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RESPONSIBLE LENDING AND RESPONSIBLE BORROWING – NEW CHALLENGES OF POLISH BANKS

1. Responsible lending and responsible borrowing – definitions of terms

The crisis on the financial markets, resulting, among others, from the crash of the mortgage market in the United States, as well as serious difficulties in the European banking sector that brought about important consequences to bank clients, including consumers, resulted in a renewed discussion of the scope of regulation on the market of retail financial services. The programme document prepared by the European Commission and entitled “Driving European recovery” [2009] identifies the need to conduct a series of reforms to overcome the crisis and stimulate an economic revival. One of the five main goals related to the responsible and credible operation of the financial markets consists of convincing European investors, consumers, small and midsize companies that their savings are safe. This aim consists of guaranteeing access to credit and to rights related financial products. Responsible lending and responsible borrowing represents the direction of work identified by the European Commission that is to support the achievement of the aforementioned goal.

The debt scale of households in the European Union, despite a weakening of economic processes, remains high. According to EBC statistics, the debt of households in the EU was shaped at a level of nearly 4.9 trillion EUR (May 2009) wherein nearly 3.5 trillion EUR consisted of mortgages and 0.6 trillion EUR consumer loans. Up until March 2009, the growth dynamics of consumer loans and mortgages represented a positive figure reaching high indicators throughout 2006-2007 and part of 2008 (from 4.5% to 9.7% *per annum*). The boom on the mortgage market was particularly visible. In 2009, the dynamics of mortgage growth considerably decreased which, combined with a worse economic situation of households, inevitably

contributed to a reduced quality of the credit portfolio [ECB Monthly Bulletin 2009] and to the appearance of difficulties in the servicing of credit obligations.

The speech of Ms. Meglena Kuneva, European Union Commissioner for Consumer Affairs, was very significant in this context as she discussed the need to recover consumer trust in the financial service sector [Kuneva 2009]. With the support of a suggestive comparison, she identified the need to protect consumers against “high-risk” financial products that “may not kill consumers but can cause them significant and unexpected economic damage – including the loss of their homes or savings.” One way to establish such protection is to introduce rules of responsible lending and borrowing.

Responsible lending and borrowing is naturally combined with problems of excessive debt. A bank loan usually represents the highest share of the obligations encumbering households. A skilful and responsible management of such debt may make it easier to escape the trap of excessive indebtedness. Research proves that this is a serious problem in the scale of the European Union. For example, we can quote that 38% of respondents admitted to having difficulty in paying off their financial obligations, to a certain extent. The layout of the provided responses is particularly interesting in the individual countries. The lowest 13% indicator was recorded in Sweden, Luxembourg, Denmark and Finland. The highest indicators were obtained in Portugal (63%), Italy (59%), Greece (59%) and Lithuania (57%). In Poland this indicator amounted to 41% [*Towards a Common...* 2008].

The introduction of new legal solutions by the European Commission is usually preceded by broad social consultations and the work of specially appointed groups of experts. In this case, the European Commission announced the initiation of public consultations on “Responsible lending and borrowing in the EU” [“Financial services...” 2009] on 15 June 2009 and, also on 15 June 2009, published the “Report of the Expert Group on Credit Histories” [2009]. This report, despite the fact that it is primarily concerned with the possibilities of improving cross-border credit information exchange, is strictly related to the issue of responsible lending and borrowing.

The introductory document to the consultations broadly presents the issue of responsible lending and borrowing. The authors of this document formulate 15 questions to which they expect to obtain answers within the scope of the consultation process. They also attempt a definition of these terms wherein the term **responsible lending** consists of a situation in which the credit products correspond to the needs of the consumers and are adapted to their financial capacity to pay off the contracted loan. On the other hand, the term **responsible borrowing** signifies a situation in which consumers, in order to obtain a loan, provide the correct, comprehensive and precise amount of information about their financial condition and are furthermore enticed to make deliberate and permanent decisions on contracting a loan.

The process of responsible lending and borrowing is described in respect to all the stages of the consumer's relations with the bank/lending institution (with particular emphasis on the stage of customer acquisition and the stage of loan agreement conclusion). The discussion also extends to the role of credit agents and the impact of incentive and commission systems on the attitude of persons selling loans. In the case of defective incentive systems in which the amount of remuneration depends on the number of loans sold and not on the fact whether the borrower fulfils his duties and pays the loan, employees may not be keen on complying with the principles of "responsible lending."¹

2. Directive on consumer credit loans

The issue of responsible lending and borrowing already served as the topic of vivid discussions during the long-term work on the new Directive on consumer credit loans that was conclusively adopted by the European Parliament on 23 April 2008 [Directive... 2008/48/EC]². As a result of the aforementioned discussions, which were conducted in times of a favourable situation on the market of retail financial services, without the pressure of a crisis and financial collapse, a decision was not taken to introduce clear-cut provisions implementing the principles of responsible lending and borrowing that would be generally binding in the EU and would be subject to full harmonization.

The content of the Directive, the Preamble in particular, provides a series of provisions that refer to the aforementioned discussions and that identify the need of informing the client in the largest possible scope so that the decision to contract debt is taken by the client in full awareness and there exists a detailed evaluation by the lender of the credit capacity of the consumer as well as the adequacy of the offered product to the client.

At this point it would be useful to provide a few quotations which I believe to be of importance. In point 26 of the Preamble it is stated that "Member States should take appropriate measures to promote responsible practices during all phases of the credit relationship, taking into account the specific features of their credit market. Those measures may include, for instance, the provision of information to, and the

¹ The consultation document provides the example of the solution used in the Netherlands where it is forbidden to use one-off commissions in the place of which the commission is paid gradually throughout the loan contract period. Undoubtedly, such a solution serves as incentive to realistically assess the credit capacity and credibility of the client and to custom fit the loan product to the actual capabilities and needs of the individual client.

² This study focuses on issues related to responsible lending and borrowing and does not present all the matters related to the Directive, its scope and method of implementation in the Polish legal conditions. The principles of the Directive should be implemented to the Polish legal system not later than by June of 2010. The Office of Competition and Consumer Protection (UOKiK) is responsible for the process of preparing the relevant legislation.

education of, consumers, including warnings about the risks attaching to default on payment and to over-indebtedness.” Further on we find a very important warning that “creditors should not engage in irresponsible lending or give out credit without prior assessment of creditworthiness.” It is stated that “creditors should bear the responsibility of checking individually the creditworthiness of the consumer.” Such assessment should be based on information provided by the consumer at the stage of credit agreement preparation as well as on information acquired during long-term business relations.

In point 28 of the Preamble we find an important recommendation related to the scope of information serving the assessment of creditworthiness. It is clearly stated that “to assess the credit status of a consumer, the creditor should also consult relevant databases.” What is also significant, access to private and public databases should be provided equally (at non-discriminatory conditions) to all the market participants, irrespective of the country of origin.

The Directive on consumer credit loans may be characterized as a “directive on information” as it defines the informational requirements imposed on the creditor towards the client at all stages of the process of shaping the creditor’s relationship with the client. Therefore, Article 4 specifies which standard information should be provided in advertisements and Article 5 discusses the information provided prior to agreement conclusion. To allow for a comparison of the various offers, the Directive introduces the obligation to use a standard European information datasheet related to consumer loans. The creditor is obliged to present such a datasheet to the client prior to the conclusion of a consumer loan agreement. Article 10 refers to information stipulated in credit agreements.

Such broad informing of the potential debtor is aimed to ensure that the decision to contract debt is taken in full awareness and responsibly. Thanks to the possibility of comparing the different offers, the decisions should also be a better choice both in respect to price as in its adequacy to the needs of the client.

The Directive imposes serious obligations on the creditor. Most of all in Article 8 it introduces the obligation to perform an assessment of creditworthiness both prior to credit agreement conclusion as well as in the case of an important change of the total debt value. Hitherto, such an obligation, based on the provisions of the Act on Banking Law, was imposed on banks and institutions that by law were authorized to grant credits. At present, this obligation has been extended to all entities that give out consumer credit loans. The obligation to study the credit capacity is of crucial importance from the point of view of responsible lending. The assessment of credit capacity and the refusal of credit to consumers who do not have the required creditworthiness should limit the risk of irresponsible lending and granting credit to consumers who will obviously be unable to pay the loan back. Failure to comply with this obligation may expose the creditor to financial losses and the risk

of being faced with a charge that the creditor himself contributed to such a loss related to unsettled credit.

The assessment of creditworthiness is not possible without the possession of the relevant information. The consumer is the source of such information and is obliged to provide “sufficient information”. Sources also include “relevant databases”. The whole text of Article 9 refers to databases and mainly relates to cross-border access to databases, i.e., to the assurance to creditors of other member states of access to databases used in a given member state for the assessment of creditworthiness at non-discriminatory conditions. Such databases consist primarily of bases maintained by Credit Bureaus (public and private).

3. Systems of information exchange – the role of Credit Bureaus

The systems of credit information exchange play an important role in the assurance of responsible lending as they allow the assessment of the scale of current indebtedness of the consumer and whether the consumer is not already over-indebted. These systems are a vital link in the process of credit capacity assessment. They also enable the verification of information provided in the credit application which further contributes to a limitation of the risk of fraudulent transactions. On the basis of historical data, these systems provide information that is necessary to assess the creditability of the consumer. The best results are achieved when it is possible to collect and disclose credit information in a broadest scope. Both favourable and unfavourable information, current and past historical data about loans already paid-off. An important supplement to credit information may consist of data of the manner in which the consumer paid off the obligations towards companies from the non-banking sector.

The **mutuality principle** represents the main principle at the base of these systems of credit information exchange and the operation of the Credit Information Bureau. This principle provides that the participants of the system may obtain credit information only when they themselves provide credit information on their respective clients to the common credit register. This pertains both to public registers where the obligation to provide credit data stems from the provisions of law as well as to private registers where the mutuality principles represent one of the key elements of the agreement. Other principles that constitute the activity of the Credit Bureau include safety, trust, impartiality and non-discriminatory access.

In all European Union states besides Luxembourg, there are established credit bureaus/registers.³ Due to differing legal conditions as well as different cultural and historical considerations in the individual states, the systems of credit information

³ The most recent study containing a characteristic of European systems of credit information exchange is found in the [“Report of the Expert Group...” 2009]. See also: [Markowski 2008].

exchange are very diverse. Three types of systems of credit information exchange can be found: **dual systems** which comprise both public credit registers as well as private credit bureaus, **private systems** which comprise solely private credit bureaus, and **public systems** which comprise solely public credit registers.

In many cases, public credit registers and private credit bureaus complement each other and perform different roles. The situation in particular European states is varied. In 12 countries there are only private credit bureaus and in the majority of cases, they collect both favourable and unfavourable information. In 10 states there exist both public registers as well as private credit bureaus. However, it should be emphasized that usually the public registers collect information in a limited scope. In four states only public registers operate. The diversity of systems of credit information exchange represents one of the obstacles to cross-border exchange of data throughout Europe. However, it should be noted that all the credit bureaus established in countries admitted to the European Union in 2004 (Poland among ten states) and later (Bulgaria and Romania) possess the most coherent model in the scope of the type of collected information (favourable and unfavourable data) and the threshold from which data are transferred (usually zero).

The largest collection of data on consumer debtors in Poland – 64 million accounts belonging to 23 million people – and on credit obligations and the debt payment history is held by Biuro Informacji Kredytowej SA (Credit Information Bureau). The Company was established at the end of 1997 by the Association of Polish Banks and a number of other banks on the basis of Article 105 Clause 4 of the Act on Banking Law. As at the end of June 2009, the system of the Credit Information Bureau SI BIK is used by 45 commercial banks, 3 banks associating cooperative banks, 209 cooperative banks and 62 cooperative savings and loan banks (through the intermediary of the National Savings and Loan Bank) – 319 institutions in total.

In Poland, besides the databases of Biuro Informacji Kredytowej SA, there is also access to the credit databases maintained by the Union of Polish Banks and economic information offices. Biuro Informacji Kredytowej SA cannot be confused with other offices of economic information that operate on the basis of particular provisions of the Act on access to business information. There are many differences between these entities, consisting not only of the legal grounds of their respective activities but also of completely different activity purposes.

Biuro Informacji Kredytowej was established to simplify and reduce the costs of the process of debtor information exchange used for the assessment of risk and credit capacity. This is an obligation imposed on banks under the Act on Banking Law reflecting the particular attention to the safety of entrusted deposits. The data collected by BIK are comprehensive and include long time intervals and are available at mutuality conditions.

The economic information offices were established to discipline debtors and to limit payment congestion, mainly simplifying the vindication processes. Their databases are fragmentary and are not subject to a mutuality principle since the entities that procure information are not required to provide data in return. These offices collect mainly unfavourable information about overdue payments towards entities which are not from the banking sector. Such information may obviously be a valuable supplement to the data from the banking sector used in the process of assessing the credit capacity and credibility of clients.

4. Are banks in Poland lending “responsibly”?

The legal provisions binding in Poland contain solutions that support the compliance with the principles of responsible lending. The Act on Banking Law imposes on banks and institutions that are statutorily authorized to grant credits (e.g. SKOK) the obligation to assess the creditworthiness prior to granting the credit. The client's possession of credit capacity understood as the ability to pay the loan with interest within the contractual terms of payment represents a condition for the release of a loan. In the event of a lack of credit capacity, the loan may be granted upon the satisfaction of additional conditions, e.g. the establishment of a special security of the loan and the preparation of a remedy plan whose implementation shall lead to the recovery of creditworthiness.

Furthermore, the provisions that specify the capital requirements that banks must satisfy also naturally impose the application of the responsible lending principle. A reduced exposure to risk, a lower level of assets weighed with risk mean a lower level of required capital and greater possibilities of developing the bank's lending activity.

It seems that the currently quoted and binding provisions should already ensure the desired behaviour of banks from the point of safe and responsible lending. The principles stipulated in the new Directive on consumer credit loans should further strengthen this direction. Despite the fact that the solutions adopted in the new Directive are limited to the credits/loans specified in the scope of type and amount, there are not obstacles for the respective countries to extend them to a greater number of credit products in the process of implementation. This mainly pertains to mortgages.

The existence of legal solutions supporting responsible lending does not mean, however, that all banks apply them in the same way. Banks have a differentiated “risk appetite” and specialize in the service of different segments of the credit market, offering credit products that are characterized by varying risk profiles. Banks apply diverse methods for the assessment of credit risk and creditworthiness, often aiming at simplifying the assessment process by resigning from a detailed analysis of the client's financial condition and refusing to reach for information from external databases (so as to accelerate the assessment process and reduce its costs). The dynamic development of statistical methods of customer assessment is

also worth mentioning. The use of credit scoring meant great progress in the development of methods of credit capacity assessment. At the same time it carries with it great risk of oversimplifying the assessment by, for example, focusing on the credit credibility of the client (since this element was included in the scoring model) and not analyzing the client's credit capacity.

Finally, banks shape their incentive systems in different ways both in respect to the sales staff as well as in respect to the management staff. In the case of bonuses "for sales", a strong pressure for short-term financial results and a strive for a rapid increase of market share, the principle of responsible lending may become less of a priority.

The gradual deterioration of the quality of consumer credit portfolios observed in the past months represents, without doubt, the consequence of reduced economic growth dynamics and of the worse economic situation of households. To a certain degree, it may also reflect the consequences of not paying enough attention to "responsible lending". This measure, however, does not fully reflect the scale of the "excessive lending" phenomenon or the over-indebtedness of the bank's individual clients, which result from the lack of compliance with the principles of responsible lending and borrowing.

The analyses conducted at the Credit Information Bureau (BIK) prove that the number of clients who are over-indebted and whose incomes are insufficient to cover the contracted debts is increasing in the Polish banking sector. The payment of old loans is financed with new loans, thereby contributing to the vicious circle of indebtedness. According to estimates, the number of over-indebted clients in the BIK database amounts to more than 660 thousand.

What are the defining characteristics of "over-indebted" clients? They have six or more active loans in many banks (the record holder has 50 active accounts). They are active clients who continuously search for new loans – more than 7 credit applications during the last 12 months (the record holder submitted 127 credit applications within 12 months). They have a relatively low income compared to clients who are not "over-indebted". In most cases, they pay their loans on time. However, they generate a much higher risk for banks compared to other clients.

Literature

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