

ECRI NEWS



European Credit Research Institute

EDITORIAL

Stimulate growth with credit - Is it still feasible?

Angelo Fiorante, ECRI/CEPS



Credit is often metaphorically described as the “lubricant of economic growth”, and advanced economies have relied heavily on its availability to foster economic development for several decades. Lately, however, it appears that imbalances between the real economy and the size of credit markets have triggered a succession of crises, like the one facing peripheral eurozone countries today.

History, in fact, tells us that most major downturns have been partially driven by some sort of credit crisis. In the 1980s, it was the Latin American debt crisis; in the 1990s, it was the Mexican peso crisis, followed by the Asian crisis, the Russian default, the Swedish property bust and Argentina’s financial crisis, and the 2000s saw the subprime-mortgage crisis in the US and finally the eurozone crisis.

The problem appears to arise from the fact that most developed countries already have high levels of debt outstanding, which seem to offset a big part of the wealth creation benefits that new credit can have. During a good part of the 1950s to the 1980s, it took approximately a \$1 increase of debt to generate a \$1 increase of GDP in the US (see Figure 1). Nowadays, the economy appears to be somewhat immune to a credit expansion, as it takes roughly a \$5 increase of debt to generate a \$1 increase of GDP. The inevitable question is whether the reliance on borrowing by consumers, companies, banks and governments has been so exponential in the last decades so as to rob credit of its wealth-creating properties?

Figure 1. US GDP growth in \$ per additional \$ of debt



Note: Includes domestic non-financial debt, presented as a 3-year moving average.
Sources: The Economist, Bureau of Economic Analysis and Federal Reserve.

Today we see a deadlock situation in the eurozone as it enters into an austerity regime to solve the debt overhang. Much of the economic growth of the pre-crisis years was actually driven by a rapid credit boom; thus relying solely on new credit to spark growth once again seems a bit optimistic. In fact, the likelihood appears to be higher that a deleveraging process will dominate the economies facing a debt overhang for the coming years, and GDP growth will have to find alternative ways to be revived.

The growth in credit and the sustainability of debt accumulation of the household sector have been a source of major concern in recent years, at least for some developed countries experiencing sluggish growth. Aggregated household credit growth in the EU-27 countries for the past seven years has consistently overshoot GDP growth. What started to be a reverse process of credit growth in 2006 was not captured by equity markets, which started to plunge only in late 2007 when the US subprime-mortgage crisis came to light (see Figure 2).

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Single EU mortgage regime assessed

At a seminar on June 23rd marking the launch of the CEPS/ECRI report entitled “A New Mortgage Credit Regime for Europe”, MEPs questioned the objectives of a new draft Directive regulating mortgage credit markets. The Commission’s proposal represents a first step towards a European mortgage market by imposing a harmonised set of rules on financial institutions and credit intermediaries, largely following those



Rapporteur Antolin Sánchez Presedo (MEP)

of the 1987 consumer credit Directive, but adding elements specific to mortgage markets. Rapporteur Antolin Sánchez Presedo emphasised targeted harmonisation and said that more room could be left for member states in consumer protection. Shadow

rapporteur Vicky Ford stressed the diversity of mortgage markets in the EU. Owner occupation ratios are totally different, she said, and regulating loan-to-value (LTV) ratios is not necessarily the solution because it is even more crucial to look at the income of the household as a source of creditworthiness. Ford also thought the creditworthiness assessment has gone too far, as lenders should be left with some level of flexibility in order to take into account all the individual aspects, again referring to the country and cultural differences. Sven Giegold, also a shadow rapporteur, on the other hand, spoke in favour of regulating LTV ratios. In particular, he suggested that LTV ratios that are not fixed but dependent on market trends could be efficient steering tools for the market. He also argued for more uniform, not minimum, harmonisation in order to promote stable developments in the mortgage credit market throughout all member states. The MEPs also questioned the scope of delegated acts for EBA.

Download the CEPS/ECRI report at www.ceps.eu/book/new-mortgage-credit-regime-europe-setting-right-priorities.

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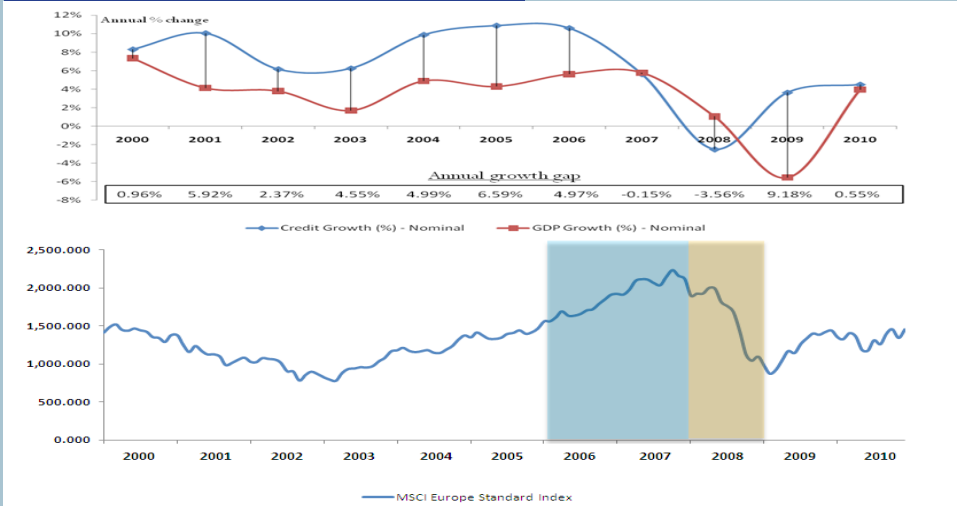
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Editorial cont. from p.1

When the economy turns sour, credit markets tend to face liquidity problems that are far more severe than those that equity markets face in downturns. Friction in credit markets is usually demand-driven, arising from investors' unwillingness to buy debt instruments in times of uncertainty, which ultimately forces the central bank to step in as lender-of-last-resort and inject money into the system. Central bank interventions may be a good way to prevent a rapid collapse in the financial system, but they can also be harmful because the expansion of unbacked credit tends to dilute the pool of real savings, which *per se* determines the aggregate amount of available credit in the economy.

Intuitively, therefore, it seems more productive to analyse 'excessive' credit trends, e.g. lowering of lending standards or long periods of high credit growth rates in economies that are already subject to high levels of accumulated debt, than to look at equity markets for spotting non-fundamental economic advances. The use of stock market performance analyses as an instrument to predict the soundness of economies is usually doomed to fail, at least when relying on the strongest form

Figure 2. EU-27 household credit growth vs GDP growth

Sources: A. Fiorante, "Lending to Households in Europe (1995-2010)", ECRI Statistical Package 2011, ECRI, Brussels, forthcoming (www.ceps.eu) and MSCI Index Performance (www.msci.com).

of the 'efficient market hypothesis' (EMH) under which stock prices reflect all information, public and private, and no one earns excessive returns.

Equity markets are likely to exhibit rollercoaster behaviour once the crisis is in full-swing. Credit markets, on the other hand, may show pre-crisis symptoms for years which do not materialise in an actual crisis in the somewhat sentiment-driven equity markets (see Figure 2). Apart from the fact that earlier crises have had their own specific characteristics, the repeated lesson taught by some of them has been that credit markets were

the epicentre of financial instability. 'Excessive' credit trends should therefore be scrutinised more carefully in the future as they might serve as a better predictor of downturns. Nevertheless, we have to bear in mind that without early intervention or proper regulation, crises will continue to erupt regardless of the form they come in – this has been the missing piece of all previous attempts at crisis resolution.

Leeway offered member states in designing DGS

The Commission's legislative proposal to revise the Directive on deposit guarantee schemes (DGS) reached a first consensus after the EP Economics Committee agreed to uphold the deposit protection limit of €100,000. The Directive aims to make deposit insurance more resilient to future crises and also to increase the harmonisation of schemes across Europe. Some claim, however, that the Commission and the Parliament are still missing the big picture in their attempt to find the right balance for the set-up of DGS.

Re-designing the Directive by taking into account the lessons learned from the financial crisis is seen as crucial for the credibility of the EU's single financial market, which was severely damaged when EU depositors realised that different levels and forms of deposit insurance co-exist across Europe. The incidence of several bank failures in Europe during the crisis, e.g. Northern Rock in the UK in 2007, and Landsbanki in Iceland in 2008, required large government intervention to discourage bank runs and to restore depositors' trust. Policy-makers are now trying to assure that neither taxpayers nor states are stuck with bearing all the costs of depositor protection in future crises.

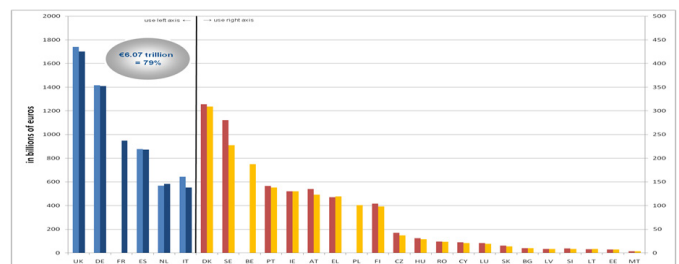
The 'flexibility' behind the design of the proposed schemes allows member states to choose the most suitable and competitive approach for addressing national specificities. This has raised concern over possible loopholes that could create regulatory gaps and thereby alter the sustainability, efficiency and reliability of Europe's deposit insurance system(s). A recent ECRI Policy Brief (see below) argues that the only way to eliminate visible shortcomings and distortion would be to establish a single pan-European fund that insures deposits of all credit institutions established in the single market.

Recommended reading:

M. Gerhardt and K. Lannoo, "Options for reforming deposit protection schemes in the EU", ECRI Policy Brief, CEPS, Brussels, March 2011 (www.ceps.eu/book/options-reforming-deposit-protection-schemes-eu).

Press release: www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+IM-PRESS+20110523IPR19959+0+DOC+XML+V0//EN&language=EN

ECRI STATISTICAL PACKAGE 2011



ECRI is set to publish the 2011 version of its Statistical Package series in August. The institute's flagship publication provides the latest available statistical information on consumer and other credit to households in Europe, allowing users to make meaningful comparisons among 38 countries, including all 27 EU member states as well as a number of selected non-EU countries, including the US and Canada.

Two versions of this valuable research tool in *Excel*-format will be available for purchase: the comprehensive ECRI Statistical Package – "Household Lending in Europe" – (Price: € 600), covers the entire retail loan market, with time series on consumer credit, housing loans and other loans to households as well as loans to non-financial corporations and total credit to the non-financial business and household sector. National accounts data such as gross disposable income and final consumption expenditure are also available in this version. The smaller ECRI Statistical Package – "Consumer Credit in Europe" – (Price: € 440), presents data on consumer credit and national accounts.

For more info contact: angelo.fiorante@ceps.eu or www.ecri.be/new/node/165

Commission provides more guidance on unfair commercial practices



The Directive on unfair commercial practices, adopted 11 May 2005, required full harmonisation in the member states. Since then, the Commission has worked on two initiatives to support the legal developments and enforcement action at national level. The first initiative, published in December 2009, came in the form of guidance on the key concepts and provisions of the Directive perceived to be problematic. The second initiative consists of an online legal database to assist the implementation process. At the official launch event on 14 June 2011, the Commission introduced the database to the member states and the industry.

The main purpose of the database is to contribute to consumer protection in all business-to-consumer practices. Soon publicly accessible via the internet, the database provides a wide range of materials on the Directive in order to increase transparency of the legal situation in the member states, such as national laws and jurisprudence, relevant court cases, and literature and comparative country analyses. In short, the database is intended to provide a platform for sharing know-how and best practices in the enforcement of the legislation and to facilitate compliance. It will be updated regularly in order to provide a consistent and ongoing source of information to the member states and stakeholders. The database will soon be available on the Commission's website.

More information at: <http://ec.europa.eu/consumers/rights/>

Listen up America: Know before you owe

This is the message the Consumer Financial Protection Bureau (CFPB) is trying to convey to American consumers as they shop around for mortgages and other types of unsecured credit. Its mission is to make sure that the US market for consumer financial products and services is fair, transparent and competitive. By fostering clearer disclosure information and publicising practices that the American credit industry must follow, consumers will be alerted to the full costs associated with their household loans.



Help Us Make It Easier to Shop for a Mortgage

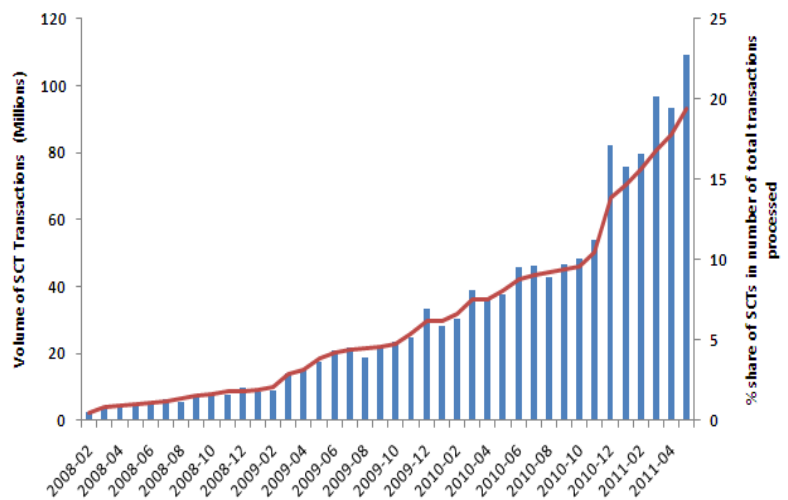
The "know before you owe" campaign aims at simplifying the disclosure forms received when applying for a mortgage. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which created the Consumer Bureau, mandated that the old framework, consisting of two documents – the "Truth in Lending Disclosure" form and the "Good Faith Estimate" – should be merged into one single document that brings clarity into the terms of agreements of mortgage loan applications.

SEPA Council calls for migration end-dates

The Single Euro Payment Area (SEPA) Council has called for an immediate implementation of the European Commission's regulatory proposal, adopted on 16 December 2010, establishing technical requirements for credit transfers and direct debits in euros. The regulation seeks to fix binding end-dates for SEPA Credit Transfer (SCT) and SEPA Direct Debit (SDD) migration. So far, the progress in developing a single pan-European payment system has gone rather slowly, which is why several stakeholders are now calling for regulatory enforcement to speed up the migration process.

The Council's latest report (see reference below) on the SEPA migration indicates that the process seems to have run behind schedule. According to recent European Central Bank data, as of May 2011, only 19.4% (see figure below) and 0.11% of all transfers in the euro area were executed as SCT and SDD, respectively. The low percentages of executed SEPA transactions indicate that many payment service providers (PSPs) are still lacking incentives to make the full switch, which the Commission attributes to various reasons, including "market uncertainty, the generally difficult economic climate, the disadvantages for first movers in a network business, the perceived lack of legal certainty on an appropriate long-term business model for SDD complying fully with EU competition rules and the duplicate costs of operating both SEPA and legacy payment systems".

SEPA Credit Transfer (SCT) migration



Source: European Central Bank.

Self-regulatory efforts have so far proven inefficient, and early adopters of the new SEPA system are facing unnecessary costs of maintaining parallel systems. Some observers assert that the full benefits of an integrated pan-European payment system can only be reaped once all PSPs have completely replaced their national payment instruments. However, it is unlikely that the migration process is going to be completed in the absence of proper incentives that can only be created by legislative intervention.

Recommended reading:

"Completing SEPA: A Roadmap for 2009-2012", SEPA Council Report (http://ec.europa.eu/internal_market/payments/sepa/council_en.htm)

Proposal for a Regulation establishing technical requirements for credit transfers and direct debits in euros and amending Regulation (EC) No 924/2009, COM(2010)775. Link: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010PC0775:EN:NOT>



Photo: David Shankle

In a speech before the Congressional Subcommittee on TARP, Elizabeth Warren, Special Advisor to the Secretary of the Treasury for the Consumer Financial Protection Bureau, stressed that "a simple and straightforward presentation of key credit terms is the best way to level the playing field between borrowers and lenders and to foster honest competition". The ongoing project has opened up an on-line forum that allows voices to be heard from both parties, the demand side as well as the supply side. The draft design for a single, simpler mortgage disclosure form is currently being revised for the second time, and the public as well as the industry are encouraged to give their feedback. The fine-print era is coming to an end, at least for mortgage disclosures, as the US is preparing itself to take a great leap forward towards giving consumers greater transparency in purchasing a mortgage.

More information at: <http://www.consumerfinance.gov/>

LATEST ECRI PUBLICATIONS

1. European Household Credit Market Trends: The grounds for regulatory changes

ECRI Commentary, No. 7, July 2011

Elina Pyykkö, ECRI/CEPS Researcher

This ECRI Commentary provides a snapshot of the current state of European household credit markets. In order to provide an EU-level analysis without aggregating all countries into single measures, member states are divided into three classes depending on their status as a member of the European Union and consequently their general financial market landscape. The commentary assesses how different types of member states have recovered from the financial crisis by looking at credit markets and other financial indicators. The evidence is then used to discuss what kind of basis the different stages of recovery provide for new EU-wide legislative proposals, in particular the Directive on mortgage credit.

Download: www.ceps.eu/book/

NEW!

2. What level of harmonisation in regulating EU mortgage credit markets?

ECRI Commentary, No. 6, June 2011

Karel Lannoo, CEO of CEPS & Director of ECRI

In this new ECRI Commentary, Karel Lannoo offers his assessment of the Commission's proposed Directive regulating retail mortgage credit, adopted on March 31st. While welcoming the initiative as a first step towards creating a European mortgage market, he expresses concern over the degree of harmonisation and the fact that many provisions are left to national implementing legislation or are not, especially in the case of sensitive items, covered at all.

Download: www.ceps.eu/book/what-level-harmonisation-eu-mortgage-credit-markets

NEW!

3. A New Mortgage Credit Regime for Europe: Setting the Right Priorities

ECRI/CEPS Special Report, July 2011

Hans-Joachim Dübel (Finpolconsult) & Marc Rothmund (former ECRI/CEPS Researcher)

This report aims to contribute to the debate on how the EU could most efficiently respond to the challenges posed and the deficiencies revealed by the financial crisis in the area of retail credit. It is based in part on discussions that took place within the CEPS-ECRI Task Force on A New Retail Credit Regime for Europe – Setting the Right Priorities, which met between May 2010 and January 2011. The discussions focused largely on the largest component of retail credit, mortgages. The report also reflects substantial independent research conducted by the authors.

Download: www.ceps.eu/book/new-mortgage-credit-regime-europe-setting-right-priorities

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4. Foreign Currency-Denominated Loans: The case of CEE countries

Forthcoming ECRI Commentary

Angelo Fiorante, ECRI/CEPS Researcher

Using the latest available statistics, this commentary looks at the composition of foreign currency-denominated loans for selected Central and East European (CEE) countries. The magnitude of lending by foreign banks in many new EU member states proved to have serious consequences in a post-crisis context. Foreign currency indebtedness has contributed to an alteration in the risk profile from a macroeconomic, financial and individual standpoint. A pivotal challenge ahead for the transition region will be to devise ways to reinforce a stable and efficient capital market that is less dependent on foreign capital inflows. This achievement would ultimately reduce these countries' vulnerability to future shocks to their economies.

5. A torrent of mortgage defaults: A possible effect of the eurozone debt crisis

ECRI Commentary, No. 5, May 2011

Angelo Fiorante, ECRI/CEPS Researcher

Portugal, Italy, Ireland, Greece and Spain have been subjected to close scrutiny throughout the eurozone debt crisis. What will be the impact on average citizens when they start to feel their belts tightened as a result of their government's insolvency or liquidity problems? A torrent of mortgage defaults may follow the euro debt crisis, if appropriate measures are not taken to both resolve the sovereign debt crisis and protect borrowers' ability to repay their loans.

Download: www.ceps.eu/book/torrent-mortgage-defaults-possible-effect-eurozone-debt-crisis

ECRI UPCOMING EVENTS

ECRI events series in the fall of 2011 will focus on challenges and opportunities for retail credit markets in the face of new regulations, new competition and technologies. The dates and details of the events will be confirmed in due time. For regular updates, please check our websites: www.ecri.eu & www.ceps.eu

Bank Diversity in Europe and New Banking Regulations

Banks are likely to reconsider their business models as a response to new legislative measures. ECRI and CEPS is planning to organize an event for discussing the implications of the new capital and liquidity requirements on banks' business models, with a special focus on bank diversity.

Challenges and Opportunities of Technical Development in Banking Systems

Technological development is shaping the retail banking industry with more security and efficiency requirements and non-bank service providers entering the market. How can technologies be used to help banks respond to these challenges?

The Shadow Economy in Europe:

Using electronic payment systems to combat the shadow economy (co-hosted by VISA)

This event is set to explore the structure and impact of the shadow economy in Europe and evaluate the role that electronic payments can play in reducing it.

Attendance at ECRI events is a benefit of membership. Non-members may be admitted for €50 per session, paid in cash at registration. If not otherwise stated, meetings are held at CEPS. Please check our websites (www.ecri.eu & www.ceps.eu) regularly for updates. For organisational reasons, we cannot accept telephone registrations. **Registration:** Please register via www.ceps.eu, or contact Isabelle Tenaerts by e-mail: isabelle.tenaerts@ceps.eu or fax: +32 (0)2 219.39.11