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Consumer Credit: A Comparative Study of U.S. and EU

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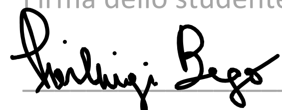

Alla mia famiglia e a Vittoria

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1. Introduction

Nowadays the spectrum and use of financial services have grown enough to become a staple of discussion, in different contexts and with every means of communication. Tv programs, radio talks, podcasts, friends' discussions: financial issues such as stock markets, mutual funds, annuities, insurance, pension plans are now commonplace discussion topic.
Moreover, from the point of view of households, individuals daily deal with – among the vast set of financial products – mortgages contracts, secured and unsecured loans, credit lines, credit or debit cards. Today, thanks to technological innovations, it is possible to transact in those asset and debt instruments not only with financial institutions or predisposed organizations in person or over the telephone, but also with computer and cellphone (with an internet connection) in any place or time.
Within the breadth of new and redesigned consumer financial products and services, none is more ubiquitous (and controversial) than the various types of products known as consumer credit.
From its origin as a small grouping of financial services used typically by the middle class between the world wars, consumer credit has grown so much that virtually all consumers use it at some point in their lives. Thus, consumer credit represents a crucial element in the everyday life of most individuals in modern society. But, what is consumer credit?
The Bank of Italy defined it as "the money lent for the purchase of goods and services required by the consumer or by the consumer's family – a car, a household appliance or a language course – or to deal with situations requiring to have cash available".
However, this is just a simple and easy definition which does not explain the whole picture. In fact, the literature on consumer credit is vast and consistent, since it does not only involve the nature of unsecured debt, but it also depends on the methodological approach used which, in turn, depends on the questions and objectives being discussed. It is possible to distinguish a management approach, which focuses on the characteristics and functioning of the credit industry; a legal approach, which regards the regulations put in place by national authorities, in particular on consumer protection matters; a socio-psychological approach, which mainly investigates consumers behavior and indebtedness choices; and, finally, an economic approach, which is mainly related to the determinants of the demand and supply of consumer credit and to the analysis of the characteristics of individuals in debt.

The scope of this thesis is to offer a transversal and complete overview of the nature and functioning of consumer credit. This will be done taking in consideration the differences between United States of America and Europe, since their consumer credit markets are the results of significant different process, history and legal framework.
Thus, in this thesis I will discuss a comparative study of consumer credit in U.S. and Europe. In particular, in chapter two I will present the economic aspect of consumer credit discussing of the traditional theory and the (alternative) behavioral approach. Then, in chapter three I will present the technical aspect on consumer credit explaining its characteristics and functioning. Subsequently, in chapter four I will present the history aspect of consumer credit, exploring its origin and evolution in U.S. and Europe. Finally, in chapter five (which represent the focus of this work) I will present the main regulation about consumer credit in U.S. and Europe, underling the legislative differences between them.

2. Economic aspect of consumer credit

The literature on consumer credit is consistent. It does not only involve the nature of unsecured debt, but it also depends on the methodological approach used which, in turn, depends on the questions and objectives being discussed.
Four main approaches may be distinguished: a management approach (discussed in chapter 3), which focuses on the characteristics and functioning of the credit industry; a legal approach (discussed in chapter 5), which regards the regulations put in place by national authorities, in particular on consumer protection matters; a socio-psychological approach (in part discussed in chapter 4), which mainly investigates consumers behavior and indebtedness choices; and an economic approach, which is mainly related to the determinants of the demand and supply of consumer credit and to the analysis of the characteristics of individuals in debt.
For what concerns the economic approach, in recent years, an alternative approach has been proposed – the so-called behavioral economics. It focuses on behavioral aspects of individuals that may affect decisions in spending, saving and indebtedness. It offers an alternative explanation of the functioning and utility of consumer credit.

In this chapter the economic approach to consumer credit will be presented. It will initially be discussed a microeconomic approach based on life-cycle and permanent income theories. Subsequently, a brief discussion about behavioral economics, which is at odds with the rationality characterizing the aforementioned traditional theories, will be presented.

2.1 Traditional theories

In this context we refer to economic models based on the economic rationality of individuals, who try to improve their standards of living by smoothing consumption over different period of their lives, through saving and borrowing decisions. Following the assumptions of these models, consumer credit demand and supply are set by individual factors, i.e. socio-economic and economic factors, and institutional factors, i.e. the institutional framework in which individuals live.

Specifically, the theoretical framework for consumption, saving and indebtedness decisions it the Life-Cycle theory, developed by Modigliani and Brumberg in 1954, and the Permanent Income Hypothesis theory, developed by Friedman in 1957. The two theories use different

economic models, but they involve similar consumption behavioral patterns[1]. The life-cycle model is really important since it influences policy makers and financial literacy strategies.
The central idea of these intertemporal consumption choice models is that households make their consumption choices (and consequently those relating to saving and indebtedness) on the basis of their wealth, current disposable income and future income expectations so as to guarantee a uniform level of consumption over their lifetimes (Vandone, 2009). The most important underlying assumption in these models is that individuals' income is typically low in the early working period of their life and then it tends to increase towards retirement. Thus, individuals at the beginning of their working life, expecting higher future incomes, fund the purchase of goods and services in order to increase their consumptions over the level provided by their current incomes. Consumer credit allows to accumulate capital assets, such as houses, but also depreciating assets (i.e. home appliances) which provide immediate services and are less expensive than external services.
Approaching the end of their working lives, instead, individuals tend to increase savings levels in order to be prepared for retirement, when consumption will be higher than earnings. In this framework, saving and indebtedness guarantee heightened economic welfare by smoothing out consumption over time (Vandone, 2009).
The "standard theory" – as defined by Modigliani – states that households' choices of consumption levels in different life's period are subject to an intertemporal budget constraint. Hence, they might decide, in a certain period, to spend more than their disposable income by borrowing and/or by lower their assets, considering that this is a temporary solution and that they die solvent. Further economic analyses have recommended to take in consideration two additional aspects for the standard model: households demand for debt is subject to other factors than income and wealth, and households may be liquidity constrained[2].
These other variables may be divided into two categories: individual and institutional. The former refers to the characteristics of individuals and households. There are two groups: socio-demographic (such as age, size, education) and economic (employment status, job profile,

[1] The Life-Cycle theory states that individuals seek to smooth consumption over their life, that is they borrow when incomes are low and save when incomes are high. The Permanent Income theory states that it is a change in permanent income (expected income in future years), rather than in current income, that leads to changes in a consumer's consumption patterns. However, the general implications of the two theories are similar – i.e. they are functionally equivalent and consistent with each other – and for this reason, for the purpose of this chapter, their names will be considered equivalent.

[2] For further information see Vandone D. (2009). Consumer credit in Europe – risks and opportunities of a dynamic industry.

financial assets). The latter refers to institutional factors that may affect local credit markets, such as the justice system, the information-sharing mechanism amongst financial institutions and the presence of informal credit circuits.
These variables have an effect both on the demand and supply side of the credit market, although not always in the same way.

- Credit demand factors

We know consider the effects of individual and institutional factors on the demand side of the consumer credit market.
For what concerns individual factors, empirical analyses have expanded the standard model by considering the effects of socio-demographic variables, such as the age of households[3], the size and make-up of families, and levels of education, on individuals' choices on spending, saving and borrowing. Consistently with the life-cycle theory, younger individuals, who expect increasing income in the future, have a significant demand for credit which, over the course of their lives, decreases since income becomes sufficient to cover expenditures. Moreover, with aging, individuals become more risk averse to indebtedness.
Higher level of indebtedness or lower capacity to save is present also in large families with children at pre-school or school age, since in this life-cycle phase expenditures are generally higher. However, children may also produce an incentive to save more, in order to ensure inter-generational transfer of assets (bequest motives).
Education has a significant positive effect on the demand for credit. Indeed, it considerably increases the probability of a higher future income and job security. And, in addition, it diminishes the costs of entering the credit market, enhancing the ability to take informed decisions (in particular about debt).
Empirical analyses have extended the standard model, which already includes economic variables such as income and wealth, by including uncertainty about the amount and variability of future income. This uncertainty has an important implication: it determines the necessity to retain liquidity as a precaution against future unexpected income reduction or liabilities' increase, through an increase in saving which causes a diminution in the demand for credit. Such uncertainty is mainly related to the type of employment and the relative employment contract. Individuals with greater uncertainty about future income (i.e. young people) or individuals with temporary employment contracts are expected to make less use of debt than

[3] The term "household" refers both to individual and family

individuals who do not have these types of uncertainty. This explains the importance of considering a variable such as uncertainty in the model.

Moving to institutional factors, the literature considers especially three factors: information-sharing amongst financial institutions with regard to the level of borrowers' credit risk, the efficiency of the justice system against insolvent individuals and the size of the informal credit market.

The main influence of institutional factors on the demand for credit consists on creating the conditions for the market to sanction opportunistic behavior. Repaying a loan, in fact, does not only depend on the capacity, but also on the willingness of the individual to respect the contractual obligations underwritten. It may happen that individuals decide to take out a loan not on the basis of future expectation of higher income (and thus as a way of anticipating expenditures), but because they know that they will not repay the debt – a phenomenon called "strategic insolvency" (Gropp et al. 1997).

The credit market's ability to efficaciously sanction opportunistic behavior influences the individuals' evaluation of the costs and benefits associated with insolvency; which, in turn, influences the tendency of individuals to respect the contractual terms of a loan.

Efficient information-sharing mechanisms amongst financial lenders allow them to know customers' financial situation and history, reducing therefore the incentive for customers to over-borrow by asking credit to different institutions.

The importance of an efficient justice system is related to the fact that the probability of delays in payments and insolvency rise when credit recovery procedures are slow and costly. Finally, the possibility to have recourse to informal credit markets – i.e. having access to loans from friends or relatives – allows individuals to better withstand a possible exclusion from the formal credit circuit.

- Credit supply factors

Even if the standard theory implies that there are not constraints on the households' part to obtain credit, the amount of the loan is subject to a ceiling or the level of interest rates applied by lenders reduce or cancel the demand for credit, forcing households to limit their spending. Thus, households might not be able to borrow according to their needs or to the extent posited by the variables discussed so far.

Credit constraint – in the traditional economic theory – derived from the existence of asymmetric information between lenders and borrowers[4]. Indeed, consumer credit supply is hampered by moral hazard and adverse selection problems. If the possibility of consuming more when borrowing today and less when repaying in the future is attractive for consumers when they expect to earn much more in later periods, borrowing is even more attractive if the higher current consumption is not associated with lower consumption in the future— namely, if consumers default on their repayment obligations (Bertola et al., 2006). Therefore, credit constraints may be explained by the need of credit suppliers of avoiding lending funds that will not be repaid. These imperfections have important consequences, in fact lenders take them in serious consideration before granting loans, in order to avoid borrowers that will not repay their debts.

Credit availability by financial intermediaries depends on an individual's socio-demographic and economic characteristics as well as his/her institutional setting (Vandone, 2009). Hence, high income and wealth, with stable employment conditions, enhance the supply of credit for borrowers.

For what concerns the institutional factors, two of them have an important impact on the supply side of the credit market: the efficiency of the justice system and the existence of information-sharing mechanisms. An efficient justice system allows lenders to recover non-performing loans rapidly at contained costs (Vandone, 2009). This is evidently important with secured debt exposures, but it has an impact also on unsecured debt exposures: the disciplinary effect on insolvent individuals is represented by information concerning them and collected by credit bureaus that may damage their prospects of accessing the credit market again in the future (Vandone, 2009).

In this context, the availability of credit depends – among other things – on the existence of information-sharing mechanisms amongst lenders, which are used to generate information about the financial situation of individuals – and hence reduce asymmetric information.

In practical terms, financial institutions seek to overcome moral hazard and adverse selection problems by screening and monitoring customers' credit-risk profiles: with regards to personal loans, the total amount of which does not justify individual detailed credit-risk evaluations,

[4] Asymmetric information derives from the fact that borrowers and lenders have different information about the probability of default. This causes two problems: adverse selection and moral hazard. The former occurs before the contract is signed, during the evaluation of the borrower's financial situation, and refers to situation in which borrowers receive higher interest rates because of their lower probability in repaying the loan. The latter occurs after the loan has been granted; the higher the interest rate the higher the probability that the borrower will enter on high risk projects.

lenders use credit scoring procedures that identify counterpart risk profiles and as a result reject or accept applications on the basis of insolvency projections generated by the model (Vandone, 2009).

- Empirical findings

Empirical analyses conducted in order to observe the determinants of households' credit markets and their coherence with the standard theories – i.e. Life-Cycle and Permanent Income models – investigated the following features:

- participation in the credit market
- level of borrowing
- cross-country characteristics
- risk of over-indebtedness
- credit constraints

We will now explore these features making reference to the existing literature, taking in consideration the aforementioned individual and institutional factors.

Participation in the credit market

Empirical analyses in this field examine the determinants of the participation of households in the credit market. Taking in consideration the socio-economic factors presented before, age profile is an important determinant in the use of unsecured debt, and this is consistent with the life-cycle model: young people are more likely to borrow than members of older age groups (Crook, 2006; Fabbri & Padula, 2004), with the percentage of individuals with unsecured debt peaking for individuals aged between 30 and 40 years of age (Del Rio & Young, 2005; Magri, 2007). For what concerns the household size, Fabbri & Padula (2004) find that there is a positive relation between levels of indebtedness and the number of household members. Similarly, Del Rio & Young (2005) and Crook (2006) have shown that married individuals are more likely to have unsecured debt than the non-married.

Education is positively correlated with debt: higher education is associated with higher probability of having unsecured debt (Grant, 2003; Del Rio & Young, 2005). This comes from empirical results in the traditional literature that indicate a higher level of education is a significant determinant of higher future incomes and greater information-processing skills, which in turn imply higher participation in the credit market (especially because of the cost-savings provided by these characteristics). However, this relation, which is true for secured debt, it is generally not for consumer credit, since it is typically unsecured.

The level of education is positively correlated with the level of financial knowledge. This is particularly important with complex financial products and services (i.e. mortgages), but it seems to be less important with simple, small loans (i.e. consumer credit products).
Even factors such as the size of the city in which the individual lives have effect on the level of indebtedness. Analyses show that, given the presence of informal credit circuit, the smaller the city the lower the probability of having debt.
Moving the attention to economic factors, the most important variable is income. Demand for credit is positively influenced by expectations of increased future receipts, as posited by the life-cycle theory: if there were no expectations of increased income in the future, there would be no need to advance spending via debt (Ferri & Simon, 2000; Crook, 2005; Cox & Jappelli, 1993). Studies reveal a positive correlation also between current income and levels of debt. Middle-income households, given their large marginal utility of consumption, may experience high level of spending and thus high demand for credit. Even high-income households have large probability of having debt giving the few constraints they face. The situation is different for low-income households: due to the low earnings and precarious employment conditions, the probability of having debt is really low. This reduces both the demand and supply of credit.
Another important factor in this context is represented by the net wealth[5]. High levels of net wealth are associated with low levels of debt, since individuals are able to finance their spending with their wealth. Individuals with intermediate levels of net wealth, instead, are more likely to access the consumer credit market, in order to improve their standards of living. Interestingly, households without a portfolio of financial assets are more likely to have unsecured debt than those who do (Del Rio & Young, 2005).
As regards labor market status, consistent with the theoretical models that consider uncertainty about future income as a factor that reduces borrowing, empirical evidence shows that demand for personal loans is higher amongst the employed in comparison to the self-employed, who are subject to greater uncertainty regarding future income (Vandone, 2009). Retired people, since they do not have expectation of rising future income, have lower probability of having debt (age effect). Findings show that unemployed people have lower probability to access the credit market. This is in contrast with the Permanent Income theory which states that temporarily unemployed individuals should demand more credit. The explanation is that the findings are based on two hypotheses: the pessimism of unemployed people about future job possibility and supply-side restrictions in the access to credit.

[5] Net wealth is equal to the sum of financial and real assets minus liabilities

Moving the focus to institutional factors, analyses have concentrated on the likelihood that lenders will have their loans repaid. Studies show how the probability of default is negatively correlated with the level of efficiency of the justice system and the existence of effective information-sharing mechanisms, whilst positively correlated with the existence of informal credit markets (Vandone, 2009). However, these factors affect secured debt, especially mortgages, but have a limited effect on unsecured debt, that is consumer credit products.

Level of borrowing

This second research field regards the amount of debt held by households. Considering individual factors, age seems to have no influence in the level of borrowing. Instead, education is a significant variable which is positively correlated with the level of borrowing.
Economic factors, such as income and level of net wealth, are positively related to the level of unsecured debt that households may have.
For what concerns the labor market, analyses show that the level of consumer credit is larger for self-employed individuals, since, among other things, they use unsecured debt as a way to fund their activities.
The effects of institutional factors on the level of borrowing is similar to their effects on the participation on the credit market. The existence of inefficient systems of justice, ineffective information-sharing mechanisms and extensive informal credit markets not only increases the probability of participation in the credit market, but also the amount of debt held by households (Vandone, 2009).

Cross-country analyses

This section refers to analyses conducted in order to explore the determinants of consumer credit in different countries and geographical areas, with the scope of investigating if there is any specific factor for them.
Households' access to credit is more limited in Continental Europe than in the United States in general, the formal consumer credit industry has been developing rapidly in all countries and is the object of extensive policy debate (Bertola et al., 2006). In the United States, the policy debate is significantly tackled. In Europe, regulatory policy issues in the credit market are very prominent – and this, along with the already existent monetary and economic union may lead to follow the steps of the United States in the credit market regulation.
The main result obtained by researches in this area is represented by the fact that there are significant differences about individual determinants of consumer credit demand.

Age is an important determinant of having debt in all countries, but the higher probabilities are reached in European countries, such as United Kingdom and Germany.
There is a positive correlation between the percentage of households who hold unsecured debt and income. This is particularly true in the United States, as well as in the United Kingdom, where individuals with middle-to-high income have large share of debt.
With regards to the employment status, retired individuals have low probability of having debt – even tough retired individuals with higher debt are in United Kingdom and Germany. Self-employed individuals may have problems to access the credit market, especially in European countries such as Italy and Netherlands. Unemployed individuals, instead, have problems in all countries in accessing the credit market.
The effects of institutional factors are quite different across countries. These effects strongly depend on the efficiency and functioning of the justice system, the information-sharing mechanism and, more in general, on how a country treats people in the credit market.

Over-indebtedness
This area of analysis seeks to explore institutional factors that may cause situations of financial instability or over-indebtedness, which enhance the likelihood that individuals will not pay back their debts. There are several causes that may lead to these adverse financial situations such as job loss, illness or divorce.
The most important and useful statistical variable is the level of debt to income: it is positive correlated with the probability of difficulties in repayment, such as delays in payments.
Other researches have shown that low incomes are the main cause of over-indebtedness and insolvency among households.
Even institutional factors, which are different from country to country, have an impact on households' capacity to repay their debts.

Credit constraints
The last research area analyses the existence of credit constraints as a means of identifying both the socio-economic profile of individuals most at risk of having their application for a loan turned down and the effect institutional factors have on lenders' credit supply (Vandone, 2009).
With reference to individual factors, age and education are positively correlated with credit. Indeed, the supply of credit increases with them. The same seems to be true for married couples and large families. Differently from its effect on the demand side, the size of the city in which individuals live has not particular influence on the supply of credit.

In the context of economic factors, income and net wealth are obviously positively correlated with the probability of having a loan. Self-employed – and a fortiori unemployed – individuals have higher probability of having their application for loans rejected.
Effects of institutional factors on the credit supply side refer mainly to the peculiar characteristics of the justice system and the existence of information-sharing mechanisms in a particular geographic area or country.
Studies have shown that the more efficient a justice system is, the lower the costs for credit recovery are and subsequently the lower the probability of credit rationing, and lower the costs of credit as lower is the amount of guarantees required (Vandone, 2009). However, these results have more impact in the area of secured debt, rather than in the area of consumer credit.
The same results hold for an efficient system of information-sharing about credit. Asymmetric information – i.e. adverse selection and moral hazard – have an impact on the consumer credit market. To verify this, Bicakova (2007) has conducted an analysis starting by showing that default rates differ according to the product for which the loan is taken (loans for the purchase of motorbikes, second-hand cars, mobile phones have higher insolvency rates over those for new cars and electrical appliances) and analyzing if that is due to the ‘‘selection effect’’ or the ‘‘good effect’’. On the basis of the first mechanism, individuals with high levels of insolvency risk will be more likely to buy certain types of goods, such a motorbike. The good effect, instead, shows the existence of various insolvency rates due to the fact that each good has specific features, such as short useful life or early obsolescence, which act as negative incentives to repay. The results have shown the existence of both effects, and for this reason Bicakova (2007) has stated that the consumer credit market is affected by adverse selection, which is induced by the selection effect, and by moral hazard, which is induced by the good effect – and this has an impact on the availability of credit.

2.2 Behavioral economics

Behavioral economics is the combination of psychology and economics that investigates what happens in markets in which some of the agents display human limitations and complications (Mullainathan & Thaler, 2000).
In recent years, it has proposed an alternative explanation to the ones made by traditional economic theories (i.e. Life-cycle and Permanent Income theories). Differently from the theories presented in the previous paragraph, which were based on the influence of socio-demographic and economic factors, behavioral economics studies about consumer credit focus

on behavioral aspects that have a considerable impact on individuals' decisions about spending, saving and indebtedness. In particular, behavioral economics is based on models deriving from empirical results and anomalies concerning consumers' behaviors, which are at odds with the notion of rationality posited in traditional economic models[6].

Traditional economic models assume the virtues of competition and disclosure in credit markets, but behavioral analyses indicate that competition in credit markets may be systematically skewed to taking advantage of the behavioral biases of consumers (Bar-Gill, 2008).

Several studies have in fact shown how the behavior of individuals deviates systematically from the "rational choice" model of standard economic theories without implying that such behavior is irrational (Vandone, 2009). Individuals, since they are human beings, may have limited cognitive abilities and may be affected by psychological factors. The psychological factors that may affect individuals' choices are, for instance, emotions, persuasion, social pressure, personal taste, forecasting errors, impatience, temptation, overconfidence, self-control problems.

Three main psychological factors are identified in the literature as inducing individuals to make non rational borrowing choices[7]:

- overconfidence bias
- availability heuristic
- hyperbolic discounting

Overconfidence bias consists on the fact that individuals tend to be overconfident about their own ability, including their ability to assess probabilities of uncertain events – and this may lead them to underestimate risk.

In the context of consumer credit, individuals tend to be overoptimistic about their exposure to risk and their ability of managing their indebtedness level. Consequently, they systematically underestimate the likelihood of adverse events (i.e. illness, job loss, etc.) which may conduct to overestimate their ability in managing households' resources. This may have serious implications such as financial fragility and over-indebtedness.

The availability heuristic means that individuals tend to estimate the probability of an event on the basis of the availability of the experience (Vandone, 2009). Basically, individuals commonly assess the probability that an adverse event happens on the basis of their previous

[6] While standard economic models assume that individuals are rational, selfish and willful, behavioral economics calls into questions these assumptions and their consequences affirming that individuals are boundedly rational (they do not use systematically the Bayes rule), boundedly selfish (they do not systematically maximize their wealth) and boundedly willful (they experience human and cognitive limitations such as temptation).

[7] See Vandone D. (2009). Consumer credit in Europe – risks and opportunities of a dynamic industry.

similar experiences, rather than on the basis of an objective analysis of the probability. Hence, the decision of an individual depends on his/her previous experience in a similar context and, in this situation, the availability of the experience is affected by the importance, the timing and the frequency of the experience itself.

In general, the more recent and frequent a certain event happened, the more probable is that individuals will overestimate the probability of a similar event occurring again; or, vice versa, individuals will underestimate the probability of a such event occurring again. Therefore, following this reasoning, if individuals do not have experiences about adverse events such as financial difficulties, insolvency problems, liquidity crises or over-indebtedness, they will underestimate the probabilities that those events might happen – and this may have important consequences on their financial behavior (i.e. they may increase the probabilities that such adverse events occur). It is also important to point out that the nature of the experience must be personal because, as Vandone (2009) stated, even if individuals are exposed to statistics about insolvency rates amongst other people, the impersonal nature of this information makes it not effective.

Considering both the overconfidence bias and the availability heuristic, it seems quite clear that individuals tend to underestimate their exposure to insolvency risk.

Finally, the concept of hyperbolic discounting consists on the fact that individuals tend to systematically overvalue imminent costs and benefits and undervalue those in the future. They do not evaluate in the same way the present and the future, in fact they give more importance to present events than to future ones.

In the credit market this factor is of particular importance in the moment in which individuals have to decide to buy on credit or with an immediate payment – that is when individuals decide to participate in the credit market or not. Hence, the decision is affected by this psychological factor which overcome the rationality of individuals, who should take decisions evaluating if their level of debt is sustainable in the future.

The hyperbolic discount explains why individuals choose “buy now, pay later” solutions that bring immediate gratification at a future cost (Vandone, 2009). It is encouraged by also other forms of credit, such as revolving credit. The hyperbolic discount factor, in fact, means that individuals adopt impatient, short-sighted behavior patterns which make it difficult for them to be fully aware of the consequences of their spending decisions on the sustainability of personal debt (Meier & Sprenger, 2007).

The effects of the hyperbolic discount factor are heightened by another behavioral concept that affects individuals’ decisions: the social environment in which they live. According to behavioral economics, indeed, individuals do not consume only to satisfy a primary need but

also to have access to the power and the prestige given by the ownership of particular goods. Hence, other psychological and social factors affect the choices of individuals when they purchase goods and services – and this is clearly at odds with traditional economic theories. These factors may lead to positive effects such as higher self-esteem and success within a social reference group.

In particular, the confrontation with other individuals is a crucial factor in the consumption choices since the level of personal satisfaction is measured with respect to the status of other individuals. As societies become increasingly more materialistic and consumerist, such competition clearly increases individuals' spending and their tendency to fund consumption by borrowing (Karlsson et al., 2004). The tendency of individuals to consume more even if they do not need it – i.e. just to access a particular social group – may lead to a raise in the demand for credit. This may be dangerous for individuals who do not know what that involves, in particular in terms of insolvency and indebtedness level.

Behavioral economics has shown that individuals are typically not aware of the existence and functioning of these psychological mechanisms. Typically, they tend to ascribe financial difficulties to exogenous factors such as illness, divorce, job loss or low-income levels. However, behavioral studies have demonstrated that such psychological factors have a great impact in the way in which individuals manage their money and take spending and indebtedness decisions. Nowadays, the literature on behavioral economics and credit is large and it influences policy making internationally.

3. Technical aspect of consumer credit

From its origin as a small grouping of financial services used typically by the lower income to middle-income segments of the middle class between the world wars, modern consumer credit has grown so much that virtually all consumers are users at some point in their financial lives (Durkin et al., 2014).

Finlay (2009) wrote that "consumer credit mainly refers to relationship in which money, goods or services are provided to an individual in lieu of payment" (e.g. credit cards, loans and mortgages). Balaguy[8] (1996), in a more formal way, stated that consumer credit "is made up of loans granted for a specific purpose and credit granted for a general use". In particular, the former category is characterized by the fact that the borrower agrees, as form of contractual obligation, to use the loan to purchase a specific product or service; the latter, instead, consists on an agreement where the borrower receives funds from the lender, without any contractual obligation about the good or service to be financed. In general, consumer credit is not guaranteed and has different tax provisions from the ones applied to mortgage credit. Several countries − France, the Netherlands, Italy and the US − allow households to deduct mortgage interest payments; while, only the Netherlands allows tax deductibility for consumer credit (subject to a cap)[9].

In a simpler way, consumer credit may be defined as "the money lent for the purchase of goods and services required by the consumer or by the consumer's family – a car, a household appliance or a language course – or to deal with situations requiring to have cash available"[10]. Hence, in this context, a consumer is a person who purchases something for personal, rather than professional, use.

In the modern economy, consumer credit has provided important economic benefits. In fact, according to Durkin et al. (2014), there are at least three major benefits: first, it makes household investments easier and timelier for families. Facilitating these types of investments, that provide their benefits for a period of time and whose purchase do not fit into monthly budgets, consumer credit allows individuals to change the pattern of their consumptions and saving flows; secondly, consumer credit, whit its capacity to facilitate the sale of the output, has significantly contributed to the growth of durable industries, where new technologies, mass

[8] See Balaguy, H. (1996). Le crédit à la consummation en France, Que sais-je?

[9] For further information see Guardia N. D. (2002). Consumer credit in the European Union. ECRI research report no. 1.

[10] See Bank of Italy (2020). Consumer credit made easy. Bank of Italy Guides.

production and economies of scale have produced employment growth and new wealth; finally, consumer credit enables to employ financial resources available from net surplus components of the economy. Basically, there is a transfer from surplus to deficit consumers.

In addition, consumer credit and, more in general, credit is a very important determinant of economic growth. In fact, in countries where it has been largely used, such as US and UK, economic growth has traditionally been strong. The idea is that credit reduces the potentially dangerous effect of the economic cycle, allowing purchases when the economy is weak, that are repaid when the economy is strong.

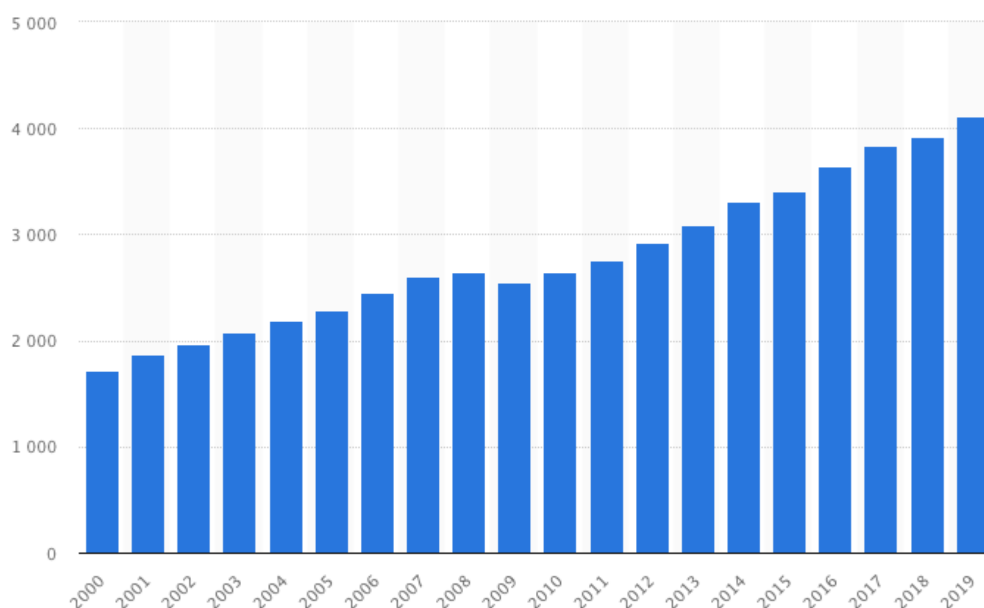

Figure 1. Consumer credit outstanding in U.S. from 2009 to 2019 (in billion U.S. dollars). From https://www.statista.com/statistics/188170/consumer-credit-liabilities-of-us-households-since-1990/

Credit is also a crucial point for the everyday life of the majority of people. Indeed, just to have an idea, the value of outstanding consumer credit in US has grown from about $1.5 trillion to over $4 trillion[11] in the last ten years. In Europe, according to Eurofinas[12], consumer credit represented around the 70% (that is more than 300 billion) of the total credit granted in Europe in 2019.

[11] From $1.5 trillion at the beginning of 2000 to more than $4 trillion nowadays. For further information: https://www.statista.com/statistics/188170/consumer-credit-liabilities-of-us-households-since-1990/

[12] Eurofinas is an association which represents consumer credit providers within the European Union. It represents 17 member associations, which in turn bring together 489 firms and more than 130 000 people.

In this chapter, it will be presented the technical and practical aspect of consumer credit: what it is, how it works, who provides it and what are the advantages and disadvantages connected with it.

3.1 Consumer credit products

Generally speaking, it is possible to define three basic kinds of consumer credit according to the flexibility of credit repayment pace. The first is noninstallment consumer credit where, regardless the way in which lenders extend credit, they expect the repayment in one lump-sum. The second one is nonrevolving (or "closed-end") installment credit, where credit is typically extended at one time and paid back with a series of similarly sized payment (the so-called "installments"), normally monthly (i.e. automobile credit). The last one is revolving (or "open-end") installment credit, where credit is extended in variable amounts and paid back with monthly payments (according to the contractual limits and provisions) at the consumer's preferred pace (i.e. credit card credit).

Noninstallment credit is the simplest form of credit and it may be secured or unsecured. It enables individuals to take possession of a good today and pay for it within a prespecified period of time. However, it may be converted to high interest credit if the individual does not repay in full at the predetermined date. The most common noninstallment loans are: single-payment loans by financial institutions, that are made directly to individuals by banks, insurance companies, stock brokerage firms, and other institutions to finance a variety of lumpy expenditures, including medical expenses, education, and payment of taxes (Durkin et al., 2014); then, retail-store charge accounts, which are credit arrangements owed to retail stores or other purchase outlets which are payable in full at one time, typically in thirty days; and finally, service credit extended by doctors, hospitals, and utility companies who do not demand immediate payment.
Overall, noninstallment credit has declined in relative importance, as the shares of charge accounts and service credit have diminished relatively, and single-payment loans are generally not counted as consumer credit (Durkin et al., 2014). Moreover, with the spread of consumer credit, noninstallment credits have been substituted by installment credits, in particular by credit cards.

Installment consumer credit is a kind of consumer credit that may be repaid with a series of payments (known as installments) typically monthly. There are two types of installment credit: nonrevolving, or "closed-end", installment credit and revolving, or "open-end", installment credit or revolving. The former is the largest segment of outstanding consumer credit by volume even if, the latter, has grown more rapidly in the last decade.
In general, nonrevolving consumer credit is very common since it helps borrowers to buy expensive items and paying for them in installments in the future. In fact, it may be used to buy a car, a boat, furniture and appliances or it may be used to cover educational costs ("student loans", very common in US).
With nonrevolving installment credit, the borrower receives a specific amount of money that he/she has to repay with a prearranged number of payments for a given period of time. Generally, the provisions of the contract cannot change until the end of the contract itself, and for this reason it is called "closed-end" credit. This highlights the main characteristic of such credit contract: consistency. In fact, the borrower expects to pay the same amount on the same date every month. "Closed-end" installment credit may be secured, if the loan is backed by a collateral, or unsecured.
According to Durkin et al. (2014), it is possible to distinguish two types of nonrevolving installment credit: direct credit, where the individual negotiates and signs the terms of the contract directly with the loan officer in person (or electronically) and thus he is the costumer of the financial institution (i.e. auto loan, home improvement, small cash installment loans at banks or finance companies); and indirect credit, where the individual negotiates and signs the contract terms with the seller of the good or service offered by its own financial institution and thus the individual is the costumer of a seller of retail merchandise or services (i.e. an automobile dealer, a furniture store, a home improvement contractor). In this case, the retail dealer receives immediate payment from the bank or financial company, and then the individual repays the financial institutions.
In the case of revolving, or "open-end", installment credit, both the credit amount used and the size of the monthly payments are at the option of the consumer, as long as the amount does not exceed the credit line or limit and the consumer makes at least some required minimum monthly payment (Durkin et al., 2014).
This type of credit has largely spread in the last decades because of its flexibility and the more willingness of creditors to provide it thanks to the new computer systems, communication hardware and risk management technology.
The primary access devices in open-end credit arrangements are credit cards and special checks – sometimes referred to as loan checks or (by issuers) as convenience checks. Indeed, using a

credit card (such as VISA or MasterCard) to buy goods or services is an example of open-end credit.

According to Finlay (2009), other common types of credit products are:

- Mail order catalogue accounts: the borrower chooses goods from the catalogue of a company and then pays for them over a number of weekly or monthly installments. Once an account has been opened, the customer is given a credit limit up to which they can make further purchases from the catalogue and receives regular statements detailing the transactions that have occurred, the outstanding balance and the minimum payment which must be made by the due date (Finlay, 2009). It possible to distinguish two kinds of mail order catalogue account: direct where there is a straightforward one-to-one relationship between the customer and the retailer; and agency, where the customer, called "agent", has the option to buy goods on behalf of relatives, neighbors and friends, receiving a commission.
- Overdrafts: a current account has an overdraft facility if it allows the borrower to spend more than the funds available in his own account. It may be authorized if it was agreed in advance between the parties or unauthorized if it is allowed by the lender, but without a contractual provision for it – in this case penalty fees or higher interests are charged.
- Pawning (pledging): the pawning of goods consists on a cash loan secured against property, with the property retained by the lender until the loan is repaid. The customer deposits goods with the pawnbroker who then gives him a cash loan which corresponds to the discounted value of the goods themselves. The borrower has a limited period of time within which he can redeem the goods paying the original loan plus interests. After this time, the pawnbroker is allowed to sell the good. Pawning is therefore a form of secured credit that is balloon in nature (Finlay, 2009).
- Payday loans and cheque cashing services: a payday loan is a short-term – usually a few days or weeks – loan to cover a borrower until he receives his next pay cheque, when the loan is repaid in full with interest. This type of lending is often associated with cheque cashing services where funds are advanced on a post-dated cheque (Finlay, 2009). They are generally used by individuals who have immediate personal need that cannot be covered in other ways.

3.2 Providers of consumer credit

According to Finlay (2009), the largest part of consumer credit is provided by the following organizations:

- Banks: a bank is a financial institution licensed to receive deposits and make loans. There are several kinds of banks such as corporate banks, investment banks and retail banks. In this context, the latter are crucial since they provide personal banking and consumer credit services, and they typically maintain branch networks. Indeed, they represent a way for individual consumers to manage their money, have access to credit, and deposit their money in a secure manner. Traditionally, retail banks obtained funds via deposits and current accounts that were then used to fund commercial lending to business but, since the 1980s, many banks have expanded their commercial operations to cover a broader spectrum of lending activities – they now offer mortgages, secured and unsecured personal loans and credit cards as a central part of their banking operations (Finlay, 2009).
- Saving and loan companies: these are profit-making organizations owned by their members (Finlay, 2009), who are depositors and/or borrowers of the organization itself. Traditionally, saving and loan companies offered mortgages financed by the saving deposited by their members but, in the last years, they have started to enlarge the range of financial services offered – including, for example, checking and saving accounts. Nowadays, even if mortgages remain their focus, they offer services very similar to the ones offered by retail banks.
- Finance houses: it is a general term that refers to lending institutions licensed to offer consumer credit. In particular, they may be defined as financial institutions that accept deposits from savers and that are specialized in the lending of money by way of instalment credit (i.e. hire purchase loans) and leasing for private consumption and business investment purposes[13]. Alternatively, they may receive funds from merchant banks or other large financial institutions but, generally speaking, they do not provide savings accounts. Other types of lending are secured and unsecured loans and card accounts. Large finance houses commonly act as third party credit providers, acting on behalf of retailers and merchants for the provision of store cards and retail credit (Finlay, 2009).

[13] Collins Dictionary of Economics, 4th ed. S.v. "finance house".

- Credit unions: they are member-owned financial cooperatives that, like saving and loan companies, use funds provided by their members to supply credit. They are able to provide very competitive terms for the credit they provide because they are run on a not-for-profit basis and enjoy a tax-exempt status (Finlay, 2009). Credit unions are based on the principle of "people helping people" and they serve interests of particular groups – such as residents of a town or members of a trade union. Therefore, they tend to operate on a small scale compared to other financial institutions, although some American credit unions – which offer a large range of financial products – have hundreds of thousands of members and billions of dollar worth of assets. At global level, credit unions differ a lot in terms of member, size and products offered.

From the point of view of the consumers there is almost no difference between the financial products offered by the aforementioned financial institutions. What differentiates them is ownership, the objectives that drive their activities and the legislation under which they operate (Finlay, 2009). Indeed, banks and finance houses are mainly concerned about profit, in order to maximize returns for their shareholders. Saving and loan companies, even if they are profit-making organizations, tend to maximize the satisfaction of their members. Credit unions, instead, are non-profit organization and thus the maximization of the benefits of their members is their mainly objective.

Banks, saving and loan associations and credit unions are all categorized as deposit taking institutions – this means that as well as providing credit, they also provide current accounts and/or savings accounts – and this puts a number of legal obligations on them to ensure that they can maintain their liquidity so that depositors' funds are protected (Finlay, 2009). Finance houses do not offer such services, and therefore tend to be subject to less stringent regulatory requirements than deposit taking institutions (Finlay, 2008).

Besides these financial institutions, consumer credit is also provided by other organizations. Among the others, there are:

- Utility companies: many utility supplies (water, gas, electricity and telecoms) are provided on a credit basis and bills are issued in arrears, usually monthly or quarterly (Finlay, 2009).
- Pawnbrokers: they offer short-term credit secured against the personal goods of the borrower. Pawnbrokers have existed since very long time: there are proofs of them in China around 2000-3000 years ago. Even if they have diversified their activity –

offering also payday lending and cheque cashing services – their importance has declined in the 20th century, especially because of the activity of the banking sector.

- Government agencies: governments may provide credit in form of social fund loans – whose repayments are directly deducted from future benefit payments – which are unsecured and interest-free loans provided for the purchase of essential items (Finlay, 2009).
- Licensed moneylenders: basically, they are home credit companies and doorsteps lenders. Even if every organization legally allowed to provide credit may be referred to as a licensed moneylender, this term is applied to those which are specialized in providing small unsecured cash loans, payday lending and cashing services. Loans typically consist on few hundred dollars, repaid in few weeks or months, while interests are impressively high: even more than 100% annum.
- Unlicensed moneylenders (loan sharks): they are known as "loan sharks" or "ah long" because of their extremely high interest rates and harassment tactics. They act in semi-legal and/or illegal way. Unlicensed moneylenders have been around for as long as regulated credit markets have existed, with references to loan sharking to be found in Greek texts dating to the second and third centuries B.C. (Homer & Sylla, 1996).

3.3 Sources of income and costs for providing consumer credit

As for every economic activity, the provision of credit involves costs and incomes. The main sources of income from the provision of credit to their customers for financial institutions are:

- arrangement and account management fees: arrangement fees, usually identified as administrative or documentation fee, are charged for setting up a new credit agreement (Finlay, 2009). Sometimes, they may be included as part of the interest, and thus they are not to be paid at the settlement of the credit. Generally, they are charged for those credit agreements that require complex and intense preparation and documentation, such as mortgages and other secured lending agreements. While there is a cost associated with the creation of any credit agreement, there is not legal requirement that fees are representative of costs and, therefore, the fees charged often bear little relation to the true cost of account set-up or account management, and many lenders will charge very high arrangement fees to offset the low interest rates they advertise in promotional literature (Finlay, 2009).

- Interest charges: interests are monetary charge for the borrowing of money, typically expressed as an annual percentage rate. They are charged in proportion to the amount of the credit and the contractual provisions agreed between lender and borrower. The process for the calculation of interests is not difficult, however, they can be computed in several different ways.
- Transaction fees: they are costs that have to be paid every time there is a debit card or credit card transaction[14]. In fact, they are also called per-transaction fees. They are in the range of 0.5%-5% of the value of the transaction.
- Late payment fees, penalty charges and early redemption fees: late payment fees are charged – usually automatically or manually by the lender in particular risky cases – when a borrower fails to respect the agreed repayment schedule. Penalty charges are typically charged when the borrower violates the terms of the agreement. Many lenders charge an early settlement fee (early redemption fee) for repaying a loan before the date specified within the credit agreement (Finlay, 2009).
- Insurance: payment protection insurance is sold to borrowers to cover credit repayments if, due to a change in circumstances, they are no longer in a position to repay their debt (Finlay, 2009). The way in which the insurance provision is charged depends on the type of the agreement, i.e. with personal loans it is charged in the initial amount borrowed while, with credit card, it is charged every month. The potential profit for the lender is significantly high, due to the high cost of the insurance provision.
- Merchant and interchange fees: interchange fees are fees that a cardholder's bank (the issuer) receives from the merchant's bank (the acquirer) when a card payment is executed[15]. They are paid to cover handling costs and the risk of approving the payment. Basically, these fees are generated every time a customer purchases items with a credit/debit card from a merchant's store.

On the other hand, according to Finlay (2009), the main costs for financial institutions for providing credit are:

- Infrastructure and overheads: infrastructure refer to fixed systems, processes and resources that guarantee a financial institution to work as it is intended. As Finlay (2009) stated, if a credit provider is planning to set up operations for the next year, the infrastructure would be all those things needing to be in place before it could begin

[14] See https://www.financial-dictionary.info/terms/transaction-fee/

[15] Ardizzi G., Zangrandi M.S. (2018). The impact of the interchange fee regulation on merchants: evidence from Italy. Bank of Italy.

trading – such as customer contact systems to manage communications to/from customers, the mechanisms for processing new credit applications, systems for the management of accounts once an account has been opened, and a collections and debt recovery function. Infrastructure and overheads may be classified into capital expenditure, depreciation and operational expenditure.

- Cost of funds: basically, they are the cost that the lender has to pay in order to get the money needed for supplying its products. In particular, they refer to the interest rate paid to collect money. This is a crucial point for financial institutions because the difference between the cost of funds and the interest rate charged to borrowers represent one of their main sources of profit. The two main sources of funds for lenders are deposits held in current accounts and saving accounts. But there are also other sources such as shareholder equity, wholesale deposits and debt issuance.
- Bad debt and write-off (charge-off): when a customer has been in default for a considerable period of time (usually between six and twelve months without making a payment) the loan is classified as bad debt (Finlay, 2009). Thus, bad debt is recognized as an expense – and it represents one unfortunate consequence of the default risk inherent to extending credit. Recognizing bad debts leads to an offsetting reduction (write-off or charged-off) to accounts receivable on the balance sheet. The amount written-off then appears as a loss in the organization’s profit and loss account.
- Fraud: fraud is an intentionally deceptive action designed to provide the perpetrator with an unlawful gain or to deny a right to a victim. It represents an issue, in particular, in the card and retail credit market. Common examples of frauds are identity theft, first party fraud (when, applying for credit, the individual falsifies some information), security compromization and account takeover. Other types of fraud are tax fraud, wire fraud, securities fraud, and bankruptcy fraud.
- Provision (and impairment charges): provision is an amount set aside against future bad debts, accounted for in the present (Finlay, 2009). This because, even if borrowers are currently meeting their repayments, it might happen that in the future they will not be able to repay because of different circumstances, and thus provisions will help lenders to be protected in case they will have bad debt to be written-off.

3.4 Cost of consumer credit for borrowers

The cost of credit is the additional amount over and above the amount borrowed and it includes interests, arrangement fees and any other charges (Finlay, 2009).

Costs may be mandatory, that is they are included in the credit agreement; or they may be optional, such as the ones for the credit insurance. In this case, it is in the borrower hands the decision to pay for them or not. Interests, instead, are charged in proportion to the amount borrowed and the terms of the credit agreement. In some circumstances, charges are made to carry out certain tasks or in response to customer behavior: arrangement fees are common for some types of lending, and many lenders charge penalty fees if a loan repayment is missed or late (Finlay, 2009). Interests are presented in various ways, but lenders are usually required to quote all mandatory charges in the form of an Annual Percentage Rate (APR). The goal of the APR calculation is to promote "truth in lending", to give potential borrowers a clear measure of the true cost of borrowing and to allow a comparison to be made between competing products (Finlay, 2009). However, an APR may not reflect the true cost of borrowing, because of the fees that are excluded – and, for this reason, it may be difficult for borrowers to compare different APRs in order to choose the one that fits the most their preferences. Nonetheless, lenders must disclose the APR to borrowers before the signing of the credit agreement.
The general formula to compute the APR is:

$$APR = \left[\left(\frac{\frac{Fees + Interests}{Principal}}{n} \right) x\ 365 \right] x\ 100$$

where:
Interests = total interests paid over life of the loan
Principal = loan amount
n = number of days in loan term

In U.S., according to the Bank of America, an easy way to compute the APR is to sum the U.S. Prime Rate (as published in the Wall Street Journal) and the margin that the bank charges[16].
In Europe, the Directive 2008/48/EC of the European Parliament and of the Council presents a basic equation, which establishes the APR, that equates, on an annual basis, the total present value of drawdowns on the one hand and the total present value of repayments and payments of charges on the other hand:

$$\sum_{k=1}^{m} C_k (1+X)^{-t_k} = \sum_{l=1}^{m'} D_l (1+X)^{-S_l}$$

[16] See https://bettermoneyhabits.bankofamerica.com/en/credit/what-is-apr

where:

X= the APR

m = the number of the last drawdown

k= the number of a drawdown, thus $1 \leq k \leq m$

C_k = the amount of drawdown k

t_k = the interval, expressed in years and fractions of a year, between the date of the first drawdown and the date of each subsequent drawdown, thus $t_1 = 0$

m' = the number of the last repayment or payment charges

l= the number of a repayment or payment of charges

D_l = the amount of a repayment or payment of charges

S_l = is the interval, expressed in years and fractions of a year, between the date of the first drawdown and the date of each repayment or payment of charges

However, European countries have some leeway over the determination of the exact situations in which this formula should be adopted, above and beyond the EU-stipulated cases.

3.5 Credit scoring

While the history of credit stretches back to 8000 years, the history of credit scoring is only 80 years old. As stated by Thomas et al. (2002) "credit scoring is essentially a way to identify different groups in a population when one cannot see characteristics that defines the groups but only related ones". It was Durand (1941), with a research project for the U.S. National Bureau of Economic Research, the first one to notice that it was possible to use the statistic approach introduced by Fisher (1936) – which was a way to identify groups in a population – to discriminate between good and bad loans. However, his project was not used for any predictive purpose. During the 1930s, some American mail-order companies had developed numerical scoring systems and sets of conditions to be satisfied in order to help in the decision of lending credit, given the inconsistencies in credit decisions of credit analysts. But it was only after the World War II that the system of credit scoring came to light. Indeed, in 1956, in San Francisco a consultancy formed by Bill Fair and Earl Isaac created what may be considered the first standardized and impartial credit scoring system. They combined the automation of credit decisions and the classification techniques developed in statics in lending decisions, proving that decisions could benefit from using statistically derived models.

Subsequently, the spread of credit cards in late 1960s made banks and other financial institutions aware of the utility of credit scoring systems. This was facilitated by the growth and

development of the computer industry. However, until the late 1970s, credit scoring was still not largely used. In that period, "traditional credit assessment relied on 'gut feel' and an assessment of the prospective borrower's character, ability to repay, collateral and security" (Thomas et al., 2002). Hence, the process was slow, because it could have taken weeks or even months for the customer to obtain a loan, and inconsistent, since the customer should have been using the same institution for years before having the possibility to ask for a loan.

This situation lasted for a long time, but since 1980s some changes happened in the lending environment facilitating the spread of credit scoring systems. Those changes were: banks started to create and sell their products; the use of credit cards grew up exponentially; banks, differently from before when they used to focus only on large lending and corporate consumers (Thomas et al., 2002), started to focus on consumer lending (recognizing large profit opportunities). All this led to the spread of credit scoring use in the relationship with clients. It has started to be used in consumer lending, especially with credit cards, for overdrafts, for installment loans, for leasing and hire purchase. Basically, credit scoring has started to be used for all consumer credit agreements.

The event that ensured the complete acceptance of credit scoring – at least in the U.S. – was the passage of the Equal Credit Opportunity Act (Thomas et al., 2002), which made illegal discriminations in the lending of credit unless the discrimination "was empirically derived and statistically valid". In this context, it was also important the role of credit bureaus. Indeed, by tracking financial information about individuals, they determine the individual's credit score which is then used by financial institution in their lending decisions. The three major credit bureaus are Equifax, which was founded back in 1899 when it was known as a retail credit company; TransUnion, which was founded in 1968 as railroad leasing organization but immediately became a credit bureau after the acquisition of the Credit Bureau of Cook County; and Experian, which is the newest one since it was founded in 1996.

With the development of credit scoring, small credit reporting companies, referred to as credit reporting service providers (CRSPs) developed into larger organizations that kept more accurate information.

In addition, in 1989, the company founded by Fair and Isaac – whose name is FICO – presented the FICO score system, which is still used and has become the industry standard. From then, credit scoring has continued to develop and nowadays it is largely used in the financial sector. This process has been helped by factors such as modernization and digitalization.

Generally speaking, "credit scoring is the set of decision models and their underlying techniques that aid lenders in the granting of consumer credit. These techniques decide who

will get credit, how much credit they should get and what operational strategies will enhance the profitability of the borrowers to the lenders" (Thomas et al., 2002).

It is a common belief that credit scoring techniques measure the effective creditworthiness of individuals, but it is not exactly like that. Indeed, creditworthiness is not an attribute of individuals like height or weight, rather it is an assessment made by the lender which depends on the characteristics and situations of both borrower and lender itself. Thus, is righter to say that credit scoring techniques measure the risk of lending to a particular individual. Through these techniques, lenders are able to assess the characteristics of borrowers and how "good" or "bad" they are, on the basis of their credit history. This serves as a basis for their lending decisions.

Credit scoring is an important tool for improving financial inclusion: it helps individuals and micro/small businesses to access credit. In addition, it is largely recognized its potential in the economic growth of the world economy.

The use of credit scoring, as well as the assortment of scoring, has substantially increased in the last years thanks to a larger range of data, increased computers power, higher demand for efficiency and economic growth. In addition, the fields of application of credit scoring have grown from the traditional decision-making of accepting or rejecting an application for credit to other purposes of the credit process such as the pricing of financial services (to reflect the risk profile of customers). Moreover, it is also used to determine the levels of regulatory and economic capital, support customer relationship management, and, in certain countries, solicit prospective consumers and businesses with offers.

The techniques utilized in credit scoring have evolved in sophistication in recent years. They have grown from the classic statistical methods to innovative ones such as artificial intelligence (including machine learning algorithms). This has also led to an increase of the data that may be taken in consideration for credit scoring models and decisions.

The innovation in the credit scoring world has resulted in wider financial inclusion and access to credit, improvement in the accuracy of the underlying models, efficiency gains from the automation of processes, and potentially an improved customer experience.

On the other hand, it also raises concerns about data privacy, fairness and potential for discrimination against minorities, interpretability of the models, and potential for unintended consequences because the models developed on historical data may learn and perpetuate historical bias.

Nonetheless, innovations in credit scoring are not spread in the whole financial world. There are emerging markets where credit service providers (CSPs) may still be operating using credit officer's individual judgment. According to the World Bank Group guidelines, in these cases a

human-centric approach should be encouraged. Moreover, this has created concerns about the effectiveness of credit scoring and technologies and has triggered a profound interest of regulators in the application of credit scoring – specifically for its implication in national financial systems.

Generally speaking, according to the World Bank Group (2019), the major advantage of credit score is that it is a quick, consistent and effective way for credit service providers to assess an applicant's eligibility for a loan or another contractual payment scheme.

3.5.1 Creditworthiness assessment in U.S.

When an individual applies for a loan of any kind (from credit card to mortgage), lenders will assess his/her creditworthiness to get a measure of the risk of lending to him/her.

In the U.S., in order to assess the creditworthiness of their customers, lenders use credit reports. A credit report is a statement that contains information about an individual's credit activity and current credit situation, based on the individual's past credit history and current status of credit accounts. A credit report contains personal information, credit accounts, collection items, public records and inquiries.

Credit reports are drawn up by credit reporting agencies, which are also known as credit bureaus. Credit bureaus track the credit history of individuals in order to generate credit reports and credit scores. They collect credit-related and non-credit data from different sources, such as financial institutions, banks, credit card companies and even phone and utilities companies. In particular, data collected regard: repayment history; amount of credit available and in use, which is called utilization; length of credit history; types of credit accounts; number of credit inquiries; records of bankruptcy, foreclosures, tax liens, or repossessions; outstanding debts in collection; and other basic information on individuals such as employment history and salary history. The three main credit bureaus in the U.S. are TransUnion, Equifax, and Experian. There also other credit reporting agencies of small and big dimensions. In general, every individual has a different credit report with each bureau, because creditors may not report information to all of them.

The most important information in credit reports, which is used by lenders to determine the risk of lending to a particular individual, is the credit score. Each company produces its own scores, and there are many types of scores for different purposes – i.e. there are credit scores designed for specific kinds of lending, such as auto loans, mortgages, credit cards, and there are credit scores for insurance products, for utility services, for cell phone service, and more.

In general, the American industry standard in credit scoring is the FICO score. Billy Fair and Earl Isaac founded the Fair, Isaac and Company in 1956 – which later changed its name in FICO. Then, in 1989, they invented the FICO score, providing a universal and impartial tool for evaluating consumer credit risk. It was soon available from all the main American reporting agencies and through the years it has become the most used credit score.

Although the formula for computing it is kept secret by the company, it is generally based on the following factors:

- payment history (35% of the score), which is the most important information in which lenders are interested in;
- amount owed (30% of the score), which indicates the amount of debt that the individual is already bearing;
- length of credit history (15% of the score), indeed longer credit histories bring higher scores;
- the amount of the new credit (10% of the score), the score takes in consideration also the amount of the new loan that the individual is asking for;
- types of credit (10% of the score), since an "healthy mix" of credit, such as installments loans or revolving credit cards, affects positively the credit score.

Specifically, a FICO score is a three-digit number based on the information contained in the credit report, which ranges from 300 to 850 (see Figure 1).

Figure 2. FICO score ranges. From: https://www.nitrocollege.com/blog/credit-score-ranges-learn-what-they-mean

Recently, the three main bureaus created a company called VantageScore in order to provide competition in the market, develop highly accurate credit scoring models, and to reliably score more consumers so that they can gain access to mainstream credit. Their aim is to develop credit scores which are the same across the three credit bureaus.

3.5.2 Creditworthiness assessment in Europe

The aim of the Consumer Credit Directive (Directive 2008/48/EC) of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers is to facilitate the emergence of an internal market in consumer credit that offers enough consumer protection across all member states.

It prevents irresponsible lending by imposing an obligation to assess the creditworthiness of consumers before lending credit. Specifically, in Article 8, it states that:

> "Member States shall ensure that, before the conclusion of the credit agreement, the creditor assesses the consumer's creditworthiness on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of a consultation of the relevant database"[17]

Recital 26 adds that creditors:

> "should be allowed to use information provided by the consumer not only during the preparation of the credit agreement in question, but also during a long-standing commercial relationship"[18]

With the "Consumer Financial Services Action Plan: Better Products, More Choice" of the 2017, the European Commission announced that it will seek to introduce common creditworthiness assessment standards and principles for lending to consumers.

The Commission recognized the importance of creditworthiness assessment, as well as the obstacles and issues characterizing the European market:

> "A key requirement for issuing consumer credit under EU law is creditworthiness assessment, which protects both the lender and the borrower. Creditworthiness assessment is also an effective preventive measure against over-indebtedness. However, credit providers face difficulties assessing creditworthiness of borrowers from other Member States, due to poor availability and comparability of relevant data in other countries"[19]

[17] See Directive 2000/48/EC of the European Parliament and the Council of 23 April 2008

[18] Ibid.

[19] See Consumer Financial Services Action Plan: Better Products, More Choice (2017). European Commission

Indeed, creditworthiness assessment in the area of consumer credit are carried out in very different ways across member states. For this reason, EU aims at the standardization and harmonization of the assessment of creditworthiness, that would facilitate cross-border lending which, in turn, could lead to lower prices and more choices for consumers.

All member states have transposed the relevant requirements on creditworthiness assessment of the Consumer Credit Directive in their national regulations – and some countries have even gone beyond the directive, implementing additional provisions.

To do that, some countries have issued non-binding guidance or guidelines, which are review and updated by national authorities. This process required time but before 2018 states should have implemented them. Other countries, instead, have recognized the existence of best practices/codes of conduct developed by creditors and they have identified them as national benchmark.

In general, the information that has to be taken into account by creditors to assess customers' creditworthiness differs a lot across member states.

Generally speaking, three approaches may be identified:

- first, a group of countries (M, DK, D, A, CZ, UK, I, L, IRL, F, GR) leave discretion to creditors as to which information is used for the creditworthiness assessment. In this case, it is the creditor that – if necessary – has to demonstrate that the information it has taken into account are sufficient and reasonable;
- second, another group of countries (EW, S, CY, IS, FIN, E, PL, SLO, HR) have a more prescriptive approach in which they require creditors to take into account information such as the consumers' income, expenditures and debts – and in certain cases, their assets. In some of these states, it may also be required to creditors to check credit databases to verify and check the existence of any payments defaults and credit history;
- finally, the last group of countries (B, LV, P, NL, SK, LT, RO, H) goes further by setting formulas for the computation of the threshold level of indebtedness according to which credit may be granted or not.

3.6 Pros and cons of consumer credit

Before the spread of credit, people had to save before making major purchase while, today, they can buy goods and services and spreading their costs over months or years. Consumer credit enables people to enjoy goods and services now – a car, a home, an education, help in

emergencies – and pay for them through payment plans based on future income (Kapoor et al., 2012). In this sense, it ensures financial flexibility over time.
Credit is more than a substitute of cash. Credit is more convenient than carrying cash, is safer and provides a handy record of transactions. Moreover, it allows people to purchase – and use while paying – goods and services that they cannot afford at the moment.
The use of credit may also give access to rewards: credit cards usually provide cash-back offers, frequent flier miles and reward points – that is, basically, free money.
These are the main advantages from the point of view of customers but, from a more general point of view, credit is also beneficial for the economy as a whole, as it helps its growth and makes it becoming a cashless economy. In addition, it improves the business of banks and other financial institutions.

On the other hand, the main disadvantage of consumer credit is probably represented by the temptation to overspend. Indeed, the ease to access credit makes it simple to buy goods and services that people do not need or cannot access with their income. This may lead to the accumulation of debt that, in turn, can cause the loss of income and/or valuable property, the worsening of the individual reputation and, in the worst case, bankruptcy. These situations have important and dangerous economic, as well as psychological, consequences that may affect the life of people. In this context, two important problems have arisen: over-indebtedness and economic inequality. The former derives from the large use of credit by people in response to the ease to access it (and their little knowledge about financial products and concepts) and to the aggressive marketing by financial institution; the latter, instead, is an economic consequence of the use of credit which has very important social and demographic effects.
Another important issue of credit is the required interest rate: credit costs money. It is a service for which you have to pay, and it is more costly than paying with cash. In fact, it will cost more due to monthly finance charges and the compounding effect of interest on interest.

4. Historical aspect of consumer credit

Even though the history of credit is significantly long and stretches back to 12000 years ago[20], consumer credit is a more recent invention. Consumer credit has become to spread between the

[20] Consumer credit is an invention of the early twentieth century but borrowing and lending are not. In prehistoric times, even before the development of common measures of value or of mediums of exchange, credit probably existed (Homer & Sylla, 2005). It existed from the very earliest phases of economic activity, even before the evolution of barter economy. In fact, old Sumerian documents (3000 B.C. circa) reveal a systematic use of credit based on loans of grain by volume and loans of metal by weight, which often carried interests. It is possible to think to the Code of Hammurabi as the first example of code regulating different form of credit, interest rates, methods of repayment, guarantees and recovery. It has also represented the first knowing law that governed usury: creditors who exceeded the fixed interest rate were punished with the deprivation of their own credit. Even before, around 8000 B.C., during the Mesolithic Age, and especially later, during the Neolithic Age (5000 B.C.), credit and capital became significant for the progress of human civilization. This was true, in particular, in Europe and Asia, and this, in turn, promoted the exchange of goods between their populations. Along with it there also grew up abuses and prejudices. Most of the earliest legal codes sought to prevent the abuse of credit or to prohibit its use. The Iranians considered taking of interest as a dishonor; the Indian relived usurers and set interest maxima; the Israelites did not permit lending at interest; the Roman and Babylonians permitted lending at interest but up to a limit; the Greeks encouraged credit without interest limit but forbade personal bondage for debt (Homer & Sylla, 2005). However, in this content, is important to notice that earliest rates were in the range 20-25% and the necessity to set a legal maximum implies that rates higher than these would often have been charged (loan sharks, as today). The Bronze Age of civilization (from 2400 B.C. to 1200 B.C.) led to important level of cultural and economic activities, but, as Homer & Sylla (2005) said, did not leave specific information about form of credit or interest rates. However, the Greeks, especially later, during the seventh century, developed and economic system that was commercial, urban and monetary, and in this context, credit facilitated trade thanks to the extensive borrowing at interest, especially on ship loans (Homer & Sylla, 2005). In addition, in the fifth and sixth centuries B.C. credit was largely spread and accepted by both the population and the authorities. However, the situation in Greece was controversial, in fact important philosophers such as Aristotle and Plato condemned credit and its purpose. Their ideas influenced also the Middle Ages theologians in elaborating the concept of usury, which has influences even on our modern attitudes to credit. In the Roman Empire usury was even considered the pillar of the Empire itself: "awful usury, continually beaten down and continually rising up again was established in Rome", as Montesquieu said. Subsequent reforms reduced its diffusion, for example, fixing the interest rates. This because of the economic and social problems caused by usury, and also because of the influence of the Church. It is possible to find referments to usury also in the Old testaments. It forbids usury in three different books (Exodus, Deuteronomy, Leviticus): they have been written between the ninth and the sixth century B.C. and they have influenced more than 2000 years of legal bans on usury. In this context of credit and usury the Church has always had an important influence: the ban on usury remained intact until the twelfth century, based on the theological idea of fraternity and natural morality; the attitude of the Church changed after the twelfth century as interest-bearing loans became an important element in the economy (growth factor), especially in Italy. During the Medieval and Renaissance

ninetieth and twentieth century in the wake of consumerism and has immediately become a crucial mean to finance consumer demand of durable goods, especially those whose value exceed consumers' income. Until the eighteenth century, when there was commercial capitalism rather than industrial and companies were small rather than big, consumer credit was an obscure phenomenon – it was seen as "the underside of society's operations"[21]. In that period, due to the lack of mass production of goods, credit was limited to particular and tiny sectors, making it a negligible phenomenon both from a social and an economic point of view. Anyway, towards the end of the nineteenth and the beginning of the twentieth century, in Europe – as well as in the United States of America – industrial revolutions took place, affecting several economic aspects such as the level of real income, the availability and commercialization on a large scale of durable goods, the mass production and the subsequent need of credit for purchases' financing.

This phenomenon evolved differently on the two sides of the ocean: in the U.S. – where merchants (and also street merchants) were the first and main providers of consumer credit – there has always been a major institutional and cultural attention to consumer credit which has led to a quicker development; while, in Europe, the evolution of the consumer credit industry has always been influenced by the social and historic context.

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period, indeed, the Church played a crucial role: it influenced the use and forms of credit that gradually developed and gained acceptance. Thus, since Medieval times, credit became a political device (and so has remained): an essential weapon of politics and of national offense and defense (Homer & Sylla, 2005). In the subsequent centuries, Calvinism had a positive, enlightened and cosmopolitan approach, accepting the crucial institutions of a commercial civilization. The Lutheranism, instead, condemned usury with the so-called "Sermons on usury". In the seventeenth- and eighteenth-century the Church started again to condemn usury, in an even more severe way. However, the great eighteenth-century movement of emancipation redirected theory on usury: European economic expansion, in particular in the North, the increased volume of commerce, the spread of colonial companies, all led to a development in credit. In this context interest-bearing loans became a controversy subject for economists, philosophers and ecclesiastics.

From the nineteenth century onwards, credit – the cornerstone of growth – was no longer a subject of heated theological debate (Gelpi & Julien-Labruyère, 2000). In this period, the most important contribution was by Adam Smith and his "An inquiry into the nature and causes of the wealth of nations", which defined the economics for the following centuries. Until the nineteenth-century, credit was seen only as the underside of society's operations. But from then on, it began to develop an independent existence of its own; moreover, in US, it took on the truly revolutionary form of hire purchase sales in order to finance home equipment for new settlers (Gelpi & Julien-Labruyère, 2000). In Europe and US, it became the most important instrument to improve standards of living, it helped to stabilize industries and, moreover, it became an important factor of social integration.

[21] See Gelpi R.M., Julien-Labruyère F. (2000). The history of consumer credit – doctrines and practices.

In particular, consumer credit grew up and developed its own existence initially in France and England. But it was in 1850, in the U.S., that hire purchase sales first emerged, representing a crucial point in the history of consumer credit.
Since then, it gained importance improving the standards of living of Americans first and Europeans then. It was legitimized earlier in the U.S. than Europe exactly because of the success of hire purchase sales in contrast with the failure of the French "monts-de-piétés". Indeed, false public charity and acquisition of social status through possession of consumer goods represented failures of the French (and, by extension, European) system. Another important indirect effect of consumer credit was the fact that it helped to stabilize industries, becoming the major factor of social integration.
In this chapter the origin and evolution of consumer credit in the U.S. and in Europe will be presented.

4.1 United States of America

The first examples of consumer credit were typically in relation to retail sales, especially in the agricultural sector. Only in the second half of the nineteenth century, after the introduction of hire purchase sales, consumer credit expanded to other durable goods. Indeed, as stated by Gelpi & Julien-Labruyére (2000), the provision of household consumer durables of an industrial nature in return for monthly payments was an overnight success. Its development was favored by the massive urbanization – caused, in turn, by the arrival of new immigrants – that occurred between the Civil War and the 1920s.
In that changing and challenging period from social and economic points of view, consumer credit helped families to overcome, or at least alleviate, obstacles – i.e. allowing migrants to realize their dreams. That period was characterized by an economic rapid growth, easy money, low interest rates and inflation which facilitated the spread and use of consumer credit. In particular, the use of credit, allowing to separate current consumption from current income, blurred social distinctions.
During the 1920s, consumer credit gained also social acceptance: it was no more an indicator of poverty, but it became a way to purchase luxury items, such as a car. The economic development and success of the car industry was favored by the possibility to buy cars through the use of credit. Companies such as General Motors and Ford, beyond manufacturing cars, started to offer credit services to buy their products (installment plans), allowing consumer credit to spread and gain social acceptance.

Considering also General Electric, for the household appliance sector, in this list we have the three main actors of the credit sector at that time – and this explain why credit "came to be seen as the greatest catalyst in the famous melting pot", that is one of the keys of the American economic successful history.
In addition, once sales on credit (i.e. installment plans) have been generally established, their development led to positive economic results. Among other things, they facilitate mass production by posing the base for a large market and improve the well-being of households increasing their satisfaction and security.
Consumer credit was tested during the Great Depression of the 1929. However, unlike the overall economy, it prospered – by expanding services to individuals who hold on their jobs and were able to meet required payments – and was perfected, even at an institutional level. In particular, it did not rise as unemployment but, instead, it followed the business cycle[22].
During the 1930s (in particular, late '30s), thanks to the diffusion of mass production, factories became efficient and started to produce consumer products and appliances on a large scale. The range of products that can be bought on installments plans increased – i.e. washing machines, furniture, refrigerators, phonographs and radios. To give an idea of the magnitude of the phenomenon consider that, by this time, about 2/3 of all autos were bought on installment plans. Thus, installment plans became a fixture of the American consumer culture, becoming the standard method for financing expensive household purchases. Moreover, by this time, essentially all retailers of durable goods had developed their repayment credit systems.
Subsequently, after the World War II, the big data era started. Early credit reports used millions of index cards with information about the life of individuals (i.e. promotions, marriages, arrests, death, etc.), sorted in massive filling systems, to keep track of consumers. The growth in demand of consumer credit products[23] followed the postwar increase in income and consumption.
During 1950s revolving credit accounts were largely spread among middle class Americans. Even tough credit card as are known today did not take off until 1960s (when financial innovation, improved technology and consumer attitudes converged), an important financial innovation came from Diners Club. They introduced charge cards – basically, dual-party credit cards – opening the floodgates for other similar consumer credit products. Indeed, in 1951,

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[22] The use of consumer credit – in particular installment credit, which was used by individuals to improve their standard of living – declined, especially in the car industry, causing losses to lenders. However, it was not affected sufficiently large to disappear or to lose its importance.

[23] Several socio-economic factors contributed to this huge development: households began to purchase more than in the pre-war period, the population increased, family needs increased, and people tended to get married earlier.

Franklin National Bank introduced the first bank card program. Few years later, in 1958, Bank of America launched BankAmericard (now VISA) which was soon followed by what are now known as MasterCard and American Express.
In 1960s, local bureaus – which collected information on household income, profession, marital status, and outstanding debts, plus informal testimonies from neighbors and colleagues – began to consolidate into national networks. Accuracy of their data was improved by standardizing credit application forms. Moreover, the first studies into the application of computer technologies to credit reporting was made in this period. And, even before computers started to be used, credit bureaus issued around 60 million credit reports per year.
Even if between late 1950s and 1970s consumer credit continued to expand, this happened at a slower rate. Indeed, the Vietnam war, a restrictive monetary policy and other social programs caused an increase of inflation and a consequent reduction in the use of consumer credit. It began to pick up again towards the middle of the 1970s and continued to do so until the 1990s. Through the late 1960s and early 1970s, there was a large intervention of the state which emanated the Truth in Lending Act (1968) – and subsequently the Fair Credit Reporting Act (1971) – in order to regulate the consumer credit market and establish a standard legal framework for credit reporting agencies. Indeed, in this period, credit scoring came to light. In 1970, Fair, Isaac and Company (FICO) launched a universal credit scoring system – which, through the years, has become the industry standard. Applying the FICO scoring system to digital data, consolidated credit-rating agencies were able to offer services that spanned the consumer-lending value chain: from generating mailing lists of prospective new customers and approving applicants to monitoring services for existing revolving-account customers (Ryan et al., 2011). During the 1970s were also introduced the automated-clearing house (ACH) systems and automated teller machines (ATMs) which transformed consumer payments. In 1972, a report of the (American) National Commission on Consumer Finance "underlines the magnitude and the importance of the consumer credit industry, both as a lubricant which oils the wheels of our great industrial machine and as the vehicle largely responsible for creating and maintaining in this country the highest standard of living in the world".
While, during the 1960s and 1970s there was a move to more products and greater access to consumer credit, the shift to "do-it-yourself financial management"[24] and the accompanying growth in household risk exposure intensified with financial deregulation in the 1980s.
During the 1980s, thanks to financial innovation, debit cards, new mortgage contracts and securitized personal loans became available, widening the range of existing consumer credit

[24] See Ryan et al. (2011). A brief postwar history of U.S. consumer finance.

products. In this period, three credit bureaus – Experian, TransUnion and Equifax – attained universal coverage across the country, becoming the industry leaders in credit scoring. This system, which has remained largely unchanged, is used in the U.S. to measure individuals' creditworthiness and thus to lend funds.

During the 1990s and 2000s, thanks to the development of internet and, in general, of the computer industry, new electronic and online services – such as electronic bill payments, online payments (PayPal), on-line trading, on-line money management sites and internet-only banks – became available.

The 2008 global financial crisis (as well as the great depression of 1929) did not originate from consumer credit market and, in addition, did not have particular adverse effect on it. The global financial crisis was originated by the overextension of mortgage credit – i.e. subprime mortgage credit – at a time when there was already an unsustainable upward bubble in housing prices[25].

A crucial element that played a role in that situation was predatory lending[26]. It refers to any lending practice that uses deceptive and unethical means to convince borrowers to accept a loan with unfair terms or a loan that they do not need. Over the past several years, predatory lending practices have been prevalent in the area of home mortgages, but it has been an issue in the consumer credit market as well. Since home loans are backed by a borrower's real property, a predatory lender can profit not only from loan terms stacked in his or her favor, but also from the sale of a foreclosed home, if a borrower defaults.

These practices were used – and are still used nowadays (surely in a smaller measure), despite the effort of governments in order to prevent them – to take advantages of borrowers' lack of understanding about loans, terms or finances. Predatory lenders typically target minorities, such as the poor, the elderly and the less educated. Since subprime borrowers largely fell into these categories, because they had poor credit or they could not get conventional loans, this explains how predatory lending contributed to the subprime crisis – i.e. predatory lending practices

[25] The crisis originated in the U.S. housing market and then spread all over the world. Households were borrowing more than they could afford and banks were lending at very low interest rates. In this way, households bought houses that they could not afford, knowing that the housing prices would grow up helping them to repay the loan. At some point, however, the housing prices started to decline making burst the financial bubble. This left households with huge mortgage debts that they could not repay – since the crisis made them losing their jobs. In addition, the crisis was aggravated by the opaque derivatives that had been built on top of the underlying mortgage assets.

[26] Predatory lending may also take the form of payday loans, car loans and any type of consumer credit product. And, even these practices may not always be illegal, they may leave victims with ruined credit, burdened with huge and unmanageable debt or homeless.

contributed to high mortgage default rates among subprime borrowers, raising them by about a third (Agarwal et al., 2014).

Summing up, the global financial crisis originated in and affected the mortgage credit market, with no direct effect on the consumer credit market. Obviously, given the bad financial situation, the consumer credit market indirectly suffered. For instance, the value of total consumer credit outstanding in U.S. declined in 2009 to $2,555 billion from $2,643 billion in 2008[27]. But from 2010 it returned to the pre-crisis level, and from then it has continued to grow year by year.

4.2 Europe

While the history of consumer credit in the U.S. consists in the development of new techniques and regulations and is free of historic influences, in Europe it is the result of years of bans, taboo and old-ages traditions.

In Europe, the history of consumer credit – and more in general, of credit – may be explained taking in consideration two different countries: France and Great Britain. In fact, they represent the two different mentalities present in Europe: Catholic and Reformist[28].

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[27] See https://www.statista.com/statistics/188170/consumer-credit-liabilities-of-us-households-since-1990/

[28] In France, the first testimony of consumer credit was the so-called monts-de-piété, a pawnbroking system which was the ancestor of consumer credit itself. It was established in Avignon in 1577. In the subsequent years other similar offices were opened in other French cities. This was the beginning of credit development in Europe. Even the government of the Spanish Netherlands, following the French example, opened monts-de-piétés in the Flanders region. These monts-de-piétés were regulated only 200 years later their creation, by Louis XVI. Then, the French Revolution and the following takeover by Napoleon brought some innovations. Following the Italian example established in Milan in the same period, Napoleon introduced a stipulation making it compulsory to have a Conseil d'Etat authorization in order to open a mont-de-piété. Another important law, enacted at the beginning of 1800s in order to prevent usury, granted the exclusive right of pawnbroking only to specific authorized institutions. By that time, credit was mainly a specifically moral assistance for ordinary people going through a temporary crisis, and who have no securities other than their tools, their furniture, their jewels and their clothes (Gelpi & Julien-Labruyére, 2000). The alternative was represented by local money lenders who, although they did not require any security, required high rates and a very long process for getting a loan. According to Gelpi & Julien-Labruyére (2000), institutionalized money lending, as practiced by the monts-de-piétés, under the guise of a good Christian conscience, did not necessarily achieve the charitable aims for which the institution was founded, and perhaps the local money lender, reviled by all, offered a service more in line with the needs of the people. In general, at that time, small bank loans were very rare especially for two reasons: loans were given on a guarantee (which was

In order to understand the differences between them we have to go back to the sixteenth century. Catholic countries were characterized by severe Church bans on money lending which imposed disadvantageous conditions for both lenders and borrowers. Protestant countries, on the other hand, left the market free to operate, without imposing bans or obstacles in money lending practices.

The first testimony of consumer credit goes back to 1572, when credit sale of necessary items was legalized. It then became wide-spread thanks to the development of pawnbroking. The situation changed in the second half of the nineteenth century, when installment credit developed. From 1890, indeed, pawnbrokers – which were widely spread in Europe – were progressively replaced by credit sales. This was a radical change because if pawnbrokers were seen as a foothold in cases of difficult economic situations, credit sales (through installment credits), instead, represented a way to improve the standards of living.

Another important financial innovation, hire purchase, came from the French practice of renting luxury furniture with an option of buying. It was initially applied to pianos, sewing machines and household furniture. Hire purchases, which involved practically no risk for both lender and borrower, were used by middle-class individuals to improve their standards of living. The rise in the standard of living helped bring about new types of loans, which were no longer intended to ensure subsistence or to provide in case of accident, but to help finance the purchase of consumer durables (Gelpi & Julien-Labruyére, 2000).

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quite difficult to obtain) and borrowing and lending were frowned upon. For these reasons, individuals borrowed secretly, exposing themselves to all sorts of abuse. Basically, the government with one hand banned consumer credit and with the other instituted false charity, increasing the moral ostracism applied to credit.

In Great Britain – since the time of the earliest Elizabethan liberalism – lending against a pledge was a private industry and, as well as in most countries, it was frowned upon. Borrowing money was admitting poverty and, indeed, transactions were mainly conducted between working classes. At that time, pawnbrokers, which worked using rudimental and brutal debt collecting methods, were a sort of banks for the poor. The early arrival of capitalism in Great Britain changed the situation of the families. Their new needs, that could not be satisfied by domestic production, imposed market purchases through currency. But the limited availability of money forced them to borrow – sometimes improving their standard of livings, sometimes causing negative effects on domestic finances. For this reason, between 1850 and the First World War, pawnbrokers expanded hugely. In particular in the big industrial areas, such as London, Manchester, Liverpool. Between the late 1980s and early 1990s, the government intervened emanating laws. Initially in order to prevent usury and criminal activities but then also to address social preoccupations. Firmly established in the British tradition, the pawnbroker was a major figure in the social upheaval caused by the Industrial Revolution (Gelpi & Julien-Labruyére, 2000).

Then, as in the U.S., the development of the car industry after the First World War facilitated the expansion of the hire purchase system, as well as the creation of specialized financing companies.
Thus, whereas the pawnbroker had helped the first generation of the Industrial Revolution to survive from day-to-day, hire purchase sales took up where they left off, by helping households to equip themselves with durable goods (Gelpi & Julien-Labruyére, 2000).
The development of hire purchases between the two world wars may be explained by the fact that it was one of the forces driving the mass sale of consumer items, and this, in turn, was facilitated by the favorable regulations. In that period, households' income increased, and they became aware of the advantages of consumer credit, which began to assume today's shape. In addition, the decline of pawnbrokers was accompanied by the diffusion of new banks and financing companies: there was a real credit boom.
After the Second World War, as a consequence of the negative economic situation, states started to introduce more regulations in consumer credit. In particular, they tried to limit the expansion of consumer credit, since it was considered one of the causes of the high inflation of the period. Nonetheless, the post-war period was characterized by a great economic expansion. This phenomenon was helped by a radical change in the prevailing attitude to credit (Gelpi & Julien-Labruyére, 2000). The advantages and benefits of consumer credit in terms of social and economic evolution were finally recognized and the moral prohibitions – deriving mainly from the Church – vanished, permitting all individuals of all social classes to access consumer credit. Beyond traditional hire purchases, other forms of consumer credit raised: personal loans, mortgage loans, credit cards, and all other forms of credit known today.
This process was simpler in Great Britain than in the other countries thanks to its economic liberalism which was very similar to the American one. Indeed, Mediterranean Europe – with France as a leader – was few years behind in the evolution of consumer credit. The moral influence of the Church, the regulation introduced by the Napoleonic Code (which was copied and/or adapted by several countries) and the presence of monts-de-piétés in the nineteenth century are possible explanations of their delay in the consumer credit industry. The situation was better in North Europe where there was the English influence.
During 1950s and 1960s, the first independent finance companies were founded all over the Europe – as well as the first credit cards issuers. The demand of consumer credit increased with economic growth and the social advances of the 1960s and the 1970s. Indeed, thanks to higher incomes, to the fact that women started to work (and this meant a new type of family with two incomes) and the diffusion of the mass production, families started to raise their standards of

living. In this period there was also a modernization and development of the banking activities which contributed to the development of the credit industry.

The most important event in Europe has obviously been the creation of the European Union. Among other things, it has created a free market[29] – with the emanation of the Schengen Treaty – and a common regulation for all member states. In fact, until the 1980s, consumer credit was regulated only at a national level, but in 1986 the EU emanated the first directive in consumer credit matter – aiming at creating common regulation and administrative provisions. The main concern of EU in consumer credit matters, beyond bringing closer the regulation of its member countries, is the consumer protection.

Finally, between the 1990s and the 2000s, the European consumer credit industry has started to grow hand in hand with the American one. As in the U.S., the global financial crisis – as well as the following sovereign debt crisis[30] that occurs amongst several European countries – did not directly affect the consumer credit market but produced negative indirect effects due to the adverse financial situation.

However, as a consequence of those adverse financial events, an important innovation has been developed in the post-crisis period: responsible lending. The basic idea of responsible lending is that lenders should not act only in their own interests, but they should also take in consideration the borrowers' interests in order to prevent consumer detriment. Responsible lending regards the whole life cycle of a credit product (including pre-contractual and post-contractual phases) and it has been introduced in order to ensure higher levels of consumers protection

The role of mortgage in consumer credit represents another difference among European countries. In Great Britain – as well as in the U.S. – it was introduced in the form of a second mortgage or a home equity loan, as a consolidation of a more expensive debt giving fiscal advantage: the household reduces its debt-burden by increasing the term, using a mortgage as collateral of the loan (Gelpi & Julien-Labruyére, 2000).

[29] This process, which only culminated with the Schengen Treaty, began in the 1960s with the Treaty of Rome, which formally opened the frontiers. At the beginning, car manufacturers were the first to expand their business and financial structures. Then, a second impulse for the creation of a federate European market came from the U.S.: thanks to the development of new marketing systems and new products (such as credit cards), consumer credit became the spearhead of American banking in Europe.

[30] The sovereign debt crisis began after the global financial crisis and spread in several European countries (PIIGS in particular). It was characterized by the collapse of financial institutions, huge governments debt and quickly increasing bond yield spreads in government securities.

Instead, in another countries, such as Germany, savings banks and banks “fill in”, with consumer credit, the part of the mortgage that has been freed by repayments on the property loan and by this means the capital released may be used for household durables or reducing overall indebtedness (Gelpi & Julien-Labruyére, 2000).
Thus, if we assume that a high level of debt is not dangerous for the society and we focus just on its social consensus and ability to increase standards of living then it seems that the German method is better. However, the level of debt is a very important issue which may have different effects in different countries, and so, in general, there is not a better method than the other.
It is important to remember that the conditions that encompass the growth of consumer credit markets are mainly historical and arise from a combination of history and regulations.

5. Legislative aspect of consumer credit

The history of credit regulation is old as credit itself: the first civilizations known in history had already endeavored to find a balance between facilitating economically useful credit extensions and protecting vulnerable borrowers against abuse by lenders (Niemi et al., 2009). In the course of time, interest rate caps, bans on usury, charitable and co-operative lending have been introduced and used. In the context of consumer credit protection, the last important innovation has been disclosure. It does not regard directly credit agreement. Indeed, "by providing consumers with full information on the cost of credit, disclosure aims at enabling consumers to choose the credit product that best fits their means and needs" (Niemi et al., 2009).

In this chapter the main consumer credit regulations of United States and Europe will be presented.

5.1 Consumer credit law in the United States of America

Whatever the influences, reasoning, and circumstances leading to current conditions, it is apparent that few areas of the American economy are as closely regulated as consumer credit (Durkin et al., 2014). However, the legal situation about consumer credit is still complex because of the mixture of federal and state law – even tough federal law preempts state law.
Until the end of 1960s, consumer protection in credit was left to single states. This because, as pointed out by Durkin et al. (2014), "consumer credit regulation evolved during a time when the federal system of governing left most aspects of local commerce as the province of state governments, and so early forms of regulation were at the state level". For this reason, states have historically regulated several features of consumer credit, in particular pricing terms such as the legal interest rate to be charged and specific lending practices.
The situation has begun to change in 1968 with the Consumer Credit Protection Act (CCPA) which represents the first federal activity in the context of consumers protection. The CCPA regulates the consumer credit industry and protects individuals – for example, prohibiting discrimination based on sex, marital status or other individuals' features. In particular, it requires lenders to disclose credit terms to costumers, protects consumers from loan sharks, restricts the garnishing of wages. It has also established the National Commission on Consumer Finance (NCCF), which investigates the consumer finance sector. Moreover, the Act regulates debt collectors, credit card companies and credit reporting agencies.

At the beginning, the CCPA consisted mainly of the Truth in Lending Act (TIL) but, as years went by, new areas of federal regulations have been introduced. As Congress enacted each additional federal consumer credit protection law, it made the new law structurally a new section ("Title") of the CCPA, so that now most federal credit regulations are collected in this location (Durkin et al., 2014).
Indeed, nowadays, the CPPA contains, among the others, five important subsidiary acts: Truth in Lending Act, Fair Credit Reporting Act (FCRA), Fair Credit Billing Act (FCBA), Equal Credit Opportunity Act (ECOA) and Fair Debt Collection Practices Act (FDCPA).
We will now proceed to examine each one of them.

- The Truth in Lending Act (TILA)

The most important component of the Consumer Credit Protection Act was the Truth in Lending Act (Title I), emanated in 1968. It was a watershed piece in the legislation about consumer protection. In addition to being the first federal intervention in consumer protection for creditors, indeed, it introduced a new fundamental approach to financial consumer protection introducing "extensive required disclosures to consumers of transaction-specific information" (Durkin et al., 2014).
Until that time the field of consumer protection was under the responsibility of states, which were mainly interested – as said before – in usury laws and controlling lending practices.
Then, information disclosure – together with civil rights protection – became one of the primary goals of federal effort in consumer protection. Much of the legislation in that area is an implementation of the TILA.
The Truth in Lending Act is designed to provide consumers with clear information about the terms and conditions of the credit they are offered (Finlay, 2009). It is the purpose of the TILA to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices[31]. Indeed, according to the Congress, "the informed use of credit results from an awareness of the cost thereof by consumers".

[31] As stated by the Congress in "a) Informed use of credit in 15 U.S. Code § 1601 – Congressional findings and declaration of purpose"

Specifically, the Act requires, once the credit agreement has been signed, detailed information about interest rate (APR must be distinctly declared, as well as the total charge for credit), repayments and outstanding debt to be included within customers' regular statements.
Thus, the TILA has been a key federal consumer protection act (Durkin et al., 2014) – indeed it regulates almost all consumer transactions involving credit – but there are also other acts which govern information protection: Consumer Leasing Act (CLA, 1976), the Real Estate Settlement Procedures Act (RESPA, 1974), the Truth in Savings Act (TISA, 1991), and the Electronic Fund Transfer Act (EFTA, 1979).

- The Fair Credit Reporting Act (FCRA)

In US, personal data – differently from Europe, where there are data protection laws – is considered a commodity that can be used as any person (or organization) desires. The existent law has just the scope to protect individuals from having their data being abused in particular circumstances. The Fair Credit Reporting Act (amended with the Fair and Accurate Credit Transaction Act 2003) puts in place controls over how credit reference agencies manage the data they hold and the purposes to which such data can be put (Finlay, 2009).
The FCRA was originally emanated in 1971 in order to regulate credit reporting, creating a flexible and largely self-enforcing law despite the changes in market, technologies and credit information, but without major amendments.
Subsequently, in 1986, the Congress adopted the Consumer Credit Reporting Reform Act in order to address four major issues that emerged in response to the changes in credit marketing and credit reporting: (1) the privacy implications of using credit reports for "prescreening" consumers to determine which were eligible and likely to respond to an offer of credit, for example, credit card, mortgage, home equity line of credit, or other credit related offers; (2) the extent to which information from credit reports could be shared among corporate affiliates without direct consumer consent; (3) the accuracy of credit reports; and (4) allegations of lack of responsiveness by the credit bureaus to consumer requests and concerns (Durkin et al., 2014). In addition, with this reforming Act, the Congress preempted the states from enacting laws dealing with a specific set of issues.
Then, the Congress emanated a new reform of the FCRA in 2003, the Fair and Accurate Credit Transactions Act (FACTA), which contains new and more actual consumer protection provisions. The most important are: individuals have the right to receive a copy of their credit reports, data of credit reference agencies must be accurate, credit reports may be provided only for specific purpose.

- The Equal Credit Opportunity Act (ECOA)

The Equal Credit Opportunity Act, enacted in 1974, prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, because an applicant receives income from a public assistance program, or because an applicant has in good faith exercised any right under the Consumer Credit Protection Act[32]. Everyone who participates in the decision to grant credit or in setting the terms of that credit is subject to these provisions. Lenders may sometimes ask for this information, but they may not be used to decide whether to grant credit or set the terms of the credit agreement. The ECOA obviously does not apply to other customers' features such as income, expenses amd credit history, which are used to determine their creditworthiness.
The Act also gives customers the right to know, within 30 days, if the application for credit has been accepted or rejected – and in this latter case, they have the right to know why. Moreover, if less favorable conditions have been offered to customers, they have the right to know the specific reasons (but only if they reject the agreement).
For these reasons, which confirm the federal effort in promoting civil rights, the ECOA is an extremely important act. Congress believed that the ECOA would provide consumers with two significant benefits: enhanced credit access and consumer education (Durkin et al., 2014).

- The Fair Debt Collection Practices Act (FDCA)

Creditors may try to collect debt in various ways but, because of "abundant evidence of the use of abusive, deceptive, and unfair debt collection practices by many debt collectors" (15 U.S.C. § 1692), the Congress enacted the Fair Debt Collection Practices Act. It establishes ethical guidelines for the collection of consumer debts. In particular, the FDCPA, emanated in 1978, "broadly prohibits a debt collector from using 'any false, deceptive, or misleading representation or means in connection with the collection of any debt'"[33]. Thus, the scope of the Act is to protect borrowers from unfair and threatening practices that debt collectors might use.
Specifically, the FDCPA prohibits debt collectors from contacting debtors before 8:00 a.m. or after 9:00 p.m., during weekends and holiday (but they can with a convenient cause) or directly

[32] See 15 U.S.C. United States Code, 2011 Edition. Title 15 - Commerce and Trade, Chapter 41 - Consumer Credit Protection, Subchapter IV - Equal Credit Opportunity. From the U.S. Government Publishing Office, www.gpo.gov.

[33] As stated by the Congress in "15 U.S. Code § 1692e. False or misleading representations".

if they have a counsel. It also prohibits debt collectors to engage in abusive behavior and unfair claims or representations.
The FDCPA applies only to third party debt collectors and it is not intended to cover the conduct of the original creditor. However, states may emanate status in order to ensure a broader cover than the Act (i.e. California did it).

- The Fair Credit Billing Act (FCBA)

The Fair Credit Billing Act, emanated in 1974, is a federal law conceived to protect consumers from unfair credit billing practices – such as unauthorized charges, charges for unaccepted or undelivered goods and services and other disputed charges. Other types of common errors recognized under the FCBA are billing of wrongs amount, calculation errors and credit card statement dispatched to an incorrect account. The Act defines guidelines for both lenders and borrowers, for handling disputes about errors on billing statement. It applies to revolving charge accounts and open-end credit accounts, such as credit cards.
The Act requires rapid written acknowledgment of consumer billing complaints and investigation of billing errors by creditors – i.e. in a charge dispute, the creditor must receive the letter of complaints within 60 days and must acknowledge the complaint in writing within 30 days after receiving it (the dispute must be solved in no more than 90 days). It also prohibits creditors from taking actions that adversely affect the consumer's credit standing until the investigation is completed and, in addition, it requires creditors to quickly post payments to consumer's account.

The Consumer Credit Protection Act, since its enactment, has been amended several times, adding provisions related (mainly) to debt collection, credit reporting, credit billing – but also in relation to others matters.
For example, in 2009, President Obama signed the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act. It amended the Truth in Lending Act, the Electronic Fund Transfer Act, the Fair Credit Reporting Act and the Mortgage Related Provisions of the Omnibus Appropriations Act (an act that regards the funding of the operation of some of the Cabinet Departments). The Act includes several provisions for the practices of financial institutions in the context of credit cards, such as bans on unfair rate and late fees, more requirements for credit card issuers and penalties for companies that violate the law.
Another relevant reform was the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, also emanated by President Obama in the aftermath of the great recession. It is "an Act

to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes"[34]. It was emanated in response to the financial meltdown which contributed to the 2008 financial crisis.

In this context, another important law is the one regarding bankruptcy. In U.S., it is covered by The Federal Bankruptcy Code of 1978, updated with the implementation of the Bankruptcy Abuse Prevention Act of 2005. It covers several types of bankruptcy, but the ones regarding personal individuals are contained in "Chapter 7" and "Chapter 13".

First of all, "bankruptcy helps people who can no longer pay their debts get a fresh start by liquidating assets to pay their debts or by creating a repayment plan"[35] – and this is a very different way of seeing bankruptcy with respect to Europe, where it is typically seen as a mechanism by which creditors may recover their funds.

Generally speaking, the bankruptcy process – even if it slightly differs from state to state – works as follows: the debtor must obtain credit counseling up to 180 days before filing for bankruptcy; the counseling, which must be approved by a credit counseling agency, has the objective to ensure that the debtor fully understands the essence of bankruptcy; then, the individual has to apply "Chapter 7" or "Chapter 13", on the basis of his/her characteristics, and submit a petition for bankruptcy to the court (paying also a fee); finally, the court assign a trustee to manage the bankruptcy process.

Specifically, debtors may apply for "Chapter 7" only if they meet at least one of two income-based criteria: their income is below the median income of the state in which they live; or they disposable income, after reasonable living expenses have been removed, is less than $12,850 (or 25% of the debtor's nonpriority unsecured debt, as long as that amount is at least $7,700)[36].

In the opposite case, individuals must apply for "Chapter 13". A particular advantage of chapter 13 is that it provides individual debtors with an opportunity to save their homes from foreclosure by allowing them to "catch up" past due payments through a payment plan.

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[34] See https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf

[35] See https://www.uscourts.gov/services-forms/bankruptcy

[36] Data from https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics

No other country in the world has passed so much legislation (and so early) concerning consumer credit. And this, according to Gelpi & Julien-Labruyère (2000), “shows both the democratic maturity of U.S. and the significant importance of credit as underpinning society”.

5.2 Consumer credit law in Europe

The main objective of the EU effort in the regulation of consumer credit has been – and still is – information disclosure. Both as a remedy for information asymmetry between lenders and borrowers and as a way to improve the quality of borrowers’ contractual choices. This because, even if in a traditional economic view, individuals are seen as rational and informed, in reality, the European consumer credit market is composed by heterogenous consumers and barriers of various nature (i.e. legal, linguistic, geographical and cultural differences, different levels of information asymmetry between lender, financial intermediary and consumer and predominant local credit cultures).

During the years, the strategies used by the EU in order to discipline the consumer credit market have been quite different, including bans on usury, interest rate caps, stimulation of cooperative lending and (mainly) information disclosure. However, given the structure and nature of the EU itself, these regulations have not brought member states to a common law. They have rather brought a combination of private and public regulations, due to the different ways in which member states transpose the European directives. The reason for that may be attributed to the fact that European directives combine economic (transparent and competitive market) and social (i.e. social consequences of over-indebtedness) concerns in a private law setting. However, through the years, regulations have developed into a balancing act between stimulating financial services and safeguarding economic interests of consumers (Van Boom & Garcia, 2009).

Generally speaking, in Europe, it is possible to distinguish two main strands[37]: a neoliberal approach based on the empowerment of consumers, who are considered to be rational individuals who maximize their utility by using in an optimal way the information available; and a social market approach which is more connected to social values with the aims of redistribution of wealth, mitigation of cultural exclusion and marginalization and increasing of autonomy and self-reliance.

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[37] See Van Boom W.H. (2009). Information disclosure in the EU Consumer Credit Directive: opportunities and limitations.

In the former approach, information disclosure and controls on unfair contractual terms may be considered sufficient to the sustainment and development of the consumer credit market. While in the latter, which is more interventionist and paternalistic, the focus is not on economic concerns but rather on a fairer access to credit.
In general terms, these strategies may be pursued together and a certain degree of overlap between them may exist. In the early stages, the rationales of European regulation of consumer credit were to protect consumers against unfair contractual provisions and to promote cross-border credit (with the goal of harmonizing information to be provided to consumers). Nowadays, instead, EU consumer policy seems to be leaning towards the neoliberal approach by gradually moving away from a conception of consumers as objects of European law towards a notion of consumers as regulatory subjects by substituting “consumer protection” with a broader notion of “consumer policy” in which consumers are empowered with tools that support their role as accountable and active actors, rather than as passive subjects that need to be protected against themselves (Van Boom & Garcia, 2009).
Given this introduction, we will now explore in detail the evolution of the European regulation of the consumer credit market.

The creation of a specific European regulation about consumer credit has been – and still is – a long and complex process. Until the end of 1970s, there was not a common regulation in Europe and consumer credit was regulated only at a national level. However, at the beginning of 1980s, discussions as the basis of a proposal for a Directive relating to consumer credit started between European Commission and member states. Since then, the regulatory framework governing consumer credit has undergone a deep transformation both at national and at Community level. This led, in 1986, to the approval and emanation of the Directive 87/102/EEC (European Economic Union, which became European Union with the Maastricht Treaty in 1992) which aimed to bring closer the laws, regulations and administrative provisions of the member states. Moreover, few years later was emanated the Schengen Treaty which introduced the liberalization of cross-country capital flows and the deregulation of domestic capital markets, with the aim of liberalizing the provision of financial services and increasing competition. This removal of capital movement restrictions, together with the introduction of the new Directive for consumer credit regulation, represented steps towards the creation of an integrated credit market.
The Directive aimed to bring “a certain degree of approximation of the laws” about consumer credit contracts. It did that covering credit agreements (different from mortgages) longer than

three months and for a fee between €200 and €20,000 – with various exception, i.e. credits to be repaid in maximum four payments in a period up to 12 months, zero interest rate loans, etc. The Directive introduced the computation and communication to consumers of the Annual Percentage Rate of Charge (APR). In addition, it introduced the right for consumers to discharge the obligations under a credit agreement before the time fixed by the agreement, with an equitable reduction in the total cost of the credit.

Specifically, the Directive introduced a minimum harmonization approach, combined with consumer protection provisions. The Community tried to achieve total harmonization of certain aspects of credit agreements relative to consumer protection, tackling non-discriminatory obstacles that could lead to competitive distortions between lenders and thus restrict opportunities for consumers to obtain credit in other member states (Guardia, 2002). The two main goals of the Directive were the protection of individuals against unfair credit terms, and the promotion of cross-border credit by means of the harmonization of the information to be provided to consumers.

The fundamental consumer protection elements of the Directive were: dispositions to guarantee a fair contractual balance between the parties and the provisions related to consumer information (Guardia, 2002). This last element confirms the importance and centrality of disclosure in the context of consumer credit protection.

Member states were free to impose stricter national laws than the ones provided by the Directive, ensuring that the minimum standards were incorporated.

Generally speaking, the level of protection of consumers and the functioning of the consumer credit market were quite different across member states (ranging from the minimum to the highest levels of protection). The Directive 87/102/EEC introduced only a minimum standard of consumer protection and this brought member states to implement additional provisions (i.e. about time limits and procedures connected with credit agreements) which led to substantial differences between them. This, in turn, led to distortions of competition among lenders from different states, creating obstacles for the creation of an internal market.

Probably, this was the main cause that limited the harmonization and integration of the European credit market.

Subsequently, the Directive was modified in 1990 (90/88/EC) and in 1998 (98/7/EC).

The Council Directive of 1990 aimed at harmonizing the financial aspects relative to the cost of credit that had not been addressed by the 1986 directive: the mathematical aspect of the calculation and the determination of the elements to be included in the APR (Guardia, 2002). Indeed, in an indirect way, listing all the elements that must be excluded from the computation,

the method and the formula for the calculation of the APR was introduced. However, the fact that has been introduced a list of elements that must not be taken in consideration, rather than a list of all elements to be included, has left some leeway to states in the determination of the elements to be included in the calculation of the costs – i.e. insurance and guarantee costs differ significantly across countries.

Hence, this attempt to harmonize the calculation of APR was not a complete success, since "the elements used to calculate the APR differ between member states and the differences of interpretation might generate differences in the APR calculated for identical products" (Guardia, 2002).

The European Parliament and Council Directive of 1998 modified again the 1986 Directive, introducing a single mathematical formula to be applied for the calculation of the APR. In particular, it stated that "the annual percentage rate of charge which shall be that rate, on an annual basis which equalizes the present value of all commitments (loans, repayments and charges), future or existing, agreed by the creditor and the borrower, shall be calculated in accordance with the mathematical formula set out in Annex II"[38]. The formula set out in Annex II was:

$$\sum_{K=1}^{K=m} \frac{A_K}{(1+i)^{t_K}} = \sum_{K'=1}^{K'=m'} \frac{A'_{K'}}{(1+i)^{t_{K'}}}$$

where:

K is the number of a loan

K' is the number of a repayment or a payment of charges

A_k is the amount of loan number K

$A'_{K'}$ is the amount of repayment number K'

$\sum$ represents a sum

m is the number of the last loan

m' is the number of the last repayment or payment of charges

t_K is the interval, expressed in years and fractions of a year, between the date of loan No 1 and those of subsequent loans Nos 2 to m

$t_{K'}$ is the interval, expressed in years and fractions of a year, between the date of loan No 1 and those of repayments or payments of charges Nos 1 to m'

[38] See Directive 98/7/EC of the European Parliament and the Council of 16 February 1998

i is the percentage rate that can be calculated (either by algebra, by successive approximations, or by a computer program) where the other terms in the equation are known from the contract or otherwise.

The reports and consultations made during later years about the 87/102/EEC and its modifications (the aforementioned 90/88/EC and 98/7/EC) showed huge differences between the laws of member states with regards to credit in general, and consumer credit in particular. Thus, the Directive no longer represented the situation in the consumer credit market. European bodies considered necessary a revision of the Directive 87/102/EEC. Issues such as technical problems in connection with accessing another market, lack of adequate harmonization of national legislations and changes to the methods and functioning of the credit industry that occurred since the 1980's required the implementation of a more modern regulation. For this reason, at the beginning of 2000s, European Union institutions started to discuss about this topic. The Commission, in 2002, proposed a revised version of the Directive 87/102/EEC, which intended to create a fully harmonized set of provisions for all member states, in order to ensure the same (high) level of consumer protection across them. However, discussions and negotiations between European institutions and member states protracted in time, leading to new proposal in October 2004 and again in November 2005. It was only in 2008 that the final proposal was adopted.

This has led to the emanation of the Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 – the so-called Consumer Credit Directive (CCD). It has repealed the Council Directive 87/102/EEC.

The introduction of the new Directive has been intended to solve different issues that had been created in the European consumer credit environment. First, it was clear that the precedent Directive was no longer able to respond to the needs of consumers leading to a general consumer dissatisfaction. Then, due to the fact that a single well-functioning consumer credit market did not exist, demand and offer of consumer credit were sub-optimal. In addition, the level of consumer protection was significantly different across member states. And, finally, the innovation and development in the consumer credit market needed to be addressed. Thus, the CCD has been emanated to respond to these key needs.

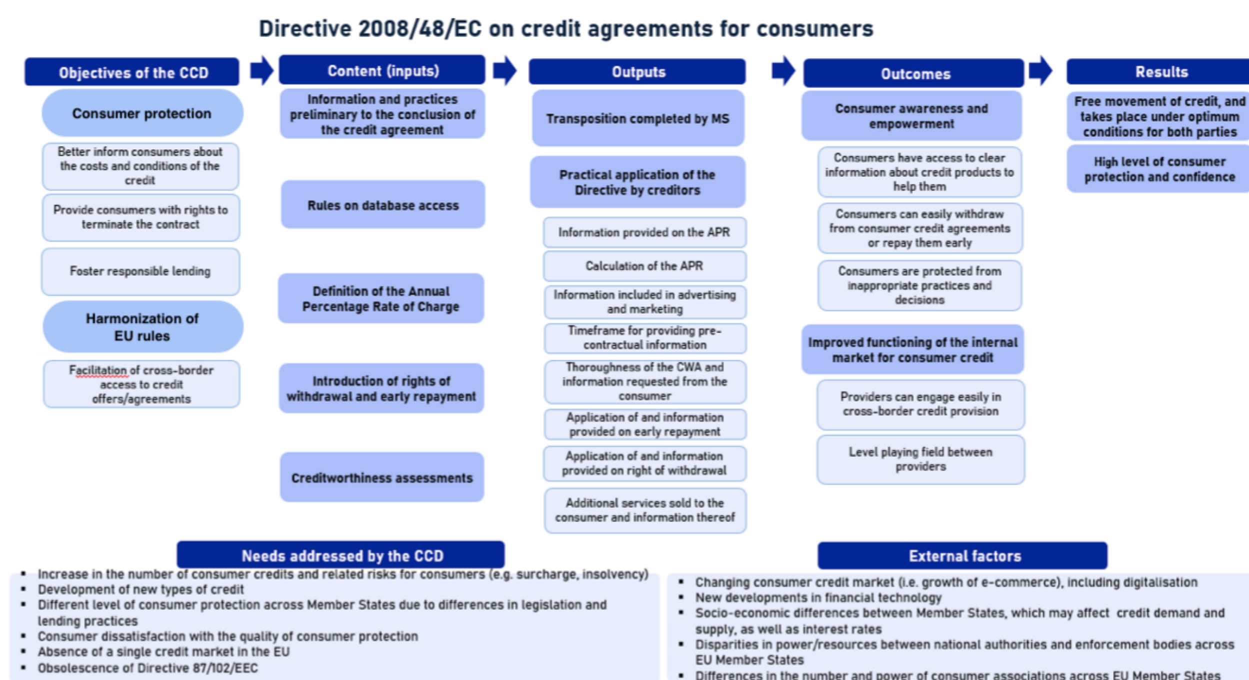

Figure 3. Logic of the intervention of the Directive 2008/48/EC on credit agreements for consumers. Adapted from Commission staff working document evaluation of Directive 2008/48/EC on credit agreement for consumers. Brussels, 5.11.2020 SWD(2020) 254 final.

The two main aims of the Directive are:

- harmonization of EU rules about credit granted to consumers who borrow to finance purchases of goods and services;
- opening of the EU's consumer loan market, improving the transparency of contract terms and the level of consumer protection.

The provisions contained in the Directive are therefore intended to achieve these aims. The first aim includes two particular objectives:

- facilitating cross-border access to consumer credit offers, and
- ensuring a level-playing field between creditors by providing a harmonized framework.

The second aim includes three particular objectives:

- informing consumers about the costs and conditions of the credit they request,
- providing consumers with rights to terminate their contract, and
- fostering responsible lending among credit providers.

As shown in Figure 3, these objectives (inputs) are correlated to specific provisions within the Directive's articles. These inputs are then transformed in outputs by the work of the member states thorough the transposition of the Directive into their national law. This leads to outcomes which should finally lead to hoped results.

Specifically, the Directive does not apply to credit agreements guaranteed by mortgages, for the acquisition of lands or properties and for less than €200 or more than €75,000. It has

broadened the concept of transparency, imposing that advertising for credit must include standard information such as – among other things – the rate of interest and cost details, the credit amount and the APR (which represents all mandatory costs in order to obtain the credit).
The Consumer Credit Directive has improved the disclosure in the pre-contractual phase, defining the essential information that lenders must provide, in a standardized format, to the customer before entering into the contract. These are, among the others, the duration of the credit agreement, the total credit amount, the borrowing rate and terms applicable to this rate, the annual percentage rate and the total amount due by the consumer, the amount, number and frequency of payments, the fees related to or resulting from the agreement and the consequences of late payment and non-performance.
Another important innovation is the fact that lenders must assess the creditworthiness of their customers before signing the credit agreement and inform the customer of the result and details of the credit database used if the application is rejected.
Finally, the CCD has introduced a new formula for the computation of the APR (as presented in Chapter 3, Paragraph 3.4), stating that the APR must not be expressed by a unique value but rather by a range from a minimum to a maximum value.

Afterwards, the CCD has been modified in three different moments. The first has been with the emanation of the Commission Directive 2011/90/EU of 14 November 2011, which has amended Part II of Annex I of 2008/48/EC Directive providing additional assumptions for the calculation of the annual percentage rate (APR) of charge.
Then, the Directive 2014/17/EU of the European Parliament and of the Council has been emanated on February 4th, 2014. Amending the 2008/48/EC Directive, it has introduced new regulation on credit agreements for consumer with regards to residential immovable property. In particular, it has introduced regulation for credit agreements for the acquisition of lands or properties and for credit agreements guaranteed by mortgages. Moreover, it has widened the credit agreements covered in the 2008/48/EC Directive, including also non-guaranteed credit agreements for the renovation of residential immovable property, for more than €75,000.
Finally, the last modification of the CCD has been made by the Regulation (EU) 2016/1011 of the European Parliament and of the Council on June 8th, 2016 – which has also modified the 2014/17/EU Directive. It has introduced innovation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds. Under this new law, all benchmark administrators have to be authorized by a competent authority or registered, even if they provide only non-significant benchmarks – and it also includes the

introduction of a third-country regime to enable non-EU benchmarks to be used by EU supervised entities.

Another important directive in the consumer credit context is the European Parliament and Council Directive 2011/83/EU of 25 October 2011. This so-called Consumer Rights Directive has given consumers the same rights across the European Union, aligning and harmonizing national consumer rules.
This Directive has then been amended by the European Parliament and Council Directive (EU) 2019/2161 of 27 November 2019, which has introduced better enforcement and modernization in European consumer protection rules, as part of "Review of EU consumer law - New Deal for Consumers" – a new regulation that has been introduced in order to enhance the enforcement of European consumer law in response to the growing risk of EU-wide infringements and to modernize the EU consumer protection rules in view of market developments.

During 2020, as evidence of its continued commitment, the EU is preparing its new consumer strategy for the years to come. In particular, the strategy will aim to update European consumer policy in order to tackle the new challenges brought by digitalization and environmental issues and to protect consumers in the new economic situation generated by the COVID-19 crisis. To do so, the EU will improve the legislation about information disclosure, consumer creditworthiness and products safety. In addition, according to the EU Agenda, it will extend the scope of the CCD to credits that are currently outside of its scope and it will simplify rules as response to the behavioral findings and insight emerged from its reports and consultations.

Consumer protection policy

As it has been said in the introduction of this chapter, the EU is making efforts in the field of consumer policy by promoting, protecting and ensuring consumers' rights in the consumer credit market. In fact, the main goal of the European consumer policy is to guarantee their rights to consumers.
To achieve this, the EU is continuously trying to align consumers rights and policies to changes in society and economy. Specifically, it protects consumers from unfair situations that they are unable to identify by themselves, it empowers consumers in order to make them able to choose on the basis of accurate, clear and consistent information, and it seeks to enhance consumers' welfare by protecting their safety and economic interests.
According to the Treaty on the Functioning of the European Union (TFEU), consumer protection matters are competence both of the EU and of the member states: once the EU has

adopted new provisions, member states are responsible for incorporating European directives in their legislative systems.
The TFEU (in force since 2012) represents the legal basis for the European consumer protection policy. Amongst other provisions, it states that consumer protection, which is a shared issue between the EU and its member states, shall be taken in consideration in the implementations of Union policies and activities. In particular, in the Article 169 the TFEU indicates that:

> "In order to promote the interests of consumers and to ensure a high level of consumer protection, the Union shall contribute to protecting the health, safety and economic interests of consumers, as well as to promoting their right to information, education and to organise themselves in order to safeguard their interests."

Through this treaty, the EU has provided a common legal basis of protection for all European consumers.
Another important document in this context is the Charter of Fundamental Rights of the European Union (in force since 2012), which states that the EU shall ensure – amongst other fundamental rights – a high level of consumer protection. This document, together with the TFEU, represent the primary law for consumer protection policy.
An important issue to be considered is that it does not exist a single definition of consumer in the EU. However, even if there is not a consistent and uniform definition of consumer – mainly because of the different ways in which member countries incorporate European directives into their legislation – most European directives define it as a "natural person who is acting for the purposes which are outside his trade, business and profession"[39]. This is a negative definition which does not apply to legal person, as has been emphasized in the case law of the Court of Justice on several occasions. Because of this low level of harmonization in the definition of consumer, member states typically extend their consumer protection policies beyond the European definition of consumer.

Considering the evolution of consumer policies, the first tool in the area of consumer protection was the "Council Resolution on a preliminary programme of the European Union Community for a consumer protection and information policy", introduced in 1975. It defined five fundamental rights: the right to protection of health and safety, the right to protection of economic interests, the right to claim for damages, the right to an education and the right to legal representation (or the right to be heard). This program has been used as basis for the

[39] Valant J. (2015). Consumer protection in the EU – policy review.

following directives and regulations in the field of consumer protection. Today, around 90 EU directives cover consumer protection issues and this, given the fact that directives do not apply directly in member states but must be incorporated in their national law, has created confusion and inconsistency among different states – indeed, the level of harmonization reached in this area is still low. For instance, if a dispute arises, consumers cannot invoke the directive against a trader directly, it is up to the national courts to apply and interpret these rules and they can request additional interpretation from the European Court of Justice through the preliminary ruling procedure (Valant, 2015). Nonetheless, since this is not frequent it may contribute to potential divergences in the interpretation of provisions deriving from EU directive.

The EU has introduced other tools to assess, monitor and improve the protection of consumers. They are: market monitoring tools, which allow to estimate the impact of existing policies and to give a direction for the future policies; awareness-raising tools, which have been developed for empowering consumers and ensure that they can assess clear, simple and transparent information in order to make informed decisions; and tools for stepping up enforcement and securing redress.

The are several areas of application of the consumer protection policies. It is, indeed, a transversal policy. There are measures of general scope and application, such as the Directive 93/13/EEC on unfair terms in consumer contracts, the Directive 95/46/EC on the protection of individuals with regard to the processing of personal data and on the free movement of such data, the Directive 1999/44/EC on certain aspects of the sale of consumer goods and associated guarantees, the Directive 2006/123/EC on services in the internal market, the Directive 2009/22/EC on injunctions for the protection of consumers' interests, the Directive 2006/114/EC concerning misleading and comparative advertising, the Directive 2011/83/EU on consumer rights and the Directive 2013/11/EU on alternative dispute resolution for consumer disputes. Moreover, there also cases in which the European legislation deals with specific issues only, such as the provision of pre-contractual information or a right of withdrawal from a contract where the circumstances in which it was made or the nature of the transaction justifies it (Valant, 2015).

The efforts of the EU in the field of consumer protection have produced some positive results, such as the lowering of roaming charges, the reduction of irregularities and non-compliance with consumer legislation identified on European websites selling different products, and the introduction of a consumers' right to change their mind (the so-called "cooling off period") together with the right to delivery within a reasonable time when purchasing online and the right to a two year guarantee when buying a product in a shop or online.

However, different studies argue that the legal framework in the area of consumer protection policies is fragmented, unsatisfactory and that important differences between national consumer regulations may deter consumers to trade across borders (Valant, 2015).

As stated by Valant (2015), the European Commission[40] has identified three interrelated gaps in the area of EU consumer protection policy: an information gap (insufficient understanding of rules and their application in practice); an implementation gap (due to incorrect transposition or application of rules), and a legislative gap (due also to the fact that EU has no, or only limited, power to legislate).

Thus, summing up, the aim of ensuring high level of consumer protection has been partially achieved but, since member states have completed directives provisions with additional element, there is still work to be done in order to achieve the (wished) highest level of consumer protection and harmonization.

The importance of jurisprudence

The CCD has been a fundamental pillar in the consumer credit law. Even other Directives have introduced significant provisions in this field, such as the Directive 93/13/EEC on unfair terms in consumer contracts, the Directive 1999/44/EC on certain aspects of the sale of consumer goods and associated guarantees, the Directive 2005/29/EC concerning unfair commercial practices and the Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property. However, given the fact that member states (due to the legislative nature of directives) have incorporated their provisions in different ways, they have not brought the hoped level of harmonization.

For this reason, there have been – and there still are – a lot of appeals to the European Court by national entities in order to obtain a right interpretation of the Directives. In particular, the European Court expresses itself on cases in which the national regulations of two countries differ. In this case, national judges refer the case to the European Court which will pronounce a sentence taking in consideration the reference European law and implementing it in the right way. In this sense, there is a lot of jurisprudence based on the Directives regarding consumer credit, as it is shown in Figure 4 and Figure 5 (they show examples of cases handled by the European Court in the context of consumer credit, considering the reference European legislation).

[40] See European Commission (2011). The Single Market through the lens of the people: a snapshot of citizens' and businesses' 20 main concerns.

2020		2019		2018	
Case	**Reference Directive**	**Case**	**Reference Directive**	**Case**	**Reference Directive**
Case C-779/18 of Milkrokasa S.A. Revenue versus XO	- Directive 2008/48/EC: • Concept of "non-interest credit costs" -Directive 93/13/EEC: • Unfair terms in consumer contracts	Case C-419/18 of Profi Credit Polska S.A. versus Bogumila Wlostowska et al.; Case C-483/18 of Profi Credit Polska S.A. versus OH	- Directive 93/13/EEC: • Article 3(1), 6(1), 7(1) - Directive 2008/48/EC: • Lawfulness of securing the debt arising under the agreement by means of a blank promissory note • Demand for payment of the debt owed under the promissory note • Scope of the court's powers and obligations	Case C-448/17 of EOS KSI Slovensko s.r.o. versus Jàn Danko and Margita Dankovà	- Directive 93/13/EEC: • Obligation to draft terms in plain intelligible language • Actions brought before the courts by persons or organisations having a legitimate interest in protecting consumers against the use of unfair terms • National law making the possibility for a consumer protection association to intervene in the proceedings subject to the consumer's consent - Directive 87/102/EEC: • Obligation to indicate the annual percentage rate in the written agreement • Agreement containing only a mathematical formula for calculating the annual percentage rate without the information necessary to make that calculation
Case C-686/19 of SIA "Soho Group" versus Patērētāju tiesību aizsardzības centrs	- Directive 2008/48/EC: • Total cost of credit for consumer	Case C-694/17 of Pillar Securitisation Sàrl versus Hildur Arnadottir	- Directive 2008/48/EC: • Concepts of "consumer" and of "transactions covered by the directive" • Maximum amount of credit	Case C-176/17 of Profi Credit Polska S.A. w Bielsku Bialej versus Mariusz Wawrzosek	- Directive 93/13/EEC: • Unfair terms in consumer contracts - Directive 2008/48/EC: • Order for payment procedure founded on a promissory note that secures the obligations arising from a consumer credit agreement
Case C-84/19 of Profi Credit Polska SA versus QJ; Case C-222/19 of BW versus DR; Case C-252/19 of QL versus CG	- Directive 93/13/EEC: • National provision providing for the maximum amount of non-interest credit costs; • Significant imbalance between the rights and obligations of the parties; • Contractual terms which do not specify the services for which remuneration is sought - Directive 2008/48/EC: • National legislation laying down a method of calculating the maximum non-interest credit cost which may be charged to the consumer	Case C-58/18 of Michel Schyns versus Belfius Banque SA	- Directive 2008/48/EC: • Obligation on the creditor to seek to establish the credit most suitable • Obligation on the creditor to refrain from concluding the loan agreement if there are doubts over the creditworthiness of the consumer • Obligation on the creditor to assess the expediency of the credit	Case C-483/16 of Zsolt Sziber versus ERSTE Bank Hungary Zrt.	- Directive 93/13/EEC: • Loan agreements denominated in foreign currency • National legislation providing for specific procedural requirements when the fairness of terms is challenged - Charter of Fundamental Rights of the European Union: • Right to effective judicial protection
Case C-778/18 of Association française des usagers de banques versus Ministre de l'Économie et des Finances	- Directive 2014/17/EU: • Credit agreements for consumers relating to residential immovable property	Case C-383/18 of Lexitor sp.z.o.o. versus Spółdzielcza Kasa Oszczędnościowo — Kredytowa im. Franciszka Stefczyka, Santander Consumer Bank S.A., mBank S.A.	- Directive 2008/48/EC: • Early repayment • Right of the consumer to a reduction in the total cost of the credit, consisting of the interest and the costs for the remaining duration of the contract		
Case C-679/18 of OPR-Finance s.r.o. versus GK	- Directive 2008/48/EC: • Credit agreements for consumers relating to residential immovable property • Penalties: effective, proportionate and dissuasive nature	Case C-290/19 of RN versus Home Credit Slovakia a.s.	- Directive 2008/48/EC: • Information to be included in credit agreements • Annual percentage rate of charge • Lack of indication of the exact percentage of that rate of charge		
Case C-66/19 of JC versus Kreissparkasse Saarlouis	- Directive 2008/48/EC: • Right of withdrawal: time limit for the exercise of that right • Requirements concerning the information to be included in a credit agreement	Case C-331/18 of TE versus Pohotovost' s.r.o.	- Directive 2008/48/EC: • Information to be included in the agreement • National legislation laying down an obligation to specify for each payment the distribution between the repayment of capital, interest and charges		
Case C-495/19 of Kancelaria Medium SA versus RN	- Directive 93/13/EEC: • Review of whether the contractual terms are unfair • Failure of the consumer to appear at the hearing				

Figure 4. Examples of cases handled by the European Court regarding consumer credit

2017		2016	
Case	**Reference Directive**	**Case**	**Reference Directive**
Case C-357/16 of UAB "Gelvora" versus Valstybinė vartotojų teisių apsaugos tarnyba	- Directive 2005/29/EC: • Concept of "product" • Recovery measures taken in parallel to the intervention of a bailiff	Case C-377/14 of Ernst Georg Radlinger and Helena Radlingerová versus Finway a.s.	- Directive 93/13/EEC: • National rules governing insolvency proceedings • Disproportionate amount of compensation • Debts arising from a consumer credit agreement • Effective judicial remedy - Directive 2008/48/EC: • Total amount of credit • Amount of drawdown • Calculation of the annual percentage rate • Obligation to provide information • Ex officio examination • Penalty
Case C-147/16 of Karel de Grote – Hogeschool Katholieke Hogeschool Antwerpen VZW versus Susan Romy Jozef Kuijpers	- Directive 93/13/EEC: • Unfair terms in consumer contracts • Examination by the national court, of its own motion, whether a contract falls within the scope of Directive 93/13 • Concept of "seller or supplier"	Case C-127/15 of Verein für Konsumenteninformation versus INKO, Inkasso GmbH	- Directive 2008/48/EC: • Rescheduling agreements • Deferred payment, free of charge • Credit intermediaries • Debt recovery companies acting on behalf of lenders
Case C-344/17 of IJDF Italy Srl versus Violeta Fernando Dionisio and Alex Del Rosario Fernando	- Directive 93/13/EEC: • National legislation permitting the principal debtor and the guarantor to be convened in front of the court • Derogation of the rules governing the forum of the consumer	Case C-42/15 of Home Credit Slovakia a.s. versus Klára Bíróová	- Directive 2008/48/EC: • Interpretation of the expressions "on paper" and "on another durable medium" • Contract referring to another document • Requirement for the agreement to be in "written form" within the meaning of national law • Indication of information required by reference to objective criteria • Information to be included in a fixed-term credit agreement • Effect of failure to include mandatory information • Proportionality
Case C-133/16 of Christian Ferenschild versus JPC Motor SA	- Directive 1999/44/EC: • Consumer protection with second-hand goods • Consumer rights in the event of lack of conformity of the goods with the contract • Period of liability for lack of conformity of the goods with the contract	Case C-168/15 of Milena Tomášová versus Slovenská republika – Ministerstvo spravodlivosti SR, Pohotovosť s.r.o.	- Directive 93/13/EEC: • Credit agreement containing an unfair term • Enforcement of an arbitration award in accordance with that term • Member State liability for damage caused to individuals by breaches of EU law attributable to a national court • Conditions of engagement • Existence of a sufficiently serious breach of EU law
		Case C-49/14 of Finanmadrid EFC SA versus Jesús Vicente Albán Zambrano, María Josefa García Zapata, Jorge Luis Albán Zambrano, Miriam Elisabeth Caicedo Merino	- Directive 93/13/EEC: • Order for payment procedure • Enforcement proceedings • Powers of the national court responsible for enforcement to raise of its own motion the fact that the unfair term is invalid • Principle of res judicata • Principle of effectiveness - Charter of Fundamental Rights of the European Union: • Judicial protection

Figure 5. Examples of cases handled by the European Court regarding consumer credit

5.3 Mortgage credit: legislative differences between U.S. and Europe

One important difference between U.S. and EU regulation is the treatment of mortgage credit. First of all, a mortgage is a debt instrument, secured by the collateral of a specific real estate property, used by individuals to make real estate purchases. In fact, since individuals do not usually have all the money to buy a real estate property, they may apply for a mortgage obtaining the money they need and with the obligation to pay it back with a set of predetermined payments (repaying the principal plus interests). Mortgages are extremely important since they are largely used by individuals to purchase the home in which they live. Moreover, among other things, they caused the 2008 sub-prime crisis which, in turn, generated the global financial crisis. Thus, for these reasons, mortgages are highly regulated nowadays.

In U.S., mortgage credit is generally regulated together with consumer credit. Indeed, it is regulated in the Truth in Lending Act (TILA), which protects consumers in their relationship with lenders. Other important laws regarding mortgage credit are included in Regulation Z, which is an implementation of the TILA made in order to ensure the disclosure of better information about costs of credit and to protect consumers from misleading practices; and in the Real Estate Settlement Procedures Act (RESPA) – which, differently from the aforementioned regulations, regards mortgage credit only – enacted by the Congress to ensure more information disclosure about costs related to home buying. Moreover, one significant regulation of mortgage credit is included in the Dodd-Frank Wall Street Reform and Consumer Protection Act which, as said before, has been emanated in response to the 2008 sub-prime crisis.

In Europe, instead, mortgage credit is separated by consumer credit. The Directive 2008/48/EC regarding consumer credit explicitly says that it does not cover credit agreements guaranteed by mortgages and for the acquisition of lands or properties. Mortgage credit is regulated by the European Parliament and Council Directive 2014/17/EU of February 4th, 2014. This so-called Mortgage Credit Directive (MCD) – to differentiate it from the Consumer Credit Directive –

"aims to ensure that all consumers who take out a mortgage to purchase a property are adequately informed and protected against the risks"[41].

The MCD defines the obligations of lenders, the rights of consumer and the common quality standards and principles.

The scope of the Directive is the creation of a single European real estate credit market. In fact, this it is the result of a series of preliminary works – in particular in response to predatory lending (which was one of the main causes of the 2008 global financial crisis) – which have always had the aim of uniform the national markets into a single European market. The two main innovation are the inclusion of mortgage-backed real estate loans into the consumer credit category and the introduction of the advisory services (in order to enhance the level of consumer protection).

The Directive applies to all loans made for the purpose of buying residential property – including loans that are guaranteed by a mortgage or by another comparable security. More specifically it applies to:

- credit agreements which are secured either by a mortgage or by another comparable security commonly used in a Member State on residential immovable property or secured by a right related to residential immovable property;
- credit agreements the purpose of which is to acquire or retain property rights in land or in an existing or projected building.

The Directive has the scope to provide more information to consumers about available mortgage products obliging lenders to give clear and understandable information about interest rates, to provide a standardized information sheet (European Standardised Information Sheet - ESIS) in order to identify the right product, to guarantee a reasonable period of reflection or a right of withdrawal and to assess consumers' creditworthiness in order to ensure that they are able to repay their debt.

The Directive also establishes conduct principles for lenders which must act honestly and transparently in the consumer's interests, ensuring that consumers have all the necessary information before signing an agreement.

[41] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.

In 2019, the European Commission has commissioned a study in order to assess the effectiveness, efficiency, relevance, coherence and EU added value of the Mortgage Credit Directive.

The main findings of the study are:

- as shown by literature reviews and consultations about responsible lending in member states, consumers' trust in the mortgage credit market has improved since the Directive came into force;
- cross-border activities have not changed significantly after the introduction of the Directive, but it is not always the reason (other reasons are language preferences, consumer trust, notarization, visits to the lender, etc.);
- the Directive states that member states shall ensure the implementation of an appropriate regulatory framework for foreign currency loans (consumers have the right to convert an agreement into an alternative currency, under specific conditions). However, after the introduction of the Directive, lenders have stopped to offer loan with this type of provision, since they would bear more of the exchange rate risk, or because the arrangements to limit the risk would be too costly. This has some disadvantages: it may be detrimental to some social groups, it may a problem for individuals who live in another currency member states, it may impact the wish of individuals to find better agreements in other member states and it may affect the use of digital services;
- the Directive has contributed to create a more even level playing field among credit providers and intermediaries as well as non-credit institutions if mostly at national level.

Generally speaking, it seems that the Directive has helped to reach a financial stability on the markets. Evidence shows that the Directive contributed to prevent consumers from taking credit they will be not able to repay and provided consumers with the opportunity to reduce their indebtedness level.

The majority of stakeholders found that the Mortgage Credit Directive has effectively contributed to the harmonization of the minimum requirements across the European Union, contributing to the functioning of the single internal market. Nonetheless, some stakeholders argue that gold-plating of rules by some member states, as well as the remaining differences in culture, language, national processes and legislation, remain a barrier to the creation of a true single market in mortgages.

MCD focus: the Italian case

In Italy, the so-called Mortgage Credit Directive (Directive 2014/17/EU) has been transposed in the Article VI of the "Testo Unico Bancario" (TUB) with the "Decreto Legislativo n. 72" of 2016 in order to ensure a high level of consumer protection in the context of mortgage agreements. The Italian legislator has incorporated in its law system the provisions included in the Directive.

The notion of credit agreement[42] is the same as in traditional consumer credit where a "creditor grants or promises to grant to a consumer credit in the form of a deferred payment, loan or other similar financial accommodation"[43].

The higher consumer protection is ensured by a series of information and assistance obligations in charge of lenders, which must respect the principles of impartiality, honesty and professionalism (as well as the general "principio di buona fede contrattuale" included in the Italian law).

The idea is to reduce the asymmetric information among financial intermediaries and consumers in order to ensure to the latter clear and transparent information which allow to take an informed decision.

Under the subjective aspect, the new framework applies to relations with consumers. While, under the objective aspect, the new framework introduced by the MCD applies to all concession agreements of any credit form but, in particular, to mortgage credit, when:

- the credit is secured by a mortgage on the property right or another right in rem on a residential property or
- the credit is finalized to the purchase or the retention of the property right on a land or on a built or projected building (in this second case, a building that has or is going to have a domestic end-use).

By definition, the real estate credit to consumers ("Diritto immobiliare ai consumatori") comprises:

- credits (mortgages) granted by lenders to consumers for the acquisition of a home or a land which will we used for non-commercial purposes. This type of contract has introduced a new framework by which a real estate contract may not include posting of real ("ipoteca" or "pegno") or personal ("fideiussioni") collateral by consumers.

[42] However, the provisions of the MCD has not changed the Italian legislation about traditional consumer credit, since they do not apply to it.

[43] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC.

- any type of credit which is guaranteed by a mortgage on the property right or another right in rem on a residential building.

The latter category means that all credit contracts aimed at financing general or specific consumer's consumption – such as the renovation of the house, the purchase of a car or the payment of a child's university tuition – fall within this framework, if they are guaranteed by a mortgage on a house. In addition, the mortgage may be also of a lower degree (second-degree, third-degree, etc.).

By all this, it is clear that, with this new framework, the European legislator and the Italian legislator have created a new market for consumer credit granted by residential property ("credito al consume garantito da beni immobili residenziali") in order to give a boost to stagnant internal European and, in particular, Italian consumption, by giving the opportunity to consumers to use as a collateral the economic value of their houses (as long as they are not subject to mortgage for their purchase). The interest rates applied to these contracts are smaller than the ones applied to traditional consumer credit, but bigger than the ones applied to the traditional mortgage credit.

One possible issue may arise if consumers do not have appropriate income flows, since lenders, in order to execute the contract, might need to sell together a huge quantity of houses. And this might happen even if the Italian legislator has introduced with the aforementioned "d.lgs. 72/2016" higher guarantees for consumers who want to access to these types of credit.

Generally speaking, the *ratio* of the MCD is the creation of a single market for real estate credit, where the systemic risk should be mitigated by the introduction of the advisory services and the reinforcement of the concept of responsible lending. The Italian legislator, following the European Directive, made it compulsory for lenders to offer advisory services – defined as "personal recommendations to a consumer in respect of one or more transactions relating to credit agreements which constitutes a separate activity from the granting of a credit and from the credit intermediation activities set out in point"[44] – to consumers before they make their decisions. The scope is to ensure that consumers take informed conscious decisions.

To conclude, the Directive 2014/17/EU has represented a turning point because it has created the new market of "credito al consumo immobiliare" with the introduction of specific provisions, mainly oriented to ensure high levels of consumer protection (such as advisory

[44] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.

services), in order to uniform the different legislation present in the various European states. The Italian law in this context is greatly aligned with the European Directive, and it actually represents a vanguard that European bodies even took as inspiration.

In practice, even if a lot has been done in this field – as represented by the improved situation in Italy after the introduction of the Directive – there still is the need to work at the European level in order to achieve higher levels of transparency and harmonization across member states for the creation of a functioning single internal market.

6. Conclusion

As discussed in this thesis, consumer credit – as it is known today – is the result of a process that started not so long ago and is still going. Its development has been always influenced by the historic, social and cultural reference context, and this helps to explain the differences between U.S. and Europe. While in U.S. there has always been a major institutional and cultural attention which has led to a quicker development, in Europe the social and historic context have delayed the development of consumer credit.

Despite its evolution process, consumer credit is nowadays a reality in the everyday financial lives of most individuals. Specifically, consumer credit is an important tool that can be used to finance purchases postponing the moment of payment. For this reason, and also for its simplicity, accessibility and spread, it is largely used by individuals. However, these advantages may also represent a problem in the sense that, if individuals do not take informed and conscious decisions, it may lead to serious financial problems (such as over-indebtedness).

From a standard economic point of view, consumer credit is a way to improve individuals' – who are assumed to be rational – standards of living by smoothing consumption over different period of their lives. It is included in the saving and borrowing decisions that individuals take every day and, in fact, it is affected by both individual (such as income, wealth, education, job) and institutional (such as the institutional framework, the level of consumer protection, the functioning of the judicial system) factors.

Behavioral theories, however, contradict the rationality of the standard economic models, assuming that individuals systematically deviate from rational choices because of psychological and cognitive issues. This has important consequences which should be taken in consideration by government bodies when they legislate.

In the U.S., consumer credit is one of the most regulated economic areas but issues, such as predatory lending, still represent a threat for consumers. In Europe, instead, the main issue is represented by the level of harmonization across member states, which inevitably affects the creation of a functioning single internal market. In this sense, a lot has been made thanks to emanation of several Directives (i.e. which have led to the creation of the new real estate consumer credit) but it seems that the goal is still far from being achieved.

In general, for both U.S. and Europe government bodies, the main issue in the consumer credit market has been – and still is – represented by consumer protection. In this field a lot has been made during the last 50 years, but it seems to not be enough. Even if high levels of consumer protection have been achieved, thanks to the effort of legislators in ensuring information disclosure, there is still room for improvement.

Therefore, to conclude, even if the legal and economic objectives achieved in consumer credit markets are remarkable on both sides of the Ocean, both may improve their framework and situation investing more effort and attention, in order to reach their – similar, but possibly different because of their history and actual aims – objectives in terms of efficiency, transparency and protection.

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