Factsheet

CREDITWORTHINESS ASSESSMENT FOR SMALL LOANS:THE KEY TO PREVENT CONSUMER OVER-INDEBTEDNESS

April 2022

Credit can help consumers to cover expenses requiring a high up-front investment or which may come unexpectedly, like a new washing machine. At the same time, credits cannot and should not replace a social safety net to cover the costs for essential needs.

Whether credit is the right solution very much depends on the consumer's ability to pay back the money. **Unaffordable credit is not beneficial for the consumer** as it will most likely increase the gap in their budget rather than diminishing it. Therefore, **a thorough creditworthiness assessment is key to avoid over-indebtedness.**

The current negotiations on the Consumer Credit Directive (CCD) have generated several discussions around creditworthiness assessments, especially for small loans. Small loans have often been presented as low risk and creditworthiness assessments as too burdensome in proportion to the risk for the creditor. This document aims to respond to the key questions raised in the debate and provides recommendations for a sound creditworthiness assessment for small loans.

Are small loans low risk for the consumer?

The risk of a loan is always proportionate to the size of a consumer's overall budget. Small loans, in particular, target vulnerable consumers living on a small budget, for whom having a sound consumer protection framework is the most important thing. In October 2021, Eurostat data[1] on poverty confirmed that "around one in five people in the EU were at risk of poverty or social exclusion", which concretely means these people face an unbalanced budget or a budget which cannot face any unexpected expenditures. Given the current trends in inflation, social exclusion might increase even further. Data from a recent study by Finance Watch indicates that users of buy-now-pay later products (BNPLs) are often consumers who cannot borrow via regular channels and/or consumers with no financial savings or planning ability.[2]

Small loans are often multiplied: a second small loan is added to cover the repayment of the first loan and so on. 80% of low-income payday loan consumers in the Czech Republic, for example, tend to roll over or take out multiple payday loans as a result of financial difficulties.[3] In Sweden, around 70% of those taking out credit of less than €195 already had debt issued by the same creditor.[4]

As small loans are taken up mostly by consumers living on a small budget and are often multiplied, they are risky and should therefore be well regulated.

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How can a creditworthiness assessment be done without increasing the costs of small loans?

A creditworthiness assessment for small loans is often not in the creditor's interest. It is perceived as costly, and, in some cases, profits are generated with the consumers' inability to pay back the loan in time or their inability to strictly respect the original terms and conditions. For some BNPL providers, for instance, late payment fees are a significant part of their revenues. Moreover, payday loan business models are designed to benefit from consumers' incapacity to repay their loans. They increase their profit with a high rate of financial penalties and rollover fees.

Open Banking can provide cost-effective creditworthiness assessment for small loans. All relevant information on income and expenditure is in the consumer's bank account statements. This data can be analysed in an aggregated way in line with the GDPR (see info box). According to the Dutch BNPL provider Tinka, this kind of creditworthiness assessment can be done within 60 seconds, with costs for the creditor ranging between 50 cents and €1.

Creditworthiness assessment with open banking

1) https://ec.europa.eu/eurostat/statistics-explained/index.phptitle=File:People_at_risk_of_poverty_2020_WEB1_FINAL.png

2) Finance Watch Study, https://www.finance-watch.org/wp-content/uploads/2022/03/CDD-consumer-credit-directive-rootcause-overindebtedness.pdf.

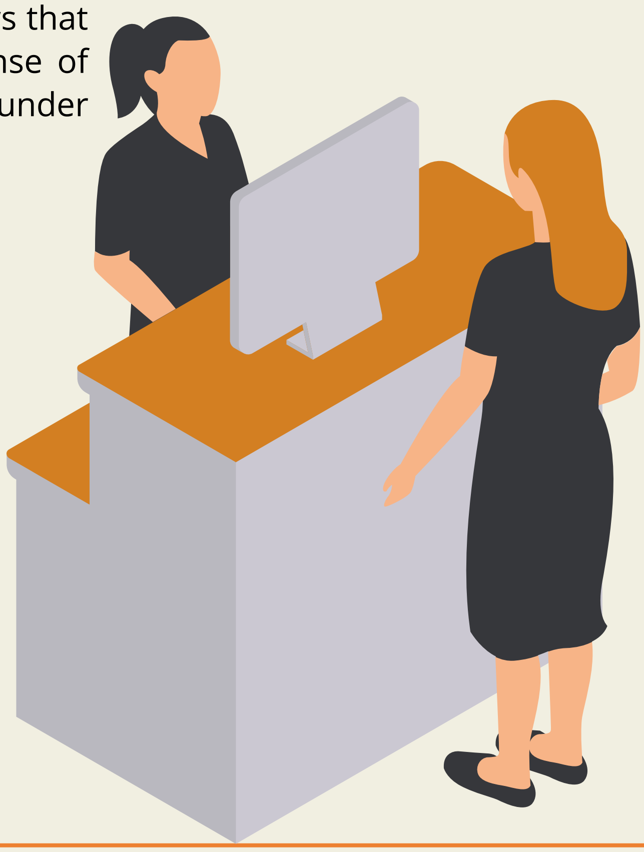
3) Finance Watch Study, https://www.finance-watch.org/wp-content/uploads/2022/03/CDD-consumer-credit-directive-rootcause-overindebtedness.pdf.

4) https://www.fi.se/contentassets/43a41c2a3077468b875858c3e7d300e0/svenska-konsumtionslan-2020-eng.pdf p. 21.

Would a simple check of a credit database or a soft credit check not be sufficient?

Relying solely on credit databases or so-called soft credit checks is problematic as key information is left out. Credit databases sometimes do not include information on small loans (e.g. the Dutch Bureau Krediet Registratie (BKR) include a EUR 250 registration limit below which the obligation to register a consumer credit does not apply) and does not deliver a full picture on the household's income and financial liabilities.[6] BEUC members OCU and Which? have also found that there are frequent errors in databases.[7]

Soft credit checks are often used by BNPL providers to verify only the cash flows on their own platform. Where the consumer uses multiple platforms or combines a BNPL with a payday loan, the full picture is missing. Worse, BEUC member Which? shows that soft credit checks give consumers a false sense of security of having their repayment ability under control.[8]



5) https://www.finance-watch.org/publication/responsible-lending-and-privacy-protection-a-consumer-perspective/

6) BEUC, The Never-Ending European Credit Data Mess, 2017, p. 31-37.

7) https://www.which.co.uk/news/2019/12/one-in-five-people-have-an-error-on-their-credit-report/ and https://www.ocu.org/dinero/prestamos/noticias/salir-registro-morosos. For more information about credit databases, please consult: https://www.beuc.eu/publications/beuc-x-2017-111_the-never-ending-european-credit-data-mess.pdf

8) https://www.which.co.uk/news/2022/01/it-doesnt-feel-like-youre-committing-to-a-credit-agreement-which-calls-for-stronger-safeguards-for-buy-now-pay-later-shoppers/

Is a simple consumer declaration sufficient evidence for the creditworthiness assessment?

Creditors often rely exclusively on consumer declarations without requiring further evidence on their financial data. A mystery shopping exercise on credit granted at the point of sale (e.g. in large furniture shops) conducted by BEUC member vzbv shows that often the consumer was solely required to show their ID card to get credit [9] . A mystery shopping exercise conducted for a Finance Watch study shows that in 58% of the cases, consumers were not asked to submit any documents to prove the accuracy of the information provided.[10]

Creditworthiness assessments should always require supporting evidence and should be duly documented allowing for enforcement of regulatory requirements.[11] Otherwise, there is a high risk that the information provided is not accurate and will lead to an incorrect assessment outcome. A 2014 judgment by the Court of Justice of the European Union stated that Article 8 of the current CCD "...must be interpreted to the effect that, it does not preclude the consumer's creditworthiness assessment from being carried out solely on the basis of information supplied by the consumer, provided that that information is sufficient and that mere declarations by the consumer are also accompanied by supporting evidence".[12]

This level of liability for creditors should be also reflected in the overall standard of creditworthiness. The formulation suggested in the European Commission's legislative proposal for a revised CCD (and implemented for mortgage credit) should therefore be maintained ("the creditworthiness assessment indicates that the obligations resulting from the credit agreement are likely to be met"). Instead, solely requiring that "there is no significant doubt that the obligations resulting from the credit agreement will be met" will leave a lot of room for interpretation (e.g. which kind of doubt will be "significant"?).

9) https://www.vzbv.de/sites/default/files/downloads/2020/03/02/20-03-02_marktwaechteruntersuchung_kreditvermittlung_im_einzelhandel.pdf, p. 38.

10) Finance Watch Study, Graph 20, p.21, https://www.finance-watch.org/wp-content/uploads/2022/03/CDD-consumer-credit-directive-rootcause-overindebtedness.pdf

11) EBA Guidelines on Loan Origination: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines

12) Judgment of the Court (Fourth Chamber), 18 December 2014 CA Consumer Finance SA v Ingrid Bakkaus and Others https://curia.europa.eu/juris/document/document.jsf?docid=169997&doclang=EN

Will a stricter creditworthiness assessment lead to financial exclusion or illegal lending?

Credit is not a solution for all financial problems and cannot replace public support systems for consumers experiencing social hardship. Where credit is unaffordable, it should not be granted. Sound supervision and enforcement is needed to ensure that there is no miss-selling of credit.

Conversely, there are cases today where consumers do not get access to credit despite a sound budget due to discrimination. For example, consumers are often denied access to credit based on their medical history. BEUC member organisations AK and vzbv also reported cases where consumers were discriminated against on the basis of age and gender and on the basis of proxies (e.g. postcodes indicating that the consumer is living in a certain neighborhood) which can indirectly lead to discrimination on the basis of racial and ethnic origin but are difficult to prove in practice.[13] The "poverty premium," which is discrimination against people with a low income, is well documented in the UK thanks to "Fair by Design"[14]. "Fair by Design" underlines that "Credit was expensive when on a low income, whatever form it took. A sub-prime credit card cost around £200 more a year and personal loans cost more than £500 extra."[15] Strict rules prohibiting the use of personally sensitive data in line with the GDPR will avoid discrimination and thus improve financial inclusion.

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13) See also Finance Watch study https://www.finance-watch.org/wp-content/uploads/2021/04/Consumer-credit-market-study-V13.pdf , p. 18/19.

14) https://fairbydesign.com/wp-content/uploads/2020/11/The-poverty-premium-A-Customer-Perspective-Report.pdf

15) https://fairbydesign.com/poverty-premium-research-turn2us/