CONSUMER LENDING IN THEORY AND PRACTICE

PETR TEPLÝ

KAROLINUM

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APR	annual percentage rate of charge
CBA	the Czech Banking Association
CCA	the Consumer Credit Act
CCB	CRIF – Czech Credit Bureau, a. s.
CNB	the Czech National Bank
CLFA	the Czech Leasing and Financial Association
ČSOB	Československá obchodní banka, a. s.
CSR	corporate social responsibility
CTIA	the Czech Trade Inspection Authority
ECB	the European Central Bank
FA	Financial Arbitrator
GDP	Gross Domestic Product
HC	Home Credit International a. s.
MCD	Mortgage Credit Directive
MFCR	the Ministry of Finance of Czech Republic
MIT	the Ministry of Industry and Trade
NERV	the National Economic Council of the Government
NGO	non-governmental organization
NRL	the Navigator of Responsible Lending
PIGS	Portugal, Italy, Greece, Spain
OECD	the Organisation for Economic Co-operation and Development
RMBS	Residential Mortgage-Backed Security

FOREWORD

This book deals with consumer lending from both theoretical and empirical points of view. The first section, focusing on theory, presents definitions of responsible lending and responsible borrowing. Next, the book discusses theoretical aspects of regulation and supervision over consumer markets and concludes with a discussion on the wider context of financial literacy, household indebtedness and the Czech consumer credit market including relevant legal, regulatory, supervisory and risk management issues. In the empirical section, the book uses The Navigator of Responsible Lending as an evaluation tool to assess both bank and non-bank consumer credit in the Czech Republic. Enclosures to the book include additional texts relevant to consumer lending (including targeted case studies and an English translation of the Czech Consumer Credit Act) and therefore provide the reader with several perspectives on the topic. The analyses and conclusions presented by the author are on the leading edge of basic and applied research since theoretical concepts are applied to, and tested against, real financial data. The complexity and rigorousness of the case studies and analyses in the book follow the conventions of the Law and Economics branch of science. Although our empirical research is done as a case study on the Czech Republic, its basic ideas and analysis methodologies might be easily applied to other countries as well.

Finally, we would like to thank our reviewers Associate Professors Eva Zamrazilová and Vladislav Pavlát for their valuable comments on the book. In addition, we extend our gratitude to Prof. Michal Mejstřík and his research team at EEIP, a. s. for expert comments on the empirical part of the work, Ms. Yael Roshwalb for her valuable contribution in editing this book, and finally to an employee of Karolinum Press, Mr. Jan Hejzl. The remaining errors and omissions naturally remain responsibility of the author.

In Prague on 25 November 2015
Petr Teplý

THEORETICAL PART

1. THEORETICAL BACKGROUND: DEFINITION OF RESPONSIBLE BORROWING AND LENDING

In this chapter we address the dual concepts of responsible borrowing and lending, which are the key concepts for the construction of The Navigator of Responsible Lending in the empirical part of this book. In the past, responsible lending has received attention from world institutions and organizations as documented by works of Financial Stability Board (2011), OECD (2011) or more recently by World Bank (2012), Hubbard-Solli (2013) or Prouza (2013). Responsible borrowing and lending should be considered in a broader context of the over-indebtedness of the population (Porter, 2012) and of financial inclusion (World Bank, 2013). To address over-indebtedness effectively, we split the issue into two parts: prevention (ex-ante approach) and alleviation of the consequences of over-indebtedness (ex-post approach), as shown in Table 1.

Alternatively, Prouza (2013)[1] identifies a primary reason for households' borrowing: the need to have steady living conditions over the years,[2] which is possible through obtaining debt. Obviously, not all households can afford pay their debts, especially when young families overstate their future income, which can partly be explained by the life-cycle economic theory (Betti, 2007). Moreover, Prouza (2013) lists three main drivers of households' over-indebtedness: financial imprudence, the occurrence of unexpected events and poverty. First, financial imprudence means poor financial decisions-making resulted

1 See also Section 9.5 for a detailed discussion on regulation of the global consumer credit market.

2 Compare with the Friedman's Permanent Income Hypothesis developed by Friedman (1957).

Table 1: Six factors of over-indebtedness

Over-indebtedness factors
Prevention of over-indebtedness
• Responsible lending • Responsible borrowing and cash management • Responsible loan repayment management
Alleviation of the consequences of over-indebtedness
• Debt counselling • Court solutions • Out-of court solutions

Source: Author based on European Commission (2007)

either from poor planning of future expenses and income (Tufano, 2009) or from the individual's over-confidence bias to repay debt (Kilborn, 2005). Second, the occurrence of unexpected events that affect debt repayment causes another driver of over-indebtedness (Morduch, 1995). This can happen on the individual-specific level (either through lower income resulting from a job loss or through higher expenses resulting from expensive medical care or through family issues such as divorce) or on the debt contract-specific level (a sudden rise in interest rates or lower value of collateral). Finally, poverty might cause heavy over-indebtedness[3] when people with low creditworthiness take loans to cover their expenses and do not earn enough to repay their debts. Even worse, some people take out a new loan, not only to repay current loans, but also to cover expenses on execution, which implies a vicious circle. Teplý (2012b) compares this vicious circle of indebtedness with Uroboros, a mythic snake eating its own tail, showing that short-term distorted thinking (e.g. taking a new loan on current loan repayment) can result in long-term catastrophic consequences (e.g. personal bankrupcy or repossession).

There are several definitions of responsible lending and borrowing. In general terms, we distinguish that i) responsible lending refers to the offer of loans (by lenders) and ii) responsible borrowing refers to the demand for loans (by borrowers). With respect to the above general definitions, responsible lending and borrowing requires fair play on both sides. Responsible borrowing is an essential counterpart of responsible lending, because loan providers depend on correct and complete information from and about the potential borrower. We want to highlight that asymmetric information ranks to one of key issues of finance, which was first discussed in the seminal article by Akerlof (1970).

3 See Section 9.3 for a more detailed discussion on indebtedness. We should note that excessive indebtedness of households might result in systemic risk (i.e. the risk of market contangion resulting in lower financial stability of the whole sector).

1.1 DEFINITION OF RESPONSIBLE LENDING

However, no unique definition of responsible lending[4] exists. For instance, European Commission (2009a) offers the following definition: "*Responsible lending means that credit products are appropriate for consumers' needs and are tailored to their ability to repay. This may be obtained through having an appropriate framework in place to ensure that all lenders and intermediaries act in a fair, honest and professional manner before, during and after the lending transaction.*" We offer a different definition: "*Responsible lending does not cause any significant harm to the debtor and simultaneously maintains or increases his living standard*." From the lender's point of view, responsible lending can be viewed in two major areas: client creditworthiness assessment and product suitability assessment.

1.1.1 CLIENT CREDITWORTHINESS ASSESSMENT

Correct assessment of the client's creditworthiness is vital for credit granting. If the client's creditworthiness is underrated, there is a higher probability of the client's failure to repay the loan. Theoretically, the credit provider or intermediary should be concerned with correctly assessing the borrower, and the borrower should be concerned with proper repayment of the loan and the related costs, fees and expenses. However, this is not always the case. The European Commission (2009a) draws attention to the fact that a mortgage provider and intermediary may have different motivations where there is the possibility to:

1) Sell the mortgage collateral;
2) Transfer the borrower credit risk using financial derivatives.[5]

Credit providers and intermediaries are motivated not to perform proper evaluation of the clients' creditworthiness. This speeds up the process and, as a result, more clients are won and more commission is earned. Employees of financial institutions who are paid for the numbers and volume of loans sold regardless of what happens further with each credit case may have a similar motivation.

A similar situation can be expected in the Czech market: a financial institution lends money to a borrower with a low creditworthiness, assuming ex ante that the borrower will fail to repay the loan. If this is the case, the creditor seizes the collateral, e.g., a computer or domestic electronic devices etc. It should be mentioned in this context that some loan providers or their representatives offer to conclude a loan with the borrower at his or her home. Thus they will

4 See Sections 9.7 and 9.8 for case studies of responsible lending in a bank and a nonbank respectively.

5 For example, Residential Mortgage-Backed Security, "RMBS".

have an opportunity to assess the value of the things that can be seized in repossession in case of the borrower's default.[6] However, the provision of loans to borrowers with a low creditworthiness is in contravention of the CLFA Memorandum on Consumer Protection in Consumer Credit Provision.[7]

1.1.2 PRODUCT SUITABILITY ASSESSMENT

Besides client creditworthiness assessment, it is also necessary to assess the suitability of the credit product for the borrower. This can be done at two levels:
1) Assessment of the suitability of the product design;
2) Assessment of the suitability of the credit product for the given borrower.

As to product design, we should mention in particular the recent credit product innovations that have occurred in the USA and in some EU member countries including, though to a minor extent, the Czech Republic. Such innovative products are, for example, interest-only mortgages, self-certification mortgages or revolving credits. Although some EU member states have statutory limits on financial indicators, such as the loan-to-value ratio or loan-to-income ratio, these binding limits have not always been respected. As said, this has not been very common in the Czech financial market.

The European Commission (2009a) believes that there is room for significant improvement in assessing the suitability of particular products for particular clients. Examples include the sale of teaser-rate loans, which the borrower would need to refinance within a short period of time or risk moving to a much higher repayment level that may be unaffordable to him/her (this happened during the crisis in the USA). Loans issued in foreign currencies, which caused problems in Hungary and in the Baltic states, are another example (indebtedness in foreign currencies is not a problem in the Czech Republic). In Hungary, for instance, the proportion of mortgages in foreign currencies (especially in Swiss francs) was 64 % as at 30 September 2010. During the global crisis, clients' mortgage instalments increased significantly, owing to the depreciation of the Hungarian forint and to increased interest rates. The Hungarian government responded by taking a relatively extreme measure: mortgage provision in foreign currencies has been banned by law since August 2010 (Hungarian National Bank, 2010).

In evaluating the client's creditworthiness, the credit provider or intermediary should assess, for example, the following criteria (European Commission, 2009b):

6 The possibility of signing a contract at the client's home is officially presented as exclusive service.

7 http://www.clfa.cz/index.php?textID=94