Those from whom evidence was received are listed in Appendix 5. The evidence itself is reproduced in Volume 2 of the Report.

¹ Council Directive 87/102/EEC of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of Member States concerning consumer credit, as amended by Directives 90/88/EEC and 98/7/EC.

6. We had previously issued an Interim Report, with Evidence,² in July 2005 on the Commission's 2004 draft, which was replaced by the text now under consideration.
7. In this Report we have not attempted to address every detail of the current proposals. Nor have we made more than the occasional comment in the main body of the Report on the drafting, although in various respects it appears to be unsatisfactory. These are matters which can safely be left to the Department of Trade and Industry, which has issued a detailed supplementary consultation paper,³ and at European level to the European Parliament, which is continuing its examination of the text. Instead, as explained in paragraph 25, we have focused on the following key issues:
 - whether the limited harmonization proposed is likely to achieve the objective of facilitating use of a single EU-wide form of consumer credit agreement;
 - will the Directive in fact provide a high level of consumer protection?; and,
 - will the full harmonization provisions of the Directive have the effect of reducing the level of protection enjoyed by consumers under the existing UK consumer credit legislation?

and on certain specific provisions of the Directive which we think may cause problems, including in particular the so-called mutual recognition provision in Article 21(2).

8. In doing so, we have also endeavoured throughout to take a Community view of the Directive rather than considering solely the implications for the United Kingdom. But we have, of course, drawn attention to those provisions which we feel would reduce the existing level of protection for consumers under UK legislation or impair the efficiency of the UK consumer credit market.
9. We are conscious of the difficulties confronting the Commission, particularly with the enlargement of the European Union, in having to take account of widely differing consumer credit markets, practices and legislation in each of the 25 Member States. As a result, provisions which may work well for some Member States may well create difficulties for others.
10. The task of reconciling the conflicting national practices and viewpoints between 25 Member States is far from easy. We should like to pay tribute to the Commission's conscientious efforts to understand the nature of these difficulties and to respond to the concerns of Member States and of the Parliament so far as they feel able to do so.
11. As noted in paragraphs 17 and 21, these efforts have led to significant improvement in successive drafts, so that the present text is much more acceptable than its predecessors. But areas of serious concern remain which we have tried to identify in this Report and which we hope will be addressed by further changes to the text of the draft Directive. **We commend this Report to the attention of the House and recommend that it should be debated by the House as soon as possible in the hope of drawing wider**

² 13th Report of Session 2005–2006, HL Paper 37.

³ Proposal for an EC Consumer Credit Directive - Supplementary Consultation (DTI March 2006).

attention to the issues raised and as a contribution to further consideration of this Proposal by the Government, the European Commission and the European Parliament.

Specialist Adviser

12. The Specialist Adviser to this Inquiry was Professor Sir Roy Goode, QC of St. John's College, Oxford. We are greatly indebted to him for the enormous contribution which his scholarship and experience has made to this Inquiry.

Preliminary Observations

Terminology

13. The proposed new Directive mainly consists of uniform rules which Member States will be required to apply without the freedom to provide or maintain either a lower or a higher standard of consumer protection. This is driven by the Commission's view that differences in the mandatory rules of Member States are inhibiting the development of a market in cross-border consumer credit. That aim is consistent with a new Commission policy of moving from what is called minimum harmonisation towards what is called full or maximum harmonization.
14. The terminology is therefore very important to understanding the nature and potential effect of the proposed Directive. Three terms are commonly used to denote differing degrees of harmonisation:
 - *minimum harmonisation* which means a minimum standard of protection for consumers which Member States may increase but may not reduce;
 - *maximum harmonisation* which means full or total harmonisation (i.e. uniform rules) so that Member States can neither reduce the level of protection for consumers nor increase it. (We will refer to this as "*full harmonization*" or as "*uniform rules*"); and,
 - *targeted harmonization* (or *targeted full harmonisation*) which denotes a mixed approach by which some rules are uniform (for example computation of the annual percentage rate of charge) while the rest embody minimum standards.

Nature of the Draft Directive

15. As stated above, most of the provisions of the draft Directive are full harmonization measures where the Directive permits neither a reduced nor an increased level of consumer protection. Any existing legislation which gives the consumer greater rights than those provided by the Directive would have to be repealed or revoked.
16. The overall effect of the Directive is to move EU consumer credit law sharply towards full harmonization and away from the minimum standards approach. However, the following provisions do not fall into this category:
 - some prescribe only minimum standards: for example, those relating to the creditor's liability for the defaults of the supplier in respect of a linked transaction. These leave Member States free to retain or introduce additional protective measures;

- some are very general in character, laying down a principle but by inference leaving the mode of implementing it to Member States. Examples are the rules providing for access to databases, the amount of the rebate of charges on early settlement, supervision of creditors and credit intermediaries and effective out-of-court dispute resolution procedures; and,
 - finally, those which are referred to by the Commission as *light regimes*, in which the normal detailed requirements are substantially reduced for certain types of transaction: for example; the provision of pre-contractual information as regards overdrafts (art. 2(3)).
17. The Commission first introduced its proposals for a new Directive in 2002. In the light of criticisms, especially from the European Parliament, it offered a new set of proposals in 2004. Later it withdrew these too, publishing its third and latest draft in October 2005. The current text reflects extensive amendments proposed by the European Parliament, most of which were accepted by the Commission and which substantially improved the quality of the Directive.
18. Our understanding of the evolving position of the European Parliament has been greatly assisted by oral evidence from Ms Arlene McCarthy MEP, Chairman of the Parliament's Internal Market and Consumer Protection Committee⁴ and by written evidence from some of her MEP colleagues.⁵
19. In Appendix 2 we set out a table of contents of the current draft of the Directive, which (a) shows whether a particular measure is a minimum or a full harmonization measure or is a mixture of the two or alternatively is general in character (see paragraphs 15 and 16 above) and (b) identifies UK legislation that may be affected by it.

Initial Analysis of the Draft Directive

20. It is widely accepted that the 1987 Directive is no longer responsive to market needs in an era of major consumer credit expansion. The Commission's initiative in proposing a new Directive is therefore to be welcomed. So, too, is the objective of promoting an internal market in consumer credit, though not necessarily by the method proposed by the Commission. It is also accepted that on some issues the establishment of a uniform rule is desirable and will not have the effect of reducing consumer protection. As stated above, even the 1987 Directive has uniform rules relating to the total charge for credit and the APR and, while the new draft changes the content of the rules, it is right that they should continue to be uniform. Similarly, there seems to be general support for full harmonization of the rules relating to the consumer's right to withdraw from a transaction and the right to pay ahead of time and receive a rebate of charges on early settlement. But the computation of the rebate is expressed merely as an "equitable reduction", thus allowing leeway for Member States to adopt different rules so long as the objective is attained. This is true also of the general rules referred to in the previous paragraph.

⁴ QQ 131-153

⁵ pp 166-167

21. Other welcome features of the revised draft are:
- the exclusion of secured credit and guarantees from the scope of the Directive;
 - a modification of the duty to give advice so as to make it clear that ultimate responsibility for the decision to take credit lies on the consumer;
 - the introduction of a “light touch” regime for overdrafts and certain other categories of the agreement;
 - the abandonment of the prohibition on the use of bills of exchange;
 - the removal of the duty to provide databases and the substitution of a duty to allow access to databases on a non-discriminatory basis; and,
 - the regulation (rather than merely registration) of creditors and credit intermediaries.
22. From the UK’s perspective, however, other aspects of the revised draft cause particular concern. These are:
- the inclusion of credit unions within the scope of the Directive, albeit within a “light touch” regime;
 - the specification of a closed list of items of information to be included in credit agreements, which would require the revocation of various information requirements currently contained in UK consumer credit regulations;
 - the inclusion of a requirement that in all cases of assignment of debts other than by way of securitisation notice of assignment is to be given to the debtor; and,
 - the provisions for mutual recognition.
23. There is also a more general concern that the concept of full harmonisation is being expanded at the price of narrowing the field covered by the Directive: for example by the abandonment of Articles relating to default and enforceability, repossession and the banning of improper procedures for the recovery of debt.
24. As indicated in paragraph 2, the Commission has said⁶ that the Directive is designed to fulfil two objectives. The first is to promote an internal market in cross-border credit by harmonizing certain rules with a view to enabling credit institutions to offer a single EU-wide consumer credit agreement instead of having to use a different form of agreement for each of the 25 Member States. The second is the provision of a high level of consumer protection.
25. We accept that the creation of an internal market in consumer credit is of great importance and of potential benefit to the consumer. But we have to ask whether the limited harmonization proposed is likely to achieve the objective of facilitating use of a single EU-wide form of consumer credit agreement. We address this issue in Chapter 5. The second objective raises two questions: will the Directive in fact provide a high level of consumer protection? And will the full harmonization provisions of the Directive have

⁶ European Commission Supplementary Memorandum COM (2005) 483 final dated 7 October 2005

the effect of reducing the level of protection enjoyed by consumers under the existing UK consumer credit legislation? We deal with the first of these two questions in Chapter 6 and the second in Chapter 7 in examining the specific provisions of the Directive.

26. The draft Directive needs to be read in conjunction with existing Community legislation relating to consumer contracts, and in particular the Directives on misleading advertising,⁷ contracts negotiated away from business premises,⁸ unfair terms in consumer contracts,⁹ protection of consumers in respect of distance contracts,¹⁰ pursuit of business of credit institutions,¹¹ distance marketing of consumer financial services,¹² and unfair business-to-consumer commercial practices in the internal market.¹³ Accordingly, the limited scope of the draft consumer credit Directive is in some degree attributable to the fact that certain issues which it might otherwise have been expected to cover are dealt with in one or other of the Directives referred to above.

The Absence of an Impact Assessment

27. We are most grateful to the Commission for its helpful answers to our questions, and in particular to Mr Dirk Staudenmayer, Head of the Unit in DG SANCO responsible for the preparation of the Directive, who gave us very useful oral evidence, and to the Director-General himself, Mr Robert Madelin, for answering a series of supplementary questions.
28. However, we have been much concerned by the fact that, despite the policy of the Commission since at least early 2005 to make no major proposals without first conducting an impact assessment,¹⁴ the Directorate responsible for the Directive (DG SANCO) has made no impact assessment to determine the validity of three key assumptions on which the policy of full harmonization rests, namely:
- that the main impediment to a cross-border consumer credit market is the existence of differences in the national laws of Member States;
 - that a move to full harmonization would have a significant effect in promoting such a market; and
 - that this would come about principally by enabling creditors to move to the point where there could use one form of consumer credit agreement throughout the European Union instead of having a separate form of agreement for each of the 25 Member States.

⁷ Council Directive 84/450/EEC as amended by Directive 9755/EC.

⁸ Council Directive 85/577/EEC.

⁹ Council Directive 93/13/EEC.

¹⁰ 97/7/EC.

¹¹ Directive 2000/12/EC.

¹² Directive 2002/65/EC.

¹³ Directive 2005/29/EC.

¹⁴ Thus in a speech to the Legal Affairs Committee of the European Parliament on 2nd February 2005 Commissioner McCreavy said: "Secondly, we must ensure that our rules are effective and cause the minimum burden for business ... No proposal leaves the house without having been subject to thorough impact assessment." It is pertinent to note that the DTI included in its supplementary consultation paper (see above footnote 3) an updated regulatory impact assessment, and that in relation to mortgage credit DG Markt commissioned detailed research (see para 76).

29. There have been repeated demands for an impact assessment, most recently by the Parliament. But the Commission has steadfastly refused to conduct one, giving as the reason the fact that work on the Directive began before the advent of the current policy on impact assessments. This does not seem to us to be a very compelling reason. We have felt considerably hampered in our task by the lack of such an assessment or, indeed, any empirical evidence from the Commission enabling us to evaluate the key assumptions on which the Directive rests. These appear to run counter to such evidence as is available from other sources, including evidence submitted to us.
30. We return to this issue in Chapter 5. Suffice to say at this point that a rigorous impact assessment would:
- analyse the measures needed to promote a greater convergence of credit institutions, instruments and practices, with the aim of making consumer credit products available on competitive terms throughout the European Union;
 - assess whether this could best be done by cross-border transactions or by the extension of credit in the target countries through subsidiaries, joint ventures, mergers or otherwise;
 - identify the principal impediments to the implementation of the measures referred to above; and
 - indicate whether there are provisions of the Directive which would have negative effects.

CHAPTER 2: HISTORY OF THE PROPOSALS

The Existing Directive

31. The current EU Directive in the field of consumer credit is the Consumer Credit Directive 1987.¹⁵ This Directive is of very limited scope. It lays down rules for:
- the computation and disclosure of the annual percentage rate of charge (APR);
 - the information to be contained in credit agreements;
 - the duty on Member States to lay down rules on the conditions for repossession of goods which would avoid unjust enrichment of the creditor;
 - the consumer's right to settle early and be given a rebate of charges;
 - the availability of defences against an assignee;
 - the protection of the consumer where paying by means of a negotiable instrument;
 - the duty on Member States to ensure that credit agreements did not affect the consumer's rights against the supplier;
 - the right of the consumer to claim against the creditor for breaches of obligation by the supplier;
 - licensing requirements; and,
 - the prevention of contracting-out of the protection given by the Directive.
32. Two features characterize the 1987 Directive as amended. First, as stated above, it is of limited scope. It contains no requirement of responsible lending, rules for advertisements (except for a statement of the APR) or for pre-contractual information (except as regards overdrafts), database access, the consumer's right of withdrawal from a supply contract and its effect on a linked credit agreement, notification of overrunning of an overdraft, or out-of-court dispute resolution.¹⁶ Secondly, like almost all consumer directives until recently, it is based on the concept of minimum standards, as opposed to full harmonisation.

The Commission's 2002 Draft

33. The first draft revised Directive was issued in 2002. Its stated aim was to promote cross-border consumer credit by moving from minimum to full harmonization and by extending the scope of the existing Directive in various ways. For example, included for the first time were "surety" agreements, a term covering both mortgages and personal security such as guarantees. The list of items forming part of the total cost of credit was expanded to cover sums payable to third parties as well as to the creditor, with requirements to

¹⁵ 87/102/EEC, as amended 90/88/EEC and 98/7/EEC.

¹⁶ On the other hand, it does contain a requirement that the creditor should not be enriched by repossession for default, a requirement not found in the new draft.

state both a lending rate (the annual rate payable to the creditor for its services, *excluding* sums payable to third parties) and the borrowing rate (i.e. the period rate represented by the amount payable to the creditor).

34. The 2002 draft also introduced the concept of responsible lending, including an obligation to consult centralized databases. The required contents of credit agreement was expanded in a list which was to be complete and not capable of addition. A right to withdraw from an agreement within a given period was also included for the first time. A “black list” of unfair contract terms was provided to run as a complement to, not a replacement of, the 1993 Directive on unfair contract terms. Bills of exchange and promissory notes, for which Member States allowing these as a mode of payment were previously required to provide suitable protection to consumers, were to be banned altogether. Also new were requirements restricting the exercise of default remedies and making the service of a default notice a pre-condition of enforcement in many cases.
35. The European Parliament strongly criticized the 2002 draft, both for the move to full harmonization, to which the Parliament was opposed, and because of what were perceived as a number of serious drafting errors.¹⁷ The Parliament amended the text extensively and indicated it wished this to replace the Commission text. The Commission declined to agree and maintained its adherence to the concept of full harmonization but did agree to accept most of the Parliament’s other amendments.

The 2004 Draft

36. The 2004 draft incorporated most of the amendments made by the European Parliament, but it proved difficult to ascertain the current state of the text, because the Commission failed to provide a consolidated text. Instead it limited itself to setting out an extensive set of amendments which the reader was then left to incorporate for himself. The DTI helpfully prepared an unofficial consolidated text, though quite understandably not assuming responsibility for its accuracy. New features of the 2004 draft were:
 - the introduction of “light touch” regimes governing contractual and pre-contractual information for overdrafts and certain other types of agreement;
 - the exclusion from the Directive of surety agreements for business loans and agreements requiring payment within three months;
 - the imposition of a duty on creditors to provide a database and to furnish consumers with the basic information they needed to shop around and compare offers of credit; and,
 - the introduction of the concept of a linked credit agreement (i.e.: one financing a supply agreement in circumstances where cancellation of the supply agreement would automatically cancel the credit agreement).

¹⁷ In addition, a study conducted by Oxford Economic Research Associates (OXERA), *Assessment of the Economic Impact of the Proposed EC Consumer Credit Directive*, found that for the UK the Directive would have a serious impact on the users of credit, increasing the cost of credit and reducing its availability, and, indeed, would affect the whole UK economy. The Executive summary of the study is reproduced as Annex I to the Sub-Committee’s Interim Report. (see footnote 18)

Our Interim Report

37. We set up an Inquiry into the 2004 draft. But on 15th June 2005, within a few weeks of starting the Inquiry, we were told that the Commission's intended to publish a revised draft in the near future. Nevertheless, we decided to carry on with most of the oral evidence sessions already arranged and produce an Interim Report to make a preliminary exploration of some of the key issues arising. These were identified as being:
- whether it was currently feasible or desirable to introduce a Directive to create a single EU-wide cross-border market in consumer credit;
 - what would be the consequences of an attempt to achieve that objective by maximum (or total) harmonisation;
 - whether it would be better to introduce appropriate minimum standards to give greater certainty for credit suppliers and improved protection for EU consumers;
 - if so, what elements should be included in those standards.
38. In our Interim Report¹⁸ we noted that it was difficult to draw firm conclusions in the absence of the Commission's revised text or any specific evidence from the Commission. We concluded that from the evidence we had received it was doubtful whether a satisfactory single cross-border market in consumer credit could be achieved in the near future simply by introducing a new Directive on the lines currently proposed. We had received no evidence to show whether a significant cross-border credit market currently existed for most ordinary consumers. But we had received evidence that a market in consumer credit was developing spontaneously among some Member States in reaction to perceived commercial opportunities through corporate acquisitions, mergers and new business ventures.
39. We also expressed serious doubts about the introduction of total harmonization to replace a broad range of existing national legislation with a common set of uniform provisions binding on all Member States. If total harmonization was undesirable or impracticable then our preliminary view was that it would be better to try to agree on a set of measures based on common minimum standards designed to strengthen the existing Directive effectively without impeding the flexibility of additional domestic legislation. We went on to list a set of issues that might be included as aspects for consideration.

Other Responses to the 2004 Draft

40. While the 2004 draft was widely considered to be a major improvement on the 2002 draft it continued to attract criticism because a number of provisions, including those relating to mortgages of land, the duty to provide a database and the rules on responsible lending, were thought to impose on the credit industry burdens disproportionate to the benefits they were designed to provide. In the light of these and other criticisms the Commission agreed to produce a third draft, which was published in October 2005. The changes made by this draft are summarized in Chapter 3, the

¹⁸ 13th Report of Session 2005–2006. HL Paper 37

concepts underpinning it are examined in Chapter 5 and the provisions themselves are analysed in Chapters 6 to 8.

The Commission's Green Paper on Mortgage Credit

41. In July 2005 a different Directorate of the Commission, DG Markt, produced a Green Paper on Mortgage Credit in the EU. Long before issuing this DG Markt had commissioned research from London Economics on the costs and benefits of further integration of the mortgage markets, as recommended by the Form Group on Mortgage Credit. The London Economics study¹⁹ was published shortly after the appearance of the Green Paper. We discuss the Green Paper briefly in Chapter 5. At this point we would note merely that both DG Markt and London Economics take a much more extended view of the concept of cross-border credit, and consequently of the concept of a market in cross-border credit, than does DG SANCO for unsecured credit.
42. Mention should also be made of the fruitful collaboration between the land registries of the EU Member States, which have come together in a joint venture, the European Land Information Service (EULIS), funded by the European Commission's eContent Programme. This is designed to provide world-wide access to European electronic land and property information, all European land and property registration services being available through a single portal, which when operational would enable customers of any connected service to have ready access to information about individual properties throughout Europe, together with 'reference information' about the registration services and the legal environment.²⁰ In addition, legal experts have been working on a common mortgage for Europe (Eurohypotheq).²¹

¹⁹ *The Costs and Benefits of Integration of EU Mortgage Markets* (August 2005).

²⁰ For details, see <http://www.eulis.org>.

²¹ See *Basic Guidelines for a Eurohypotheq: Outcome of the Eurohypotheq workshop* November 2004/April 2005 (Mortgage Credit Foundation, Warsaw, May 2005).

CHAPTER 3: A SUMMARY OF THE CHANGES MADE BY THE COMMISSION'S CURRENT (2005) PROPOSED CONSUMER CREDIT DIRECTIVE

Modifications of the Full Harmonisation Approach

43. In its October 2005 draft the Commission has again insisted on the general concept of full harmonisation but has made a number of concessions in response to criticisms of the earlier draft as set out below.
44. First, the Commission has significantly reduced the scope of the Directive, with the result that most of the uniform rules relate to the provision of contractual and pre-contractual information.
45. Secondly, as regards certain provisions the Commission has departed from full harmonisation:
 - to allow minimum standards (as in the case of joint and several liability of the creditor for breaches of duty by the supplier under a linked transaction);
 - to apply a light regime (for example, in the case of overdrafts), leaving it open to Member States to apply their own rules as to matters covered by provisions of the Directive which are disapplied by virtue of the light regime;
 - to state a principle but leave the detail to Member States (as in relation to the provision of a rebate for early settlement and the manner and extent of the duty on the creditor to give explanations of products offered to the consumer); and
 - to provide, albeit in somewhat cryptic language, for what it describes as “mutual recognition” in the application of certain provisions, by which is meant that as regards those provisions the creditor should be entitled to rely on its own law, so far as conforming to the Directive, instead of being bound by the debtor’s law.
46. Thirdly, the Commission has now altered the Article laying down the principle of harmonisation to make it clear that the prohibition against additional measures of protection for the consumer applies only insofar as the Directive contains harmonised provisions. In other words, Member States are free to maintain or introduce measures on issues on which the Directive is silent or as regards persons or transactions excluded from the application of a particular provision (e.g. under a light regime applicable to the person or transaction in question).

Principal Specific Changes

47. The principal specific changes introduced by the 2005 draft, in addition to amendments to some definitions, are the following (we pick up a few drafting points *en passant*):

Scope

48. The scope of the draft Directive has been narrowed by;
- excluding credit agreements secured by a mortgage on immovable property or another comparable “surety” commonly used in a Member State;²²
 - excluding surety agreements and interest-free credit repayable in three months, whether in a single sum (as required by the earlier draft) or by instalments;
 - reducing the limit of application of the Directive from credit not exceeding €100,000 to credit not exceeding €50,000; and,
 - exempting altogether, lower-cost loans to a restricted public, which in the previous draft were subject to a light regime.
49. As against this, two exemptions previously given have been removed: namely credit agreements under which the credit is repayable by not more than four instalments over a period not exceeding 12 months and start-up or personal development loans granted by public or officially recognized institutions.²³

Duty to advise

50. Article 5(5) now puts this in terms of a duty to provide explanations to consumers of the advantages and disadvantages of products offered to them in order to enable them to assess whether the proposed agreement is adapted to their needs and to their financial situation.

“Light touch”

51. The types of credit agreement susceptible to the “light touch” information requirements have been expanded.

Ban on doorstep selling of credit agreements

52. This has been dropped on the ground that it is sufficiently covered by existing Community legislation.

Linked transactions

53. The revised draft introduces the concept of a linked transaction. This covers two types of transaction. The first is a linked credit agreement, that is, an agreement to finance the supply of goods or services where the creditor is the supplier or uses the services of the supplier in connection with the preparation or conclusion of the credit agreement. The consumer’s exercise of a right to withdraw from the supply transaction means that he or she is no longer being bound by the linked credit agreement. The second is where the creditor is not the supplier but extends credit under a pre-existing agreement with the supplier. In such a case a consumer who fails to obtain redress for breaches of duty by the supplier may pursue remedies against the creditor to

²² See para. 115. The exclusion of mortgage credit is logical in view of the separate exercise being conducted into that field by DG Markt as mentioned earlier and described in more detail in Chapter 5.

²³ However, it may be that some of these are picked up in the separate exemption for lower-cost loans to a restricted public given by art. 2(2)(k).

the extent and under the conditions determined by Member States. This latter provision is carried over from the existing Directive.

Database access

54. It is no longer necessary to establish a data base, only to give access to one already in existence.

Bills of exchange

55. The ban on use of bills of exchange in consumer credit transactions, which was opposed by the UK Government, has been dropped.

Unfair terms

56. Article 15 of the 2004 draft, which set out numerous terms that were to be regarded as unfair to the consumer, has been dropped in its entirety and instead a new paragraph 3 has been added to the Annex to the Directive on unfair terms in consumer contracts (93/13/EEC) which is more limited in scope than the old draft Article 15.

Default remedies

57. An entire chapter devoted to the remedies of the creditor on default by the consumer and restrictions on debt recovery by debt collection agencies has been dropped. The reason given for this is that these matters were considered sufficiently covered by national legislation. In addition the creditor may now suspend a right of draw-down on an open-ended credit agreement without having to justify its decision and give prior notice to the consumer.

“Mutual recognition”

58. When implementing and applying the provisions governing responsible lending, pre-contract information, linked transactions and the liability of the creditor thereunder, overrunning of overdrafts, licensing and the obligations of intermediaries, Member States, without prejudice to necessary and proportionate measures on grounds of public policy, may not restrict the activities of creditors established in another Member State and operating within their territory in accordance with the Directive. This opaquely worded provision in the new Article 21(2) is discussed in detail in Chapter 8.

The APR

59. The previous draft of the new Directive, like the current Directive, contained two Annexes concerning the APR: one stating the mathematical equation that has to be satisfied in order for the APR to be correctly stated, the other giving worked examples of the computations. The equation has been reformulated, though the substantive effect appears to be very similar, but the examples have been dropped. The effect is to replace two Annexes consisting of some 20 pages with a single Annex of a little over a page. In addition, the basis for calculation of the APR has been clarified, with particular reference to sums payable for payment protection insurance. The mathematics may look formidable but it is unnecessary for the consumer to be concerned with them.

60. The rules on the APR embody two key principles, which are also to be found in our own Consumer Credit (Total Charge for Credit) Regulations 1980.²⁴ The first is that the amount of the total charge for credit should include not only the interest or finance charge payable under the credit agreement itself but also all fees payable in connection with the credit agreement and known to the creditor and all costs relating to ancillary services (insurance, maintenance, etc.) which are a condition of obtaining the credit. The underlying purpose is to prevent the creditor from burying part of the credit charge in charges under ancillary contracts, thereby producing an artificially low rate of credit charge. The second principle is that the total charge for credit should be expressed not only as an amount or as a nominal rate (i.e. one which ignores the frequency of compounding) but as an effective annual percentage rate of charge, that is, a rate which is a function of funds in use (i.e. at the service of the debtor) and thus enables comparisons to be made between contracts of different payment intervals.

Other changes

61. In addition there are numerous minor changes, partly of substance and partly of drafting, as well as a few provisions of which the meaning is unclear.
62. The overall effect of the above changes is to preserve the emphasis on full harmonization but to reduce the scope of the Directive by excluding altogether secured credit and guarantees and to reduce the substantive content by dropping several significant substantive provisions, including requirements and restrictions relating to the exercise of default remedies, so that in place of minimum harmonization on a relatively broad base we now have full harmonization on a relatively narrow base.
63. Ms McCarthy told us²⁵ that, despite some differences in approach in the Parliament, the 2005 draft was generally considered to be a substantial improvement on the previous text. But MEPs remained opposed to full harmonization. She preferred a hybrid, targeted approach²⁶. Meanwhile, the Parliament has added its own request for an impact assessment. Apart from this we understand that further progress is unlikely to be made until the Council has reached a common position, which may not be until early 2007.

²⁴ SI 1980/51.

²⁵ Q 132

²⁶ QQ 134, 140

CHAPTER 4: UK CONSUMER CREDIT LEGISLATION

The UK Consumer Credit Market

64. The UK consumer credit market is one of the most highly developed and sophisticated in the world, both in terms of the diverse range of institutions that provide credit and in terms of the different forms of agreement available. In volume, credit extended to consumers by UK credit institutions accounts for some 30% of the total amount of consumer credit across the European Union as it existed prior to the admission of a further 10 Member States. Total UK consumer debt passed the £1 trillion mark in the summer of 2004. In the year 2004/2005 16,568 licences under the Consumer Credit Act 1974 were issued by the Office of Fair Trading, and the total number of licences in issue runs into hundreds of thousands. New products and practices are constantly evolving, and this presents a challenge to the lawmaker, who has to balance protection for the consumer against the need to avoid undue restrictions on entrepreneurial activity.

Consumer Credit Legislation

65. Over the past 30 years UK legislation governing consumer credit has evolved into a wide-ranging, integrated and complex set of statutory provisions which reflect the diversity and sophistication of the market. The first comprehensive review of UK consumer credit law was that conducted by the Crowther Committee, whose report recommending sweeping changes to the law was published in 1971²⁷ and led to the enactment of the Consumer Credit Act 1974. This is a major statute running to 193 sections and five schedules and is buttressed by a large number of statutory instruments, of which the most relevant for our purposes are those relating to the supply, form and content of agreements, the provision of pre-contract and post-contract information, the content of advertisements, the composition of the total charge for credit and computation of the annual percentage rate of charge (APR), and the various exemptions from the statutory requirements. The DTI is responsible for the legislation, the Office of Fair Trading (OFT) for the operation of the licensing regime and for oversight of the conduct of licensees and the fairness of their contract terms.
66. The 1974 Act has recently been complemented by the Consumer Credit Act 2006, enacted on 30th March 2006 but not yet in force. This is itself a major enactment running to 71 sections and four schedules. The Act significantly extends the OFT's powers and responsibilities and contains further provisions on the supply of post-contract information, default, and unfair relationships (particularly relevant in the context of the draft Directive's requirement of responsible lending), as well as substantially strengthening the statutory rules relating to licensing and penalties for infractions. In addition, first-mortgage lending has since 2004 been regulated by the Financial Services and Markets Act 2000 ("FSA") under the supervision of the Financial Services Authority.

²⁷ Consumer Credit: Report of the Committee (Cmnd 4596, 1971).

67. The Financial Ombudsman gave us details of the alternative dispute resolution service he and his staff provide under the FSA for the resolution of disputes relating to the provision of FSA-regulated financial services by firms regulated by the Act.²⁸ This jurisdiction is prospectively extended by sections 59 to 61 of the Consumer Credit Act 2006 to cover all consumer credit businesses not regulated by the FSA. The Financial Services Ombudsman can entertain complaints from consumers and from small businesses (yearly turnover under £1 million) if they have complained to the financial firm concerned and remain dissatisfied with its response. The FSA imposes on FSA-regulated firms an obligation to have in place appropriate procedures for the handling of complaints. The 2006 Act empowers the Financial Ombudsman Service, with the approval of the Financial Services Authority, to set equivalent rules for the handling of complaints by credit firms who are otherwise outside the FSA regime. Under section 228(2) of the FSA the Financial Services Ombudsman is empowered to make determinations on the basis of what is fair and reasonable in all the circumstances of the case and is not limited by rules of law.
68. The draft Directive potentially affects numerous provisions of existing UK legislation (see Appendix 2 for details). This is not by itself a ground of objection to the Directive. But it would be a cause for serious concern if the Directive's full harmonization provisions were significantly to reduce the high level of consumer protection which the UK has developed over several decades and which it is the avowed task of the Commission to promote. As will be seen later, there are some aspects of the Directive which in our view *would* reduce protection for the consumer and for no good reason. A prime example is the provision relating to the content of consumer credit agreements. We examine the impact of the Directive on this and other aspects of UK legislation in Chapter 7 and, as regards the content of agreements, in Appendix 3.
69. The UK legislation is tailored to the structure and practices of the UK consumer credit market. Much of it might be irrelevant in an EU Member State in which consumer credit is relatively undeveloped. But it is the product of careful and prolonged analysis, first, by the Crowther Committee in its 1971 Report, and later by the relevant government department (currently the DTI) and the Office of Fair Trading, following a stream of consultation papers, and extensive discussions with the consumer credit industry and consumer organizations, over a period of years. As we shall argue later, we see no good reason why, for example, carefully crafted safeguards for the British consumer, such as statutorily prescribed information about the consumer's rights and limits of liability under provisions of the 1974 Act which are in themselves unaffected by the Directive, should be jettisoned merely because they do not feature in the Directive's list of items to be included in consumer credit agreements.

²⁸ pp 156–158

CHAPTER 5: FULL HARMONISATION AS A MEANS TO PROMOTE THE INTERNAL MARKET

The Importance of the Internal Market

70. As previously stated, the aim of the Directive is to promote an internal market in cross-border consumer credit while at the same time providing a high level of consumer protection. The draft Directive must be judged on its ability to achieve both objectives. Whether it does so is a matter we examine in Chapter 6. A separate question is whether the effect of some of the full harmonization provisions is likely to reduce the existing level of protection for UK consumers under the present legislation. That question is addressed in Chapter 7.
71. The development of an internal market is a central pillar of EU policy. DG SANCO, the Commission Directorate responsible for the draft Directive, has not provided an analysis of the benefits that would flow from an internal market in cross-border consumer credit. But the London Economics Report on Costs and Benefits of Integration of EU Mortgage Markets, commissioned by DG Markt as a follow-up to its Green Paper on mortgage credit, estimates that for secured credit for house purchase and improvement the net present value in 2005 of increases in product availability through to the year 2015, discounted back to 2005 at the standard discount rate of 3.5%, would be €94.6bn. This represents the estimated net value of new initiatives going beyond the gradual integration to be expected in the absence of such initiatives, whether such integration is effected by cross-border dealings or by any other mechanism.
72. The above figures relate exclusively to mortgage credit, which is far and away the largest form of consumer credit in terms of value. The Green Paper noted that at the end of 2004 the value of outstanding residential mortgage loans represented about 40% of the EU GDP. The figures in the London Economics study demonstrate the potential value that would be added by an internal market in mortgage credit. What is lacking is any comparable set of projections for unsecured consumer credit. Moreover, whereas the London Economics study looked at the economic implications of all forms of market integration, DG SANCO is concerned solely with the development of an internal market in *cross-border* consumer credit (see paragraph 38). Accordingly, the figures provided by the London Economics study do not provide any basis for assessing whether the development of a cross-border market in unsecured consumer credit is feasible in the immediate future and would add sufficient value to justify the risk and expenditure involved.
73. Because British finance houses have wide experience derived from meeting the needs of what is generally regarded as the EU's largest and most sophisticated consumer credit market, they should be well-placed to gain from an internal market. An internal market should also benefit European consumers by broadening the market base and introducing greater efficiency and sharper competition between lenders which should lead to increased consumer choice and might also reduce borrowing costs. The reduction in national barriers should also, in theory, lead to greater certainty over transactions for lenders and borrowers alike, to mutual benefit.

74. The importance of developing an internal market in consumer credit as a desirable goal is thus not in issue. The question is whether the objective circumstances in the EU indicate that the time is ripe to stimulate the development of that market and, if so, how best it is to be achieved. DG SANCO have taken it as read that the time is indeed ripe for developing one particular vehicle for market integration, namely cross-border credit, and that the first step towards achieving that development is to harmonise certain aspects of consumer credit law, principally in order to facilitate the use of a single EU-wide form of consumer credit agreement in place of separate forms in each of the 25 Member States.
75. The Commission's Consumer Policy Strategy 2002–2006 stated that one of its goals was to increase the confidence of consumers in cross-border trade. As Professor Stephen Weatherill, the Jacques Delors Professor of European Law in the University of Oxford and an expert in European Community consumer law and policy, noted in his written evidence to us,²⁹ the strategy document revealed a growing preference for full or maximum harmonization, marking a departure from the 'political bargain' by which the growth of an EC consumer law brought with it an acceptance that the EC rules would operate only as minimum standards. The move toward full harmonization in the draft consumer credit Directive is seen as assisting the objective of promoting consumer confidence in cross-border credit.

The Concept of Cross-border Credit

76. We have drawn attention to the work being done by DG Markt on mortgage credit not merely to show the potential economic significance of that part of the market, but also to illustrate a striking contrast between the approaches of the two Directorates, DG Markt and DG SANCO. In assessing the case for Community action in the EU mortgage credit market DG Markt went to considerable trouble to establish the facts. Not only did it commission research from London Economics, as previously stated, but it also set up a Forum Group on Mortgage Credit to assess the barriers to integration and attached great weight to the Group's recommendations and the outcome of consultations.

"The Commission will consider carefully all input received through this consultation process. Action will be proposed by the Commission only if it is demonstrated that there is a clear business case for Commission intervention in the EU residential mortgage credit markets, i.e. if the potential benefits of intervention can outweigh the anticipated costs of such intervention."³⁰

77. Moreover, DG Markt took a broad view of the concept of cross-border lending; indeed, it was surprised by the Forum Group's request for a definition.

"The Commission is not clear as to why this definition is needed. It assumes that it would be useful for the purpose of measuring integration. The Commission considers that there is cross-border lending whenever a service crosses a border, be it through free provision of services, through an establishment (branch or subsidiary) or via an agent."³¹

²⁹ pp 82–85

³⁰ Green Paper, Introduction, para. (4).

³¹ Green Paper, Annex I, para. (1).

The same approach was adopted in the London Economics research paper.

“Definition of integration”

“We define mortgage integration to imply the ideal case that the same mortgage products are available in all EU countries at the same prices. This condition could come about through extensive cross-border trade, where the borrower and lender are in different countries, but could also come about through other mechanisms. Thus banks could physically enter foreign markets, either by building new branch networks or setting up or acquiring subsidiaries in the target country. Alternative domestic lenders could imitate foreign lenders. Finally, in some countries greater development of markets for mortgage financing would permit domestic lenders to offer similar products to those available elsewhere, at similar prices.”³²

78. By contrast, DG SANCO, which as we have said has declined repeated requests for an impact assessment, has focused on the development of an internal market by cross-border lending. That means lending by a credit institution in one Member State to a consumer in another Member State. DG SANCO accepts that there are other ways of marketing consumer credit products, for example, by creating an establishment in the other Member States where the consumers reside, but has told us that it is not doing anything in the current Directive either to promote these alternative methods of marketing or to create an impediment for them. This is somewhat surprising because, at least so far as the UK is concerned, credit suppliers seem to be able to access foreign markets already by these alternative means and the Directive would do little enhance this ability.³³ Moreover, the evidence we have received³⁴ is that virtually all credit institutions entering into a foreign market do so by acquisitions of local banks or finance houses, joint ventures, mergers, the establishment of branches and participation in local networks, and that of all the modes of cross-border credit mentioned in the passage quoted above the mode to which DG SANCO has restricted itself is currently considered the least practicable and is rarely used. But it is the only mode which the full harmonization concept embodied in the draft Directive is designed to promote.

The Case for Full Harmonisation as a General Concept

79. The move from minimum standards to full harmonization reflects a new trend in EU consumer protection policy. The draft Directive does retain some minimum harmonization provisions, as well as other provisions which are general in character and thus leave the mode of implementation to Member States, but the emphasis has shifted sharply towards uniform rules. The twin objectives, as previously stated, are promotion of an internal market in cross-border consumer credit and the provision of a high level of consumer protection.
80. We accept that there are areas in which full harmonisation is appropriate: particularly those in which the utility of the proposed rules is relatively unaffected by differences in national markets, as in the case of the EU Directives on comparative advertising and safety standards. For such cases

³² *The Costs and Benefits of Integration of EU Mortgage Markets*, p. 4.

³³ DTI Supplementary Consultation (see footnote 3), p. 76. See further below, paras 86 et seq.

³⁴ QQ 55-57, pp 158-160, pp 34-39, pp 106-108, pp 161-162, pp 53-57

uniform rules stimulate competition, reduce costs, simplify transactions and bring benefits to EU producers and consumers. The question is whether these considerations hold good for the development of an internal market in cross-border consumer credit.

81. Professor Weatherill told us³⁵ that, while maximum harmonization represented a break with the existing political bargain in the field of EC consumer law, the consumer could clearly benefit from the advantages of economic integration which flow from the maximum harmonization model, namely wider consumer choice within a more competitive market. In principle, therefore, he favoured the full harmonization approach. However, it involved a shift of legislative authority from state level to EU level. It would be crucial to determine the content of the proposed regulatory regime, and in particular the level at which consumer protection was set. Harmonisation generated market efficiencies and wider choice but could lead to a loss of consumer protection. There was a trade-off to be made.
82. Industry put more emphasis on the difficulty of penetrating local markets without a significant presence³⁶. The Commission stressed the absence of common legal rules³⁷. Professor Weatherill³⁸ was in favour of a more intensive regulatory impact assessment, as the Commission appeared to be proceeding by assertion, not on the basis of empirically-grounded evidence, and he found the case unconvincing.

Will Full Harmonisation Help to Promote an Internal Market in Consumer Credit?

83. The Commission has devoted considerable efforts to ascertaining the content of consumer credit laws in the different Member States and to identifying the differences in such laws. It is a matter for regret, therefore, that it has not felt it necessary to present any evidence to support its contention that such differences are the main obstacle to the development of an integrated market through cross-border credit or that the move to full harmonisation of a very limited number of rules would make any significant difference. Indeed, as we have said previously, it has so far resisted all demands to conduct an economic impact assessment.
84. While recognising the existence of other obstacles to the development of an internal market through cross-border lending, the Commission attributes the lack of such a market principally to differences in national consumer credit laws, which require a financial services provider to adapt its contracts to accommodate 24 other sets of mandatory rules, whereas with full harmonisation one could come close to a situation where banks could use a single contract for marketing a single product in the whole European Union. This is the fundamental premise on which the move to full harmonisation is based.³⁹

³⁵ Q 154, pp 82–85

³⁶ QQ 53–57, pp 158–160, pp 34–39, pp 106–108, pp 161–162, pp 53–57

³⁷ Q 3, Q 5, Q 11, pp 16–18

³⁸ Q 155

³⁹ Q 3

Will harmonization facilitate the use of a single EU-wide consumer credit agreement?

85. The Commission asserts that the Directive will facilitate the use of an EU-wide consumer credit agreement, instead of separate agreements for each of the law districts within the European Union. We consider that this is unsubstantiated and overlooks several relevant factors. In the first place, consumers in a given country will expect agreements they enter into to be produced in the local language, and the EU has 21 official languages. Secondly, the scope of the Directive, even if fully implemented as it stands, is very limited, so that aspects of consumer credit law which it does not cover but which may be regulated by national laws will require advice from local lawyers and their involvement in the preparation of contracts for local use. Thirdly, there are local laws other than those relating to consumer credit which may have to be taken into account in the preparation of contracts, for example, laws governing contracts, sales, and agency. All these factors mean that full harmonisation of a limited number of legal rules is extremely unlikely to facilitate a single EU-wide contract.

Do different national laws impede an internal market in cross-border consumer credit for other reasons?

86. Even if harmonization of certain consumer credit laws of the Member States would not avoid the continued need for separate forms of consumer credit agreement in each Member State, might such harmonization remove other significant barriers to the development of a cross-border market in consumer credit? We think it worth raising this question despite the fact that the Commission itself relies on the development of an EU-wide consumer credit agreement as the main benefit to be derived from full harmonization. That is a view we have rejected for the reasons set above. But leaving this on one side, and acknowledging that as a general rule differences in national laws of Member States constitute in some degree an obstacle to enterprises seeking to transaction business across the EU, we note that the Commission has not produced any evidence to show that in the field of consumer credit the differences which the draft Directive seeks to eliminate are the main impediment to the development a market in cross-border credit.
87. Indeed, the evidence we have received from the UK Cross Industry Group⁴⁰ and the Institute of Credit Management⁴¹ is that the lack of such development is principally due to a range of quite different factors, in particular, the widely differing stages of development of consumer credit in the different Member States; the credit risk for lenders in not having the amount and quality of information available to local providers to assess creditworthiness; differences in language and culture; the impracticability of penetrating a local market without an establishment in the country concerned (see paragraph 91); and the legal risks and costs arising from differences in laws governing default remedies and the enforcement of creditors' rights, which are outside the scope of the revised draft Directive.
88. Precisely the same conclusion was reached in the London Economics study, which showed that it was rare for lenders to engage in cross-border credit transactions, and we have had evidence along the same lines from the UK

⁴⁰ QQ 53–58, pp 34–39, pp 53–57

⁴¹ pp 158–160

Cross-Industry Group⁴² and the Institute of Credit Management.⁴³ The former also told us that in carrying on business in the target country itself, which is almost always the method chosen to break into a foreign market, creating legal contracts is a minor part of the exercise; the true “business killers” are tax, restrictive local employment laws and practices, access to local payment systems, and other constraints on the running of a business.

89. To similar effect is the DTI’s supplementary consultation paper, issued in March 2006.⁴⁴ Annex C of this paper included an updated partial regulatory impact assessment which, among others things, addressed the likelihood of a cross-border market in consumer credit:

“A number of barriers to a single consumer credit market in the EU currently exist. These include:

1. Differences in culture and language
2. Personal preferences about the products of national lenders (trust, reputation, nationally tailored products etc.)
3. Different legal systems
4. The tendency for consumer credit customers to prefer local providers
5. The lack of full monetary harmonization between the UK and the EC.

Reducing these barriers has the potential to increase cross border trading between the UK and the EU. With evidence that the UK market is becoming increasingly saturated, such cross border trade could go some way to facilitating access to new markets for UK operators.

However, it is difficult to see the emergence of a cross border market in consumer credit unless the harmonization measures included in the Directive fully address the underlying barriers to cross border trade that currently exist within the EC, which they seem unlikely to do.

This is a particular issue given the response of industry to the DTI’s initial consultation, which expressed a general concern that the Directive would not achieve its aim of facilitating cross border trade...⁴⁵

90. Nor has the Commission provided any evidence to show how appropriate their single market approach might be for those newer Member States that have only relatively recently moved from a planned economy to a market economy, and may not have had sufficient time to build up both the institutional infrastructure and market practices required to support major credit market activity.
91. The credit providers have told us that significant market penetration can be achieved only by “scale entry”, that is, the establishment of volume market presence through mergers, acquisitions, joint ventures, setting up local subsidiaries or participation in local networks.⁴⁶ They have given examples and have told us that consumers are reluctant to deal with a credit provider that has no establishment in their countries. That view is supported both by

⁴² QQ 53–58, pp 34–39, pp 53–57

⁴³ pp 158–160

⁴⁴ DTI Supplementary Consultation Paper (see footnote 3)

⁴⁵ DTI Supplementary Consultation Paper (see footnote 3), pp. 72–73.

⁴⁶ QQ 53–58, pp 34–39, pp 53–57

the London Economics study and by a recent Special Eurobarometer survey of consumer attitudes commissioned by DG SANCO, which showed that 85% of respondents spontaneously indicated that they had never purchased financial services from firms situated in another Member State, while 75% said that they would not consider doing so in the future, the main reasons given being lack of information and language problems.⁴⁷

92. We recognize that over time ways may well be found to develop the exchange of data and the provision of other arrangements that will facilitate the development of a true cross-border market—the creation of EULIS by the European Land Registries⁴⁸ is a case in point—but this lies in the future. As the UK Cross Industry Group put it in their oral evidence, the market will not develop through isolated requests for cross-border credit, because it is necessary to have a mass market in order to utilize credit scoring systems, which depend upon a pool of customers sufficient to inform the results of the credit scoring. That can only be done within the target country, by absorbing the local culture and the local law.

Views on Full Harmonisation

93. We are struck by the fact that the move to full harmonisation is opposed by consumer organisations, who fear it will reduce consumer protection; by the credit industry, which one might have thought would benefit from the move but which in fact is concerned that it will impose costs that will be passed on to consumers and may retard market growth; and by the European Parliament, which has repeatedly rejected full harmonisation and has insisted on retaining the concept of minimum harmonisation. As recently as January 2006 the European Financial Services Round Table rejected both the minimum and the maximum harmonization approach and concluded that the way forward was the adoption of a more flexible approach towards further market integration based on targeted harmonization.⁴⁹ Similar views have been expressed by the European Banking Industry Committee (EBIC).⁵⁰ The DTI also, while supportive of several provisions of the revised Directive, has added its voice to the concerns expressed by industry and the consumer organizations.⁵¹

Assessment of the Full Harmonization Approach

94. In the light of all these considerations we consider that the case for full harmonization as a general principle in relation to consumer credit has yet to be made. The market may well develop spontaneously in time through commercial initiatives, the adoption of market practices from other Member States and changes in consumer demand. The impact of factors such as internet borrowing or the development of financial transactions within the eurozone may also impel the development of a single market in cross-border consumer credit. But those prospects have not been examined by the

⁴⁷ Special Eurobarometer 230, *Public Opinion in Europe on Financial Services* (September 2005).

⁴⁸ See para 42

⁴⁹ Consumer Protection - Consumer Choice - Deepening EFR's concept on consumer protection in retail financial services.

⁵⁰ See Annex to EBIC letter 2/5/02 pp 115–128

⁵¹ QQ 20, 30, 34, 98, 211

Commission and we have not had evidence that would enable us to assess the possibilities.

95. We believe that in the present state of market development the full harmonization approach is unlikely to have to have any significant effect in promoting cross-border consumer credit. We also consider that the most effective way of creating an internal market in consumer credit is to encourage a greater convergence of market development and practice in the consumer credit field through other mechanisms of the kind identified in the London Economics study: the establishment or acquisition of subsidiaries or branches in the targeted Member States, borrowing of foreign market products and practices by local lenders, and the like. This is already happening in some degree and does not appear to depend on the limited uniformity of rules which the draft Directive is designed to provide. Pan-European models along one or other of these lines have been established by a number of companies, including Cetelem, Citigroup, GE Consumer Finance, Santander Consumer Finance and Sofinco, most of these penetrating a foreign market by acquisitions.⁵²
96. However, Ms McCarthy told us that the Parliament⁵³ had received evidence from business that there remain considerable barriers for companies who wish to set up local branches or subsidiaries in other countries and are faced with a raft of rules, administrative rules and licensing requirements. She argued that, while mergers and acquisitions are happening, Member States are becoming more and more protectionist and reluctant to allow mergers and acquisitions involving foreign companies.
97. It seems to us, therefore, that rather than giving such emphasis to cross-border credit, with all the difficulties that this involves for penetration of a market, the Commission might do better to focus on ways to facilitate convergence of market practice by removing the obstacles which, as described by Ms McCarthy and other witnesses,⁵⁴ stand in the way of the current modes of operating in foreign markets, (especially legal and administrative problems of establishment, employment, conduct of business and taxation policies).
98. When the consumer credit markets of the Member States have converged to the point where a broadly similar range of products is available on competitive terms throughout the European Union, then that might well be the appropriate time for fully harmonised rules across a much wider range than that covered by the current draft. The joint evidence we received from the National Consumer Council, Citizens Advice and *Which?* took the view that it would be better to adhere to the traditional minimum harmonization approach but to broaden significantly the ambit of the Directive⁵⁵ to provide better consumer protection
99. We consider that further work on the present draft should be suspended until a proper impact assessment has been carried out which identifies the scope for and obstacles to the development of an internal consumer credit market, whether cross-border or otherwise, and examines whether the full

⁵² Mercer Oliver Wyman, *Consumer Credit in Europe: riding the wave* (November 2005), para. 6.4.

⁵³ Q 136

⁵⁴ *ibid* and QQ 53–57, pp 158–160, pp 34–39, pp 106–108, pp 161–162, pp 53–57

⁵⁵ QQ 94–95, Q 107, Q 108, pp 59–61, pp 160–161

harmonization proposed would be likely to promote the development of the market without significant detriment to the high level of protection at present enjoyed by consumers in countries such as the UK. In the absence of compelling evidence that this would be the case, we would favour retaining the targeted harmonization approach but extending the Directive to cover a wider range of issues.

Conclusions and Recommendations

100. **We do not doubt the important potential benefits to business and consumers of developing an internal market in consumer credit, but only how best this is to be achieved. The Commission's focus is on the development of a market in *cross-border* credit, and it sees full harmonisation as advancing that objective. But we conclude that the Commission's case for a move to this approach in the field of consumer credit is based on a questionable premise that this will promote an internal market in cross-border credit by facilitating the use of a single EU-wide credit agreement. That premise is not supported by a proper impact assessment, or by any other evidence that we have seen.**
101. **On the basis of the evidence we have been given, we further conclude that:**
 - **at present the lack of a market in cross-border consumer credit is mainly due to other factors, such as language, culture and the impracticability of penetrating a foreign market except by scale entry requiring an establishment in the target country, and that full harmonization is unlikely either to displace the need for separate credit agreements for each Member State or to facilitate an internal cross-border market for other reasons.**
 - **the most effective way of creating an internal market is to encourage a greater convergence of market development and practice through other means, such as the establishment or acquisition of branches and subsidiaries and the borrowing of foreign market products and practices by local lenders, as is already happening, and the removal of local obstacles such as legal and administrative impediments to establishment, employment, conduct of business and taxation policies.**
 - **full harmonization may well be appropriate at the point when a broadly similar range of products is available throughout the European Union on competitive terms.**
102. **We therefore strongly recommend that further work on the present draft Directive should be suspended until a proper impact assessment has been carried out. Unless this provides compelling evidence that the full harmonisation proposed would be likely to promote an internal market in cross-border consumer credit, the principle of targeted harmonization should be retained but the scope of the Directive should be extended to cover a wider range of issues.**

CHAPTER 6: DOES THE DIRECTIVE PROVIDE A HIGH LEVEL OF CONSUMER PROTECTION?

103. The question raised by this Chapter is whether the Commission is right in thinking that the “one size fits all” model produced by full harmonisation is consistent with a high level of consumer protection. We examine this from two angles: the widely differing states of development of different consumer credit markets in the EU; and a comparison of the ambit of the Directive compared with that of existing UK consumer credit legislation. Neither of these arises under the provisions of the current Directive, which sets minimum standards but leaves each Member State free to provide such additional forms of consumer protection as it considers necessary in the light of the conditions of its consumer credit market and the needs of its consumers. A separate question is the potential of some of the full harmonization provisions to reduce the level of consumer protection currently provided by UK legislation. We deal with this in Chapter 7.

Differences in Market Development

104. We have already noted that there are huge disparities in the consumer credit markets of EU Member States which derive not only, or even primarily, from differences in laws but from their widely differing states of development. The UK has by far the largest volume and diversity of consumer credit in the EU. The development of that market has been accompanied by the gradual introduction over many decades of a wide range of consumer protection laws and regulations tailored to UK circumstances and needs.
105. The Inquiry has not established the extent to which a similar framework of laws and regulations exists in other Member States, nor to what extent such a framework might be relevant to the needs of other Member States. But it seems clear that much of the detailed legislation appropriate for a highly developed consumer credit market is unlikely to be appropriate in a country whose consumer credit market is still rudimentary, and conversely that legislation suitable for the latter will be inadequate for the former. From the perspective of many of the new Member States the level of consumer protection given by the Directive may indeed be high by comparison with what they have now. But it falls short of the standard set by UK legislation even before it was strengthened by the Consumer Credit Act 2006.
106. The Commission’s proposals aim at an intermediate position which they contend produces a high level of consumer protection and would no doubt be seen as such in a number of Member States but which, for a very developed market such as that of the UK, represents in certain respects a significant reduction in the level of protection currently enjoyed by UK consumers, particularly in relation to the supply of information in credit agreements. As one study notes:
- “Looking at the aggregate figures, it is evident that the EU consumer credit market is fragmented across national markets with significant variations in size and structure ...

Considering the consumer credit per capita across the EU member states, a wide variation also appears ...

Regarding market structure, there are also clear differences in national market characteristics. As previously mentioned, each country has developed

its own credit culture, practices and legislation. This framework leads to a different use of credit in each country, which is reflected in the different compositions of credit at the national level ...

Correspondingly, the impact that legislation on consumer credit may have in EU countries will differ according to their market diversity, the relative importance of consumer credit in their economies and social needs, which could vary depending on conjunctural situations. It is difficult to find a common model that fits all markets. Moreover, rapid reaction to specific situations or problems in a specific country is rendered more difficult.”⁵⁶

The Ambit of the Directive Compared With UK Legislation

107. The draft Directive is held out as providing a high level of consumer protection. However, it is heavily focused on information requirements and contract rights, and as the consumer organizations have pointed out it does not really address the types of problem on which they are consulted by consumers.⁵⁷ Moreover, by comparison with the UK legislation there are notable omissions.⁵⁸ For example, the concept of credit is a restricted one and does not cover hire-purchase (hire with an option to purchase), which is justifiable in terms of legal concept but ignores the economic reality of the transaction. There are no restrictions on the canvassing or solicitation of consumer credit or on the unsolicited issue of credit cards. There are no provisions equivalent to those recently introduced by the Consumer Credit Act 2006 relating to unfair credit relationships, or the original provisions governing extortionate credit bargains which the 2006 Act replaced.⁵⁹
108. The Directive also has nothing to say about pre-requisites of and restrictions on the exercise of default remedies, such as termination of the agreement, repossession of the goods, and the like.⁶⁰ These important measures of consumer protection featured in the previous draft but have been dropped. There are also no licensing requirements or other provisions concerning debt collectors, who do not fall within the definition of “credit intermediary.”
109. We make these points not to denigrate the benefits of the Directive, which are considerable (and which, it should not be overlooked, are supplemented by other Community instruments) but simply to underline the point that what constitutes a high level of protection in one Member State may fall well short of what is provided in another. We should also emphasize that the omissions from the Directive are not a cause for concern so far as the UK itself is concerned, because they all relate to matters covered by the Consumer Credit Act which, being outside the Directive, are unaffected by it.

⁵⁶ Karel Lannoo and Almudena de la Mata Muñoz, *Integration of the EU Market: Proposal for a More Efficient Regulatory Model* (Centre for European Policy Studies, No. 213/November 2004), pp. 9–10.

⁵⁷ pp 59–61, QQ 94–95

⁵⁸ In addition to the dropping of secured credit, which is justifiable in view of the separate review of mortgage credit currently being conducted by DG Markt.

⁵⁹ However, there are provisions in the unfair contract terms Directive covering unfair terms in consumer contracts, and Art. 27 of the draft consumer credit Directive adds three additional terms specifically related to consumer credit agreements as defined by the latter Directive.

⁶⁰ But aggressive commercial practices are among the unfair commercial practices outlawed by Directive 2005/29/EC concerning unfair business-to-consumer commercial practices, and these would include the use of harassment in the collection of debts or other enforcement of agreements.

Conclusions

110. **We conclude that, while the draft Directive possesses many good features and may well provide a high level of consumer protection in those Member States whose consumer credit markets and legislation are relatively undeveloped, its very limited scope means that it affords a level of consumer protection which falls well short of that provided by legislation in such countries as the UK.**

CHAPTER 7: THE FULL HARMONISATION PROVISIONS OF THE DIRECTIVE AND THEIR POTENTIAL EFFECT ON THE LEVEL OF CONSUMER PROTECTION IN THE UK

111. This chapter is concerned only with the extent to which those provisions of the draft Directive laying down detailed uniform rules to be observed by all Member States, including “light touch” provisions, may adversely affect the existing high standard of consumer protection in the UK. It does not discuss rules embodying minimum standards or provisions of a general character which leave the detail of implementation in the hands of Member States, for these cannot affect consumer protection standards. Such rules and provisions are examined in Chapter 8 purely for the purpose of seeing whether they raise other significant problems—for example, problems of compatibility with established market practice—which need to be addressed by modification of the text.
112. There have been a number of welcome changes from the 2004 draft. These include a reduction in the upper limit of application of the Directive, the exclusion of secured lending, the introduction of flexibility into determination of the rebate for early payment, clarification that the consumer’s withdrawal from a credit agreement would not affect the supplier’s right to be paid for goods financed by the credit, and abandonment of the prohibition on the use of bills of exchange.⁶¹ Several of the new provisions appear uncontentious and we have little or nothing to say about them. Other provisions—in particular, the provisions relating to the content of consumer credit agreements and to indemnities payable by the consumer on early repayment—reduce the level of protection currently given to consumers under UK legislation, while yet others impose additional burdens on creditors.
113. Any suggestions for change we recommend in this and the previous chapter may also affect the recitals in the Directive’s preamble. We have not concerned ourselves with these, but draw attention to the point as such recitals play a significant role in the interpretation of a Directive.

The Ambit of Full Harmonisation

114. A useful amendment to the former Article 20 (now Article 21) makes it clear that on matters not covered by the Directive Member States are free to introduce or maintain their own provisions.

Scope (Article 2) and Definitions (Article 3)

115. Apparently Article 2(2) is intended to exclude all secured credit, whether the security is in land or anything else, which is far from apparent from the text. Further confusion is caused by the fact that the definition of “surety” in the 2004 draft, which applied the normal meaning of guarantee, has been dropped, so that the term is now undefined and is used to cover both personal guarantees and security in property. This may be puzzling to the UK reader but finds its counterpart in the London Economics study, which notes that there are some countries in which loans for house purchase are typically secured only by a personal guarantee, so that the study uses the

⁶¹ See generally above, paras 48 *et seq*

term “mortgage” to include such loans. It would certainly be helpful if the Directive were to reinstate a definition of “surety” and use the term “mortgage” or “security interest” to denote security in an asset.

116. For the reason set out in paragraph 107, hire-purchase agreements should not be exempt from the Directive.
117. Some respondents, for example the European Banking Federation, urged that overdrafts should be excluded from the scope of the Directive altogether. That would go further than current UK legislation, which simply exempts them from the formalities of agreement in the conditions laid down by a determination by the Office of Fair Trading (OFT). Overdrafts are included in the “light touch” regime provided by Article 2(3), but this is arguably not light enough, because it retains the provisions requiring advertisements to contain information which the bank will not normally have prior to conclusion of the agreement, such as the APR and the amount of the credit. Indeed, the current requirements for overdrafts are significantly more prescriptive than in the 2004 draft. We therefore think that while overdrafts should not be wholly excluded the light touch should be made lighter in relation to them, by exempting them from the provisions relating to contract and pre-contract information, and Article 2(3) amended accordingly.
118. The exemption in Article 2(4)(b) is intended to include credit unions, but if credit unions are to remain governed by the Directive Article 2(4)(b) needs to be amended. It is intended, for example, to apply a light touch regime to credit extended by credit unions. But this is not stated specifically and the membership link is restricted by reference to a common employment or former employment or residence or employment in a district common to the members. The Citizens Advice Bureau⁶² and the Association of British Credit Unions (quoting the World Council of Credit Unions)⁶³ argued that this definition is much too narrow. It would exclude, for example, affiliations based on membership of a trade union or political party or linked by employment common to a group, as distinct from a particular company, or by religion.
119. We note also that the “light touch” regime now proposed for credit unions is significantly more onerous than in the previous draft of the Directive. DTI told us that this would impose burdens which would be too much for credit unions, and particularly the smaller ones, to bear.⁶⁴ Ms. McCarthy was inclined to agree and thought it might seriously impair the important work that credit unions do in serving those who might otherwise not have access to affordable credit⁶⁵. But she pointed out that views differed among Member States, depending on their local circumstances.⁶⁶
120. Ms McCarthy⁶⁷ and the DTI Minister⁶⁸ told us they would prefer to see credit unions exempted from the Directive altogether. The responses to the DTI’s initial consultation are said to have been nearly unanimous in

⁶² Q 125

⁶³ pp 105–106

⁶⁴ Q 44

⁶⁵ Dr Paul Jones of Liverpool John Moores University agreed (pp 160–161)

⁶⁶ Q 132, Q 152

⁶⁷ Q 131, Q 152

⁶⁸ Q 229

supporting that view.⁶⁹ This is a view we share. It would always be open to a Member State to regulate credit unions under its domestic legislation if it felt that local conditions required this. But if credit unions are to be kept within the scope of the Directive the definition must be broadened to cover all types of credit unions and the “light touch” regime would need to be made even lighter.

121. The exception from the definition of “credit agreement” in Article 3(c) is too wide. It fails to distinguish, for example, pay-as-you-go insurance where monthly premiums are payable separately for each month, which is plainly not credit at all, from an agreement under which an annual premium for a year’ cover may be paid by monthly instalments, which is equally clearly a credit agreement. There is also concern about the breadth of the definition of “credit intermediary”. Thus the Mail Order Traders’ Association has pointed out that the definition is so wide that it would bring some 5.7 million agents within the regulatory ambit, which could spell the demise of the agency mail order trade.⁷⁰

122. **We recommend that:**

- **the definition of the word “surety” in the 2004 draft should be reinstated, and the term “mortgage” or “security interest” used to denote security in an asset;**
- **hire-purchase agreements should not be excluded from the scope of the Directive;**
- **the provisions relating to contract and pre-contract information should not apply to overdrafts which should continue to be governed by the other provisions of the Directive so far as applicable;**
- **ideally credit unions should be excluded from the Directive altogether on the basis that it would be open to any Member State to regulate credit unions in its domestic legislation if it considered that local conditions made this desirable;**
- **but if credit unions are to be kept within the Directive the concept of the common link embodied in Article 2(4)(b) should be expanded to encompass other types of link on which credit unions are based and the “light touch” regime applicable to credit unions should be made lighter;**
- **the wording of Article 3(c) should be amended to distinguish the provision of pay-as-you-go services from services provided on credit;**
- **the definition of “credit intermediary” should be narrowed to exclude those for whom it is inappropriate, for example, mail order traders.**

⁶⁹ See the DTF’s Supplementary Consultation Paper (see footnote 3)

⁷⁰ pp 163–165

Standard Information for Advertising (Article 4)

123. Despite the fact that the Article prescribes the information which an advertisement is to “include”, this Article is apparently intended as a full harmonization provision. It would be helpful if that were made clearer, for example, by substituting “state” for “include.” Article 4(4) could also be clarified so as to show that it is linked to Article 4(2) and that the use of a representative example is permitted. But the DTI have told us that a representative example could be misleading and it would be better to substitute a typical example, as in the UK legislation.⁷¹ Where there is a low introductory rate followed by a higher rate at the end of the low-interest period the UK rules requires a statement of the go-to rate, whereas the Directive would require a blended rate produced by an average of the introductory rate and the higher rate. The DTI favours the UK approach.
124. We believe these points deserve further consideration. In other respects there seems to be general support for Article 4, and we have no other comments to make on it.
125. **We recommend that:**
- **if Article 4 is intended as a full harmonization measure, that should be made clear, for example by substituting the word “state” for “include.”**
 - **Article 4(4) could usefully be clarified to show its link with Article 4(2) and the fact that use of a representative example is permitted;**
 - **in the case of low introductory rates consideration should be given to a requirement to state the go-to rate (i.e. the higher rate charged at the end of the introductory period) instead of a blended rate.**

Responsible Lending (Article 5)

126. Article 5 includes a duty on the part of the creditor and, where applicable, the credit intermediary to adhere to the principle of responsible lending, which carries with it both the provision of pre-contractual information by the creditor/intermediary and assessment by the creditor of the consumer’s creditworthiness on the basis of information provided by the latter. This is an important topic on which we have received a number of submissions and we deal with it in Chapter 9.

“Light Touch” Pre-Contractual Information (Article 6)

127. We have previously mentioned that the “light touch” provisions include formalities of contract which create difficulties in relation to agreements for overdraft facilities. We believe that these should not be subject to formal requirements.

Database Access (Article 8)

128. The 2004 text required the provision of databases. This was a cause for concern. The current Article 8 requires only that in the case of cross-border credit a Member State is required to ensure access to databases in that

⁷¹ Q 20

Member State for creditors from other Member States under non-discriminatory conditions. This is a welcome change.

Information to be Included in Credit Agreements (Article 9)

129. This is a full harmonization provision which in our view would result in a significant diminution in the information available to the consumer under current legislation. It is true that in Article 9 the list of the required contents of a consumer credit agreement is lengthy, and the Commission certainly considers that it produces a high standard of protection. Nevertheless, Article 9 is defective in three respects: first, it does not cater for information not known at the time of entry into the agreement; secondly, it fails to allow for information requirements arising from provisions of UK legislation several of which are themselves outside the scope of the Directive; and thirdly, it requires the provision of certain items of information which it could be burdensome to provide and for which the consumer is rarely likely to have a need.

Information not known at time of agreement

130. Article 9 assumes that, except for assumptions made by the creditor in calculating the APR, all the items listed in Article 9(2) will be known at the time of the consumer credit agreement so as to be capable of being stated in it. This is not the case. For example, the duration of an agreement for overdraft may well be indefinite; the amount, number and frequency of payments will under many agreements, particularly those for running-account credit such as a budget or option account, be dependent on the post-agreement exercise of choices by the consumer; and the costs of maintaining an account recording payments and draw downs will depend on the use made of the account. Under UK legislation items not known at the time of the agreement and necessary for determining the total charge for credit, the APR and the amount of the credit are covered by a series of statutory assumptions or alternatively by allowing estimated information, whereas Article 9(2)(e) does not prescribe any assumptions, referring only to assumptions made by the creditor in calculating the APR, and makes no provision for estimated information.
131. The Association of British Credit Unions has also drawn attention to the fact that the requirement to state the cost of credit fails to address exchange rate issues arising from the fact that some members of the European Union, including the UK, are outside the Eurozone.⁷² Moreover, as the European Banking Federation has pointed out,⁷³ there are certain items of information prescribed by Article 9 that the creditor cannot be expected to provide or procure, for example, costs incurred by the consumer to third parties which do not enter into the total cost of the credit as defined by Article 3(f).

Information currently required but barred by the Directive

132. UK legislation currently requires the inclusion of a list of goods and services provided by the credit, the cash price, and a credit limit for running-account credit. It also prescribes notices in statutory form advising the consumer of

⁷² pp 105–106

⁷³ pp 128–146

the restriction of his or her liability on termination of a conditional sale agreement, the exposure of goods to repossession on default, and the availability of advice from trading standards officers and Citizens' Advice Bureaux. These are requirements which arise from provisions of the Consumer Credit Act that are themselves unaffected by the Directive. We do not see why UK consumers should be deprived of information which is important to their awareness of their rights. These are only examples. A full list of requirements that would have to be dropped from the UK legislation is contained in Appendix 3.

Burdensome information

133. Article 2(2)(g) requires the inclusion of an amortization schedule in agreements where capital amortization of a credit agreement with a fixed duration is involved, the table to contain a breakdown of each repayment to show capital amortization, the interest and, where applicable, the additional costs. The 2004 draft also required a new amortization table every time there was a change in the borrowing rate, but this requirement has now been dropped. Even so, it has been put to us by the DTI⁷⁴ that the requirement for such a table to be included in the agreement at the time it is made is burdensome and serves little useful purpose in most cases. That is our view too.

134. **We recommend that:**

- **Article 9 should be made a minimum harmonization provision since, as a full harmonization measure, it would deprive UK consumers of a number of items of information currently required to be included in consumer credit agreements, thereby significantly reducing the level of consumer protection;**
- **Article 9 should also be amended to cater for cases where the relevant facts required, other than for the calculation of the APR, are not known at the time of the agreement, e.g. by providing assumptions or permitting the use of estimated information;**
- **Article 9 should also be amended to address the exchange rate problem in stating the total cost of credit where one party is based in a Member State outside the Eurozone and the other is in a Member State within the Eurozone;**
- **the creditor should not be required to provide details of costs incurred by the consumer to third parties which do not enter into the total cost of the credit as defined by Article 3(f);**
- **the requirement to provide an amortisation schedule should be dropped.**

Right of Withdrawal (Article 13)

135. There seems general support for a uniform rule on a right of the consumer to withdraw from a credit agreement without giving any reason. But there are differences of view on the detail and on the length of the period allowed, namely 14 calendar days from the date of the agreement or the date on which

⁷⁴ Q 28

the consumer receives the contractual terms, whichever is the later. Existing UK law provides no right of cancellation in the case of agreements signed at the creditor's business premises or signed elsewhere without oral representations in the presence of the debtor in the course of antecedent negotiations.⁷⁵ The Directive therefore significantly expands the right of withdrawal, and it has been suggested that this may lead to deferment of an advance by the creditor or of the delivery of goods by the supplier in a linked transaction until the period allowed for cancellation has expired, causing inconvenience to the consumer. We have no firm view on this and we invite the DTI to let us have their views following their consideration of responses to their supplementary consultation paper.

136. **We conclude that there appears to be general support for uniform rules on the consumer's right of withdrawal as provided by Article 13, and we recommend that the DTI should consider and report to the Committee whether the detail is satisfactory in the light of responses to the its supplementary consultation paper.**

Linked Transactions (Article 14)

137. This Article deals with two different aspects of a linked transaction. Under Article 14(1) a consumer who has exercised a right of withdrawal from a contract for the supply of goods or services by a trader is no longer bound by a linked credit agreement. UK law has no such provision, dealing instead with the converse case where the consumer cancels the credit agreement, in which case the linked supply agreement is also cancelled. Article 14(2) provides for the creditor's liability for breaches of the supply contract by the supplier, but the extent and conditions of exercise of the remedy are left to Member States and Article 14(2) is without prejudice to national rules governing joint and several liability of the creditor, so that Article 14(2) is not a full harmonization provision.
138. We have received no submissions concerning Article 14 and make no recommendation.

Early Repayment (Article 15)

139. Article 15 gives the consumer a right to pay ahead of time and receive "an equitable reduction in the total costs of the credit." This leaves some leeway for Member States to determine how this is to be achieved. Except in the two cases mentioned in Article 15 the creditor is entitled to an indemnity for early settlement according to the amount or calculation method used in the agreement. The purpose of this is to compensate the creditor for the initial costs incurred in setting up the transaction. In leaving this amount of the indemnity to be determined by the agreement Article 15 is more generous to the creditor than the UK legislation. This requires the rebate to be calculated on the basis of an actuarial distribution of the credit charge and compensates the creditor for setting-up costs by treating settlement, in relation to agreements running for more than a year, as deferred by a calendar month or, if the credit so elects, 28 days. The creditor cannot stipulate for any greater compensation. Thus Article 15 does in some degree reduce the level of consumer protection as regards rebates for early settlement.

⁷⁵ Consumer Credit Act 1974, s. 67.

140. However, we have received no submissions on Article 15 and make no recommendation about it.

Assignment of Rights (Article 16)

141. The requirement that notice of assignment of a debt should be given to the debtor, though on the face of it conducive to transparency, is likely to cause confusion in the case of non-notification financing (that is, financing under which assignments are not notified to debtors and the supplier continues to be responsible for the maintenance and collection of accounts). An exception has already been made for securitisation. But, if Article 16 remains in its present form, this needs to be extended to block discounting and invoice discounting, and, indeed, all arrangements under which ledgering and collection are left in the hands of the assignor-supplier.⁷⁶
142. Under block discounting arrangements, which have been utilised for a great many years, a supplier assigning its debts to a finance house—typically in small-unit transactions which the finance house may not wish to administer—is left responsible for maintaining the accounts and collecting in the debts as undisclosed agent of the finance house. To require a notice of assignment to be given would have several disadvantages. First, it would disturb the relationship between supplier and customer. Secondly, the notice of assignment, unless stating otherwise, would lead the customer to the correct conclusion that he or she would thereafter be legally obliged to stop making payments to the supplier and make them instead to the finance house. But the latter would have no record of any account and no knowledge of the customer or the transaction. Meanwhile the supplier, not receiving payments, would be recording a default and would threaten proceedings. Hence there would be confusion all round. It is true that the notice of assignment could state that the consumer should continue to make payments to the supplier, but then consumers might well ask themselves why they were being given the notice in the first place.
143. We would only add that the lack of notice of assignment cannot in any way adversely affect the consumer's rights or interests. Consumers who continue to pay the assignor obtain a good discharge and incur no liability to the assignee. They also continue to be entitled to set off against their liability to the assignor any cross-claims they have against the assignor on another account which arise from dealings entered into prior to receipt of a notice of assignment.
144. Article 16 would create no problems if limited to cases where the assignee was intending to enforce payment itself. A requirement to give notice of assignment would then conform to the current law. That may be what is intended by Article 16 but it needs to be stated. In that event it would seem unnecessary to maintain the exemption for securitisation.⁷⁷
145. **We conclude that Article 16, which requires notice of assignment to be given in all cases where the creditor assigns its rights under the agreement, does not represent the present law in the UK and would**

⁷⁶ QQ 41–42, QQ 84–89, pp 51–53, pp 128–146

⁷⁷ An alternative approach, as suggested by the European Banking Federation (pp 128–146), is to reformulate the exemption to cover all cases where the assignment is effected for the purpose of transferring the credit risk or for refinancing purposes, which would certainly solve many of the problems, but we have an immodest preference for our more general formulation.

cause confusion to consumers and disturb a practice of very long standing by which suppliers who block discount consumer credit agreements to finance houses continue to maintain customers' accounts and responsibility for collections without giving notice of assignment.

146. **Article 16 would function perfectly well if limited to cases where the assignee wishes to take steps to collect payment, at which point notice of assignment would be required. We therefore recommend that Article 16 be amended accordingly.**

Calculation of the APR (Article 18)

147. The existing Directive already requires a statement of the APR and prescribes both what enters into the total charge for credit and the mode of calculation. The Directive enlarges the composition of the total charge for credit and changes the equation⁷⁸ it is necessary to satisfy if the stated APR is to be correct. There seems general support for this Article, though there may be questions arising on the detail.
148. Accordingly we have no recommendations to make on Article 18.

Regulation of Creditors and Credit Intermediaries (Article 19)

149. The duty imposed on Member States to ensure that creditors and credit intermediaries are supervised or regulated creates no problems for UK law, which has required the licensing of creditors and intermediaries from the time the licensing provisions of the Consumer Credit Act 1974 came into force. Though the exemption given in the 2004 draft to creditors authorized under the banking consolidation Directive 2000 has been deleted, we assume it remains the case that a credit institution within that Directive who secures authorization from one Member State need not secure separate authorizations to conduct business in other Member States. We feel it would be helpful if Article 19 stated this explicitly.
150. **We therefore recommend an amendment to Article 19 to restore the exemption contained in the 2004 draft by which credit institutions authorized in a Member State under the banking consolidation Directive 2000 do not require authorization to conduct business in another Member State.**

Alternative Dispute Resolution (Article 23)

151. Article 9(1) provides that credit agreements are to contain information regarding access to out-of-court dispute resolution procedures and specify the formalities to be followed if a creditor or credit intermediary makes use of such procedures.⁷⁹ Article 23 requires Member States to ensure that adequate and effective out-of-court procedures are put in place, using existing bodies where appropriate, and to encourage those bodies to cooperate in order to resolve cross-border disputes concerning credit agreements. The UK legislation previously referred to already provides for ADR by the Financial Ombudsman Service and for the provision of

⁷⁸ Inaccurately described in Article 18(1) as a formula, which suggests, erroneously, that it is a formula for calculating the APR.

⁷⁹ Curiously, no reference is made to their use by the consumer.

complaints procedures (see paragraph 33). As regards cross-border collaboration, the Financial Ombudsman Service is a founder member of FIN-NET, the European network of financial ADR systems, launched by the European Commission in February 2001 and designed specifically to facilitate the out-of-court resolution of disputes where the creditor is based in one Member State and the consumer lives in another.⁸⁰

152. **We conclude that the current UK legislative provisions and cross-border collaboration arrangements appear adequate to fulfil the requirements of the Directive relating to out-of-court dispute resolution. We therefore have no recommendations to make concerning Article 23.**

Loss of Flexibility

153. We have drawn attention both in this chapter and elsewhere in this Report to the impact of the full harmonization approach on the level of consumer protection in Member States with highly developed consumer credit laws. There is a further problem with full harmonization which we have not previously mentioned. In mature markets such as that in the UK new consumer credit products, documents and practices are constantly being developed, and these not infrequently carry with them a need for additional protection for consumers which can readily be effected by statutory instrument after appropriate consultation. By contrast, as the present case illustrates, amendments to an EU Directive can take years. The Commission has not so far provided an adequate response to the suggestion that full harmonisation would prevent Member States from changing domestic legislation rapidly and flexibly when needed, a point made in the study by Lanoo and Muñoz referred to earlier.⁸¹
154. **In addition to the difficulties of full harmonization to which attention has already been drawn, we are concerned that it would remove the flexibility which Member States currently have to respond rapidly through new regulations to the emergence of new products and practices. We therefore recommend that, except in relation to those full harmonisation provisions which we have identified as generally acceptable, the concept of minimum harmonisation should be retained.**

⁸⁰ pp 156–158

⁸¹ Above, see footnote 56

CHAPTER 8: MUTUAL RECOGNITION

The Meaning of Article 21(2)

155. We come now to Article 21(2). This provision has attracted a good deal of opposition from Member States, not least because of the difficulty of understanding its meaning and the fact that it appears to run counter to the stated aim of the Directive to provide a high level of protection for the consumer. Article 21(2) is in the following terms:

“When implementing and applying Article 5(1), (2) and (5),⁸² Article 13,⁸³ Article 14(1) and (2),⁸⁴ Articles 15,⁸⁵ 17,⁸⁶ 19⁸⁷ and 20,⁸⁸ and without prejudice to necessary and proportionate measures which Member States may take on grounds of public policy, Member States shall not restrict the activities of creditors established in another Member State and operating within their territory in accordance with this Directive either through freedom of establishment or free provision of services.”

Paragraph 5.11 of the Commission’s Explanatory Memorandum offers the following explanation of Article 21(2):

“In general, both harmonisation and mutual recognition have contributed to EU market integration, while ensuring that consumer interests are taken into account. The policy mix chosen in a given area invariably depends on the characteristics of that area and should be decided on a case-by-case basis. Finding the right mix requires an application of the proportionality principle in designing a solution, combining where appropriate harmonization with mutual recognition.

Against this background, the Commission suggests to maintain the full harmonisation approach with a degree of flexibility for Member States in certain areas...

In some cases the proposal gives leeway to national implementation, mainly due to existing heterogeneity as regards national markets or national legislation. This is the case, for instance, in the context of early repayment or overrunning. However, it is also necessary to ensure that the degree of flexibility provided for national implementation within the limits of the Directive does not contribute to raise additional barriers to the single market in consumer credit. Therefore, the Commission complements its full harmonization approach with mutual recognition for a limited number of issues. This helps to reduce burden on businesses who want to offer consumer credit across borders.

As a result of the proposed provision on mutual recognition, a creditor would only have to comply, for an activity in another Member State than the one he is established in, with legal requirements of its Member State of origin (or

⁸² Dealing with pre-contractual information.

⁸³ Concerning the consumer’s right of withdrawal.

⁸⁴ Relating to linked transactions.

⁸⁵ Dealing with early repayment.

⁸⁶ Concerning overrunning of the total amount of credit.

⁸⁷ Relating to the regulation of creditors and intermediaries.

⁸⁸ Dealing with the obligations of intermediaries.

equivalent ones) and not with those of the host Member State. In the area of contract law, this could lead to another result than foreseen by Article 5 of the Rome Convention.⁸⁹ In an Article 5 situation, which would lead to the application of the law of the country where the consumer has his habitual residence, this latter law may establish standards that, in relation to the equivalent standards applicable in an incoming creditor's home country, restrict that creditors activity, for instance by being higher (or different) than his home country standards. In that case, if areas mentioned in the mutual recognition clause are concerned, the host Member State has to ensure that the said standards would not apply to the contract. Either the law chosen by the parties, or, in the absence of such a choice, the requirements of the creditor's home country law would continue to apply..."

156. Professor Weatherill pointed out to us that this explanation is both self-contradictory and inaccurate⁹⁰. We agree. The penultimate sub-paragraph begins by saying that the creditor would, in relation to the various matters covered by Article 21(2), be able to comply with the legal requirements of its Member State of origin. The last sentence, however, asserts something quite different: namely the application of the law chosen by the parties or, failing that, the law of the creditor's home country. In fact Article 21(2) does not embody any choice of law rule, and there is certainly no justification for the suggestion that the law chosen by the parties applies. Rather the effect of Article 21(2) is to introduce, in relation to the listed provisions, the concept of home State control. That means control by the law of the Member State in which the creditor was established,⁹¹ as distinct from host State control, which means control by the law of another Member State in which the creditor is carrying on business.

The Concept and Extent of Home State Control

157. In regard to the right of establishment the concept of home State control has long featured in European Community law. For example, under the regime established by the Banking Consolidation Directive 2000, Member States are obliged to require credit institutions—that is, undertakings whose business it is to receive deposits or other repayable funds from the public and to grant credits for their own account—to obtain authorization before commencing their activities.⁹² However, a European institution incorporated in or formed under the law of one Member State (the home State) which has its principal place of business in that State and is authorized by the supervisory authority of that state to act as a credit institution in that State is in principle entitled so to act in any other Member State (the host State) without separate authorization from the supervisory authority of the host State.⁹³ Accordingly in its application to the authorization under Article 19 of credit institutions

⁸⁹ This is a reference to the EEC Convention on the law applicable to contractual obligations, 1980, implemented in the UK by the Contracts (Applicable Law) Act 1990. Article 5 provides, in relation to contracts with consumers, that in given conditions the freedom of the parties under Article 3 to choose the law governing their contract shall not have the result of depriving the consumer of the protection afforded to him by the mandatory rules of the country in which he has his habitual residence.

⁹⁰ QQ 170–178

⁹¹ The Explanatory Memorandum refers to “legal requirements of its [the creditor’s] Member State of origin (or equivalent ones)”.

⁹² Art. 4.

⁹³ Art. 13.

falling within the Banking Directive Article 21(2) is otiose (see also paragraph 93).

158. What is new about Article 21(2) is that it extends the concept of host State control to certain issues affecting contractual rights and obligations, namely the right of withdrawal, linked transactions and early repayment. So a UK consumer could be supplied with a copy of an agreement made in the UK which says nothing about the possible application of foreign law. In accordance with UK statutory requirements, that agreement would set out the consumer's rights to cancel the agreement, to claim against a creditor for breaches of duty by the supplier under a linked transaction and to settle early and receive a rebate of charges. But the consumer may later find that those rights are not governed by UK law at all but by the law of some other Member State which, though conforming to the Directive, provides a lower standard of protection.
159. However, even this is not clear, because Article 21(2) operates "without prejudice to necessary and proportionate measures which Member States may take on the ground of public policy." This exception seems to us largely to negate the rule, for in the above example it would leave UK law free to operate measures that were "necessary and proportionate," which from the UK perspective would be all the rules governing the rights of withdrawal, early settlement and claims against the creditor. Moreover, as the European Banking Federation pointed out in its written evidence to us,⁹⁴ it is unclear why the particular provisions listed in Article 21(2) were selected for this special treatment.

The Problems of Home State Control

160. On this basis we cannot see the point of seeking to import rules of law of another Member State in which the creditor was incorporated. On the contrary, the effect of so doing would be to cause confusion and expense. In particular:
- consumers would be unaware that part of their rights were governed by a law other than their own;
 - consumers would be unable to obtain advice on such law from their local Citizens' Advice Bureau, Money Advice Centre or lawyer, who would be able to help them on their rights and obligations under UK law but could not be expected to be familiar with the consumer credit laws of the other 24 Member States;
 - Article 21(2) may well result in inconsistency between the information required by UK law to be contained in the agreement concerning the consumer's rights and the content of those rights under the creditor's law, thus rendering the information misleading unless accompanied by a note drawing attention to the possibility of a foreign law applying, which would leave the consumer no wiser;
 - in any proceedings in the UK in which the creditor sought to rely on its own law it would be necessary to call expert evidence of the content and effect of that law (for example, if the creditor were established in Germany it would have to call an expert in German law to give evidence

⁹⁴ pp 128–146

on that law to a UK court), which would involve delay and considerable expense.

161. It seems to us remarkable to find these provisions in a Directive designed to enhance consumer protection and in particular to ensure that consumers were fully informed of their rights. Moreover, as the Commission's Explanatory Memorandum states, one effect is to override the primacy given to the mandatory rules of the host State by Article 5 of the Rome Convention and to subordinate such rules to those of the home State in relation to the matters mentioned above. Article 5 of the draft Regulation which is to replace the Rome Convention goes further, requiring the exclusive application of the debtor's law in order to avoid the confusion resulting from consumers being subjected to two different legal systems. That has been criticized as excluding the parties' choice of a foreign law even as regards matters not covered by mandatory rules. But, whatever the force of that criticism, it seems to us that in relation to mandatory rules laid down by the Directive the debtor's rights and obligations should be governed exclusively by his or her own law.
162. The joint submission by Citizens Advice, the National Consumer Council and "*Which?*"⁹⁵ also suggested that mutual recognition could allow credit providers to comply with rules set by their home state regulator which gave less protection than the rules set by the regulator in the consumer's home state.
163. We put these points to Mr Staudenmayer when he came to see us. His response was that there were many cases where Article 5 of the Rome Convention did not apply, that Article 5 already permitted a freedom of choice, subject only to the mandatory rules of the debtor's law in cases within Article 5, and that most of the provisions of the Directive affected by Article 21(2) were sufficiently detailed as to ensure that there was unlikely to be much difference between the debtor's law and the creditor's law. But this last point, which was also made subsequently by Mr Madelin in a letter to us⁹⁶, seems to us to be self-defeating, for if it is correct then it seems to us to make Article 21(2) unnecessary. Furthermore, we cannot imagine that in the relatively few cases in which creditors engage in cross-border lending they would want to superimpose parts of their own law on to the debtor's law and involve themselves in the expense of calling expert evidence on their law. Indeed, Mr Staudenmayer told us⁹⁷ that there were a number of banks in Europe which as a marketing strategy would offer the consumer the application of his own law.

Conclusions and Recommendation

164. **We conclude that the mutual recognition provisions contained in Article 21(2) are confusing, unnecessary and detrimental to the interests of consumers. To allow a foreign creditor (as regards provisions relating to the right of withdrawal, claims against the creditor for the supplier's breaches, and early payment and rebates), to invoke the mode of implementation of the Directive prescribed by its own law rather than that of the consumer causes serious problems.**

⁹⁵ pp 59–61

⁹⁶ Q 9, pp 16–18

⁹⁷ Q 9

In the first place, it exposes consumers to two different sets of mandatory rules without their even being aware of that fact. Secondly, it prevents consumers from obtaining local advice as regards the foreign mandatory rules. Thirdly, in the event of proceedings by the creditor in the consumer's Member State, the parties would incur delay and considerable expense in arranging for experts on both sides conversant with the foreign law concerned to give evidence (and possibly conflicting evidence) of its content and effect. This is particularly inappropriate for proceedings against a consumer.

165. We therefore recommend that, in relation to mandatory rules, the debtor should be governed solely by his or her own law and therefore that Article 21(2) should be deleted.

CHAPTER 9: RESPONSIBLE LENDING

Introduction

166. Article 5(1) of the draft Directive, which is headed “Pre-Contractual Information”, provides for adherence to the principle of responsible lending. Our Interim Report⁹⁸ suggested that basic principles for the conduct of consumer credit transactions might be founded to some extent on an agreed definition of responsible lending which had been introduced, but not fully developed, in the Commission’s earlier draft of the Directive. We were also aware that considerable attention had been given in the media and published reports to the dramatic growth of consumer indebtedness in the UK and the perception that this was driven to some extent by irresponsible behaviour by lenders through mass marketing of consumer credit products with insufficient regard for the economic and social consequences.
167. We therefore decided that, before attempting to evaluate the references to responsible lending as set out in Article 5(1), we first needed to consider the published evidence of over-indebtedness in the UK, the extent to which this appeared to result from irresponsible lending, and the various steps taken in the UK to address the problem of over-indebtedness and to promote responsible lending both by legislation (including the recently-enacted Consumer Credit Act 2006) and by self-regulation. In doing so, we hoped that the UK experience might be relevant for other EU Member States and might provide some guidance for assessing the provisions of Article 5.

The Growth of Consumer Credit in the UK⁹⁹

168. The subject of over-indebtedness is complex. Our treatment of it is necessarily brief and limited to the context described above. Undoubtedly there has been an explosive growth in consumer credit in the UK in recent years. Amounts outstanding now exceed £1 trillion, though some 84% of this consists of secured home loans,¹⁰⁰ for which there are accordingly matching assets. At the end of March 1996 net unsecured loans outstanding stood at £69.4 million. By the end of March 2006 that total had risen to £191.4 million.
169. This massive increase in both secured and unsecured lending results from a variety of factors. These include the removal of credit controls in the 1970s and a sustained period of low interest rates which has contributed to the growth of home ownership and the inflation of house prices. At the same time, a large number of credit institutions have entered what has become an aggressively competitive market, offering a much wider range of products than was previously available. The resultant competition has made consumer

⁹⁸ 13th Report of Session 2005–06, HL Paper 37

⁹⁹ We have not ourselves examined the growth of consumer credit in other Member States, but the Commission has procured various studies and Mr. Madelin drew our attention to the annual statistical publication of the European Credit Research Institute, the most recent of which gives detailed statistics of consumer credit in what were then the 15 Member States of the European Union over the period 1995 to 2004. See Camille Selosse and Lorna Schrefler, *ECRI Statistical Package 2005: Consumer Credit and Lending in Europe 1995-2004*.

¹⁰⁰ See Bank of England Monetary and Financial Statistics April 2006, table A4.3.

credit much more easily available. The number of credit cards issued,¹⁰¹ the total volume of credit extended through credit cards, the number of cards held by one cardholder and the amount of credit card indebtedness of the average household have all increased substantially. The debt-income ratio has risen from less than 50% in the 1970s to 140% in 2005.¹⁰²

170. Coupled with these developments has been the targeting of low-income consumers in the sub-prime (or non-status) market.¹⁰³ That in itself is not considered objectionable by the Government. On the contrary, as part of its strategy to tackle financial exclusion, the Government has gone to considerable trouble to encourage the major banks to develop business with low-income families, for whom borrowing through sources other than mainstream financial services is either unavailable or costly.¹⁰⁴ A number of banks have acted in partnership with charities for the homeless and other charitable bodies in opening up affordable forms of credit to low-income families. The Government is also seeking to enhance the financial capacity of credit unions and community development finance institutions.

The Problem of Over-Indebtedness in the UK

171. It is now some 35 years since the publication of the Crowther Report on consumer credit,¹⁰⁵ which discussed the problems of the over-committed debtor in some detail.¹⁰⁶ Much of that discussion remains valid today. What has changed is that the consumer credit business has become very highly competitive while much more information is now available about consumer debt.
172. Over the past few years many studies have been made of consumer over-indebtedness in the UK, among them the Kempson Report (2002),¹⁰⁷ the MORI Financial Services Report (2003),¹⁰⁸ the NMG Research surveys for the Bank of England (2003)¹⁰⁹ and (2004),¹¹⁰ the OXERA Report (2004),¹¹¹ the inter-departmental annual surveys,¹¹² the Griffiths Report (2005),¹¹³ the

¹⁰¹ According to the evidence given to us by the UK Cross Industry Group there are now 70 million credit cards in issue. (pp 53–57)

¹⁰² Griffiths Report (below footnote 113), p. 10.

¹⁰³ As far back as July 1997 the OFT had issued guidelines for such lending, which were revised in November 1997 (*Non-status Lending: Guidelines for lenders and brokers*).

¹⁰⁴ DTI/DWP/DCA, *Tackling Over-Indebtedness: Annual Report 2005*, paras. 5.22 et seq.

¹⁰⁵ Consumer Credit: Report of the Committee (Cmnd. 4596, 1971).

¹⁰⁶ Chapters 3.6, 9.3.

¹⁰⁷ Elaine Kempson, *Over-indebtedness in Britain: A Report to the Department of Trade and Industry*, an analysis of a survey by MORI.

¹⁰⁸ Financial Over-Commitment Survey, commissioned by Citizens Advice.

¹⁰⁹ The Distribution of Unsecured Debt in the United Kingdom: Survey Evidence.

¹¹⁰ See Orla May, Merxe Tudela and Garry Young, *British household indebtedness and financial stress: a household-level picture*, Bank of England Quarterly Bulletin, Winter 2004, p. 414.

¹¹¹ *Are UK households over-indebted*, a Report prepared by Oxford Economic Research Associates (OXERA) for the Association for Payment Clearing Services, British Bankers' Association, Consumer Credit Association and Finance & Leasing Association.

¹¹² DTI/DWP/DCA, *Tackling Over-Indebtedness: Annual Report 2005*; DTI/DWP, *Tackling Over-Indebtedness: Action Plan 2004*.

¹¹³ *What Price Credit?*, the report of the Griffiths Commission on personal debt. See para. 172.

CSFI paper by Antony Elliott (2005)¹¹⁴ and the recent report by Citizens Advice (2006).¹¹⁵ In addition, the House of Commons Treasury Committee has examined credit card charges and marketing and its Second Report includes a chapter on data sharing and responsible lending.¹¹⁶ Finally, the Department for Constitutional Affairs has made proposals for the relief of over-indebted consumers.¹¹⁷

173. As some of the above reports show, there is no agreed definition of over-indebtedness. Professor Elaine Kempson's survey reported heavy credit use strongly associated with reported levels of financial problems where more than 25% of the gross income of the household was spent on unsecured consumer credit.¹¹⁸ OXERA, having noted that there is no generally accepted definition of over-indebtedness, defines over-indebted consumer households or individuals as those who are in arrears on a structural basis (as distinct from those who are simply unwilling to meet their commitments or are only temporarily unable to do so) or at a significant risk of getting into arrears on a structural basis.¹¹⁹ A widely-used objective indicator of over-indebtedness is the ratio of debt to income, which as indicated in paragraph 169 has nearly tripled over the past 30 years. A subjective indicator is whether individuals or households consider themselves overburdened with debt.
174. In April 2004 the Rt. Hon. Oliver Letwin MP, then Shadow Chancellor of the Exchequer, set up the Commission on Personal Debt under the chairmanship of Lord Griffiths of Fforestfach to gather evidence about the way in which families, and especially low-income families, get into debt-spirals and to identify means by which those families could best be helped. The Commission published its Report¹²⁰ in March 2005. It contains an instructive analysis of the problems of over-indebtedness in the UK. This found that at least some of the causes of over-indebtedness arose from: the aggressive marketing of credit by banks and other credit institutions; the extension of credit to borrowers without an adequate or any prior assessment of creditworthiness; the automatic raising of credit limits; the inappropriate consolidation of loans, and taking out new credit cards to finance the repayment of existing debts. This accords with evidence from other surveys.
175. The substantial level of over-indebtedness, and the extent to which this has increased significantly over the years, is indicated not only by the above-mentioned surveys but also by records maintained by Citizens' Advice Bureaux and Money Advice Centres. For example, the latest survey conducted by Citizens Advice¹²¹ showed that nearly two in five households depended entirely on benefit income, the average total household debt was

¹¹⁴ *Not waving but drowning: Over-indebtedness by misjudgement*, published by the Centre for the Study of Financial Information 2005.

¹¹⁵ *Deeper in debt*, a survey by Jane Phipps and Francesca Hopwood Road of 567 clients from 61 bureaux, published in May 2006.

¹¹⁶ *Credit card charges and marketing*: Second Report of Session 2004-05 (HC 274); *Transparency of Credit Card Charges*: First Report of Sessions 2003-04 (HC 125), Chapter 3.

¹¹⁷ *A Choice of Paths: Better options to manage over-indebtedness and multiple debt* (Consultation Paper CP 23/04).

¹¹⁸ Above, footnote 107, p. 39.

¹¹⁹ Above, footnote 111, para 3.

¹²⁰ *What Price Credit?*

¹²¹ Above, footnote 115.

£13,135 and on average debts were 17.5 times the borrower's total monthly household income.

176. Witnesses from the UK Cross-Industry Group argued that, since the percentage of defaults to credit extensions has remained broadly constant in money terms, the higher incidence of default is mainly a reflection of the overall increase in the growth of credit.¹²² Moreover, the Government's second annual report on over-indebtedness¹²³ records that the number of borrowers who find their repayments a "heavy burden" has not changed significantly over the past 10 years and fell slightly in 2004. There also appears to be a relatively high level of satisfaction with the services of credit providers.
177. So far, the problem of over-indebtedness appears to have affected a relatively small number of households. No doubt that is due in no small measure to the strength of the economy and the relatively low level of unemployment and of interest rates currently prevailing in the UK. But many other households (including middle-income households) who are living at the limit of their resources would go into default on the occurrence of some adverse event, such as ill-health, loss of employment or substantial unexpected expenditure. Those risks would inevitably be greatly increased if there were a deterioration in the economic environment, a point to which the Bank of England has more than once drawn attention. This assumes particular significance with the prospect of higher interest rates and with a sharp increase in the number of individual insolvencies, nearly 70,000 becoming insolvent in 2005. That is the highest figure since records began.

The Importance of Responsible Lending

178. Against this background, it is important to bear in mind that the primary responsibility for avoiding over-commitment and for ensuring an ability to discharge commitments as they fall due falls lies with the borrower. In the words of the Kempson Report:

"A responsible credit agreement can depend just as much on responsible borrowing as on responsible lending".¹²⁴

But as we have noted in paragraph 174, the Griffiths Report and other surveys have shown that at least some responsibility falls on the credit industry.

179. As indicated in paragraph 170, the grant of credit to low-income families by prime lenders is encouraged by the Government in order to prevent the economic exclusion of this category of borrower. But it is all the more important to ensure that such borrowers are likely to be able to meet their commitments. Much of the problem arises because in many cases lenders simply have no information about other commitments entered into by an intending borrower, upon whom they may be reliant for information if this is not stored on an accessible database (see paragraph 186).

¹²² This was the position foreseen 35 years ago in the Crowther Report, (see footnote 105), para. 9.1.6.

¹²³ Published in 2005 by the DTI and the Department for Work and Pensions in association with other government departments.

¹²⁴ *Over-Indebtedness in Britain*, above, footnote 107, para 4.2, which noted three main areas of concern as regards irresponsible borrowing: borrowing to refinance other credit, incurring of commitments by households in the knowledge that they will struggle to repay and impulsive and unplanned purchases and credit, linked to financial difficulty and heavy borrowing.

180. In the UK voluntary codes of conduct drawn up by lending organisations have attempted to address these problems. The Finance & Leasing Association's Lending Code 2006, which replaced the 2004 edition and came into force on 1 June 2006, precludes FLA members from offering credit without a prior credit appraisal. Section 1C.1 provides as follows:
- “We will make sure that all loans (including pre-approved loans and credit card cheques) go through a sound and proper credit assessment”.
181. This is amplified by section 5 of the Code, which lists a number of factors that are taken into account in making the credit assessment, and a separate set of factors which may show a high risk of experiencing financial difficulty, such as having four or more credit commitments and spending more than 25% of gross income (before deductions) on consumer credit. Reference is also made to credit-scoring (see paragraph 183) and the availability of a leaflet explaining it.
182. The Banking Code 2005 also provides for the lender to make a credit assessment before giving a limit on a credit card (section 10.9) or lending money or increasing the customer's overdraft (section 13.1). Both Codes also require the provision of information on key features of products offered to the consumer. However, the FLA Lending Code applies only to FLA members and the Banking Code only to those organisations that undertake to abide by it.

Credit Scoring

183. The traditional method of deciding whether credit should be granted to a consumer was by interview of the applicant for credit and appraisal of the application by a loan officer, who would also draw on his or her experience in coming to a decision. That method was shown to be unreliable, in that credit was being granted to consumers who should not have been given it and was being refused to those who were in fact well-qualified to receive it.
184. So the process of evaluation on an individual basis by a human agency was largely replaced by credit scoring, a computer-based process in which characteristics considered relevant to creditworthiness are assessed electronically in the following way:
- Income, financial assets, amount of existing indebtedness, length of credit history, payment record, length of residence at current address, occupation, employment pattern, number of accounts and of credit cards held and other relevant data are identified by a statistical analysis of the profiles of a large sample of the creditor's customers and their repayment histories.
 - Each characteristic is weighted according to its relevance to the degree of predictability of the ability to repay or the likelihood of default.
 - The applicant for credit is then measured against the statistical pool of customers and for that purpose is allocated points for each characteristic based on information supplied by the applicant or obtained from other sources, for example, information held on databases maintained by credit reference agencies, and the register of county court judgments.
185. The total score will determine the applicant's eligibility for credit or alternatively influence the interest rate charged, a feature of the increasingly-used technique of risk-based pricing, in which the rate of interest a consumer

is charged varies according to the lender's assessment of the likelihood of default.¹²⁵

186. While credit-scoring has been found much more reliable as a method of assessing creditworthiness, it is based on statistical analyses which do not necessarily reflect a particular individual's suitability for credit of a given amount in any particular case. Most significantly, the accuracy of credit-scoring techniques has yet to be tested by an economic downturn and increased levels of unemployment. What is more, credit institutions often have only an incomplete picture of a debtor's circumstances. The relevant data, so far as it is available at all, may be distributed among various databases maintained by different credit reference agencies. Credit institutions are now taking more active steps to pool information in order to give a better picture of a particular consumer's overall position.
187. Lending institutions do not always resort to credit scoring. It is, for example, common practice for lenders extending home credit—that is, credit of small amounts taken for short periods of time with modest repayments collected weekly from the debtor's home—to rely on their prior knowledge of their customers instead of using credit scoring. Again, credit scoring may not be thought necessary for existing customers with a good track record; and various lenders may use alternative techniques for credit appraisal. The criteria for assessing risk vary from one credit institution to another, but the feature common to credit institutions, as we were told by the UK Cross-Industry Group, is that they do not extend credit without a prior credit check.¹²⁶

Existing Measures to Promote Responsible Lending in the UK

188. In the UK various measures are already in place or impending to promote responsible lending. First, steps have been taken by lenders to reduce the risk of over-commitment by consumers. These include credit scoring as a prerequisite to the extension of credit, a move by the credit industry towards data sharing, the availability of free debt advice, and the encouragement of more transparent credit literature and better information and early advice to consumers.
189. Secondly, there is self-regulation through codes of practice such as those issued by the banking industry and the Finance & Leasing Association (see paragraphs 180–181). Some of these codes have in the past been criticized as being too lax and have been gradually tightened over the years. However, they are not always observed in practice (though observance of the Banking Code is monitored by the Banking Code Standards Board) and infractions are not necessarily visited with sanctions to secure enforcement. There is an innate tension between competition and the maintenance of ethical and prudential standards, and faced with loss of market share there must be a great temptation for lenders to depart from principles of responsible lending.
190. Thirdly, in considering fitness to hold a licence under the Consumer Credit Act 1974, the Office of Fair Trading (OFT) has always been required to take account of business practices appearing to it to be deceitful or oppressive or

¹²⁵ pp 57–58. There is also a useful general description of credit scoring in Mr. Antony Elliott's CFSI Report (see n 97) at pp. 38–41. See also the credit industry's *Guide to Credit Scoring 2000*. As to risk-based pricing, see the HC Treasury Committee Second Report on credit charges and marketing, paras. 43–46.

¹²⁶ pp 57–58

otherwise unfair or improper (whether unlawful or not), which could include a failure to act responsibly in extending loans. Under a new section 25(2B) of the Act (introduced by section 29(2) of the Consumer Credit Act 2006) the OFT is now specifically enjoined to take account of practices that involve irresponsible lending. In future, where such practices have been adopted, the OFT will have extended powers to impose sanctions, including not only refusal, suspension or revocation of a licence (as now) but also the imposition of a civil penalty. The OFT will also have powers to issue what may conveniently be labelled cease and desist notices.

191. Moreover, section 19 of the recently-enacted Consumer Credit Act 2006 (not yet in force) prospectively replaces the extortionate credit bargain provisions of the Consumer Credit Act 1974 (which had proved ineffective) by giving the court wide powers to order repayment of sums paid by the consumer, or the reduction or discharge of the consumer's liability, where the court determines that the relationship between the creditor and the debtor arising out of the agreement is unfair. For this purpose, the court may take account not only of the terms of the agreement but also the way in which the creditor has exercised or enforced any of its rights under the agreement or any related agreement and any other thing done (or not done) by or on behalf of the creditor, either before or after the making of the agreement or any related agreement.
192. Somewhat surprisingly, the statutory provisions do not identify any badges of unfairness or, indeed, supply any meaningful criteria for identifying an unfair credit relationship. The question is left entirely open to the court to decide, although we assume that the OFT will give some guidance. So one of the grounds on which the court could exercise its powers, when the amending legislation has come into force, is that the creditor acted irresponsibly in making the loan. That could apply where the creditor had no reason to suppose at the time of making the loan that the consumer would be able to repay it in accordance with its terms. This is also a factor which the Financial Ombudsman Service could take into account in cases referred to it.
193. Finally, various measures have been proposed by the Department of Constitutional Affairs to assist the consumer who wishes to repay debts incurred but needs a breathing space to do so or has no prospect of repaying debt.¹²⁷ Among these are reform of the administration order system and the introduction of enforcement restriction orders. For debtors who have no prospect of repaying their debts it is proposed to introduce a new form of order, the debt relief order. The bankruptcy regime has already become lighter in that a debtor can obtain discharge from bankruptcy in 12 months instead of three years, whilst the individual voluntary arrangement, by which the debtor reaches an arrangement with creditors, is available as an alternative to bankruptcy.

The Directive's Provisions on Responsible Lending

194. These considerations set the context in which we examined Article 5 of the Directive. Article 5(1) is expressed in the following terms:

“The creditor and, where applicable, the credit intermediary shall adhere to the principle of responsible lending. Therefore, the creditor and, where

¹²⁷ See above, footnote 117

applicable, the credit intermediary, shall comply with their obligations concerning the provision of pre-contractual information and the requirement to assess the consumer's creditworthiness on the basis of accurate information provided by the latter,¹²⁸ and, where appropriate, on the basis of a consultation of the relevant database.

Where the credit agreement allows the creditor to change the total amount of credit, after the date of conclusion of the credit agreement, the creditor shall update the financial information at his disposal concerning the consumer and shall assess the consumer's creditworthiness before any significant increase in the total amount of credit."

195. Paragraphs 2 and 4 of Article 5 set out the information which is to be provided to the consumer, though in the case of overdrafts and other agreements covered by the "light touch" regime the provisions of paragraphs 2 and 4 are replaced by Article 6.
196. Article 5(5) then goes on to say:
- "Member States shall ensure that creditors and, where applicable, credit intermediaries provide adequate explanations to the consumer, in order to put the consumer into a position 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 in accordance with paragraph 2 as well as the advantages and disadvantages associated with the products proposed. Member States may adapt the manner by and extent to which this 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."
197. Thus under Article 5(1) the principle of responsible lending has at least three aspects:
- (1) The creditor must supply the consumer, in good time before the consumer becomes bound by the agreement, with the items of information prescribed by Article 5(2) and (4).
 - (2) The creditor must provide the consumer with such explanations as will enable the consumer to assess whether the proposed credit agreement is adapted to his or her needs and financial situation. This may involve explaining the advantages and disadvantages of the products proposed.
 - (3) The creditor must take appropriate steps, including any appropriate consultation of the relevant database, to assess the consumer's creditworthiness.
198. Unfortunately, what is less clear is whether the concept of responsible lending is limited to these three requirements or whether it is a more general concept of which the three requirements in question are merely examples. If the latter be the case, there is no definition of responsible lending in the Directive and it is presumably for Member States to determine the extent, if any, to which the duty goes beyond the above requirements¹²⁹ or alternatively

¹²⁸ This presumably means "on the basis that the information supplied by the consumer is accurate" and is not intended to impose on the consumer a duty to provide accurate information.

¹²⁹ Q 38

to leave the matter to the courts.¹³⁰ These are points that could usefully be clarified in the final text of the Directive.

199. The mutual harmonization provisions in Article 21(2), which we have examined in some detail in Chapter 8, apply to Article 5(1), (2) and (5). Consequently, a creditor who satisfied the responsible lending requirements imposed by its home State in conformity with the Directive would not also have to comply with any higher standards that might be imposed by the law of the host State.
200. On behalf of the European Commission Mr. Staudenmayer told us that the lender would have to assess creditworthiness on the basis of the information available and ask relevant questions of the prospective borrower as well as supplying the latter with information. But he stressed that the ultimate responsibility for assuming the commitment lay with the borrower.¹³¹ He pointed out that most indebtedness was caused by unforeseen personal difficulties. The Directive could not protect against “accidents of life”. Nor was “the fight against over-indebtedness” one of the Directive’s main aims.¹³²
201. Our evidence from the credit industry took issue with Article 5 on three grounds. The primary ground was that responsible lending was best left to self-regulation and, in particular, to the codes of practice and the monitoring of them by the relevant industry organizations. Subsidiary grounds of objection were that the concept of responsible lending was too vaguely expressed (a view which appears to be shared by the DTI),¹³³ and that the duty imposed by Article 5(5) to provide “adequate explanations” and information as to “the advantages and disadvantages of the products” constituted an interference with the market which might impose burdens which the industry was not equipped to bear.¹³⁴
202. The UK Cross Industry Group, while acknowledging that at first glance the proposals appear to embody concepts that are sensible and benign, felt that the rules would create serious market inefficiencies, lead to a swing to running-account credit products, rule out cross-border lending and intervene in the lender’s credit-grating processes to the detriment of the consumer.¹³⁵ The Group was particularly concerned that, in contrast to the UK legislation directing the lender *not* to lend irresponsibly, the Directive seeks to dictate how the lender should act in every case. They saw that as abrogating the right of lenders to make their own risk assessment and potentially subjecting them to speculative civil claims by their customers, thereby forcing lenders to adopt defensive lending systems¹³⁶

¹³⁰ Irresponsible lending would be included as a matter to be taken into consideration by the court in determining whether there was an unfair credit relationship within the meaning of s.140A of the Consumer Credit Act 1974 as inserted by s. 19 of the Consumer Credit Act 2006.

¹³¹ Q 13

¹³² Q 14

¹³³ CIG views at QQ 75–80, pp 34–39, p 53, pp 53–57, pp 57–58. See also the evidence of the Minister (QQ 221–223) to the effect that it was hard to define responsible lending and that this was best left to the courts. Debt on Our Doorstep submitted evidence which included a statement of Six Principles for Responsible Lending. These formed the basis of the Principles for Responsible Lending adopted by the National Community Reinvestment Coalition in Brussels in April 2006. (pp 109–114)

¹³⁴ pp 34–39, p 53, pp 128–146, pp 57–58.

¹³⁵ pp 34–39, p 53

¹³⁶ pp 53–57

203. The European Banking Federation was also concerned with the potential private law liability that Article 5 might impose. The Federation considered that responsible lending was a matter for banking supervision, not private law, and also noted that it was not accompanied by a balancing provision for responsible borrowing.¹³⁷
204. The joint written evidence from Citizens Advice, the National Consumer Council and *Which?* noted that the number of consumer debt enquiries received by Citizens' Advice Bureaux (CAB) had grown by 118% over the last 10 years. In 2004/5 the CAB dealt with over 5 million problems, almost a fifth of which related to credit indebtedness. The three bodies support the responsible lending principle but consider that it is poorly defined, and that it is not clear how Member States are to ensure compliance.¹³⁸ They tend to agree with the Government that responsible lending does not lend itself to a single definition; what was needed was guidance to lenders, backed up by regulation. The National Consumer Council likewise considered that flexibility was needed, particularly because there were different problems in different Member States.¹³⁹
205. Ms McCarthy thought that it would be wrong to try to tackle the problems of indebtedness through the Directive, although better quality credit products and improved information could help to prevent indebtedness. Poor lending practice was often a cause of bad debt, but it was hard to see how it could be monitored effectively. It was not clear how the "duty to advise" should be interpreted. The Parliament was still considering how best to deal with this.¹⁴⁰
206. Professor Weatherill thought "responsible lending" was a "nebulous" concept which would be hard to define legally. Apart from the possibility of some general statement of obligation on credit suppliers, he considered it would be best to leave the problem to be tackled at national level, according to local needs and circumstances.¹⁴¹
207. Both the National Consumer Council and Citizens Advice¹⁴² felt that the Directive should do more to tackle the post-contractual practices of some lenders over debt collection, undue default charges and irresponsible debt consolidation.
208. The DTI's provisional position, as reflected in its supplementary consultation paper,¹⁴³ is that while the revised Article 5 is an improvement on the previous draft there are still grounds for concern. If Article 5 is intended to confine the duty of responsible lending to the provision of pre-contractual information and a creditworthiness check then, since it is a full harmonisation provision, that might preclude action by Member States in clear cases of irresponsible lending. On the other hand, a general responsible lending requirement ignores the fact that ultimately it is for the lenders to

¹³⁷ pp 128–146

¹³⁸ pp 59–61. Article 5 does not itself prescribe any sanctions for non-compliance, that being left to rules laid down by Member States (Art. 22), the only requirement being that the penalties provided for must be "effective, proportionate and dissuasive."

¹³⁹ Q 110

¹⁴⁰ QQ 138–140

¹⁴¹ QQ 188–191

¹⁴² Q 107

¹⁴³ See footnote 3, pp. 26–27.

decide how best to assess the creditworthiness of potential borrowers. The DTI supplementary consultation paper¹⁴⁴ suggests recasting the requirement to prohibit *irresponsible* lending. That would be line with the newly-added provision of the Consumer Credit Act referred to above.

Our Views on the Approach to Responsible Lending in Article 5

209. It is clear from the evidence we have received that British creditors do not dispute the good sense and fairness of the policy embodied in Article 5, namely that creditors should adhere to the principle of responsible lending and that this involves both the provision of adequate pre-contract information to the consumer and a proper assessment of the consumer's creditworthiness. Moreover, despite the large-scale marketing of consumer credit which is unavoidable if products are to penetrate the market, the evidence we have received from the UK consumer credit industry insists that it is the almost invariable practice of lenders to appraise the creditworthiness of consumers who apply for credit in response to the marketing where information about them is not already on file.
210. Nevertheless, in the light of the accumulated experience of the CAB and other organisations dealing with the problems of the over-indebted consumer in the UK, we do not feel able to accept the view that this should be left entirely to self-regulation, although we acknowledge that self-regulation has a useful role to play. Given that the duty to refrain from irresponsible lending is now enshrined in UK legislation, we do not see how the UK can argue that self-regulation suffices for the purpose of Community law.
211. We have not been able to examine the extent to which the British experience is relevant to that of other Member States. We accept that much will depend on local circumstances, with which Member States are best-placed to deal. On the other hand, we would expect the convergence of business practices in this field to generate similar problems, if they have not already done so. We therefore see the need to establish a common benchmark of essential requirements on the lines of Article 5, around which Member States could frame their own consumer protection measures as appropriate.
212. However, it does seem to us that the ambit of the duty to lend responsibly is uncertain. While responsible lending is probably not susceptible to a comprehensive legal definition, we consider that Article 5(1) should be revised to make it clear whether the content of the duty is limited to fulfilment of the specific requirements laid down in other paragraphs of Article 5 or whether these requirements are simply illustrations of a more general duty. In the latter case, we consider that duty should be left in the hands of Member States to interpret through local laws and regulations that take account of local circumstances, so long as the requirements of Article 5(2) and (5) are satisfied. Much would also depend on the effectiveness of local regulatory practice.
213. We also have some sympathy with the industry view that the ambit of the duty to provide the consumer with explanations, including the advantages and disadvantages of products, is unclear and could impose burdens beyond those the creditor could reasonably be expected to assume. It is true that effect of the last sentence of Article 5(5) is to leave it to Member States to

¹⁴⁴ See footnote 3, pp 10/11

determine the manner and extent to which the assistance to the consumer is to be given. It is also true that the new section 140A of the Consumer Credit Act (see paragraphs 108–109) is as indeterminate as Article 5(1) and (5) of the Directive. On the other hand, we see some force in the argument that there is a difference in kind between a duty to refrain from lending irresponsibly and a duty to furnish the consumer with the advantages and disadvantages of the products offered so as to enable him or her to make an informed choice. Lenders cannot reasonably be expected to denigrate their own products, and there are limits to the extent to which they can be expected to take steps to protect intending borrowers from the consequences of their failure to have proper regard to their own interests. After all, it is always open to the consumer to ask for more information.

214. We believe it would be reasonable to provide that (a) lenders should not engage in irresponsible lending, and (b) that consumers should be given the information prescribed by Article 5(2) and any further information about the products offered which they may reasonably require and which is known to the lender and is practicable for the lender to furnish. But we do not believe that the onus should be on lenders to explain the relative advantages and disadvantages of different products. That is a matter on which consumers should be expected to exercise their own judgment. Article 5 should be revised accordingly.
215. We note that section 33E of the Consumer Credit Act 1974, inserted by section 42 of the Consumer Credit Act 2006, expressly provides for the preparation and publication of guidance by the OFT in relation to the manner in which it exercises its new statutory powers over licensees. Experience in implementing that guidance in relation to the requirement not to engage in irresponsible responsible lending may shed valuable light on the implications of Article 5, in whatever form it finally appears. Given the uncertainties of this Article, effective regulatory supervision will be critical and a vital potential safeguard.
216. In preparation for the Commission's review of the Directive 5 years after entry into force under Article 24, we suggest the Government should invite the OFT to consult with its counterparts in other Member States to compare best practice and offer suggestions on practical ways of implementing that requirement in relation to developments in the market. We hope that this might contribute to a fresh approach by the Commission to the problem and perhaps to the drawing up of some useful guidelines for EU regulators. But in doing so, important national differences of implementation would need to be given due weight. Any guidelines would also need to avoid being unduly prescriptive.
217. Our Interim Report¹⁴⁵ suggested that consideration might also be given to the desirability and feasibility of common measures to curb high-pressure sales tactics, deliberate mis-selling of credit products, extortionate interest rates, irresponsible extension of credit levels and debt consolidation, and coercive debt-collection practices. That reflects concerns expressed to us in evidence by the National Consumer Council and Citizens Advice.¹⁴⁶ Article 5 does not itself deal with aggressive or otherwise abusive or undesirable marketing practices. But we note that there is a separate and more general Directive on

¹⁴⁵ HL Paper 37 (see footnote 2)

¹⁴⁶ Q 107

Unfair Business-to-Consumer Commercial Practices¹⁴⁷ which prohibits unfair and aggressive commercial practices and misleading actions and omissions.

Conclusions and Recommendations

218. **While the amount of over-indebtedness in the UK does not appear to have risen significantly relative to the amount of credit extended, we conclude that it nevertheless gives cause for concern. Moreover, we see a serious risk of a substantial increase in the level of default if interest rates were to rise or there were to be a significant deterioration in the economic environment.**
219. **We accept that the concept of responsible lending, in the sense of not lending irresponsibly, is accepted by all interest groups in the UK, and that codes of practice already require prior assessment of creditworthiness and the provision of information on key features of products offered. But we conclude that making of offers of credit on the basis of inadequate information in a highly-pressured marketing environment contributes to the causes of over-indebtedness.**
220. **We further conclude that, while self-regulation, including the adoption of codes of practice, has an important role to play in ensuring responsible lending, it should not displace the need for legislation.**
221. **On the whole, we accept that, for the time being, necessary measures to protect consumers from irresponsible lending are best left for Member States to evolve in the light of local circumstances, as has been done in the 2006 Consumer Credit Act. Nevertheless, we conclude that there is a need for some Community-wide framework for the regulation of irresponsible lending.**
222. **But we have reservations about the concept of responsible lending as a satisfactory basis for a legal requirement. Moreover, it is unclear from Article 5 whether the requirement of responsible lending is limited to fulfilment of the conditions specified in Article 5(2) and (5) or is a general concept of which these conditions are merely illustrations. We recommend that Article 5(1) be revised to clarify this point.**
223. **If Article 5(1) is intended to prescribe a general duty relating to responsible lending, we recommend that it should be amended to make it a duty not to engage in irresponsible lending. For the time being, the interpretation should be left to Member States through their own national laws, regulations and regulatory practices.**
224. **We also recommend that consumers should be given the information prescribed by Article 5(2), and that Article 5(5) should be reworded so as to limit the lender's duty to the provision of further information about the products offered which the consumer may reasonably require and which is known to the lender and practicable for the lender to furnish.**

¹⁴⁷ Directive 2005/29/EC dated 11 May 2005.

225. **We conclude that effective regulation is a vital safeguard, given the uncertainty of Article 5, which must be taken fully into account when the Directive is reviewed 5 years after entry into force under Article 24. We therefore recommend that practical guidelines on interpreting responsible lending, recognising important national differences and avoiding being unduly prescriptive, should be drawn up after full consultation with national regulators as part of that review process.**

CHAPTER 10: CONCLUSIONS AND RECOMMENDATIONS

Chapter 1—Introduction

226. We commend this Report to the attention of the House and recommend that it should be debated by the House as soon as possible in the hope of drawing wider attention to the issues raised and as a contribution to further consideration of this Proposal by the Government, the European Commission and the European Parliament.

Chapter 5—Full Harmonisation as a means to promote the Internal Market

227. We do not doubt the important potential benefits to business and consumers of developing an internal market in consumer credit, but only how best this is to be achieved. The Commission's focus is on the development of a market in *cross-border* credit, and it sees full harmonisation as advancing that objective. But we conclude that the Commission's case for a move to this approach in the field of consumer credit is based on a questionable premise that this will promote an internal market in cross-border credit by facilitating the use of a single EU-wide credit agreement. That premise is not supported by a proper impact assessment, or by any other evidence that we have seen.
228. On the basis of the evidence we have been given, we further conclude that:
- at present the lack of a market in cross-border consumer credit is mainly due to other factors, such as language, culture and the impracticability of penetrating a foreign market except by scale entry requiring an establishment in the target country, and that full harmonization is unlikely either to displace the need for separate credit agreements for each Member State or to facilitate an internal cross-border market for other reasons.
 - the most effective way of creating an internal market is to encourage a greater convergence of market development and practice through other means, such as the establishment or acquisition of branches and subsidiaries and the borrowing of foreign market products and practices by local lenders, as is already happening, and the removal of local obstacles such as legal and administrative impediments to establishment, employment, conduct of business and taxation policies.
 - full harmonization may well be appropriate at the point when a broadly similar range of products is available throughout the European Union on competitive terms.
229. We therefore strongly recommend that further work on the present draft Directive should be suspended until a proper impact assessment has been carried out. Unless this provides compelling evidence that the full harmonisation proposed would be likely to promote an internal market in cross-border consumer credit, the principle of targeted harmonization should be retained but the scope of the Directive should be extended to cover a wider range of issues.

Chapter 6—Does the Directive provide a High Level of Consumer Protection?

230. We conclude that, while the draft Directive possesses many good features and may well provide a high level of consumer protection in those Member States whose consumer credit markets and legislation are relatively undeveloped, its very limited scope means that it affords a level of consumer protection which falls well short of that provided by legislation in such countries as the UK.

Chapter 7—The Full Harmonisation Provisions of the Directive and their Potential Effect on the Level of Consumer Protection in the UK

231. We recommend that:

- the definition of the word “surety” in the 2004 draft should be reinstated, and the term “mortgage” or “security interest” used to denote security in an asset;
- hire-purchase agreements should not be excluded from the scope of the Directive;
- the provisions relating to contract and pre-contract information should not apply to overdrafts which should continue to be governed by the other provisions of the Directive so far as applicable;
- ideally credit unions should be excluded from the Directive altogether on the basis that it would be open to any Member State to regulate credit unions in its domestic legislation if it considered that local conditions made this desirable;
- but if credit unions are to be kept within the Directive the concept of the common link embodied in Article 2(4)(b) should be expanded to encompass other types of link on which credit unions are based and the “light touch” regime applicable to credit unions should be made lighter;
- the wording of Article 3(c) should be amended to distinguish the provision of pay-as-you-go services from services provided on credit;
- the definition of “credit intermediary” should be narrowed to exclude those for whom it is inappropriate, for example, mail order traders.

232. We recommend that:

- if Article 4 is intended as a full harmonization measure, that should be made clear, for example by substituting the word “state” for “include.”;
- Article 4(4) could usefully be clarified to show its link with Article 4(2) and the fact that use of a representative example is permitted;
- in the case of low introductory rates consideration should be given to a requirement to state the go-to rate (i.e. the higher rate charged at the end of the introductory period) instead of a blended rate.

233. We recommend that:

- Article 9 should be made a minimum harmonization provision since, as a full harmonization measure, it would deprive UK consumers of a number of items of information currently required to be included in

consumer credit agreements, thereby significantly reducing the level of consumer protection;

- Article 9 should also be amended to cater for cases where the relevant facts required, other than for the calculation of the APR, are not known at the time of the agreement, e.g. by providing assumptions or permitting the use of estimated information;
- Article 9 should also be amended to address the exchange rate problem in stating the total cost of credit where one party is based in a Member State outside the Eurozone and the other is in a Member State within the Eurozone;
- the creditor should not be required to provide details of costs incurred by the consumer to third parties which do not enter into the total cost of the credit as defined by Article 3(f);
- the requirement to provide an amortisation schedule should be dropped.

234. We conclude that there appears to be general support for uniform rules on the consumer's right of withdrawal as provided by Article 13, and we recommend that the DTI should consider and report to the Committee whether the detail is satisfactory in the light of responses to the its supplementary consultation paper.
235. We conclude that Article 16, which requires notice of assignment to be given in all cases where the creditor assigns its rights under the agreement, does not represent the present law in the UK and would cause confusion to consumers and disturb a practice of very long standing by which suppliers who block discount consumer credit agreements to finance houses continue to maintain customers' accounts and responsibility for collections without giving notice of assignment.
236. Article 16 would function perfectly well if limited to cases where the assignee wishes to take steps to collect payment, at which point notice of assignment would be required. We therefore recommend that Article 16 be amended accordingly.
237. We therefore recommend an amendment to Article 19 to restore the exemption contained in the 2004 draft by which credit institutions authorized in a Member State under the banking consolidation Directive 2000 do not require authorization to conduct business in another Member State.
238. We conclude that the current UK legislative provisions and cross-border collaboration arrangements appear adequate to fulfil the requirements of the Directive relating to out-of-court dispute resolution. We therefore have no recommendations to make concerning Article 23.
239. In addition to the difficulties of full harmonization to which attention has already been drawn, we are concerned that it would remove the flexibility which Member States currently have to respond rapidly through new regulations to the emergence of new products and practices. We therefore recommend that, except in relation to those full harmonisation provisions which we have identified as generally acceptable, the concept of minimum harmonisation should be retained.

Chapter 8—Mutual Recognition

240. We conclude that the mutual recognition provisions contained in Article 21(2) are confusing, unnecessary and detrimental to the interests of consumers. To allow a foreign creditor (as regards provisions relating to the right of withdrawal, claims against the creditor for the supplier's breaches, and early payment and rebates), to invoke the mode of implementation of the Directive prescribed by its own law rather than that of the consumer causes serious problems. In the first place, it exposes consumers to two different sets of mandatory rules without their even being aware of that fact. Secondly, it prevents consumers from obtaining local advice as regards the foreign mandatory rules. Thirdly, in the event of proceedings by the creditor in the consumer's Member State, the parties would incur delay and considerable expense in arranging for experts on both sides conversant with the foreign law concerned to give evidence (and possibly conflicting evidence) of its content and effect. This is particularly inappropriate for proceedings against a consumer.
241. We therefore recommend that, in relation to mandatory rules, the debtor should be governed solely by his or her own law and therefore that Article 21(2) should be deleted.

Chapter 9—Responsible Lending

242. While the amount of over-indebtedness in the UK does not appear to have risen significantly relative to the amount of credit extended, we conclude that it nevertheless gives cause for concern. Moreover, we see a serious risk of a substantial increase in the level of default if interest rates were to rise or there were to be a significant deterioration in the economic environment.
243. We accept that the concept of responsible lending, in the sense of not lending irresponsibly, is accepted by all interest groups in the UK, and that codes of practice already require prior assessment of creditworthiness and the provision of information on key features of products offered. But we conclude that making of offers of credit on the basis of inadequate information in a highly-pressured marketing environment contributes to the causes of over-indebtedness.
244. We further conclude that, while self-regulation, including the adoption of codes of practice, has an important role to play in ensuring responsible lending, it should not displace the need for legislation.
245. On the whole, we accept that, for the time being, necessary measures to protect consumers from irresponsible lending are best left for Member States to evolve in the light of local circumstances, as has been done in the 2006 Consumer Credit Act. Nevertheless, we conclude that there is a need for some Community-wide framework for the regulation of irresponsible lending.
246. But we have reservations about the concept of responsible lending as a satisfactory basis for a legal requirement. Moreover, it is unclear from Article 5 whether the requirement of responsible lending is limited to fulfilment of the conditions specified in Article 5(2) and (5) or is a general concept of which these conditions are merely illustrations. We recommend that Article 5(1) be revised to clarify this point.

247. If Article 5(1) is intended to prescribe a general duty relating to responsible lending, we recommend that it should be amended to make it a duty not to engage in irresponsible lending. For the time being, the interpretation should be left to Member States through their own national laws, regulations and regulatory practices.
248. We also recommend that consumers should be given the information prescribed by Article 5(2), and that Article 5(5) should be reworded so as to limit the lender's duty to the provision of further information about the products offered which the consumer may reasonably require and which is known to the lender and practicable for the lender to furnish.
249. We conclude that effective regulation is a vital safeguard, given the uncertainty of Article 5, which must be taken fully into account when the Directive is reviewed 5 years after entry into force under Article 24. We therefore recommend that practical guidelines on interpreting responsible lending, recognising important national differences and avoiding being unduly prescriptive, should be drawn up after full consultation with national regulators as part of that review process.

APPENDIX 1: SUB-COMMITTEE G (SOCIAL AND CONSUMER AFFAIRS)

The Members of the Sub-Committee which conducted this Inquiry were:

Lord Colwyn
Earl of Dundee
Baroness Gale
Baroness Greengross
Lord Harrison
Baroness Howarth of Breckland
Baroness Morgan of Huyton
Lord Moser
Baroness Neuberger
Baroness Thomas of Walliswood (Chairman)
Lord Trefgarne

Declarations of Interest

A full list of Members' interests can be found in the Register of Lords Interests:

<http://www.publications.parliament.uk/pa/ld/ldreg.htm>

Members have drawn particular attention to the following relevant to this inquiry.

Lord Colwyn
Chair, Campbell Montague Int. Ltd

Baroness Neuberger
Member/Trustee of the British Council
Non-Executive Director, VHI (Irish health insurer)

APPENDIX 2: TABLE OF CONTENTS AND TEXT OF THE REVISED DRAFT DIRECTIVE ON CONSUMER CREDIT AND UK LEGISLATION THAT MAY BE AFFECTED BY IT

Note: “M” means that the provision provides a minimum standard, Member States being free to add further measures for the protection of the consumer. “H” means that the provision is a harmonisation rule from which Member States may not deviate. “G” means that the provision is general, leaving the mode of implementation to Member States. For some provisions this classification is not applicable and for one it is mixed. Details of UK legislation affected by the Directive or needing review in the light of its provisions are shown in italics.

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	Determinations of the OFT under section 74(1)(b) and (c)
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	Consumer Credit Act 1974, sections 43–47
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	Consumer Credit (Advertisements) Regulations 2004
Article 5 (H)	Pre-contractual information
	Consumer Credit Act 1974, sections 61, 62, 64, 65, 140A*
	Consumer Credit (Cancellation Notices and Copies of Documents) Regulations 1983
Article 6 (H)	Pre-contractual information for credit grantors in the form of an overdraft facility and for certain specific credit agreements
	Consumer Credit Act 1974, section 74(1)(b)
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CHAPTER III	DATABASE ACCESS
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Article 9 (H)	Information that must be included in credit agreements
	Consumer Credit Act 1974, sections 61, 63–65

- Consumer Credit (Agreements) Regulations 1983, as amended
- Consumer Credit (Total Charge for Credit) Regulations 1980
- Consumer Credit (Disclosure of Information) Regulations 2004
- Article 10 (H) Information on the borrowing rate
Consumer Credit Act 1974, section 82
- Consumer Credit (Notice of Variation of Agreements) Regulations 1977
- Article 11 (H) Credit agreement in the form of an overdraft facility
Consumer Credit Act 1974, section 78
- Consumer Credit (Running-Account Credit Information) Regulations 1983
- Consumer Credit (Prescribed Periods for Giving Information) Regulations 1983
- Article 12 (H) Open-end credit agreement and long term agreements
- Article 13 (H) Right of withdrawal
Consumer Credit Act 1974, sections 56, 57, 67–74
Determination of OFT under section 74(1)(b) and (c)
- Article 14 (M) Linked transactions
- Article 15 (H) Early repayment (but rebate calculation left to Member States so long as it results in an “equitable reduction”)
Consumer Credit Act 1974, sections 94 and 95
Consumer Credit (Early Settlement) Regulations 2004, regs 2–4 (cases where no entitlement to rebate).
Note: the creditor’s “right of indemnity” under the draft Directive does not feature as such in the rebate regulations but is indirectly picked up in the rule as to deferment of the settlement date.
- Article 16 (mixed) Assignment of rights
- Article 17 (H) Overrunning of the total amount of credit
- CHAPTER V ANNUAL PERCENTAGE RATE OF CHARGE
- Article 18 (H) Calculation of the percentage rate of charge
Consumer Credit (Total Charge for Credit) Regulations 1980
- CHAPTER VI CREDIT INTERMEDIARIES
- Article 19 (G) Regulation of creditors and credit intermediaries
Consumer Credit Act 1974, section 145
- Article 20 (H) Obligations of credit intermediaries
Consumer Credit Act 1974, section 155

CHAPTER VII	IMPLEMENTING MEASURES
Article 21	Harmonisation, mutual recognition and imperative nature of the Directive
Article 22 (G)	Penalties
Article 23 (G)	Out-of-court dispute resolution
Article 24	Transposition
CHAPTER VIII	TRANSITIONAL AND FINAL PROVISIONS
Article 25	Repeal
Article 26	Transitional measures
Article 27	Amendment to Directive 93/13/EEC
Article 28	Entry into force and applicability
Article 29	Addressees
ANNEX	The basic equation expressing the equivalence of drawdowns on the one hand and repayments and charges on the other <i>Consumer Credit (Total Charge for Credit) Regulations 1980.</i>

APPENDIX 3: INFORMATION REQUIREMENTS OF EXISTING UK LEGISLATION GOVERNING THE FORM AND CONTENT OF CREDIT AGREEMENTS THAT WOULD HAVE TO BE DROPPED UNDER THE DIRECTIVE AS FALLING OUTSIDE ARTICLE 9(2)

1. Heading and type of agreement.
2. List of goods and services financed by the credit.
3. Cash price of goods and services financed by the credit.
4. Any different rates of interest payable in different circumstances.
5. Details of how and when interest charges are applied.
6. Financial information to be shown together as a whole with no interspersal.
7. Running-account credit: credit limit.
8. Mode of appropriation of payments to be allocated for different purposes.
9. Any scope for benefits from tax relief.
10. Details of when/where variations might occur during the agreement and that no account has been taken of them.
11. Description of goods taken in pawn.
12. Statutory statements:
 - (1) Restriction of liability on termination of conditional sale agreement
 - (2) Liability to repossession of goods if default in payment under a conditional sale agreement
 - (3) Rights of pledgor under pawn agreement not exempt from the Directive (because liability not limited to the pawn), including right to redeem
 - (4) Notices for multiple agreements.
13. Rules governing signatures and signature boxes.
14. Form and content of modifying agreements.

APPENDIX 4: CALL FOR EVIDENCE

Sub-Committee G of the House of Lords EU Select Committee started an Inquiry in June of this year into European Commission proposals for harmonisation of consumer credit laws and regulations in the EU to replace the current EU Directives on consumer credit.

The Inquiry was suspended when the Commission announced that the draft text then under consideration was shortly to be replaced. The Select Committee issued an Interim Report on the Inquiry (HL Paper 137) on 27 July, based on the evidence received to that date.

On 7 October the Commission issued a new text for the proposal entitled:

Modified proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers amending Council Directive 93/13/EC (Commission reference 13193/05 COM (2005) 483 final) which is available on the Commission (DG SANCO) website: http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2005/com2005_0483en01.pdf

The Sub-Committee has decided to resume the Inquiry by examining this new proposal and would welcome written evidence about it, both from those who have already given evidence to the Inquiry and from any other interested parties.

The Commission proposal has three main stated objectives: establishing the conditions for a genuine internal market in consumer credit; ensuring a high level of consumer protection; and, improving the clarity of EC regulation by recasting the three existing Directives on consumer credit.

The Sub-Committee would particularly welcome views on:

- whether it is currently feasible or desirable to introduce a Directive to create a single EU-wide cross-border market in consumer-credit;
- what would be the consequences of attempting to achieve that objective in the way proposed by the Commission, in particular by the introduction of maximum harmonisation as opposed to minimum standards (which are the basis of the existing Directives) and by applying the law of the creditor's State instead of that of the debtor to certain requirements imposed by the revised Directive;
- what changes should be made to the current EU Directives to ensure in current circumstances appropriate and effective EU-wide minimum standards for consumer-credit transactions that would give greater certainty for credit suppliers and improved protection for EU consumers;
- what elements should be left to national legislation or self-regulation in Member States; and,
- the extent to which the Commission's modified proposal meets, or fails to meet, those requirements.

Interested parties are invited to submit a concise statement of written evidence to this Inquiry by **Wednesday 14 December 2005**.

APPENDIX 5: LIST OF WITNESSES

The following witnesses gave evidence. Those marked with * gave oral evidence and written evidence

Association of British Credit Unions Limited

Association of Chartered Certified Accountants (ACCA)

Barclays

Citizens Advice*

Debt on our Doorstep

Department of Trade and Industry*

European Banking Federation

European Banking Industry Committee (EBIC)

European Commission*

European Federation of Finance Houses Association (Eurofinas)

Experian

Financial Ombudsman Service

Institute of Credit Management

Dr Paul A Jones, Liverpool John Moores University

Lloyds TSB

Mail Order Traders' Association

Arlene McCarthy MEP*

Joachim Wuermeling MEP, Kurt Lechner MEP and Malcolm Harbour MEP

National Consumer Council*

UK Cross Industry Group*

Professor Stephen Weatherill, Somerville College, Oxford*

Which?

APPENDIX 6: RECENT REPORTS

Recent Reports from the Select Committee

Session 2005–06

Scrutiny of Subsidiarity: Follow up Report (15th Report, Session 2005–06, HL Paper 66)

Evidence by Commissioner Franco Frattini, Commissioner for Justice, Freedom and Security on Justice and Home Affairs Matters (1st Report, Session 2005–06, HL Paper 5)

Ensuring Effective Regulation in the EU (9th Report, Session 2005–06, HL Paper 33)

Evidence from the Minister for Europe—the European Council and the UK Presidency (10th Report, Session 2005–06, HL Paper 34)

Reports prepared by Sub-Committee G (Social Policy and Consumer Affairs)

Session 2003–2004

The Working Time Directive: A Response to the European Commission’s Review (9th Report, Session 2003–04, HL Paper 67)

Sexual Equality in Access to Goods and Services (27th Report, Session 2003–04, HL Paper 165)

Session 2004–2005

Proposed European Union Integrated Action Programme for Life-long Learning (17th Report, Session 2004–05, HL Paper 104)

Session 2005–2006

Proposed EU Consumer-Credit Harmonisation Directive: Interim Report (13th Report, Session 2005–06, HL Paper 37)

Paediatric Medicines: Proposed European Union Regulation (20th Report, Session 2005–06, HL Paper 101)

Proposed European Institute for Gender Equality (24th Report, Session 2005–06, HL Paper 119)