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BRIEFING

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The Consumer Credit Directive: is it all changing again?

More change is afoot in the consumer credit world. This time, change is being driven by Europe in the shape of a new initiative: the Consumer Credit Directive, which must be implemented into UK law by June 2010. The UK government has recently published a consultation on its proposals to implement the Directive. In this briefing, we go through the main themes coming out of the consultation, with a view to helping the industry assess how it should prepare to change again, if change it really must.

More change is afoot in the consumer credit world. Not long after the introduction of the last set of changes to the UK consumer credit regime, which underwent significant reform as a result of the implementation of the Consumer Credit Act 2006 between April 2007 and October 2008, the industry is being forced to take another look at the regulation of its business and ask itself: is it all really changing again?

Background

A new initiative, the Consumer Credit Directive (2008/48/EC) (the Directive), must be implemented into UK law by June 2010. The UK government has recently published a consultation on its proposals to implement the Directive. It is not adopting a copy-out approach to implementation but instead it will have the more complex task of amending existing UK consumer credit legislation to bring it in line with the Directive.

The Directive aims to create a comprehensive and harmonised framework for the regulation of consumer credit across Europe. It is a maximum harmonisation directive, and so the UK government will have little room for manoeuvre in relation to the types of agreements that are covered by the Directive and the requirements that the Directive imposes in relation to them. Having said that, the Directive does not cover all types of credit agreements currently regulated by UK consumer credit legislation and the UK government is planning to give industry some flexibility in applying the Directive's requirements to such agreements.

While many of the Directive's requirements are similar to existing provisions of UK consumer credit legislation, it imposes a number of new requirements on lenders. It will also bring changes to some of the existing exemptions from regulation.

Scope of the Directive

The Directive applies generally to credit agreements below €75,000 entered into with natural persons for non-business purposes, subject to certain exemptions. Its general scope is narrower than the existing regime set out in the Consumer Credit Acts 1974 and 2006 (CCA) and a number of agreements that are currently regulated by the CCA fall outside the Directive's scope. These include:

- loans to sole traders, small partnerships and unincorporated bodies;
- loans above €75,000;
- second charge mortgages; and
- credit with no interest or other charges.

Lenders should be aware that these types of agreement will not be removed from regulation and the CCA as amended by the Directive will generally apply to such agreements. However, as highlighted throughout this briefing, the UK government has indicated that certain of these non-Directive agreements will be exempt from some of the Directive's new requirements.

Changes to existing exemptions

Lenders should also take note that a number of exemptions from the current CCA regime will have to be modified as they do not align exactly with the Directive's exemptions. Because the Directive is a maximum harmonisation directive, UK law cannot provide exemptions for agreements within the Directive's scope for which the Directive provides no corresponding exemption. Lenders should carefully review their range of credit products that are currently exempt and determine whether any of these will be brought back into regulation from June 2010.

High net worth exemption

In spite of coming into force as recently as April 2008, the high net worth (HNW) exemption will be modified, as the Directive does not provide for a corresponding exemption. The UK government intends to amend the HNW exemption so that it will only be available to agreements that provide for credit above €75,000. Currently, the amount of a loan is not relevant to application of the HNW exemption. This change is particularly relevant for the private wealth market in which lenders frequently rely on the HNW exemption.

Short-term loans

The exemption for loans to be repaid within 12 months by no more than four instalments will also be changed as the Directive does not provide for a corresponding exemption. The UK government plans to amend this exemption by proposing that such short-term loans must also be free of interest and other charges in order to be exempt. This proposed change will obviously have a significant impact on products relying on this exemption – the interest-free requirement will effectively bring such loans back into regulation.

Low-cost credit not offered to the general public

The CCA currently provides an exemption for low-interest loans offered to certain classes of person (and not the public generally, eg student loans) that have an interest rate of no more than 1 per cent above the base rate. This exemption will have to be aligned with the Directive's exemption for loans offered to a 'restricted public', which is narrower than the CCA exemption in that those loans must be granted pursuant to a 'statutory provision with a general interest purpose'. However, it seems to give lenders slightly more flexibility in setting interest rates for such loans – the rates must be lower than those 'prevailing on the market', as opposed to the CCA maximum rate of 1 per cent above the base rate.

This change will impact lenders who offer low-cost credit to particular classes of persons. Only such loans made pursuant to statute can now be exempt. The consultation indicates that low-cost student loans will continue to be exempt under the Directive's new exemption. Fortunately for employers who rely on the existing CCA exemption to offer low-interest loans to their employees, the UK government is proposing to implement the Directive's specific exemption for employee loans. Those loans are exempt where 'credit is granted by an employer to his employees as a secondary activity free of interest or at annual percentage rates of charge lower than those prevailing on the market and which are not offered to the public generally.'

Pre-contractual information

The Directive prescribes pre-contractual information that must be provided to a borrower 'in good time' before the borrower becomes bound by the agreement. The information must be disclosed in a new format, the Standard European Consumer Credit Information sheet (SECCI). This requirement will replace the current CCA requirements as set out in the Consumer Credit (Disclosure of Information) Regulations 2004. Lenders will need to update their pre-contractual documentation, systems and processes to ensure compliance with the new requirements. Lenders that conclude contracts at a distance should note that by providing the SECCI they will be deemed to have complied with the pre-contractual requirements of the Financial Services (Distance Marketing) Regulations 2004.

Despite some minor differences, the sort of information to be disclosed under the SECCI is broadly equivalent to the existing CCA requirements. However, lenders must exactly follow the format of the SECCI when providing pre-contractual information (although they are free to provide extra information voluntarily in a separate information sheet). Accordingly, new pre-contractual documentation will be required for agreements entered into after the implementing legislation comes into force.

The obligation to provide the SECCI in 'good time' before the borrower becomes bound by the agreement goes further than the current CCA requirement simply to provide such information before an agreement is made. The precise meaning of 'in good time' is not clear – the consultation states that its meaning will vary in different circumstances and the UK government is considering giving further elaboration in its implementing regulations by including the requirement that the lender cannot unreasonably delay the provision of pre-contractual information and that the borrower must be able to take the information away for further consideration.

For certain loans outside the scope of the Directive – business loans, second charge mortgages and loans above €75,000 – the UK government is proposing that lenders should have the option of either complying with the new requirement or the existing CCA requirements (although lenders will have to adopt a consistent approach for those loans). This will be beneficial for those lenders who exclusively engage in lending under non-Directive agreements, who may not need to update their systems to adapt to the SECCI. However, most lenders may prefer to have a consistent approach to pre-contractual information across their credit products.

Contractual information

The Directive also requires certain information to be contained in the credit agreement itself. The Consumer Credit (Agreements) Regulations 1983 (the Agreements Regulations), which prescribes the CCA's form and content requirements, will be updated to bring it in line with the Directive.

The Directive's contractual information requirements are similar to its pre-contractual requirements, although the manner in which the information must be presented is less prescriptive than the SECCI (or what is required at present under the Agreements Regulations). The substance of the requirements is broadly similar to the current requirements under the Agreements Regulations. There are, however, a number of additional information requirements, including:

- details on the borrower's right to request an amortisation table for fixed duration loans;
- a statement showing the periods and conditions for the payment of interest and of any associated charges if charges and interest are paid without capital amortisation; and
- the procedure to be followed to terminate the agreement.

Accordingly, changes to standard documentation will be necessary for new agreements entered into after the implementing legislation comes into force.

Helpfully, there is no set format for the presentation of contractual information such as the SECCI. Instead, there is a more general and less prescriptive obligation to specify the information in a 'clear and concise manner'. Lenders will welcome the UK government's indication that it will repeal some of the CCA's provisions on the presentation of contractual information that go beyond what is required by the Directive, such as the current requirement for lenders to set out information in a particular order without interspersing, and the rules on the prominence of such information.

As is the case with pre-contractual requirements, the UK government has indicated that lenders will have a choice as to whether to apply the existing CCA requirements or the new Directive requirements to certain loans outside the scope of the Directive, ie business loans, second charge mortgages and loans above €75,000.

Adequate explanations

One of the significant changes being introduced by the Directive is the requirement for lenders to provide 'adequate explanations' to borrowers before the agreement is concluded, so as to enable the borrower to assess whether the loan is adapted to his needs and financial situation. The Directive provides that, where appropriate, this should be done by explaining the pre-contractual information, the essential characteristics of the credit product and the specific effects it may have on the borrower, including the consequences of default. The Directive's recitals indicate that this should be done, where appropriate, in a 'personalised manner'.

Member states have discretion on how to implement this new requirement and accordingly the UK government has published its proposals with some detail. There

will be a general duty on lenders to provide sufficient explanation about the features of their credit products to enable borrowers to make informed choices and to decide whether or not a credit product would be suited to their needs. In complying with the general duty, lenders will have to meet certain minimum information requirements, which vary depending on the type and size of credit offered.

The consultation sets out four categories of explanation that lenders may be required to provide:

- *basic generic information*, covering information on default (eg providing relevant examples of default charges) and right of withdrawal (discussed further below);
- *additional generic information*, covering information on how interest rates and charges affect the total cost of borrowing, how interest and annual percentage rate (APR) work and how cost can compound over time;
- *basic product-specific information*, covering explanations of costs broken down into component parts and circumstances in which costs might increase and, if applicable, explanation of how variable interest rates work together with an example showing the effect of interest rate increases; and
- *additional product-specific information*, which varies depending on the type of credit product. For example, for credit cards, lenders will be expected to give explanations on how 0 per cent balance transfers work, the dangers of making only minimum repayments, the order of allocation of payments and how terms and conditions differ for credit card cheques. Lenders may also be required to signpost borrowers to an approved comparison website if appropriate.

Which of the above categories of information requirements will have to be complied with will depend on the type of credit product being offered. The consultation sets out 10 separate types of credit products and how the information requirements will vary across such products. For example, for prime fixed-sum loans, basic generic information and basic-product-specific information must be provided, and for such loans above £500, additional generic information must also be provided. For credit cards, all four categories of information requirements must be complied with.

While some lenders may with some justification view the proposed requirements as overly-prescriptive, the proposals add clarity to the Directive's rather vague obligation to give adequate explanations. Furthermore, the UK government's approach of distinguishing the requirements based on the type of credit product, rather than a lender's assessment of an individual borrower's level of understanding, is to be welcomed.

What is not made explicitly clear in the consultation is what mode of communication should be used to provide the required explanations. The recitals to the Directive state that the explanations should be made in a 'personalised manner'. While this seems possible in respect of in-branch or telephone credit applications, it is not clear whether, in respect of written or internet applications, the lender should telephone the borrower to provide the relevant explanations before the agreement is concluded.

The UK government is proposing that the obligation to provide adequate explanations should apply across all regulated credit agreements, except second charge mortgages. It is also considering excluding business lending and lending above €75,000 from this obligation.

Assessment of borrower's creditworthiness

Another significant new obligation imposed on lenders by the Directive is the requirement to assess the creditworthiness of the borrower, based on information obtained from the borrower or by consulting a credit reference agency. This obligation arises both before the conclusion of a credit agreement and before any significant increase in the total amount of credit under an existing agreement is agreed. The consultation points out, by reference to the Directive's recitals, that the objective of this requirement is 'the consumer's well-being and not merely the risk to the lender of default'. The aim is to ensure responsible lending and that lenders examine the affordability of the proposed loan.

Again, member states have discretion on how to implement this new requirement and the UK government has published a relatively detailed and prescriptive

proposal. All lenders will be under a duty to base their lending decisions on a reasonable assessment of the borrower's creditworthiness, making reasonable assumptions so as to avoid contributing to over-indebtedness.

Lenders will also have to comply with certain minimum standards, depending on the type and size of the loan. The consultation sets out three levels of 'creditworthiness-checking':

- Level 1 (all loans above £100): requires lenders to check the borrower's credit status by obtaining relevant data from a credit reference agency or information provided by the borrower regarding existing income and credit commitments.
- Level 2 (includes fixed-sum loans above £500, all credit cards and all non-status lending): in addition to level 1 checks, requires lenders to proactively seek evidence from the borrower to estimate the borrower's disposable income on the basis of total income and financial commitments. Future economic and other changes, in particular the possibility of interest rate changes, must also be considered in assessing affordability.
- Level 3 (includes fixed-sum loans above £1,000, credit cards with credit limit above £500 and non-status lending above £300): in addition to levels 1 and 2, lenders will be required to take appropriate steps to verify information provided by the borrower, taking a reasonable degree of responsibility for its accuracy. Lenders will also be required to check whether the borrower's financial or other relevant circumstances might change and to take account of all relevant commitments, such as family.

The UK government is planning to apply the requirement to assess creditworthiness across all regulated credit agreements, other than second charge mortgages and pawnbroking.

While the UK government's proposals add clarity to the Directive's general requirement to assess creditworthiness, they can be criticised as being excessively prescriptive. In particular, the Level 3 requirement to verify information provided by the borrower, which applies to a broad range of credit products, could be onerous to comply with in practice (especially in respect of matters such as a borrower's outgoings).

Right of withdrawal

The Directive gives borrowers the right to withdraw from a credit agreement within 14 days after the conclusion of the agreement, or from when the borrower receives the terms and conditions, whichever is the latest. This withdrawal period is similar to the withdrawal period under the Financial Services (Distance Marketing) Regulations 2004 in respect of credit agreements concluded at a distance.

This represents another change from the existing CCA regime, which does not provide for a universal right of withdrawal. Currently, borrowers only have the right to cancel credit agreements that are not secured on land and where a representation has been made to the borrower during face-to-face negotiations with the lender, and the borrower has signed the agreement away from the lender's business premises. In these circumstances, the borrower generally has the right to cancel within five days from the date after he receives his copy of the executed agreement or notice of his right to cancel.

The Directive provides that a borrower must repay the capital and accrued interest without undue delay and no later than 30 days after giving notice. This is to be contrasted with the current CCA regime where the borrower does not have to pay interest if he repays the credit within a month of cancellation. It should be noted that the Directive does not provide for a right to withdraw from an agreement for the purchase of goods or services that has been financed by the credit agreement.

The UK government is proposing to implement this new right of withdrawal in respect of most regulated credit agreements, including certain types that fall outside the scope of the Directive. Notable exceptions include second charge mortgages and loans above €75,000 (which have not been made for the purpose of debt consolidation). The UK government is still considering whether to implement the right of withdrawal in respect of loans up to £25,000 entered into for business purposes. For regulated credit agreements where the new right of withdrawal will not apply, borrowers will have to rely on the narrower cancellation rights provided by the CCA.

Early repayment

The Directive gives borrowers the right to make full or partial repayment of a loan at any time and the right to a reduction in the total cost of credit corresponding to the interest and costs applicable to the remaining duration of the contract. Borrowers already have the right to make early repayment in full under the CCA's early settlement framework but not the right to make partial repayments. The UK government regards the existing early settlement regime as consistent with the Directive and intends to retain it (including, for example, the rebate formula) in respect of full repayment and also to extend its scope to cover partial repayments.

Where the amount of the early repayment exceeds £8,000, lenders will have a new right to compensation for costs directly linked to the early repayment provided that such repayment falls within a period for which the borrowing rate is fixed. Lenders cannot claim compensation for repayments in respect of overdrafts or insurance contracts intended to provide a repayment guarantee. The compensation cannot exceed 1 per cent of the amount repaid early, or 0.5 per cent if the outstanding period of the loan is less than one year. The UK government is not prescribing any method for the calculation of compensation – lenders should use their own method, which must be disclosed to the borrower in both the SECCI and the credit agreement itself.

Calculation of APR

Lenders will be required to adapt to a new method of calculation of APR as set out in the Directive. Annex 1 of the Directive prescribes a new formula to be used by lenders in calculating the total charge for credit, which will replace the existing UK formula. The consultation points out that the mathematical effect of the new formula (which has been updated in line with accounting best practice) is identical to the effect of the current UK formula.

The Directive also contains assumptions to be used in calculating the APR. The assumptions are broadly similar to existing UK law but are less detailed and more high-level. The consultation states that the higher level assumptions will not create material gaps and would not result in differing interpretation by lenders in their APR calculation. Nevertheless, the UK government is planning to add further clarification to a number of assumptions in its implementing regulations.

Advertising

The Directive will introduce significant changes to the CCA's advertising requirements set out in the Consumer Credit (Advertising) Regulations 2004. Where an advertisement gives an indication of an interest rate or other figures relating to the cost of credit, the Directive requires certain standard information to be included with the advertisement. The interest rate (whether fixed or variable), charges included in the total cost of credit, the total amount of credit and the APR must be provided when the information requirements are triggered. Other types of information must also be provided if relevant: the duration of the credit agreement, cash price/advance payment for goods/services in case of credit in the form of deferred payment, total amount payable and amount of instalments.

The new information requirements represent an increased burden on lenders when compared with the existing CCA advertising regime. Currently, where an interest rate is quoted in the advertisement, the APR must also be displayed but no other financial information is required. Where other financial information is given, the current requirement is that the APR must be twice the size of any other financial information.

The Directive provides that the standard information must be specified in a 'clear, concise and prominent way by means of a representative example'. The representative example is to comprise one overarching offer for a particular amount of credit, which includes all the standard information applicable to such an offer. Where the total amount of credit being offered is not known at the advertising stage (which will be in most cases), lenders must assume the total amount of credit to be €1,500 (£1,200). To be a 'representative example' the terms disclosed in the advertisement must be as good as, or better than, the terms that at least 50 per cent of borrowers would receive if, as a result of the advertisement, they entered into a credit agreement for €1,500 (£1,200) (or if known, another particular amount).

It is important for lenders to note that their advertisements will have to quote an APR that is based on the representative example, rather than the current requirement to quote the APR that is 'typical'– ie the highest APR that at least 66 per cent of the eventual number of borrowers formally accepting a credit agreement in response to the advertisement are expected to be given. There will also be changes to the way APR is presented in advertisements. Lenders will no longer be required to give APR greater prominence than other financial information but should now present the APR as prominently as the other standard information.

Lenders should also note that the UK government intends to retain other features of the existing advertising regime, such as restrictions on the use of prohibited expressions and prescribed 'wealth warnings' on the basis that they do not relate to the cost of credit and are therefore not within the scope of the Directive.

Overdrafts and overrunning

The Directive provides for a light touch regime in respect of both overdrafts and overrunning. An overdraft is defined as an explicit credit agreement whereby a creditor makes available to a consumer funds that exceed the current balance in the consumer's current account (ie an authorised overdraft). Overrunning is akin to an unauthorised overdraft, and is defined as a tacitly accepted overdraft whereby a creditor makes available to a consumer funds that exceed the current balance in the consumer's current account or the agreed overdraft facility.

Authorised overdrafts

The Directive prescribes bespoke pre-contractual, contractual and post-contractual information requirements in respect of authorised overdrafts that are repayable on demand or within three months (in practice, most overdrafts are repayable on demand). The pre-contractual information requirement is broadly similar to the current light touch requirement applicable to authorised overdrafts, which includes disclosure of credit limit, interest rates and charges. The information requirements, which do not have to be in the form of a SECCI, must be provided to the borrower in writing in good time before he becomes bound by the agreement – however, if a borrower requests over the phone that an overdraft be made available with immediate effect, the creditor can give a more limited disclosure orally and then confirm the required information in writing immediately after the conclusion of the agreement.

The contractual requirements are similar to those in respect of pre-contractual information. However, additionally, they will have to show the total cost of credit – it is unclear how this should be calculated in practice given the uncertain nature of overdrafts (eg the length of time in which the borrower will repay). The consultation indicates that guidance may be issued on this.

As regards post-contractual information, the Directive requires lenders to provide regular statements of account. The UK government has indicated that lenders will be allowed to continue to provide statements between monthly and six-monthly intervals as per the existing CCA requirement. The statements will now have to include the applied interest rate as required by the Directive.

Unauthorised overdrafts

Lenders will have increased obligations in respect of unauthorised overdrafts following the implementation of the Directive. Currently, where a borrower's current account is overdrawn for three months or more, the lender must inform the borrower in writing of the annual interest rate and other charges within seven days after the end of such three-month period.

From 2010, borrowers will need to be informed 'without delay' if there has been an overrunning in excess of £100 for more than one month. The borrower should be notified of the amount of the overrunning and the applicable interest rate and other charges or penalties. This notification will need to be updated every three months thereafter.

Upon the opening of a current account, lenders will also need to include in the current account agreement details and conditions of the interest rate and charges applicable to overrunning if there is a possibility that this will be tolerated by the lender. This information should continue to be provided on a regular basis (proposed to be annually).

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Assignment of rights

The Directive contains provisions dealing with the assignment of a creditor's rights under a credit agreement. Following the Directive's implementation, the original creditor will be obliged to inform the borrower of the assignment except where the original creditor has agreed with the assignee that either the original creditor (or a third party to whom servicing has been delegated by the original creditor) will continue to deal with the borrower. This will mark a change in English law with respect to equitable assignments (notice is already required for legal assignments). This new requirement could be relevant for lenders that sell portfolios of credit agreements in the context of securitisations or otherwise, although in most of these cases the original creditor or third party provider will continue to deal with the borrower.

The Directive also contains provisions to ensure that borrowers' set-off rights are not prejudiced by an assignment, but the UK government does not consider that these will require any change to English law.

Credit intermediaries

The Directive imposes new disclosure obligations on credit intermediaries – a newly defined type of service provider (which will include persons that currently engage in credit brokerage under the CCA). Credit intermediaries will be subject to three sets of disclosure obligations:

- they must disclose in advertising and other documentation intended for consumers the extent of their powers (eg whether they can offer loans on behalf of lenders or only forward applications to the lender), and, in particular, whether they act exclusively for one or more creditors or as an independent;
- any fee charged to a consumer by the credit intermediary must be agreed with the consumer and disclosed in paper or a durable medium before the conclusion of the credit agreement (note that this will not apply where a credit intermediary is paid a commission by the lender); and
- they must communicate to the lender the fee payable by the consumer to the credit intermediary so the lender can take this into account when calculating the APR.

Next steps

The consultation period is due to end on 10 June 2009 and it is expected that the UK government will issue draft regulations for the implementation of the Directive later in the summer. Final regulations are expected to be laid before parliament in November 2009 and are due to come into force on 10 June 2010.

As there will only be a seven-month period between the final regulations being published and full implementation, lenders should start considering the effect of the changes brought about by the Directive on their credit products at the earliest opportunity so that they can plan to update their systems and processes in good time before June 2010.

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