

EFIN Research
Working Group on Over-Indebtedness

Unfair Lending Practices and Toxic Loans



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1. Definitions

a) *Unfair lending practices*

Unfair lending practices cover several types of practices:

- Use of misleading or oppressive behaviour when advertising, selling, or enforcing a credit agreement;
- Lack or poor creditworthiness assessment in order to check whether a borrower can afford to repay their loans;
- Lack or insufficient explanations on the key features of a credit agreement so borrowers cannot make an informed choice.

b) *Toxic loans*

Loans that are designed in such a way that it is almost impossible for the borrower to not be confronted at one time or another to a default of payment.

Predatory lending benefits the lender and ignores or hinders the borrower's ability to repay the debt. All the risks are passed on the borrowers. In addition, the lenders or their intermediaries often try to take advantage of a borrower's lack of understanding about loans, terms or finances.

2. Examples

Foreign currency loans

Definition and problem description

Foreign currency loan (hereafter 'FX loan') is defined as "*a credit agreement where the credit is (a) denominated in a currency other than that in which the consumer receives the income or holds assets from which the credit is to be repaid; or (b) denominated in a currency other than that of the Member State in which the consumer is resident.*"¹

During the 2000s, millions of consumers in Central and Eastern Europe (CESEE) took personal loans and home loans denominated in FX. At the time, interest rates of home loans in Swiss francs and euro were significantly lower than those in national currency, while providing high margin to the lenders. For example, in December 2008 in Romania, interest rates for CHF and EUR denominated home loans were about 6% and 8% respectively, while loans in lei cost about 10%.

Thus, consumers were encouraged to massively borrow in FX. For example, in 2013, in Hungary, Romania, Bulgaria, Croatia, Serbia, and Latvia, between 60% and 88% of the outstanding loans to the households were denominated in a foreign currency, mainly Swiss franc (CHF) and euro. But in 2008 the Swiss franc rose sharply, while other currencies, like

¹ Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (Mortgage Credit Directive), Art 4.

forint and zloty, were devalued. A second shock came later when the Swiss National Bank announced that it would no longer hold CHF at a fixed exchange rate with the euro, and subsequently CHF appreciated by 20%. This sent borrowers' monthly payments soaring in local-currency terms and leaving many of them owing more than their houses were worth.

Examples of increased debt burden for FX borrowers:

- A Polish consumer, who in 2007 borrowed CHF 250 000 (600 000 zlotys), in October 2013 was owing his bank 1.1 million zlotys. Total loss for Polish FX borrowers is estimated at 144bn zlotys (EUR 33bn).
- In 2008, an Austrian consumer borrowed CHF 214 000 (EUR 131 000) where the loan was combined with an investment vehicle, i.e. monthly repayments were put in an investment fund; the investment fund collapsed and CHF soared against EUR in January this year (EUR 1=CHF 1.05 versus CHF 1.2 previously); the consumer's debt increased by EUR 34 000 and he had to sell his apartment to service the debt.
- Slovenia: a representative example of a consumer who borrowed EUR 100 000 (in CHF) for 20 years in June 2006: initial monthly instalment of EUR 612 would grow to EUR 739 by the end of 2008 and to EUR 855 by January 2015. The remaining debt, starting at EUR 100 000, would still be at the level of EUR 99 004 in January 2015 despite high debt service. A consumer who would borrow the same amount on the same day in EUR would be owing only EUR 68 670 to the bank.

It can be argued that the FX lending in CESEE countries was a form of sub-prime lending as they combine several major risks all of which are passed on to the borrower: all of those loans are non-capped variable rate loans indexed on a foreign currency which has an impact not only on the monthly repayments, but also on the outstanding capital.

Banks claim that they could not possibly foresee huge FX fluctuations. Yet, according to an economist at the Swiss National Bank, *"banks in Europe have continuously held more foreign-currency-denominated assets than liabilities, indicating their awareness of the exchange-rate-induced credit risk they face."*

In France, UFC-Que Choisir had access to some BNP Paribas internal documents which show that the bank was well aware of the risk of rising Swiss Franc, while the documents distributed to the borrowers insisted on the stability parity for many years between the euro and the Swiss franc.

EU law and actions by Member States

The EU Mortgage Credit Directive Art 23 contains provisions on FX loans: depending on the transposition in each individual Member State, FX borrowers will have the right to convert their loan under certain conditions into an alternative currency or will be protected by alternative arrangements (e.g. caps, warnings), or both. However, the law will enter into force in all Member States only in March next year, plus it will not address the problem of the existing contracts.

As a response to market volatility, some Member States' authorities took decisive steps to protect distressed borrowers, while some others opted for soft measures out of fear of undermining the stability of the banking sector.

For examples, the Hungarian government fixed the Swiss franc-forint exchange rate at 180 until the end of 2014, thus allowing borrowers to convert their loans into local currency at a favourable rate. In France, the Consumer Law amended in 2013 prohibits selling FX loans to consumers, unless at least 50% of the borrower's income is in this foreign currency, or if this

borrower owns at least 20% of his assets in this currency². In 2010, the Austrian Financial Market Authority urgently recommended banks not to grant foreign currency loans to households. The Croatian government fixed the franc rate against the kuna at 6.39 for one year to put a cap on the mounting debts (burden for banks is estimated at about EUR 52 million), but the borrowers want the loans to be converted into the national currency and the interest rates to be reduced to the level where they stood when the loans were taken.

The measures adopted at national level are being scrutinised by the European Commission which could consider that some of them are obstacles to the free movement of capital within the EU, which might force the Member States concerned to reconsider their measures.

Case law

In recent years, a growing number of cases related to FX loans were brought before national courts and numerous questions submitted to the Court of Justice of the EU. Arguments of the plaintiffs were essentially based on provisions of the Unfair Contract Terms Directive and Unfair Commercial Practices Directive: unsuitable products sold to consumers; risk disclosure by providers insufficient or misleading; inappropriate assessment of borrowers' creditworthiness by banks, etc.

In April 2014 the European Court of Justice, ECJ, ruled on a Hungarian case, referred to it by a Hungarian Court: *Árpád Kásler and his wife v OTP Jelzálogbank*. The Káslers had contested the bank's charging structure, which they claimed unduly favoured the bank and also claimed the loan contract had not been clear: the contract authorised the bank to calculate the monthly instalment on the basis of the selling rate of the CHF, on which the loan was based, whereas the amount of the loan advanced was determined by the bank on the basis of the buying rate of the CHF. Following the ECJ judgement which partly sided with Káslers, in April 2014, the Hungarian Supreme Court ruled in favour of the Káslers: the fee structure had indeed favoured the bank and was not fair, the contract was not clear enough and the loan should be linked to interest rates set by the Hungarian Central Bank.

Payday loans – by EFIN,

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Definition and problem description

Payday loans are small short-term single-payment high-interest loans intended to carry the borrower through a temporary cash deficiency. As it is described by the payday lenders themselves, they are quick one-time loans expected to cover unexpected expenses, such as sudden medical costs or a breakdown of a car used for commuting. However, shiny from the surface, it has been a controversial topic for researchers and policy-makers.

On one hand, the advocates of payday lending state that these loans are the best option for the less fortunate who encounter unforeseen expenses. This claim does make sense: payday loans can be cheaper than paying overdraft fees to the bank or late fees for utilities. Nevertheless, neither the assertion of "one-time" borrowing nor "to cover unexpected expenses" is true: as it will be shown in the following chapters, their business model seems to actually heavily depend on borrowers' inability to afford the loan and their subsequent necessity to borrow multiple times.

Creditworthiness assessment – the weakest link

A significant reason for unfortunate consequences to the customer is a lack of assessment when

² Art L. 312-3-1 du code de la consommation.

applying for a loan. An appropriate assessment of credit worthiness should ensure that the borrowers do not experience substantial discomfort when returning the credit, however, a number of examples show that the ability to pay back is too often not evaluated properly.

A researchⁱ conducted by the Office of Fair Trading (OFT) in the UK found that most payday lenders do ask for a bank statement from their customers, however, it seems to be used only to validate employment or for fraud checking purposes, rather than to actually assess affordability.

Adding to this argument are the figures found by Lietuvos Bankas (the central bank of Lithuania)ⁱⁱ : in Lithuania, 39% of all payday borrowers are under the age of 25. More importantly, for a lot of these young customers, their relatives are the ones who pay back the loan. Hence, it raises questions about the thoroughness of the assessments if such a high number of young people who are still dependent on their families can receive a loan. Additionally, this brings up another point - a lot of companies still advertise and issue loans to unemployed people just proving the the assessment process in these firms is inadequate.

The already mentioned research by OFT also discovered that 74% of lenders handle affordability assessments for all new customers, 67% - for all new loans and only 23% - for each rollover. And even with such low figures of assessing affordability, lenders usually ask for statements of one month only and then fail to keep evidence of assessing their clients' disposable income.

Rolling Over, Refinancing and Repeat Borrowing

The main flaw of these loans is that they are not used the way they are said to be supposed to: instead of being taken out once and repaid on the agreed upon time, they are often extended (rolled over³) or refinanced⁴ numerous times. OFT came to a shocking conclusion: in the UK, 28% of loans are rolled over or refinanced at least once and 5% - four or more times. Excluding roll-over and refinancing, 58% of customers took out more than one new payday loan in a yearⁱⁱⁱ, 15% took out more than 5. In Lithuania, the first figure of rolling over is found to be as high as 37%^{iv}.

Moreover, it has been shown that multiple borrowers are responsible for most of the payday lenders' revenue. In the UK, borrowers who had already taken out a loan from a firm, account for more than 80% of all loans issued by that firm^v.

Lack of Competition and Unfair Advertising

Irresponsible lending seen in payday lending market is not a problem occurring in a few short-term lending firms but is rather the essence of this kind of business. It seems that the competition between payday lenders relies on the speed and ease of the approval instead of the price and the risks being taken: 60% of payday lending websites emphasize speed and simplicity over price^{vi}. A more disturbing note on this fact is that most of the consumers at the time of borrowing are in a weak bargaining position and the firms take advantage of that by concentrating on the speed.

Furthermore, even if they do shop around, the payday lending market is monoline: lenders offer basically the same product to everybody: short-term (two-week or one-month) single-installment loans. And as the industry itself claims, this model only works when consumers suffer from a temporary lack of funds. However, it is already more than obvious that a lot of the customers of payday lenders suffer from a long term financial problems. Hence, a question arises – why don't the lenders offer a different product that fits the needs of the second group of customers? A multi-installment longer term loan would seem to serve these customers better – but almost no payday lenders offer such an alternative.

Moreover, after looking closer at the advertising tactics used by payday lenders, they are aggressive and create inadequate expectations to the consumers, offering gifts and discounts for loyal customers

³ "Rolling over" beyond the original repayment date so the duration of the credit is extended but the amount of the credit and the terms and the conditions are unchanged while extra fees are charged.

⁴ Refinancing on different terms and conditions; the outstanding loan amount is repackaged into a new loan, possibly with additional borrowing and/or over a longer term.

Profiting from the Misfortune

It has become quite obvious that payday lenders go out of their way to build customer loyalty and turn them into high-frequency borrowers. They not only generate more revenue for the payday lenders by rolling over or taking out new loans, they are also less costly^{vii}. The two main reasons for that are:

- The loss ratios are lower for repeat borrowers. Just the mere fact that they have taken out loans multiple times and repaid every one of them, shows their reliability.
- The operating costs are lower. Verification of a new customer (validation of identity, of a bank account, of a telephone number) might be rather expensive but it can be excluded for the repeat customers.

Another way to look at it is: the payday lenders claim that the price of lending is so high because of high risk of default. It makes sense in economic background. However, shouldn't a product be considered toxic just because it causes so many people to default and consequently cost them a lot in fees and, probably even worse, damage their credit history irretrievably?

Additional charges after repaying late or defaulting are not included into APR. Hence, they are a legal way for the price of the loan to be increased. And the consumers often fail to recognize them as fees that could apply directly to them. It might be because there is a lack of clarity from the lenders' side but it also might be caused by the consumers' overconfidence. A research explaining patterns of borrowing^{viii} have found that most of the people are overoptimistic about their ability to repay or to encounter financial shocks.

Possible Solutions

To control the way excessive use of payday loans have been harming the consumers, a lot of different solutions have been implemented in the EU and other places around the world. To understand the regulation strategies and their effect on the market, we will take a look at the the most widely used solutions.

Limiting Simultaneous Borrowing

Restrictions on simultaneous borrowing signifies limiting the number of loans a certain consumer can receive at a given time either from a single lender or all the lenders countrywide. To implement the latter, a mutual database for all the payday lenders has to exist and be used.

Restriction on borrowing from the same lender has basically no impact on neither the number of outstanding loans nor the amount borrowed. It is obvious as the market of payday lending is gigantic and receiving credit from a different lender is uncomplicated. Not so apparent is the ineffectiveness of limiting simultaneous borrowing countrywide. It has been proved to be unsuccessful where it has been implemented (e.g. Virginia and South Carolina, USA^{ix}). Nevertheless, this restriction can be beneficial if combined with size caps.

Size Caps

A size cap is a limitation on the maximum amount that can be borrowed. Specifically for payday loans, they have been set as a fixed amount or as a percentage of the borrower's monthly income.

A quantitative research^x of payday lending restrictions have found that maximum size caps affect the amount consumers are borrowing, however, not significantly. There might be various reasons for such results. If the size ceiling is not lower than the amounts usually borrowed, it evidently has very little effect. Also, if simultaneous borrowing from different firms is allowed, the consumers can effortlessly receive credit from multiple lenders at the same time, hence receiving more than the size cap imposes. Thereby, if size ceiling as a restriction were practised, it should be combined with a ban of simultaneous borrowing and be low enough to have impact.

Cooling-off Periods

Cooling-off period is a length of time after paying off the last loan during which borrowing is not allowed. Intended to stop repeat borrowing, it usually lasts for a few days, sometimes the length depends on the amount of roll-overs already exercised and, in rare cases, a cooling-off period can be set up as a maximum number of loans per period for a single individual.

- Although this prohibition does not have the popularity other regulations do, it has been shown that when Virginia, Washington and South Carolina, USA, implemented cooling-off periods, they experienced an immediate and steep drop in repeat borrowing^{xi}.

Rollover Limitations

To decrease the scale of repeat borrowing, roll-over limitations have become a widely applied tool. They can prohibit rolling over completely or set an upper limit to the number of roll-overs. Sometimes roll-overs are permitted only if some part of the principal has been paid or if a maximum roll-over fee limit is respected. Establishing roll-over limitations has had a negative impact on repeat borrowing^{xii}. It might seem intuitive but if no cooling-off periods are in place, instead of rolling over, the borrower could just take a new loan to repay the last one. However, even when it is the case, roll-over ban still seems to have an emotional impact on borrowing repeatedly.

- Minimum Term Limits

Minimum term limits put a lower cap on the length of a payday loan. It varies from a few weeks to a few months. In some cases, it can be described as pay periods. Its intention is to tackle the problem of short maturity that often does not allow the customers to receive financing to repay the loan.

It can be argued that if the loan is repaid in one instalment, it makes little difference whether the length of the loan is a bit longer. However, it definitely grants more time for the customers to balance their finances and probably avoid borrowing in the future.

Maximum Term Limits

Maximum term limit puts an upper cap on the length of a payday loan. Usually, it falls somewhere in between one and six months. This regulation has been very popular in the USA and it has been set up as protection from harmful debt collection practices^{xiii}. Specifically, to protect the consumers from deferred loans that strip them from control of their own income. Nonetheless, in countries where payday lenders do not have direct access to their customers' bank accounts, such a restriction is meaningless as it has no other visible impact.

Extended Repayment

Extended repayment requirement makes amortizing option available. Its application varies: it can be optional or obligatory; it can be made available when entering into contract or after a certain number of roll-overs.

The effects of optional requirements are shady because if payday lenders can avoid amortization, they do, but compulsory amortization seems to have a positive impact on the well-being of the borrowers.

In 2010, Colorado, USA, policy makers completely changed the law regulating payday lending^{xiv}. It is quite complicated but essentially lump-sum two-week product was replaced by multi-instalment six-months minimum without prepayment penalty. It also ensured that payday lenders cannot earn the origination fee immediately thus discouraging them from motivating their clients to refinance. The consequences of this law were instantly obvious:

- Lower costs - the average cost to a single borrower fell by 42% and the APR dropped by 60%.
- More transparency - before only 13% of fees paid were represented by the contracted

cost, after it grew to 87%.

- Less roll-overs - the percentage of loans renewed or refinanced fell by 51% and average number of loans per person in a year plummeted by 71%.
- Public savings - public debt counsellors started servicing considerably less clients with payday loan debt.

Price Caps

Price caps put an upper limit on the price of the loan. Usually ceiling is placed on APR but sometimes it is described as a maximum cost per amount lent. It has probably been the most widely used restriction and there are a few reasons why^{xv}: to increase risk-averseness of the consumers, to prevent excessive interest rates and the abuse of over-indebted consumers. Setting APR limit to 36% (fees included) or less, practically establishes prohibition of payday lending overall. In 18 states of the USA where such a regulation exists, only 3 still have operating payday lenders^{xvi}.

Recommendations

- **Banning foreign currency loans** to borrowers who do not receive income or do not have no assets in that currency (e.g. French consumer law)
- **Capping the consumer loans' interest rates**
- **Banning teaser loans** in which the borrower pays a very low initial interest rate, which increases after a few years; such loans try to entice borrowers by offering an artificially low rate and small down payments.
- **Making lending via online marketplaces more secure**

A beginning could be a Commission consultation looking into risks related to online marketplace lenders. Such a consultation could help to identify loopholes in existing rules. The results of this consultation could then be used to set up good market practices and develop basic security tools for consumers.

As regards prevention and financial inclusion:

- **Implement asset building oriented policies** in order to limit the temptation of having to resort to banks with unfair practices.
- **Promote community-based initiatives** such that would act as firewall for vulnerable collectives while constraining external dependence.

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