DG Internal Market and Services

Study on Credit Intermediaries in the Internal Market (MARKT/2007/14/H) Contract ETD/2007/IM/H3/118

Final Report
by Europe Economics

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EXECUTIVE SUMMARY

What is a Credit Intermediary?

1 The term "credit intermediary" is defined in a number of, but far from all, Member States. Looking at those countries where it is defined, a reasonable, synthetic definition would be that a credit intermediary is an individual or firm that does not directly provide credit itself but rather facilitates an individual or firm obtaining access to such credit from a third-party credit provider. This would include intermediaries tied to one or more particular credit providers and those that are fully independent. The end borrower might be a consumer or a business.

2 It was clear from our initial interview programme with stakeholders (*see Section 2 for further details*), that the nature and role of intermediaries varied across different credit markets (in other words, there is not a monolithic market for credit intermediation *per se*). In this report, we explore the nature and scale of credit intermediation in the following credit markets :

- Residential mortgage credit
- Point-of-sale retailer credit
- Other consumer credit
- Business finance (specifically business mortgages and business leasing).

3 Our judgement was that this specific split of different credit markets (formed in discussion with stakeholders, and these being markets where some intermediary activity — at least in some Member States across the EU27 — was known to exist) would allow fruitful analysis, without placing an excessive data gathering burden upon those same stakeholders. Whilst we readily acknowledge that there is some supply-side substitutability between different credit intermediaries (in other words, a particular credit intermediary may intermediate more than one of these product categories), we believe that by reviewing the role of credit intermediaries within the context of these particular product markets, their role can be best understood.

Methodology Underpinning this Study

4 The public domain contains only very limited data that directly deals with the economics of credit intermediation across the EU27. The data that is available tends to be restricted in geographic coverage (e.g. the UK is typically better provided for than other Member States) and across different credit markets. This meant that the study was heavily reliant upon the various strands of original research that we conducted. In particular, we focused upon:

– Stakeholder surveys. Tailored, comprehensive surveys were addressed to credit intermediaries (both individual firms and national associations), lenders (again, both individual firms and national associations), regulators and consumer associations across the EU27 (*see Section 2 for further details)*.

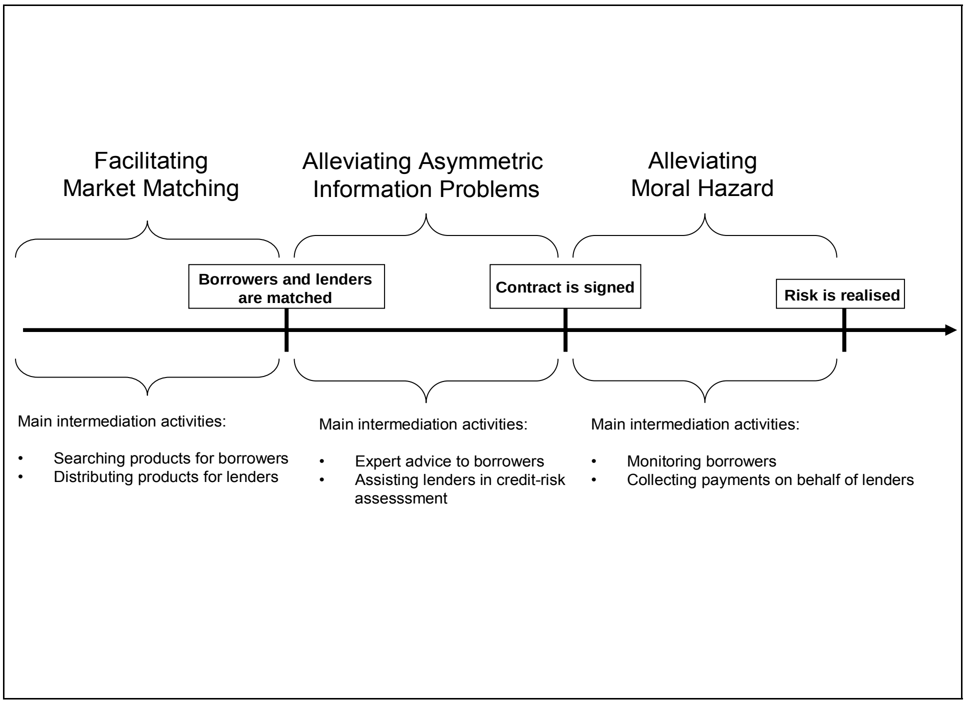
– Stakeholder interviews (*see Section 2 for further details)*.

– The development of an analytical framework to better comprehend the economic role of credit intermediaries and to assist in the integration of the data gathered *(this is introduced below, and covered in more detail at Section 3 and at Appendix 1)*.

The Economic Role of Intermediation

5 We illustrate below a high-level summary of the ways in which a credit intermediary may benefit borrowers and/or lenders in a credit transaction.

Figure 1: The economic role of Intermediation within the borrower-lender relationship



Source: Europe Economics

6 Our study indicates that the main credit intermediary activities relate to market search, product distribution and the provision of advice. This implies that the chief benefits to consumers should come in terms of:

– Reduced prices (consumers choose to use an intermediary, and price represents an important decision variable).

- Increased product choice.
- More transparent credit markets (for instance, through the provision of expert advice by intermediaries to consumers).

7 For lenders, credit intermediaries fundamentally provide an incremental, low-cost distribution channel for their products. Where a lender lacks a branch network, intermediaries represent a particularly important distribution option (the alternative being telephone- and internet-based lending). *(Section 3 explores this framework in more depth).*

Market Failure, Consumer Detriment and Regulation

8 Although valuable, the economic benefits of intermediation may not be achieved. The key sources of potential market failure that we identify relate to asymmetric and incomplete information and to the misalignment of incentives.

Potential conflicts of interest and other sources of market failure

9 As part of our analytical framework, we considered — by credit product — the different economic contributions made by intermediaries and the prevalent remuneration schemes. The aim of our analysis was to establish whether there was the *potential* for a conflict of interest between the intermediary and the other parties to a credit transaction. We have focused on the market-matching facility and the alleviation of asymmetric information. We have excluded the intermediaries' role in alleviating moral hazard because it does not appear to be material.

Table 1: Remuneration Schemes and Potential Conflict of Interest

CREDIT PRODUCT	SIGNIFICANCE OF ECONOMIC CONTRIBUTION		MOST COMMON REMUNERATION SCHEME	POTENTIAL CONFLICT OF INTEREST
	to borrowers	to lenders		
Residential Mortgage	Market matching (very high) Reducing information asymmetry (very high/high)	Market matching (very high) Reducing information asymmetry (very low)	Volume-based commission	Present
Point-of-Sale	Market matching (medium) Reducing information asymmetry (medium)	Market matching (very high) Reducing information asymmetry (very low)	Volume-based commission	Absent
Other Consumer Credit	Market matching (medium) Reducing information asymmetry (medium/high)	Market matching (very high) Reducing information asymmetry (low)	Volume-based commission	Present

Business Finance	Market matching (very high) Reducing information asymmetry (high)	Market matching (very high) Reducing information asymmetry (medium/low)	Volume-based commission (tied) Fixed commission (untied)	Present

Source: Survey and Theoretical Framework

10 From the above, we conclude that there exists a structural inefficiency in performing tasks aimed at alleviating asymmetric information where the main mode of remuneration is a volume-based commission. The latter are very effective in reassuring lenders that credit intermediaries will put sufficient effort into the distribution and promotion of credit products, but they hinder the credibility of intermediaries' ability to mitigate information asymmetries. However, we consider POS intermediation (and to a lesser extent, business finance intermediation) to be qualitatively different in this regard from the other two areas that we have studied. This is largely due to the nature of the activities undertaken (POS) and the nature of the borrowers (business finance).

11 An obvious case of vulnerability to detriment is where the lender is reliant on the probity of the intermediary to reliably prepare documentation and, in particular, to assess the income level of the potential borrower. Here, there may be incentives for the intermediary to mis-state the applicant's income, motivated by the commission due to the intermediary. We have found a number of examples of this, across a mix of intermediary roles. This is not to say that the problem is widespread, simply that it exists.

12 For instance, the UK FSA says the problem of mortgage fraud has become widespread in recent years because of "easy credit conditions and streamlined application processes" and has called on lenders to apply stricter protocols. Given that market conditions in the UK are very different from those that held sway over the past few years, a market response seems probable anyway as lenders switch from volume-driven strategies towards greater focus upon quality of risk (the UK has seen sharp reductions in the availability of self-certification mortgages, for example).

13 In the rest of Europe, the situation is less clear cut, although it seems rather unlikely that the appetite amongst lenders for sub-prime lending would be increasing in the immediate future. The availability of sub-prime mortgages has reduced in Italy, for instance (from what was anyway a small base). Self-certified mortgages are far from universally available across the EU27 (for example, being prohibited in Italy and Belgium).

Evidence on sources of consumer detriment

14 The evidence we have collected suggests that the most significant source of consumer detriment is the recommendation of products that are either unsuitable to the borrower's personal circumstances or else are not price-competitive. The cause of this form of detriment seems to be systematic and stems from conflicts of interest. Where acting primarily as distribution channels — i.e. as the delegated salesmen of credit products — credit intermediaries are often involved in providing consumers with putatively "expert advice". However, the widespread use of commissions conditional on the conclusion of a contract creates systematic incentives for intermediaries to provide advice that secures

agreements rather than serves the best interests of consumers. This form of detriment is particularly relevant for residential mortgages (and hence financially very significant), since mortgages are relatively complex for consumers to understand (compared with other credit products we consider), and intermediary involvement in the provision of expert advice in this area is very high.

15 Another common form of detriment (across several credit products) arises from misleading advertising by credit intermediaries. Typically such misleading advertising exploits the borrowers' limited knowledge of the general market conditions and the role credit intermediaries play in the market. From the evidence gathered, typical examples of misleading advertising would be where intermediaries attract consumers by offering unrealistic offers on credit (for example, credit at a zero interest rate by POS intermediaries) or induce borrowers to believe that the intermediaries concerned are entitled to authorise credit provision even though, in fact, only the lender can make this decision.

The role of regulation

16 Well-designed regulatory intervention can resolve (or at least mitigate) some of the market failings that result in detriment to the consumer. We have found a clear correlation between the degree of regulation and the perceived significance of detriment with respect to the provision of advice, as identified by bodies such as regulators and consumer associations. However, we qualify this in two ways:

- Compliance with regulation can incur an incremental cost to the effected business — and the benefits to consumers of regulatory intervention may not outweigh the costs to business of complying with it. For instance, there is a potential detriment to consumers from not having access to financial products because of over-regulation raising prices and increasing the difficulty of obtaining products, or of lost innovation.
- Similarly, the perceptions of the respondents (consumer associations and the regulators themselves) may have been influenced by the regulatory structure in place. In other words, pre-conceptions about the likely risks associated with an unregulated environment may bias the assessment of the potential risk.

17 The current regulatory framework in respect of credit intermediaries is highly varied, both by Member State and by credit product. As a generalisation, there is a hierarchy in which mortgage credit intermediation is the most closely regulated, closely followed by consumer credit. By comparison, point-of-sale intermediation and business finance intermediaries are not subject to stricter regulation than these categories in any Member State, and in a number of countries are subject to a lower level of regulatory oversight *(please see Section 4 and Appendix 2).*

Table 2: Statutory regulatory models in the EU27

Main Category	Member States	Sub-categories (where applicable)
Consumer and mortgage credit intermediary focused	Austria, Belgium, Bulgaria, Estonia, Ireland, Malta, Netherlands, Portugal, Romania and the UK	**Of which, residential mortgage intermediary focused:** Austria, Ireland, Netherlands and the UK
Consistent approach	Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Poland, Slovenia, Spain and Sweden	**Of which, consistently significant level**: Hungary **Of which, consistently moderate level**: Germany, Italy, Slovenia **Of which, consistently low level**: Czech Republic, Denmark, Finland, France, Greece, Poland, Spain and Sweden
Reliant upon the market	Cyprus, Latvia, Lithuania, Luxembourg and Slovakia	**Of which, self-regulation present**: Slovakia

Source: Surveys, EE analysis

18 A number of Member States are looking at credit intermediaries with a view to increasing the statutory regulatory role (Belgium, Spain and Slovakia).

The Current Scale of Credit Intermediation

19 We summarise below the value of credit intermediated in EU27. It is evident that mortgage and point-of-sale intermediation are by far the most significant segments in value terms.

Table 3: Value of credit intermediated, 2007

	Mortgages €m	*Indirect distrib-ution as proportion of mortgage credit*	*Direct distrib-ution as proportion of mortgage credit*	**Point-of-sale €m**	*POS distribution as proportion of consumer credit*	**Other consumer credit €m**	*Other indirect distribution as proportion of consumer credit*	*Direct distribution as proportion of consumer credit*
Austria	1,422	*35.0%*	*65.0%*	2,830	*24.5%*	695	*6.0%*	*69.4%*
Belgium	3,424	*15.0%*	*85.0%*	2,378	*20.2%*	914	*7.8%*	*72.0%*
Bulgaria	377	*12.5%*	*87.5%*	829	*18.0%*	237	*5.1%*	*76.9%*
Cyprus	52	*2.0%*	*98.0%*	239	*11.7%*	72	*3.5%*	*84.8%*
Czech Republic	1,462	*22.0%*	*78.0%*	2,944	*41.5%*	379	*5.3%*	*53.1%*
Denmark	2,161	*5.0%*	*95.0%*	2,082	*15.8%*	425	*3.2%*	*81.0%*
Estonia	43	*2.0%*	*98.0%*	419	*25.8%*	9	*0.5%*	*73.7%*
Finland	289	*1.0%*	*99.0%*	1,854	*15.2%*	82	*0.7%*	*84.1%*
France	33,030	*22.5%*	*77.5%*	18,728	*20.7%*	6,909	*7.6%*	*71.6%*
Germany	38,870	*32.5%*	*67.5%*	39,488	*37.9%*	4,507	*4.3%*	*57.8%*
Greece	1,520	*10.0%*	*90.0%*	2,699	*11.5%*	1,627	*6.9%*	*81.6%*
Hungary	728	*25.0%*	*75.0%*	4,394	*34.8%*	710	*5.6%*	*59.6%*
Ireland	20,285	*60.0%*	*40.0%*	1,540	*6.6%*	1,431	*6.1%*	*87.3%*
Italy	23,533	*25.0%*	*75.0%*	28,984	*40.2%*	4,666	*6.5%*	*53.4%*
Latvia	102	*5.0%*	*95.0%*	523	*26.8%*	51	*2.6%*	*70.5%*
Lithuania	37	*2.0%*	*98.0%*	608	*28.6%*	13	*0.6%*	*70.8%*
Luxembourg	656	*15.0%*	*85.0%*	77	*8.9%*	43	*5.0%*	*86.1%*
Malta	1	*1.0%*	*99.0%*	352	*23.4%*	29	*1.9%*	*74.7%*
Netherlands	39,816	*45.0%*	*55.0%*	4,043	*17.1%*	3,963	*16.8%*	*66.1%*
Poland	656	*24.0%*	*76.0%*	4,445	*12.5%*	2,754	*7.8%*	*79.7%*
Portugal	1,062	*15.0%*	*85.0%*	5,353	*37.4%*	1,049	*7.3%*	*55.3%*
Romania	2,678	*12.5%*	*87.5%*	7,867	*41.5%*	1,147	*6.1%*	*52.4%*
Slovakia	444	*20.0%*	*80.0%*	385	*21.7%*	95	*5.4%*	*72.9%*
Slovenia	263	*15.0%*	*85.0%*	1,575	*37.2%*	139	*3.3%*	*59.5%*
Spain	27,176	*20.0%*	*80.0%*	21,868	*28.3%*	6,450	*8.4%*	*63.3%*
Sweden	455	*1.0%*	*99.0%*	3,517	*40.9%*	19	*0.2%*	*58.9%*
United Kingdom	363,589	*70.0%*	*30.0%*	27,880	*10.8%*	14,968	*5.8%*	*83.4%*
	564,130			187,901		53,382		

Sources: Surveys (please see Section 2 for a summary of the data gathering process), EMF (Hypostat 2008), ECRI Statistical Package 2008, eurofinas, ECB, leaseurope, EE calculations. Please note that due to rounding the sum of the indirect and direct distribution of a particular product may not sum to 100 per cent exactly in all cases.

20 In the respective sections on these markets (and also on business finance) we describe the current scale of credit intermediation in more depth (reviewing dimensions such as the volume of transactions intermediated, the number of intermediaries involved, the revenues and number of employees of these intermediaries). *(Please see the sub-sections entitled "The Scale of Intermediation" in each of Sections 5, 7, 9 and 11 for details).*

21 The data provided in this study is based upon 2007. As such, it will clearly not fully reflect the impact of the credit crunch (particularly its escalation in the third quarter of 2007) and the significant downturn in economic prospects currently being experienced across the EU27. Inevitably, this will impact upon the credit intermediation sector — the reduced availability of mortgage credit in some Member States (such as the UK) and a significant drop in the demand for consumer durables and cars are likely to be felt particularly keenly. The potential impact of current economic conditions upon market structure is, at present, much less clear. Crucial to the determination of this include the relative focus by lenders upon margin and quality of lending against the need for efficient distribution of product.

These are likely to vary Member State by Member State, and over time within each Member State.

22 Credit intermediation is fundamentally a sector dominated by small- and medium-sized enterprises. This is because, in most of the markets, the actual scale of the opportunity means that to grow a large business is difficult (or impossible). Furthermore, it is in many ways very much a "people business" with, therefore, limited barriers to entry and exit (since, for instance, someone can leave an established intermediary and set-up as a new business without committing to substantial capital investment). This is particularly the case in those markets where specific regulation is limited or even non-existent. This means that an experienced intermediary working within a larger organisation may find it attractive to set up individually or in a micro-business rather than continue in a corporate setting.

23 The nature of the business should restrict the cost impact arising from economies of scale (i.e. a small business is likely to be able to compete on cost with a larger one). The businesses being budded from are in any event often relatively small themselves (so that the advantage of a pre-existing brand name, say, is reduced). Inevitably, much of this budding off is likely to be led by the more successful intermediaries. This means that barriers such as acquiring access to distribution agreements with lenders should be less than might otherwise be the case.

24 The costs of market entry for intermediaries may have been further reduced by technological innovation (for instance, access to internet-based platforms which aggregate products and prices from various lenders). Many intermediaries operate on a multi-channel basis (i.e. not just office-based but using the telephone and internet also).

25 Technological development has also enabled lenders to enhance direct offerings to borrowers, which may reduce the value of the search function of intermediaries for many consumers (by increasing price transparency). Intermediaries may need to adapt as technology continues to change, with new business models creating an increasing polarisation of choice between the quality of advice and price competitiveness.

26 The role of technology is qualitatively different at point-of-sale intermediaries, where the increasing sophistication of IT has reduced the cost of the intermediation activity. However, point-of-sale intermediation is at risk from cannibalisation by other credit products (such as pre-approved credit and personal lending — these and other terms are defined in the Glossary at Appendix 3) which in most Member States are more likely to be supplied through a direct distribution channel.

27 A number of roles are possible for an intermediary in a credit setting. Our study finds the main functions to be:

(a) **Market search** for the borrower or consumer. The intermediary can reduce the search time for the consumer to locate a credit product, so reducing the consumers' transaction cost.

(b) The other side of this is that the intermediary can **generate leads** for credit providers. In other words the intermediary acts as a supplementary, indirect distribution channel for those credit providers with a branch network and as a crucial element of the distribution chain for those without such a network.

(c) Provide expert assistance to consumers in the purchasing process. This includes activities such as **providing and explaining pre-contractual information** to borrowers, explaining the main features and risks of specific products, and providing expert recommendations (**suitability advice**).

28 In addition, for point-of-sale intermediation, customers gain access to a convenient source of finance, without the requirement to search for it (however, this convenience may come at a price in terms of the competitiveness of the interest rate attached to the loan, *please see Section 7).*

29 Support from lenders is the market norm where the intermediary is tied (either exclusively or non-exclusively) to the credit provider and can comprise a mixed package of marketing, training, IT and even legal support. This support is less prevalent for other intermediaries, albeit still relatively commonplace.

30 Differences between those intermediaries which are tied and those which are not are also apparent with respect to the remuneration structures of intermediaries, both upstream and downstream. The former typically have greater complexity within the overall upstream remuneration structure, with the most common base being a volume-based commission scheme. It is apparent that in many instances the remuneration structure is frequently geared towards the role of the intermediary as a distribution channel for lenders (i.e. with upstream remuneration being most important and being geared towards commission-related structures). This is particularly notable with those intermediaries with product ties to one or a small number of credit providers *(please see, in particular, the sub-sections entitled "The Business Models of Intermediaries" and "The Potential for Consumer Detriment" in each of Sections 5, 7, 9 and 11).*

Intermediaries and Cross-border Activities

31 When one looks at the scale of cross-border trade — where the lender and borrower are located in different Member States — then the scale of such activity in retail financial services is extremely limited. For instance, in the mortgage market it is generally understood to account for less than one per cent of total activity even in the markets where it is most significant (the Benelux countries).

32 There are a number of potential barriers to such trade — linguistic, cultural, regulatory, tax — and a trusted credit intermediary could be of use in overcoming at least some of these barriers. However, our results indicate that intermediaries play only a limited role in this at present (i.e. dealing with expatriates and the buyers of holiday homes). *(Please see Sections 13 and 14).*

1 INTRODUCTION

1.1 This Europe Economics Report was commissioned by Directorate General Internal Market and Services, and covers a study conducted between January 2008 and January 2009, investigating the nature and extent of credit intermediation in the European Union.

The Structure of this Report

1.2 We set out below the structure of the remainder of this report.

(a) Section 2 reviews the methodology that has underpinned our work and summarises the data gathering conducted and the number of data points gathered.

(b) We set out in Section 3 our analytical framework for defining, understanding and analysing the different forms of credit intermediaries. It is worth noting that in practice different terms are used in describing what we refer to as credit intermediaries. These terms include the equivalents of "broker", "agent", "adviser" as well as intermediary itself. We use "intermediary" in this study (prefixed by credit when we refer to the general case, and by a product group when we being more specific), except where the use of an alternate is necessary or helpful to exposition (for instance, if local law differentiates between a broker and an agent).

(c) This is complemented by Section 4 which identifies the potential market failures relevant to credit intermediaries, introduces the differing regulatory models in the EU27 and analyses the potential for consumer detriment that may arise at different stages of the consumer's product choice process and the systemic potential for detriments.

(d) In Section 5 we present our description and analysis of intermediaries operating in the residential mortgage credit market. This is complemented by three case studies in Section 6 (on the emergence of independent mortgage intermediaries in Germany, on the switch from self- to public regulation in the UK and, finally, on ING's acquisition of Interhyp — an example of vertical integration with a bank acquiring an intermediary).

(e) In Section 7, we turn to intermediation conducted at point-of-sale (i.e. a form of retailer finance). Again, this is supported by case studies in Section 8 — one dealing with point-of-sale financing in motor retail in Spain, the other examining the financing of white goods in Sweden.

(f) Section 9 reviews the nature of intermediation in other forms of consumer credit (such as unsecured lending). This is supported by two case studies: the first looks at Affinity Partnerships, the other the role of intermediaries in the provision of home credit in a number of Member States (see Section 10).

(g) Section 11 focuses upon intermediation in the business finance market (specifically business mortgages and business leasing). This is complemented by and draws upon a case study reviewing the business leasing sector in Italy (which is heavily reliant upon the involvement of intermediaries) and another looking at the role of intermediaries in supplying business mortgages in the Czech Republic. This is included in Section 12.

(h) Finally, Section 13 examines the role of intermediaries in the promotion of cross-border activity. Section 14 is a case study looking at the role of two intermediaries that specialise in this market segment.

1.3 The appendices to this report are as follows:

- Appendix 1 sets out a set of mathematical treatments related to our analytical framework.
- Appendix 2 contains a Member State by Member State breakdown of the regulatory and supervisory regime relating to credit intermediaries, according to the breakdown of sectors identified above.
- Appendix 3 contains a glossary explaining technical terms and any abbreviations that have been used.

2 METHODOLOGY FOR THE STUDY

2.1 We identify here the main aspects of our methodology, particularly with reference to data gathering and the development of our analytical framework.

Data Gathering

2.2 We have gathered data from a broad mix of sources. In particular, we highlight the following.

Academic literature

2.3 Although the sector is large, credit intermediaries have not been closely studied at the European level, so we conducted a broad review of the literature on the European consumer and business credit markets. In particular, we focused upon existing treatments of the intermediary relationship in economic theory and collating those data sources on intermediaries and the credit markets in which they operate.

Public domain data

2.4 The sources of public domain data used included:

- Eurostat.
- Eurobarometer surveys, e.g. the 2004 Special Report on Consumer Finance.
- The European Central Bank.
- Mercer Oliver Wyman, 2007, “European mortgage markets — 2006 adjusted price analysis.”
- Oliver Wyman, 2006, “European Mortgage Distribution — Changing Channel Choices”.
- Hypostat 2008.
- European Mortgage Federation Factsheets.
- European Federation of Finance House Associations (Eurofinas), “Eurofinas Statistics”.
- Leaseurope statistics.
- The 2007 Finaccord report on Vehicle Retail Financing.
- The European Credit Research Institute (ECRI) 2008 dataset, “Consumer Credit in Europe”.

2.5 We highlight that the public domain data contains only very limited data that directly deals with the economics of credit intermediation across the EU27. The data available to us was restricted in geographic coverage (e.g. the UK was better provided for than other Member States) and across different credit markets. This meant that the study was heavily reliant upon the various strands of original research data described below.

Stakeholder interviews

2.6 We conducted a number of interviews with stakeholders. These had two broad aims:

- Close to the inception of the project, we wanted to broaden and deepen our understanding of the dynamics of the credit markets and the role of credit intermediaries within this. The objective here was to provide a reality check to the theoretical underpinning to the analytical framework that we were developing in a parallel research strand.

- Throughout the remainder of the project, contact with stakeholders was continued in order to add "colour" to our work.

2.7 The stakeholder interviews conducted included the following:

(a) **European Federation of Building Societies (27 February 2008)**. Andreas Zehnder — Chairman; and Christian König — Legal Adviser.

(b) **CBFA (the Belgian Banking and Insurance Regulator) (13 March 2008)**. Luc Roeges — Deputy Director; Annick Madderbenning — Consumer Protection; and Luc van Calder — Legal.

(c) **European Savings Bank Group (13 March 2008)**. Astrid Hagenah — Head of Legal Affairs; and Leticia Hernando — Adviser, Legal Affairs.

(d) **UK Financial Services Authority (UK FSA) (14 March 2008)**. Keith Hale — Technical Specialist (Mortgages & EU); Lucy Yank — EU/International Team (Retail Policy Division)

(e) **Syndicat des Intermédiaires en Opérations de Banque, SIOB (French intermediary trade association) (12 June 2008).** Jean-Pierre Demahis, Herve Wignolle

(f) **Association of Mortgage Intermediaries (UK intermediary trade association) (18 June 2008)**. Andrew Strange, Richard Farr

(g) **Council of Mortgage Lenders (UK lender trade association) (26 June 2008)**. Andrew Heywood; and Bob Pannell — Head of Research.

(h) **National Association of Commercial Finance Brokers (UK intermediary trade association) (16 September 2008)**. Adam Tyler — Chief Executive and Nikki Cann — Associate Director.

2.8 We take this opportunity to express our gratitude to those bodies that assisted us in this way.

Case studies

2.9 The data gathering process was further enriched by conducting 10 case studies to unpick in greater detail an aspect of credit intermediation in a particular Member State (or States). Our sources for these are summarised within each of the relevant sections.

2.10 The case studies cover the following topics:

- Germany — focus upon the emergence of independent mortgage intermediaries (see Section 6).
- Netherlands/Germany — consideration of potential implications of vertical integration using ING Direct acquisition as an example (see Section 6).
- UK — focus upon the changing regulatory framework of the mortgage intermediation market, using John Charcol as an example (see Section 6).
- Spain — focus on consumer vehicle finance POS intermediation (see Section 8).
- Sweden/Finland — non-vehicle POS intermediation (see Section 8).
- France — focus upon affinity partnerships (particularly in the area of credit cards and personal loans), aimed at understanding the extent to which these can usefully be categorised as credit intermediaries of any form (see Section 10).
- Czech Republic, Poland and Hungary — focus on home credit agents (see Section 10).
- Italy — focus upon business leasing intermediaries (see Section 12).
- Slovakia/Czech Republic — business mortgage intermediation (see Section 12).
- (Primarily) Spain/UK — cross-border mortgage intermediation (see Section 14).

Stakeholder surveys

2.11 We developed and issued tailored surveys to the following stakeholder groups: regulators and other public authorities; intermediaries and associations of intermediaries; lenders and association of lenders and consumer associations. We sought to identify stakeholders in each Member State and these were invited to participate in the survey.

Development process

2.12 A survey was designed and tailored to each of the stakeholder types identified above. We initiated a survey design process based upon the draft analytical framework arising from the literature review and the initial stakeholder interview programme. Since there was some overlap between these, the development of the survey and the analytical framework were iterative.

2.13 In order to ensure that the questions were easily understood and produced responses that met the needs for this study, we conducted pilots of the surveys. These were conducted with the UK FSA, the European Banking Industry Committee (of which the European Mortgage Federation is a part), the Italian leasing association (Assilea), the European Savings Bank Group and EUROFINAS.

2.14 There is considerable overlap in the themes covered in the different surveys and the judgement was made that by piloting with the lenders and regulators we would get the necessary sense of what is relevant and answerable. Of course, the comments arising from the piloting process were reflected in the surveys for all of the stakeholder categories.

Survey structure

2.15 Broadly, the surveys contained questions that aimed to provide information on the following topics:

- Statistics on the structure of intermediation: the number of intermediaries, broken down between credit markets, with data on the value and volume of lending intermediated, commission earned, and so on.

- Views on market structure, such as its concentration and its past and expected future development (both of lenders and of credit intermediaries).

- Regulation of credit intermediaries: the laws in force there, both those applying generally in a credit market, and specifically to those credit intermediaries operating within it. In particular: in what areas intermediation is specifically forbidden or regulated, what activities are allowed (or prohibited) for credit intermediaries, what rules are imposed by credit providers, and whether there is compulsory or voluntary registration of intermediaries.

- Known cases of fraud or widespread consumer dissatisfaction, including the damages caused, any compensation paid and by whom, the consequences for the parties, and any resolution mechanisms used.

- Cross-border activity: how widespread are links between member nations, either the link between consumer and intermediary, intermediary and lender, or local lender and foreign owner. Further, whether these links are more common under certain business models, and why, and what history there has been of cross-border activity, and what economic impact greater cross-border provision would have.

- Impediments to cross-border activity: whether legal, economic, institutional, cultural, or behavioural, and personal judgements of the difference that would be made by complete or partial harmonisation of legislation.

- Other matters of interest.

2.16 The nature of the study meant that the information that we have asked for was very wide-ranging. The table below identifies the broad themes that we focused upon in the survey. This is organised by each stakeholder survey, and illustrates where particular themes were covered by more than one survey.

Table 2.1: Explanatory variables and the stakeholder surveys

	Intermed-iaries	Lenders	Regulators	Consumer associations	Public domain data
Legislative definition			●		●
Regulatory requirements	○	○	●	○	●
Market structure (size and concentration)	●	●	●	○	●
Cross-border activity	●	●	●	●	
Importance of indirect distribution	○	●	●	○	
Competition between intermediaries	●	○	○	○	
Intermediaries' ties structure	●	●			
Business model of point-of-sale intermediaries	●	○	○	○	●
Intermediary pre-contractual activities for borrowers	●	●		●	
Intermediary pre-contractual activities for lenders	●	●		●	
Intermediaries' retailing activity for lenders	●	●		●	
Intermediaries' post-contractual activities	●	●		●	
Intermediary remuneration	●	○		○	
Product characteristics (complexity & variety)	●	●		●	
Borrower purchaser experience					○
Borrower financial sophistication					○
Consumer detriment			●	●	

Key: ● = comprehensive coverage; ○ = partial or less comprehensive coverage

2.17 E-mails were sent to stakeholders including a link to the online survey, a briefing paper explaining the background to the study, a PDF version of the relevant survey and an introductory letter from DG Internal Market and Services explaining our role in the study overall. Extensive chasing was conducted by telephone and/or by e-mail.

Results

2.18 We summarise below the number of data points generated by our private research (i.e. excluding public domain sources) by stakeholder group and by sector. Whilst we recognise that the number of credit intermediaries providing data was disappointing, a number of the responses came from national associations of intermediaries (providing much broader coverage than a single credit intermediary). In addition, by the nature of the market, the other stakeholder groups can compensate, to some extent at least, for this (i.e. a lender is an equivalent source to a credit intermediary in respect of the relationship between the two).

Table 2.2: Number of data points by stakeholder group

	Lenders	Intermediaries	Consumer Associations	Regulators/ other public bodies
Number of responses	90	24	15	32

Table 2.3: Number of data points by sector

	Residential Mortgages	POS credit	Other consumer credit	Business Finance
Number of responses	96	103	96	71

Table 2.4: Coverage by stakeholder and Member State

	Lender	Intermediary	Regulator	Consumer association
Austria	■		■	
Belgium	■	■	■	
Bulgaria			■	
Cyprus	■		■	■
Czech Republic	■	■	■	■
Denmark			■	■
Estonia	■		■	
Finland	■		■	■
France	■	■	■	■
Germany	■	■	■	■
Greece	■			
Hungary	■		■	
Ireland	■	■	■	■
Italy	■	■	■	■
Latvia			■	■
Lithuania			■	■
Luxembourg	■		■	
Malta	■		■	
Netherlands	■	■	■	
Poland			■	
Portugal	■		■	■
Romania			■	■
Slovakia	■	■	■	
Slovenia		■	■	
Spain	■	■	■	■
Sweden	■	■	■	■
UK	■	■	■	■

KEY:

■ **Stakeholder coverage in specified Member State**

Collation from all sources

2.19 Once the data was gathered, we matched up the data so as to be on a harmonised basis and eliminated any conflicting results that arose.

Development of the Analytical Framework

2.20 Our research strands (particularly in reviewing academic literature and the initial stakeholder interviews) were brought together in the analytical framework in Section 3 and Appendix 1 of this report.

Consumer Detriment

2.21 We received qualitative assessment of the perceived significance of consumer detriment from the following consumer associations. These were also asked for real-life examples in support of the assessments made. We also received similar qualitative assessments from a number of the regulators that participated in the survey.

Table 2.5: List of Consumer Association Respondents

Country	Consumer Association
Cyprus	Cyprus Consumers' Union & Quality Of Life
Czech Republic	SOS Consumers protection association
Denmark	Danish Consumer Council
Finland	The Finnish Consumers´ Association
Germany	VZBZ (Federation of German Consumer Organisations)
Ireland	National Consumer Agency
Latvia	Latvian National Association for Consumer Protection
Lithuania	State Consumer Rights Protection Authority
Portugal	Associação de Consumidores de Portugal
Romania	National Authority for Consumers Protection
Romania	Romanian Association for Consumers' Protection
Spain	Instituto Nacional del Consumo
Spain	Asociación de Usuarios de Bancos, Cajas y Seguros
Sweden	Swedish Consumer Agency
Sweden	National Board for Consumer Complaints (Allmänna reklamationsnämnden)

Source: Surveys

3 ANALYTICAL FRAMEWORK

Introduction

3.1 In order to establish a robust analytical framework for this study, and as a contribution towards defining what a credit intermediary is, we performed two tasks:

(a) A focused literature review encompassing both academic and non-academic writing to provide a theoretical underpinning to our work.

(b) A targeted programme of interviews with stakeholders to provide practical insight from the perspective of market participants.

3.2 This section covers the following topics:

- How should credit intermediation be understood and defined
- Different types of transaction costs
- The contribution of intermediaries
- Intermediaries' remuneration
- Integration of the Internal Market
- Definition and modelling of cross-border trade

3.3 We then offer some conclusions on the analytical framework and explain how we use it in later analysis.

How should Credit Intermediation be Understood and Defined

3.4 In this section we employ standard concepts derived from economic theory in order to establish an analytical framework within which credit intermediaries can be defined and studied. We then link these theoretical concepts to the actual functions carried out by credit intermediaries.

The role of intermediaries in economic theory

3.5 Our first step towards developing a clear definition of what credit intermediaries do and are is to draw lessons from the treatment of the intermediary relationship in economic theory.[1]

[1] See Spulber (1999), "*Market Microstructures: Intermediaries and the Theory of the Firm*", Cambridge University Press.

3.6 We have identified three main branches of the theory that provide a systematic treatment of intermediation.

(a) The first addresses the role intermediaries play in lowering transaction costs.

(b) The second addresses the strategic role intermediating agents play in increasing the contracting power of one party in a bargaining process.

(c) The third deals with the role intermediary retailers have in vertically separated markets (i.e. markets where producers make use of independent retailers to reach end-consumers).

3.7 The majority of this section considers the first of these, drawing on material from the other two roles where appropriate.

3.8 The second strand of the literature assumes that the price of the good exchanged is not determined by market interactions but by the bargaining process undertaken by the trading parties. This price formation mechanism is relevant for businesses characterized by relationship-specific, customised investments. However, the (largely) consumer-orientated credit markets are, in contrast, characterized by relatively standardized products.

3.9 The literature on vertically separated markets relies upon the assumption that the retailer physically buys products from the producers. This form of intermediation is less relevant in credit markets. In addition, instead of addressing the beneficial effect of intermediation, it largely relies on the concept of double marginalisation[2] and emphasises the negative welfare effects produced by independent retailers against the benefit of having a vertically integrated distribution chain (i.e. one without intermediaries/wholesalers/retailers).

Transaction Costs, Intermediation, and the Intermediary Margin

3.10 Following the first branch of the literature, in order for intermediation to have a role, two conditions must be met.

(a) Consumers and suppliers seeking to trade in a direct exchange market must incur transaction costs.

(b) Intermediaries must be able to facilitate trade at lower transaction costs.

3.11 Transaction costs are meant here in the most general economic form and represent anything that may reduce trade gains or prevent trade from happening altogether.

2 Double marginalisation is the phenomenon by which consumers end up paying a higher price as a consequence of the vertical separation of the market (i.e. the fact that producers and retailers are separated entities).

3.12 The ability of intermediaries to facilitate trade by lowering transaction costs gives such intermediaries the possibility of charging a 'price' for their services. In the economic theory of intermediation the 'price' charged by an intermediary is typically viewed as the spread between an ask-price and a bid-price. The ask-price is the price charged to consumers (borrowers) while the bid-price is that offered to suppliers (lenders). When these agree to a trade via an intermediary they commit to trade at those prices.

3.13 The concept of the bid-ask spread applies most straight-forwardly to the business activity of some types of intermediaries who buy loans at a (bid) price, and resell them at a higher (ask) price. We consider that this type of intermediary is closest to being another category of lender (i.e. like a retail bank borrowing funds from a wholesale bank). However, the concept is also relevant for credit intermediaries more pertinent to our study who do not acquire any property rights or responsibilities on the goods traded.

3.14 Consider for instance a mortgage intermediary that receives a brokerage commission each time a contract (between a borrower and a lender) is signed. Irrespective of which side of the transaction pays the commission, interpretation in terms of bid-ask spread is possible. If consumers pay the commission, the bid-price corresponds to the price (e.g. interest rate) specified in the contract, and the ask-price is the contract price plus the commission. If, in contrast, lenders pay the commission, then the ask-price is the contract price while the bid-price is the contract price net of the commission.

3.15 This study includes also intermediaries whose business activity cannot be directly described in terms of bid-ask spread, like intermediaries who charge a time-based fee, or indeed a fee irrespective of whether or not a deal between the parties is reached.[3] Typically, the goal of this kind of intermediation activity is to increase the probability (to consumers and/or to suppliers) of finding a trading partner or to make trade happen in a shorter time. In this situation the intermediary earns a margin for reducing costly delays in the transaction and/or for making transactions more likely to happen.

3.16 This implies that a key characteristic of any intermediation activity is that the intermediary margin is achieved by charging at least one side of the market.

3.17 In light of the theory just described, we can conclude that the two main characteristics that a market must possess for intermediation to be recognised are as follows:

(a) **The existence of intermediaries is based on their ability to facilitate trade by reducing transaction costs.**

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[3] An interpretation in terms of bid-ask spread is still possible at a theoretical level. For instance, consider the situation of a consumer who pays a certain fee in order to increase the chance of an uncertain transaction taking place. The expected utility that the consumer gets in this situation can always be re-modelled as one in which the consumer trades off the higher chance of concluding the transaction with a higher price (ask-price) to be paid once the transaction happens.

For this study, the types of transaction cost that are potentially relevant are:

– Administrative costs of collecting the documents necessary to open a credit line, time spent in filing credit applications, costs of writing and formalising contract;

– Consumers' cost of searching among credit products;

– Lenders' cost to advertise, promote and distribute credit products;

– Costs represented by trading opportunities that are lost as a result of consumers' lack of confidence in the products' suitability, or lenders' reluctance to offer credit to a consumer for whom it is hard to assess credit worthiness; and

– Costs to monitor borrowers' repayments, or to recover credit from defaulting consumers.

(b) **The intermediary margin is achieved by charging at least one side of the market.**

Charging structures typically used in the credit intermediary market are:

– Commissions, to borrowers and/or to lenders, conditional on a contract (concerning the purchase of credit products) being signed;

– Fees to borrowers and/or lenders for undertaking activities that facilitate the reaching of a credit agreement (whether or not the actual credit agreement is signed); and

– Risk-sharing schemes in which the intermediary receives a payment conditional on the borrower respecting his or her contractual duties.

3.18 We provide a more formal discussion of the intermediation theory pertinent to this study in Box 3.1 below, and discuss the specific intermediaries' contributions towards a reduction of transaction costs and the specific remuneration forms adopted by intermediaries in the remainder of the section. Further discussion and proofs are set out in Appendix 1.

Box 3.1: Intermediation Theory

Monopolistic intermediation

We begin with a deliberately simplistic example — that of a monopoly intermediary (i.e. there is only a *single* intermediary operating in the market) — as this allows a description of the role of intermediation in a relatively simple manner. When a single intermediary operates in the market its margin is:

$$\text{Margin} = \text{Bid price} \times \text{Demand} - \text{Ask price} \times \text{Supply}$$

and the optimal pair (bid-price, ask-price) = (p^*_A, p^*_B) is determined by maximizing the margin subject to two constraints:

(i) Supply must equal demand, i.e., $D = S$

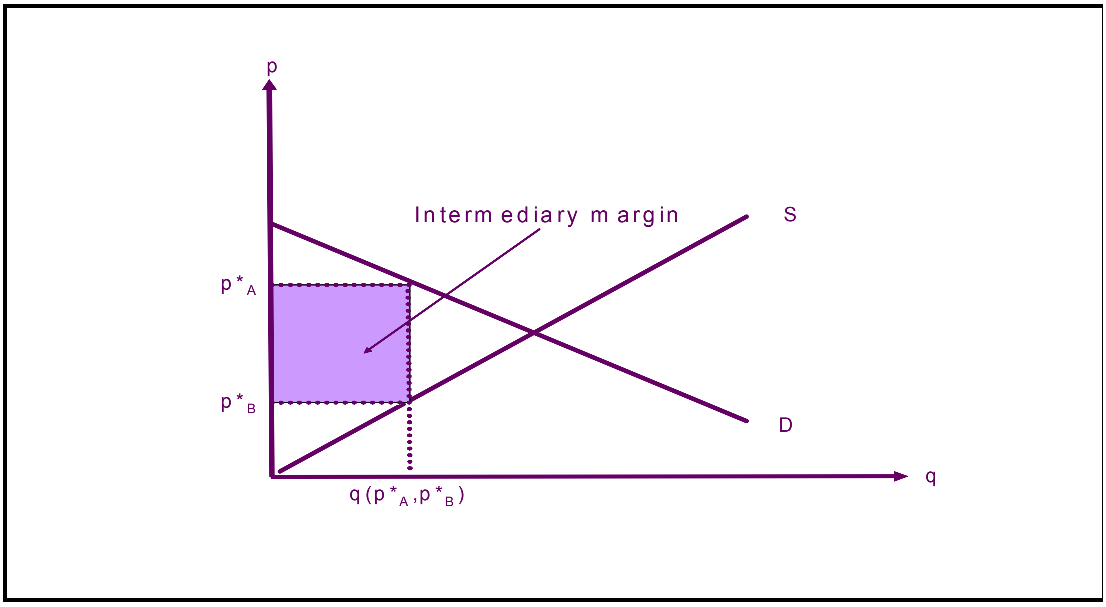
(ii) The surpluses that both consumers and suppliers achieve when dealing through the credit intermediary must be at least as large as those achieved the in case of direct trade.

The first constraint is a standard market clearing condition, while the second is a consistency condition: if at least one trading party is better off by trading directly with the other, then the intermediary would not be able to operate.

When the consumer and producer surpluses are larger than in the direct market, the exact values of p^*_A and p^*_B depend on the elasticity of demand and the elasticity of supply, and we refer the reader to Appendix 1 for more details on this matter.

Figure 3.1 below depicts the outcome of a market in which a single monopoly intermediary operates. In this case, the intermediary is able — as a monopolist — to sequester a part of the welfare gain that would accrue to borrowers and lenders under perfect competition as its profit (there will also be a deadweight loss, where some of the welfare is lost to all parties).

Figure 3.1: The intermediary pricing strategy

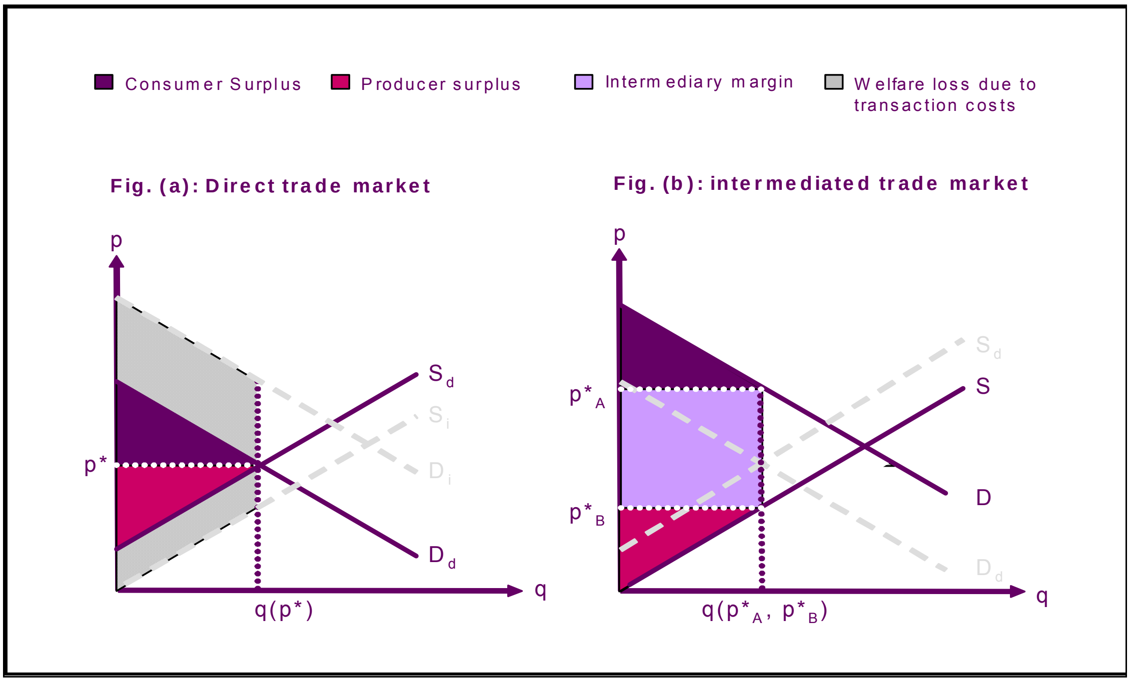


In Figure 3.2 a competitive direct market is compared to an intermediated market. In Figure 3.2 (a) shows the standard outcome of a competitive direct market where the equilibrium price p* is determined by the intersection of demand D_d and supply S_d (the subscript “d” signifies direct), and the socially optimal output Q* is produced.

The advantage, to lenders and consumers, of dealing through the intermediary lies in the lower transaction costs they have to bear. Consequently, the supply function and the demand function in case of intermediated trade (denoted by S and D respectively) are higher than the supply and demand functions in the direct market.

Figure 3.2 (b) refers to a situation where the consumer and producer surpluses are equal to that in the direct market. In this case the optimal strategy for the intermediary is to set an ask-price p_A and a bid-price p_B that leave consumers and lenders indifferent between trading directly or through the intermediary. The increase in welfare due to the intermediary activity is represented by the intermediary margin. Moreover, the intermediary margin corresponds exactly to the welfare loss due to the transaction costs present in the direct market (the grey area in Figure 3.2 (a)). This is always the case if a single intermediary operates and constraint (ii) holds.

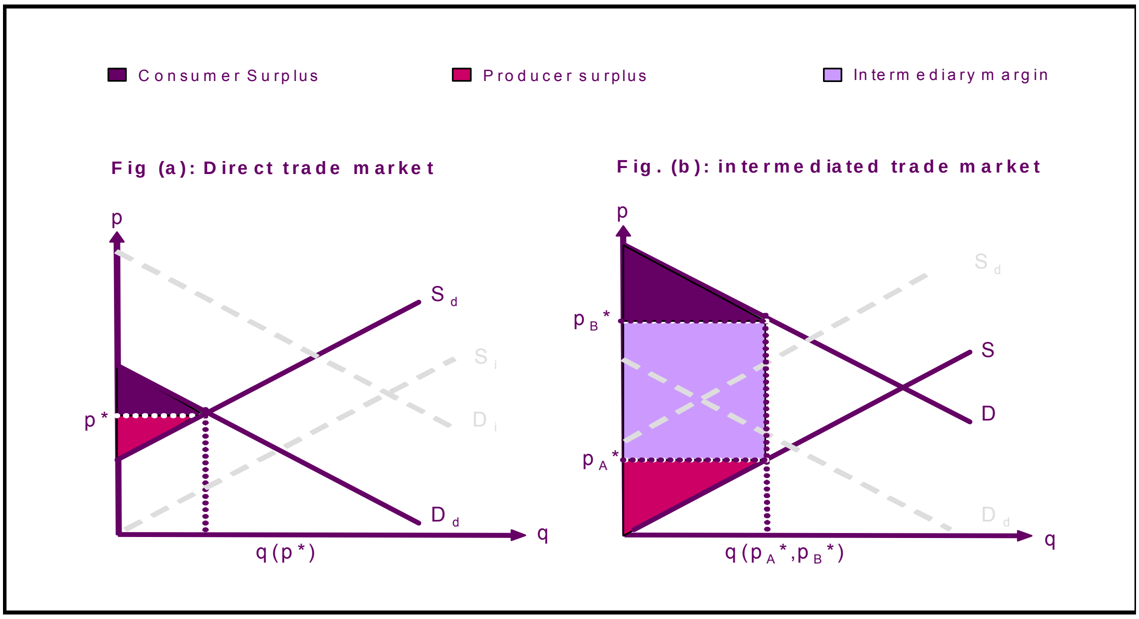
Figure 3.2: The effect of intermediation on social welfare (1)



3.19 The extent of welfare improvement can be even larger than that depicted in Figure 3.2.

Figure 3.3 describes a situation when the consumer and producer surpluses from intermediation are larger than those that arise in the direct market due to the significant decrease in transaction costs caused by the intermediary activity. In this situation the exact values of $p*_A$ and $p*_B$ depend on the elasticity of demand and the elasticity of supply, and we refer to Appendix 1 for more details on this matter. Here the consumers' and producers' surpluses increase as a result of intermediation activity.

Figure 3.3: The effect of intermediation on social welfare (2)



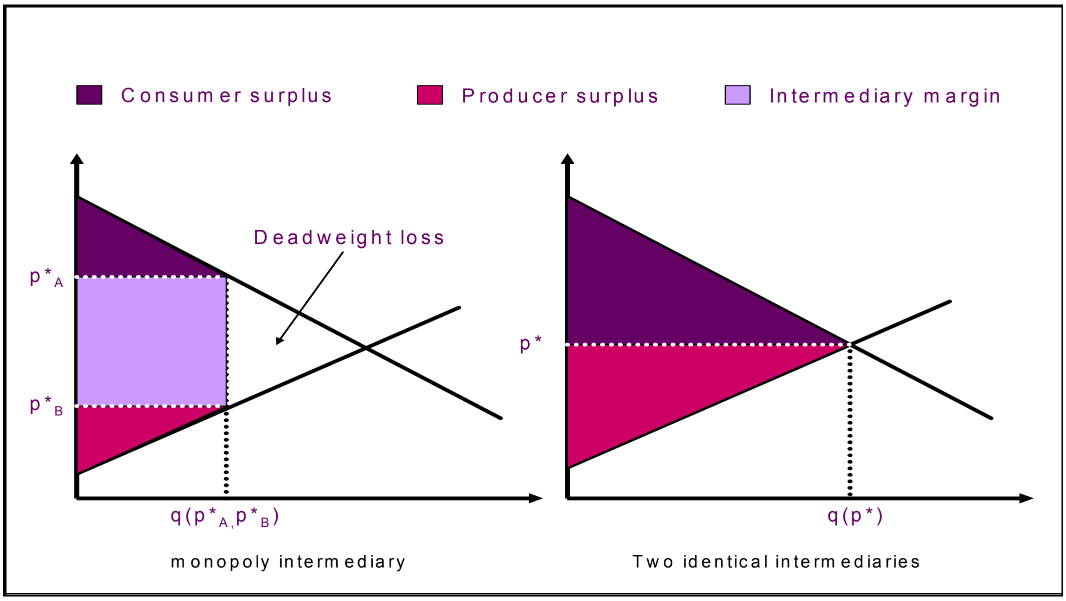
To conclude, whenever there is scope for such a monopoly intermediary to enter the market, the positive effects on welfare are unambiguous: the aggregate surplus always increases, and an increase of surplus may also be observed at the individual consumer and supplier level.

Competition between homogenous intermediaries

Assuming that intermediaries are homogenous is a way to approximate the behaviour of a market where intermediaries offer almost identical services and provide very similar credit products.

When the intermediaries are homogenous, the bid-ask spread collapses to the equilibrium price that would have emerged in a perfectly competitive market (i.e. in this case, the economic effect of the market failure is fully resolved). This is the case as each intermediary has an incentive to undercut the ask-price of its competitor in order to attract consumers, and to outbid competitor bid-prices in order to attract suppliers. As a result the intermediaries' margin disappears, the amount of credit provided in equilibrium increases, and with it social welfare (see Figure 3.4).

Figure 3.4: The welfare effect of intermediary competition



Competition between heterogeneous intermediaries

The assumption of identical intermediaries is clearly very restrictive. In reality all intermediaries are differentiated in some sense. Consumers may value credit intermediaries differently for two main reasons:

(a) Each intermediary offers a different service; and

(b) Intermediaries offer identical services, but each is linked to a set of lenders that offer differentiated products, or is differentiated by intangible factors (such as reputation or brand).

The same reasoning applies to lenders who, besides appreciating differences among the intermediary services offered, may prefer some credit intermediaries to others because of the specific characteristics of the consumer platform they give access to.

Because such intermediaries are differentiated, when the number of intermediaries increases, so does the variety of intermediary services available in the market. It then becomes crucial to make clear assumptions on what is the impact of variety. Economic theory identifies two possible effects:

- The number of consumers and suppliers stays constant, and the only effect of the higher variety is that some consumers and some suppliers switch to new intermediaries as a result of the wider range of intermediation services available.
- The number of consumers and suppliers increases with variety because new consumers and some new suppliers that were previously outside the market, will now enter because they are attracted by the new services available.

We shall adopt here the first assumption, again on the grounds of simplicity (the second case is discussed in more depth in Appendix 1). The key results of having competition between differentiated intermediaries (which are formally derived in Appendix 1) are listed below.

Concerning intermediaries:

- Each intermediary earns a margin that depends on how differentiated its services are compared to those of competitors. The more differentiated the services are (either horizontally or vertically), the higher the intermediary's margin.

- The intermediary's margin decreases in the number of intermediaries operating in the market, but it does not disappear even when the number of intermediaries becomes very large. This is because the differentiated nature of intermediation services allows intermediaries still to enjoy a degree of effective market power.

Concerning lenders and borrowers:

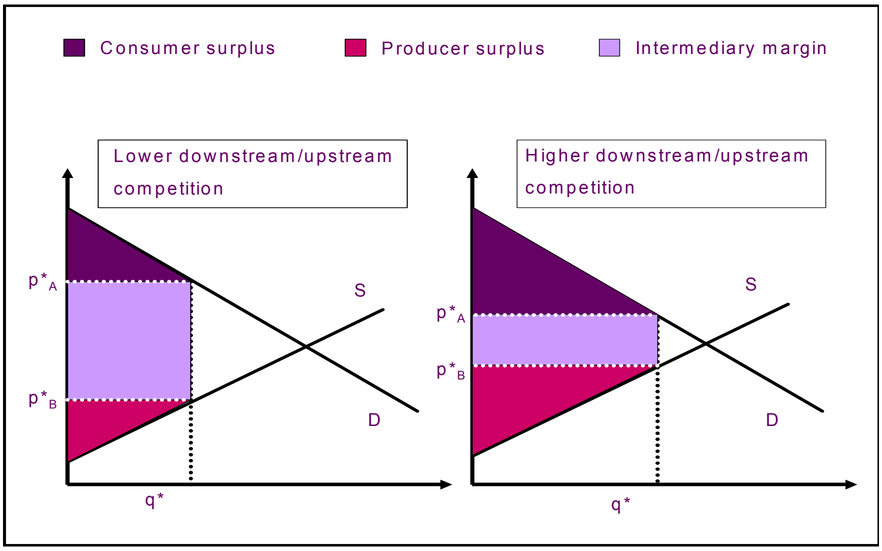
- An increase in downstream competition (i.e. intermediaries being perceived as more similar in the eyes of consumers) leads to higher consumer and producer surpluses (see Figure 3.5). The intuition is as follows: since intermediaries compete more aggressively in order to attract consumers, they charge them less, eventually end up with more customers. In order to satisfy the larger demand, they must also ensure access to an accordingly larger supply of credit products, and therefore they will reduce the costs of the intermediation activity to the lenders.

- An increase in upstream competition (i.e. intermediaries being perceived more similar in the eyes of lenders) would lead to higher consumer and producer surpluses (see Figure 3.5).

- The intuition is similar to that above. Intermediaries compete for lenders by charging them less, and end up securing increased access to credit products. Consequently, they also need to charge less to consumers.

- Finally, an increase in the number of intermediaries leads to higher consumer and producer surpluses.

Figure 3.5: The chain-effect of more downstream/upstream competition



Source: Europe Economics

A Definition of a "Credit Intermediary"

3.20 In terms of the stakeholder surveys, we considered it important to allow respondents to provide their national definition of "credit intermediary" and to inform us of the types of credit intermediaries operating within their Member State. In this way — given the significant differences between Member States in terms of the definition, existence and the nature and extent of credit intermediary activities — we hoped that we would not preclude potentially relevant types of intermediary from the study.

3.21 Different Member States within the EU27 define a "credit intermediary" in different ways, and apply the term to different types of business. For our purposes, the broad definition of a credit intermediary adopted for the surveys was

> an individual or firm that does not provide credit itself but rather facilitates an individual or firm obtaining access to credit from a third-party credit provider. We understand that there may be a chain of parties between the ultimate borrower and the credit provider — we are interested in those intermediaries with a direct relationship or interaction with the ultimate borrower or potential borrower. The end borrower may be a consumer or a business. This includes intermediaries tied to one or more particular credit providers and those that are fully independent.

Typology of credit intermediaries

3.22 Equipped with this understanding of credit intermediation, we provide below an introduction to the list of the types of credit intermediaries that we include in this study:

(a) **Residential Mortgage intermediaries (see Sections 5 and 6)**. Residential Mortgage intermediaries advise clients seeking to purchase a property of their credit options and subsequently arrange credit for their client with the appropriate credit provider. Such intermediaries may be tied-agents (i.e. the intermediary will recommend products offered by one or more specific credit providers) and those who are independent of any specific credit provider. The activities of the mortgage intermediary may also vary, from a comprehensive advisory offering to a more straightforward matching function.

(b) **Point-of-sale Intermediaries (see Sections 7 and 8)**. They include:

- Vehicle retailers who supply credit to customers. For example, an individual seeking to purchase a new car may arrange credit at the point of purchase through the vehicle retailer, rather than directly arranging credit with a bank or similar organisation.

- Other retailers providing point-of-sale credit. An example of this would be an individual who seeks to purchase, say, a consumer durable such as a new television and wishes to pay for the item over a period of time. Again, the customer may arrange credit at the point of purchase through the retailer, rather than directly arranging credit with a bank or similar organisation.

(c) **Consumer credit intermediaries (see Sections 9 and 10)**. These include:

- Consumer credit brokers. These intermediaries assist consumers in accessing consumer credit, particularly where the consumer’s credit history is impaired.

- Home credit intermediaries (typically known as “agents”). Home credit providers typically use self-employed agents to intermediate between themselves and the borrowers. These intermediaries will normally visit the homes of the potential and actual borrowers (hence, “home credit”).

(d) **Business finance intermediaries (see Sections 11 and 12)**. These are intermediaries dealing with various forms of business finance, such as commercial mortgages or asset finance.

3.23 It is stressed that the list above should be taken as being indicative rather than exhaustive. Equally, a web-site where both sellers and buyers have free-of-charge access and can interact with each other may be more accurately classified as a “platform” than as an intermediary *per se*. The reason is that platforms charge neither consumers nor suppliers, as they typically make profits by selling space to advertisers that are attracted by the platform’s usage share.

3.24 Also, these are not necessarily mutually exclusive categories — in other words, a mortgage intermediary may offer both residential and commercial mortgages, and so on. We expand upon this point in the next sub-section.

Supply-side substitutability

3.25 To the extent that providers of credit intermediation services of one form (say, residential mortgage credit) are able, at low cost, to switch to providing other credit intermediation services (say, consumer credit), credit intermediation markets will not be strictly separable. For example, many UK providers of other financial services advice also provide residential mortgage intermediation services.[4] In such cases, then, the degree of supply-side substitutability for credit intermediaries providing one form of intermediation as a primary service to supplying its current secondary service as its primary form of intermediation will probably be high.

3.26 In other cases, however, the nature of the intermediation provided will be different — where these are fundamentally dissimilar activities there is less reason to suppose that substitutability will be high.

3.27 Our view is that to gain traction upon the scale and nature of credit intermediation, is best done by focusing first upon the credit product intermediated. This is how we have structured Sections 5–12 of this report. Other types of intermediary are referred to in the remainder of the report as and when appropriate.

3.28 We now expand what credit intermediaries do, exploring where appropriate these different categories.

The Economic Contribution of Intermediaries

3.29 The theory of intermediation identifies four main economic contributions of intermediaries:[5]

(a) Economies of scale

(b) Decreasing search and matching costs

(c) Alleviating adverse selection

(d) Mitigating moral hazard.

4 See Europe Economics' PIFs report for the UK FSA.

5 Please see the list of literature reviewed for further details on the relevant literature.

3.30 Each contribution is associated to the reduction of a specific type of transaction cost, and Appendix 1 has a more detailed theoretical description of the mechanisms by which these economic contributions can be achieved. We discuss below how these contributions are linked to specific activities that a credit intermediary may potentially undertake.

Economies of scale

3.31 When parties trade directly they engage in a variety of costly and time consuming activities (e.g. bargaining, negotiating, writing contracts). Where intermediaries handle a high volume of transactions with multiple buyers and sellers, they can potentially achieve significant economies of scale.

3.32 For instance, borrowers may have high opportunity costs of undertaking administrative tasks related to the process of filing a credit application, and might prefer dealing through an intermediary. Similarly, an intermediary may assist a lender in the preparation of the credit agreement (e.g. by writing contracts and undertaking associated administrative tasks).

3.33 Thus credit intermediation facilitates the conclusion of a credit agreement where lenders and borrowers may find it convenient to shift, to a credit intermediary, costs such as:

- The administrative cost of collecting the documents necessary to open a credit line;
- The opportunity cost of the time spent in filing credit applications;
- The costs of formalising a contract.

3.34 The evidence collected through our survey indicates that administrative tasks represent a significant activity undertaken by point-of-sale intermediaries, with more than 80 percent of lenders involving such intermediaries in administrative work that is ancillary to the conclusion of the credit agreement.

3.35 Similarly, a review of consumer assessment websites revealed that — in Germany and the Netherlands, for example — credit intermediaries were identified by *satisfied* borrowers as being “helpful”, “user-friendly” (by comparison to banks) and “efficient”.[6]

Search and matching costs

3.36 Intermediaries enhance market performance by coordinating market transactions.[7] They act as a matching mechanism: they match consumers with specific needs to suppliers that offer particular products and, by doing so, they increase the overall volumes of trade.

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[6] There are a number of websites drawing together both positive and negative feedback from customers. See http://www.baugeld-vergleich.de and http://www.geld-lenen-site.nl/geld-lenen-ervaringen/. Whilst obviously subjective, such anecdotal material is useful to illustrate this point and ground it in practical experience.

3.37 In a credit market characterized by differentiated products and by consumers with various financial needs and risk preferences, the activity of searching plays an important role as it allows consumers to gather information about products and price quotations. Consumers can avoid costly market search by relying on intermediaries that present them with a range of products. Similarly, lenders seeking to reach consumers can make use of credit intermediaries, thus avoiding the need to open branches, advertise, and promote their products.

3.38 Our analysis relies on an important assumption, namely that the activity of searching for intermediaries is (effectively) costless. If intermediaries are single-tied (hence increasing the consumer's need to search among competing credit intermediaries) then the contribution of intermediation towards solving search problems may be rather limited (see for instance, 4.16 and 7.84 for examples of where detriment arises from limited search by the intermediary). In contrast, if tied to a single lender, intermediaries can be a more effective distribution channel because the exclusive relationship shields lenders from a direct comparison with other suppliers.

3.39 Typical intermediation activities aimed at, or with the effect of, decreasing consumers' market search costs are:

- Searching products for borrowers; and
- Providing customers with price quotations.

3.40 On the supply side, typical activities include:

- Establishing links with clients;
- Distributing credit products; and
- Promoting and advertising lenders' products.

3.41 The evidence gathered through this study shows that being a market-matcher represents the most important role that intermediaries play in the credit market. The degree of engagement in activities aimed at searching and (even more importantly) distributing and promoting products is very high across all credit products and irrespective of the tied/untied nature of intermediation (see also Table 3.2).

3.42 *The Value of Mortgage Advice (2008)*[8] estimated that the average initial rate achieved by a borrower approaching a lender directly in the UK was 6.31 per cent, with the equivalent rate achieved through a mortgage intermediary being 5.48 per cent — a significant saving.

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7 See for instance Gehrig (1993).
8 Conducted by NMG Financial Services Consulting on behalf of the Association of Mortgage Intermediaries.

Adverse selection

3.43 In some markets, information asymmetries between the trading parties may be so severe as to cause a form of market failure known as "adverse selection". This is a market process in which consumers select a product of inferior quality (or do not purchase it at all) due to having access to a different information set to the provider of the product.

3.44 In economic theory it has been argued[9] that adverse selection that arises in a direct exchange market can be alleviated if the two sides of the market deal through an intermediary.

3.45 In a credit market setting, asymmetric information works at two levels: on the one hand consumers are not fully aware of the characteristics of a credit product and, on the other hand, lenders do not know the risk of default of borrowers.

3.46 In this context, problems of adverse selection are represented by trading opportunities that would be lost due to consumers' lack of confidence (e.g. a borrower does not purchase a potentially suitable product because he does not fully understand its characteristics), or lenders' reluctance to offer credit to a potentially valuable client (e.g. a lender's inability to recognise the creditworthiness of borrowers).

3.47 If they are perceived as experts and succeed in acting as quality guarantors for both sides of the market, credit intermediaries may alleviate these problems. For instance, credit intermediaries may assist borrowers in the purchase of credit products by:

- Suggesting suitable products;
- Warning clients about the risk associated with specific products; and
- Explaining contract terms.

3.48 The involvement of a credit intermediary in the assessment of the suitability of a credit product to a borrower is found in a number of Member States. This is the case in the Netherlands with respect to mortgage credit and to some forms of consumer credit, if the credit intermediary is providing advice.[10]

3.49 On the lenders' side, intermediaries may be engaged in activities such as:

- Direct assessment of the credit-risk of customers (perhaps from knowledge gained through a long-standing relationship with the borrower);

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9 See for instance Biglaiser (1993).
10 See summary of the Financial Services Act, in Appendix 2.

- Indirect assessment of the creditworthiness of customers (e.g. by confirming whether a customer meets the requirements — set by the lender — necessary to be eligible for a loan).

3.50 One of the findings of this study is that intermediation activities aimed at alleviating borrowers' asymmetric information are more significant for relatively complex credit products like residential mortgages and business finance products (please see Table 3.2, Sections 5 and 11). In contrast these activities have less weight for relatively simple and standardised products, e.g. point-of-sale credit (see Table 3.2 and Section 7). This finding confirms the intuition that when the product's characteristics are difficult to understand, expert advice and recommendation become important aspects of the intermediary's activity.

3.51 With respect to the intermediary's involvement in activities aimed at alleviating asymmetric information for lenders, we note the following:

- First, it is crucial to identify who is allowed to make the ultimate lending decision. Many Member States explicitly forbid credit intermediaries from making independent lending decisions, thus decreasing the scope for their involvement in risk-assessment (paragraph 4.144 identifies these Member States).

- Second, some assessment of creditworthiness may be done in order to establish what would be a more suitable product (this may not be possible through a credit register everywhere) or simply to assist a lender in making its assessment (e.g. by gathering information on the borrower).

3.52 Our analysis shows that there is some evidence of intermediary involvement in *assisting* lenders in the assessment of the creditworthiness. This function is particularly relevant among business mortgage intermediaries (e.g. as opposed to residential mortgage intermediaries). Further detail with respect to credit intermediaries and creditworthiness checks can be found at paragraphs 4.144 to 4.145 in the next Section).

Moral hazard

3.53 Moral hazard arises when a party insulated from a risk may behave differently from the way it would behave if it were fully exposed to that risk. In order to mitigate moral hazard problems significant resources must be allocated to collect information in order to monitor the post-contractual behaviour of a party. Economic theory has suggested that, in financial markets, intermediaries may be able to collect information more efficiently and be able to do so at lower opportunity costs than lenders.[11]

[11] See for instance Diamond (1984).

3.54 In a credit market, the post-contractual behaviour of borrowers may increase the risk of default on some legal obligation of the debt contract (i.e. not making interest and/or capital payments when due). In an attempt to minimize this risk, lenders could delegate to intermediaries the task of monitoring borrowers (on the basis that the intermediary has a more direct relationship with the borrower). For instance, an intermediary could be more effective in collecting payments on behalf of the lenders by visiting borrowers regularly and monitoring borrowers' financial situation closely.

3.55 Similarly, it is conceivable that moral hazard problems arise in respect of the post-contractual behaviour of lenders. For instance, a mortgage lender could choose to take a particularly aggressive line towards a borrower in relation to late payment difficulties and re-possession/forced sale. Therefore, in principle, credit intermediaries could undertake some form of monitoring activities on the behalf of borrowers, such as encouraging lenders to respect the terms (and spirit) of the contract agreement.

3.56 Therefore, from the viewpoint of lenders, intermediaries' engagement in activities aimed at alleviating moral hazard would include:

- Monitoring borrowers' post-contractual performance;
- Collecting borrowers' repayments; and
- Recovering credit from defaulting consumers.

3.57 From the viewpoint of borrowers, intermediaries could undertake activities such as:

- Monitoring lenders' compliance with contract terms; and
- Assisting borrowers in filing complaints against non-performance by the lender.

3.58 We have not been able to confirm evidence of intermediaries being involved in any activity aimed at monitoring the post-contractual behaviour of lenders (i.e. ensuring that the lender respects the contract terms, and assisting borrowers in consumer compliance processes). Therefore, the role of intermediation in the alleviation of moral hazard problems for borrowers, despite being a theoretical possibility, our findings indicate not to be material.

3.59 In contrast — even though limited to some market niches — the intermediaries' engagement in payment collection and credit recovery can be very significant. In the home credit market, for example, intermediaries (typically self-employed agents) are used by lenders with the primary purpose of visiting the homes of borrowers to collect payments as this imposes a form of discipline on borrowers' spending behaviour. We refer to the case study on "home credit" (Sections 9 and 10) for more details on the matter.

The Role of Intermediaries in the Credit Market

3.60 The theoretical analysis carried out so far represents the basis on which to build an understanding of how credit intermediaries operate in reality. The goal of this approach is twofold.

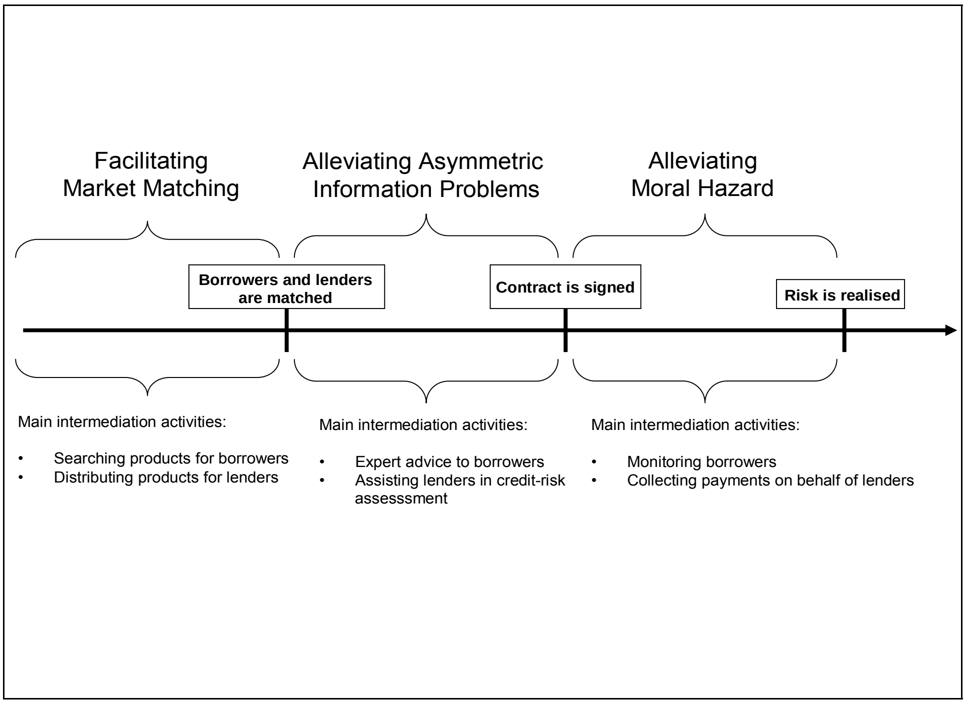
3.61 First, it allows the identification of a comprehensive list of the activities undertaken by credit intermediaries, as well as a rigorous understanding of the economic contributions of each activity (see the table below). Where an activity has been identified as theoretically possible, but our study has not found significant evidence in practice, we have italicised that activity below.

Table 3.1: Intermediaries' Activities and Their Economic Contributions

HIGH-LEVEL ECONOMIC CONTRIBUTION	ACTIVITIES AIMED AT DELIVERING THE CONTRIBUTION	
	For borrowers	**For lenders**
Economies of scale	– Collecting documents – Filing credit applications – Other administrative tasks	– Collecting documents – Formalising contracts – Other administrative tasks
Decreasing search and matching costs	– Searching products for borrowers – Providing customers with price quotations	– Establishing links with clients – Distributing credit products – Promoting and advertising lenders' products
Alleviating asymmetric information and adverse selection	– Suggesting suitable products – Warning about the risk involved in specific products – Explaining contract terms	– *Direct assessment of the credit worthiness* – Confirming whether customers meet credit worthiness requirements set by the lender
Alleviating moral hazard	– *Monitoring lenders' compliance with contract terms* – *Assisting borrowers in filing consumer complaints*	– *Monitoring borrowers' post-contractual performance* – Collecting borrowers' repayments (particularly in the case of home credit, as discussed in Sections 9 and 10) – *Recovering credit from defaulting consumers*

3.62 Second, it allows the studying of the role of intermediation within the entire timeframe in which the borrower-lender relationship comes to be. This timeframe is not limited to the duration of a credit-agreement, but starts with borrowers' financial needs and lenders' need to attract customers, and ends with the realisations of the risks intrinsic to any credit relationship (please see below).

Figure 3.6: The Role of Intermediation within the borrower-lender relationship



Source: Europe Economics

3.63 Note that we have excluded administrative tasks (justified by economies of scale) from the above graphic as, potentially, they apply at all stages. For instance, credit intermediaries may assist lenders in the assessment of creditworthiness by collecting documents and doing other paper work.

3.64 It is important to stress that even though intermediaries may in principle be involved in all the activities listed in Table 3.1, in reality the actual degree of engagement in these activities is shaped by factors such as product market characteristics, contractual relationships with the lender (e.g. tied and untied) and national legislation.

3.65 We have therefore integrated the theoretical framework on intermediaries' economic contributions and remuneration schemes with the data gathered through the surveys. This serves multiple purposes:

(a) To provide a high level analysis of how effective intermediary business models are in delivering economic benefits;

(b) To understand whether intermediaries act as neutral third parties between borrowers and lenders, or whether they are inclined to act in the interest of one side of the market (either the consumer or the lender);

(c) To provide a balanced view on the intermediary relationship as a whole, and therefore an informed opinion that could be the starting point for possible policy interventions.

3.66 In order to see the connection between the factual findings and the theoretical framework we link the activities undertaken by intermediaries directly to the economic contributions set out in Table 3.1. This link is made clear below:

(a) Economies of scale: such as undertaking administrative work;

(b) Facilitating market matching: being a distribution channel (for lenders) and searching for products (for borrowers);

(c) Alleviating asymmetric information: providing pre-contractual information and providing suitability advice (to borrowers) and undertaking credit checks (for lenders);

(d) Alleviating moral hazard: collecting payments (for lenders).

3.67 In Table 3.2 below we summarise the extent to which intermediaries' business models observed in reality deliver the economic benefits implied by our theoretical predictions. The degree with which intermediaries are engaged in the activities listed above are calculated from the outputs of our survey as follows:

– *Very high*: more than 80 per cent of intermediaries are involved in related tasks;

– *High*: 60-80 per cent of intermediaries are involved in related tasks;

– *Medium*: 40-60 per cent of intermediaries are involved in related tasks;

– *Low: 20*-40 per cent of intermediaries are involved in related tasks;

– *Very low*: 0-20 per cent of intermediaries are involved in related tasks.

Table 3.2: Economic Contribution of Intermediaries in Reality

CREDIT PRODUCT	ECONOMIC CONTRIBUTION	Borrowers	Lenders
Residential Mortgage	**Economies of scale**	Medium	
	Market matching	Very high	Very high
	Reducing information asymmetry	Very high (tied) / High (untied)	Very low
	Alleviating moral hazard	Very Low	Very low
Point-of-Sale	**Economies of scale**	Very high	
	Market matching	Medium	Very high
	Reducing information asymmetry	Medium	Very low
	Alleviating moral hazard	Very low	Very low
Other Consumer Credit	**Economies of scale**	High	
	Market matching	Medium	Very high
	Reducing information asymmetry	High (tied) / Medium (untied)	Low
	Alleviating moral hazard	Very Low	Very Low
Business Finance	**Economies of scale**	Very high (tied) / Medium (untied)	
	Market matching	Very high	Very high
	Reducing information asymmetry	High	Medium (tied) / Low (untied)
	Alleviating moral hazard	Very Low	Medium (tied)/ Low (untied)

Source: Surveys and Theoretical Framework

3.68 We refer the reader to the “Business Models” sub-sections of 5, 7, 9 and 11.

Conclusions

3.69 The conclusions we can draw are as follows:

(a) Economies of scale play an important role only for point-of-sale intermediation and business finance intermediation. This role is less important elsewhere.

(b) The most important economic contribution of an intermediary is that of being a market matcher. Indeed, all intermediaries are highly engaged in this activity, irrespective of the product intermediated and the specific nature of the agreement (tied or untied) with lenders.

(c) Alleviating the borrower's asymmetric information problems is the other key activity that intermediaries undertake for consumers. This is particularly true for residential mortgages (where potentially low financial literacy, together with the high credit value, suggest that impartial expert advice might be particularly valuable) and business finance products. In contrast, lenders tend to solve information asymmetries in-house (i.e. these functions are not outsourced to intermediaries).

(d) An interesting finding is that activities aimed at alleviating consumers' asymmetric information problems appear to be more prevalent among tied intermediaries, i.e. among those intermediaries that work in closer contact with lenders (see the sections dealing with the individual product categories). However, this may at the same time create potential concerns for consumer detriment because intermediaries could use their role as "expert advisors" to actually pilot the consumers' choice towards products that are not in the consumers' best interest. In other words, the tied intermediary has excellent product information (due to the relationship with the lender), but may not be incentivised to share all of the information available with the borrower. However, the robustness of this claim must be supported by additional evidence, i.e. by looking at whether the intermediaries' remuneration arrangements impose incentives that are not compatible with the intermediary's role of expert advisor.

(e) Despite the theoretical possibility that intermediation may play an important role in alleviating moral hazard problems, our data suggest that intermediaries' contribution in this dimension is rather limited[12] (with the possible exception of business finance and niche markets like that of home credit).

3.70 Finally, national legislations can also play a role in shaping the actual degree of engagement in intermediation activities. One example of how the engagement and/or lack of engagement in specific activities is influenced by national legislation is provided by the Italian legislation which identifies two categories of intermediaries: independent brokers ("*mediatori creditizi*") and tied agents ("*agenti in attivita' finanziaria*"). The former are defined as being credit intermediaries who do not act solely in the interest of either party and whose main task is to match demand and supply (hence they are primarily involved in market-matching activities). The latter act in the interests of lenders and their primary activity is to distribute and promote the lenders' products. Moreover, both types of intermediaries are prohibited from handling borrowers' money (e.g. collecting borrowers' payments). We return to this topic in Section 4.

Intermediaries' Remuneration and Incentives

3.71 As already discussed, a key characteristic of any intermediation activity is that the intermediary margin is achieved by charging at least one side of the market. In this section we categorise remuneration schemes according to *how* the intermediary is paid rather than *who* pays the intermediary. The specific way in which the intermediary is remunerated has an impact on the intermediary's incentive to perform certain tasks, irrespective of who actually bears the intermediation charges.

3.72 The typologies of schemes we will discuss are:

(a) **Commission:** the payment to the intermediary is conditional on a contract being signed.

- *Fixed commission:* the intermediary receives a fixed payment for each credit agreement being *signed.*

- *Volume-based commission:* the payment is expressed as percentage of the volume of credit agreed between the parties.

(b) **Fee:** the intermediary is paid a fixed fee for the services it provides, independently of whether a credit agreement is eventually reached.

(c) **Risk-based remuneration**: The intermediary is paid conditional on the borrower respecting his contractual duties. An example of this type of remuneration is represented by an agreement in which the intermediary earns a percentage on the amount repaid by the borrower.

3.73 As is clear from, for example, Figure 5.8, p108, (in respect of mortgage credit intermediaries), commissions of both varieties from credit providers are common place. Fixed fees are less widespread (although the upstream remuneration of consumer credit intermediaries is something of an exception to this — as Figure 9.9, p201, illustrates). In terms of risk-based remuneration, it is noted that, in the Netherlands, commission payments to mortgage and consumer credit intermediaries cannot be one-off in nature — such payments need to spread throughout the duration of the credit product in question.

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[12] It is important to stress that in the survey we used the activity of "collecting payment on behalf of lenders" as a proxy for activities aimed at monitoring borrowers' post-contractual behaviour.

3.74 There are other remuneration structures that are possible, at least in theory. For instance, a credit intermediary could be rewarded with a fee that varied in relation to the number of credit products found for a borrower. However, it is apparent that such a scheme, whilst motivating an intermediary to search, would need careful control to avoid an intermediary providing more offers, regardless of appropriateness. Equally, it could result in a situation where the consumer is overwhelmed by the choice faced. For these reasons, we are not surprised to have found no evidence of such a scheme in practice.

3.75 In practice, a credit intermediary may receive payments from more than one side, and/or in more than one form, with respect to a particular transaction (see for instance Figure 12.6, p252, which illustrates that the Italian business finance intermediaries in question frequently receive a performance-related bonus payment from lenders, in addition to volume-based commission. Figure 9.10, p202, illustrates how remuneration from both sides is commonplace in consumer credit intermediation). This increases the potential tension between the economic incentives in place and the intermediation activity undertaken.

Market Matching

Commission

3.76 Commissions are an efficient form of remuneration when the intermediaries' primary task is to act as a market-matcher. Since payments to the intermediary are conditional on a contract being signed, the intermediary has incentives to search extensively among credit products and price quotations in order to provide customers with a satisfactory match. Similarly, lenders can rely on the fact that the intermediary will put in enough effort to establish links with client and advertise their products. If volume-based, commissions could deliver additional benefits to lenders' by tailoring the amount of the commission to the credit volume.

3.77 The evidence gathered throughout this study shows that commissions are by far the most commonly used form of remuneration across intermediaries operating in all credit products (see the sections that deal with the intermediaries' business models for more precise information). This result is in line with the finding that being a market-matcher and an efficient retail channel is the important role played by credit intermediaries.

Risk-based remuneration

3.78 Since under risk-based remuneration schemes there is no payment unless a valid credit contract exists, this type of scheme can also incentivise intermediaries to perform "search and promote" activities. However, inefficiencies arise because the intermediary is forced to bear a risk even though required to perform a task (i.e. market matching) that typically does not involve structural risks.

Fee

3.79 A guaranteed fixed fee does not provide the intermediary with any incentive to put in effort to either search for or to distribute products.

Alleviating asymmetric information

Risk-based remuneration

3.80 Risk-based payment schemes do particularly well in creating the right incentives for intermediaries to take responsible lending decisions (in the case where intermediaries are entitled to do so), or to assist (appropriately) lenders in creditworthiness assessment. Moreover, it is in the intermediary's interest to recommend suitable products because any default/missed payment by consumers reduces (e.g. through a claw-back mechanism or an adjustment to future cash flows) and/or delays the stream of payments to the intermediary. This type of remuneration therefore should be particularly useful in the alleviation of asymmetric information problems.

3.81 Our evidence shows that risk-based payment schemes, in practice, are a rather uncommon occurrence. However, their presence is more material among business finance intermediaries (see Section 11). The fact that business finance intermediaries are also those who are most involved in providing support with respect to credit worthiness assessment suggests that market players recognise the incentive implications of this typology of scheme. More narrowly, in the Netherlands, commissions to credit intermediaries can only be paid in monthly instalments over the duration of the loan. (In other words, it is forbidden for a lender to pay one-off commission to a credit intermediary.)

Fee

3.82 Fees have a neutral impact on the performance of tasks aimed at alleviating asymmetric information. On the one hand, they do not incentivise intermediaries to perform these tasks but, on the other hand, they also do not create any conflict of interests.

Commission

3.83 A commission, by contrast, imposes a clear misalignment of incentives when the primary intermediary function is related to solving information asymmetries. The intermediaries' concern with concluding agreements may lead them not to disclose the risk associated with certain products, or to recommend credit products that are not in the consumer's best interest. The risk of consumer detriment could be further aggravated by volume-based commissions. Here the credit intermediaries' incentive to conclude agreements involving a large amount of credit may result in consumers becoming over-extended. On the lenders' side, intermediaries might have incentives to develop strategies in order to provide lenders with a misleading picture of the credit risk involved.

3.84 The widespread use of commissions in the intermediary credit market raises concerns about the possibility of structural market inefficiency, and the consequent materiality of the forms of detriment just described. These issues are discussed in detail in the analysis of structural market inefficiency in Section 4 of the report.

Alleviating moral hazard

Risk-based remuneration

3.85 Under a risk-based remuneration scheme, intermediaries have an interest in monitoring and/or collecting borrowers' repayment as efficiently as possible because any default/missed payment by consumers reduces or delays the stream of payments.

3.86 An instructive example of these incentive mechanisms at work is represented by the business models adopted in the "home credit" sector. This market niche is characterised by lenders making use of intermediary agents with the primary purpose of collecting payments and recovering credit. In order to ensure that agents perform this task as diligently as possible the remuneration agreement means that the agents earn a percentage of each instalment repaid by the borrowers. We refer to the case study on "home credit" in Section 10 for more details.

Fee and commission

3.87 Neither fee nor commission schemes incentivise the undertaking of post-contractual tasks because the intermediary can secure its entire margin already at the conclusion of the contract (in the case of a commission) or even before that (in the case of a fee).

Conclusions

3.88 In light of the above, our analysis suggests that each one of the three remuneration schemes described is best suited to deliver a specific economic benefit. In the following table, for each intermediation activity, the remunerations schemes are ranked from "best suited" (green and *italics*) to "average"(orange) and "least well suited" (red and **bold**).

Table 3.3: Remuneration Schemes and Incentives

INTERMEDIATION ACTIVITES	REMUNERATION SCHEMES
Market Matching	*Commission* Risk-based remuneration **Fee**
Alleviating asymmetric information	*Risk-based remuneration* Fee **Commission**
Alleviating moral hazard	*Risk-based remuneration* Fee, Commission

4 MARKET FAILURE, CONSUMER DETRIMENT AND REGULATION

4.1 This section is organised as follows:

(a) We first assess the main causes of market failure relevant to an understanding of credit intermediation.

(b) We then identify different forms of consumer detriment, for each type describing real-life examples of the problems in order to discuss the role that regulatory interventions may play in preventing or mitigating detriment.

(c) We describe the main regulatory models in EU Member States.

(d) We finally describe proposed regulatory changes at the Member State level and asses the potential impact of the Consumer Credit Directive.

4.2 Although market failure and detriment are closely related, there is a conceptual difference between the two concepts. Market failure refers to the idea that, if a market were operating in a *laissez-faire* environment, it would systematically fail to deliver some of the economic benefits that it is supposed to deliver. Therefore, without an adequate market-led adjustment, or without an appropriate regulatory intervention, a market prone to failure would typically result in some form of detriment. Well-designed regulatory interventions can resolve (or at least mitigate) some of the market failings that result in detriment.

4.3 However, even if an appropriate regulatory framework is present, detriment may still arise from other causes that are not related to the incorrect functioning of the market. For instance, detriment may be the consequence of fraudulent and illegal activities. On the other hand, detriment can also be the result of excessive or ill-designed regulation.

Causes of Market Failure

4.4 We provide here a description of the general characteristics of the credit market that may lead to failures. Real life examples of detriment are provided in the next sub-section.

Asymmetric and incomplete information

4.5 Incomplete information describes a situation where market participants do not have access to complete information about the market (for instance, regarding the motivation and incentives of all of the other market participants).

4.6 An information asymmetry is a sub-set of this: it applies to the situation where one of the market participants has more or better quality information than the other(s). In this context, this could apply to a situation in which a consumer has an informational disadvantage (compared to credit intermediaries and lenders) in understanding product characteristics and contract terms. Equally, the consumer could (and indeed arguably should) be better informed about his or her default risk profile. Nor is the asymmetry necessarily centred upon the consumer — there is also the situation where the credit intermediary could have access to superior information than the credit provider.

4.7 Other aspects, crucial in determining the extent of potential consumer detriment, are features of the specific product being intermediated. Some products (like mortgages) are purchased relatively infrequently, hence increasing the likelihood of consumers having little understanding of the product. Moreover, the charging structure may be relatively complex and consumers may find the actual benefit of the products opaque and unclear. Finally, consumer detriment may even be difficult to identify, as unsuitable sales of some products may be identified only years later.

4.8 An example of incomplete information would be a borrower with limited knowledge of the general market conditions attracted by a misleading advertising message (for instance, one that implied that the credit intermediary would make the final decision as to whether or not credit would be granted, without realising that the credit intermediary is not entitled to make independent lending decisions). Alternatively, a borrower seeking a whole market search might rely on a tied intermediary not realising that he or she would gain information only about products provided by a limited number of lenders.

4.9 With regards to "free services" such as pre-contractual information, a public-good problem can arise amongst retailers. Retailers can free ride on each other and the public good is under-supplied as a result, i.e. consumers receive less information prior to purchasing the product.[13] A sub-set of these problems would be the insufficient disclosure of the fees and commissions due to or from borrowers and lenders respectively. This may mean that the assessment of the product price is made more difficult for the borrower.[14]

Misalignment of incentives

4.10 The detrimental effect of asymmetric and incomplete information may be further aggravated by the misalignment of intermediaries' incentives with those of borrowers and lenders.

4.11 The discussion provided in the preceding section (see paragraphs 3.71 to 3.88 above) demonstrated that the specific remuneration scheme adopted by intermediaries is crucial in determining potential conflict of interests. Therefore, when we talk about misalignment of incentives in the context of credit intermediation, we have in mind a situation in which credit intermediaries are significantly engaged in a certain task and, at the same time, are remunerated through schemes that impose incentives that speak against the performance of that task.

[13] If none of the value of the service is appropriated, i.e. there is a pure externality, a zero level is supplied in equilibrium.
[14] There is also the theoretical (paradoxical) possibility that greater transparency of information may facilitate tacit collusion.

Bundling and tying

4.12 Tying is the practice of selling at least two products together when at least one of these products is not available to purchase separately.[15] More precisely, if we have two products A and B, where A is the tying product and B is the tied product, the consumer cannot buy A without buying B. For example, in the case in which a lender offers a loan conditional on the additional purchase of credit insurance, the loan is the tying product (A) and the insurance is the tied product (B) since it is possible to buy the insurance without a loan but not to have a loan without the insurance.

4.13 In addition to tying, firms can engage in what is called ‘bundling’. Under ‘pure bundling’ the firm refuses to sell either of the two goods separately and under ‘mixed bundling’ the firm does sell the products individually but you can receive a discount or other benefits from buying them together, this is also known as ‘commercial tying’.

4.14 Intermediaries may be instructed by lenders to offer product bundles or tied products as these practices are a means by which lenders can increase their market power and extract a higher surplus from consumers. Moreover, bundling and tying usually make price comparisons more difficult and therefore increase the risk of consumers having imperfect information.

4.15 An example would be a credit intermediary indicating that the availability of a particular credit product would be conditional upon the purchase of credit insurance.

Downstream market foreclosure

4.16 Since intermediaries serve as a retail distribution channel, lenders could use exclusivity agreements with intermediaries in order to form strategic ties that limit competitors’ access and penetration in the market, and so limit consumer choice (see the figure below). An example would be point-of-sale credit intermediaries tied to a single credit provider (our study indicates that this is most common in non-motor retail — see Section 7).

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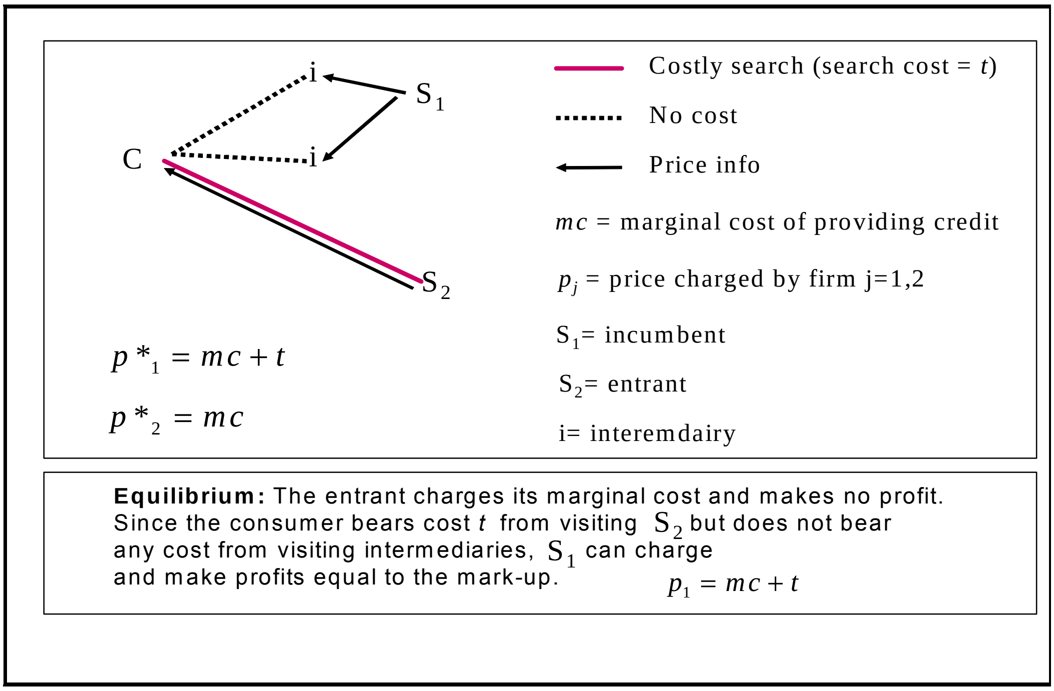
15 It is important to stress that here the term “tying” has a meaning different from that describing a situation in which the intermediary has a contractual agreement with the lenders.

Figure 4.1: Downstream market foreclosure



4.17 Outside of point-of-sale, the barriers to entry for new credit intermediaries are rather low. This is likely to make the use of an exclusivity agreement with the intention of foreclosing the market unfeasible.

Shift of regulatory burden

4.18 In some circumstances, a motivation for a lender to use intermediaries might be as a means of reducing the regulatory burden upon its own business. In a case where the regulatory burden upon intermediaries was reduced by comparison to the lender, this might act to decrease consumer protection. For instance, a lender, in making a direct sale of a specific debt product might be obliged to ensure its salesforce informed the borrower of the associated risks and made some assessment of its suitability to his or her circumstances. If, due to a lacuna in the applicable regulatory framework, such obligations did not apply to products sold through credit intermediaries then this would increase the potential scope for detriment to the consumer to occur. This said, we are not able to quote a specific example of this, in practice.

4.19 The Consumer Credit Directive (CCD)[16] has an objective of avoiding such a shift of the burden (by placing some regulatory requirements upon the relevant credit intermediaries). The potential impact of the CCD is described more fully at 4.169 to 4.195 below. However, the CCD does not apply to business finance nor to mortgage credit, and therefore, this remains a potential risk in those areas, at the least.

Regulatory failure

4.20 In addition to market failure, a regulated market may also experience regulatory failure, i.e. a situation in which the benefits of regulation may be offset by the costs of regulation. This may happen when regulation was badly designed in the first place or when it triggered unforeseeable or unintended effects that resulted in a net welfare loss after the introduction of the regulatory measure, or it may be the result of market or technological changes that mean that a regulation well designed for earlier circumstances is no longer appropriate.

4.21 One example of regulatory failure in the credit market is the risk of arbitrage behaviour by intermediaries if different rules were to be applied to products that are close substitutes.

Market-based solutions

4.22 It may be that the market can address, in part or in full, these failures. In other words, the identification of an apparent market failure does not automatically call for a regulatory intervention.

4.23 For instance, the intermediary could aim to achieve a desirable reputation through the provision of good service (e.g. achieving a reputation for borrower-friendly service or the securing of best price deals) over a sufficient length of time and/or through advertising/branding. In this case, its name could have enough value to it such that it would install protocols so that brand-damaging market failures would be minimised.

4.24 However, the nature of intermediation may limit the scope for some of these market-based solutions to gain traction in achieving a solution to some or even all of the failures identified above. For instance, a remuneration structure that aligns the incentives of the lender and the intermediary may not align the incentives of the intermediary with the borrower (where the intermediary is acting for both parties) — indeed, it may actually have the opposite effect in such a case.

4.25 Equally, some of the products being intermediated are credence goods (i.e. the valuation of the product is a non-trivial exercise, even to an expert), so that some market failures may not be apparent until the lapse of a significant period of time. This could also reduce the effectiveness of market-based solutions.

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[16] The Council adopted the final text of the Consumer Credit Directive (CCD) on 23 April 2008 and it must now be implemented by Member States before 12 May 2010.

Potential versus concrete market failure

4.26 A consequence of the possibility of market-based solutions is that, looking to the future, there can only ever be concrete grounds for identifying potential market failure — all concrete evidence of market failure is concrete evidence of "potential market failure". Market failure is, by its nature, not something that can be demonstrated "concretely" as opposed to "potentially", because one can never concretely observe how the market would have adapted had regulation not been introduced. Our discussion of market failure should be interpreted in this light.

Detriment

4.27 The goal of this section is to provide evidence of different forms of detriment that occur in practice. For each form of detriment identified we provide a discussion aimed at:

- Identifying what type of market failure is responsible for the detriment; and
- Understanding the role regulatory interventions play in preventing or mitigating that form of detriment.

4.28 We have categorised different forms of detriment using the analytical framework of the previous section. Within this framework we can group forms of detriment according to the specific phase of the borrower-lender relationship in which the detriment arises (see Figure 3.6). That is, we distinguish between:

– Detriment that arises through credit intermediary **market-matching.**

– Detriment that arises through credit intermediary activity aimed at **alleviating asymmetric information.**

– Detriment that arises through intermediary activity aimed at **alleviating moral hazard.**

4.29 For each form of detriment identified we provide a discussion aimed at:

– Identifying what type of *market failure* is responsible for the detriment;

– Understanding the role *regulatory interventions* and *code of practices* play in preventing or mitigating the detriment.

Forms of detriment arising through the intermediary market-matching activity

Misalignment of incentives

4.30 An example where a credit intermediary is remunerated despite not finding a competitive product.[17]

> An Italian consumer commissioned a *mediatore creditizio* (a form of credit intermediary defined under Italian legislation) to find a residential mortgage of €120,000 at a pre-agreed maximum interest rate. The agreement between the consumer and the mortgage intermediary was formalised in a contract which stated that the borrower would pay the intermediary a "commission" of €2,000 (i.e. a volume-based commission equal to 1.67 per cent of the value of the loan) conditional on the intermediary's ability to secure such a loan. In addition, the contract contained a clause stating that – provided the mortgage credit intermediary had been successful in finding a loan — a penalty of €1,600 (i.e. the initial commission of €2,000 reduced by 20 per cent) would still be due if the borrower decided against obtaining the loan proposed by the intermediary.
>
> Eventually the mortgage credit intermediary was successful in finding a credit agreement but in the meantime the borrower had received a more competitive offer from his own bank. The borrower decided to purchase the mortgage from the bank and paid the €1,600 penalty to the mortgage credit intermediary.

Market failure

4.31 The main issue involved here stems from the *misalignment of incentives.* In Section 3 (3.76 to 3.79) we stressed that commissions (as opposed to fixed fees) are an effective remuneration scheme when the primary goal of the intermediary is to search for products. In the case described above, the payment structure may at first glance appear to be a commission but in reality it is (in large part) equivalent to a fixed fee — the penalty clause ensures the intermediary receives a minimum of €1,600, irrespective of the competitiveness of the mortgage product eventually proposed. This payment structure did not impose sufficient incentives to carry out an effective market search as confirmed by the fact that the consumer was more successful in finding a competitive product.

4.32 It is important to stress that, had the intermediary had in parallel a commission-based remuneration agreement with the lender, this would have partially preserved the incentive to put effort in searching. However, a fixed fee agreement with the borrower can still cause detriment because the borrower bears a certain cost, whilst the benefits remain uncertain.

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[17] Italian consumers' forum http://www.migliormutuo.it/forum/forum.asp?FORUM_ID=10

4.33 The role that fixed-fee payments play in determining forms of detriment like the one just described is well understood. For instance the president of Adusbef (the Italian Association of consumers of financial products) has recently warned consumers about the risks of relying on credit intermediaries that ask for upfront payments.[18]

Regulation and codes of conduct

4.34 In Italy, even though the legislation imposes requirements aimed at ensuring transparent communication of intermediary charges, there are no restrictions on the specific forms that intermediary remunerations can take. Consequently, it is ultimately up to consumers to fully understand that different payment schemes have different effects on the intermediary's incentive to perform particular tasks.

4.35 There is, however, some degree of self-regulation in some Member States. For instance, the Italian association of credit brokers (Assocred) encourages its members not to charge consumers at all (i.e. they receive a commission from lenders). However, a restriction such as this will not of necessity align the interests of all parties (i.e. the credit intermediary *may* have an incentive to intermediate a credit product, regardless of its suitability for the consumer).

4.36 Finally, regulatory restrictions may prevent the possibility of borrowers paying for a search service that might not come through, by explicitly forbidding intermediaries from charging consumers prior to the successful conclusion of a credit agreement. Just such a restriction applies in France (see later in this Section for further coverage of the restrictions in place).

Misleading advertising

4.37 The Italian Competition Authority has recently investigated and taken action against several cases of unfair advertising practises undertaken by independent credit intermediaries[19] dealing with consumer credit and residential mortgages. Three type of marketing practice emerged as being of particular concern:

The promise of securing a credit agreement for consumers within an unrealistic time period (typically 48 hours). This was done by inducing consumers to believe that the intermediary was entitled to provide credit, and was not just simply a mediator between the borrower and the lender.

Marketing messages explicitly targeted to sub-primes customers with the promise of "deleting" credit histories and which offered unconditional access to credit. However, they did not state that the interest rate charged was far above that typically offered to primary clients.

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[18] Source: Il Sole 24Ore, http://vitolops.nova100.ilsole24ore/2008/06/mutui-a-prova-d.html/

[19] The cases, *"Provvedimenti"* No. 16964, 16965, 16998, 17000, 17001, 17002, 17005, 1732, can be found on the Italian Competition Authority website (www.agcom.it), unde the "*Pubblicità ingannevole e comparativa*" (misleading advertsising) section.

> The failure to provide complete and transparent information about both the cost of the credit product advertised and that of the intermediation charges, thus, making it impossible for the consumer to assess the competitiveness of the offer as a whole. In particular, it was advertised that a service was free of intermediation charges, whilst the investigation carried out by the Authority revealed the presence of agreements between the lender and the intermediary that allowed the transfer of intermediation charges through the cost of the loan.

Market failure

4.38 All three cases are examples in which detriment is caused by *incomplete information.* In the first two examples intermediaries exploit the limited knowledge consumers have about the intermediation role in the credit market. In Italy, credit intermediaries do not have the power to make an independent lending decision, therefore any promise of granting a loan has no real foundation. Similarly, credit intermediaries do not have access to the central credit database in Italy and, besides that, credit data manipulation would be an illegal activity.

4.39 Similar detriment issues have been found elsewhere — for instance, in Austria the Ministry of Social Affairs and Consumer Protection stated that: "[…] it is very difficult for consumers to distinguish different types of intermediaries and their restrictions […]".[20]

4.40 Similarly, the Czech Consumer Association has cited cases where consumers were not aware that the use of a credit intermediary meant only the possibility of arranging credit and did not mean that they would be automatically provided with credit.[21]

4.41 Evidence from consumer complaints in Slovakia[22] suggests that clients are not always aware of the fact that the intermediary may have a contract with a specific institution, and will therefore only consider a limited range of products.

4.42 In the third example, the credit intermediaries have exploited the consumers' lack of understanding about the typical characteristics of products available in the market. Evidence of similar practices was identified in Poland[23] where an intermediary advertised in a local newspaper the possibility of arranging credit at a zero interest rate and free of intermediation charges. In reality, the offer was conditional on the purchase of compulsory insurance that would imply a total cost of credit equal to an 11 percent interest rate. However, this information was printed in very small print.

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20 Source: http://www.bmsk.gv.at/cms/site/attachments/5/1/7/CH0107/CMS1218534269685/taetigkeitsbericht_kap9.pdf)
21 Information from the Association of Financial Intermediaries and Financial Advisers (AFIZ) correspondent
22 Information from survey respondent
23 Source: http://216.239.59.132/search?q=cache:CEADT1JrljgJ:www.uokik.gov.pl/download/Z2Z4L3Vva2lrL3BsL2tzZ19weXRhbmlhLnYwLzI3NC8zLzEvZGVjeXpqYV9ucl9ybHUxOF8wNV96X2RuaWFfMTYuMDUuMDUucGRm+RLU-61-185/05/IM&hl=pl&ct=clnk&cd=1&gl=pl

4.43 Again, the Hungarian Consumer Protection Agency at the Economic Competition Office noted that in recent years, most of the infringements identified by it related to the provision of inaccurate advertising information. For example, an advert for commercial credit did not explain that the favourable rate was available only in very conditional cases.[24]

4.44 Misleading advertising may lead to the creation of a "false focal point of competition" where intermediaries seek to influence consumer choices by systematically providing an over-optimistic picture of the credit opportunities they can offer.

Regulation and codes of practice

4.45 In most Member States, credit intermediaries are not obliged to communicate their relationship with the lender (e.g. whether they are tied or independent). This inevitably means that the customers' information set is incomplete. Exceptions are identified at 4.119(a) below.

4.46 In general, cases relating to misleading advertising may constitute an infringement of existing national (advertising) legislation. The main credit-specific problems are associated with the vulnerability of consumers of low financial literacy who can be attracted by unrealistic offers or advertising that omits important information (such as the typical APRC available on credit).

4.47 There are many programs throughout the EU27 aimed at improving financial education. For instance, in an attempt to increase consumers' awareness, the Romanian National Authority for the Protection of Consumers has launched an educational program called "Family Budget" for the improvement of standards in financial education.

Forms of detriment arising through credit intermediary activity aimed at alleviating asymmetric information

Exploitation of asymmetric information

4.48 We provide below several real-life examples in which a credit intermediary has exploited rather than alleviated asymmetric information.

> A Polish customer purchased a personal loan though an intermediary. Prior to signing the contract the intermediary assured the borrower that the interest rate would be 6.9 percent, as previously advertised. In reality the intermediary knew that over the time period covered by the contract the interest would rise up to 20 percent. Our review of consumer complaints websites in Poland reveals accusations of credit intermediaries failing to provide accurate information about the credit product (e.g. information about the repayment plan) and the contract terms (e.g. extra costs related to late repayments).[25]

[24] Source: http://www.delmagyar.hu/belfold_hirek/egyre_tobb_a_panasz_a_lakossagi_hitelekkel_kapcsolatban/2061211/
[25] http://www.bankier.pl/wiadomosc/Posrednik-posrednika-1607411.html

Anecdotally, several consumer complaints in Slovakia referred to a credit intermediary's inability (or unwillingness) to provide a clear explanation of overall charges and repayment plans.[26]

In a case referred to the UK Financial Ombudsman, a couple visited a mortgage intermediary and obtained a residential mortgage that offered a special rate of interest for the first two years. Towards the end of the two-year period, the intermediary made an appointment to see them again, to discuss their mortgage options. He informed the couple that when the two-year deal came to an end, the interest rate on their mortgage would increase and they would then need to pay the lender's standard variable rate. The intermediary stated that it would be better for them to take out a new mortgage with a different lender. The couple acted on the intermediary's recommendation and re-mortgaged, and as a consequence of this the intermediary received an additional commission from the new lender. However, some months later the couple discovered that if they had stayed with the original lender, the rate would not have increased in the way in which they had been led to believe it would.[27]

A Polish retailer advertised consumer credit at a "zero percent interest rate and at no extra cost". In fact, this was possible only with the additional purchase of compulsory insurance leading to an effective interest rate of 5-7 percent.[28]

4.49 A further example relates to a credit intermediary splitting the credit risk of a borrower. In Belgium most creditors allow credit insurers in the "secondary market" to insure their credit agreements. Before the creation of a centralised database by the Belgium National Bank, each of the two available credit insurers, for each credit application, would consult its own database where all insured credits are registered. The existence of two independent and unlinked databases allowed the split of credit. This happened by dissimulating to the credit insurer that the creditor had already granted (or received an application for) a loan, which is (or will be) insured by the other credit insurer.

A consumer requested a consumer credit intermediary to find a loan of €20,000. The credit intermediary asked for €10,000 of creditor X (insured at Gerling-Namur) and €10,000 to creditor Y (insured at Euler-Cobac). The intermediary did not communicate to either of the creditors that there was a request to the other. Both applications were approved with the result was that 40 per cent of the consumer's income after rent went on credit charges and in due course the consumer defaulted.[29]

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26 Source: Slovakian consumer forums.

27 Correspondence from UK Ombudsman representative

28 Source: http://216.239.59.132/search?q=cache:ust81FOh5jwJ:www.uokik.gov.pl/download/Z2Z4L3Vva2lrL3BsL2tzZ19weXRhbmlhLnYwLzI3NC8xLzEvZGVjeXpqYV9ucl9ybHU2XzIwMDdfd19zcHJhd2llX3N0b3Nvd2FuaWFfcHJha3R5a19uYXJ1c3phLnBkZg+RLU+%E2%80%93+61-35/05/MW&hl=pl&ct=clnk&cd=1&gl=pl

29 Belgian Ministry of Economy (FOD Economie, Volume 2002, serial number 1-2, page 67).

Market failure

4.50 Detriment here is generated by *asymmetric information* and further aggravated by *misalignment of incentives*. We have already argued that, when the primary goal of the intermediary is to alleviate asymmetric information, commissions are a potentially sub-optimal remuneration scheme because they incentivise an intermediary to prioritise the conclusion of a credit agreement (see 3.80 to 3.84).

4.51 In the credit splitting example, a volume-based commission led the intermediary to provide a misleading picture of the credit risk involved. Typically lenders are protected here by keeping such credit-assessment activity fully in-house. However, in this case the intermediary made strategic use of seemingly neutral administrative tasks (i.e. filing applications) in order to hide the actual credit risk of the borrower.

Regulation and codes of practice

4.52 Whilst hindering the apparent effective ability of credit intermediaries to alleviate information asymmetries, commissions are extremely effective in incentivising intermediaries in carrying out their market-matching function.

4.53 Credit intermediaries are not typically obliged to disclose their payments to borrowers (however, this is the case, for instance, in Ireland), although some of the individual credit intermediaries that participated in our survey stated that was their customary practice. Moreover, it is interesting to notice that since the Wilson *versus* Hurstanger Limited case (November 2007), the code of conduct for UK commercial credit intermediaries (issued by the NACFB) recommends that they should fully disclose to borrowers and potential borrowers their fee arrangements with lenders.

4.54 In the Belgian case referred to at 4.49 above, the key problem was the lack of a central credit risk database. In other words, the existence of a central database should have reduced the informational disadvantage of the lenders relative to the credit intermediary (i.e. it would have reduced or eliminated the information asymmetry).

4.55 An initiative by the lenders may solve this problem. Although this was not the solution in Belgium, in Italy ASSILEA, in 1989, introduced an automated credit database to which all members of the association have access.

Forms of detriment arising through credit intermediary activity aimed at alleviating moral hazard

4.56 We have not been able to find evidence of detriment stemming from this typology of activities. On the other hand, our findings indicate that there is very limited engagement by intermediaries in these functions outside a few niche areas.

Summary and conclusions

4.57 The table below summarises the main findings of this section and the preceding section dealing with market failure. For each stage of the borrower-intermediary-lender relationship, it indicates different forms of market failure (and the associated detriment), suggests the type of regulatory intervention that could mitigate that failure, and provides examples of Member States where the legislation is currently in place.

Table 4.1: Market Failure, Detriment, and Regulation

Stages	Potential market failure and detriment	Potential regulatory intervention
The credit intermediary sets up a business		Licensing of the credit intermediary Prudential requirements (such as a minimum level of professional indemnity coverage, e.g. Bulgaria. See 4.119 for further examples)
Consumer approaches the credit intermediary	**Imperfect information** Consumer chooses wrong type of intermediary (e.g. tied instead of independent) Consumer uses intermediary believing that the credit intermediary is entitled to provide credit directly The consumer is (or will be) exposed to higher charges than he or she expects	Intermediary is obliged to disclose its contractual relationship with the lenders (e.g. Hungary. See 4.119 for further examples) Intermediary is not allowed to undertake advertising activities in a manner that may induce customers to believe that he is entitled to provide credit (e.g. Austria, See 4.119 for further examples) Regulations aimed at preventing misleading advertising Requirement that relationship between borrower and the credit intermediary is formalised in a contract (e.g. Estonia, See 4.119 for further examples)
Intermediary searches and offers products to the customer	**Misalignment of incentives** Intermediary is paid a fixed fee when the primary function is market search **Imperfect information** Consumer does not know whether the product or range of products he or she is being offered is competitive	Intermediary is obliged to disclose remuneration agreement with the lender (e.g. Ireland. See 4.119 for further examples) Intermediary is forbidden to charge consumer (e.g. Belgium. See 4.119 for further examples) Intermediary is forbidden to charge consumer prior to completion of the contract (e.g. France) If tied, the intermediary is obliged to communicate the share of the market that he covers in terms of range of products offered (e.g. Hungary. See 4.119 for further examples)

Intermediary provides the customer with advice on product suitability and customer chooses a product	**Asymmetric information** The consumer does not fully understand the product characteristics **Misalignment of incentives** Intermediary is paid a commission and incentivised to conclude a deal, potentially regardless of suitability to the borrower	Credit intermediary specifically required to provide suitability advice to the borrower Intermediary is obliged to disclose remuneration agreement with the lender (e.g. Ireland, See 4.119 for further examples) Intermediary is not allowed to call himself “advisor” or to use other terms that may induce consumers to believe that the intermediary’s primary task is that of providing neutral advice
Intermediary collects documents and assists lender with credit worthiness assessment	**Asymmetric information** The intermediary is better placed than the lender in assessing the credit worthiness of the borrower **Misalignment of incentives** Intermediary is paid a commission and is incentivised to misrepresent credit risk	Intermediary is not allowed to undertake direct credit worthiness assessment (e.g. Greece. See 4.144 for further examples) Existence of a centralised credit risk database
Contract is signed		A formalised complaints process or system of redress is in place (e.g. Bulgaria. See 4.119 for further examples)

Source: Europe Economics

Specific Forms of Consumer Detriment

4.58 In our survey, consumer associations and regulators were explicitly asked about the perceived significance of detriment caused by credit intermediaries across different product markets. The forms of detriment the respondents chose form were:

(a) Direct fraud by the credit intermediary

(b) Overcharging by the credit intermediary

(c) Recommendation of non-competitive product by the credit intermediary

(d) Recommendation of unsuitable product by the credit intermediary.

4.59 This choice includes forms of detriment that were clear to understand and so minimised the risk of misinterpretation by respondents.

4.60 Second, each detriment can be linked to a market failure that is typically responsible (direct fraud is an exception, in that it is not related to any particular cause of market failure — instead being the consequence of an explicitly illegal activity). We describe below what these associated market failures are:

(a) *Overcharging by the intermediary* is typically caused by *imperfect information*, i.e. the consumers' lack of knowledge about credit intermediaries and their charges, and can be further aggravated by *misalignment of incentives*.

(b) *Recommendation of a non-competitive product* is typically due to *incomplete information* (e.g. lack of knowledge about price range in the market), *asymmetric information* (e.g. the borrower, unlike the credit intermediary, does not understand the full cost associated with a product), or a combination of the two, and can be further aggravated by *misalignment of incentives*.[30]

(c) *Recommendation of an unsuitable product* is typically generated by *asymmetric information* (e.g. the borrower does not understand the product's characteristics) and can be further aggravated by *misalignment of incentives*.

Table 4.2: Detriment and its Causes*

Form of detriment	Typical cause
Over-charging	Incomplete information
Recommendation of a non-competitive product	Incomplete information, asymmetric information
Recommendation of an unsuitable product	Asymmetric information, misaligned incentives

* *Misalignment of incentives can be present in all detriment forms*

4.61 The view of the survey respondents was that well-designed regulatory intervention can resolve (or at least mitigate) some of the market failings that result in detriment to the consumer. However, compliance with regulation can incur an incremental cost to the effected businesses — it is not guaranteed that the benefits to consumers of regulatory intervention outweigh the costs to business of complying with it (in other words, that society as a whole will be better off). In addition, regulation can have unintended consequences that more broadly impact upon the economy (leading to additional costs and/or benefits). For instance, there is scope for detriment to consumers from not having access to financial products because of over-regulation raising prices and increasing the difficulty of obtaining products, or of lost innovation.

[30] In the case of point-of-sale intermediaries, recommendation of a non-competitive credit is typically due to downstream market foreclosure.

4.62 Of course, the perceptions of the respondents may have been influenced by the regulatory structure. In other words, pre-conceptions about the likely risks associated with an unregulated environment may bias the assessment of the potential risk. Equally, there may be a close correlation between a culture attuned to the identification of consumer detriment and a set of stringent consumer protection legislation. This means that the latter does not necessarily allow the inference to be drawn that significant consumer detriment is (or was) in existence. The results should be viewed in this context.

Direct fraud

4.63 Direct fraud is a particular form of detriment on two counts. First, it is not directly related to a market failure, but is instead the consequence of criminal behaviour by the intermediary. Second, it typically harms, in practice, lenders rather than consumers.

4.64 Where the lender is reliant on the probity of the credit intermediary to reliably prepare documentation and, in particular, to assess the income level of the potential borrower, there is some potential for the intermediary to mis-state the applicant's income. The motivation would be the commission due to the intermediary.

Recommending expensive and unsuitable credit products

4.65 Many of the consumer associations that participated in our survey expressed the concern that credit intermediaries can be swayed by commissions payable by lenders to recommend a specific credit product that is either unsuitable to the borrower's personal circumstances or else is not price-competitive. Intermediaries are not typically obliged to disclose such payments to borrowers (however, this is the case in Ireland), although this may be the custom of individual intermediaries.

4.66 This form of detriment is likely to be more present when the following conditions are met:

– First, this type of detriment is likely to be more frequent where the credit intermediaries' degree of engagement in providing advice to the consumer is high (see Table 4.3 in the next sub-section).

– Second, where the typical compensation scheme (e.g. volume-based commission) creates a potential conflict of interest (see Table 4.3).

4.67 This is a potentially very significant problem. Moreover, the appreciation by the consumer of whether detriment has been suffered may be impaired by the nature of the credit product in question. For instance, certain forms of mortgage (e.g. an endowment mortgage, where the repayment of the capital borrowed is linked to the performance of an investment product) are credence goods whereby it is not always evident that the product bought was the most suitable until some time after purchase, if at all.

4.68 On the other hand, in a competitive market, the scope for such price differentiation should be significantly curtailed. This will be more manifest where the credit products are less varied (in this case, there may be a trade-off such that a reduced risk of a non-competitively priced product may be offset by reduced choice, and perhaps increased difficulties in locating a suitable product). This means that under competitive conditions the objective of the lender in distributing products through credit intermediaries is to win business at the expense of other lenders — i.e. it is not to sell non-competitively priced products at the expense of borrowers. However, to the extent that lenders are able to (and in fact do) set differential commissions on their suite of credit products, the above analysis should hold.

Over-charging by the intermediary and other forms of potential detriment

4.69 Over-charging is a form of detriment related to the fact that credit intermediaries charge more for their services than was truly justified (i.e. it is not the trivial case of charging beyond the agreed sum).

4.70 Although a typical remuneration arrangement is a volume-based commission paid to the intermediary by the lender, charges to borrowers are not uncommon. In those instances where intermediaries charge borrowers directly, over-charging may be present:

- For a tied intermediary, if the level of remuneration does not reflect the more limited market search activity which, on average, brings a lower economic value to borrowers than a whole-market search.

- If there is little competition between credit intermediaries with regards to a specific market or market segment.

4.71 As noted previously, lenders and credit intermediaries generally have greater financial knowledge than do consumers. This asymmetric information problem could allow intermediaries to charge more for their services than is truly justified and the problem is exacerbated if there is a lack of transparency about the full cost that the consumer will incur in order to access credit.

4.72 Further, if consumers are myopic or short-sighted such that they ignore future detriment, the potential for intermediaries to cause consumer detriment may be greater. Depending upon the remuneration arrangements, overcharging could be achieved through high interest rates, large commission charges or a combination of the two.

4.73 Other potential causes of consumer detriment would include a failure to hold client and credit intermediary assets in separate accounts, a failure to conclude an action promised to a consumer and requiring clients to purchase unnecessary products in order to access the credit intermediation facility.

Structural Market Inefficiency

4.74 In the previous section we have identified a number of potential causes of market failure and related them to real-life cases of detriment. However, in reality, some forms of failure are likely to occur more frequently than others. The goal of this section is to assess whether the credit intermediary market is prone to a market failure that arises in a systematic manner.

4.75 The above discussion (and that in Section 3) implies that an ideal intermediation market is one where intermediaries are highly specialised, i.e. some intermediaries are specialised in market-matching and are remunerated through commissions; others are focused mainly upon the alleviation of asymmetric information and are paid through risk-based remunerations.

4.76 However, our study indicates that credit intermediaries often perform several tasks in parallel, with a variety of up- and down-stream remuneration schemes. However, the different modes of remuneration provide different incentives to the credit intermediary and may not always be well matched to the actual activities that the credit intermediary is undertaking in a specific case. Indeed, the "right" incentive for one task may undermine the incentive for another.

4.77 Therefore when we talk about structural inefficiency in the context of credit intermediation, we have in mind a situation in which intermediaries are significantly engaged in a certain task and, at the same time, are remunerated through schemes that impose incentives that speak against the performance of that task (see Table 3.3).

4.78 In order to assess the materiality of a systematic conflict of interest, we have used our survey data to identify the most common remuneration schemes adopted across different product markets, and we have then compared it to the significance of specific intermediation activities in that market.

4.79 We have focused on the market-matching facility and the alleviation of asymmetric information. We have excluded the intermediaries' role in alleviating moral hazard because it does not appear to be material. In addition, activities justified by economies of scale typically include routine tasks that are ancillary to the core business and so should not be sensitive to the specifics of the payment scheme.

Table 4.3: Remuneration Schemes and Potential Conflict of Interest

CREDIT PRODUCT	SIGNIFICANCE OF ECONOMIC CONTRIBUTION		MOST COMMON REMUNERATION SCHEME	POTENTIAL CONFLICT OF INTEREST
	to borrowers	to lenders		
Residential Mortgage	Market matching (very high) Reducing information asymmetry (very high/high)	Market matching (very high) Asymmetric information (very low)	Volume-based commission	Present
Point-of-Sale	Market matching (medium) Reducing information asymmetry (medium)	Market matching (very high) Asymmetric information (very low)	Volume-based commission	Absent
Other Consumer Credit	Market matching (medium) Reducing information asymmetry (medium/high)	Market matching (very high) Asymmetric information (low)	Volume-based commission	Present
Business Finance	Market matching (very high) Reducing information asymmetry (high)	Market matching (very high) Asymmetric information (medium/low)	Volume-based commission (tied) Fixed commission (untied)	Present

Source: Survey and Theoretical Framework

4.80 From the above, we conclude that there exists a structural inefficiency in performing tasks aimed at alleviating asymmetric information where the main mode of remuneration is a volume-based commission. The latter are very effective in reassuring lenders that credit intermediaries will put sufficient effort into the distribution and promotion of credit products, but they hinder the credibility of intermediaries' ability to mitigate information asymmetries.

4.81 The extent to which structural inefficiencies might potentially harm consumers is significant, especially in the markets for residential mortgages and other consumer credit products. The incentives produced by volume-based commissions create the *possibility* of advice being used as a way to persuade borrowers to purchase specific products and/or to hide the risks involved. Despite a conflict of interest also being present in the business finance sector, we believe that there are fewer issues here because the end-consumers are also business entities and their information disadvantage towards the credit intermediaries should be less marked.

4.82 From Table 4.3, we draw the following conclusions:

(a) Potentially serious conflicts of interest can be present for residential mortgages and other credit products among some intermediaries. This is the case because, while volume-based commissions are very effective in reassuring lenders that intermediaries will put sufficient effort into the distribution and promotion of credit products, such volume-based commissions may hinder the credibility of intermediaries in acting as expert advisors in the interests of consumers.

(b) The potential for misalignment of incentives is moderated in the case of the business finance sector because the relative importance played by fixed-based commission partially alleviates this problem.

(c) The scope for a conflict of interest is absent for point-of-sale intermediaries because, for this product category, the intermediaries' engagement in activities aimed at providing expert advice to consumers is rather limited.

(d) The remuneration arrangements are highly efficient from the lenders' point of view because they provide intermediaries with high incentives to distribute and promote their products (and hence in a competitive market, in this dimension are valuable to consumers).

Robustness check

4.83 In order to test the robustness of the conclusion obtained by the above, we have cross-checked our predictions with information gathered directly through the survey. We questioned consumer associations about the perceived risk of consumer detriment arising from *recommendation of inappropriate* products and r*ecommendation of non-competitive products* (i.e. forms of detriment that indicate poor quality advice) in product markets that have no or very little regulation. The choice of unregulated markets is the natural one because our predictions rely on the implicit assumption that the credit intermediaries are operating in such an environment.

Table 4.4: Robustness Check

CREDIT PRODUCT	PREDICTION OF CONFLICT OF INTEREST	ANSWERS ON PERCEIVED RISK OF CONSUMER DETRIMENT[31]
Residential mortgage	Present	3.85 (i.e. significant perceived risk)
Point-of sale credit	Absent	3.0 (i.e. average perceived risk)
Other consumer credit products	Present	3.75 (i.e. significant perceived risk)
Business finance	Moderate	3.0 (i.e. average perceived risk)

Source: Survey and Theoretical Framework

[31] The degree of perceived risk varies from 1 = *No or negligeble risk* to 5=*high perceived risk.*

4.84 In line with our analysis, the perceived potential for consumer detriment is higher for residential mortgage and other credit products, as compared to business finance. The only result that is not entirely in line with our prediction concerns point-of sale intermediaries, where the risk is perceived as being somewhat higher than our prediction. It seems more likely that the potential detriment here is likely to be the consequence of a restricted market-search activity by consumers (i.e. the *quid pro quo* of the convenience of point-of-sale availability of finance)

Conclusions

4.85 We summarise here our main findings:

(a) Credit intermediaries often operate with remuneration agreements compatible with the efficient delegation of retailing activities.

(b) Where acting primarily as distribution channels — i.e. as the delegated salesmen of credit products — intermediaries may also undertake the delicate task of providing consumers with “expert advice”. However, the fact that tied intermediaries — i.e. those that work in closer contact with lenders — are apparently more frequently engaged in the provision of advice than those that are untied, suggests the *possibility* of advice being used as a way to persuade borrowers to purchase specific products, though this may also just mean that people believe they can “see through” a sales pitch.

(c) The intermediary market in the business finance sector is more sophisticated as lenders tend to delegate more activities (e.g. those aimed at alleviating adverse selection problems) to intermediaries rather than keeping them in-house. This is also reflected by the higher importance (as opposed to the other credit sectors) played by risk-based remuneration schemes (see for instance Figure 11., where the percentage of tied intermediaries adopting risk-based payment schemes is close to 30 per cent).

(d) The business finance sector presents reduced detriment issues. First, the fact that the fixed-based commission is most common payment scheme among untied intermediaries conveys more credibility (as opposed to the case of volume-based commissions) to the quality of expert advice provided by the intermediaries. Second, since end-consumers are also business entities, their informational disadvantage towards intermediaries should be less marked.

Regulatory Principles

4.86 Some key principles have been established at the European level with regards to the market failures previously identified in this section.

Asymmetric information and incomplete information

4.87 The high level principle set in the "Green Paper on Retail Financial Services in the Single Market" is that advice should be objective, based on the profile of the customer, and commensurate with the complexity of the products and the risks involved.

4.88 Consumers may not possess adequate **financial literacy** and may even be unaware of the degree of the **complexity of the transactions** they are entering into.[32] Consumer detriment may then emerge both with respect to what a consumer may reasonably expect from a given contract but also, if not especially, with respect to expectations constructed from misunderstanding of the clauses of the contract.

4.89 Two studies were commissioned in 2007 to get a better picture of the level of financial education provided in the EU.[33] The results indicated that such provision is very good in countries such as the UK, Germany and Italy but almost non existent in countries like Greece, Bulgaria and Latvia.

4.90 It was also found that basic areas, for example, how to use a bank account and budgeting skills were common features of educational schemes whereas information related to savings, insurance and retirement planning received less attention. To this respect, the Commission's Communication on financial education[34] set out the agenda for supporting the provision of high quality financial education to help customers make informed choices about the best products for their needs.

4.91 The focus is not only on consumer detriment, but also on the lenders' informational problems. For instance, the "White Paper on the Integration of EU Mortgage Credit Markets" stresses that both lenders and, when involved in a mortgage loan, credit intermediaries should assess "by reasonable means" the creditworthiness of the borrowers. Consequently, one initiative that the Commission undertook in 2008 to improve accessibility and quality of credit data is the creation of an expert group on credit histories. The experts will present their recommendations in the form of a report by 1 May 2009.

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32 Of course, consumers can also be ill-informed about the detail of products or services in many sectors subject to only restricted regulation, e.g. car repair, in which there is little or no regulation in respect of the general value or nature of the products or services supplied (although their safety may be regulated).

33 Survey on financial literacy schemes in the EU 27, Evers and Jung, 2007 and Better access to financial services and financial education, Report of the survey on financial education, Observatoire du credit et de l'endettement et al, 2007

34 Communication from the Commission: Financial Education, European Commission, 2007.

4.92 We note, in passing, that credit intermediaries have the capacity to reduce issues associated with financial literacy (or the lack of it), by taking on the burden of advice. In other words, consumers would not need to understand financial products if they could reliably locate someone who did understand those products, and then rely on that individual's advice. It follows that if the efficient functioning of credit intermediary advice and salesmanship could be ensured, that would represent an alternative to improving the financial literacy of consumers.

Mis-alignment of incentives and price-transparency

4.93 Issues such as mis-alignment of incentives and price-transparency are involved in the requirement to disclose the fees that are charged by the intermediary, as well as his status with respect to the lender.

4.94 Article 21, "Certain obligations of credit intermediaries vis-à-vis consumers", in the Consumer Credit Directive (which excludes mortgages) 2008/48/EC of 23 April 2008, states the following:

4.95 "Member States shall ensure that:

(a) *a credit intermediary indicates in advertising and documentation intended for consumers the extent of his powers, in particular whether he works exclusively with one or more creditors or as an independent broker;*

(b) *the fee (if any) payable by the consumer to the credit intermediary for his services is disclosed to the consumer, and agreed between the consumer and the credit intermediary on paper or another durable medium before the conclusion of the credit agreement;*

(c) *the fee (if any) payable by the consumer to the credit intermediary for his services is communicated to the creditor by the credit intermediary, for the purpose of calculation of the annual percentage rate of charge."*

4.96 The goal of these requirements is to help consumers in assessing the actual price of the credit purchased as well as making them aware of the potential conflicts of interest of the intermediaries they deal with. However, as we explore below, the disclosure of commissions, when present, is far from a universal requirement currently. Even when present, it needs to be recognised that such disclosure does not *change* the incentives applicable to a credit intermediary — the disclosure only provides added transparency to assist the interpretation, by the consumer, of the "advice" provided.[35]

[35] There is also the well-known danger that disclosed commissions might constitute a focal point for consumers — so that the relative size of the commission takes on undue weight in the calculations of the consumer. This could mean that consumers might think that a product on which the credit intermediary had a lower commission was a better value product, even when this was not the case.

Main Regulatory Models

4.97 We describe here the main regulatory models in place in the EU27.

Consumer focussed

4.98 The regulatory regimes of some Member States cover only (or with greater stringency) those intermediaries that interact with consumers. These are Austria, Belgium, Bulgaria, Estonia, Ireland, Malta, Netherlands, Portugal, Romania and the UK.

4.99 This regulatory model indicates that the national competent authority considers either that detriment is more likely to occur in relation to consumer products or that the proportional welfare effects arising from an instance of detriment would be greater for consumers.

4.100 There are several plausible explanations for this point of view, not least of which is asymmetric information. It seems reasonable to believe that consumers are less well informed about relevant financial products than are businesses and hence the problem of asymmetric information about products between lender/intermediary and borrower are greater for consumer products.

4.101 In addition to this, the number of intermediated consumer credit products is greater than the number of intermediated business credit products and the volume of sales of any one consumer product likely exceeds the sales of any one business product. Therefore, the number of instances at which detriment could occur is greater. Given this, and provided all else is equal, consumers seem more likely to suffer detriment than are businesses and hence it is understandable that some regulators would wish to devote their resources towards protecting consumers rather than businesses.

Residential mortgage focussed

4.102 This sub-category comprises a subset of Member States with customer focussed regulatory regimes in which significantly greater regulation applies to mortgage credit intermediaries than to other consumer credit intermediaries and point-of-sale intermediaries. This categorisation is applicable to Austria, Ireland, the Netherlands and the UK.

4.103 An interesting aspect of Ireland's regulatory model is that it involves very close monitoring of residential mortgage intermediaries (with the potential for on-site visits of practising intermediaries in this area).

4.104 The rationale here is that if a consumer suffers detriment at the hands of a mortgage credit intermediary, the adverse impact on the consumer is likely to be significantly greater than that which could be inflicted by other categories of intermediary. Mortgages are generally a consumer's greatest financial responsibility and so if, for example, they are recommended an expensive product, the impact on their disposable income could be substantial.

Consistent regulation

4.105 There are a number of Member States within which the same degree of regulation applies to all types of credit intermediary. These are the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Poland, Slovenia, Spain and Sweden.

4.106 Differences between these Member States are, however, rather significant.

4.107 This model of regulation appears to be based on the roles of market participants (i.e. as intermediaries between lenders and borrowers) without reference to precise business activity or type of customer. In this context, mortgage intermediaries, point-of-sale intermediaries, consumer credit intermediaries and business finance intermediaries are perceived as broadly equivalent to each other. There appears not to be a perception that any one type of intermediary is more likely to cause consumer detriment than any other and, as a result, the same regulations apply to all intermediaries.

4.108 Given the differences between Member States noted above, it does appear that regulators assess the potential for consumer detriment as part of the policy development process. Using the same examples as above, the activities of credit intermediaries are far more developed in Ireland than in, say, Denmark and hence it is not surprising that regulation is stricter in the former than the latter.

Business focussed

4.109 No regulatory regime has greater focus on business customers (including SMEs) than on consumers. As we have noted above, a number of Member States explicitly reduce the level of statutory regulation in the business finance area by comparison to consumer finance intermediation.

Reliance upon the market

4.110 In some Member States, the national competent authority does not supervise credit intermediaries and intermediaries are subject to little or no formal regulation or dedicated legislation (of course, this reliance on the market is not total, since standard consumer protection laws will still exist). These are Cyprus, Latvia, Lithuania, Luxembourg and Slovakia. Of these, our study indicates that self-regulation is only present in Slovakia. This is described in more detail later in this section.

4.111 This is driven by either a low level of intermediary penetration or the perception that where such penetration is more significant, that the risks do not warrant a regulatory intervention (although Slovakia is considering regulation as of the date of this report. This is discussed further below).

Summary and conclusions on regulatory models

4.112 We summarise below the above categorisation of the EU27 Member States.

Table 4.5: Regulatory Models

Main Category	Member States	Sub-categories (where applicable)
Consumer focused	Austria, Belgium, Bulgaria, Estonia, Ireland, Malta, Netherlands, Portugal, Romania and the UK	**Of which, residential mortgage focused:** Austria, Ireland, Netherlands and the UK
Consistent	Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Poland, Slovenia, Spain and Sweden	**Of which, consistently significant level**: Hungary **Of which, consistently moderate level**: Germany, Italy, Slovenia **Of which, consistently low level**: Czech Republic, Denmark, Finland, France, Greece, Poland, Spain and Sweden
Reliant upon the market	Cyprus, Latvia, Lithuania, Luxembourg and Slovakia	

Source: Surveys, EE analysis

4.113 It is apparent from the above analysis that there is considerable diversity in the approach adopted by regulators to credit intermediaries. In a minority of Member States, the regulatory framework is geared towards those credit intermediaries dealing with consumers or a particular credit product category (i.e. residential mortgages). It is noteworthy that the Netherlands, Ireland and the UK — the three Member States with the longest tradition of significant credit intermediary activity (particularly in the residential mortgage market) — all fall into this category.

4.114 In a significant number of Member States, the above analysis indicates a considerable degree of reliance upon the market to regulate the activities of credit intermediaries in combination with standard consumer protection law, contract law, and so on. We examine in the next sub-sections the categorisation of regulation in the EU27 in greater detail and then discuss the self-regulatory initiatives in the EU27. We then proceed to discuss current proposals in play in a number of Member States to strengthen the regulatory framework within which credit intermediaries are currently operating.

4.115 One effect of such interventions is potentially to replace the concept of "buyer beware" (which may be felt to be less relevant here because of the market failures and limited comprehension problems discussed above) with a system of "regulatory badging" whereby consumer protection and confidence in the value of products comes through the regulation of advice.

Categorisation of Regulatory Frameworks in the EU27

Introduction

4.116 The degree to which credit intermediaries are regulated varies widely between EU Member States.[36] We have based our analysis upon the following sources:

- A review of the relevant legislation identified to us by survey participants or identified in our own research.

- Specific views expressed by national competent authorities regarding regulatory interventions made. These views were provided primarily through our stakeholder survey. The regulators and other relevant respondents were provided with a checklist of both entry requirements (e.g. "minimum standards/qualifications needed to begin acting as an intermediary") and ongoing requirements (e.g. "disclosure to potential borrowers of ties to lenders", "requirement to assess suitability of product to borrower"). This information was provided in respect of credit intermediation on a credit product by product basis.

- Self-regulation by the intermediaries themselves. Where credit intermediaries are more developed, a code of conduct has frequently been introduced (this is identified 4.147 to 4.153 below and at Appendix 2).

4.117 Appendix 2 contains a detailed description of the evidence identified.

Key categories of regulatory intervention

4.118 We have looked at the number of categories of regulatory action. These categories are designed to cover in a systematic manner the potential sources of market failure and the associated interventions already identified at Table 4.1.

4.119 The categories adopted are as follows:

(a) **The transparency of the credit intermediary's relationship with a lender**: we consider two main aspects to this. First, we considered whether the nature of the intermediary's relationship with a lender needs to be disclosed to the potential

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36 For clarity, we refer here to all credit intermediaries here — where we mean only mortgage intermediaries, or some other sub-category, we explicitly say so. Appendix 2 details for each Member State the local definition of credit intermediary — where there is one, identifies relevant legislation and describes the key provisions of the regulation that applies. .

borrower — specifically, in the case where the credit intermediary is tied to one or a small number of lenders, such that the market search function would be restricted to a mere sub-set of the credit product market in question.

Such a measure will be most effective where such transparency is in place from the outset of the relationship between the borrower and the credit intermediary. The full disclosure of such ties is required in Hungary; in the Netherlands, an intermediary is required to state whether it is independent or not. However, in some Member States — for instance Austria — the disclosure is more limited and relates only to the *identity* of the credit provider (although, since the omission of this information would invalidate the contract, the intermediary has a clear incentive to disclose this).

The disclosure of such relationships is regulated (to some degree in Austria, Estonia (excluding business finance intermediaries), Finland, France, Greece, Hungary, Ireland, Italy, Malta (where the provision is limited to mortgage and consumer credit intermediaries), Netherlands (where this provision is limited to mortgage and consumer credit intermediaries), Portugal (where this provision is limited to mortgage and consumer credit intermediaries), Slovenia and the UK (where this provision is limited to mortgage and consumer credit intermediaries).

Second, we considered whether the intermediary's remuneration arrangements with lender(s) required disclosure to consumers. This is of concern, regardless of the nature of the relationships that the intermediary has. Such disclosure would provide a borrower with significant information that would act as a counter-weight to "police" any misalignment of incentives on the part of the intermediary. This is because different remuneration mechanisms (e.g. whether the lender pays the intermediary a fee or a commission) have a direct impact on the intermediary's incentive to perform.

Such disclosure provisions are present in Bulgaria (excluding business finance intermediaries), Germany, Hungary, Ireland, Malta (where these provisions are limited to mortgage and consumer credit intermediaries), Netherlands (where these provisions are limited to mortgage and consumer credit intermediaries) and the UK (where these provisions are limited to mortgage and consumer credit intermediaries). The purpose here is primarily to combat asymmetric and imperfect information problems.

(b) **The transparency of the credit intermediary's relationship with the consumer**: there are a number of potential provisions here.

A separate written contract between the borrower and the credit intermediary and the nature of terms within such a contract is a requirement in the following Member States: Austria, Czech Republic, Estonia, Finland, Germany, Malta (where this provision is limited to mortgage and consumer credit intermediaries), Portugal (where this provision is limited to mortgage and consumer credit intermediaries) and the UK. Austria has a comprehensive suite of regulations here — with measures touching upon the value and terms of the credit, duration of the contract and any offer and details of the remuneration arrangements between the credit intermediary and the borrower.

Regulation dealing with fee disclosure or governing the fees between the credit intermediary and the borrower apply in a number of Member States — Austria, Belgium, Bulgaria, Estonia, France, Germany, Ireland and the Netherlands, Malta (where this provision is limited to mortgage and consumer credit intermediaries) (please see 4.138 where this is discussed further).

Advertising and marketing standards prevent misleading advertising or marketing campaigns from materialising. Member States that require compliance with specific standards are Austria, Belgium, Bulgaria, Czech Republic, Hungary, Ireland, Italy, Malta, Netherlands, Slovenia, UK and Sweden. In several instances, there are no specific rules on marketing and advertising, but the general rules in the relevant marketing/advertising legislation would apply

(c) **Prudential standards**: measures here would include a minimum capital requirement for the credit intermediary and/or a minimum level of professional indemnity insurance.

Capital adequacy requirements are present in Bulgaria (where this requirement is limited to consumer credit intermediaries, at least those intermediating pre-approved consumer credit), Germany, Malta (excluding business finance), and the UK (where this requirement is limited to mortgage intermediaries). In most cases the minimum level is set on a discretionary basis by the competent authority, with the exception of Germany where credit intermediaries require a start-up capital of €125,000.

In the UK, mortgage intermediaries are required to take out professional indemnity insurance. The minimum limits of indemnity set out in the UK FSA's rules are on an annual basis, thus firms should not obtain cover with the required annual minimum limit of indemnity spread over a longer period (18 months for example).[37] A defined level of insurance is also required in the Netherlands (where the provision is limited to mortgage and consumer credit intermediaries) and Austria (where this provision is limited to mortgage intermediaries).

(d) **Professional standards applying to the entry into or the conduct of business by a credit intermediary**: in terms of market entry, a standard regulatory intervention would be minimum standards and/or qualifications that would be needed in order to begin acting as an intermediary. This is to ensure that all the market participants confirm, at the very least, to a benchmark standard. This fosters confidence in the market as consumers can undertake transactions in the knowledge that the credit intermediaries that they use are of at least a minimum standard set by the regulator.

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37 http://www.fsa.gov.uk/pubs/policy/04_02/buying_pii.pdf

For countries where entry qualifications or standards apply, the level of any vocational qualification is seldom specified in the legislation. For example, in Austria the activity of credit intermediation is part of the role of a "financial consultant", with the requirement for what is only described as a "comprehensive qualification". On the other hand, the non-vocational qualification required is a high school diploma.

The set of minimum standards is also seldom specified and varies across Member States, and can include physical requirements (such as a fixed address and staff criteria), legal requirements (such as obtaining a licence or registering with competent authorities) and varying levels of competence. For instance, in Ireland the intermediary must fill out an application for authorisation which must include, amongst other things, details of all undertakings for which it intends to act as an intermediary. If successful, the authorisation is then valid for 12 months, and a register of authorised entities is available on the supervisor's website. The requirements for mortgage intermediaries are more stringent and include an additional tax clearance certificate and a Certificate of Incorporation.

Other countries where intermediaries are required to meet minimum standards or qualifications before market entry are Bulgaria (where the entry requirement is only to notify the competent authority about the scope of the intermediary's intended activity), the Czech Republic, France, Germany, Greece, Hungary, Ireland (but more stringent for mortgage intermediaries, as mentioned above), Italy, Malta, the Netherlands (where this requirement is limited to mortgage and consumer credit intermediaries), Poland, Slovenia and the UK.

Ongoing minimum training requirements, of course, ensure the continual education of mortgage intermediary staff, preventing the possibility of poor advice being given to the potential borrower. A minimum amount of training is defined by the regulators in Austria (where the provision is limited to mortgage intermediaries, linked to the "comprehensive qualification") and the Netherlands. In the UK the benchmark qualification for all financial advisors (including mortgage and other credit intermediaries) is the Certificate in Financial Planning or equivalent, but this is not obligatory.

Similarly, a "fit and proper" test looks to ensure that the quality of management and/or of individual credit intermediaries is of a consistent, acceptable standard in order to offer general protection to consumers. These requirements can apply on either an entry or ongoing basis, to ensure that directors and managers have the necessary skills and qualities both to start a business and to last over time. For example, Irish law requires that the directors and managers of credit intermediaries meet standards of competence and probity. Maltese law requires such persons to have the requisite experience and competence and also to be conversant with the various financial products they deal with. Similar fit and proper tests or requirements apply in Austria, the Netherlands (where the provision is limited to mortgage and consumer credit intermediaries), Sweden and the UK.

(e) **The scope of advice**: weight has been given to the requirement to consider the suitability of the product for the consumer's circumstances and also to any requirements to find the best price for a product.

This is to ensure that borrowers purchase credit products that are well suited to their needs, and which match their risk-profile. Given a level of financial illiteracy, regulation of this sort makes comparison between credit products easier for consumers, thus fostering a more competitive market.

This requirement for intermediaries to assess the suitability of products to the consumer is embodied in national law in Austria (applicable to mortgage intermediaries only), Belgium, Hungary, Ireland, Malta, and the Netherlands. In the UK the requirement to assess the suitability of the product for the borrower is only relevant where advice is given. The requirement to explain risks and/or other key data to potential borrowers follows a similar rationale to the requirement to assess the suitability of a product; unsurprisingly, the same countries that have implemented that regulation are included among those that have also passed legislation requiring intermediaries to explain the risks associated with the loan to the potential borrower.

This is required in Austria (where the application of this provision is limited to mortgage and consumer credit intermediaries), Belgium, Bulgaria, Hungary, Ireland, Malta, the Netherlands (where the provision is limited to mortgage and consumer credit intermediaries) and Slovenia. In the UK intermediaries are required to explain risks and/or other key data to some extent; this falls under their obligation to disclose full information regarding the credit contract.

(f) **A formalised or streamlined system of redress**: this type of regulation ensures that a consumer receives the deserved amount of compensation, which should give consumers greater confidence in using mortgage intermediaries. In addition, it can regulate the timeframe in which cases are heard and reduce the cost of taking action for the consumer.

In the UK, there are procedures for handling complaints and redress, as laid down by the Financial Ombudsman Service. Similar requirements exist in Bulgaria (where the requirement is limited to consumer credit and POS intermediaries), Denmark (the decisions of the Consumer Complaints board in response to a complaint are not legally binding, but if not complied with may be brought before a civil court), Ireland, Malta and the Netherlands (where it is limited to mortgage and consumer credit intermediaries).

Approach to quantification

4.120 Within each category, we have assessed the relative stringency of the measure(s) identified in order to create a quantitative score for a particular Member State's regulatory framework in that category.

4.121 The score for each type (i.e. (a)—(f)) of intervention is a maximum of two in each category (with the exception of (f) where it is one). This represents our value judgement of the relative significance of these categories. We have used the aggregate scores to further categorise the regulatory framework *itself* as represented by these different interventions and measures:

- Up to three has been taken as a "low" level of regulation (the maximum score is eleven).
- More than three, fewer than six has been taken as a moderate level of regulation.
- More than six: has been taken as a "significant" level of regulation.

4.122 The same criteria have been applied to each type of intermediary and hence the categorisation is comparable across the various credit intermediary types (enabling us to state, for instance, that our findings indicate that mortgage intermediaries are subject to at least as much, and sometimes more stringent regulatory intervention than any other category).

4.123 It should be noted that our analysis does not take into account that, in the absence of specific legislation and supervision, lenders may stipulate set requirements and hence there is an element of indirect "regulation", i.e. there is some oversight by the lenders. The strength of this oversight is likely to be a function of the market environment. This oversight is likely to have increased or will be increasing in response to the "credit crunch". However, the primary objective of such oversight is the protection of the lender (e.g. against default), not protection of the consumer.

4.124 We now turn to the different categories of credit intermediary.

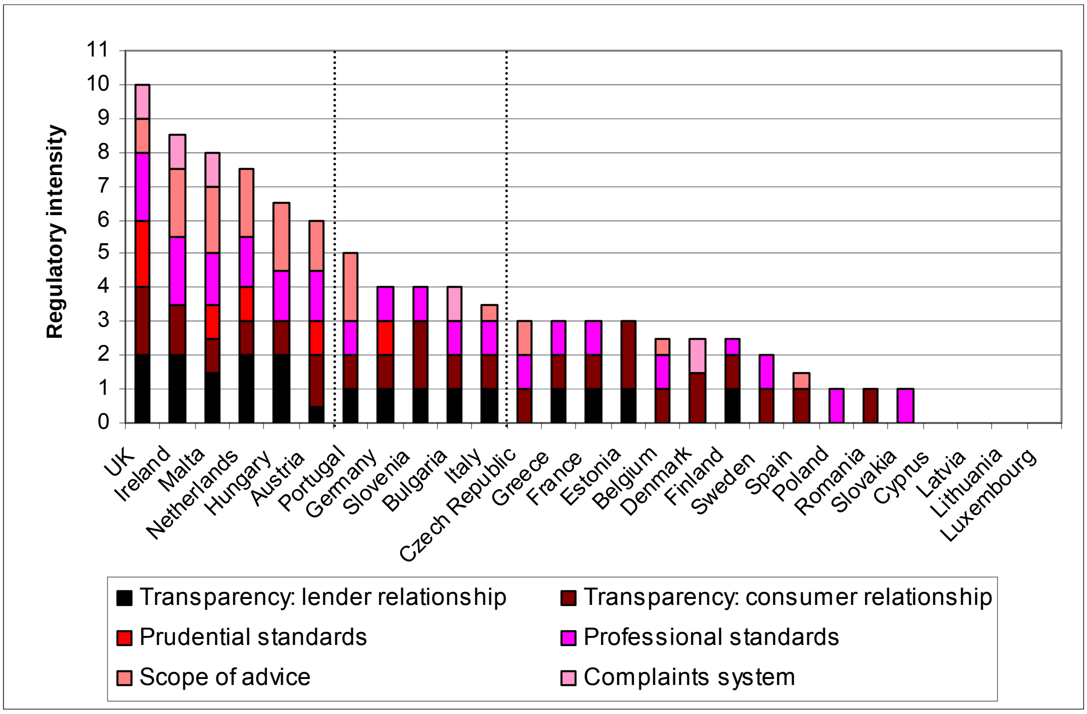
Regulatory framework of residential mortgage intermediaries

4.125 As we have already noted, this category of intermediary is subject to regulation that is at least as stringent as any other. Based upon our analysis, Austria, Ireland, the Netherlands and the UK have stricter regulatory protocols in respect to mortgage credit intermediaries than to other categories. In particular, we highlight the following:

- In Austria and the Netherlands, the prudential standards are applied with regards to satisfying the competent authority as to a satisfactory level of professional indemnity insurance.
- In Ireland, a regime of on-site inspections is applicable only to intermediaries in this area.
- The UK FSA has to be satisfied regarding the capital base of the advisor.

4.126 We present graphically the breakdown of our analysis by the different categories below.

Figure 4.2: Regulatory framework for residential mortgage intermediaries across EU27



Source: Surveys, EE analysis. The dotted lines indicate the boundaries between the high, medium and low intensity.

4.127 Following on from this analysis, we have categorised the various regulatory frameworks across the EU27 below.

Table 4.6: Regulation of Residential Mortgage Intermediaries

No or limited explicit statutory regulation of credit intermediaries in this sector)	Moderate level explicit statutory regulation of credit intermediaries in this sector	Significant explicit statutory regulation of credit intermediaries in this sector
Belgium,[38] Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia,[39] Spain,[40] Sweden	Bulgaria, Germany, Italy, Portugal, Slovenia	Austria, Hungary, Ireland, Malta, Netherlands, UK

Source: Surveys, Interviews, EE analysis.

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38 Belgium has a draft law which would aim to bring mortgage intermediaries under statute and introduce the same level of consumer protection to an intermediated sale as applicable in the case of a direct sale.

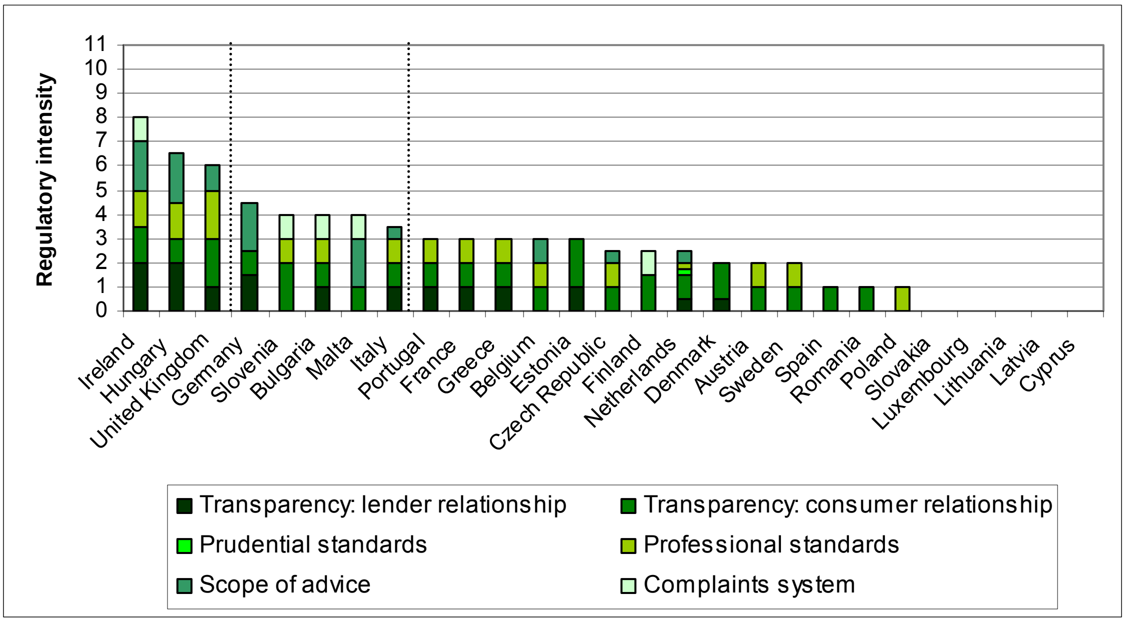
39 Mortgage intermediaries in Slovakia have a voluntary code of conduct. Slovakia is expected to introduce legislation in 2009 which will, amongst other things, require mortgage credit intermediaries to be regulated

40 Spain is expected to introduce legislation in 2009 which will, amongst other things, require mortgage credit intermediaries to be regulated.

Regulatory framework of POS intermediaries

4.128 We present graphically the breakdown of our analysis by the different categories below.

Figure 4.3: Regulatory framework for POS intermediaries across EU27



Source: Surveys, EE analysis. The dotted lines indicate the boundaries between the high, medium and low intensity.

4.129 Following on from this analysis, we have categorised the various regulatory frameworks across the EU27 below.

Table 4.7: Regulation of POS Intermediaries

No or limited explicit statutory regulation of credit intermediaries in this sector)	Moderate level explicit statutory regulation of credit intermediaries in this sector	Significant explicit statutory regulation of credit intermediaries in this sector
Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Portugal, Romania, Slovakia, Spain, Sweden	Bulgaria, Germany, Italy, Malta,Slovenia	Hungary, Ireland, UK

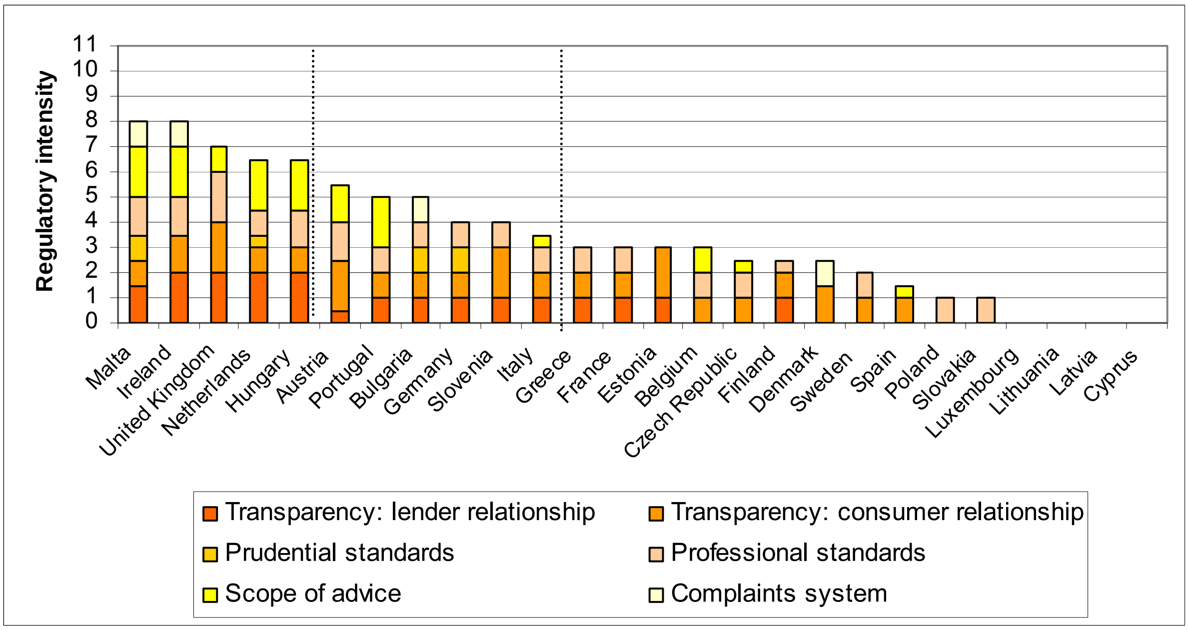
Source: Surveys, EE analysis

4.130 A number of Member States have been identified as regulating POS intermediation less strictly than that of consumer or mortgage credit intermediation. These are Austria, Bulgaria, Malta, Netherlands, Portugal, Spain and the UK. Indeed, our analysis of structural market inefficiencies at Table 4.3 indicates that POS intermediation is a lower level of concern than these other categories.

Regulatory framework of other consumer credit intermediaries

4.131 We present graphically the breakdown of our analysis by the different categories below.

Figure 4.4: Regulatory framework for other consumer credit intermediaries across EU27



Source: Surveys, EE analysis. The dotted lines indicate the boundaries between the high, medium and low intensity.

4.132 Following on from this analysis, we have categorised the various regulatory frameworks across the EU27 below.

Table 4.8: Regulation of Other Consumer Credit Intermediaries

No or limited explicit statutory regulation of credit intermediaries in this sector)	Moderate level explicit statutory regulation of credit intermediaries in this sector	Significant explicit statutory regulation of credit intermediaries in this sector
Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia, Spain, Sweden	Austria, Bulgaria, Germany, Italy, Portugal, Slovenia	Hungary, Ireland, Malta, Netherlands, UK

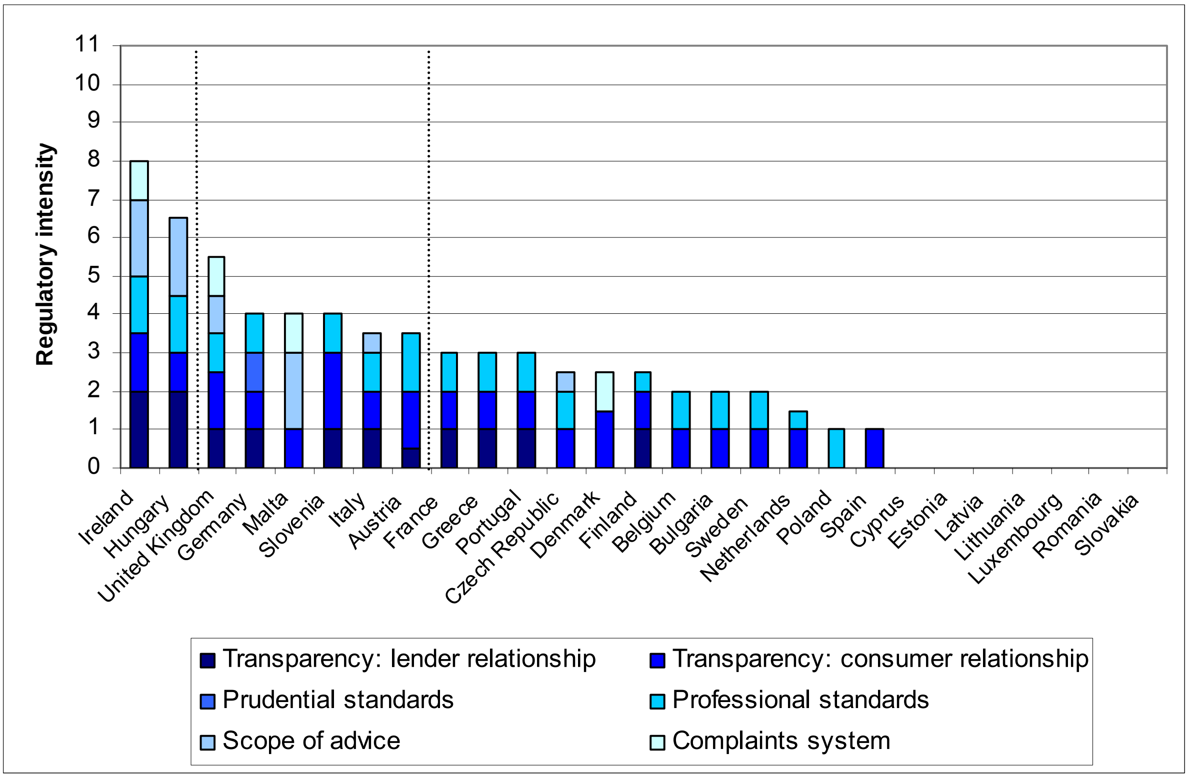
Source: Surveys, EE analysis

4.133 In most Member States, the regulation of consumer credit intermediaries (excluding POS) closely resembles that of mortgage credit intermediaries. We have already identified above the ways in which certain Member States regulate the latter group more closely. There are also some instances where the opposite applies: in Bulgaria, prudential requirements apply to consumer credit intermediaries.

Regulatory framework of business finance intermediaries

4.134 We present graphically the breakdown of our analysis by the different categories below.

Figure 4.5: Regulatory framework for business finance intermediaries across EU27



Source: Surveys, EE analysis. The dotted lines indicate the boundaries between the high, medium and low intensity.

4.135 Following on from this analysis, we have categorised the various regulatory frameworks across the EU27 below.

Table 4.9: Regulation of Business Finance Intermediaries

No or limited explicit statutory regulation of credit intermediaries in this sector)	Moderate level explicit statutory regulation of credit intermediaries in this sector	Significant explicit statutory regulation of credit intermediaries in this sector
Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Portugal, Romania, Slovakia, Spain, Sweden	Austria, Germany, Italy, Malta, Slovenia, UK	Hungary, Ireland

Source: Surveys, EE analysis

4.136 Our work on quantification of regulatory intensity indicates that this segment is subject to the least regulation.

Comparison of Measures

4.137 In this section, we compare and contrast some of the key regulatory interventions. This builds upon the narrative in "key categories of regulatory intervention" above.

Restrictions on fees

4.138 We have discussed above measures dealing with the transparency of fees and commissions between credit intermediaries and borrowers. There are also more direct interventions seeking to regulate this area:

– Restrictions on level of payment. In Austria, there is a cap on commissions equal to five per cent of the gross credit intermediated. In France (in respect of mortgage and consumer credit) the intermediary can not be remunerated as a function of the interest rate granted.

  The objective here is to protect consumers from excessive charges (Austria also has anti-profiteering provisions in its legislation dealing with credit intermediaries). However, it is conceivable that — by capping intermediary income — some credit products may cease to be economically attractive to intermediate to particular borrower segments, so foreclosing some market-matching activity by credit intermediaries.

– Restrictions on payment of fees directly from borrowers. Such payments are prohibited in Belgium, Bulgaria, and Ireland.

  In Estonia (mortgage and other consumer credit intermediaries only) and Germany, there are explicit provisions such that a consumer is only liable to pay commission to the intermediary where the credit granted is due to the activities of the intermediary. In France, no payment to the intermediary is possible until the loan is finalised.

  Implicitly, these forms of restriction — following on from our analytical framework — effectively forbid the sale of disinterested advice to borrowers.

– Regulation of payment timing. In the Netherlands (mortgage and consumer credit), commissions payable to intermediaries can only be paid in monthly instalments over the life of a loan. We have identified previously the attractions of such "risk-based" remuneration structures (see 3.76 above).

– Other restrictions on payment. In Germany (in respect to the intermediation of the consolidation of consumer credit), payment to an intermediary is only due where the APRC is not increased.

Measures dealing with behavioural integrity

4.139 Austria has a number of statutory provisions aimed at ensuring the behavioural integrity of credit intermediaries, e.g. they are not allowed to profiteer. Another noteworthy restriction in Austria is that credit intermediaries are not permitted to offer credit at rates below those available through the direct channel. This restricts the market-matching efficiencies achievable through indirect distribution.

4.140 In Belgium, credit intermediaries are not allowed to solicit at a customer's house, unless approached by the potential borrower first, with the permission confirmed in writing.

4.141 In Finland, Portugal and Spain there are regulations limiting intermediaries to being tied agents of a single institution (or group in the case of Spain) only. As with a number of the other measures identified above, this would act to restrict the scope and efficiency of the market-matching function of credit intermediaries.

Definitions of a credit intermediary

4.142 Not all Member States have a statutory definition of a credit intermediary. These are normally fairly broad in scope, aiming to capture those parties assisting in the execution of a credit agreement, including introduction services. A number (in Estonia, Germany, and Hungary) explicitly rule out the intermediary from directly providing credit.

Restrictions on credit intermediary activities

4.143 There are a number of other restrictions on the behaviour of credit intermediaries, as identified in full at Appendix 2. We comment here upon those that have a clear impact upon the activities undertaken by credit intermediaries.

Creditworthiness assessments

4.144 We identify three ways in which a credit intermediary could be involved in the credit worthiness assessment of a potential borrower:

- Gathering information (such as the income details of the borrower) in order to provide assistance to the credit worthiness assessment ultimately conducted by a lender.
- The actual making of the independent lending decision. Our evidence indicates that this is rare. Indeed, the making of such assessments is expressly prohibited in Belgium, Greece, Italy and Malta. This is implied by current regulation in France and Hungary.
- Making such an assessment on an indicative basis, in order to assist the credit intermediary in assessing the suitability or otherwise of particular credit products. For instance, if a borrower is likely to be assessed as a sub-prime risk, then knowledge of this by the credit intermediary will assist the search function for appropriate products.

4.145 On this third point, it is noted that the scope for access by a credit intermediary to credit risk databases is not uniform across the EU. Access is allowed only to banks and credit institutions (and, in some cases, the individual borrowers) in Belgium, the Czech Republic, Ireland, Italy, Latvia, Poland, Romania and Slovakia — thus effectively excluding a credit intermediary from this resource. However, an experienced credit intermediary may be able to make an effective assessment of the likely credit worthiness of a borrower, based upon information gathered relating to the borrower's income and so on.

Money-handling activity

4.146 There is a restriction on a credit intermediary being involved in money-handling in Austria (specifically, debt collection), Hungary (so-called type "b" intermediaries) and Italy. Our study indicates that this is, in any case, an atypical activity for credit intermediaries.

Self-regulation

4.147 In a number of these cases, however, there is an element of regulation within the industry itself. We examine the nature of this within this sub-section.

4.148 There are a number of forms of self-regulation in this arena:

– The development and application of a code of conduct by an association of credit intermediaries. This is the case in Bulgaria, Czech Republic, Poland, Slovakia, and the UK. Of these, it is in the Czech Republic, Slovakia, and the UK that such structures are most developed.

– The development and application of a code of conduct by an industry association that includes credit intermediaries, alongside credit providers (and potentially other firms). This is the case in Belgium (where the code was jointly developed by an association of credit intermediaries and by the Belgian Banking Association), Finland, where the guidance offered to POS intermediaries has been developed by the Federation of Finnish Financial Services (and the Finnish Consumer Agency), and Sweden.

– The development of a code of conduct by an association of lender institutions that encourages credit intermediaries to adopt it. This is the case in the Netherlands.

4.149 Most of the codes of conduct deal with professional and ethical matters between the credit intermediary and the consumer — for instance that the information provided to potential borrowers should be clear, comprehensive and timely. The codes identified in the Czech Republic, Finland, Slovakia, and the UK incorporate such a measure, or something close to it.

4.150 The situation in Belgium is slightly different — the main focus is on the relationship between the credit intermediary and the lending institution. This means that the credit intermediary is, under the code, to provide full information on a potential borrower and to only promote those borrowers where full recovery of the credit is expected (i.e. addressing the information asymmetry between the lender and the credit intermediary). Furthermore, there are a number of measures that effectively eliminate sub-prime lending (e.g. the supply of further credit to already over-indebted or otherwise vulnerable consumers cannot be explicitly encouraged).

Penalties

4.151 The examples of self-regulation which are described above (and covered in more depth at Appendix 2) do not have statutory back-up. This means that application by a credit intermediary of a particular code of conduct will be essentially voluntary, with the varying nature and application of the penalties for non-compliance of considerable importance.

4.152 The Association of Financial Intermediaries and Financial Advisers (AFZIZ) in the Czech Republic and Association of Financial Intermediaries and Financial Consultants in Slovakia have similar schema of sanctions for breaches of their respective codes. AFZIZ, for instance, has a range of potential measures. These include written warnings, fines, the suspension of membership, exclusion from AFZIZ and even the publication of information about the disciplinary action. The latter is particularly strong, provided that potential borrowers are sufficiently aware of the existence of the industry body in question for such a measure to have teeth.

4.153 With the other bodies, expulsion from the industry association is the strongest sanction available.

Current Developments in Regulation

4.154 There are a number of legislative initiatives currently being mooted across Europe.

Belgium

4.155 We understand from our stakeholder interview with the Commission Bancaire Financière et des Assurances (CBFA) that a draft law relating to intermediaries is being considered in Belgium. The CBFA sees a lacuna in the local regulatory framework on mortgage intermediaries at present. The CBFA regulates mortgage credit for the purposes of buying or building a home. In this case, an intermediary would need to be registered and would be supervised according to product and marketing (i.e. advertising) rules. However, the quality of advice provided by such intermediaries is not covered. In addition, commercial mortgages are not covered at all.

4.156 The new law, as and when introduced (the date remains uncertain), would aim to introduce the same level of consumer protection to an intermediated sale as applicable in the case of a direct sale. In particular, the law as currently drafted would introduce:

- It would set out what would be required to become an intermediary (i.e. prudential criteria). The aim would be to make sure mortgage intermediaries were financially solid and had fit and proper management. The prudential criteria are intended to be analogous to those required of banks, albeit in a slightly simplified form;

- It would cover the behaviour of the intermediaries, such as 'Know Your Client' requirements and disclosure of whether the intermediary's status is tied or independent. It is not proposed to cover the disclosure of fees; and

- A formula for (cheap) dispute resolution, including a menu of potential sanctions from the Belgian regulator, CBFA.

4.157 The CBFA would like to achieve the same level of consumer protection if buying from an intermediary as if buying directly from the mortgage provider. The CBFA informed us that the consultation on the draft law had been completed.

Spain

4.158 An "Ante-proyecto de Ley"[41] on credit intermediation was approved by the Council of Ministers on 4 July 2008, and was subsequently passed as a Draft Law on 18 July. It now awaits final approval from Parliament. The Draft was submitted by the Minister of Economy and Finance, Pedro Solbes, and the Minister for Health and Consumer Affairs, Bernat Soria, and aims to introduce regulation for all firms engaged in providing brokerage services on mortgages and other consumer credit. The proposed law will regulate, for the first time, the activity of credit intermediaries. Such firms are currently not under the supervision of the Bank of Spain nor subject to the existing regulatory framework for relevant financial activities.

4.159 The main objective of the draft law is the fact that current rules regarding mortgage and consumer credit protection are perceived in Spain to be fragmented and incomplete, and refer primarily to credit and advice obtained through conventional channels (i.e. directly from banks). This concern was first addressed in 2007, when the Senate approved a motion urging the government to move forward with legislation to complete the regulatory framework.

4.160 The new law would result in:

(a) Wider protection to consumers in contracting with non-financial entities, in mortgage credit and in the consolidation of debt.

(b) New obligations of transparency and informational requirements that companies engaging in this kind of activity will have to comply with.

(c) Information to the consumer will have to include all of the commissions, charges, and expenses arising from each contract.

(d) Obligations for the companies to subscribe for, before the start of this activity, insurance for civil responsibility (compensation for damages) and to enrol in a State Public Register.

(e) This will apply to firms engaging in credit intermediation that are currently not under the supervision of the Bank of Spain nor subject to the existing regulation for financial activities.

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41 http://www.congreso.es/portal/page/portal/Congreso/Congreso/Iniciativas/IniTipo?_piref73_1335527_73_1335526_1335526.next_page=/wc/detalleDocumento&idIniciativa=121&numExpediente=7&numDocumento=0&paginaActualB=null

4.161 The new law would also include a schedule of possible violations and corresponding penalties, and provide for alternative (out-of-court) conflict resolution such as arbitration. An English summary, published by Confederación Agrupación Financiera de Estafados, is also available.[42]

Slovakia

4.162 A new Act on Financial Intermediaries and Financial Consultancy in the Financial Market is in a drafting process and should be in place from 2009. [43] Some regulation of credit intermediaries is expected to be a part of the new Act.

4.163 In particular, this law is anticipated to give intermediaries some specific obligations such as requiring intermediaries to fully inform consumers of their fee arrangements with lenders.

UK

4.164 The UK FSA has recently expressed concern about "easy credit conditions and streamlined application processes" that have “contributed to a heightened mortgage fraud risk”.[44] Mortgage intermediaries are seen as an additional contributing factor. The UK FSA is reported as being disappointed with the involvement of lenders in its whistle-blowing initiatives against intermediary fraud, with just 35 out of the leading 150 lenders having made reports since 2006.

4.165 The UK FSA expects a market response from lenders, including an increased involvement in its whistle-blowing scheme.[45] The market response from lenders may also include a review of the dependency upon intermediaries. In terms of regulatory change, the UK FSA says it may require “senior staff at mortgage intermediaries to become *individually* approved” (our italics) by it in the future. [46]

4.166 Some commentators have suggested that such problems illustrate the importance of UK FSA regulation of mortgage intermediation, and may imply a need for further such regulation.[47] Others argue that these problems have arisen even in the presence of regulation, and that it is the regulation itself that has weakened market disciplines and created such problems, so that the recommended solution is the removal of regulation.[48]

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[42] http://asoccafines.blogspot.com/2008/10/proyecto-de-ley-por-el-que-se-regula-la.html

[43] https://lt.justice.gov.sk/(S(fyul0f45jnh3vweu4yty4245))/Document/DocumentDetails.aspx?instEID=1&matEID=175&docEID=4591&docFormEID=16&docTypeEID=6&langEID=1&tStamp=20080714120558170&AspxAutoDetectCookieSupport=1

[44] Philip Robinson, director of the FSA's financial crime and intelligence division. Quote attributed http://news.bbc.co.uk/1/hi/business/7519100.stm, 22 July 2008.

[45] Quote attributed http://news.bbc.co.uk/1/hi/business/7519100.stm, 22 July 2008.

[46] http://news.bbc.co.uk/1/hi/business/7519100.stm

[47] Comments in the House of Commons by Chancellor Alistair Darling.

[48] John Redwood MP and Simon Wolfson, Freeing Britain to Compete (August 2007).

4.167 It is also noted that UK FSA reports have found that the risks of consumer detriment associated with poor training and competence of mortgage intermediaries are lower than with investment products intermediated by financial advisors, so that the case for an exams requirement is less.[49]

4.168 Other submissions to the UK FSA have contended that a significant problem is that the presence of a UK FSA badge and various regulations requiring the offering of best advice creates in the consumer's mind the *illusion* those intermediaries on commission — who are fundamentally salesmen — are not in fact salesmen. A potential solution would be to mandate strict separation of roles. This means that an intermediary on commission (whether tied or untied) would be forced to state to consumers that she is a salesman, and that they should interpret her advice in the context of her own financial interest in selling products to them; whilst only an intermediary with no commission or other financial stake in the consumers' product purchasing decisions should be able to describe herself as an "advisor".

The Potential Impact of the Consumer Credit Directive

4.169 The Council adopted the final text of the Consumer Credit Directive (CCD) on 23 April 2008 and it must now be implemented by Member States before 12 May 2010. The Directive focuses on transparency and consumer rights.

4.170 The Directive, which applies to personal loans ranging from €200 to €75,000 but does not cover mortgages or hiring and leasing agreements, has a number of strands. Firstly, it seeks to help consumers to compare credit offers from different providers by harmonising standards of pre- and post-contractual information provision. To this end, creditors must provide pre-contractual information on a standard form known as Standard European Consumer Credit Information. This will ensure that consumers receive the same type of information, including the APRC, from each provider in each Member State. In turn, this is intended to help consumers compare products both within and across Member States. The Directive notes specifically that “in general, the pre-contractual information requirements should also apply to credit intermediaries”.

4.171 The Directive also attempts to ensure that all European consumers have the same rights in relation to early repayment and ‘cooling-off’ periods. In terms of early repayment, compensation may not exceed one per cent of the amount of the debt that has been repaid early. If debtors repay less than one year prior to the due date, compensation is reduced to 0.5 per cent. In terms of ‘cooling-off ‘periods, the Directive states that consumers may cancel a credit agreement without specifying a reason within a period of 14 days after the contract is signed.

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[49] Europe Economics, Training and Competence Report for the UK FSA, December 2007. Considering credit products only, mortgages are typically more complex (and also normally involve a higher financial commitment on behalf of consumers).

4.172 Article 21 of the Directive applies specifically to credit intermediaries. This Article states that Member States should ensure that:

(a) Credit intermediaries specify in advertisements and documentation provided to consumers whether they are tied or untied.

(b) The service fee, if any, intermediaries charge consumers is disclosed to the consumer and agreed between the parties prior to the conclusion of the contract.

(c) The intermediary informs the creditor of the service fee charged to the consumer so as to allow the creditor to calculate the APRC.

Potential impact on intermediaries

4.173 The CCD will apply to only a subset of the credit intermediaries considered in this study. In particular, it does not apply to mortgage credit or leasing and thus intermediaries involved in these activities will not be affected. Neither will business finance intermediaries, for obvious reasons.

4.174 In the segments where it does apply, some agreements intermediated will be exempt from the Directive because the amount of credit is less than €200.

4.175 The direct impact of the CCD on the demand for intermediary services is uncertain, but is likely to be most significant for consumer credit intermediaries. On the one hand, increased ease of comparability could lead to a number of consumers becoming confident enough in their own financial ability that they no longer require the services of an intermediary. On the other hand, a number of consumers that may previously not have engaged in search because of a lack of financial confidence and unwillingness to rely on the intermediary's judgement may begin to consult intermediaries. These consumers may feel able to compare the offers now that the information is presented in a standardised format but wish to save the effort of searching for individual quotes themselves and thus consult an intermediary.

4.176 Whether or not the CCD will impose additional costs on a credit intermediary, and the magnitude of these costs, depends upon the type of activities they undertake on behalf of lenders. If the sole activity of the intermediary is to compare products and refer potential borrowers to lenders, the CCD is likely to have limited cost impact. However, if the intermediary also provides pre-contractual information, the Directive is likely to have a greater impact. Of course, it is possible that some existing costs would be offset and that ongoing costs may fall as lenders and intermediaries become familiar with the new arrangements.

4.177 Intermediaries that provide pre-contractual information on behalf of lenders would likely incur both one-off familiarisation costs and ongoing costs. Sources of ongoing costs would be the time taken to complete the form and printing costs. Further costs may arise if intermediaries screen potential borrowers on behalf of lenders. The Directive contains an obligation for creditors to assess the credit-worthiness of the potential borrower on the basis of sufficient information obtained either from the borrower or by consulting the relevant database. Such costs would arise only for intermediaries conducting business in Member States that do not currently have such provisions in place.

4.178 In addition to the dependence upon the activities of the intermediary, the impact of a given increase in costs on an intermediary's profit will, to some extent, depend upon its remuneration arrangements with lenders and consumers. In the absence of intermediaries, the increased costs would be borne by lenders and so it might be expected that intermediaries that are remunerated by lenders would seek to renegotiate their fee arrangements. Clearly, such a possibility exists only for those intermediaries that are remunerated by lenders, either alone or in addition to remuneration from consumers.

4.179 For those intermediaries that are remunerated by consumers, the intermediary may increase the up-front charge levied on borrowers either in addition to or instead of negotiating a fee increase with lenders.

4.180 The decision of whether or not to seek to recoup the additional costs is a strategic business decision for the intermediaries. The impact of an intermediary increasing his up-front fee as a result of the CCD depends to a significant degree upon the responses of his competitors. If all his competitors were to increase their fees, there would be a negligible impact on his business in terms of the number of customers and his revenue per customer would not change. If, however, he raised his fee whilst all of his competitors kept theirs fixed, it might be expected that there would be a substitution towards his competitors and hence there could be a non-trivial impact on his revenue.

4.181 The issue is further complicated by the fact that fee arrangements differ between intermediaries. There will be some intermediaries where the upfront fee does not change (at a minimum those that are remunerated by lenders alone). Given this, competitors are unlikely to wish to pass the full cost increase on to consumers by raising their fee. The difference between the cost increase and fee increase could be absorbed by the intermediary or recouped from lenders.

Potential impact on lenders

4.182 To some degree, the cost impact of the CCD on lenders is determined by their arrangements with intermediaries. For those lenders that do not remunerate intermediaries, costs will be incurred only for direct lending (e.g. lenders will need to establish processes for calculating the APRC and would incur costs each time a form is completed).

4.183 As noted above, for those that pay credit intermediaries for their services there could be an additional element of cost if intermediaries successfully negotiate an increased fee. Given such an increase, the lender then faces a strategic choice of whether or not to raise the cost of his credit products. The lender's optimal choice depends upon the actions of other lenders and hence the impact of the Directive on the cost of borrowing is not at all certain.

4.184 A further impact on lenders derives from the harmonisation of early repayment laws. In a number of Member States, early repayment charges have been so prohibitive as to effectively tie consumers to their provider. The CCD will prevent this strategy and hence a refinancing market may emerge. In other instances, lenders will be affected simply because the compensation they receive for early repayment of a given loan will fall.

The potential impact on consumers

4.185 The impact of the CCD on consumers is partially determined by the actions of lenders and intermediaries. If neither lenders nor intermediaries take an action that raises the cost of a loan, there would be no direct cost impact on the consumer. However, if either the fee charged by intermediaries or the interest rate charged by lenders rises whilst all other factors remained unchanged, consumer welfare is adversely affected. In such circumstances, it would be more costly for the consumer to obtain the same credit product as she would prior to the introduction of the CCD and hence the additional cost would be incurred for no benefit.

4.186 In fact, whilst the cost of the loan may rise as a result of the CCD, all other factors do not remain unchanged. In particular, the fact that pre-contractual information is to be provided in a standardised format should enable some customers to compare the offers of different providers and thereby obtain a less costly and/or more suitable credit product. The impact on consumer welfare is therefore not certain and will depend upon whether the potential benefit of increased comparability outweighs the increased cost of the loan. It is quite possible that certain consumers would experience a net cost whilst others would derive a net benefit.

4.187 Firstly, there are likely to be few benefits for consumers that currently obtain credit through untied intermediaries. This is because one of the functions of such intermediaries is to advise customers of their various options and recommend the most suitable product.

4.188 The same cannot be said of tied intermediaries — to obtain a product that is at least as suitable as that which would be obtained by consulting an untied intermediary, the consumer may need to obtain quotes from a number of tied intermediaries. This implies a more general point that achieving the potential benefits of the CCD relies on consumers obtaining several quotes, either directly or through tied credit intermediaries.

4.189 In theory, if consumers already engage in search but are unable to compare the offers adequately then the CCD will not impose additional search costs but could lead to increased welfare as some consumers will become empowered to choose the most appropriate product from a range of offers. In practice, however, it is unlikely that consumers currently engage in search and bear search costs unless they believe that they can understand and compare the offers and hence only financially confident consumers currently engage in search. The benefit to such consumers is therefore likely to be negligible.

4.190 For those that are not financially confident at present but would be confident when pre-contractual information is presented in a standardised manner, assessing the net benefit of the CCD is a matter of comparing the potential welfare benefit of choosing a cheaper or more suitable product with the increase in search costs and potential increase in the cost of any given loan.

4.191 In addition to the potential benefits from improved comparability, the Directive could also serve to reduce the number of incidences of consumer detriment. One example of this is that it will no longer be possible for lenders or intermediaries to 'hide' any element of the cost of the loan and hence consumers will be increasingly aware of the terms and conditions of the loan prior to its enactment.

4.192 A less direct benefit to consumers could derive from increased competition amongst intermediaries and, more importantly in terms of the total cost of the loan, lenders. Such competition might be stimulated both within Member States and cross-border. If the increased comparability of loan offers and greater propensity of consumers to engage in search stimulates price competition amongst lenders, consumers are likely to benefit from a reduction in the interest rate and hence overall cost of the loan. Similarly consumers may benefit from reduced charges if competition amongst intermediaries is stimulated. The latter effect appears rather less likely *ex ante* given the existing diversity of intermediary remuneration structures.

The potential impact on cross-border trade

4.193 Article 9 of the CCD states that

> "Each Member State shall in the case of cross-border credit ensure access for creditors from other Member States to databases used in that Member State for assessing the creditworthiness of consumers. The conditions for access shall be non-discriminatory."

4.194 This is intended to reduce one of the barriers to cross-border trade, namely the difficulty of assessing the credit-worthiness of consumers located in a different Member State. It is interesting to note that the Directive does not specify that intermediaries should be granted access, only creditors. This implies that the role of intermediaries envisaged by the Council does not extend to conducting creditworthiness checks on potential borrowers.

4.195 Nonetheless, this element of the Directive could increase the confidence of lenders in conducting cross-border trade. In combination with increased ease of comparability amongst consumers, the CCD could stimulate cross-border credit agreements. This is somewhat more likely for consumer credit other than vehicle finance or point of sale credit.

The Impact of the Unfair Commercial Practices Directive

4.196 The deadline for transposition of the Unfair Commercial Practices Directive (2005/29/EC) was 12 June 2007. The Directive aims to boost consumer confidence and make it easier for businesses (especially small- and medium-sized businesses) to carry out cross-border trade. It does not target the sale of credit products specifically, but these are not excluded from its coverage either. Germany, Spain, Lithuania, Luxembourg, Hungary, and Finland are late in transposing the Directive into their national laws.

4.197 The Directive outlines two main categories of unfair commercial practices: "misleading" marketing and "aggressive" or high-pressure sales practices; these are with reference to the "average consumer". It also includes a "blacklist" of those practices which are regarded as unfair and thus banned.

4.198 The implementation of the Directive should in theory facilitate cross-border credit intermediation by providing a common platform for what is deemed to be an unfair commercial practice, thus clarifying consumers' rights in cross-border commercial situations.

4.199 The impact upon a particular credit intermediaries will depend upon:

- The extent to which the Unfair Commercial Practices Directive represents a shift from prior regulatory or legislative practice.
- The extent to which they engaged in the prescribed commercial practices prior to transposition of the Directive (if it has been transposed in the relevant Member State(s)) — if such activities were not used, then obviously behaviours will not need to change in response to the Directive.
- The extent to which the lenders engaged in those practices — in particular, whether there was a marked difference between the lenders and the intermediaries in the use of such unfair practices.
- The extent to which the implemented Directive will be enforced, and in particular whether there will be any divergence in enforcement between intermediaries and lenders.

International Perspective

4.200 In this section we describe the regulatory frameworks in the EEA and the USA.

Residential mortgage and consumer credit intermediation

EEA

4.201 Iceland has no legislation or regulation that applies specifically to mortgage intermediaries (or to credit intermediaries more generally). However, mortgage intermediaries must, under the Act on Unfair Commercial Practices and Transparency of the Market, inform customers of all the costs that the customer will bear prior to signature of the credit agreement.

4.202 Regulation of mortgage intermediaries in Norway is somewhat stricter than in Iceland, and is comparable to a moderate degree of regulation according to our categorisation. Norwegian mortgage intermediaries must inform both parties of the remuneration that will be demanded for the assignment, and who shall pay it prior to the contract being entered into. They must also provide certain information to both lenders and borrowers, including the effective interest rate, inclusive of any guarantee costs, prior to a loan contract being entered into.

USA

4.203 From a review of Federal laws and regulations and of documents outlining the main state laws and regulations, there appear to be no requirements that apply specifically to credit intermediaries. However, a number of general credit acts enacted at both federal and state level are applicable to credit intermediaries as described below.

4.204 At Federal level, the most significant laws and regulations are contained within the Consumer Credit Protection Act (CCPA), which is an umbrella instrument comprising all consumer credit provisions in the United States Code. The following Acts are contained within the CCPA:

(a) The Equal Credit Opportunity Act which was passed in 1974 and implemented by Regulation B. This Act prohibits discrimination in the granting of credit. It should be noted that the act applies to creditors, defined as follows:

> "Creditor means a person who, in the ordinary course of business, regularly participates in a credit decision, including setting the terms of the credit…the term creditor also includes a person who, in the ordinary course of business, regularly refers applicants or prospective applicants to creditors, or selects or offers to select creditors to whom requests for credit may be made."

(b) The Truth in Lending Act which was passed in 1968 and implemented by Regulation Z, which mandates a uniform method of disclosing the costs and terms of consumer credit transactions.

This Act was "instituted to promote consumer understanding of the direct and indirect costs, terms, and conditions of their credit agreements"[50] and requires creditors who deal with consumers to make certain written disclosures concerning all finance charges and related aspects of credit transactions (including disclosing finance charges expressed as an APR[51]). It also established, for some credit agreements, a three-day 'cooling off period' following signature of a contract within which consumers could freely cancel the contract without penalty.

(c) The Consumer Leasing Act, passed in 1976 and implemented by Regulation M, which applies to all persons that are lessors of personal property and requires lessors to give consumers "clear and conspicuous" disclosure of the costs and terms of the lease where the value of the lease is no more than $25,000 (i.e. about €36,000).

4.205 In addition to the CCPA, another important Act that applies to credit intermediaries is the Federal Trade Commission Act. Section 5(a) of this Act prohibits "unfair or deceptive acts or practices in or affecting commerce" where "unfair acts or practices" are defined as those that cause or are likely to cause substantial consumer detriment, which consumers cannot reasonably avoid and are not outweighed by benefits to consumers or to competition. These prohibitions apply to consumer credit transactions generally and hence would apply to intermediaries.

4.206 All states have their own consumer protection statutes and similar consumer credit laws which often overlap federal laws. Consumer protection is more stringent in some states than in others.[52]

4.207 The majority of states have implemented anti-predatory lending and consumer credit protection laws with varying degrees of protection. Examples of such laws include the New Jersey Home Ownership Security Act 2002; the New Mexico Home Loan Protection Act 2003; and the Texas Finance Code which covers all Texas credit laws and thus includes consumer credit.

4.208 North Carolina has been seen as a leader in many areas of consumer credit law. For example, it was the first state to introduce legislation — the Predatory Lending Act 1999 — to curb predatory mortgage lending whilst preserving consumer access to credit.

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50 Centre for Responsible Lending Policy Paper No. 2 (2002) 'The Case for Predatory Lending Reform'

51 This is the US conceptual equivalent to the APRC.

52 See a state by state review by the National Conference of State Legislatures, http://www.griffith.edu.au/centre/cccl/pubs/ccrio0405.pdf

4.209 The Uniform Consumer Credit Code (UCCC) has been adopted in at least eleven states, including Indiana, Iowa, Wyoming, Oklahoma, Idaho, South Carolina, Maine, Utah, Wisconsin, Kansas and Colorado.[53] Where adopted, the UCCC generally applies to loans, mortgages, credit sales, and advances made in that state.

4.210 The UCCC is relatively restrictive. For example, in addition to its aims of furthering consumer understanding of the terms of credit transactions and fostering competition among suppliers of consumer credit, it also provides interest rate ceilings and prescribes maximum charges for all creditors.

4.211 In addition to the federal regulations, mortgage intermediaries are licensed or registered and must comply with pre-licensing and continuing education requirements and criminal background checks in forty-nine states and the District of Columbia. Further, in the majority of these states individual employees of mortgage intermediaries must be licensed or registered and in many states employees must pass tests in order to become licensed. This, in particular, is fairly rare in the EU. The National Association of Mortgage Brokers (NAMB) members adhere to a Code of Ethics and best lending practices.

Current developments

4.212 According to the academics Tito Boeri and Luigi Guiso, financial literacy is particularly low among those who have taken out sub-prime mortgages in the USA, and that some mortgage intermediaries (typically referred to as brokers in the USA) have exploited this low financial literacy by advising their clients to invest in financial assets that were not well-suited to their ability to bear risk.[54]

4.213 This is supported by the head of the mortgage banking industry's trade group, the Mortgage Bankers Association, claimed brokers profited from a home loan boom but did not do enough to examine whether the borrowers could repay [55] (although the primary responsibility for the latter must fall with the lenders themselves, unless explicitly sub-contracted to the intermediaries). Furthermore, a new study by an advocacy group, the Center for Responsible Lending, highlights that those sub-prime borrowers who dealt through mortgage brokers paid more than three per cent more than borrowers who got the same loans directly from lenders. This is taken to suggest that the brokers responsible for this put homeowners into more expensive loans than necessary in order to earn commission.[56]

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53 See http://www.kslegislature.org/legsrv-statutes/index for the Kansas implementation as an example.
54 http://www.voxeu.org/index.php?q=node/488
55 http://www.msnbc.msn.com/id/18804054/
56 http://www.mortgageloan.com/are-brokers-to-blame-for-bad-credit-mortgage-crisis-2034

4.214 However, there are a number of other factors at play. We have already referred above to the responsibility of the lenders themselves. Borrowers, too, need to take responsibility for decisions made. At a higher level, the lengthy period of loose monetary policy in the USA is regularly cited as a factor and the financial innovation that allowed the creation of new products such as mortgage-backed securities has massively magnified the scale and reach of the crisis.[57]

4.215 The response to the credit crunch and a series of scandals involving mortgage brokers, has been a series of proposals to increase US mortgage regulation further still. Indeed, a Senate Banking Committee bill of May 2008 — expected to be approved by the full Senate in due course — would require individuals to pass proficiency tests, undertake continuing education and be fingerprinted by the FBI. The bill also endorsed an initiative by the Conference of State Banking Supervisors to license previously unregistered mortgage brokers.

POS intermediation

4.216 In addition to the requirement to inform customers of all the costs that the customer will bear prior to signature of the credit agreement, Icelandic point of sale intermediaries — including motor vehicle retailers — are required to assess the suitability of a product for a given borrower, comply with money-laundering legislation and present key data to borrowers in a standardised manner. Such requirements place Iceland towards the more stringent end of a scale based on degree of regulation in EU Member States.

4.217 Norwegian regulation of POS intermediaries is lighter than that of mortgage and consumer credit intermediaries. Such intermediaries must comply with the Sales of Goods on Credit Act in addition to the Financial Contracts Act but it is not clear that there are any specific regulatory requirements on intermediaries themselves.

4.218 The regime applicable in the USA is described within the equivalent sub-section of the chapter dealing with residential mortgage intermediaries.

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57 http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3579171.ece

5 INTERMEDIATION OF RESIDENTIAL MORTGAGES

Introduction

5.1 In this section we examine the extent and nature of credit intermediation in the residential mortgage markets within the individual Member States of EU27.

5.2 Before turning to the intermediaries, we summarise below some of the diversity in the mortgage credit market generally across EU27.

Table 5.1: Mortgage credit across EU27, 2007

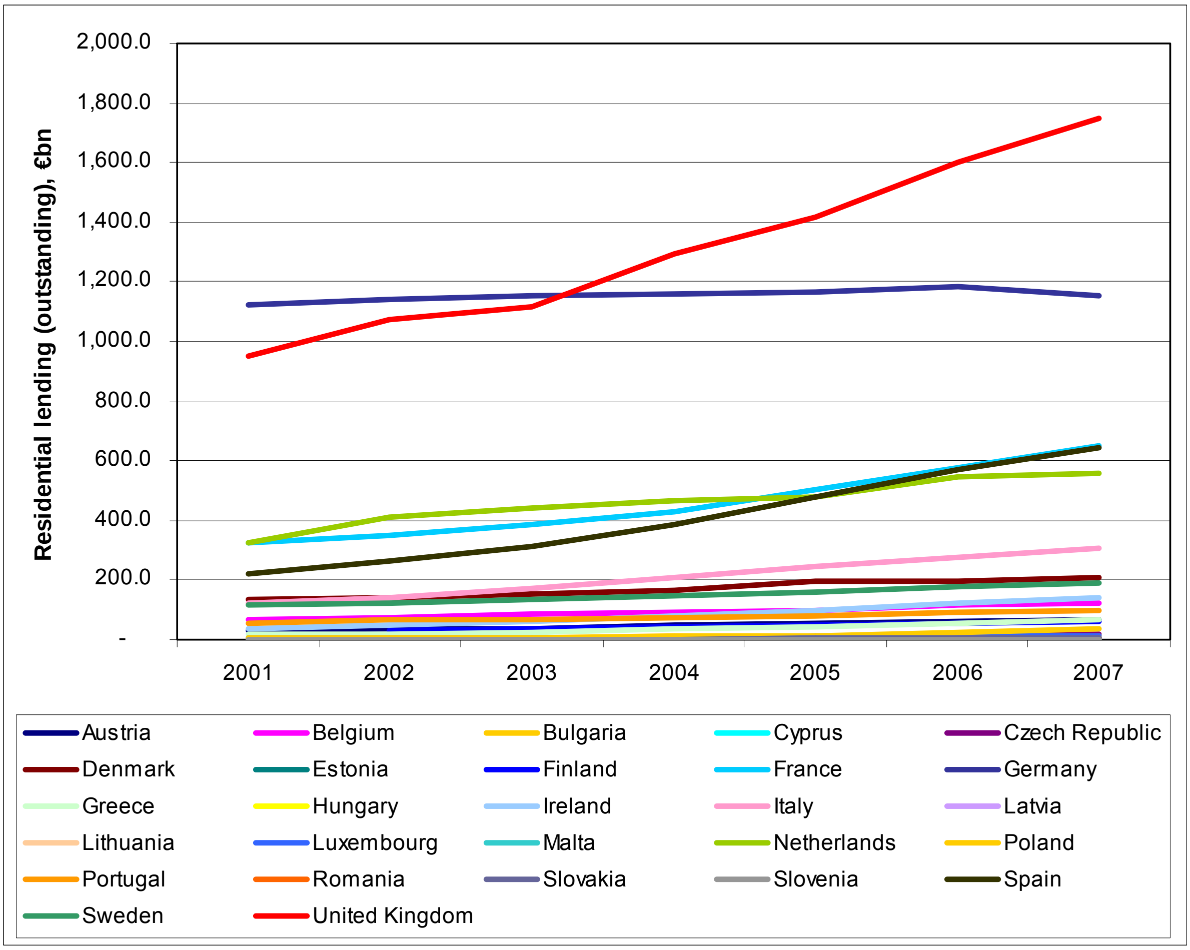
	Total OUT-STANDING lending, €bn	OUT-STANDING mortgage debt/GDP, %	OUT-STANDING mortgage debt/ capita, €000
Austria	65.1	24.0%	7.8
Belgium	121.8	36.8%	11.4
Bulgaria	2.9	9.9%	0.4
Cyprus	7.0	44.7%	8.9
Czech Republic	19.6	15.3%	1.9
Denmark	211.4	92.8%	38.7
Estonia	5.6	36.8%	4.2
Finland	61.7	34.3%	11.7
France	651.1	34.4%	10.2
Germany	1,155.7	47.7%	14.0
Greece	69.4	30.4%	6.2
Hungary	12.5	12.4%	1.2
Ireland	139.8	73.4%	32.2
Italy	304.2	19.8%	5.1
Latvia	6.7	33.7%	3.0
Lithuania	4.8	17.3%	1.4
Luxembourg	13.8	38.3%	29.0
Malta	2.0	37.3%	4.9
Netherlands	559.0	99.9%	34.1
Poland	36.0	11.7%	0.9
Portugal	101.1	62.1%	9.5
Romania	4.3	3.5%	0.2
Slovakia	6.5	11.9%	1.2
Slovenia	2.7	7.7%	1.3
Spain	646.7	61.6%	14.4
Sweden	189.4	57.1%	20.7
United Kingdom	1,745.8	86.5%	28.8

Source: Hypostat 2008, eurostat (2007 GDP and population data), EE calculations

5.3 In terms of the absolute value of outstanding mortgage credit, the UK and Germany clearly stand apart. However, whereas the outstanding mortgage loan stock was relatively unchanged at the end of 2007 from its value in 2001, the value of such loans in the UK was 84 per cent higher in 2007 against 2001. This is illustrated in the chart below.

5.4 Relative to GDP, the Netherlands and Denmark have particularly significant mortgage credit markets. On the other hand, the mortgage market is starting from a relatively low base in most of the New Member States. The changing value of gross residential mortgage lending, 2001–2007, is shown below.

Figure 5.1: Evolution of residential loans outstanding, 2001–2007



Source: EMF Hypostat 2008 (2001-2007)

The Current Scale of Intermediation

5.5 We set out below the estimated shares of mortgage intermediaries as a distribution channel in the retail of mortgages and other lending secured on own property in the EU27. This is translated into a value and volume measure relating to the annual *flow* of mortgages in 2007.

Table 5.2: Share of intermediaries in the retail of mortgages and other lending secured on own property, 2007[58]

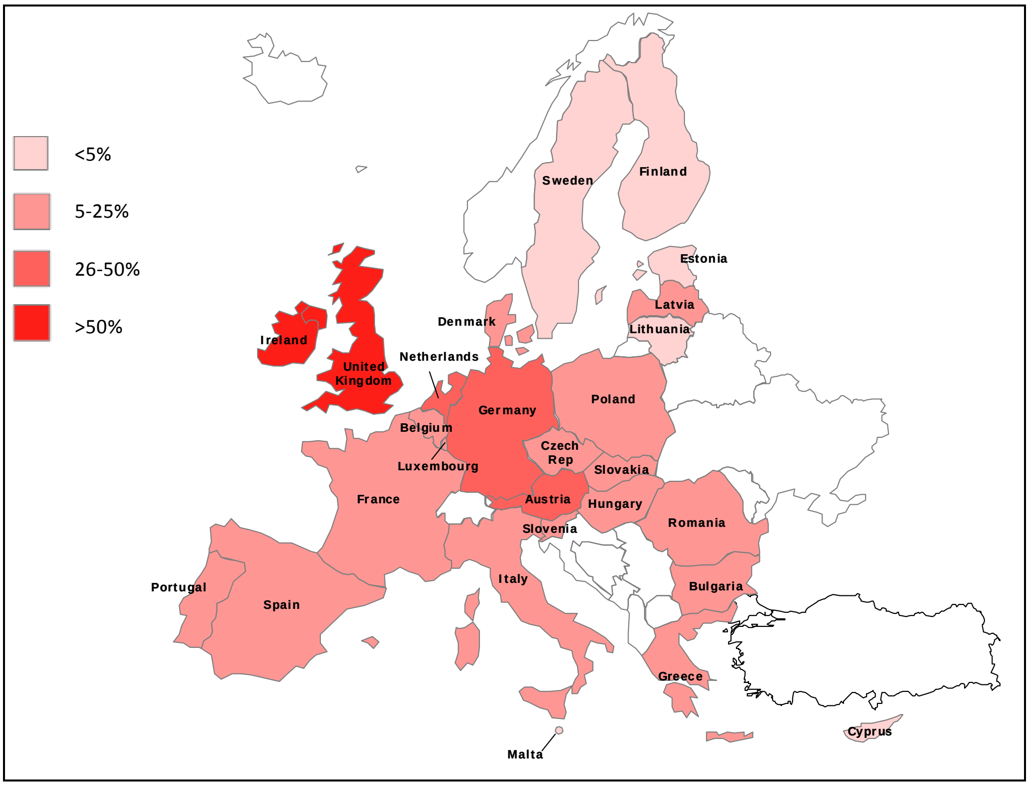
	Intermediary share (%)	*Direct share (%)*	Value (FLOW) €m	Volume (FLOW) 000s
Austria	35.0%	*65.0%*	1,422	14
Belgium	15.0%	*85.0%*	3,424	34
Bulgaria	12.5%	*87.5%*	377	19
Cyprus	2.0%	*98.0%*	52	3
Czech Republic	22.0%	*78.0%*	1,462	21
Denmark	5.0%	*95.0%*	2,161	22
Estonia	2.0%	*98.0%*	43	2
Finland	1.0%	*99.0%*	289	3
France	22.5%	*77.5%*	33,030	330
Germany	32.5%	*67.5%*	38,870	268
Greece	10.0%	*90.0%*	1,520	20
Hungary	25.0%	*75.0%*	728	24
Ireland	60.0%	*40.0%*	20,285	203
Italy	25.0%	*75.0%*	23,533	193
Latvia	5.0%	*95.0%*	102	5
Lithuania	2.0%	*98.0%*	37	2
Luxembourg	15.0%	*85.0%*	656	4
Malta	1.0%	*99.0%*	1	0
Netherlands	45.0%	*55.0%*	39,816	346
Poland	24.0%	*76.0%*	656	15
Portugal	15.0%	*85.0%*	1,062	14
Romania	12.5%	*87.5%*	2,678	134
Slovakia	20.0%	*80.0%*	444	15
Slovenia	15.0%	*85.0%*	263	4
Spain	20.0%	*80.0%*	27,176	163
Sweden	1.0%	*99.0%*	455	5
United Kingdom	70.0%	*30.0%*	363,589	1,605
			564,130	3,468
EU27 average	41.5%	*58.5%*		
EU15 average	42.6%	*57.4%*		
Eurozone average	27.2%	*72.8%*		
EU12 average (NMS)	13.8%	*86.2%*		

Source: Surveys,[59] EMF and ECB (2007 data), EE calculations

58 Where there is a difference, the intermediary share is of mortgages by value. (For instance, in the UK, intermediaries act in respect of just 64 per cent of mortgages by volume of transactions — i.e. the average mortgage loan intermediated is 30 per cent larger than the typical loan sold directly).

5.6 The differentiation in market penetration by mortgage intermediaries is illustrated below.

Figure 5.2: Intermediary penetration in the mortgage credit market



Source: smartdraw

Typology

5.7 There are a number of different forms of mortgage intermediary in operation across the EU27. In terms of activities undertaken, the following groupings are apparent:

- Mortgage brokers or advisors. This would typically be taken to be a mortgage intermediary providing intermediation services to borrowers, potentially at least, searching across the whole market of mortgage products (or at least a fair selection thereof). The extent of the service provided will vary from intermediary to intermediary.

[59] The analysis in this section is based upon up to 96 data points (see also Section 2). We have identified in this section where the number of responses was significantly less than this (typically where more detailed, and potentially more sensitive data — such as relating to remuneration structures, etc).

– Tied mortgage agents. Here, the selection of mortgage would be from a product suite limited to an individual lender (or a small number of lenders, i.e. multi-tied). However, as we have discussed in Section 4, it is not necessary in all EU27 Member States for the mortgage intermediary to disclose to potential borrowers that such tied relationships exist.

– Mortgage introducers. This would be characterised as a rather limited intermediation activity. It might include, say, real estate brokers who provide qualified leads to lenders and/or identify a limited suite of potential lenders to their own customers.

Tied and untied models

5.8 We characterise below the relationships that intermediaries have with lenders.

Table 5.3: Business model mix

Majority of intermediaries are tied or multi-tied	**Intermediaries are evenly split between those that tied and those that are untied**	**Majority of intermediaries are untied or cover "whole of market"**
Finland Italy Portugal Spain *Slovakia*	Belgium Czech Republic *Germany*	Austria France Ireland UK

Source: Surveys. Italics indicate that the data is limited and so conclusion is less robust. Data for other countries not available.

5.9 There are specialist mortgage intermediaries, with all or nearly all of their income derived from this activity, and also non-specialists. The latter will typically include the likes of Independent Financial Advisers — who will be providing clients with a broad spectrum of advice, including investment advice and as such will be typically regulated quite heavily for at least that activity — and generalist credit intermediaries who will also seek to intermediate other categories of consumer credit. In the UK, just over half of the firms authorised to conduct mortgage intermediation business are non-specialists in that activity. Put another way, approximately two-thirds of the Financial Advisers authorised by the UK regulator, the UK FSA, provide mortgage intermediation advice.[60]

[60] http://www.fsa.gov.uk/pages/About/Teams/Retail/statistics/advice/index.shtml and http://www.fsa.gov.uk/Pages/About/Teams/Retail/statistics/mortgage/index.shtml

The credit crunch

5.10 The above table takes an historic perspective. As such, it will not fully reflect the impact of the "credit crunch" and current market conditions. These are likely to affect the overall situation of mortgage intermediaries, but may be most noticeable in the mortgage market. For instance, in the UK gross mortgage lending in October 2008 was 44 per cent down on the same quarter of the previous year.[61] Looking at loans for house purchase (i.e. excluding remortgaging), the drop in the value of lending was 57 per cent.

5.11 The proportion of lending to first time-buyers being processed through mortgage intermediaries had decreased to 72 per cent from 75 per cent (by value) in the same quarter of the previous year. With respect to remortgages, the share for intermediaries had dropped to 60 per cent (from 67 per cent) over the same time frame. However, whilst further development in terms of the importance of intermediaries appears likely, the direction of this change in the countries most affected by the credit crunch is not yet clear.

The EU average

5.12 For the EU27 as a whole just over 40 per cent of mortgage credit lent was through intermediaries. However, it should be noted that this figure was heavily influenced by the high penetration in the UK market (and by the relative importance of the UK mortgage market — although as noted above the size of the UK market has in any event declined significantly during the course of 2008).[62]

5.13 There is clearly significant variation across the EU in the importance of intermediaries as a distribution channel. There are a number of possible reasons for low penetration by intermediaries in particular credit markets. This is explored more fully below.

Variation in penetration

5.14 We examine below the data gathered on market penetration by intermediaries during the course of this study against three factors:

- The degree of concentration in the banking sector
- The perceived extent of competition in the mortgage market
- The ratio of population to individual bank branches.

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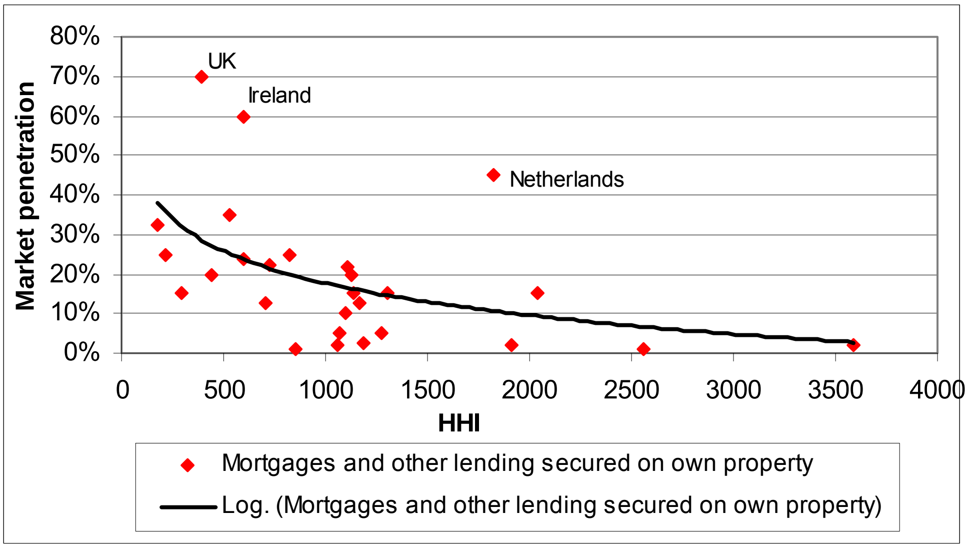
61 Council of Mortgage Lenders.

62 Indeed, the British Bankers Association stated that as at August 2008, the monthly mortgage approvals were 61 per cent lower than the equivalent month in 2007.

Concentration

5.15 The Herfindahl-Hirschman Index of concentration (HHI) is the sum of squares of market shares, defined as percentages. It plays a prominent role as an initial screening device in merger analysis, particularly in the US. The HHI concentration measures are reported on a scale of 0 (perfect competition) to 10,000 (monopoly). In anti-trust analysis, markets with HHI greater than 1,800 are considered highly concentrated. The Member States with highly concentrated markets in lending, i.e. with a HHI greater than 1,800, are the Netherlands, Lithuania, Belgium, Finland and Estonia.

Figure 5.3: HHI and market penetration for intermediation of residential mortgages[63]



Source: Survey, ECB Banking Structures (2006 data, study published October 2007)

5.16 The graph above shows a clear and intuitive relationship between the HHI and the extent of penetration by intermediaries. As markets become more concentrated (and the value of the HHI rises) the extent of market penetration declines.

5.17 In a small market, particularly where the credit institutions are highly concentrated (e.g. the largest, say, three banks have a high market share) the *search function* attributable to mortgage intermediaries is much devalued. This is particularly the case where the specific credit market remains competitive. The effect would be further amplified if the diversity of the credit products marketed was limited. Our study suggests that this explanation has some force at least in the context of some of the Scandinavian countries (e.g. Finland and Sweden).

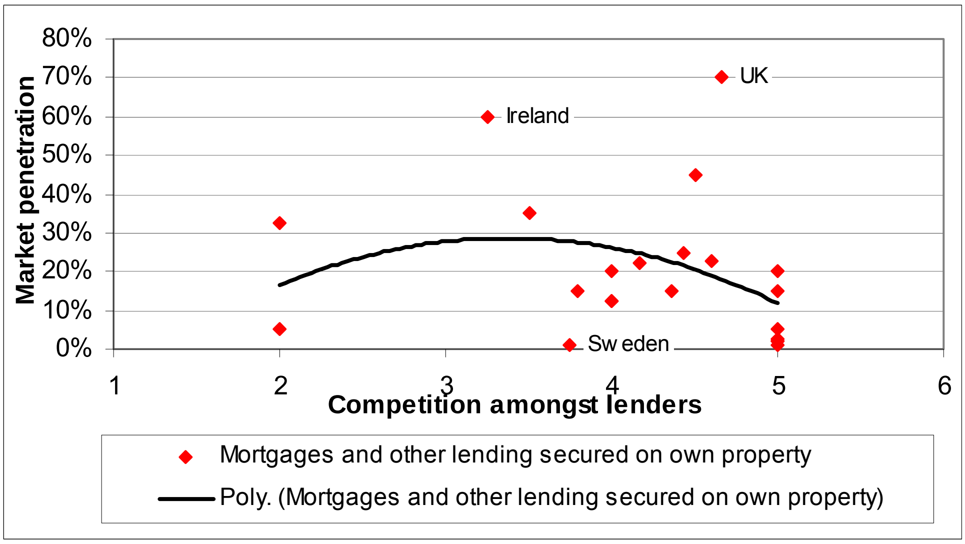
63 The relationship between intermediary penetration and the HHI has an R^2 of about 31 per cent (based on natural log values in order to linearise the relationship).

5.18 A universal banking tradition, such as in Scandinavia, (as opposed to having specialist mortgage banks and/or other finance providers) would (particularly in smaller markets) also tend to increase concentration and so reduce the value of the search function provided by the intermediaries.

Competition

5.19 Although the Herfindahl-Hirschman Index has some explanatory power, it is stressed that this data is only available to us across the EU27 for the banking sector *as a whole* — it is not specific to the mortgage market in each Member State.

Figure 5.4: Lender competition and intermediary market penetration for residential mortgages[64]



Source: Surveys

5.20 If a low level of competition is driven by a concentrated market, one would expect this to be linked to a lower level of intermediary penetration due to the reduced value of the search function of intermediaries as described above.

5.21 Again, there is likely to be a mutual interaction between the extent of indirect distribution and the market entry and expansion of credit providers that lack a branch network. Indeed, the point has been made previously that "a 'tail' of smaller lenders often use third-party distribution to grow volumes (with mixed success)".[65]

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64 Based on the results of our survey, we constructed a measure of the degree of competition amongst lenders, expressed on a scale of 1 to 5, where 1 represents weak competition and 5 represents strong competition.

65 OW (2006), "European Mortgage Distribution: Changing Channel Choices".

5.22 On the other hand, in a more competitive market, if the competition is largely on price (driven, at least in part, by a relatively uniform product facilitating greater transparency of pricing), this would also be consistent with a reduced search function and consequently a lower level of intermediary penetration. However, the Box 5.1 below highlights an extract from one of our case studies that suggests that whilst more homogenised products may result in increased competition on price, it would also be expected to promote increased focus on costs as a natural corollary of this.

Box 5.1: The emergence of independent mortgage intermediaries in Germany

Germany's mortgage market has been relatively stable over the past few years, showing limited growth. According to Interhyp, and evidence from the available literature, it has been this *lack* of growth and resulting structural changes in the mortgage market that have been the most important factors influencing the growth of intermediaries.

The move towards using intermediaries is part of the business strategy of banks that, in a tight market, have to find other ways of increasing their market share and business volume and reducing costs. Due to largely undifferentiated products such competition is likely to be price-based, which necessitates lenders becoming as efficient as possible in order to price their products aggressively. Cutting down on distribution costs has been the main mechanism to achieve this.

Technology has also played a large role in the growth of intermediaries, particularly of independent intermediaries (by reducing the search cost to the intermediary of reviewing a more extensive range of lender offerings). Through internet searches and online trading platforms intermediaries have access to a wider customer base and are able to arrange loans far more efficiently than traditional lenders. It has made the mortgage market more transparent and increased consumer's demand for competitively priced products, which translates into higher demand for intermediaries' services. In turn, lenders may explore greater product differentiation as a means of restoring profitability.

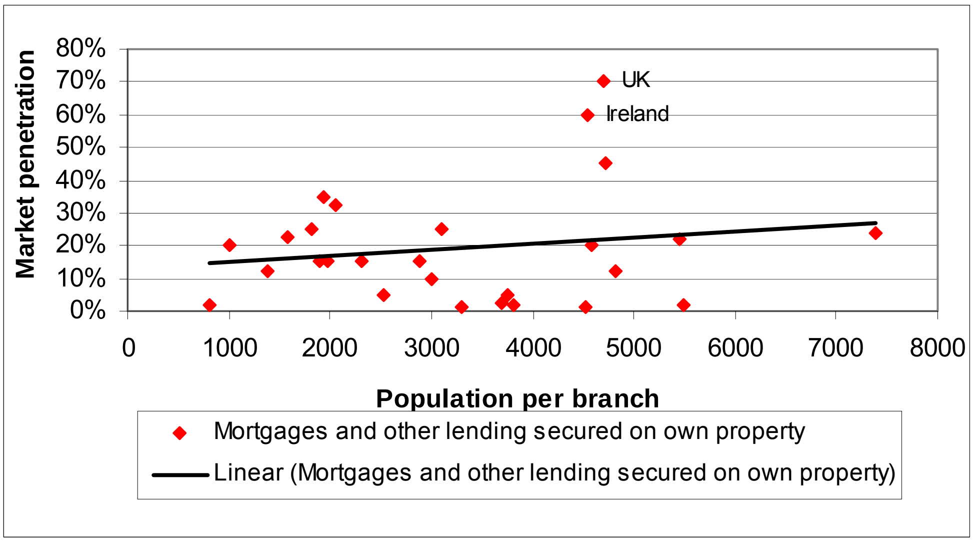
The move towards the use of internet-based trading platforms has also contributed to the growth in the number of intermediaries, and provides further cost savings to participating lenders. The majority of the benefits of this increase have been felt by lenders.

Source: Case study, please see next Section

Bank branch density

5.23 We compare below the penetration of mortgage credit intermediaries with bank branch density.

Figure 5.5: Population per branch and intermediary market penetration for residential mortgages



Source: Survey, ECB Banking Structures (2006 data, study published October 2007)

5.24 Another factor which, from our analytical framework, could influence market penetration levels is the population per branch. If there are a greater number of customers in any given area, we would expect more branches to open in that area. The trend in Figure 5.5 is in line with this expectation. However, the relationship is not strongly statistically significant.

Other factors

5.25 It could be that the rate of growth of the mortgage market may explain an *increase* in the penetration of intermediaries (as opposed to the level achieved). A comprehensive record of the extent of penetration by intermediaries is not available prior to this study. It is therefore not possible to robustly test this hypothesis. In addition, evidence from one of our case studies gives the opposite view (see Box 5.1).

5.26 As noted in Box 5.1, lenders seeking to cut down on distribution costs may outsource all or part of their internal sales function as a mechanism to achieve this. Similarly, changing technology has also played a general role in the growth of intermediaries.

5.27 Reliance upon intermediaries is, of course, not without a cost to the lenders or consumers. Looking first at the lenders, the main costs and risks raised were:

(a) Direct margin pressure driven by the requirement to pay intermediaries fees and commission for the new business generated.

(b) Indirect margin pressure through the cost of control and monitoring, and also training to drive adequate product knowledge.

(c) The sourcing through an intermediary means that the mortgage provider is likely to know the customers less well. This may result in the following:

- A potential diminution of average credit quality. This may even in some cases cross over into downright fraud whereby some intermediaries fabricate details of the customer application in order to ensure the customer obtains the mortgage credit, and the intermediary receives his or her commission. We highlight below some examples of this phenomenon from the UK, the Czech Republic and Ireland.

- The customer base becomes more liable to churn through re-mortgaging (our work suggests that this is rather more restricted in scope geographically, being most prevalent in the UK. In some Member States, there are significant penalties on early term re-mortgaging). The credit crunch may serve to diminish the scope for such re-mortgaging in at least the short- to medium-term.

5.28 We examine the potential impact upon consumers later in this Section. First, we turn to the business models used by mortgage intermediaries.

The Business Models of Mortgage Intermediaries

Introduction

5.29 This section provides an analysis of the activities intermediaries undertake on behalf of lenders and consumers. The analysis is carried out by breaking down intermediaries depending on whether they are tied to specific credit providers (including multi-ties) or whether they are independent.[66]

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[66] We have also investigated the possibility of breaking down the analysis by single Member State but we have concluded that this would not be the appropriate way to proceed for two reasons: (a) The variation in responses among different Member States is significantly lower than compared to the variation among the different products, reinforcing the need for a distinction by credit products, and (b) Breaking down the responses at the Member State level (in addition to breaking down by product) would necessarily result in such a segmented and small sample that it would seriously undermine the reliability of the results without, based upon (a), adding materially to the information content.

5.30 The core activities in which mortgage credit intermediaries are typically engaged are:

(a) **Generating leads,** with intermediaries being used by lenders as a distribution channel and, therefore, helping them to establish links with potential customers and promote specific products.

(b) **Market search**. This is for borrowers, or potential borrowers, and includes presenting clients with a range of different products and price quotations, and effectively helping them in the time-consuming activity of market search.

(c) **The provision of pre-contractual information.** This would include an explanation of the contract, its clauses, and the obligations that arise from its signing.

(d) **Suitability advice**. This refers to those activities intended to alleviate asymmetric information problems for consumers such as explaining the main features and risks of specific products and providing expert recommendations.

(e) **Credit checks**. The intermediary could conduct credit checks of the potential borrower on behalf of the lender.

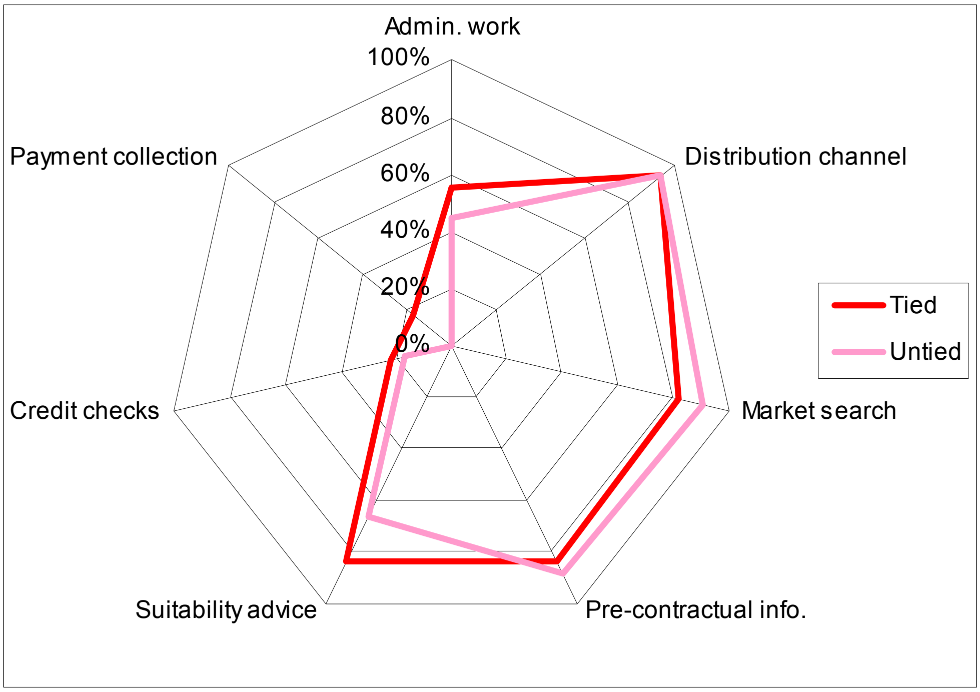
(f) **Administrative work**, conducted for borrowers and potential borrowers. This includes activities such as preparing standardised contracts, collecting applications and other relevant documents from the potential borrowers, and generally being engaged in other administrative duties.

(g) Finally, an intermediary can **collect payments** by borrowers on behalf of the lender.

Activities undertaken for consumers and lenders

5.31 Figure 5.6 illustrates the views of stakeholders on the activities that mortgage intermediaries undertake.

Figure 5.6: The activities of mortgage intermediaries for consumers and lenders



Source: Surveys (based on 36 stakeholder views)

5.32 At this aggregated level, there is surprisingly little difference between tied and untied intermediaries. That said, the balance between activities undertaken for lenders against those undertaken for borrowers is, to a small degree, more significant in the case of tied intermediaries. In other words, most of the intermediaries covered by the survey face both ways (as one would expect of an intermediary), but the tied intermediaries tend to be more tilted towards the lender perspective.

5.33 A stark example of this is in connection with money-handling activity (i.e. the collection of payments, the transfer of funds, and so on) — indeed, our evidence indicates that such money-handling activities are prohibited in Austria, Hungary and Italy. Our findings suggest that, where it is not so prohibited, it is not widespread in the context of mortgage intermediaries and that, to the limited extent that it is present, it is restricted to those intermediaries with product ties with a particular lender.

5.34 Similarly, our study suggests that credit checks on the borrower do not feature heavily in the activities undertaken by mortgage intermediaries (a notable exception identified in our survey are tied mortgage intermediaries operating in the Belgian market — however, the responsibility for the actual credit assessment stays with the lender under Belgian law).

5.35 On the other hand, the market search function is slightly more pronounced where the intermediary is nominally independent. However, the apparent evidence that tied intermediaries are more involved in the provision of suitability advice is perhaps counter-intuitive as one would expect independent intermediaries to be the most focused on the provision of services to consumers.

5.36 That market search also figures prominently as a role for the tied intermediaries is not surprising as a residential mortgage represents the most important investment in the lifetime of most households, thus, reaching a price competitive agreement is of key importance to consumers.

5.37 This can be significant. For instance, *The Value of Mortgage Advice (2008)*[67] (based on then current market conditions), estimated that the average initial rate achieved by a borrower by approaching a lender on a direct basis was 6.31 per cent, with the equivalent rate achieved through a mortgage intermediary being 5.48 per cent. Under various scenarios (not repeated here), there was an average annual saving achieved from purchasing via an intermediary with a reported value of these savings achieved by intermediaries for their clients of between £1 billion and £1.2 billion per annum.

5.38 For consumers, in addition to a reduced market search cost (and the potential benefit from securing a less expensive mortgage than would be the case without search), there is alleviation of the consumers' asymmetric information problem (i.e. the relative importance of the recommendation of suitable products and the explanation of pre-contractual information, i.e. so making the mortgage market more transparent for consumers. Of intermediated mortgage sales in the UK, fully 92 per cent were advised, as opposed to 40 per cent of direct sales).[68]

5.39 In addition, our case studies relating to the German and UK mortgage markets indicate that increased intermediary penetration plays a role in increasing product choice, in part at least by promoting market entry by new mortgage providers (specifically those that lack a branch network).

5.40 The generation of leads is clearly an important activity from the perspective of lenders. Indeed, a view repeatedly expressed by lenders in our survey was that the use of intermediaries added an additional distribution channel at little or no initial cost. In particular, the sunk cost of a branch network can be avoided. In addition, enhanced customer acquisition may come from mortgage intermediaries being potentially more motivated than sales staff employed directly by the lender (due to a remuneration structure more focused upon commission than salary).

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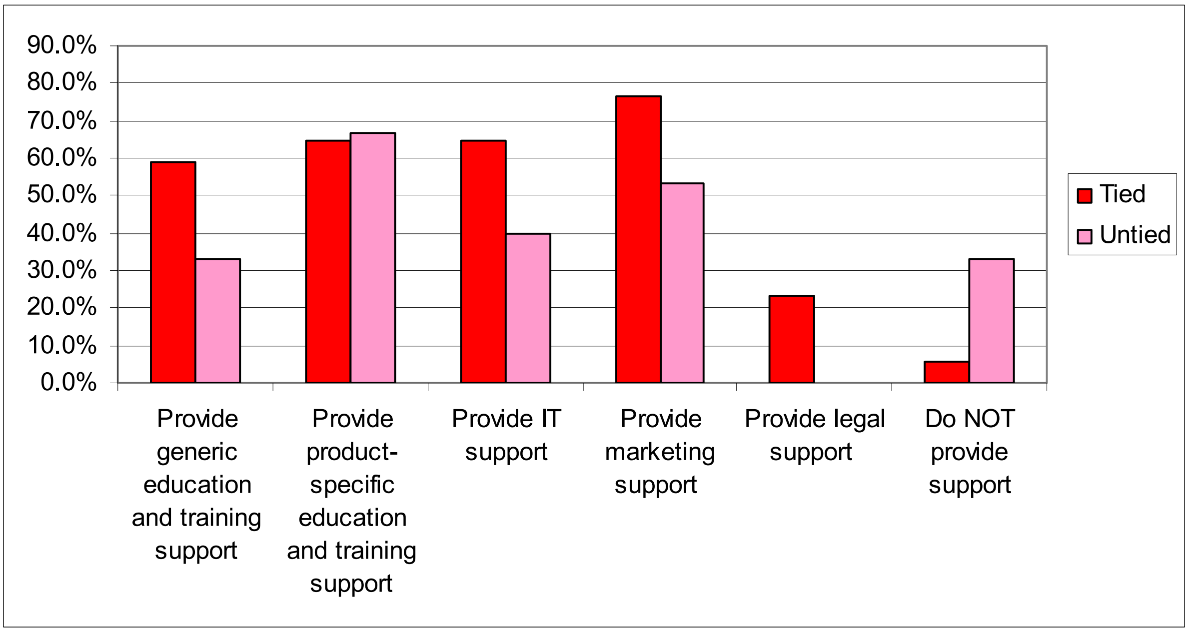
67 Conducted by NMG Financial Services Consulting on behalf of the Association of Mortgage Intermediaries.
68 PSD Data, FSA March 2008

Lender support

5.41 It is clear from the above that both broad categorisations of intermediary (tied and independent) have a close relationship with lenders. A more marked difference between tied and united intermediaries is observable when one looks at the question of the type of support that intermediaries receive from lenders.

5.42 As Figure 5.7 shows, tied intermediaries are more likely to receive education and training (both generic and product specific), IT and marketing support and legal support. In contrast, only a small fraction of mortgage intermediaries (all untied) receive no support at all (Spanish participants in the survey were an exception, with support provided by all lenders to both categories of intermediary). The support to untied intermediaries is mostly geared to the promotion of specific products and execution (IT support).

Figure 5.7: Support provided to intermediaries by lenders



Source: Surveys (based on 30 stakeholder views)

The remuneration of intermediaries

5.43 In order to draw a comprehensive picture of intermediation business models we have also investigated different forms of remuneration adopted by mortgage intermediaries. We have distinguished remuneration schemes aimed at charging lenders (upstream remuneration) from those used to charge consumers (downstream remuneration). The key forms of upstream remuneration are listed below:

(a) **Fixed fee:** a fee which is paid irrespective of whether a contract agreement is actually signed.

(b) **Ongoing client retention (risk-sharing) fee:** a periodic fee paid within the period in which a client is honouring his contractual duties.

(c) **Fixed commission on drawing down of credit:** a fixed commission paid each time a credit agreement is signed.

(d) **Volume based commission:** a commission which depends on the size of credit agreed upon in the contract.

5.44 Downstream remuneration may include:

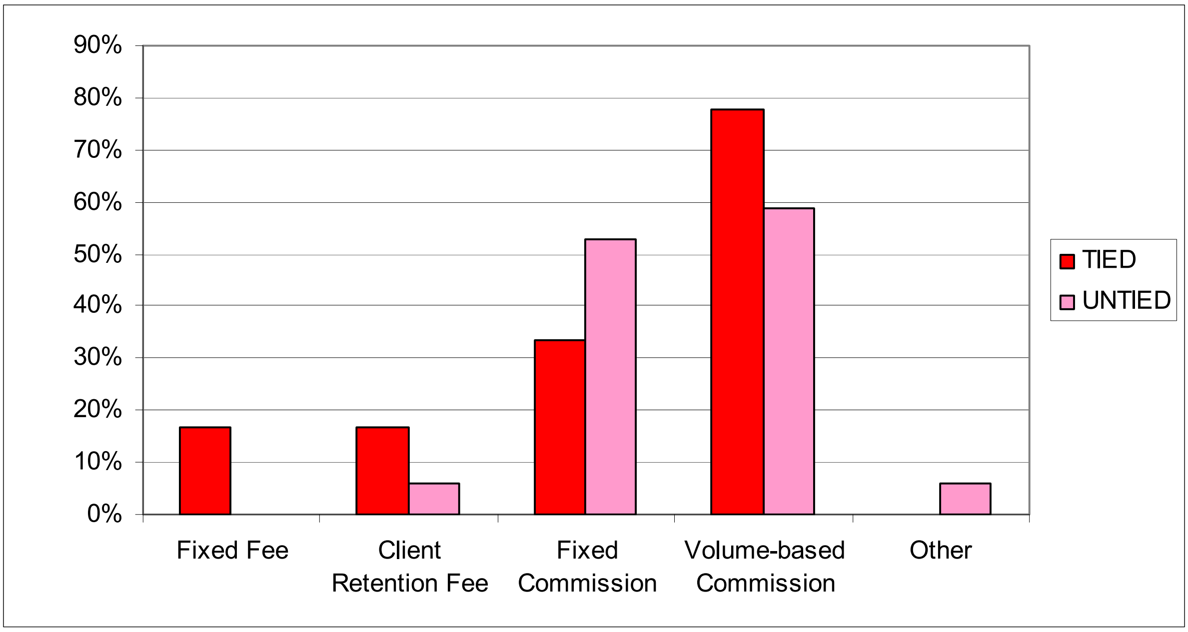
(a) **Fixed fee:** a fee which is paid irrespective of whether a contract agreement is actually signed.

(b) **Variable fee:** a fee linked to the time spent with the intermediary.

(c) **Volume based commission:** a commission which depends on the size of credit agreed upon in the contract.

5.45 The first issue we have investigated is to what extent each side of the market (lenders and borrowers) is actually charged by intermediaries. Only two per cent of the intermediaries covered in our survey charge the consumer only, whilst 59 per cent receive their remuneration only from the lender. Just under two fifths were identified as receiving remuneration from both parties.

Figure 5.8: Comparison of upstream remuneration of tied and untied models



Source: Surveys (based on 34 stakeholder views)

5.46 A first important point is that there is a significantly higher relative importance played by volume-based commission for tied intermediaries. This is explainable by the fact that, since tied intermediaries work mainly in the interest of lenders, a remuneration scheme tailored to the amount of credit is an effective way to incentivise high sales volume.

5.47 Second, there is a significantly higher relative importance played by fixed commission for untied intermediaries. Independent intermediaries might be anticipated to be more committed to meet consumers' need (as opposed to tied intermediaries). As a consequence they are also more likely to adopt a compensation scheme that does not speak against this role. A commission based purely on the size of credit increases the misalignment of the intermediaries' incentives compared with that of consumers.

Summary Financial Data on Mortgage Intermediaries

5.48 We set out below our estimate of commission and fee revenues generated by mortgage intermediaries across EU27.

Table 5.4: Range of revenues from mortgage intermediation, 2007[69]

	€m		
Austria	15	-	18
Belgium	36	-	43
Bulgaria	4	-	5
Cyprus	1	-	1
Czech Republic	15	-	18
Denmark	23	-	27
Estonia	0	-	1
Finland	3	-	4
France	347	-	413
Germany	408	-	486
Greece	16	-	19
Hungary	8	-	9
Ireland	122	-	162
Italy	247	-	294
Latvia	1	-	1
Lithuania	0	-	0
Luxembourg	7	-	8
Malta	0	-	0
Netherlands	418	-	498
Poland	7	-	8
Portugal	11	-	13
Romania	28	-	33
Slovakia	6	-	7
Slovenia	3	-	3
Spain	285	-	340
Sweden	5	-	6
United Kingdom	2,925	-	3,075
	4,940		**5,491**

Source: Surveys, EE calculations

5.49 The range of revenues is driven by who the intermediaries are receiving income from: as already noted, this can be both sides to the transaction being intermediated or only one party (when it is typically the lender). In revenue terms, the UK market has clearly been considerably the most important. Whilst the credit crunch is likely to reduce this lead for the UK, it is unlikely to overturn it.

69 This is based upon the survey data received providing average commission levels receivable by intermediaries linked to market shares and market sizes. Where country-specific data has been available (e.g. the UK), this has been used.

Employment and firm numbers in mortgage intermediation

5.50 We set out below our estimates of the employment (in Full Time Equivalents, FTEs) at mortgage intermediaries and the number of mortgage intermediaries (i.e. firms, partnerships and sole traders).

Table 5.5: The number of intermediaries and employment in mortgage intermediation across EU27, 2007[70]

	Inter-mediaries	Employment (FTEs)		
	000s	000s		000s
Austria	0.1	0.1	-	0.3
Belgium	0.2	0.4	-	0.6
Bulgaria	0.0	0.1	-	0.1
Cyprus	0.0	0.0	-	0.0
Czech Republic	0.1	0.3	-	0.4
Denmark	0.1	0.2	-	0.4
Estonia	0.0	0.0	-	0.0
Finland	0.0	0.0	-	0.1
France	0.6	2.3	-	3.3
Germany	0.8	2.7	-	4.6
Greece	0.1	0.3	-	0.4
Hungary	0.0	0.1	-	0.2
Ireland	0.6	1.2	-	2.3
Italy	1.1	2.5	-	4.2
Latvia	0.0	0.0	-	0.0
Lithuania	0.0	0.0	-	0.0
Luxembourg	0.0	0.1	-	0.1
Malta	0.0	0.0	-	0.0
Netherlands	1.4	4.2	-	7.1
Poland	0.0	0.1	-	0.2
Portugal	0.1	0.2	-	0.3
Romania	0.2	0.5	-	0.7
Slovakia	0.0	0.1	-	0.1
Slovenia	0.0	0.0	-	0.1
Spain	0.8	2.9	-	4.9
Sweden	0.0	0.0	-	0.1
United Kingdom	7.1	29.2	-	34.2
	13.3	47.6	-	64.5

Source: Surveys, EE calculations

70 These figures are based upon what public data is available, supplemented by estimates based upon data on revenue per employee and average headcount data, from both our survey and the Amadeus database of Europe's largest 7 million companies, in combination with the revenue estimates already described.

5.51 It is clear that the sector is dominated by small and medium sized businesses (i.e. fewer than 250 employees). Intermediaries that are larger than this are relatively rare — for instance, Interhyp, the subject of one our case studies, is a particularly large mortgage intermediary, the market leader in Germany by some distance with in excess of 3 per cent of the total mortgage market (and we calculate 10 per cent of the mortgage intermediary segment). As is illustrated at Table 5.6, Interhyp has just 450 employees.

5.52 There are two factors at play here in keeping the typical size of firms down:

– First, in most of the markets, the actual scale of the opportunity means that to grow a large business is difficult (or impossible).

– Second, this remains very much a “people business” with limited barriers to entry and exit (particularly in those markets where specific regulation is limited or even non-existent). This means that an experienced intermediary may find it attractive to set up individually or in a micro-business rather than continue in a corporate setting, with the nature of the business restricting the cost impact arising from economies of scale (i.e. a small business is likely to be able to compete on cost with a larger one). The businesses being budded from are in any event often relatively small themselves (so that the advantage of a pre-existing brand name, say, is reduced). Inevitably, much of this budding off is likely to be led by the more successful intermediaries. This means that barriers such as acquiring access to distribution agreements with lenders should be reduced. The costs of market entry may have been further reduced by technological innovation, as described at 5.63 below.

– Third, as has already been identified, many mortgage intermediaries are non-specialists. In other words, those acting as mortgage intermediaries may not be a majority of the complement of those businesses. Indeed, in a non-specialist sole trader the FTE acting as a mortgage intermediary may be less than one.

Cost structure

5.53 As noted above, we have used the Amadeus database to support our work on employment in the mortgage intermediary sector. However, the characteristic small-scale of the businesses means even Amadeus will not pick up all of the businesses operating as intermediaries. Rather more importantly, the disclosure of what are nearly always private operations is generally quite limited.

5.54 However, before discussing cost structure and profitability, we contrast two, relatively extreme, cases in terms of size, below.

Table 5.6: Cost structure and profitability

	Interhyp (Germany)	**Small specialist mortgage broker (Ireland)**
Value of mortgages (€ m)	5,700.0	50.0
Volume (000s)	39.3	0.3
Average mortgage value (€ 000)	145.0	150.0
Revenue (€ m)	75.0	0.3
EBIT (€ m)	27.0	0.2
EBIT %	36.0%	66.7%
Average commission	1.32%	0.60%
People	450	3
People cost as % of revenue	39.0%	80.0%

Source: Surveys, Interhyp financial report (2007).

5.55 The size of commission payments is clearly a highly sensitive piece of data, and there has been some reluctance to share this information with us. From what we have seen, there is substantial variation in commissions intra-country and, to a lesser extent, between countries. Subject to these qualifications, the data we have indicates that lender commissions would be typically in the range of 0.55–1.0[71] per cent of the mortgage loan value. Where the borrower pays as well (which our survey suggest is in about 40 per cent of cases), such fees would be normally at a lower level than this. For instance in the UK downstream fees may average about half the level of upstream remuneration.

5.56 The key cost is payroll (including bonuses payable). In the case of Interhyp above, just over 60 per cent of operating costs are payroll-related. A substantial part of the other costs incurred are payable to partners, including other intermediaries, and are therefore likely to also be payroll related.

[71] The only whole of market data available on this is from the UK (the FSA) with upstream remuneration being equivalent to about 0.55 per cent of UK mortgage values intermediated.

5.57 The key driver of the flexibility of the cost base of intermediaries generally will therefore be local employment conditions (when recruiting) and local labour legislation (when down-sizing).

Drivers of profitability

5.58 There are a number of drivers of profitability. In particular, we have examined the following:

(a) The characteristic relationships in the market (i.e. do borrowers tend to build relationships with lenders, with intermediaries, both or neither). Capturing the relationship with the borrower will, all else being equal, increase the market power of that party.

(b) The level of competition between lenders and between intermediaries. These were then compared to establish a relative measure.

5.59 We have modelled the combined impact of these two measures, and the table below presents the results. We have not included those Member States where intermediary market share is understood to be limited in this exercise. On the one hand, robust data is not available and it is unlikely, in any event, to be revelatory in that where the intermediaries do not represent a significant alternate distribution channel, their negotiating position is unlikely to be strong.

Table 5.7: Remuneration levels

Expected below average remuneration (below 1 per cent of loan value)	Expected average remuneration (between 1 per cent and 1.25 per cent of loan value)	Expected above average intermediary remuneration (above 1.25 per cent of loan value)
Germany Ireland UK	Austria Czech Republic Italy France Netherlands Romania Spain	Bulgaria Portugal Slovakia

Source: Surveys.

5.60 This exercise ties in closely to our analysis of intermediary revenues, with the exception of Germany (where our survey results indicate actual revenues being at the average level, i.e. higher than predicted) and Portugal (where our survey results indicate actual revenues being at the average level, i.e. lower than predicted).

5.61 Another factor, of course, is market structure. Trivially, a large intermediary in a particular market (such as John Charcol in the UK or Interhyp in Germany) has a much enhanced competitive position compared to an operation of two-three individual intermediaries. This will also impact upon profitability at the individual business level. The only market that we are aware of where the intermediaries are significantly concentrated is Slovakia. This has been reflected in the above table.

Credit crunch

5.62 However, as already noted, current market conditions are likely to have a significant impact upon the volume of mortgage credit being intermediated in the markets affected. This is likely to result in market exit and reduced employment. The box below is an extract from one of case studies illustrating this point.

Box 5.2: The UK mortgage intermediary industry and the credit crunch

In the context of the recent adverse developments in the credit markets, there has been a very significant decline in the level of product offerings in market. In particular, a report by the London School of Economics (LSE) stated that there has been a decline in the number of product offerings in the sub-prime sector of approximately 80-85 per cent, about a 50 per cent reduction in the buy-to-let segment and significant reductions in self-certification mortgages. This means that the reductions have been focused in those product areas where intermediaries play the most significant role in the UK (indeed, according to the Intermediary Mortgages Lenders Association, both sub-prime and self-certification loans are almost exclusively sold via intermediaries rather than direct through lenders' branches).[72] This has reduced the value of the search function played by intermediaries. Curiously, the first quarter of 2008 saw an increase in intermediation penetration in the mortgage market up to 80 per cent of first time buyers, although this had dropped back slightly to 78 per cent in Q2.[73] This is not expected to continue, and, anyway, was on markedly reduced volumes.

According to the UK FSA itself, it has not been particularly surprised or concerned by the recent developments — it is seen as a result of expected changes in the risk appetite of lenders. John Charcol has noted that recently lenders had increased the difference between the terms of the products on offer at their own branches and those of the products available to intermediaries. For instance, some mortgage products offered at lenders' branches are 50 basis points cheaper than that available at intermediaries. John Charcol believes that lenders are trying to feed their own branches and control the flow of business, given the different business environment. However, it noted that so far such price differentiation has not been effective, which may suggest the value in the brands and services provided by intermediaries.

John Charcol does not expect that there will be much improvement in market conditions this year. Further, it believes that lenders will continue to control products rather than boosting product development which will mean that the rate at which innovative products are released onto the market will slow. There is a sense that the balance of power between lenders and intermediaries has switched to the favour of the former. March 2008 may have represented a further inflection point, with the impact of the

72 The mortgage market just needs a good dose of confidence, 15 October 2007, IMLA.
73 CML data.

credit crunch being felt more profoundly subsequent to the near collapse of Bear Stearns and its subsequent rescue by JP Morgan.

At the end of June 2008, John Charcol announced that it would close three offices in the UK as well as reducing its permanent headcount by around one quarter. As part of this significant cost reduction program, the Chief Executive and Chief Financial Officers left the business.

Some specialist lenders are likely to exit the market (these tend to lack branch networks, and are therefore dependent upon the mortgage intermediary channel). On the other hand, banks with branch networks need a *de minimis* volume of business — it is not clear yet whether this will favour intermediaries, or whether these players will prioritise direct business. The downturn in the housing market has resulted in a greater emphasis being placed upon credit risk over the life of the mortgage. The sharp reduction in sub-prime product offerings and the increased requirements for equity[74] indicates that lenders are now consciously seeking lower risk business than previously (which according to the standard theory of finance is associated with lower returns than would otherwise be the case[75]).[76]

Source: Case study, see the next Section.

Technological developments

5.63 The growth of the mortgage intermediary market has created the need for a more efficient mechanism by which to coordinate the services of intermediaries and lenders. Some trends suggest the move of the mortgage intermediary market towards a 'platform' world, whereby lenders and intermediaries are brought together under a unified matching system. Such platforms also provide extra value-added services such as securitisation, data management, pre-closing and consumer relationship management.[77]

5.64 These developments, with the increasing emergence of platforms such as eHYp, europace and Mortgage Brain, may lower the barriers to covering the whole of the market (or at least sufficient lenders to proxy for this).

5.65 There is the possibility of the expansion of Europace through a joint venture between Hypoport and Stater NV (Holland's largest independent mortgage intermediary) to bring Europace into the Dutch market. As the Netherlands has one of the largest and most developed mortgage intermediary markets in the EU[78] this venture is a sign both of the value of a platform such as Europace to an established mortgage intermediary market, and of its potential to influence future growth in Germany.

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74 See, for instance http://www.moneymarketing.co.uk/cgi-bin/item.cgi?id=175872&d=340&h=341&f=342. This describes the withdrawal from the market of a 85 per cent mortgage by a leading mortgage provider in the UK.

75 See, for instance, the Capital Asset Pricing Model.

76 Once the market bottoms, the demand for sub-prime is likely to be higher (assuming that any recession results in more people with impaired credit histories). Similarly, there is likely to be a strong demand for >100 per cent mortgages (which have essentially ceased to be available in the UK) in response to collapsed house prices leading to negative equity situations (and without >100 per cent mortgages, moving house — say for a new job — would become impossible).

77 Mercer Oliver Wyman (2007) "European Mortgage Distribution: changing channel choices"

78 Mercer Oliver Wyman (2007) "European Mortgage Distribution: changing channel choices"

5.66 It is possible that the use of such technology will spread throughout the EU, bringing together mortgage markets in an efficient and cost-effective way and facilitating their increased integration.

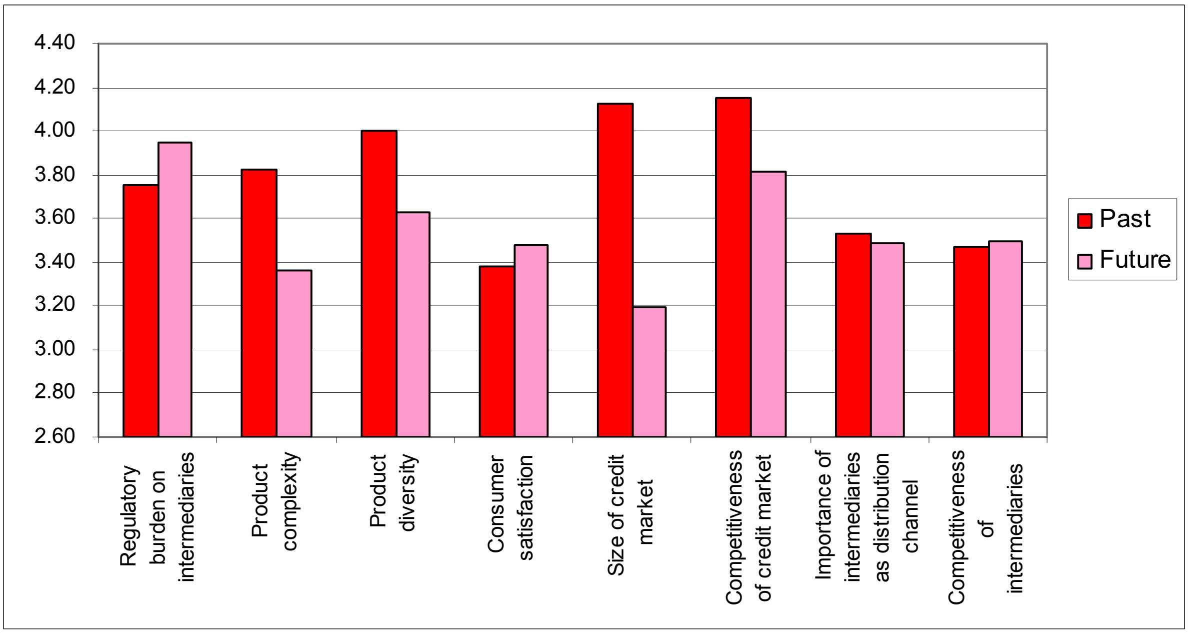
5.67 Most large intermediaries are using a multi-channel approach, i.e. the interface with consumers is partly through face-to-face contact, but frequently supplemented with at least one of a telephone- or internet-based interface. Both the John Charcol and Interhyp case studies illustrate this point.

Developments

5.68 The figure below illustrates the views of stakeholders — mortgage intermediaries, lenders and regulators — in regard to how several features relevant to intermediation of residential mortgages have changed over the past five years and how the same features are expected to change over the next five years.

5.69 It should be noted that these results are based upon data gathered between April and July 2008. As such, they will self-evidently not reflect the recent credit market turbulence (particularly that ensuing from the collapse of Lehman Brothers in September 2008 to date) and the associated change in sentiment concerning the short- and medium-term prospects of the economic situation across the EU27.

Figure 5.9: Trends in the Market for Residential Mortgages



Source: Surveys. Stakeholders were asked to rank features using a score of 5= significant increase, 3=stable and 1= significant reduction.

5.70 Respondents across the EU27 considered that there had been a minor increase in regulation of mortgage intermediaries in the past five years and expect a further step-change in regulation in the future. This future anticipated increase in regulatory burden is, however, driven by the announced legislation in Belgium, Spain and Slovakia. This is described in Section 4.

5.71 It is evident that the credit crunch is expected to transform the market for residential mortgages from one of extremely strong growth to one in which growth is far more gradual. Indeed, an interview with the Council of Mortgage Lenders in the UK revealed that the strategy of mortgage providers has changed from a volume-driven one to the large product portfolio lenders now aiming to achieve responsible, low-risk lending at least in the UK. The credit crunch is, therefore, likely to cause the predicted fall in the growth rate of product complexity and diversity.[79] This is because when narrowing their product portfolio, lenders will begin by removing the most high risk products.

5.72 It is interesting to note that the correlation between individual stakeholder responses for the expected future trends of product diversity and product complexity is 71 per cent. This provides strong support for the idea that increased diversity of residential mortgage products entails increased complexity. In addition to this close link between the trends themselves, the trends in complexity and diversity could be closely linked to the trend in market competitiveness.

5.73 The link with market competitiveness could operate in two directions. Firstly, as the market becomes more competitive mortgage providers may find it necessary to provide innovative products so as to differentiate themselves from the crowd and attract customers. Alternatively, mortgage providers may develop complex products for other reasons and this could then be seen as making the market more competitive, especially if some of the complex products have been developed by market entrants. One might expect that as mortgage products become increasingly complex and diverse, the importance and competitiveness of intermediaries would increase. There are several reasons for this, including the fact that consumers generally find it difficult to understand complex products and therefore cannot determine which product represents the best value and is most appropriate for them.

5.74 That the future trends in importance and competitiveness of intermediaries are not expected to differ from those of the past may appear counter-intuitive in light of current market conditions. To explain this, it is important to remember that intermediaries serve functions for both consumers and lenders. Due to the credit crunch and its subsequent negative impact on product complexity and diversity, intermediaries may arguably be of less value to consumers over the next few years than they have in the past. On the one

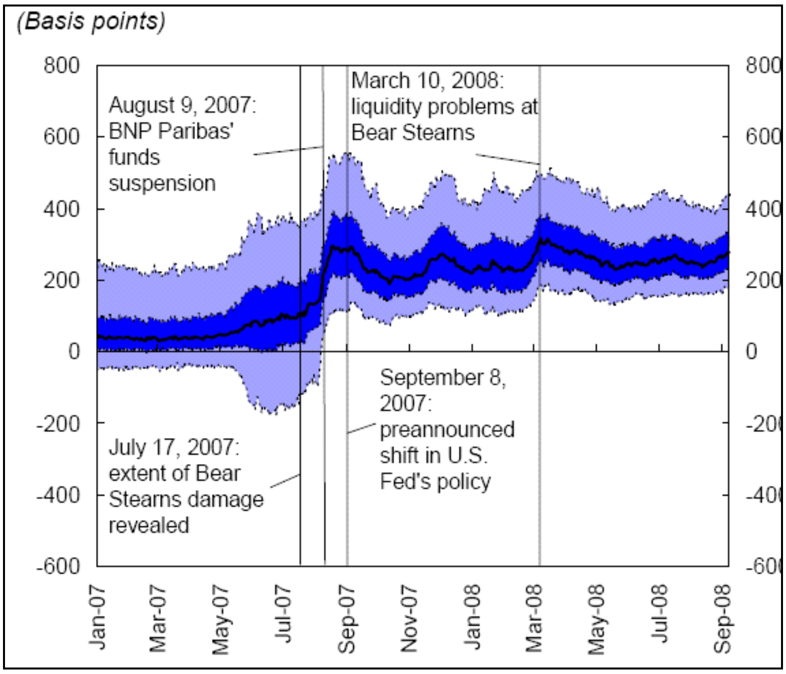
[79] In this context, diversity refers to an increased variety of products. Increased variety is generally good for consumers because it increases number of products from which they can choose. However, increased variety may come at the cost of increased complexity. This is certainly true for residential mortgage products.

hand, it is possible that the value of the search function that they conduct on behalf of consumers would be reduced in such circumstances. On the other, of course, it is possible that a mortgage intermediary could be of additional value, by making the difference to the borrower between securing a specific credit product or not (the actual effect will be dependent upon the extent to which product diversity is reduced).

5.75 However, the value of intermediaries to lenders is unlikely to be adversely affected by the credit crunch and may in fact increase. In particular, mortgage providers may begin to see greater value in the typical intermediary activities of generating leads and promoting their products when the number of customers seeking mortgages decreases.

5.76 One important aspect of recent market developments is that risk has been re-priced upwards (meaning that the relative price of particular credit products has changed) and the price relation has become more volatile. This is illustrated below. The result is that the assessment of suitability of a particular credit product has become more complex and difficult than previously (for both potential borrowers and intermediaries).

Figure 5.10: The estimated global price of risk, 2007–2008



Source: Lombardi and Sgherri, based upon Bloomberg LP and IMF staff calculations[80]

80 Lombardi, M. J., and Sgherri, S (forthcoming), "A Global Repricing of Risk or New Episodes of Financial Contagion?" IMF Working Paper (Washington: International Monetary Fund)

5.77 In addition, the direct and indirect impact of the credit crunch is not being felt equally across the EU27. In particular:

(a) countries experiencing declining house prices after previous booms (e.g. Denmark, Ireland, Spain and the United Kingdom) are expected to see the sharpest economic downturns (Hilbers et al, 2008);[81] and

(b) the IMF notes in its October 2008 Regional Economic Outlook on Europe,[82] that for the emerging economies extent of the slowdown varies considerably across the region, depending on the speed of the earlier expansion, the resulting external imbalances, and the stance of macroeconomic policies.[83]

The Regulatory Framework across EU27

5.78 Intermediaries arranging credit for individuals seeking to purchase a property are typically subject to a level of regulation (where applicable), normally at least at the level applied to the other categories. We have described at Section 4 our approach to the determination of the boundaries between each of these categories of regulation.

5.79 We repeat our categorisation of Member States' regulation of mortgage intermediaries below for the reader's convenience.

Table 5.8: Regulation of Residential Mortgage Intermediaries

No or limited explicit statutory regulation of mortgage intermediaries	Moderate level explicit statutory regulation of mortgage intermediaries	Significant explicit statutory regulation of mortgage intermediaries
Belgium,[84] Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia,[85] Spain,[86] Sweden	Bulgaria, Germany, Italy, Portugal, Slovenia	Austria, Hungary, Ireland, Malta, Netherlands, UK

Source: Surveys, Interviews, EE analysis.

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81 Hilbers, P, Hoffmaister, A, Banerji, A and Shi, H (2008), "House Price Developments in Europe: A Comparison," IMF Working Paper 08/211 (Washington: International Monetary Fund).
82 http://www.imf.org/External/Pubs/FT/REO/2008/EUR/ENG/ereo1008.pdf
83 The IMF classifies Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and the Slovak Republic (as well as a number of non-EU members) as "emerging" economies.
84 Belgium has a draft law which would aim to bring mortgage intermediaries under statute and introduce the same level of consumer protection to an intermediated sale as applicable in the case of a direct sale.
85 Mortgage intermediaries in Slovakia have a voluntary code of conduct. Slovakia is expected to introduce legislation in 2009 which will, amongst other things, require mortgage credit intermediaries to be regulated
86 Spain is expected to introduce legislation in 2009 which will, amongst other things, require mortgage credit intermediaries to be regulated.

5.80 We return to this categorisation later in this section when we seek to identify the linkages between the regulatory environment and the potential for consumer detriment. We produce an extract from one of the case studies at Section 6 below which describes in more detail the transition in the UK from a self-regulatory framework to regulation by the UK financial regulator, the UK FSA.

Box 5.3: The UK mortgage intermediary industry and regulatory change

It is believed by the intermediaries themselves that the self-regulatory framework in place (i.e. the Mortgage Code Compliance Board (MCCB)) prior to UK FSA regulation, did a very good job of introducing regulation into a market that previously had had none. However, it is conceded that there were inevitably limits to what self-regulation could achieve given the limited powers of enforcement. It is worth noting that the move to UK FSA regulation drew heavy criticism from both lenders and intermediaries, as it was felt the UK FSA was exceeding the remit given to it by HM Treasury.[87]

The UK FSA identified four key issues for regulation in this area:

- Poor information
- The inability of consumers to use information effectively in the decision-making process
- Improper sales tactics (specifically regarding concerns over the treatment of customers in arrears)
- Regulatory gaps (there was particular concern regarding the piecemeal approach to regulation at the time as some mortgage lenders were subject to regulation while others only to the voluntary code).

With regards to the comparative efficacy between the MCCB and the UK FSA regulatory frameworks, it was noted by some survey respondents that when comparing what the different requirements delivered relative to the cost of the system, it is hard to justify the extra cost of the UK FSA statutory regulatory regime given what the system delivers in return. However, it is believed that the UK FSA regime has done a lot to improve consumer protection in the market especially with regards to establishing a central body to which consumers can complain and seek compensations from. From the industry perspective on the other hand, it is thought that the old system functioned and performed well and that the question now is what can the UK FSA do differently.

Of course, it is also correct that the regulation of mortgage credit intermediaries has coincided with the continuation of rapid house price inflation, and since late 2007 deflation. It is obvious then that many of those UK mortgage holders facing negative equity will have acquired mortgages from intermediaries under UK FSA regulation (i.e. those buying from November 2004 through to, say, late 2007). In this sense, UK FSA regulation has not prevented the detriment arising.

In general, practitioners prefer principles-based regulation. Instead of singling out intermediaries as a group of entities to be subject to special regulations, the UK FSA regulates relevant *activities*, namely arranging or advising on a regulated mortgage. The regulatory regime is neutral, not favouring one distribution channel over another, which means, for the same activity, lenders and intermediaries will be subject to the same regulations.

Source: Case study, please see next Section

87 http://www.cml.org.uk/cml/policy/issues/271.

Regulatory initiatives

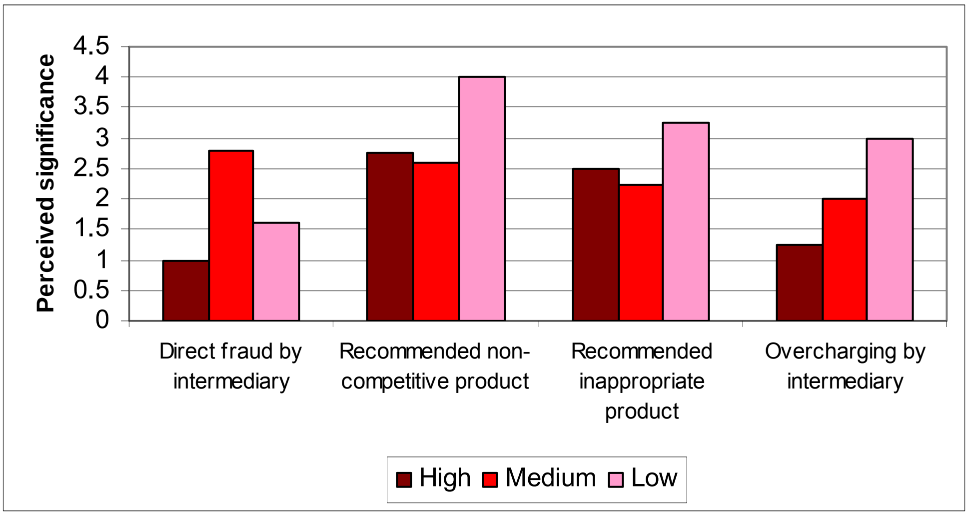
5.81 We have identified in Section 4 the proposed regulatory changes in Belgium, Slovakia, Spain and the UK.

Consumer Detriment

Introduction

5.82 This section should be read in conjunction with our analysis at Section 4. We compare below the broad categorisations of the divergent regulatory frameworks that we describe in Section 4 and compare these to the perceived significance of particular forms of potential detriment below, as identified by the consumer associations and regulators which made this assessment as part of our survey.

Figure 5.11: The perceived significance of specific sources of consumer detriment in mortgage intermediation according to our analysis of the level of explicit regulation

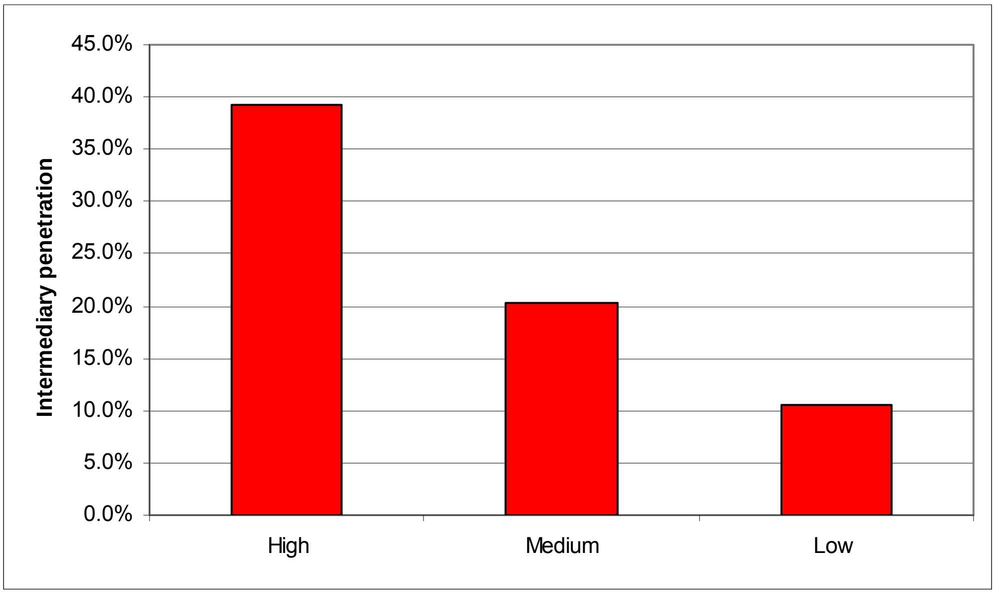


Source: Surveys, EE analysis. 5 = high perceived significance, 1 = no or negligible perceived significance

5.83 The above chart indicates a weak correlation between a higher level of regulation and a lower perceived significance of a particular form of consumer detriment (the perception of significance is higher where we have found a "low" level of regulation by comparison to where we have found a "high" level). Of course, the perceptions of the respondents may have been influenced by the regulatory structure. In other words, pre-conceptions about the likely risks associated with an unregulated environment may bias the assessment of the potential risk. The results should be viewed in this context. That said, the perceived significance of recommending a non-competitive product is strikingly high where regulatory intensity is low.

5.84 Before discussing the potential sources of detriment, we compare below the degree of mortgage intermediary penetration in the mortgage credit market and the degree of regulation according to our classification.

Figure 5.12: Mortgage intermediary penetration and our analysis of the level of explicit regulation



Source: Surveys, EE analysis

5.85 There is a clear correspondence between the degree of regulation and the level of penetration. Most of the countries with a high degree of regulation — in particular, the UK, the Netherlands and Ireland — have a relatively long history of significant market penetration by mortgage intermediaries. Certainly, the above chart is consistent with the idea that regulatory action in this area is attracted by increasing prevalence of intermediaries as a distribution channel. For those Member States such as the UK, the Netherlands and Ireland, it is hard to sustain the thought that the regulation of mortgage intermediaries has been a significant cause of market exit for those intermediaries.

5.86 The figure below shows how the perceived significance of consumer detriment changes with respect to the intermediaries' status (i.e. whether tied/untied). Member States where tied mortgage intermediaries are in the majority are perceived as having far more exposure to the recommendation of non-competitive products to consumers. The same applies to the overcharging of consumers.

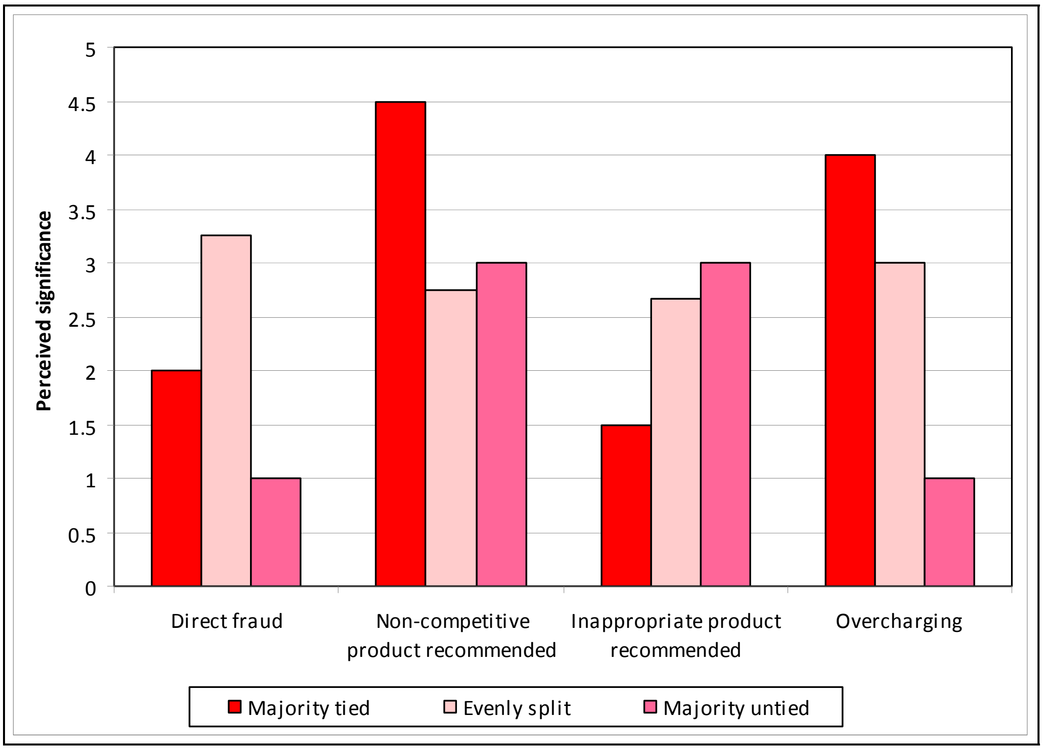
5.87 The intuition for this result is that, as opposed to independent intermediaries, tied intermediaries propose a smaller range of products to customers. This increases the risk of consumers making a purchasing choice with a limited knowledge of the entire options available in the market. As a consequence of the limited market searching contribution[88]

[88] It is important not to confuse market searching with the activity of searching among products. For instance, tied intermediaries are also highly involved in searching for products for consumers — however the range of products across which they are allowed to search is limited by their ties to a limited number of lenders.

of a tied intermediary, it is also more likely that consumers perceive the price paid for the intermediation service as being excessively high.

5.88 Instead, where independent mortgage intermediaries are in the majority, the recommendation of inappropriate products is perceived as a greater concern. We believe two factors are at play here. The first is the idea we identified at paragraph 4.85, whereby an untied intermediary may have less knowledge about specific products compared to a tied intermediary, due to the lower level of product education and training received from lenders. Secondly, consumers may be more inclined to follow the advice of an untied intermediary because his or her independence from particular lenders is perceived as impartiality. However, the widespread use of commissions, including amongst independent intermediaries, can create incentives that act against wholly impartial advice.

Figure 5.13: Perceived detriment and industry structure



Source: Surveys, EE analysis

Direct fraud

5.89 Direct fraud is a specific form of detriment for two reasons. First, it is not directly related to a market failure, but is instead the consequence of criminal behaviour by the intermediary. Second, it typically harms, in practice, lenders rather than consumers. Where the lender is reliant on the probity of the mortgage intermediary to reliably prepare documentation and, in particular, to assess (or at least be the conduit for information about) the income level of the potential borrower, there is some potential for the intermediary to mis-state the applicant's income. The motivation would be the commission due to the mortgage intermediary.

5.90 The UK FSA says the problem of mortgage fraud has become widespread in recent years because of "easy credit conditions and streamlined application processes" and has called on lenders to apply stricter protocols.[89] Given that market conditions in the UK are very different from those that held sway over the past few years, a market response seems probable anyway as lenders switch from volume-driven strategies towards greater focus upon quality of risk (the UK has seen sharp reductions in the availability of self-certification mortgages, for example).

5.91 On the other hand, of the mortgage-related complaints made to the UK's Financial Ombudsmen Service, just two per cent related to intermediaries.[90]

5.92 We present below some specific examples.

Examples

Česká spořitelna, the largest Czech bank, is concerned that intermediaries sign deals with customers who have weak credit histories and are more likely to make payments late. Indeed, press reports of April 2008 state that mortgages sold through brokers are seven times more likely to be delinquent than the ones sold at Česká spořitelna branches, a fact which is disputed by brokers. The bank has had bad experiences with some external associate brokers and so has amended contracts by inserting clauses that enable the bank to test clients referred to them by brokers more thoroughly. It has also decided to limit its contact with external mortgage brokers.

5.93 As of July, 17 mortgage intermediaries have been banned for fraud in the UK during 2008 whilst another 24 "live" cases are being investigated by the UK FSA.[91] The UK FSA is targeting another 200 firms to ensure that appropriate checks are in place. In terms of some specific examples:

In one case, the UK FSA banned three East London brokers — Muhammad Adnan Ashraf and Muhammad Asim Iqbal, directors of OCS Property and Financial Services Limited and Mohammed Atif Mayo, a director of Mac & Mayo Property Services Limited — for supporting false mortgage applications to lenders with false or misleading documents. The UK FSA also cancelled the trading permission of both companies.

Mr Ashraf submitted a mortgage application in his own name that contained false income details and was supported by an illegitimate copy of a driving licence. Mr Iqbal submitted mortgage applications to lenders which were based on false information. In nine applications, the financial accounts used to support customers' mortgage applications contained identical figures, despite the accounts being for different types of business and apparently being prepared by three different accountants. Mr Iqbal also provided false and

89 http://www.fsa.gov.uk/pages/About/What/financial_crime/fraud/key_issues/mortgage/index.shtml.
90 AMI.
91 http://news.bbc.co.uk/1/hi/business/7521601.stm.

misleading information to the UK FSA about the nature of sales undertaken by OCS and the number of accounts that OCS sent to lenders.

Mr Mayo submitted a mortgage application in his own name that contained false information about his income and occupation. This was supported by false payslips from a company of which he had never been an employee. He also submitted to a lender at least one other mortgage application which contained false income details and was supported by false financial statements. Mr Mayo also failed to notify the UK FSA that Mac & Mayo had been removed from the panels of at least six mortgage lenders.

A second example is that of Gordon Benville, an independent financial adviser who traded as Kingsfield in Deal, Kent. Mr Benville was imprisoned for three and a half years after pleading guilty to 16 offences on 11 June 2008. All of these offences were related to his activities as a mortgage broker or financial adviser, twelve of which related to obtaining a money transfer by deception (totalling £440,637) and four were fraud offences. Mr Benville had previously been suspended by the UK FSA and his assets had been frozen.

Recommending expensive and unsuitable mortgages

5.94 One might expect this form of detriment to be particularly present to some extent in this area for two main reasons. First, this type of detriment is likely to be more frequent than others simply because the intermediaries' degree of engagement in providing advice is high. Second, because the typical compensation scheme (i.e. volume-based commission) creates a potential conflict of interest (see Table 4.3). Indeed, many of the consumer associations that participated in our survey expressed the concern that intermediaries can be swayed by commissions payable by lenders to recommend a mortgage product that is either unsuitable to the borrower's personal circumstances or else is not price-competitive. Intermediaries are not typically obliged to disclose such payments to borrowers (however, this is the case in, for example, Ireland), although this may be the custom of individual intermediaries. The existence and nature of the contractual relationship with a lender, if not the remuneration, may also be disclosed.

5.95 Given the scale of the mortgage loans being intermediated, this is a potential issue of some magnitude. Moreover, by the nature of mortgages — generally, since they are credence goods whereby it is not always evident that the product bought was the most suitable until some time after purchase, if at all — the result of purchasing inappropriate or not price competitive products may pass the consumer by. (To give a sense of scale, if one per cent of all mortgages intermediated in 2007 (i.e. about €564 bn) were overpriced by one basis point, the incremental cost to consumers would be €0.5 million.)[92]

5.96 On the other hand, in a competitive market, the scope for such price differentiation should be significantly curtailed. This will be more manifest where the mortgages are less varied (in this case, there may be a trade-off such that a reduced risk of a non-competitively

92 In other words, the product of 1 per cent x 0.01 per cent x €564bn.

priced product may be offset by reduced choice, and perhaps increased difficulties in locating a suitable product). This means that under competitive controls the objective of the commissions payable by lenders to intermediaries is to win business at the expense of other lenders — i.e. it is not to sell non-competitively priced mortgages at the expense of borrowers.

5.97 We now turn to some of the examples of actual detriment that we have been able to uncover. These examples relate to the detriment arising as a consequence of the failure of the intermediaries to alleviate the borrowers' asymmetric information problem. More specifically these are examples in which the intermediaries take advantage of the consumers' asymmetric information about the product characteristics to their own advantage. This issue is likely to extend beyond the Member States from which we have gathered examples.

Examples

The UK FSA fined Robin Knox, managing director for Mortgage and Property Services Limited (MPSL), £17,500 for exposing 500 of his clients to the risk of receiving unsuitable advice. Mr Knox was also banned for lacking competence and capability and for failing to ensure that his firm had proper systems and controls in place and the trading permission of MPSL has also been withdrawn. The UK FSA stated that it would have imposed a more significant fine on Mr Knox, and a financial penalty of £60,000 on MPSL, were it not for his financial difficulties.

The UK FSA found that the firm's advisers recommended mortgages which were unsuitable for the clients' needs and circumstances. This included cases where clients were advised to take out a sub-prime mortgage where it appeared that prime mortgage contracts may have been available.

In a case referred to the UK Financial Ombudsman, the complainants visited a mortgage broker and obtained a mortgage that offered a special rate of interest for the first two years. Towards the end of the two-year period, the broker made an appointment to see them again, to discuss their mortgage options.

He informed the couple that when the two-year deal came to an end, the interest rate on their mortgage would increase and they would then need to pay the lender's standard variable rate. The broker stated that it would be better for them to take out a new mortgage with a different lender. The complainants acted on the broker's recommendation and re-mortgaged. However, some months later they discovered that if they had stayed with the original lender, the rate would not have increased in the way they had been led to believe.

The broker refused to accept responsibility for the costs the couple had incurred as a result of a re-mortgage that had not, as it turned out, been necessary. The complainants referred took the matter to the Financial Ombudsman, which upheld the complaint. It stated that the broker had misled the complainants because he should have carried out a thorough review of the terms of their existing mortgage prior to recommending that they re-mortgage. The broker admitted that he had failed to do this. The Ombudsman stated that the broker should refund the complainants' re-mortgage costs and pay them £150 for the inconvenience he had caused them.[93]

In a case referred to the Irish Ombudsman a woman who had money to invest as a result of a divorce settlement had sought advice from a multi-agency investment broker. Acting on the advice she invested €100,000 in a bond and €51,000 as a deposit on the purchase of two apartments to be built in Liverpool. Her complaint was in respect of the advice to invest €51,000 in the two apartments, where she was advised that she would not have to complete the purchase because the properties in question would be "flipped over" prior to closing and she would then have a handsome profit of approximately €20,000. She handed over the money for the deposit.

Fourteen months later the broker informed her that due to a downturn in the market for apartments in Liverpool, there would not now be any "flip over" and that consequently she would now require a mortgage of €500,000 to complete the sale. She was unable to do this and so forfeited her deposit of €51,000 and was required to pay €3,000 in costs. The broker argued that the individual that arranged the property deal did so in a personal capacity and was not employed by the intermediary. The Ombudsman did not accept that defence and awarded the complainant compensation totalling €40,000.[94]

Over-charging by the intermediary and other forms of potential detriment

5.98 As noted previously, lenders and intermediaries generally have greater financial knowledge than do consumers. This information advantage could allow intermediaries to charge more for their services than is truly justified. This problem is exacerbated if there is a lack of transparency about the full cost that the consumer will incur in order to access credit.

5.99 The other potential causes of consumer detriment could include a failure to conclude an action promised to a consumer and requiring clients to purchase unnecessary products in order to access the mortgage (such as accident-related insurance).

Example

In one case referred to the UK Financial Ombudsman[95], the Complainant took out a mortgage that offered a fixed interest rate for two years, after consulting a mortgage intermediary. Soon after the fixed-rate period ended, she visited the broker again. She asked him to arrange a re-mortgage as she could not afford the new – variable rate – repayments.

On the mortgage intermediary's recommendation, the Complainant took out a 2-year 'tracker' mortgage which means that the mortgage interest rate changes whenever the Bank of England announces a change in its base interest rate. Soon after, the Complainant decided she would prefer the certainty of a mortgage with a fixed rate of interest. The intermediary agreed to arrange this for her but failed to do so.

[93] http://www.financial-ombudsman.org.uk/
[94] http://www.ombudsman.gov.ie/en/
[95] Correspondence from UK Ombudsman representative.

In subsequent months, the Bank of England increased interest rates several times leading to an immediate, corresponding, rise in the Complainant's repayments. The Complainant asked the broker to pay compensation because his oversight had led to her having "the wrong type of mortgage" and was unable to afford the repayments. She further stated that the broker should compensate her for the fact she had not been able to proceed with the purchase of a new flat because of the very high cost of the mortgage repayments.

When the broker refused her request, the Complainant took the matter to the UK Financial Ombudsman. The Complaint was upheld in part. The Ombudsman stated that the broker should pay the Complainant compensation to cover the difference between what she would have paid, if she'd had the mortgage she had asked for, and the total amount she was likely to have to pay over the same period with the 'tracker' mortgage, and should also pay £250 for the distress and inconvenience his error had caused the Complainant. However, the Ombudsman was not persuaded that the broker should be liable for the fact that the increased cost of her mortgage meant she had lost the opportunity to buy the particular property she had wanted. The broker was only ever arranging a re-mortgage, and could not reasonably have realised that this might also affect a separate property purchase.

Cross-border Activity

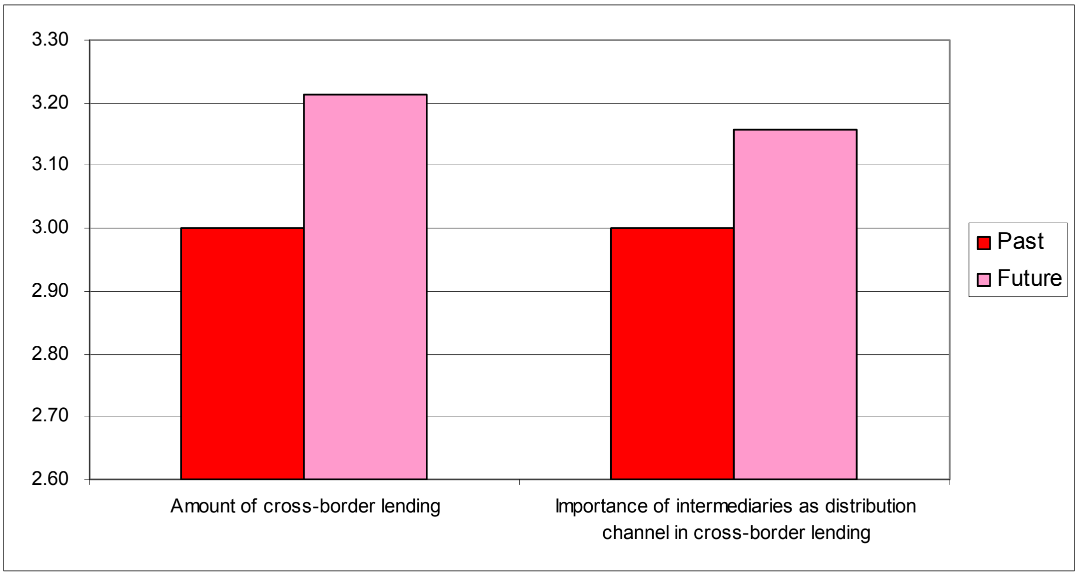
5.100 The extent of cross-border activity in retail banking is very limited. A eurobarometer poll estimated that no more than one per cent of mortgage lending in any one Member State is cross-border (meaning that the borrower and the lender providing the funds were located in separate Member States).

5.101 The figure below identifies the views of stakeholders — including intermediaries, lenders, consumer associations and regulators — on the trends in cross-border activity, and the role of intermediaries within it over the past five and next five years.

5.102 As stated previously, these results are based upon data gathered between April and July 2008. As such, the results may be best seen as a guide to longer term trends rather than necessarily the immediate future.

5.103 In contrast to the anticipated slowdown of domestic mortgage markets over the next five years, cross-border lending volumes were expected to weakly increase, with intermediation expected to become more important as a distribution channel. By contrast, the importance of the role of intermediation in such lending was seen as static over the previous five years. In other words, our survey results indicated anticipated growth in cross-border activity in mortgage lending, with mortgage intermediaries growing in importance as a driver of that increased activity.

Figure 5.14: Trends in cross-border activity



Source: Surveys. A score of 3= stability. 1= significant reduction and 5 = significant increase.

5.104 The views of individual participating stakeholders on the trends in cross-border activity and the role of intermediaries within it were highly correlated (with a correlation coefficient of 89 per cent). The anticipated growth in importance attributed to intermediaries as a distribution channel for cross-border lending is suggestive of a leading, but non-exclusive, role in this development. This ties in with our analysis at Section 13, where lenders (weakly) prefer either direct (but remote) channels such as telephone- or internet-based banking or the establishment of an actual physical presence to the use of intermediaries.

5.105 The extent of cross-border activity, the barriers to its growth and the role of intermediaries are considered more fully in Section 13 below.

6 CASE STUDIES RELATING TO MORTGAGE INTERMEDIARIES

The Emergence of Independent Mortgage Intermediaries in Germany[96]

The German mortgage market

6.1 The residential mortgage market in Germany, despite being large (more than €1 trillion outstanding and over €100bn new loans generated in 2006[97]) has seen little growth over the past ten years. This is due to the relatively limited growth in homeownership rates and limited scope for early repayment/remortgaging, a context of a stagnant economy and a relatively "cold" housing market.

6.2 The demand for mortgages for letting purposes has declined considerably from around 50 per cent of all mortgage loans in the nineties to less than 20 per cent in 2003, due to the high risk of high-value mortgages on letting property and the abolition of government aid in this sector. This implies that there has been some growth in own-home mortgages. [98]

6.3 The overall slow growth of the market has been exacerbated by low returns, with post-tax profit at 0.2 per cent of mortgage outstanding in 2005.[99]

6.4 Product standardisation is a key feature of the market. In 2003 it was estimated that 98 per cent of the market volume was annuity loans with a fixed interest rate of ten years on average and fixed terms of repayment. This has resulted in strong competition for the same product which, combined with low returns and a limited demand growth, has pushed lenders to find other ways on which to reduce their costs and increases their market shares. [100]

The emergence of intermediaries

6.5 Some of the first intermediaries may have emerged as part of a process of cost-cutting by banks whereby direct sales forces were effectively outsourced by banks. The intermediaries created in this way are likely to have begun, at least, as tied agents with a consequently limited product set.

6.6 There are two independent mortgage intermediaries, Interhyp and Dr Klein, which are clearly larger than their peer group. Interhyp was founded in 1999, and is now the largest mortgage intermediary in Germany, accounting for 3.2 per cent of all new private

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96 In addition to reviewing relevant literature, we interviewed on 30 May 2008 the CEO of Interhyp, one of the largest independent mortgage brokers in Germany, and conducted a subsequent online interview with the German Consumer Agency Verbraucherzentrale Bundesverband, or VZVB in June 2008.

97 Hypostat (2006): European Mortgage Federation, (EMF).

98 Kretchmar, T and Damaske, M (2003) "Development of the Intermediary Market in Germany" *Journal of the International Union for Housing Finance* p1

99 Mercer Oliver Wyman (2007) "European Mortgage Distribution: Changing Channel Choices".

100 Kretchmar, T and Damaske, M (2003) "Development of the Intermediary Market in Germany" *Journal of the International Union for Housing Finance* p1

mortgage business in Q1 2008 in a highly fragmented market. Interhyp's current annual mortgage volume is about €5.7bn.[101] However, the next two largest intermediaries in Germany are tied.[102]

Drivers of the growth of mortgage intermediaries

6.7 Literature suggests that the growth in intermediary operations in the EU has followed the growth of the mortgage market.[103] The situation in Germany is somewhat different. According to Interhyp it has been the *lack* of growth and resulting structural changes in the mortgage market that have been the most important factors influencing the growth of intermediaries.

6.8 The move towards using intermediaries is part of the business strategy of banks that, in a tight or stagnant market, have to find other ways of increasing their market share and business volume whilst reducing costs. Due to largely undifferentiated products such competition is likely to be price-based, which necessitates lenders becoming as efficient as possible in order to price their products aggressively. Cutting down on distribution costs has been the main mechanism to achieve this.

6.9 Technology has also played a large part in this trend, with regards to the increasingly prominent role of independent intermediaries (by reducing the search cost to the intermediary of reviewing a more extensive range of lender offerings). Through internet searches and online trading platforms intermediaries have access to a wider customer base and are able to arrange loans far more efficiently than traditional lenders. It has made the mortgage market more transparent and increased consumers' demand for competitively priced products, which translates into higher demand for intermediaries' services. In turn, lenders may explore greater product differentiation as a means of restoring profitability.

6.10 Interhyp relies on its proprietary software, eHYP, to match the application data from prospective borrowers with the credit and pricing criteria designed by the lenders, and calculate which type of mortgage best meets customers' requirements. Interhyp also offers a range of insurance products for mortgages including loan security and life insurance policies. Due to restrictions imposed by the lenders, Interhyp does not intermediate on cross-border trade. [104]

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[101] This implies that, on Interhyp's data, the new lending in residential mortgages in Germany is around €180 billion. This is significantly higher than the data available from the EMF.

[102] Mercer Oliver Wyman (2007) "European Mortgage Distribution: Changing Channel Choices"

[103] Mercer Oliver Wyman (2007) "European Mortgage Distribution: Changing Channel Choices"

[104] Interhyp interview

6.11 Interhyp relies heavily on the internet both to attract clients and process mortgage contracts, but their mortgage consultants confirm all deals either over the telephone or in person i.e. there is no self-service option. Around one third of mortgages are sold as a result of personal meetings; the rest by telephone.

6.12 Despite this, the use of the internet brings about large cost savings for intermediaries in terms of marketing to clients, attracting business and matching customers with lenders.[105] Indeed, from 1999 to 2003 the market segment of the online mortgage business experienced an increase from €0.5bn to €4bn per year (new business).

The impact on lenders

6.13 The Interhyp interview identified a number of positive consequences for lenders due to the rise of mortgage intermediation in Germany. Lenders are able to underwrite many mortgages at a relatively low transaction cost, saving on the expenses associated with personnel and client and market research. On average, using a mortgage credit intermediary results in very high conversion rates from inquiry to a signed contract, as loans submitted by the intermediary have already been checked against the lender's credit guidelines and are accompanied by all the documents required for the final loan decision. Very few applications are refused (one in 20 for Interhyp) and this saves the lender a great deal of resources.[106]

6.14 The presence of a well-developed intermediary distribution channel also encourages new entrants to the mortgage market, particularly those without a branch network. Non-deposit taking institutions (such as mortgage wholesalers) are able to enter the market as mortgage providers without having to bear the costs of direct distribution. [107]

6.15 Bigger, more established banks can also benefit from the presence of intermediaries, with many big banks distributing nearly all of their mortgages this way. They find this strategy important as their in-house mortgage distribution networks are often not big enough to realise the economies of scale that are available to intermediaries, and making use of the latter's services leaves them free to focus on other aspects of their business on which they hold a comparative advantage. [108]

6.16 On the other hand, the literature has identified some disadvantages of the rise in intermediaries. Due to increased competition from intermediaries, banks' traditional advantage of being customers' first port of call for mortgages is being eroded. This requires them to take a more disciplined approach to the management of their branch sales force, including resource allocation and incentives, in order to source more

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105 Interhyp interview
106 Interhyp interview
107 Interhyp interview
108 Interhyp interview

mortgage leads and convert these to sales.[109] This could foster efficiency, but may also result in more resources than necessary being devoted to distribution and market research. In a similar vein, greater resource may be put into product differentiation.

The impact upon consumers

6.17 According to Interhyp, the chief benefits to consumers derived from use of Interhyp's services come in terms of reduced prices, increased product choice and more transparent mortgage markets.

6.18 Experienced intermediaries have extensive knowledge of the market place and consumer buying behaviour which lenders can use in designing products which better meet the needs of consumers, thus leading to mortgage markets being more consumer-focused.

6.19 However, the literature identifies possible areas of consumer detriment. For example, consumers may not be easily able to distinguish the commissions paid by the lenders to the intermediaries if these charges are included in the overall loan agreement, and this weakens their ability to assess the independence of the intermediary. This is not just a problem for those intermediaries that are obviously not wholly independent, being part-owned by lender institutions or otherwise tied to one or a small number of lenders. Even intermediaries covering the whole market (and thus seen as 'independent'), or near to it, may have mis-aligned incentives and have a pecuniary incentive to recommend products based upon the commission they would be due to receive rather than based upon the needs of the customer). More considered consumer protection frameworks may be needed as the number of service contracts (e.g. due to the involvement of an intermediary) and different pricing models increase.[110]

6.20 Indeed, a key concern of the German consumer association, Verbraucherzentrale Bundesverband (VZBV) is the true independence of intermediaries. This is particularly the case concerning the pressure on intermediaries to cross-sell products (such as life or payment protection insurance). The existence of commission payments from lenders can inhibit the independence of intermediaries as advisers to borrowers, and encourage them to sell products that are not suitable or necessary for the client.

Regulation

6.21 There is no explicit regulation of intermediaries in Germany. However, according to Interhyp, there are many built-in mechanisms which can limit the power of the intermediaries. Mortgage intermediaries in Germany operate within a highly regulated industry. All banks are regulated (regarding data protection, competition law etc) and the intermediaries have to abide by these in order to attract their business.

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109 Oliver Wyman (2007) "European Mortgage Distribution: Changing Channel Choices"
110 Oliver Wyman (2007) "European Mortgage Distribution: Changing Channel Choices"

6.22 In addition, Interhyp does not explicitly charge their customers commission for their services. They are paid by the lender when a contract has been completed, and, as this payment is included in the overall loan agreement, the consumer is aware of the commission structure from the beginning.

6.23 Furthermore, due to the relatively standardised nature of mortgage products,[111] intermediaries compete mainly on price, and if they do not offer clients competitive prices they will lose the business. This checking mechanism has been enhanced by the increased transparency of the market that the internet provides to consumers. This transparency is also available to the intermediary through trading platforms; they can access a far wider range of offers at a reduced search cost.

6.24 VZBV considers there to be considerable risk of consumer detriment in the broking of mortgage products — including the recommendation of not best price products or over-charging the borrower. It feels that more regulation of intermediaries would be appropriate (undertaken by the German financial services regulator, BaFin). This could include making them liable for compensation in the case of failure to provide adequate advice;[112] having strict rules about fee transparency; and having a minimum standard of qualification for intermediaries.

6.25 In the opinion of VZBV, specific measures to alleviate these risks would include a requirement for intermediaries to have financial capacity of four per cent of the sum of annual premiums received; and/or the requirement that clients' monies be transferred via strictly segregated client accounts which would not be used to reimburse other creditors in the event of bankruptcy.

Competition

6.26 In Germany, with its already tight mortgage market, developments in competition have been felt more in the intermediary market. Intermediaries are increasingly using sophisticated technology to handle the complexity of lenders and product offers, and to compete for the limited demand. The most efficient intermediaries benefit from preferred treatment from lenders, thus allowing them to be even more aggressive on retail price and attract more business. [113]

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[111] Ninety-eight per cent of the market volume in 2003 derived from annuity loans with a fixed interest rate of ten years on average and fixed terms of repayment Kretchmar, T and Damaske, M (2003) "Development of the Intermediary Market in Germany".

[112] Intermediaries to hold professional indemnity insurance against liability arising from professional negligence (at least €100,000 applying to each claim).

[113] Interhyp Interview

6.27 The presence of intermediaries also promotes both national presence and local service of lenders. Through intermediaries large lenders are able to attract consumers who want local, personal advice, and small firms are able to attract consumers outside of their limited local area. This contributes to competition by homogenising the market.[114]

6.28 The German intermediary market, despite the increase in the number of entrants and corresponding improvements in competition, is still dominated by Interhyp and Dr Klein. The VZBV feels this is some cause for concern, as a larger, less concentrated market would offer more to consumers in terms of competitive loans.

6.29 Furthermore, the takeover of independent intermediaries by large lenders (such as ING Direct's takeover of Interhyp) may have further negative implications for competition and the independence of the intermediaries. The VZBV is concerned that consumers may lose out in terms of the impartiality and quality of advice.

Cross-border trade

6.30 The presence of intermediaries in Member States can provide an accessible distribution network through which foreign lenders can penetrate the mortgage market. Therefore, the rise in mortgage intermediaries in the EU is encouraging for the integration of European mortgage markets and the provision of cross-border services.

6.31 However, according to Interhyp, there is very little scope for foreign lenders to penetrate the German market, as the very tight conditions do not make the required resource expenditures worthwhile. German lenders do not appear willing to supply cross-border credit, despite the fact this would enable them to gain access to bigger, more dynamic markets.[115] Interhyp considers this is mainly due to legal and product-specific barriers.[116] Working through an intermediary is not sufficient for lenders, and they typically prefer to be based operationally in the other country.

6.32 Intermediaries' role in facilitating cross-border trade is at present more noticeable in enabling non-resident customers to take out mortgages through local lenders.[117] The customer benefits from the intermediary's knowledge of the language and legal idiosyncrasies of the foreign market, and the intermediary is able to provide the lender with valuable advice regarding credit assessment of the foreign client. However, there is still much evidence to suggest that consumers currently do not have a large appetite to engage in cross-border mortgage purchasing.[118]

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114 AMI (2007) "Response from the Association of Mortgage Intermediaries to the Mortgage Funding Expert Group and Consumer Industry Dialogue Group Final Reports"
115 Interhyp interview
116 Securing rights to a property and handling repossession is difficult in a different legal setting and with no physical presence.
117 For example, IMS is an intermediary based in Spain, but marketed directly at British citizens wishing to buy second homes in Spain.
118 Eurobarameter; AMI; MOW

Summary of key findings

6.33 The growth of independent mortgage intermediaries in Germany has largely resulted from the inactive mortgage market and lenders' needs to cut costs through contracting out the distribution of their mortgage products.

6.34 The majority of the benefits of this increase have been felt by lenders. There are potential areas of consumer detriment caused by non-transparent fee structures, the possible decline in independence of the intermediaries and the dominance of two large intermediaries.

6.35 There is currently no regulation of mortgage intermediaries by BaFin. There is little appetite for cross-border lending, both by German lenders into foreign markets, and foreign lenders into the German market. This limits the opportunity for mortgage intermediaries.

6.36 The move towards the use of internet-based trading platforms has also contributed to the growth in the number of intermediaries, and provides further cost savings to participating lenders.

The UK Mortgage Intermediary Industry, Regulatory Change and the Credit Crunch[119]

Mortgage intermediation in the UK

6.37 Credit intermediation is very important as a distribution channel for mortgages, accounting for 61 per cent in terms of number of sales or 66 per cent in terms of loan value. John Charcol — one of the largest and best regarded independent mortgage intermediaries in the UK[120] — believes that the competitive advantage of intermediaries over direct-distribution by lenders is the advice that is valued by customers.[121] According to the

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[119] The research under-pinning this case study was derived as follows:
(a) Interviews with the FSA, John Charcol (22 May 2008), the Association of Mortgage Intermediaries (18 June 2008) and the Council of Mortgage Lenders (26 June 2008)
(b) Desk-based research on relevant FSA regulations and other documents
- FSA website
- NERA (2003) The Economic Cost of the Proposed Regulation of Mortgage Sales
- CML (2005) " Mortgage regulation one year on"
- FSA (2002) Consultation Paper 146: The FSA's approach to regulating mortgage sales
- FSA (2000) Consultation Paper 70: Mortgage Regulation: The FSA's high level principles
- FSA (1999) Cost benefit analysis of Mortgage regulation.

[120] For instance, John Charcol won the Mortgage Adviser of the Year award in 2006, as voted for by the readers of 'What Mortgage'. Other awards won are listed at http://www.johncharcol.co.uk/aboutus.aspx.

[121] Customers mainly need advice on issues like fixed-rate mortgage versus floating-rate ones (trackers), the length of the deal, and early repayment penalties.

Association of Mortgage Intermediaries (AMI), 92 per cent of all intermediary sales were advised, compared with 40 per cent of direct sales.[122]

6.38 According to the UK FSA, in 2007 the volume of mortgages and other lending secured on own property in the UK was about 2.1 million, with total value of £293 billion. Commissions paid to intermediaries *by lenders only* amounted to £1,040 million. This equates to about £800 per mortgage sold through an intermediary, over 0.5 per cent of such mortgage values. Our study indicates that this is below the level experienced in most other Member States.

6.39 There were 7,083 authorised firms conducting mortgage intermediation in the UK, according to the UK FSA.[123] Among these, about 75 per cent are independent firms, while the remaining 25 per cent are tied agents.[124] John Charcol is one of the biggest mortgage intermediaries in the UK, which has three distribution channels, including face-to-face advisors, telephone advisors, and its website. It makes money from both commissions charged on clients and lenders (mostly conditional on the close of deal) and selling of related products (mostly insurance). It tries to provide on-going services (e.g. newsletter and advice) to retain customers but does not charge fees for the services.

6.40 The mortgage intermediaries are much more fragmented than lenders, as evidenced by the fact that the five largest lenders have 53 per cent market share while the five largest intermediaries (including several networks) have 17 per cent market share.

6.41 Competition and product diversity in the mortgage market increased significantly over the period from 2002/3 to 2006/7, perhaps by a factor of four or five.[125] Overall, lenders have been more willing to take on riskier customers up to the credit crunch and this has tended to open up the market for these customers. In particular, there has been a large increase in the number of offerings in the sub-prime sector (which is typically comprised of borrowers with 2–3 County Court Judgements against them). In the early 2000's there was significantly less product choice for these types of borrowers.

6.42 Further examples of the increase and the change in the nature of product offerings include flexible and off-set mortgages. With regards to the former, it was not previously standard practice for lenders to allow over- or under-payments of loans whereas in many cases, this flexibility is now an inherent feature of many mortgage loans. The availability of these more flexible mortgages, which involve customers being able to off-set a mortgage loan against other accounts held with the same lender in order to achieve an overall

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122 AMI, (2008) "Value of mortgage advice"

123 Figures from the AMI suggested that, in 2008, there were over 11,500 registered intermediary firms and an estimated 40,000 advisers.

124 Figures from the AMI suggested that, in 2008, over 96 per cent of mortgage advisers provide whole-of-market advice.

125 However, it was noted that the reported number of products will of course depend on one's definition of "product". Thus, this calculation may in fact represent derivations of the same product and thus while the increase has been substantial this figure may nonetheless over-estimate the scale of the change to some degree.

better rate, has also increased significantly since the 1990s. Other areas that are thought to have experienced significant change are charging and pricing practices in the market.

6.43 Another development is that a significant portion of new products were introduced by firms with little or no branch networks. These firms rely heavily on intermediaries to distribute products and find customers, and this is partly the reason why the market share of mortgage intermediaries in the UK has increased significantly compared with five years ago.

6.44 For intermediaries in particular, the result of this increased choice has enabled them to specialise in niches in a way they would have been unable to do previously. The main driver of the above product innovation is the competitive nature of the market combined with high levels of liquidity in the mortgage market in recent years. Increases in liquidity for example, and not having branch structures, has been an important factor in the increased use of intermediaries.

The switch from self- to UK FSA regulation

6.45 It is believed by the intermediaries themselves — to the extent represented by John Charcol — that the self-regulatory framework in place (as regulated by the MCCB[126]) prior to UK FSA regulation, did a very good job of introducing regulation into a market that previously had had none. However, it is conceded that there were inevitably limits to what self-regulation could achieve given the limited powers of enforcement.

6.46 With regards to the comparative efficacy between the MCCB and the UK FSA regulatory frameworks, it was noted by John Charcol that when comparing what the different requirements delivered relative to the cost of the system, it is hard to justify the extra cost of the UK FSA statutory regulatory regime given what they system delivers in return.

6.47 John Charcol felt that the UK FSA regime has improved consumer protection in the market especially with regards to establishing a central body to which consumers can complain and seek compensations from. From the industry perspective on the other hand, it is thought that the old system functioned and performed well and that the question now is what can the UK FSA do differently.

6.48 However, some commentators have argued that UK FSA regulation may have weakened the position of consumers, by giving them the illusion that the "advice" they received from mortgage intermediaries is not salesmanship, even when the intermediary has a commission interest in a sale. The proffered solution is to mandate strict separation of roles – so, an intermediary on commission (whether tied or untied) should be forced to state to consumers that she is a salesman, and that they should interpret her advice in the

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126 The Mortgage Code Compliance Board (MCCB) was established by the industry to perform a dual function — maintenance of a register of mortgage lenders/intermediaries with a stated commitment to comply with its code and monitoring compliance of mortgage lenders/intermediaries with the Mortgage Code. The MCCB had a majority of public interest members.

context of her own financial interest in selling products to them; whilst only an intermediary with no commission or other financial stake in the consumers' product purchasing decisions should be able to describe herself as an "advisor".

6.49 In general, practitioners prefer principles-based regulation. Instead of singling out mortgage intermediaries as a group of entities to be subject to special regulations, the UK FSA regulates relevant activities, namely arranging or advising on a regulated mortgage. The regulatory regime is neutral, not favouring one distribution channel over another, which means, for the same activity, lenders and intermediaries will be subject to the same regulations.

Regulatory rationale

6.50 The UK FSA identified four key issues for regulation in this area:

(a) Poor information.

(b) The inability of consumers to use information effectively in the decision-making process.

(c) Improper sales tactics (specifically regarding concerns over the treatment of customers in arrears).

(d) Regulatory gaps (there was particular concern regarding the piecemeal approach to regulation at the time as some mortgage lenders were subject to regulation while others only to the voluntary code).

6.51 The regulatory regime implemented by the UK FSA is based around the sale of first charge mortgages and thus covers more than just the direct lenders of these mortgages.

Types of mortgage covered by UK FSA regulation

6.52 According to UK FSA regulation, the main characteristics of regulated mortgage credit contracts are as follows:

(a) The borrower must be an individual or a trustee;

(b) The lender must take a first legal charge over the property in the UK; and

(c) At least 40 per cent of the property must be occupied by the borrower or a member of their immediate family, or intended for their occupation.

6.53 In addition to the above, the UK FSA's definition of a regulated mortgage contract also includes loans where the security is a first charge over the borrower's residential property. Thus, the UK FSA highlights a number of loans in this respect that may fall within the realms of legislation on mortgage lending. These include the following:

(a) Lending for home improvements

(b) Lending for debt consolidation

(c) Secured overdrafts and secured credit cards

(d) Bridging loans.

6.54 However, the UK FSA's definition would *not* cover the following types of loans:

(a) Buy-to-let mortgages (unless the tenant is a member of the borrower's immediate family, or intended for their occupation)

(b) Second-charge loans

(c) Loans to companies (except in the case of trustees).

Relevant regulation

6.55 The areas of UK FSA regulation of most relevance to intermediaries and those with the most potential impact on the business of intermediaries included the following:

(a) Financial promotion — a ban on cold-calling. This was estimated to lead to about 0.5 per cent of mortgage sales and, *ex ante*, was expected, by NERA, to result in a one-off cost of about £2.2 million, with 0.5 per cent of small and medium sized intermediaries ceasing to operate.

(b) Pre-application disclosure requirements.

(c) Advice and selling standards.

(d) Requirements to ensure the fair treatment of consumers.

(e) Improved redress. Having to join the Financial Ombudsman Scheme (FOS) would create direct costs for intermediaries in terms of tariffs and FOS fees. Further costs would also be incurred as a result of any increase in the number of customer complaints faced.

6.56 It was predicted that as a result of the UK FSA proposals with respect to the conduct of business and authorisation, a number of intermediaries were likely to exit the market (no estimated figure was given).

6.57 Although this was one way in which competition was expected to be affected, the report noted that the respondents to its survey expected that those who were likely to exit the market would most likely be 'low quality' intermediaries. This is because it would be this type of intermediary who would be faced with the highest incremental costs. However, while it thought that the implication of this would be an improvement in the average quality level in the market, it was also noted that this may pose the risk of some consumers not being served.

Regulatory impact

6.58 In 2005, the Council of Mortgage Lenders published a report entitled "Mortgage regulation…one year on" which highlighted the results of two surveys carried out to ascertain the views of intermediaries on the impact of UK FSA regulation a year on.[127]

6.59 The first survey was published for the Intermediary Mortgage Lenders Association (IMLA) in September 2005. This survey of 296 firms suggested there was a unanimous view among intermediaries that their firms' costs have increased as a result of regulation. The key points were as follows:

(a) 98 per cent claimed that they had seen their costs rise by (an average) 14 per cent;

(b) 72 per cent claimed that their clients had benefited from the regime; and

(c) 67 per cent thought that their clients were not receiving better advice as a result of the new regime.

6.60 The second source was the Association of Mortgage Intermediaries (AMI) census, also published in September 2005, which highlight the following:

(a) 41 per cent of the AMI's members polled believed that there had been improvements in the standards of both customer service and advice; and

(b) 52 per cent of AMI's members polled stated that their largest concerns related to the costs of compliance.

Overall impact

6.61 Overall, the UK FSA believes that its regulation does not play a vital role in the evolvement of the mortgage intermediary market in the UK — it is not a regulatory-driven market.

6.62 For instance, when asked whether the UK FSA requirements regarding information disclosure has meant that intermediaries now tend to get more information from lenders, the UK FSA was of the view that their regulations have not had an effect on this. Even prior to the introduction of the regulatory regime, the market already provided intermediaries with a high level of information on lenders through the existence of sourcing solutions, like Mortgage Brain[128] and Trigold.[129] These are business to business

127 www.cml.org.uk/cml/filegrab/13-2005-regulation.pdf?ref=4222
128 http://www.mortgage-brain.co.uk/index2.aspx

producers of information on mortgage products (much like consumer price comparison tools) and are typically updated on a daily basis. This has been the main tool that intermediaries have relied on to retrieve information about the products that are available from lenders both before and after the regulatory regime was introduced.

6.63 John Charcol has expressed some concern on the extra cost of the UK FSA regime compared with the self-regulation regime under MCCB. It acknowledges that the MCCB regime had its limits and the new UK FSA one did bring benefit, but it is unclear whether the extra cost is justified by the extra benefit.

Cross-border business

6.64 John Charcol has not developed any overseas business yet, despite interest from some customers in buying properties abroad. The main reason is its concern that it may not be able to provide the top quality advice and service to customers in overseas markets. Although regulatory issues do impose some challenges, it does not believe that they are the most important obstacles for doing cross border business, since there are many ways to overcome this, say by taking over a local intermediary, which should give it enough knowledge and experience about local regulation.

The impact of the "Credit Crunch"

6.65 In the context of the recent adverse developments in the credit market, there has been a very significant decline in the level of product offerings in market. In particular, a report by the LSE stated that there has been a decline in the number of product offerings in the sub-prime sector of approximately 80-85 per cent and about a 50 per cent reduction in the buy-to-let segment (June 2008). This means that the reductions have been focused in those product areas where intermediaries play the most significant role in the UK. This has reduced the value of the search function played by intermediaries. Curiously, the first quarter of 2008 saw an increase in intermediation penetration in the mortgage market up to 80 per cent.[130] This is not expected to continue, and, anyway, was on markedly reduced volumes.

6.66 According to the UK FSA itself, it has not been particularly surprised or concerned by recent developments — it is seen as a result of expected changes in the risk appetite of lenders. John Charcol has noted that recently lenders had increased the difference between the terms of the products on offer at their own branches and those of the products available to intermediaries. For instance, some mortgage products offered at lenders' branches are 50 basis points cheaper than that available at intermediaries. John Charcol believes that lenders are trying to feed their own branches and control the flow of business, given the different business environment. However, it noted that so far such

129 http://www.trigold.co.uk
130 CML data.

price differentiation has not been effective, which may suggest the value in the brands and services provided by intermediaries.

6.67 John Charcol does not expect that there will be much improvement in market conditions this year. Further, it believes that lenders will continue to control products rather than boosting product development which will mean that the rate at which innovative products are released onto the market will slow. There is a sense that the balance of power between lenders and intermediaries has switched to the favour of the former. March 2008 may have represented a further inflection point, with the impact of the credit crunch being felt more profoundly subsequent to the near collapse of Bear Stearns and its subsequent rescue by JP Morgan.

6.68 At the end of June 2008, John Charcol announced that it would close three offices in the UK as well as reducing its permanent headcount by around one quarter. As part of this significant cost reduction program, the Chief Executive and Chief Financial Officers left the business.

6.69 Some specialist lenders are likely to exit the market (these tend to lack branch networks, and are thus dependent upon intermediary channel). On the other hand, banks with branch networks need a *de minimis* volume of business — it is not clear yet whether this will favour intermediaries, or whether these players will prioritise direct business.

6.70 The downturn in the housing market has resulted in a greater emphasis being placed upon credit risk over the life of the mortgage. Lenders are now consciously seeking lower risk business (with associated lower returns).

Summary of key findings

6.71 Intermediaries are a very important distribution channel for mortgage products in the UK with about 60 per cent market share.

6.72 The UK mortgage intermediary sector is highly fragmented, with 7,083 authorised firms conducting intermediation and the five largest intermediaries (including several networks) accounting for 17 per cent of the market. The level of lenders is more concentrated than the level of mortgage intermediaries, as the five largest lenders have 53 per cent market share.

6.73 Competition and product diversity in the mortgage market has increased significantly over the past six years, from around 6,000 in 2002/3 to 20,000 in mid 2007. There also have been many new lenders entering the market, many of which have little or no branch network and rely heavily on intermediaries to distribute their mortgage products. The main driver of the product innovation that has taken place is the competitive nature of the market combined with high levels of liquidity in recent years. The number of products, especially in the sub-prime sector, has however decreased significantly since the credit crunch.

6.74 Instead of regulating mortgage intermediaries as a separate group, the UK FSA regulates activities, namely "arranging" and "advising on" regulated mortgage products, a regulatory approach which is distribution-channel-neutral.

6.75 Overall, the UK FSA believes that its regulatory regime works reasonably well to achieve its main rationale of consumer protection, and it also feels that the regulation does not play a vital role in the evolution of the mortgage intermediary market in the UK.

6.76 The credit crunch is likely to adversely impact upon the intermediary sector. This is likely to be concentrated on those intermediaries focused upon the credit impaired, and similar, market segments, but not exclusively so. John Charcol — the largest independent mortgage intermediary in the UK — announced significant staff reductions and office closures at the end of June 2008.

6.77 Some commentators have suggested that the problems around the credit crunch illustrate the importance of FSA regulation of mortgage intermediation, and may imply a need for further such regulation (Chancellor Alistair Darling). Others have noted that these problems have arisen even in the presence of regulation, and that it is the regulation itself that has weakened market disciplines and created such problems. The recommended solution is the removal of regulation (John Redwood MP). As such, the idea of regulation of mortgage intermediation remains politically contentious in the UK (the most significant market in EU27, and one of the most closely regulated).

The ING-Interhyp Merger[131]

6.78 ING DIRECT announced its plan to launch a public tender offer for Interhyp in May 2008. The takeover was given regulatory approval by the Dutch Central Bank on July 14, and on August 18 2008 ING DIRECT announced that the final transaction had been completed. In this section, we explore the possible impacts of the merger.

6.79 This exploration is at a qualitative, hypothetical and indicative level. This means that, naturally, we are not aiming at providing a clear-cut answer to whether the merger would eventually be beneficial or detrimental to consumers: this would require a carefully devised empirical analysis similar to that undertaken by the authorities involved in the relevant decisions regarding the merger. Instead, whilst we use this transaction as a real-world example of vertical integration, our analysis is at a *theoretical level only* and, in the absence of the private domain data that would have been available to the Dutch Central Bank, must be seen as speculative.

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131 Our methodology here was to review the merger against a theoretical framework based upon classical merger analysis. This was supported by interviews with representatives of both Interhyp and of the VZBV (see the first case study in this section).

Vertical mergers and two-sided markets

6.80 Mergers between firms operating at different and adjacent levels of the value chain are defined as vertical mergers.

6.81 In this case, we focus on ING as a lender, despite the wide range of ING activities. Interhyp is an intermediary and the provider of an efficient platform connecting lenders to borrowers.

6.82 Interhyp's activities are characteristic of two-sided markets: it deals at the same time with lenders and borrowers. The marginal cost of adding an agent onto its activities is, in our understanding, rather small due to the technological aspects of its operations. On the other hand, the increase of the size of one side of the market is beneficial to the other side — lenders want the group of potential borrowers to be as wide as possible, and vice-versa.

6.83 All these features make market definition more complicated for any anti-trust analysis. In particular, the relationship between costs and pricing is typically less clear-cut than usual,[132] and we often find that only one side of the market pays the intermediary — in our case it is most usually the lender. However, payment by both parties (borrower and lender) is not uncommon elsewhere, particularly where the intermediary lacks product ties.

Efficiency gains

6.84 Vertical mergers often result in efficiency gains for the new entity. These gains stem, first, from reductions in transaction costs:[133] the merged entity operates as a unique block and does not engage in costly negotiations.

6.85 A more formal analysis of efficiency gains refers to the "double marginalisation" concept,[134] related to the mark-ups (the wedges between production costs and prices) applied by the two firms, in our case the intermediary and the lender.

6.86 In the current situation, when Interhyp offers its services to lenders, it charges a fee that is devised in order to maximise its profits, i.e. where prices exceed marginal costs.

6.87 With vertical integration, the intermediation activity is internalised and is carried out at the "efficient" level, i.e. up to the extent that the marginal benefits compensate for the marginal costs. The double marginalisation is replaced by a single marginalisation,

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132 An excellent article on two-sided market Mark Armstrong (2006): "**Competition in Two-Sided Markets**," RAND Journal of Economics, The RAND Corporation, vol. 37(3), pages 668-691

133 The economic analysis of transaction costs is linked to Professor Oliver Williamson. See, e.g. Williamson, Oliver E. 1981. "The Economics of Organization: The Transaction Cost Approach." American Journal of Sociology 87:548-577

134 The concept was first introduced in Spengler, J.J. (1950): "Vertical Integration and Anti-Trust Policy", *Journal of Political Economy*, 58: 347-52.

applied by the integrated "lender *plus* intermediary" firm to the borrower. The lender will charge an interest rate to the borrower which, *ceteris paribus*, is lower as the cost of the lending activity has been reduced as a result of the merger.

6.88 The competition in this market, as we have argued above, mainly revolves around prices. This is the case as capacity constraints (funds for the lenders, space on the platform for the intermediaries) are unlikely to be the main strategic variables. Under these conditions,[135] cost reductions are likely to give an important competitive edge to the vertically integrating lender.

ING-Interhyp and the other lenders

6.89 The behaviour of the merged entity with respect to the other lenders may vary, *vis a vis* the pre-merger strategy followed by Interhyp.

6.90 If the merged entity has complete latitude in its future choices — which may not be the case if the merger were to be allowed subject to behavioural restraints — profit maximisation is likely to entail different conditions offered to lenders for the use of Interhyp services.

6.91 Simply refusing to serve lenders, i.e. ING's competitors, would result in higher profits for ING which, probably, would not compensate the loss in potential profits from Interhyp's operations. Such a strategy could still make sense if no alternative platforms were available and ING could reasonably expect to drive other lenders out of the market, so that in the long run profit increases from lending activities would make this strategy worthwhile. However, even under the assumption of no behavioural conditions for the merger, this strategy would probably prompt ex-post intervention by anti-trust authorities.

6.92 Charging higher prices or reducing the quality of services to other lenders would be more likely to happen. Unlike Interhyp alone, the merged entity would take into account the positive effect of raising other lenders' costs on ING profitability.

6.93 Also in this case, how effective this strategy would be and how much it would reduce the profitability of Interhyp platform would depend on market conditions. The higher the substitutability of the platform, and hence the elasticity of the lenders' demand for Interhyp services, the lower the cost impact on ING's competitors and the foreclosure effect of this strategy.

6.94 The possibility of consumer detriment, then, is linked to Interhyp's market power, that is inversely proportional to its substitutability. Notice that, for consumer detriment to arise, this power does not require Interhyp to be the single important firm. Even if Hypoport's Dr. Klein is at least as important, lenders could still be damaged if Dr. Klein were to become

[135] In economic analysis terms, firms engage in Bertrand competition, i.e. they are willing to lower prices to capture market shares, up to their marginal prices. On the other hand, when capacity constraints bind, they engage in Cournot competition, i.e. on quantity.

their only significant supplier of intermediation services — either due the refusal to supply by the merged entity or due to significant price increases. Dr. Klein could, in fact, find it profitable to raise its own prices.

6.95 Given that mortgages in Germany are relatively standard (as discussed in the first case study in this Section), competition is likely to be highly correlated with price. In technical terms, Dr. Klein and Interhyp prices are likely to be strategic complements: this means that when competition mainly occurs on price, an increase in price by one firm prompts a similar move by competitors. (In addition, the option of a direct purchase from a lender remains a potential choice for any borrower.)

6.96 On the other hand, competition in platforms is characterised by network effects: we could not assume, as we would in different markets, that price increases by the two main firms is likely to foster quick entry. The value of a network depends on the number of participants — in this case, as mentioned above, on the size of the opposite side of the market — so that new entry should try to build up a critical mass of users in order to be viable. That is, the two main intermediaries are likely to possess an important advantage with respect to prospective entrants.

Impacts on competition and consumer welfare

6.97 The efficiency gains from the merger, as previously said, are likely to give a competitive advantage to ING as a lender (hence, presumably, its interest in the transaction).

6.98 For this to amount to competition foreclosure, we would need to assume that other lenders would not be able to match ING offers and would exit the market, first, and that future entry in case ING subsequently increase its prices (i.e. interest rates to borrowers) would be hampered by set-up costs or other barriers.

6.99 Unless both conditions are satisfied, efficiency gains would result in increasing consumer welfare, even though competitors would probably lose market share and profits.

6.100 While reducing ING costs would, we argue, probably benefit consumers, the same does not apply if Interhyp's behaviour with the other lenders change in the ways described above. If the costs of ING's competitors increase, this would be detrimental to consumers, even more if Dr. Klein reacts by increasing its fees.

6.101 These behavioural changes are not necessarily profitable for the merged entity, though, and in case they were, they may be limited either by conditions imposed to allow the merger or by the threat of subsequent antitrust action punishing that behaviour.

6.102 To sum up, efficiency gains are likely to enhance consumer welfare, but possible behavioural changes by Interhyp may counterbalance this effect, with a net effect which may be positive or negative (depending on quantitative aspects beyond the scope of this analysis).

Impact on cross-border lending

6.103 As we have seen, there is mixed evidence with regards to the potential effects of these intermediation activities on cross-border lending. Interhyp, in particular, does not appear to be fostering foreign lenders' penetration into the German market.

6.104 It would be simplistic to conclude that the merger would have no effects in that respect, however. It may well be that, without the merger, Interhyp would eventually imitate Dr. Klein in facilitating the operations of foreign lenders in Germany. This possibility would become stronger if regulatory changes occurred in the meantime reducing the main hurdles to cross-border lending (like, for instance, the differences in national regulations, difficulty in access to credit information and in tracking down delinquent borrowers).

6.105 The merger may result in lower incentives for Interhyp to foster access by foreign lenders into its platform and hence to German borrowers, as penetration by foreign lenders would reduce ING profits. Again, the extent of the difference (with *versus* without the merger) in Interhyp's behaviour depend on the trade-off between the profits from the intermediation activity (which would drive towards fostering a large base of lenders on the platform) and the profits from lending.

6.106 In turn, the scope of this reduction upon cross-border lending in the German market — under the hypothesis that the merger results in changing Interhyp's behaviour — depend on the degree of substitutability. Dr. Klein is, in our understanding, the only other independent intermediary of comparable size currently operating in the German market. Even leaving to one side the technological costs of setting-up a new platform, other existing competitors and prospective new entrants may find it difficult to build-up a significant two-sided (lenders and borrowers) network of users.

6.107 Overall, the merger could in principle limit the expansion of cross-border lending activity. We should remark again that in order to reach clear-cut conclusion on this impact, as well as the impacts on competition and consumer welfare, a deeper study including empirical analysis would need to be conducted, and this lies outside the scope of this study.

7 INTERMEDIATION AT POINT-OF-SALE

Introduction

7.1 Credit from a third party lender can be available at point-of-sale at many retailers. The retailers gain additional sales by acting as intermediaries between their customers and the lenders. The customers gain access to a convenient source of finance, without the requirement to search for it (however, this convenience may come at a price in terms of the competitiveness of the interest rate attached to the loan — the market search function at point-of-sale is clearly curtailed). The lender gains an additional network of potential distributors of their products, and — for lending secured upon cars, for instance — attach the loan more closely to the good.

7.2 Indeed, some specialised finance providers do not have a substantial branch network or may even lack branches completely. As such, these institutions are heavily dependent upon point-of-sale as a distributional channel for their credit products.

7.3 Intermediation at point-of-sale is clearly ancillary to the main business of the retailer. However, it may still make a significant contribution to the retailer's income by increasing turnover (assuming that goods are not being sold at a loss) and/or by qualifying for commission payments from the lender.

7.4 We begin by extending the analytical framework developed at Section 3 to POS intermediaries.

Extension to the Analytical Framework

7.5 Point-of-sale intermediaries are a grouping where the classification of the business activities undertaken as intermediation remains unclear. Bertola et al. (2005) show that when financing is potentially available to enable the purchase of a product, it is typically offered at interest rates lower than those available in the direct market. The author's interpretation is that, since retailers subsidize customers in this way, the lending activity is not a form of credit intermediation *per se* but rather a form of bundling, i.e. a price discrimination strategy. However, since credit is clearly being intermediated in a literal sense, we will not drop this typology from the study.

7.6 Whilst the author's conclusion is logically consistent with our definition of an intermediary, it brings a practical problem in terms of the application of our analytical framework. Retailers could offer credit at a zero-interest rate but increase the fixed price of the product accordingly. This seems plausible as consumers that pay in cash often receive significant discounts on the product price. Given their specific nature, we will model point-of-sales intermediaries separately from primary intermediaries.

7.7 In this Section we focus on the role of those agents who sell goods — typically durables such as cars, computers, etc — and also offer credit to their customers. When the actual providers of the credit are not the sellers themselves, then these agents act as intermediaries: they bring together the borrowers (their clients) and the lenders. We aim at understanding why they choose to do so.

7.8 The informational issue does not seem to be the main point here: typically, what they know about the borrower is simply that she has chosen to buy the good they sell.

7.9 A first, obvious reason why this sort of intermediation happens consists in the willingness by the lenders to provide credit against those durables: it is the partnership between lenders and retailers that makes collateral lending feasible. Moreover, intermediation happens because it is much more practical than having an office of the lender close to every seller of the durables.

7.10 The implication on the pricing of the credit may be ambiguous: on one hand, the seller may have a better time than a single consumer in securing favourable credit conditions. On the other, given that the borrower may not have the time, nor the incentive, to look for alternative sources of credit tied to that particular durable, the seller may get a high margin (in terms of interest rates) in his credit intermediation activity. This latter effect, however, will be limited by the degree of competition on the “durable plus credit” bundle. Overall, the effect on consumer welfare may be favourable.

7.11 The same conclusion holds with regard to another aspect of credit: the signalling of good quality of the goods being sold. The fact that the appropriate functioning of the good is, explicitly or implicitly, set as a condition for paying all instalments may be seen as evidence that the seller does not expect problems in that area.

7.12 However, insights from behavioural economics suggest that factors linked to credit should be considered. First, consumers may not fully understand the nature of the contract they sign, e.g. with regards to clauses on repossession of the goods (although depreciation makes this a lesser problem than with house mortgages). That information asymmetry exists may be obvious: the suppliers have prepared the credit contracts or at least have higher incentives in understanding it as they repeat the transactions more often than individual customers. The problem is that many customers may not take fully into account the very existence of this asymmetry, which should make them wary of agreeing to sign, for instance, lengthy contracts with conditions difficult to grasp in a limited time.

7.13 More curious phenomena have been reported in the literature with regards to the excitement that a cash-constrained consumer may feel when presented the good along with credit opportunities. So-called projection bias may lead to the overestimation of the future pleasure felt over the life of the good and to underestimate the cost of giving up other goods or services as a result of entering the transaction. These phenomena are not just linked to anecdotes related to particular individuals: they have been documented empirically, included by suitably designed experiments where their effects on decision-making can be "isolated" from other influences.[136] Many sellers of durable goods seem, in fact, aware of the possibility that "excited" customers may have a significantly higher willingness to pay for the "good and credit" bundle: a typical example is the possibility offered to prospective buyers to spend time driving a brand new car.

7.14 Another aspect is highlighted by Bertola et al (2005)[137] who argue that credit conditions are often used as means to engage in price discrimination. They document empirical evidence in Italy that consumer credit conditions are often more favourable than what could be found in the market, and that many sellers actually lose money by offering credit — similarly as when they offer a discount — as the amount credited by the bank to the retailer's account is less than the cash price. Here we develop this intuition, without reproducing their model.

7.15 One simple fact behind the differential attractiveness of credit lies in the fact that interest, even if lower than what could be found in the market, is anyway high enough to be unattractive for cash-rich consumers: for this to be the case, the interest rate needs to be higher that safe bonds available in the financial market. This could be the case even for "zero interest" credit offerings, which may hide commissions and other expenses linked to the opening of the credit transaction. The incentive on the part of the seller to offer this possibility is evident: even if money is lost on the credit side of the transaction, the retailer gains the surplus on cash-constrained consumers who would otherwise not buy their goods, while the other consumers will pay cash.

7.16 This strategy would anyway be sustainable and profitable even if the interest charged to the final consumers were really "zero" or anyway a level below interests on no-risk bonds, if some costly activity — such as paperwork — is linked to the credit transaction. If cash-rich consumers happen to be those whose time has the higher opportunity costs, they will still have incentives to pay cash. This selection mechanism would work much in the same way as when coupons are offered by sellers: besides limiting the observation of prices by competitors, another rationale of this behaviour (as opposed to simply reducing prices), consists in the fact that price sensitive consumers will tend to be more willing to spend time to collect those coupons.

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136 Lowenstein, G, O'Donoghue, T and Rabin, M (2003), Projection Bias in Predicting Preferences, Quarterly Journal of Economics provides both a formal model for understanding projection bias and summarises evidence from a broad range of sources.

137 Bertola, G, Hochguertel, S and Koeniger, W (2005) "Dealer pricing of Consumer Credit" *International Economic Review*, 2005 vol. 46 (4): 1103-1142.

7.17 The overall effects of this on consumer welfare are ambiguous. The surplus enjoyed by cash-rich consumers is lower than what it would be if, instead of offering credit to some, sellers reduced their prices to all customers (i.e. if the equilibrium price without credit were lower). This result is in line with what happens to consumers with the highest willingness to pay in standard price discrimination models.[138]

7.18 For those consumers who would neither buy at all at the given price nor at the equilibrium price without credit — but choose to do so as a result of the credit offering — the surplus increases. Unless those problems analysed by behavioural economics are particularly significant, the very fact that they choose to enter a transaction implies that the surplus is positive while, trivially, it would be zero if they chose not to.

7.19 This second result is in line with what happens with usual price discrimination to consumers with the lowest willingness to pay. The sign of the surplus variation is unknown for those who take the credit option but would have bought anyway at the equilibrium price without credit. The magnitude of the price reduction which would take place without price discrimination and the opportunity cost of money determines the sign. By definition, sellers gain from the options of engaging in price discrimination.

138 To the extent the good in question bundled with a credit product is not the same as the good alone, it is not formally price discrimination.

Consumer Credit in the EU27

Table 7.1: Outstanding consumer credit across EU27, 2007[139]

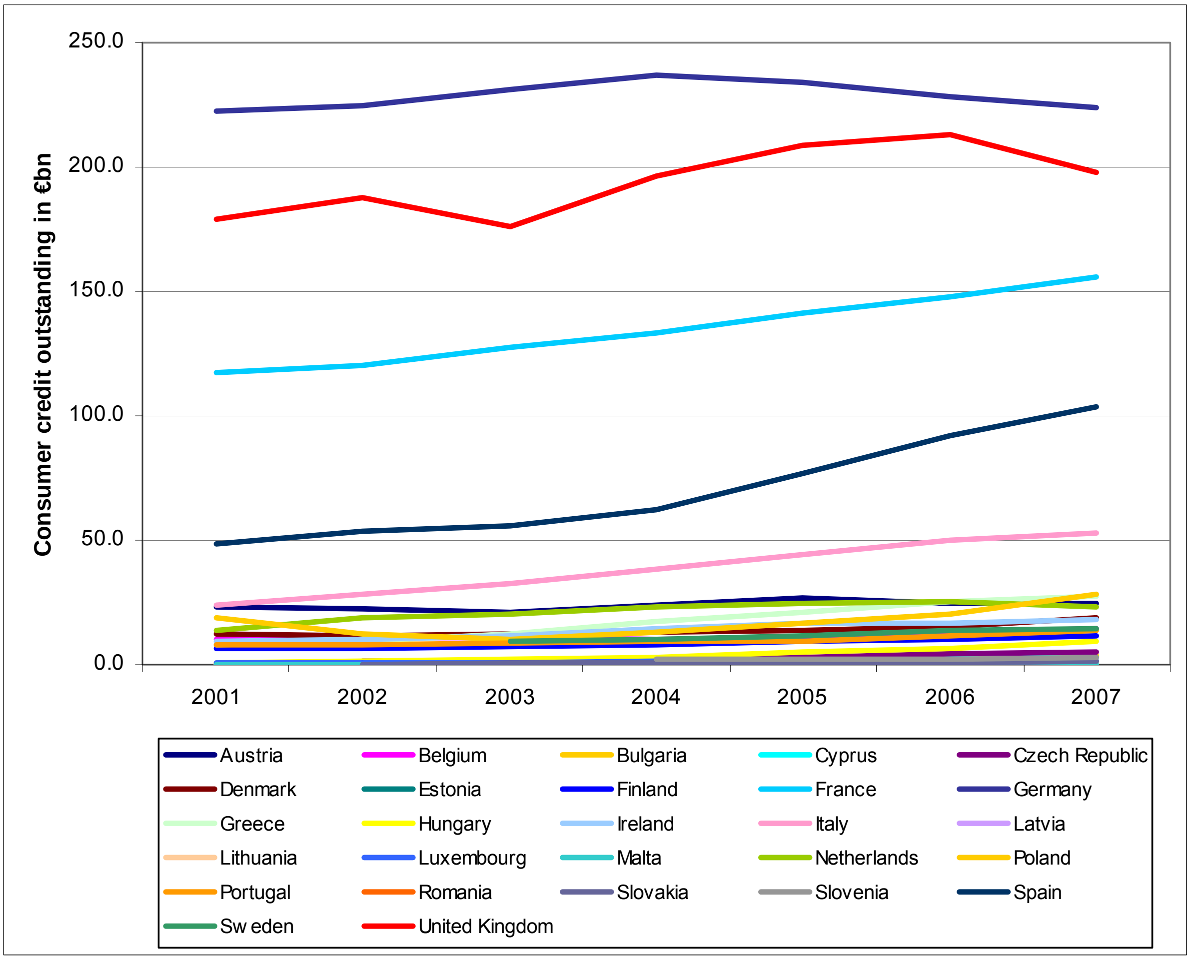
	Total OUT-STANDING lending €bn	OUT-STANDING CONSUMER CREDIT/GDP, %	OUT-STANDING consumer credit/capita, €000
Austria	24.4	9.0%	2.9
Belgium	14.2	4.3%	1.3
Bulgaria	3.6	12.6%	0.5
Cyprus	3.1	19.9%	4.0
Czech Republic	5.2	4.1%	0.5
Denmark	18.6	8.2%	3.4
Estonia	0.8	5.1%	0.6
Finland	11.2	6.3%	2.1
France	155.6	8.2%	2.4
Germany	223.7	9.2%	2.7
Greece	27.5	12.1%	2.5
Hungary	9.5	9.4%	0.9
Ireland	18.4	9.6%	4.2
Italy	52.7	3.4%	0.9
Latvia	1.0	5.2%	0.5
Lithuania	1.1	3.8%	0.3
Luxembourg	1.2	3.2%	2.4
Malta	0.3	5.3%	0.7
Netherlands	23.4	4.2%	1.4
Poland	28.5	9.3%	0.7
Portugal	13.8	8.5%	1.3
Romania	15.3	12.6%	0.7
Slovakia	1.2	2.3%	0.2
Slovenia	2.7	8.0%	1.4
Spain	103.4	9.8%	2.3
Sweden	14.3	4.3%	1.6
United Kingdom	197.7	9.8%	3.3

Source: ECRI (2007 data), eurostat (2007 GDP and population data), EE calculations.

139 Comprehensive data splitting outstanding consumer credit between that arising at POS and through other channels is not available (EUROFINAS do publish such information relating to their own membership — however, this currently covers only thirteen Member States).

7.20 We illustrate the evolution of consumer credit across the EU27 from 2001 to 2007 below.

Figure 7.1: The evolution of outstanding consumer debt, 2001–2007



Source: ECRI 2008 StatisticalPpackage

7.21 Within a growing market for consumer credit, although point-of-sale lending is growing, its share of new credit granted is on the same secular downward trend (from 43 per cent of consumer credit granted in 2003 to 37 per cent in 2007).[140]

The Current Scale of Intermediation at Point-of-Sale

7.22 In this section, we deal with all point-of-sale financing on a combined basis to avoid unnecessary repetition. However, where an interesting point requires further decomposition we do so.

140 Eurofinas members only.

7.23 We set out Table 7.2 below the estimated share of retailer finance as a proportion of the flow of consumer finance (excluding for the sake of clarity, mortgage credit). In addition, we identify estimates of the value and volume of transactions financed at point-of-sale in 2007, decomposed between vehicle and other retailers.

Table 7.2: Importance of retailer finance, 2007

	POS as proportion of all consumer credit	Value of motor retail finance, FLOW €m	Volume of vehicle finance at POS, FLOW 000s	Value of other retail finance, FLOW €m	Volume of other retail finance at POS, FLOW 000s
Austria	21.2%	2,617	218	293	210
Belgium	20.2%	2,174	169	204	286
Bulgaria	18.4%	237	59	517	1,035
Cyprus	14.0%	80	8	85	85
Czech Republic	41.5%	745	124	2,199	2,597
Denmark	16.0%	1,149	96	885	632
Estonia	27.4%	407	68	11	22
Finland	15.2%	1,354	93	500	500
France	20.7%	10,343	992	8,385	7,162
Germany	37.9%	31,680	2,241	7,808	6,147
Greece	11.6%	2,177	186	511	638
Hungary	35.1%	1,322	220	2,909	3,636
Ireland	8.6%	1,295	108	167	119
Italy	40.2%	22,336	1,970	6,648	3,872
Latvia	26.1%	422	70	108	135
Lithuania	29.7%	505	84	94	117
Luxembourg	8.8%	69	4	9	6
Malta	23.4%	270	27	82	47
Netherlands	17.1%	2,968	183	1,075	907
Poland	13.8%	1,671	167	2,057	2,571
Portugal	37.4%	2,680	234	2,673	1,800
Romania	41.9%	923	231	5,450	6,812
Slovakia	21.2%	264	44	132	165
Slovenia	36.7%	684	114	965	1,207
Spain	28.3%	9,574	680	12,294	10,470
Sweden	40.9%	2,810	143	707	352
United Kingdom	10.8%	14,708	871	13,172	6,586
		115,464	9,404	69,939	58,115

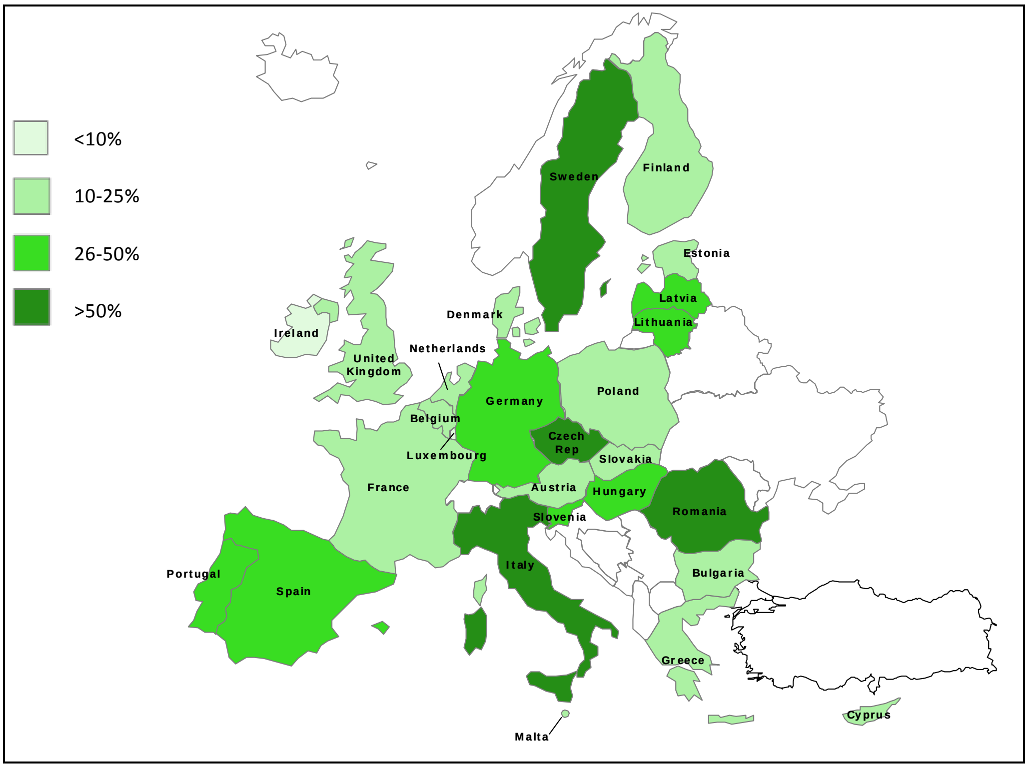
Sources: Survey,[141] finaccord, eurofinas (2007), leaseurope (2007), EE calculations.

141 Survey data used in this section is based upon up to 103 data points (see also Section 2). We have identified in this section where the number of responses was significantly less than this (typically where more detailed, and potentially more sensitive data — such as relating to remuneration structures, etc)

7.24 Based upon the above, the average across the EU27 is that about 22 per cent of consumer credit is accessed at point-of-sale. The relative importance of indirect distribution compared to direct distribution across consumer credit as a whole is shown below. The above table relates to 2007. It is not yet clear how the credit crunch and the downturn in economic prospects will impact upon the value of credit intermediated or the relative penetration of POS in the broader context of consumer credit.

7.25 The differentiation in market penetration by POS intermediaries is illustrated below.

Figure 7.2: POS intermediary penetration in the consumer credit market



Source: smartdraw

7.26 Vehicle retail is the most important credit market at point-of-sale, with the value of credit intermediated typically larger than that lent against all other consumer goods. Of course, it must be recognised that there are fundamental differences between vehicle finance and non-vehicle finance. In particular:

(a) The average credit value is significantly greater, with an average value across EU27 of about €12,300, against about €1,200 for non-vehicle retail. In other words, non-vehicle retailer finance is largely a volume-based business.

(b) Part of the appeal of financing at POS is a clearer connection to the product being financed and consequently enhanced security. However, in the event of default used motor vehicles offer two advantages:

– The individual value of a loan is greater. Therefore, trivially, the cost-benefit exercise for a lender in prosecuting a borrower is quite different.

– The market for used vehicles is more liquid and transparent than for consumer durables generally (where re-possession of the goods against which the credit has been secured is possible).

Credit products available

7.27 The financing of many other consumer goods is available at point-of-sale. The most common categories are:

(a) Motor vehicles (both new and used).

(b) White good consumer durables (e.g. refrigerators).

(c) Brown good consumer durables (e.g. televisions).

(d) Beige (or grey) consumer durables (e.g. PCs).

(e) Furniture.

(f) Kitchen and bathrooms.

7.28 Acceptance ratios appear to be typically in the range 75 per cent to 85 per cent.[142] The most advanced and automated systems contend that data input by the retailers, decisions are made and acted upon within 3–5 minutes (our evidence indicates that the decision time is typically longer on vehicle retail, where 10–15 minutes is the norm).[143] The lender systems base such decisions upon the input data and/or credit histories, where available.

7.29 There are a number of potential forms of retailer finance. Of particular note are:

(a) Hire purchase agreements where ownership of the product immediately transfers to the buyer.

(b) Contract purchase agreements where ownership does not automatically transfer, but there are options to purchase the good at the end of the financing agreement. The existence of such options is a complicating feature of the agreement, although also providing additional flexibility to the consumer. Whilst we recognise that such agreements are of a different legal form to a traditional loan, the substance of the transaction is to assist in financing the use of the asset, and it is therefore relevant to include it in this study.

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142 Based on data from Saturn Media Markt and Comfort Card.
143 Mercedes-Benz believes that a decision is made in under 15 minutes in over 85 per cent of cases.

(c) Other product-specific loan and financing agreements.

7.30 Where such choice of financing product exists at a specific retailer, the consumer will need to make a choice between different options. Lenders frequently provide decision trees and similar tools and training to assist in this.

7.31 Pre-approved credit and revolving credit facilities (i.e. credit that is not specific to an individual good) are also established elements of the retailer finance offering in many Member States. We have incorporated these into the section dealing with other forms of consumer credit.

Variation in significance

The lender perspective

7.32 A first, obvious reason why this sort of intermediation happens consists in the willingness by the lenders to provide credit against those durables: it is the partnership between lenders and retailers that makes collateral lending feasible.

7.33 Again, as with mortgage intermediaries, retailer finance provides face-to-face access to additional customers. The retailer extends the reach of the lender and, in a sense, becomes a “local branch” of the relevant credit providers, albeit one where there are considerable limitations on what is done, and, presumably, on what the borrower expects to be done by the individual acting as an intermediary.

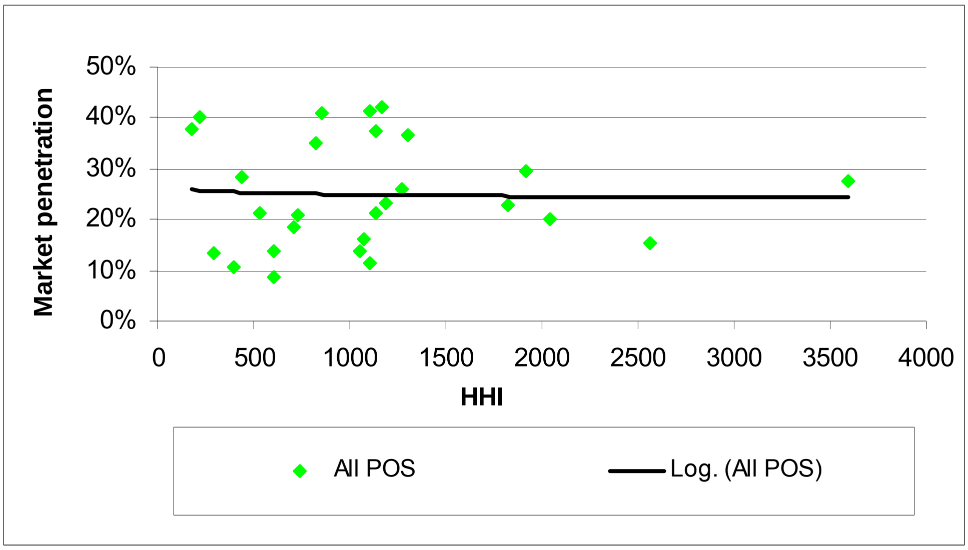
7.34 A clear benefit to the lender is the avoided advertising costs that would otherwise be expended in locating suitable potential borrowers. However, some of this may be re-distributed towards brand building, in that there is frequently choice of lenders at the point-of-sale. The responsibility for such marketing materials will typically be the sole responsibility of the credit provider.

7.35 However, whilst the relationships between the intermediaries and the lenders may not be on an exclusive basis, there will be restricted choice, i.e. at point-of-sale, the borrower is not selecting a credit product from the whole of the market. This restriction of consumer choice needs to be set against the voided search cost on the borrower from the convenience of the (limited) selection.

Market concentration

7.36 There is no clear relationship between the concentration of the banking sector and market penetration by retailer finance. This lack of a clear relationship is likely to be a function of the prevalence of retailer finance across EU27. In addition, this lack of a clear relationship between concentration in the banking sector and market penetration of POS finance may be due to the existence of other market participants (such as specialist finance houses and captive lenders associated with the major automotive groups) which may not have been picked up fully by the data set that we have.

Figure 7.3: HHI and market penetration for POS

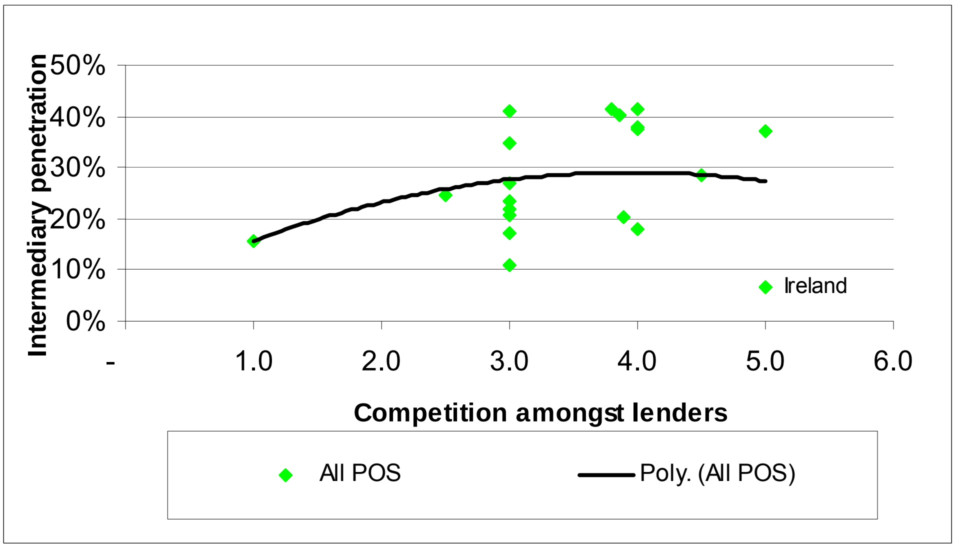


Source: Surveys, ECB Banking Structures (2006 data)

Competitiveness of lenders

7.37 There is a weak positive relationship here. At higher levels of competitiveness, there may be greater product and channel innovation by lenders — this is likely to increase the cannibalisation of retailer finance by other credit products (particularly, pre-approved credit and fixed date loans).

Figure 7.4: Lender competition and market penetration for POS

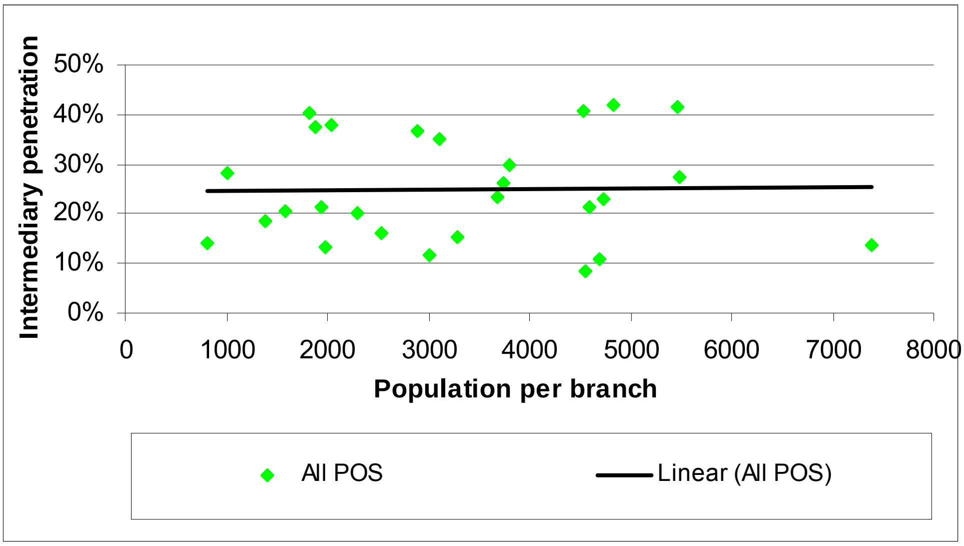


Source: Surveys

Bank branch density

7.38 We illustrate below the share of consumer credit (excluding mortgage credit) intermediated at point-of-sale with bank branch density.

Figure 7.5: Market penetration and branch population for POS



Source: Surveys, ECB Banking Structures (2006 data)

7.39 It is apparent that intermediation at point-of-sale bears no significant relationship with bank branch density. Such intermediation acts as a proxy for additional branches for the credit provider, so that this is, *prima facie*, surprising.

7.40 However, given the prevalence of this business model and the point that even a high density of bank branches will not compete with all other forms of retail, this is perhaps less surprising on reflection. In addition, the increasing availability of consumer credit directly from lenders (either over the internet or the telephone) may make the physical presence of bank branches increasingly less relevant.

The consumer perspective

7.41 POS finance is very convenient for a potential borrower (particularly individual consumers and small businesses). In effect, a retailer, with its access to the credit provider, becomes a “one stop shop” from the borrower’s viewpoint (although the actual credit decision is taken remotely and by another party).

Box 7.1: Point-of-sale vehicle finance in Spain

Financing the purchase of vehicles has become a standard process which reinforces the commercial profitability of the vehicle retail sector. In the past, it used to be the case that those who could afford to pay cash were offered important discounts, so that those who could not were paying a higher price on which, moreover, a high interest rate would be added.

Nowadays many manufacturers have a captive financial arm. In the context of a mature and highly competitive market for new and used vehicles, this allows companies to keep viable profit rates. Price conditions, including the offerings of discounts, do not depend on whether the consumer is able or willing to pay the full amount or prefers to enter into a credit arrangement.

At the same time, however, points-of-sale typically use additional sources of funding. For example, the Spanish Santander Consumer Finance offers various financial arrangements that are presented by dealers to the final consumers. Intermediation by the dealers is compensated with commissions, whose level depends on the characteristics of credit arrangement.

Complementary products, most notably insurance packages, are often offered in connection to the finance of car purchase. These possibilities are presented in the form of “mixed bundling”, wherein the “price” of the bundle (being interest rates for the credit part) is lower than what could be secured buying the two (or more) items separately. Instances of “pure bundling” or “tying”, where the purchase of one item is a necessary condition to get the other(s) were not observed. Overall, we conclude that no evidence was found of anti-competitive practices leading to notable consumer detriment.

Source: Case study, see next section

Business Models of Point-of-Sale Intermediaries

7.42 Our work suggests that the role of the retailer within retailer finance is reasonably standardised across EU27, and again, we look at the activities undertaken on a EU27 basis. Paragraphs 5.29 to 5.30 describe the nature of the activities undertaken by intermediaries.

Breakdown of exclusive and non-exclusive relationships

7.43 For motor retailer finance, whilst some retailers have exclusive agreements with lenders, these appear to be generally a minority. The market norm is for some choice of lender at point-of-sale. This is illustrated at Table 7.3 below.

Table 7.3: Relationship exclusivity mix (motor retail)

Majority (50 per cent or more) of dealers have relationships with lenders on a non-exclusive basis	Significant majority (over two thirds) of dealers have relationships with lenders on a non-exclusive basis
Austria	
Czech Republic	Belgium
Cyprus	Bulgaria
Denmark	France
Finland	Hungary
Germany	Ireland
Greece	Italy
Romania	Poland
Slovenia	Portugal
Spain	UK
Sweden	

Source: finaccord (2007 survey), supplemented by surveys. Data not available on other Member States from these sources..

7.44 In the Netherlands and Slovakia, just under half of motor dealers have relationships with multiple lenders. Looking across all dealers (i.e. those with both only one lender relationship, and those with more than one), the average number of lender relationships varies from 1.78 (Sweden) up to 4.79 (the Republic of Ireland).[144]

[144] Based on finaccord's survey of motor dealers conducted in 2007.

7.45 There is evidence that outside of motor retail finance, the number of relationships with lenders is reduced. This is most likely the case with smaller retailers with lower volumes and values of business.

Table 7.4: Relationship exclusivity mix (other retail)

Majority (i.e. over half) of relationships with lenders on an exclusive basis	Majority (i.e. at least half) of relationships with lenders on non-exclusive basis	Significant majority (i.e. at least two thirds) of relationships with lenders on non-exclusive basis
Slovenia Sweden UK	Bulgaria Finland France	Belgium Czech Republic Germany Italy

Source: Surveys, case study, eurofinas (2007). Data not available on other Member States.

7.46 The following extract from our case study on Swedish retailer finance reinforces this point.

Box 7.2: Swedish retailer finance

Dala Hemtjanst is a small white goods retailer that uses a single lender to provide in-store credit. This is predominantly due to the small volume of transactions, although the retailer did feel that having a relationship with just one lender reduces administrative costs and adds to the speed of credit application processing. The retailer judged that the majority of Swedish stores that provide point-of-sale credit would also use only a single lender.

Dala Hemtjanst does not receive any commission from the lender for products sold via point-of-sale credit. It is a sufficiently mutually beneficial relationship without this. Dala Hemtjanst sells goods that otherwise might not be if customer credit was not available. It follows that there is sufficient margin in the sale of the good itself. The lender gains additional volume, which compensates for the initial costs of locating retailers and setting up and maintaining systems with them. For this reason, there is little pressure or encouragement on customers (through, for example, special offers or discounts) to take out credit.

Although Dala Hemtjanst is encouraged by their lender to secure new clients for them, they do not provide any explicit support in the form of training or IT support. Around once a year the lender visits the store to brief the management on new products or processes. The store's role in the credit application is quite limited. They provide the customer with the documents to fill out and explain areas of the contract, and then submit the application to the lender and wait for the approval. They do not undertake any of the check themselves.

Source: Case study, see next section

7.47 This means that the activity of the typical POS intermediary in non-motor retail is likely to be a less effective proxy for the market search function than the typical POS intermediary in motor retail. Indeed, looking forward to the "Detriment" section at the end this chapter, the significance of non-competitively priced credit products is perceived to be greater in the former category of POS intermediary.

Activities undertaken for consumers and lenders

7.48 Figure 7.6 below illustrates the views of stakeholders on the activities undertaken by retailers.

Figure 7.6: Activities undertaken for borrowers and lenders

Source: Surveys (based upon 66 stakeholder views)

7.49 The completion of administrative tasks is a key role undertaken for both consumers and lenders. This will generally involve entering details into a terminal linked to the credit provider's IT system. The other main functions are to act as a distribution channel as a substitute branch network for lenders and to explain pre-contractual information to borrowers.

7.50 Italian POS intermediaries appear, however, to be a partial exception to this: their main functions are as a distribution channel and to explain pre-contractual information — the completion of administration is less prominent.

7.51 It is clear from the above that the responsibility for conducting credit checks rests with the lender (as with mortgage intermediaries, Belgium represented an exception — and even here the involvement of POS intermediaries in this activity was limited). There is an associated delegated function in explaining pre-contractual information to the borrower.

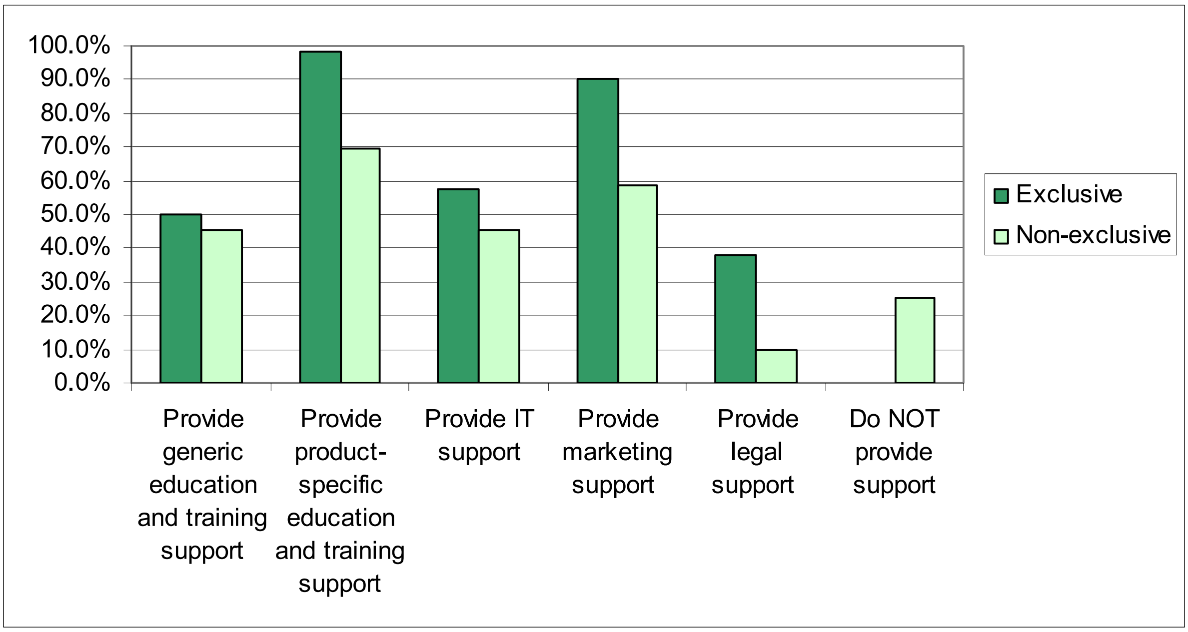
7.52 The actual market search function appears likely to be limited in scope — trivially the case for a retailer with an exclusive agreement with a credit provider.

7.53 The *nature* of the suitability advice is also likely to be rather limited: as noted above, there is often a choice of credit product (at least in motor retail), and many lenders will provide training and/or simple tools such as decision trees to enable staff at the retailer to help the customer make such a decision.

Lender support to retailers

7.54 The support provided by lenders is described in Figure 7.7 below.

Figure 7.7: Support provided by lenders to POS intermediaries



Source: Surveys (based upon 67 stakeholder views)

7.55 The nature of the support provided is in line with the activities undertaken e.g. the IT support is designed to provide a direct link to the credit providers systems. There are significant differences between the level of support offered to retailers with whom the lender has an exclusive agreement compared to those where the relationship is on a non-exclusive basis, with particular emphasis on the levels of marketing support and product-specific training available.

7.56 It is also notable that around one quarter of lenders do not provide support to those POS intermediaries with whom they have non-exclusive relationships. It is interesting to note that Italy, France and Belgium conform to this model of discriminating between the two categories of intermediary — lenders in Germany, the UK and Spain (at least those participating in our survey) all state that they tend to offer support to both POS intermediaries operating on both an exclusive and non-exclusive basis.

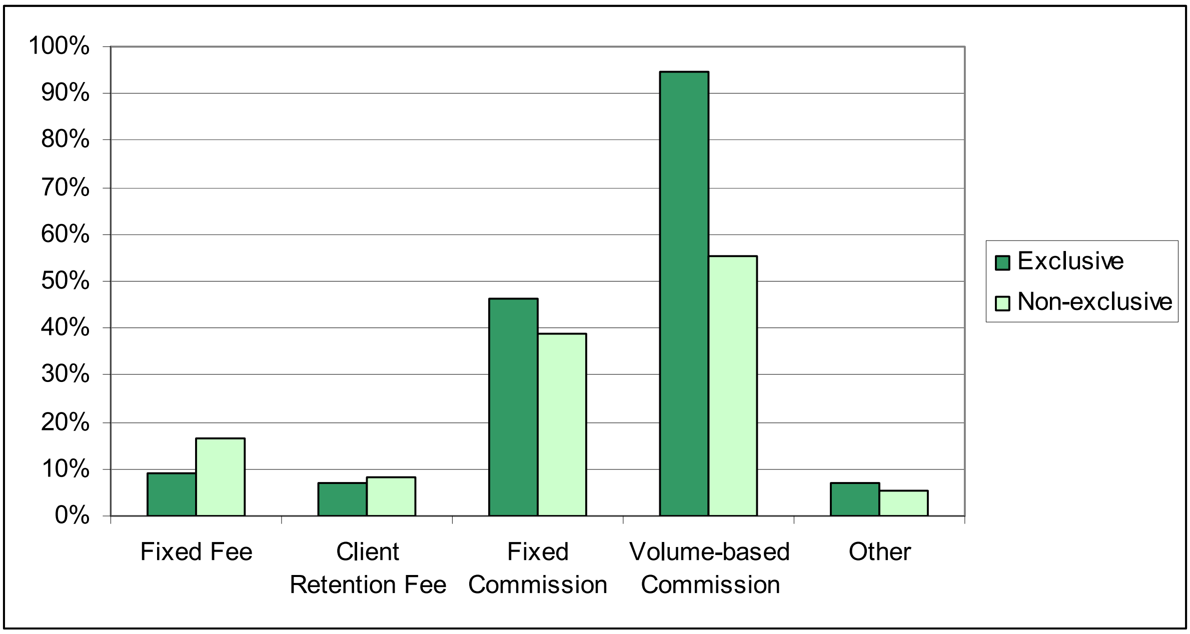
Remuneration of retailers

7.57 The lender (normally) bears a commission cost in respect of products intermediated. (We are not aware of a situation where the borrower directly pays the *intermediary* in respect of the credit services provided.)

7.58 As with intermediation generally, the distance from the customer raises risks of mis-selling credit products (e.g. inadequately explaining the cost profile). Lenders appear to view these risks as minor provided that appropriate controls (in terms of the training, support and follow-up) are good enough.

7.59 The upstream remuneration structure is compared below for those retailers operating on an exclusive and on a non-exclusive basis.

Figure 7.8: Upstream remuneration structure



Source: Surveys (based upon 61 stakeholder views)

7.60 It is noteworthy that retailers with exclusive agreements (i.e. with a single lender) have more complex remuneration arrangements (they are more likely to have two, or more, of the commission or fee arrangements described above). In addition, volume-based commissions are much more prevalent (an important exception being Germany, where fixed commissions are strongly preferred). In addition, French lenders appear to prefer a fixed fee to remunerate POS intermediaries acting on a non-exclusive basis rather than fixed or volume-based commission structures.

Summary Financial Data

7.61 We set out below our estimates of the revenues generated by retailers in respect of retailer finance.

Table 7.5: Revenues from point-of-sale intermediation, 2007[145]

	€m		€m
Austria	40	-	53
Belgium	33	-	44
Bulgaria	5	-	7
Cyprus	2	-	2
Czech Republic	17	-	23
Denmark	20	-	26
Estonia	6	-	8
Finland	22	-	29
France	176	-	236
Germany	495	-	661
Greece	34	-	45
Hungary	28	-	37
Ireland	20	-	27
Italy	352	-	470
Latvia	7	-	9
Lithuania	8	-	10
Luxembourg	1	-	1
Malta	4	-	6
Netherlands	47	-	63
Poland	32	-	43
Portugal	47	-	63
Romania	31	-	43
Slovakia	4	-	6
Slovenia	12	-	17
Spain	174	-	235
Sweden	44	-	59
United Kingdom	254	-	340
	1,913		2,563

Source: Surveys, EE calculations

7.62 The majority of this revenue (towards 90 per cent in most Member States) is generated by motor retail finance. The value of financing intermediated is significantly higher; moreover, and more significantly, the typical commissions (based upon our survey results) are significantly higher. This is described further in the next sub-section.

145 This is based upon the survey data received providing average commission levels receivable by intermediaries linked to market shares and market sizes. This analysis *was* based upon 66 stakeholder views. On this basis we consider it to be broadly representative in the manner that we have applied it.

Cost structure and profitability of point-of-sale finance

Vehicle retail

7.63 The typical value of credit extended at point-of-sale in vehicle retail is in the range €6,000–€20,000 dependent upon the Member State (the range in the EU15 is between about €12,000 and €20,000). The commission payable by the lender to a retailer who successfully arranges credit at point-of-sale averages about 1.8 per cent.[146] No payment is made by the borrower/purchaser of the car.

7.64 Looking at a €16,000 credit arrangement, at this average commission, would mean a payment by the lender of €300. The processing time for this has been reduced to perhaps less than minutes using best practice systems. There are, of course, other costs for the retailer — such as the time spent by staff in training, discussions about point-of-sale finance with potential borrowers that do not result in such a transaction.

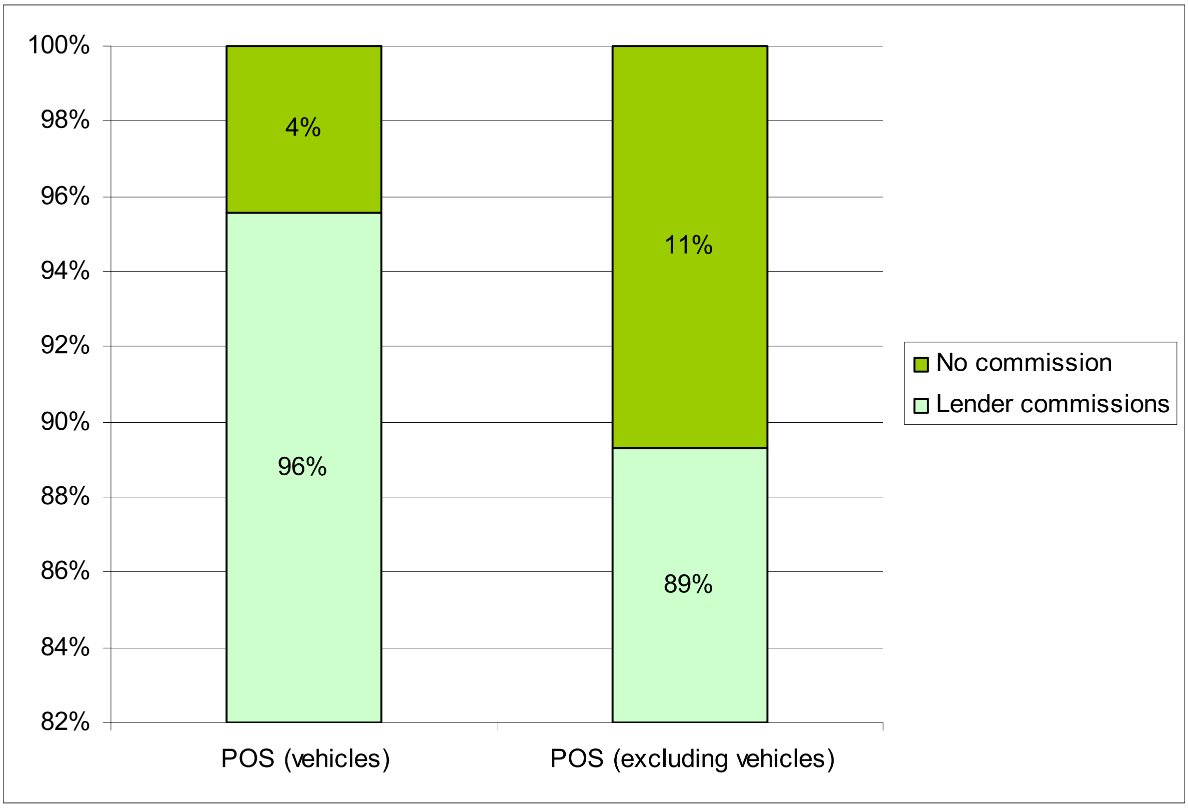
7.65 However, this would appear to be a high margin additional source of business from the perspective of the point-of-sale intermediary. It is noted that the Finaccord study found that in excess of 90 per cent of dealerships were able to provide such finance, which is perhaps indicative of its appeal.

146 Based upon our survey.

Non-vehicle retail

7.66 As noted above, the typical value of retail finance outside of motor vehicles is much less — an average of €1,200 across EU27 (with significant variation between Member States). The proportion of retailers not receiving commissions from lenders is rather higher (albeit still relatively small), as illustrated below.

Figure 7.9: Upstream remuneration of retailers in respect of point-of-sale intermediation



Source: Surveys

7.67 Indeed, the average commission payable to retailers by lenders from our survey was around 0.3 per cent. At this rate, the average transaction would earn just under €5 for the retailer. Based upon the views of leading credit providers that processing time has been reduced to less than five minutes, this is not unattractive in isolation.

7.68 However, given that the retailer would bear other costs — actual and opportunity costs — the appeal of retailer finance may be more usually in the margined achieved on additional sales facilitated by having access to a point-of-sale offering rather than the commissions due from lenders.

Employment in retailer finance

7.69 We set out below our estimates of the FTEs engaged in intermediation at point-of-sale.

Table 7.6: FTEs engaged in retailer finance and the number of participating retailers, 2007

	FTEs 000s	Proportion of all sales staff		Inter-mediaries 000s
Austria	1.5	0.8%	>	3.0
Belgium	2.2	1.3%	>	8.2
Bulgaria	1.1	0.5%	>	0.8
Cyprus	0.4	1.5%	>	0.3
Czech Republic	5.0	2.0%	>	2.8
Denmark	2.8	2.2%	>	2.3
Estonia	0.1	0.3%	>	0.3
Finland	1.0	0.9%		5.4
France	25.5	3.7%	>	32.2
Germany	20.1	1.4%		73.9
Greece	3.2	1.1%	>	2.2
Hungary	7.0	2.3%	>	5.5
Ireland	0.7	0.6%	>	1.3
Italy	5.9	0.8%		37.1
Latvia	0.1	0.2%	>	0.2
Lithuania	0.5	0.5%	>	1.0
Luxembourg	0.2	2.3%	>	0.4
Malta	0.1	0.6%	>	0.2
Netherlands	8.5	2.3%	>	16.1
Poland	12.5	1.0%	>	12.9
Portugal	5.2	2.0%	>	5.7
Romania	4.3	0.8%	>	0.9
Slovakia	0.4	0.2%	>	0.3
Slovenia	0.7	1.4%		0.7
Spain	20.6	2.1%	>	11.2
Sweden	1.9	1.1%		4.1
United Kingdom	30.5	1.8%	>	27.4
	161.8		>	256.5

Source: Surveys, ILO (2006 data), finaccord (2007), eurofinas (2007), eurostat (motor retail firms and employment, 2003— NB Greek retail employment data not available, estimated based upon Portugal as a proxy), EE calculations

7.70 The number of workers is based upon estimates of the proportion of time spent on POS intermediation activity (processing both successful and unsuccessful transactions and product-specific and general training). Using eurostat and ILO data on the number of motor and general retail workers designated as working in sales (as opposed to, say, back office functions) we have calculated the approximate FTEs for such POS intermediation activity in total. This activity taking 1–2 per cent of such workers' time, in the aggregate, is typical. It is likely that there is some degree of specialisation in larger retailers where achievable in order to restrict training costs and to build a limited expertise. Given the short processing times for the different forms of retailer finance identified above, the actual time spent in intermediation directly with customers will be well below the FTE levels indicated in the above table.

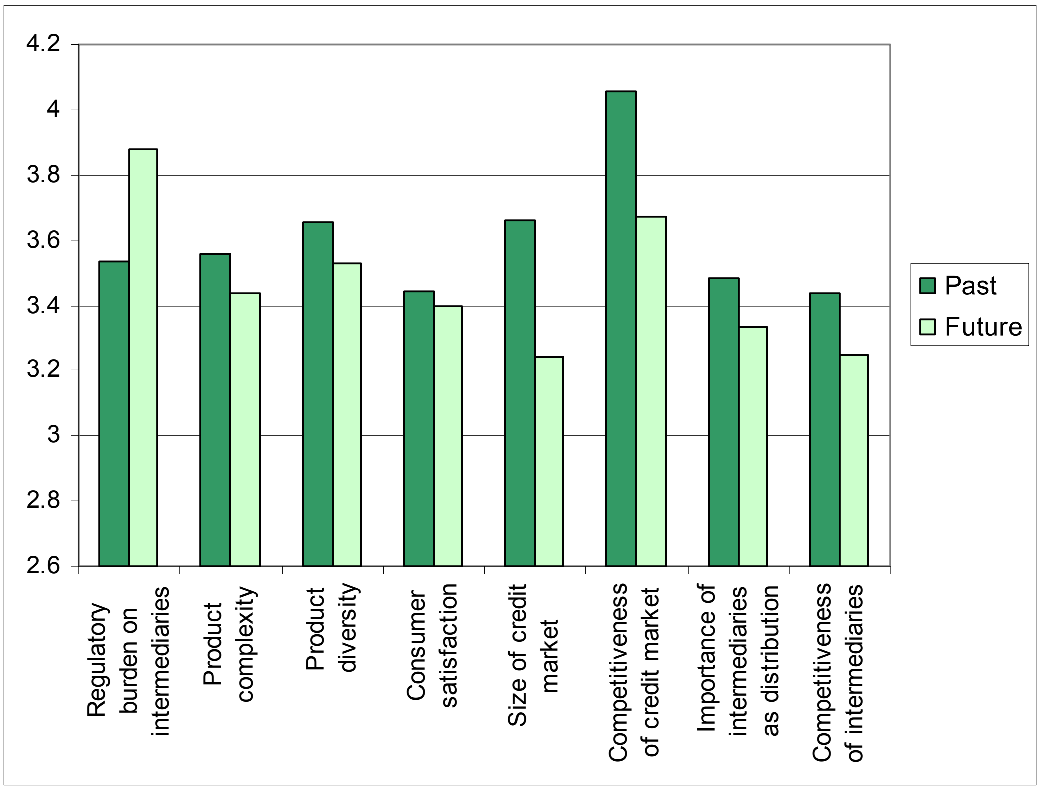
7.71 The data on the number of retailers offering POS finance is limited. In most instances, the number of POS intermediaries represents motor retailers only.

Developments

7.72 The figure below illustrates the consolidated views of stakeholders participating in our survey with regard to how certain key variables have changed over the past five years and are expected to change over the next five.

7.73 As previously noted, these results are based upon data gathered between April and July 2008. As such, they will self-evidently not reflect the recent credit market turbulence (particularly that ensuing from the collapse of Lehman Brothers in September 2008 to date) and the associated change in sentiment concerning the short- and medium-term prospects of the economic situation across the EU27.

Figure 7.10: Trends in retailer finance



Source: Surveys

7.74 The shift in regulatory burden upon point-of-sale intermediaries is largely related to the implementing measures associated with the Consumer Credit Directive. The reduced confidence about the growth in importance in point-of-sale as a distribution channel may reflect increased concern about cannibalisation from other credit products.

Regulatory Framework

7.75 In section 4, we discussed the approach we took to categorise the regulatory regime of different Member States. We do not repeat that discussion here.

7.76 On the basis of the above responses and further information provided by national regulators, we categorise Member States' regulation of POS intermediaries as shown below. It is apparent that the regulatory approach to retailer finance (in terms of the retailers as intermediaries) is at a lower level in a number of Member States to that applicable to, say, the intermediaries operating in the residential mortgage market (i.e. the entry and ongoing requirements are more limited).

Table 7.7: Regulation of POS Intermediaries

No or limited explicit statutory regulation of POS intermediaries	Moderate level explicit statutory regulation of POS intermediaries	Significant explicit statutory regulation of POS intermediaries
Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Portugal, Romania, Slovakia, Spain, Sweden	Bulgaria, Germany, Italy, Malta, Slovenia	Hungary, Ireland, UK

Source: Surveys, EE analysis

Consumer Benefit and Consumer Detriment

7.77 This section should be read in conjunction with our analysis at the beginning of Section 4. In response to our survey, consumer associations and regulators assessed the scope for consumer detriment resulting from point of sale credit intermediation. In terms of the consumer benefit from retailer finance, we have already alluded to the convenience to the consumer and the potential for avoided search costs. In Box 7.3 below, we discuss the consumer welfare implications identified within a case study on motor retail POS finance.

Box 7.3: Analysing the welfare effect in retailer finance

The change in consumer welfare can be identified as follows. With respect to a counterfactual where those intermediated arrangements do not exist, consumers would either pay cash, or resort to direct lenders, or simply be unable to buy the car. Revealed preference arguments — broadly speaking, if you choose something it means that it is better for your welfare than the available alternatives[147] — suffice to say that a rational consumer who does get intermediated credit is better off than in the counterfactual, and are reinforced by considerations with regards to competition. It is natural to assume that intermediated credit entails higher competitive pressure for captive finance providers and for direct lenders, so that even consumers who do *not* buy with the funding provided by non-captives (e.g. SCF and BBVA), benefit from the availability of those possibilities.

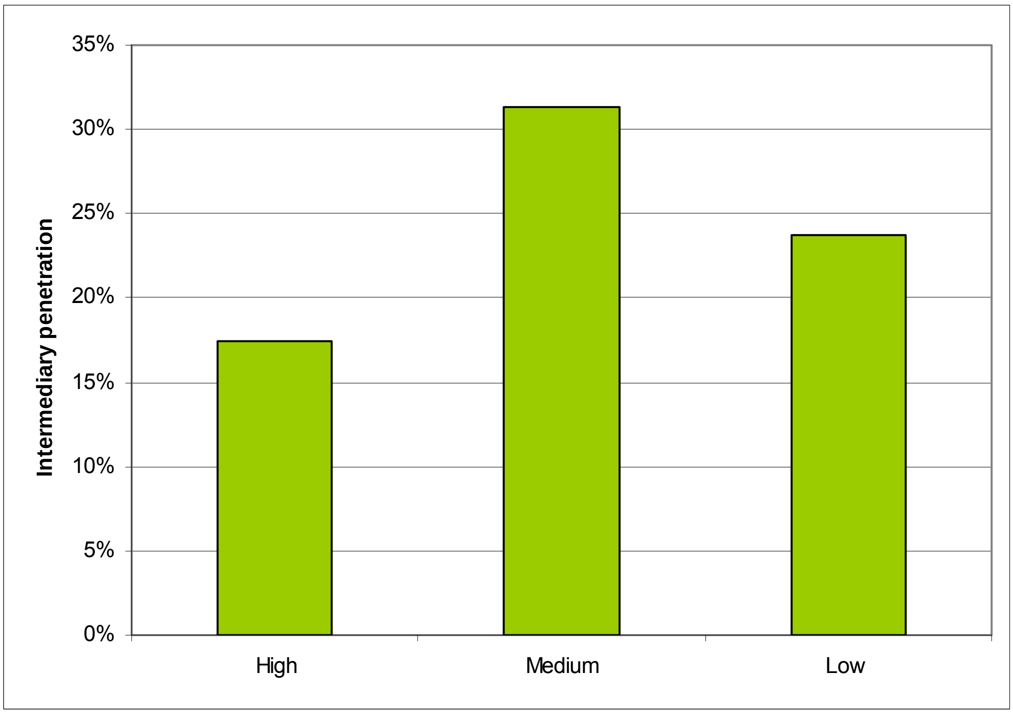
It is not straightforward to assess the extent of detriment suffered by EU consumers due to the lack of cross-border transactions linked to car purchases. The above mentioned element of proximity to the customer as a component of the value added by POS intermediation suggests, however, that this detriment may be rather limited. It is unclear to which extent those consumers who, due to car price differentials, are willing to search and able to buy a car in an EU Member State where they do not reside, fail to do so because of the difficulty to achieve credit arrangements at the point-of-sale.

Source: Case study, see next section

7.78 There is no clear correspondence here between the level of regulation/supervision and the degree of POS intermediary penetration. It may be that credit providers may have a significant effect on POS intermediary behaviour, in the absence of significant regulation.

[147] Exceptions may occur, however, when consumers' decisions is negatively affected by myopia or other flaws that hamper the perfect rationality typically assumed in economic analysis, and the actual costs of repaying the debt is not fully understood. In this case, the availability of credit may result in excess of purchasing activity.

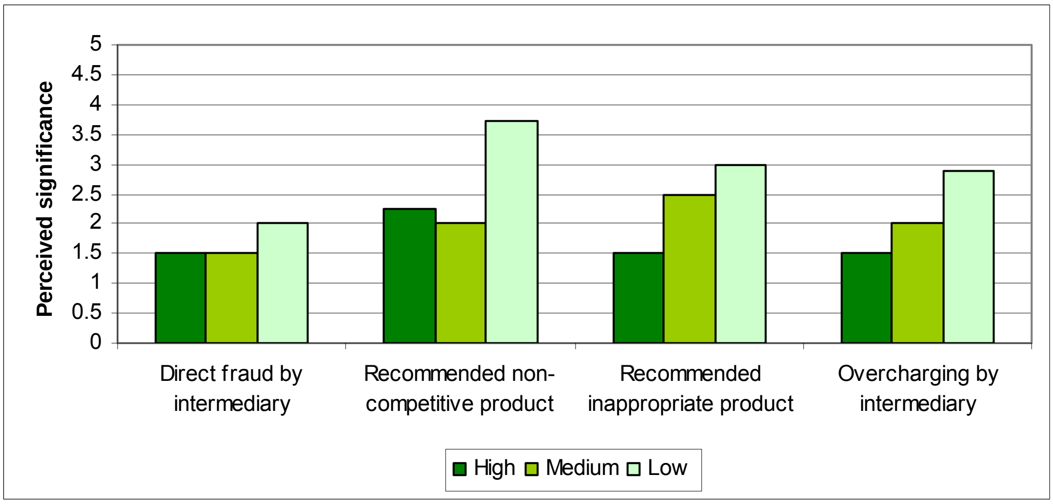
Figure 7.11: The degree of penetration according to level of regulation



Source: Surveys, EE analysis

7.79 We have compared the perceived significance of particular forms of potential detriment to our broad categories of the different regulatory frameworks.

Figure 7.12: The perceived significance for consumer detriment according to level of regulation



Source: Surveys, EE analysis (5 = high perceived significance, 1 = low perceived significance)

7.80 The graph shows that the perceived significance of the types of consumer detriment relating to poor quality advice tends to be higher where the level of regulation is lower (although the relation is less clear cut than in the other categories — see, for instance, section 9). On the other hand, the perceived significance of direct fraud by the intermediary is not clearly correlated to the intensity of regulation — this detriment may relate more to local cultural norms than the regulatory framework *per se*).

7.81 We note in passing, on balance — whilst the view is not universal — respondents considered non-motor retail finance intermediation to pose an increased risk by comparison to motor retail finance. This may be linked to reduced choice of credit providers that our study indicates prevails in the former category.

7.82 This is perhaps unsurprising but, as mentioned in the case of mortgages, the graph does not necessarily indicate that the benefits to consumers (since well-designed regulatory intervention can resolve (or at least mitigate) some of the market failings that result in detriment to the consumer) outweigh the costs (and possible consequential consumer detriment) to businesses of complying with it.

7.83 Direct fraud is not perceived to be a major source of consumer detriment. Intermediaries' scope for direct fraud may be limited with point-of-sale credit provision, mainly because the contract is usually processed from beginning to end in front of the consumer under a tight deadline.

7.84 Recommending a non-competitive product is seen as the most significant source of consumer detriment. In the case of non-vehicle point of sale, this could be due to the fact that intermediaries usually work with a very limited number of lenders (perhaps only one) and therefore the customer may not be exposed to an adequate range and price of products. The survey respondents considered non-motor retail a cause of greater concern in this respect than motor retail (again, this may be linked to the more limited lender choice that our study indicates is more prevalent in the former). There are often high contract penalties attached to point-of-sale credit. A series of practical problems may increase a consumer's perceived cost of searching for better products, and can further aggravate this situation. For instance, our survey indicated that often contract conditions may be complex. Customers may be "pressurised" to accept the credit contract and take their purchase home.

7.85 In addition to this, the recommendation of a non-competitive or inappropriate credit product may be possible where a cash-constrained customer is 'excited' at the possibility of purchasing the good he or she wants (i.e. a car, etc) and may overestimate the pleasure they will receive from the good and underestimates the cost of entering into the credit transaction.

7.86 Overcharging could occur even in 'zero interest' offerings if these hide commissions or other expenses linked to opening the credit transaction. Retailers have an incentive to promote credit offerings as it means they will receive the custom of someone who ordinarily may not buy the product.

7.87 Overcharging is the source of consumer detriment most reduced by a higher regulatory environment. This could be because, after direct fraud, it is the most noticeable source of detriment, one which is more likely to be reported and therefore acted upon.

Examples

7.88 However, notwithstanding the above, we have only located or been made aware of very few specific, real-life cases relating to point-of-sale intermediation. This corresponds with our analysis in Section 3. We set out these examples below. Both relate to the exploitation of asymmetric information (in the second case, an attempt to exploit such an asymmetry).

> A Polish retailer advertised consumer credit at a "zero percent interest rate and at no extra cost". In fact, this was possible only with the additional purchase of compulsory insurance leading to an effective interest rate of 5-7 percent.[148]

> A Danish consumer bought a water bed from a retailer, on credit from a third party lender. The retailer processed the loan application (completed by the consumer), with the credit granted whilst the consumer was still in the shop. The consumer later annulled the purchase due to substantial defects and raised a claim against the retailer for the repayment of loan installments already made. He was backed by the Consumer Complaints Board. The lender countersued for the remaining loan installments.

> Although entitled to refuse potential borrowers, the lender had actually committed itself not to and an agreement under section 5(2) of the Credit Agreements Act was found to exist. The consumer was therefore able to claim the installments paid back and have the future installments annulled.[149]

Cross-border Activity

7.89 The figure below identifies the views of stakeholders on the trends in cross-border activity, and the role of intermediaries within it over the past five and next five years. These results are based upon data gathered between April and July 2008. As such, they may be best interpreted as a guide to long-term trends rather than predictions applicable to the short-term.

7.90 Cross-border lending volumes are expected to weakly increase and intermediation is expected to become more important as a distribution channel. Further, the importance of the role of intermediation in such lending is expected to increase more significantly during the next five years than it has in the past.

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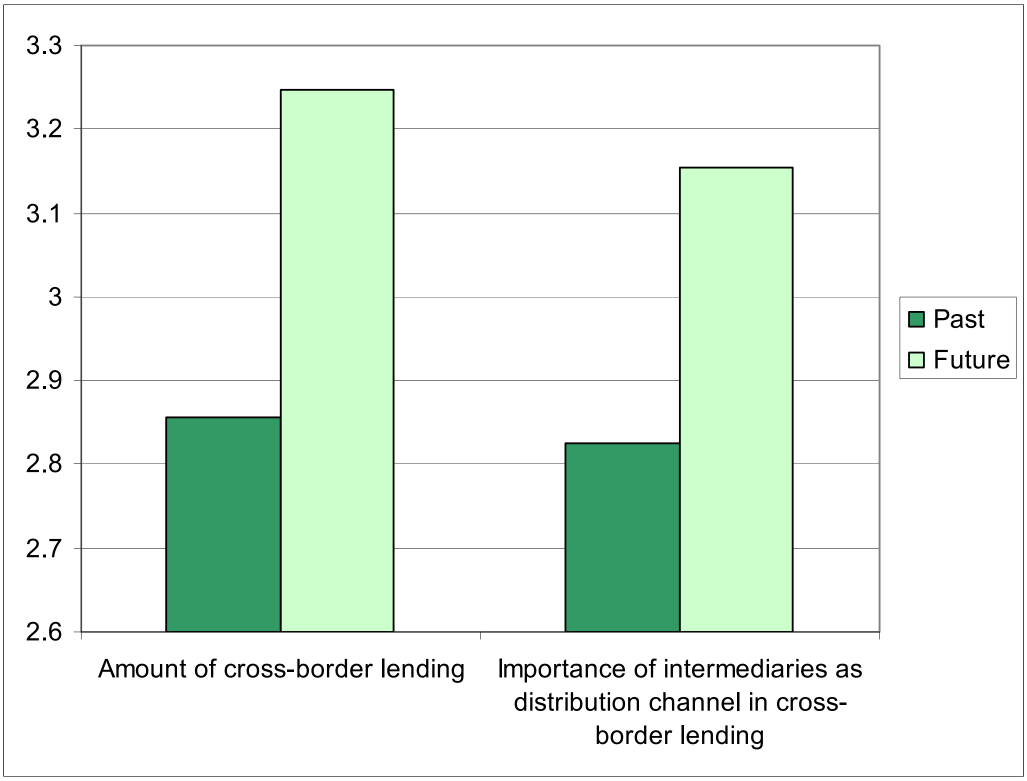
148 Source: http://216.239.59.132/search?q=cache:ust81FOh5jwJ:www.uokik.gov.pl/download/Z2Z4L3Vva2lrL3BsL2tzZ19weXRhbmlhLnYwLzI3NC8xLzEvZGVjeXpqYV9ucl9ybHU2XzIwMDdfd19zcHJhd2llX3N0b3Nvd2FuaWFfcHJha3R5a19uYXJ1c3phLnBkZg+RLU+%E2%80%93+61-35/05/MW&hl=pl&ct=clnk&cd=1&gl=pl

149 Consumer Complaints Board Archives, www.forbrug.dk

Figure 7.13: Trends in cross-border activity



Source: Surveys. A score of 3= stability. 1= significant reduction and 5 = significant increase.

7.91 However, barriers remain to cross-border trade through retailer finance. The extent of cross-border activity, the barriers to its growth and the role of intermediaries are considered more fully in Section 13 below.

8 CASE STUDIES RELATING TO INTERMEDIATION AT POINT-OF-SALE

Santander Consumer Finance and Point-of-sale Vehicle Finance in Spain[150]

8.1 The sale of motor vehicles is frequently coupled with the provision of credit at point-of-sale. Dealers engage in the activity of credit intermediation between their final customers and the finance providers.

8.2 Most of the main manufacturers have "financial arms" so that the sales of their cars are linked to the offer of credit by a different division — these are typically referred to as "captive" finance providers. An increasingly important role is being played by non-captive providers, i.e. by financial institutions offering a credit product in relation to car purchases.

8.3 Two Spanish institutions, Santander Consumer Finance and BBVA, are particularly prominent as providers of credit intermediated at the point-of-sale. Santander Consumer Finance, in particular, has succeeded in securing a position of market leadership in Spain and in several other countries (mostly within the EU). As a consequence, the analysis of the *modus operandi* of Santander Consumer Finance should shed some light on POS intermediation related to vehicles more broadly. This case study is complemented by research on the operations at points-of-sale in Spain and, to a lesser extent, in Italy.

Background

8.4 According to Mercer Oliver Wyman (MOW), in Spain, it accounted for 35 per cent of consumer credit outstanding. The use of point-of-sale finance is increasing in Spain (already in excess of 97 per cent of dealerships offer financing options at point-of-sale. However, according to finaccord the average number of providers per dealer dropped

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150 Our research for this case study consisted of the following.

We interviewed a small number of Santander Consumer Finance senior representatives (22 and 26 May 2008). Two interviews took place with dealers located in Spain who use Santander as a non-captive provider (19 and 20 May 2008). In addition, we spoke to a former Italian dealer to give a longer time horizon to our knowledge of this market and to provide a non-Spanish, non-Santander contrast to the remainder of our research. This helped us to understand how their operations in relation to the provision of credit have evolved and the current relations with captive and non-captive finance institutions have changed over time.

We also conducted a mystery shopping exercise to refine our understanding of what is offered to clients. It has been especially valuable in achieving clarification on the non-availability of credit for potential customers without residency in Spain (an Italian consultant based in Barcelona mystery shopped for a car on credit in Spain).

Desk-based research included:
a) The European Commission's papers, including the "Green Paper on Retail Financial Services in the Single Market" (2007) and "White Paper on Financial Services Policy 2005-2010".
b) Several academic papers such as, among others, Bertola et al, "Dealer pricing of Consumer Credit" (2005), provided interesting insights regarding the strategic interaction between the agents involved (finance providers, dealers and end consumers).
c) MOW's "Consumer Credit in Europe: riding the wave", 2005 provided an overall picture of the market for consumer credit and data related to vehicle credit.
d) The report "Automotive Finance and Leasing for Consumers in Europe" by Finaccord.

from 2.8 to 2.1 in the period 2002–6. This may be attributable in part to the growing dominance of Santander Consumer Finance and BBVA as independent suppliers to the dealer channel).

8.5 Dealerships may use a number of finance providers for several different reasons, including: the need to source better value deals and a higher level of service for customers; the potential to earn superior commissions from different finance companies; the need to find alternative finance solutions for some customers who fall outside the lending criteria used by mainstream finance providers.

8.6 Stagnant profitability in the retail of new and used vehicles, along with changes to block exemption rules, led to consolidation in the market, where the number of dealers seems to have stabilised after some years of significant decrease, and to the emergence of multi-marque dealers and car supermarkets. In this context, financial services are becoming more important in the profitability of the sector. In this context, Fiat and GM sold (in 2006 and 2007, respectively) controlling shares of their financial arms, moves aimed at improving cost-effective funding. Greater emphasis is being placed on offering product and service bundles, including finance and insurance as well as repair and maintenance.

Economic and financial analysis of POS intermediation

The lender's perspective

8.7 Contact with the client is presented as the cornerstone of the strategy of the whole Santander group. Indeed, the consequent high density of its distribution network is part of the typical model of competition in Spanish banking.[151] Santander Consumer Finance (SCF)'s strategy is consistent with this, qualified by the contact with clients being indirect, via the point-of-sale.

8.8 That same strategy is implemented in Spain and in all the 19 countries where SCF has expanded,[152] in all of them becoming a strong presence among credit providers. When considering credit arranged at the points-of-sale in Spain, the combined market share of captive finance providers is, according to SCF, around 40 per cent, against around 60 per cent for non-captives (SCF quote being 22 per cent *versus* 15 per cent for BBVA).

8.9 The same philosophy is applied in all different national contexts. It consists in providing a high quality of service to the point-of-sale in terms of information flows, customised financial offers, including attractive fees for the dealer and competitive credit conditions for the final customer. In exchange, dealers collect customer data along with the

151 As reported by the Bank of Spain in its documents and annual reports, see www.bde.es.

152 This includes another 14 EU countries (Germany, Italy, Portugal, Poland, Sweden, UK, Finland, Netherlands, Austria, Hungary, Czech Republic, France, Denmark and Slovakia), two European countries outside the EU (Russia and Norway), and three American countries (USA, Mexico and Chile).

characteristics of the vehicle and of the requested financial arrangement. The cross-selling of other consumer credit products is part of SCF's strategy.

8.10 SCF's automated systems based on credit scoring techniques result in a rapid decision as to whether to provide credit. Efficient risk management systems were mentioned by SCF representatives as a means to reinforce the competitiveness of SCF, capable of achieving a very low level of cost to income ratio below 30 per cent.

8.11 In this context of flexible financial arrangements, forms of bundling of products are offered, including a variety of insurance schemes. While bundling typically implies better conditions compared to the separate purchase of stand-alone components, these offers are never presented in forms of "pure bundling" or "tying" where the customer would be "forced" to buy one product to get the other.

The dealer's perspective

8.12 Meridiana Motors is a medium-size dealer located in Barcelona, Spain. They sell Fiat and Alfa Romeo brands and intermediate credit for SCF and for a captive finance provider.

8.13 SCF's support mainly consists in having one dedicated professional within SCF, who proposes different credit packages which Meridiana Motors will offer to clients according to their needs. The main focus of the interaction between SCF and Meridiana Motors consists in achieving the highest possible flexibility in providing different credit alternatives tailored to those needs and to customer risk profiles. This is consistent both with Meridana Motor's objective to boost car sales and with SCF's goal to conclude a high number of credit transactions while limiting the inherent risk.

8.14 The SCF representative, who is not physically located at Meridiana Motors premises and also interacts with other dealers, can be contacted whenever special requests from clients arise, and interacts weekly with Meridiana Motors.

8.15 The transaction follows standardised procedures, whereby Meridiana Motor collects the data on the potential borrower's profile as requested by Santander Consumer Finance. The latter takes sole responsibility for the approval of the credit and bears the whole risk.

8.16 A commission is paid by Santander Consumer Finance according to the type of credit transaction, which may or may not include bundles with different financial products, mainly insurance packages. The discounts offered to clients are invariant to the credit transactions.

8.17 Reagroup is a Renault point-of-sale located in Esplugues, in the Barcelona metropolitan area. Credit for their customer comes from a captive finance provider, Renault FI. Hence intermediation is happening between two parts of the same firm, Renault, which provide us with a useful contrast.

8.18 Renault FI establishes what kind of information should be requested of the client and the credit packages to be offered, and takes full responsibility for the decision to grant credit. Whilst those procedures are set by Renault FI main branch in Madrid, the high level strategy with regards to financing vehicle purchases is defined by Renault headquarters in Paris.

8.19 Credit has become an important source of Renault profitability. The main focus of the credit policy consists in fostering car sales, in an increasingly difficult sector, and credit transactions; however, it has been observed by the salesforce that the recent credit crunch effects the availability of credit. Clients with a limited credit history or a relatively "unsafe" combination of employment situation and salary may find it harder than in the recent past to obtain credit.

8.20 POS intermediation is beneficial to consumers in a number of ways. In particular, point-of-sale becomes part of the distribution network of efficient financial institutions. This results in lower costs of the credit providing activity, that are, to some extent, passed through to consumers in the form of better financial terms and an increased variety of credit arrangements. This can be seen especially in the contrast between today's situation, where the price of the car does not depend on whether credit is arranged, and the past where big discounts were offered to those willing and able to pay cash.

Economic analysis

8.21 The change in consumer welfare can be identified as follows. With respect to a counterfactual where those intermediated arrangements do not exist, consumers would either pay cash, or resort to direct lenders, or simply be unable to buy the car. Revealed preference arguments — broadly speaking, if you choose something it means that it is better for your welfare than the available alternatives[153] — suffice to say that a rational consumer who does get intermediated credit is better off than in the counterfactual, and are reinforced by considerations with regards to competition. It is natural to assume that intermediated credit entails higher competitive pressure for captive finance providers and for direct lenders, so that even consumers who do *not* buy with the funding provided by non-captives (e.g. SCF and BBVA), benefit from the availability of those possibilities.

153 Exceptions may occur, however, when consumers' decisions is negatively affected by myopia or other flaws that hamper the perfect rationality typically assumed in economic analysis, and the actual costs of repaying the debt is not fully understood. In this case, the availability of credit may result in excess of purchasing activity.

8.22 The practice of bundling does not seem to entail anti-competitive effects. Rather, as it appears to occur in the form of "mixed bundling" (better conditions if you get the bundle but also the availability of financial products on a stand-alone basis) for complementary goods, it has welfare-enhancing properties.[154]

8.23 From the mystery shopping, we observed a high variety of terms offered with credit rates around 7 to 9 per cent APRC. Despite the dispersion, these are reasonable rates for depreciating durables.

8.24 Incidentally, the mystery shopping allowed us to observe that the physical presence of credit providers in the point-of-sale is relatively rare, but possible (it was observed in one case only with one BBVA representative being located in a big dealership in Barcelona).

8.25 Furthermore, we also observed that bundling arrangements are presented as possibilities, where the simplicity of having more needs being solved in a single transaction is often cited as an important advantage besides favourable rates, and never as an "obligation", whereby one would need to get, for example, insurance in order to obtain credit.

Economic and financial analysis of cross-border activity

The lender's perspective

8.26 SCF's international expansion has happened through acquisitions of foreign institutions and the set-up of new branches. Cross-border activity in terms of providing credit to citizens who do not reside in the same nation of the dealer where the credit is intermediated remains virtually non-existent.

8.27 SCF representatives link this outcome to demand and supply-side components. On the demand side, our evidence indicates that proximity — geographical but also linguistic and cultural — between the client and the point-of-sale is crucial. The very source of competitiveness, i.e. the capillary networks of dealers connected to SCF leading to this proximity, leads to a low level of requests for credit-based purchase decisions by residents in a foreign country. On the supply side, it is more difficult to assess credit worthiness and to track down a customer, and to enforce mechanisms of pressure.

The dealer's perspective

8.28 Looking at Meridiana Motors, credit to foreign residents is not granted, as the validation of data may be more difficult and, especially, as it is likely to be much harder to exert pressure on borrowers when credit is not being repaid. The main issue does not seem to be based on language barriers but on the costs of tracking down borrowers located abroad and somehow "force" them to pay their debts.

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[154] An excellent, and mostly non-technical, explanation of the economic effects of bundling can be found in Nalebuff, B. (2003) "Bundling, Tying and Portfolio Effects" Department of Trade and Industry working paper #1, London.

8.29 For Reagroup, cross-border credit transactions do not occur: foreign residents would need to obtain credit from their local branch of the Renault finance arm.

8.30 The Italian dealer did sell cars to non-Italian buyers, who never requested credit. As a consequence, the issue of funding purchases by foreign residents was never presented during the life of the firm. The impression of the firm's representative, however, is that such a request would have had a small chance of being satisfied, due to a combination of factors linked to the difficulty to assess credit worthiness and to recover the loan in case of failure to pay by the borrower.

8.31 Mystery shopping reinforced this view with regards to the availability of credit for non-residents. Presenting the issue of an Italian resident considering the possibility of buying a car in Spain in conjunction with a credit arrangement, we found that while the purchase is, of course, theoretically possible, funding typically is not available without the "tarjeta de residencia" (resident's card).

8.32 This was the case for all the 12 dealers contacted — three with face-to-face interaction in Barcelona, nine contacted by phone and located in different regions of Spain. Invariably, the main reasons were connected with the difficulty of dealing with customers who do not repay; in some cases it was mentioned that current turbulence in credit markets render that perspective even more difficult.

8.33 More specific remarks concerned the legal issue of being able with Spanish residents only to get access to their salaries or other possessions in the event of default. In addition, prior to the approval of credit, the information required for effective credit scoring is made more difficult.

Economic analysis

8.34 The absence of cross-border arrangements is potentially troublesome in terms of consumer welfare. In principle, this may reduce the possibilities for consumers to secure the best arrangements in the internal market, and hence distort competition thereby giving lower incentives to cut prices.

8.35 While we have seen that intermediation enhances consumer welfare, by the same token any limitations are likely to reduce it. However, a close observation of the competitive dynamics leads us to think that, within the subject matter, the consumer detriment may actually be limited.

8.36 The very fact that intermediation by dealers strengthens the distribution network of SCF and its competitors led us to observe that proximity to the client may indeed be an important source of competitive advantage. Hence, those who do want to secure credit at the point-of-sale are mostly residents in the area where the point-of-sale is located — and physical, linguistic and cultural vicinity is quite likely to be advantageous in terms of post-of-sale services. The issues of assessing credit worthiness and tracking down delinquent borrowers may be secondary to this.

8.37 Overall, demand and supply side analyses lead us to assume that limitations to POS intermediation to those who reside in the same country are probably not a major source of consumer detriment.

Summary of key findings

8.38 Financing the purchase of vehicles has become a standard process which reinforces the commercial profitability of the vehicle retail sector. In the past, it used to be the case that those who could afford to pay cash were offered important discounts, so that those who could not were paying a higher price on which, moreover, a high interest rate would be added.

8.39 Nowadays many manufacturers have a captive financial arm. In the context of a mature and highly competitive market for new and used vehicles, this allows companies to keep viable profit rates. Price conditions, including the offerings of discounts, do not depend on whether the consumer is able or willing to pay the full amount or prefers to enter into a credit arrangement.

8.40 At the same time, however, points-of-sale typically use additional sources of funding. For example, the Spanish Santander Consumer Finance offers various financial arrangements that are presented by dealers to the final consumers. Intermediation by the dealers is compensated with commissions, whose level depends on the characteristics of credit arrangement.

8.41 Finance providers define what information regarding borrowers must be collected, decide whether to provide credit, pay the equivalent amount to dealers along with commissions and assume the whole risk attached to these operations.

8.42 Complementary products, most notably insurance packages, are often offered in connection to the finance of car purchase. Those possibilities are presented in the form of "mixed bundling", wherein the "price" of the bundle (being interest rates for the credit part) is lower than what could be secured buying the two (or more) items separately. Instances of "pure bundling" or "tying", where the purchase of one item is a necessary condition to get the other(s) were not observed. Overall, we conclude that no evidence was found of anti-competitive practices leading to notable consumer detriment.

8.43 International expansion of Santander Consumer Finance has been pursued via acquisitions of foreign financial institutions and setting up branches abroad. Coordination from Madrid leads to economies of scale and scope and high efficiency.

8.44 Cross-border credit transactions are virtually non-existent. The available evidence indicates that there is only limited demand for it. We have found that, on the supply side, there is no possibility of arranging credit at the point-of-sale for consumers who do not reside in Spain. The main argument presented, both at the point-of-sale and in speaking to a finance provider, consists in the difficulties in tracking down borrowers who fail to pay and, especially, to get hold of the salary and funds implicitly offered as guarantee for repayment. Assessing credit worthiness, prior to the grant of credit, was also mentioned as more difficult when non-residents are involved.

8.45 Financial institutions in the EU and most notably in Spain are characterised by proximity to the client as a key element of their strategy, and this is certainly the case for the likes of Santander and BBVA. POS intermediation represents a relatively cheap means of achieving this proximity when offering to finance car purchases. We find that this type of intermediation enhances the welfare of consumers, who enjoy a wide variety of credit arrangements tailored to their needs at reasonable interest rates.

8.46 It is not straightforward to assess the extent of detriment suffered by EU consumers due to the lack of cross-border transactions linked to car purchases. The above mentioned element of proximity to the customer as a component of the value added by POS intermediation suggests, however, that this detriment may be rather limited. It is unclear to which extent those consumers who, due to car price differentials, are willing to search and able to buy a car in an EU Member State where they do not reside, fail to do so because of the difficulty to achieve credit arrangements at the point-of-sale.

Point-of-sale Intermediation in Swedish Retail[155]

8.47 This case study explores the provision of credit at the point of sale in Sweden, particularly the interaction between the intermediary and the consumer, and what the lender provides to the intermediary. The focus is on retail excluding vehicles, which has been specifically covered in another case study. A key point of difference is that the value of transactions is likely to be much smaller.

Background

8.48 Data from Eurofinas' Swedish members,[156] which make up 43.2 per cent of the total Swedish national market for consumer credit and car finance, gives an indication of the non-vehicle point of sale credit market in Sweden. In 2006, outstanding credit for consumer goods[157] was €747m, with €305m in new credit granted.

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155 Our methodology was as follows: we interviewed a Swedish retailer (July 2008), who offers point of sale credit through their stores, and a Swedish lender which uses point of sale intermediaries. To add a broader scope to the study we also reviewed several general point-of-sale credit information sources.

156 There are thirty-six members of the Association of Swedish Finance Houses.

157 Includes electronics and household appliances (average loan €1,400) and larger goods such as lounge suites and kitchens (average loan €7,400)

Evolution of retail point of sale credit

8.49 According to a retail finance expert,[158] retail finance has progressed significantly over the last 15 years. In the past, retail finance was store driven. Credit was offered at the till point, and there was little or no regulation and staff offering credit had little training. The process was very lengthy (an average of 45 minutes) and required the customer to undergo basic 'know your customer' and credit check procedures before a call was made to the credit provider. The decision from the lender was not always instant, and the store could often ultimately overturn it. More importantly, the store was responsible for any bad debt and local fraud management.

8.50 Currently, best practice means that credit is offered and the decision completed at the till, through an online application process or phone call with a real-time decision. The whole process is underpinned by training, a regulatory framework and systems and controls, and takes on average three minutes. The retailer is able to print all the paperwork as soon as it is confirmed, and pass all information onto the customer.

8.51 The lender is responsible for the credit check (which may be contracted out to a Credit Reference Agency where that is an available service) and the final decision, and is responsible for all aspects of the loan.

8.52 The retailer is expected to have full knowledge of the technical procedures, and to be competent to gather all required data in line with regulation. The retailer should inform customers properly regarding the credit facilities, contractual agreements, and credit and card features. The retailer has no responsibilities or impact regarding credit decisions.

8.53 The credit provider has exclusive ownership of the credit policy, credit decision and follow-up of credit files. They are responsible for verification of all data. The provider should also update, inform and train the retailer regarding regulation and commercial subjects.

The retailer experience

8.54 Dala Hemtjanst AB is a Swedish white-good retailer. The proportion of goods they sell through point-of-sale financing is very limited. On average one customer per day will make use of their financing service, whilst the majority of customers not paying cash use credit cards. The main reason given by the retailer is the convenience of using a pre-approved card, as opposed to going through the process of form-filling and credit checks in store, and the fact that it is common for most people these days to have a credit card.

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[158] Gary Toner, Head of Compliance, GE Money (Eurofinas powerpoint presentation 2008 to DG Internal Market)

8.55 Dala Hemtjanst uses a single lender to provide their in-store credit. This is predominantly due to the small volume of transactions, although the retailer did feel that having a relationship with just one lender reduces administrative costs and adds to the speed of credit application processing. The retailer judged that the majority of Swedish stores that provide point-of-sale credit would also use only a single lender.

8.56 Dala Hemtjanst does not receive any commission from the lender for products sold via point-of-sale credit. It is a sufficiently mutually beneficial relationship without this. Dala Hemtjanst sells goods that otherwise might not be if customer credit was not available. It follows that there is sufficient margin in the sale of the good itself. The lender gains additional volume, which compensates for the initial costs of locating retailers and setting up and maintaining systems with them. For this reason, there is little pressure or encouragement on customers (through, for example, special offers or discounts) to take out credit.

8.57 Although Dala Hemtjanst is encouraged by their lender to secure new clients for them, they do not provide any explicit support in the form of training or IT support. Around once a year the lender visits the store to brief the management on new products or processes. The store's role in the credit application is quite limited. They provide the customer with the documents to fill out and explain areas of the contract, and then submit the application to the lender and wait for the approval. They do not undertake any of the checks themselves.

The lender experience

8.58 The large Swedish lender that we interviewed uses around 200 POS intermediaries that are tied to its products. These relationships, although tied, are not exclusive. In order to encourage the intermediaries to promote their products and use them as their provider of point-of-sale credit, the lender provides support in the form of product-specific education and training, as well as marketing and IT support.

8.59 The latter is internet-based, and the most substantial form of support. Via the internet the intermediary can access the credit decisions of the lender and have a rapid response to a credit application. This process makes selling the products much quicker and more effective for the retailer, as it can access the decision and print off the necessary information for the customer as soon as it comes through. Most dealers use this internet-based system, as it is highly effective.

8.60 The lender's intermediaries carry out far more activities than the Swedish retailer mentioned previously. They prepare the credit contract and undertake other paperwork on behalf of the lender, as well as explaining pre-contractual information to potential clients. They promote specific credit products and assess the suitability of the product for the potential client, and also undertake and arrange credit checks for the lender.

8.61 The lender remunerates its intermediaries through a fixed fee on draw down of credit, as well as on volume based commission.

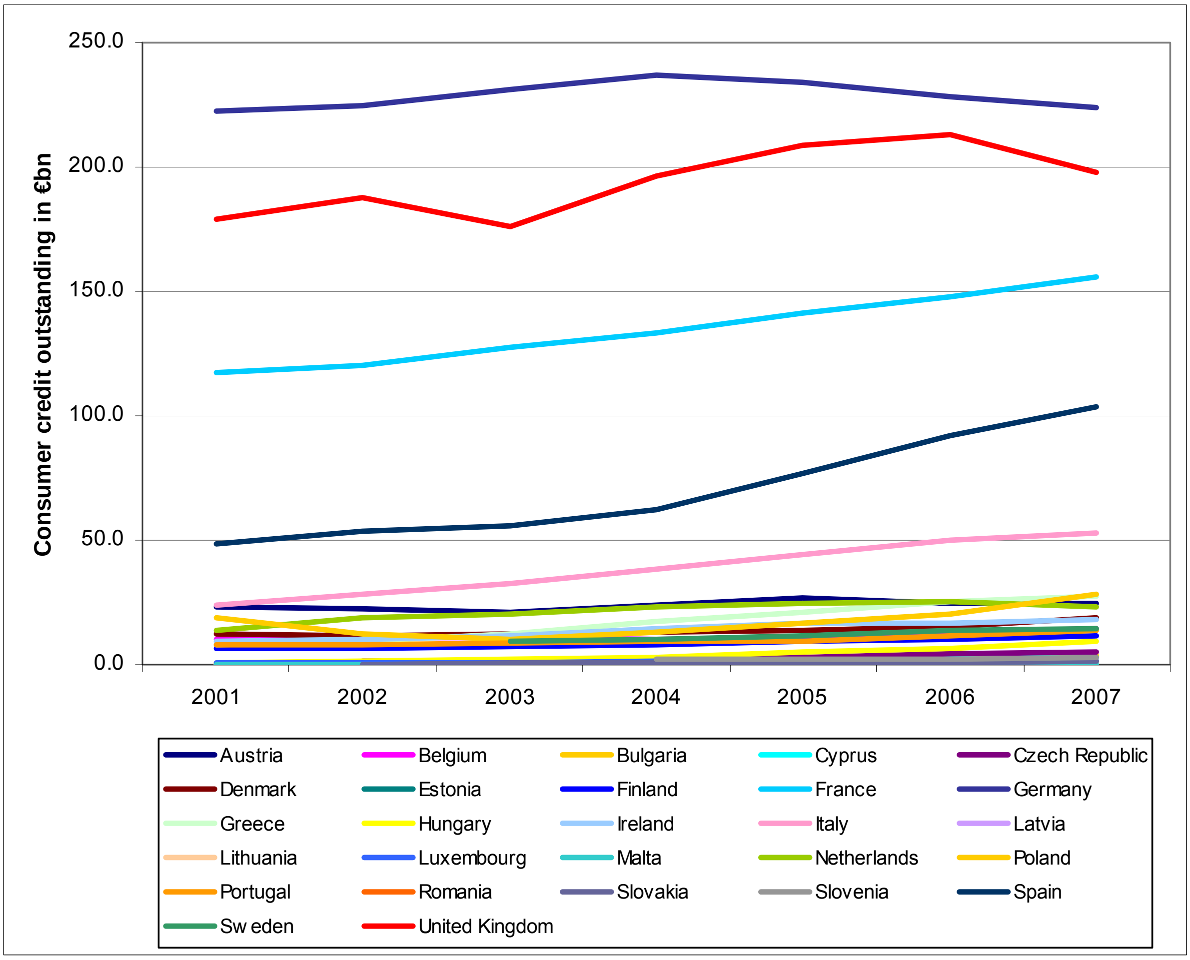
8.62 The lender confirmed that using point of sale intermediaries is very profitable and generates a substantial part of its business volume (48 per cent of point of sale revenue). The lender has access to many more clients, and is saved the administrative aspects of arranging the deal. However, the intermediaries are exposed to customers with a whole range of credit statuses, and, in order to keep the good relationship with the intermediary, the lender sometimes has to accept borderline customers who they ordinarily would not accept if it was a direct arrangement. However, they feel this is worthwhile given the profitable nature of the relationship.

9 OTHER CONSUMER CREDIT INTERMEDIATION

Introduction

9.1 In this section we examine the role of intermediaries in providing other forms of consumer credit not yet discussed above. The graphic below summarises the development of the consumer credit market as a whole across EU27 (i.e. including both direct and indirect distribution).

Figure 9.1: The development of consumer credit, outstanding, 2001–2007, €bn



Source: ECRI 2008 statistical package

9.2 Of the total consumer credit outstanding at the end of 2006, fully 75 per cent related to individuals in the following five Member States — UK, Germany, France, Spain and Italy.

The Current Scale of Intermediation

9.3 The types of consumer credit intermediated and considered below include:

(a) Unsecured fixed duration loans

(b) Pre-approved credit (such as credit cards, overdraft facilities)

(c) Home credit and other forms of doorstep lending.

9.4 These categories include so-called sub-prime lending. The share of intermediaries is shown below.

Table 9.1: Share of intermediaries in consumer credit markets, 2007

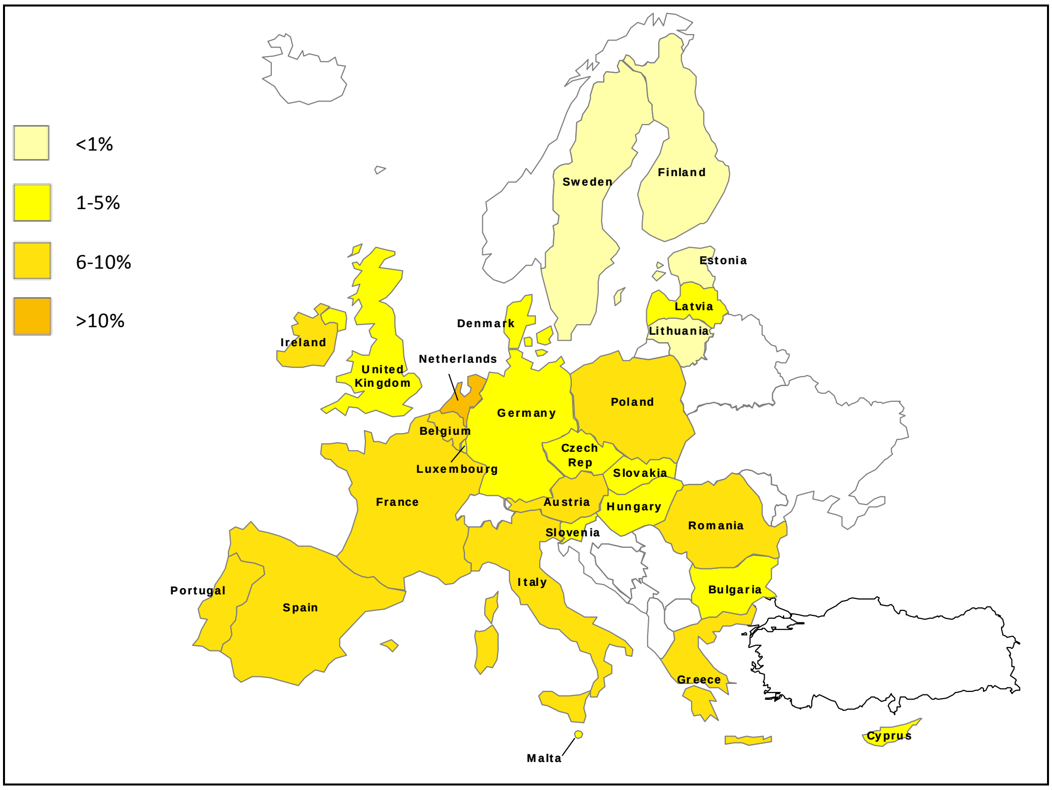
	Intermediary share (%)	Value, FLOW €m	Volume, FLOW 000s
Austria	6.0%	695	138
Belgium	7.8%	914	139
Bulgaria	5.1%	237	380
Cyprus	3.5%	72	122
Czech Republic	5.3%	379	355
Denmark	3.2%	425	115
Estonia	0.5%	9	14
Finland	0.7%	82	80
France	7.6%	6,909	2,758
Germany	4.3%	4,507	948
Greece	6.9%	1,627	433
Hungary	5.6%	710	1,012
Ireland	6.1%	1,431	564
Italy	6.5%	4,666	917
Latvia	2.6%	51	75
Lithuania	0.6%	13	19
Luxembourg	5.0%	43	13
Malta	1.9%	29	15
Netherlands	16.8%	3,963	354
Poland	7.8%	2,754	3,661
Portugal	7.3%	1,049	405
Romania	6.1%	1,147	1,634
Slovakia	5.4%	95	118
Slovenia	3.3%	139	135
Spain	8.4%	6,450	1,498
Sweden	0.2%	19	7
United Kingdom	5.8%	14,968	3,455
		53,382	19,362

Source: Surveys, eurofinas (2007), ECRI 2008 Statistical Package, EE calculations

9.5 The intermediary share is as a percentage of all consumer credit (the average across EU27 is about 6.4 per cent). Scandinavian countries appear to have particularly low levels of penetration by intermediaries. The overall value of credit intermediated represents less than 10 per cent of the value of mortgage credit intermediated (conversely volumes are higher).

9.6 The differentiation in market penetration by the intermediaries is illustrated below.

Figure 9.2: Intermediary penetration in the consumer credit market



Source: smartdraw

9.7 The market is highly varied, with average credit product values varying from less than €1,000 to €11,300 (the Netherlands). The table below combines the share of point-of-sale intermediation and the other types of intermediaries covered in this section (such as consumer credit intermediaries) to provide an aggregated share of intermediaries in the consumer credit market (excluding mortgage credit).

Table 9.2: Importance of intermediaries in consumer credit, 2007

	POS	Other inter-mediary	Total indirect	*Direct distribution*
Austria	25%	6%	31%	*69%*
Belgium	20%	8%	28%	*72%*
Bulgaria	18%	5%	23%	*77%*
Cyprus	12%	4%	15%	*85%*
Czech Republic	42%	5%	47%	*53%*
Denmark	16%	3%	19%	*81%*
Estonia	26%	1%	26%	*74%*
Finland	15%	1%	16%	*84%*
France	21%	8%	28%	*72%*
Germany	38%	4%	42%	*58%*
Greece	11%	7%	18%	*82%*
Hungary	35%	6%	40%	*60%*
Ireland	7%	6%	13%	*87%*
Italy	40%	6%	47%	*53%*
Latvia	27%	3%	29%	*71%*
Lithuania	29%	1%	29%	*71%*
Luxembourg	9%	5%	14%	*86%*
Malta	23%	2%	25%	*75%*
Netherlands	17%	17%	34%	*66%*
Poland	13%	8%	20%	*80%*
Portugal	37%	7%	45%	*55%*
Romania	42%	6%	48%	*52%*
Slovakia	22%	5%	27%	*73%*
Slovenia	37%	3%	40%	*60%*
Spain	28%	8%	37%	*63%*
Sweden	41%	0%	41%	*59%*
United Kingdom	11%	6%	17%	*83%*
EU27 average			29%	*71%*
EU15 average			28%	*72%*
Eurozone average			35%	*65%*
EU12 average (NMS)			32%	*68%*

Sources: Surveys,[159] finaccord (2007 survey), eurofinas (2007), ECRI 2008 Statistical Package, EE calculations

9.8 On a combined basis, then, intermediaries account for about 30 per cent of consumer credit in the EU27, with the balance accessed directly.

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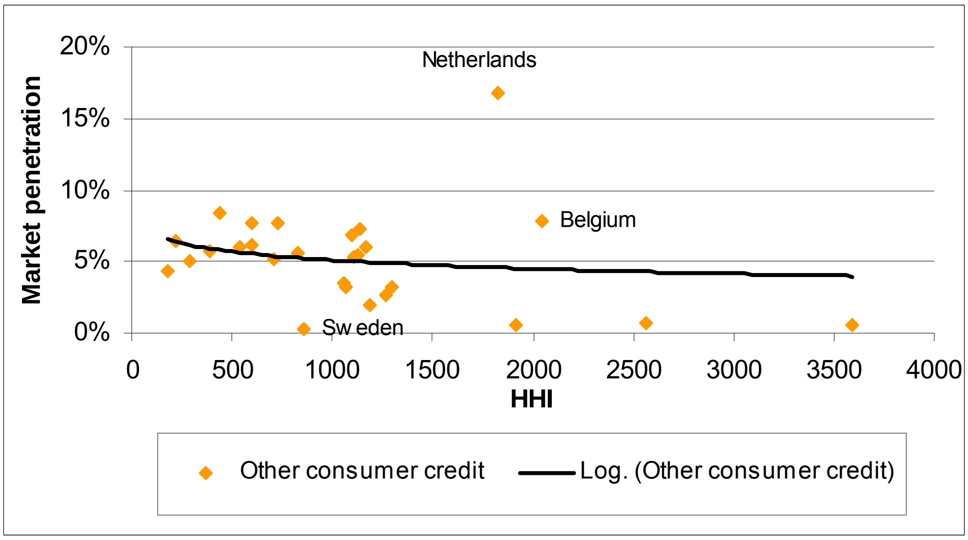
159 Survey data used in this section is based upon up to 96 data points (see also Section 2). We have identified in this section where the number of responses was significantly less than this (typically where more detailed, and potentially more sensitive data — such as relating to remuneration structures, etc).

Variation in intermediary penetration

9.9 It is interesting to note that intermediary penetration is low relative to the other categories of products considered. This could be because banks still hold a traditional advantage in the distribution of pre-approved credit or unsecured loans, and that the value of the intermediaries in terms of providing advice or reducing search costs is not high, outside of those categories of consumer with a poor credit record, or no credit record at all.

9.10 The figure below shows the relationship between concentration and the importance of intermediaries — the value of the market search function of intermediaries is decreased in the most concentrated markets.

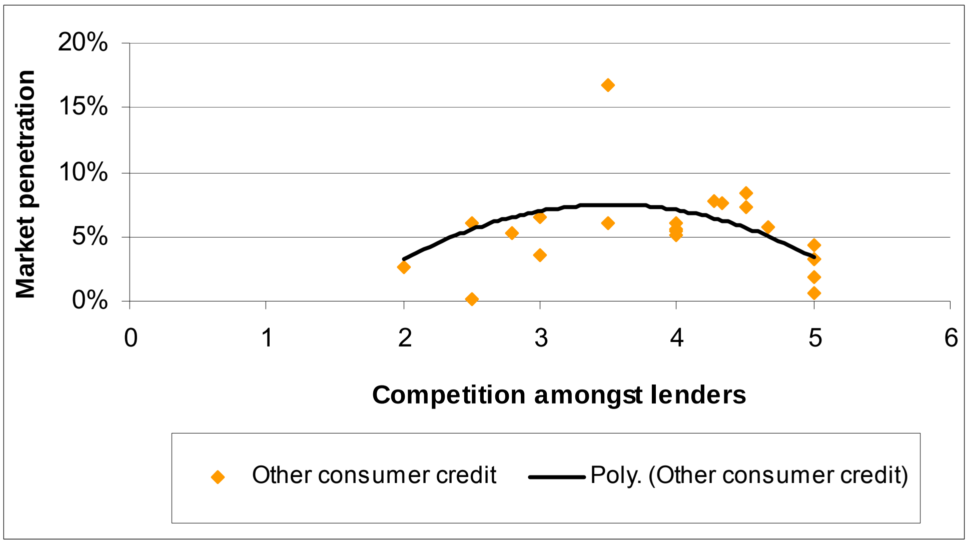
Figure 9.3: HHI and intermediary penetration of other consumer credit[160]



Source: Surveys, ECB Banking Structures (2006 data)

[160] The relationship between intermediary penetration and the HHI has an R^2 of about 25 per cent (based on natural log values in order to linearise the relationship).

Figure 9.4: Lender competition and intermediary penetration of other consumer credit

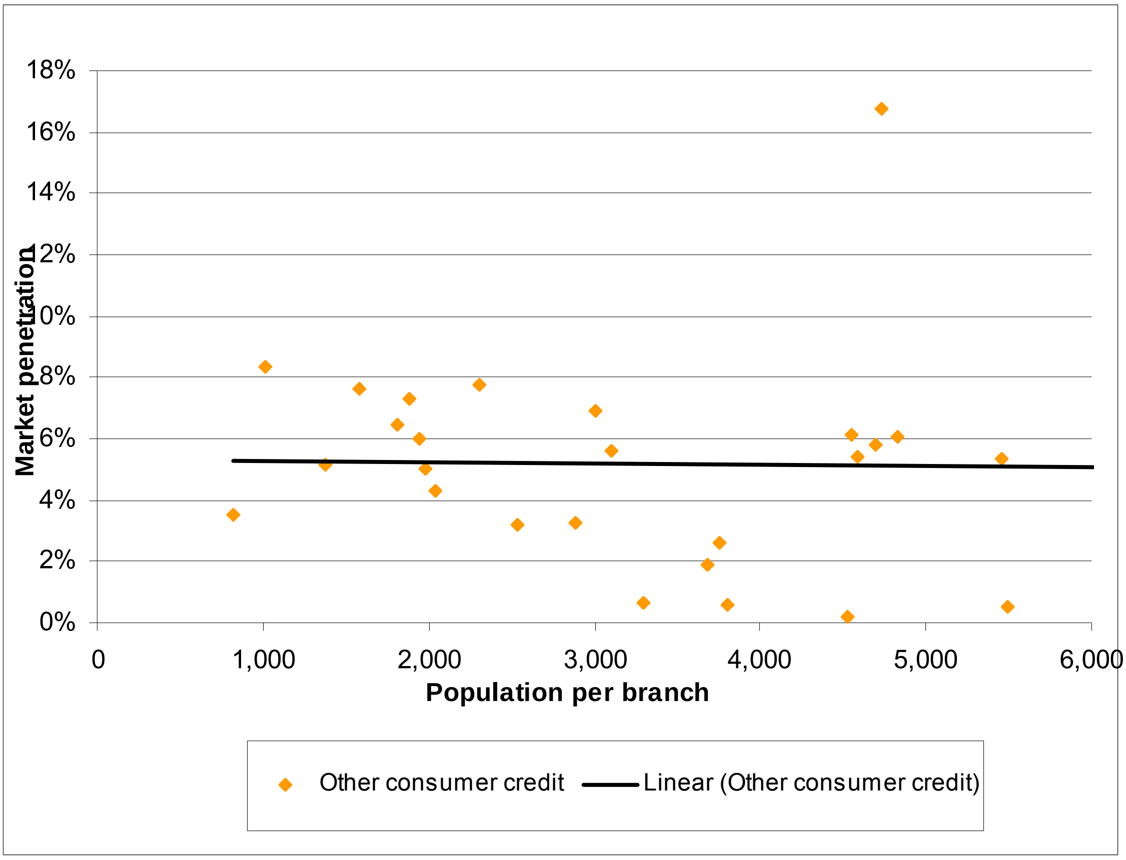


Source: Surveys

9.11 The relationship between lender competition and intermediary penetration may be as follows: if the lower levels of competition are explained by high concentration, then the market search function value is reduced. On the other hand, if a *high* level of competition amongst largely homogenous products results in price competition, again, the search value may be depressed.

9.12 The figure below illustrates the association of *higher* intermediary penetration with *lower* branch density, as we would expect.

Figure 9.5: Bank branch density and intermediary penetration of other consumer credit



Source: Surveys, ECB Banking Structures (2006 data)

Other forms of consumer credit intermediary

9.13 A further potential category of consumer credit intermediary is the recent development of social or peer-to-peer lending. This is described briefly at Box 9.1 below. It is not straightforward to classify peer-to-peer lending within existing financial services taxonomies. The marketing of these businesses typically emphasises that they are not banks, and indeed they are normally specifically set up so as to avoid being so classified (and attracting the associated regulation).

9.14 The peer-to-peer platform will be involved in the assessment and rating of credit risk and in enabling some degree of pooling of risk — however, the pricing of that risk is determined by the interactions between borrowers and lenders in the marketplace. This latter point, in combination with the reduced overhead by comparison to a traditional bank, could be, in theory, sources of efficiency for those using the peer-to-peer lending platform.

9.15 Although such a marketplace is involved in facilitating the matching of borrowers and lenders, there is no role in actively advising either lenders or borrowers on the suitability or otherwise of specific credit transactions.

9.16 Whilst exhibiting some differences, then, from a classic financial intermediary model (such as a bank), and sharing some characteristics with a consumer credit intermediary, it remains far from clear that peer-to-peer lending platforms should be classified as a credit intermediary either. They appear to be a separate category and should, perhaps, be treated as such.

Box 9.1: Peer-to-peer lending

The UK's zopa.com was the one of the first online marketplaces to enable peer-to-peer borrowing and lending. It has subsequently set up in Italy also. Peer to peer (or social) lending is a recent phenomenon: to date, lending through Zopa's UK arm has reached just over €30 million. The lending is unsecured and to date has been mostly for car purchase, home improvement and debt consolidation. Within the EU27 there are a number of other players in this area, such as:

- boober.nl (set up in the Netherlands, and subsequently expanding to Italy);
- kokos.pl and monetto.pl (Poland)
- loanland.se (Sweden)
- smava.de (Germany)

Zopa in its UK operation restricts lenders to about €29,000 (£25,000) unless that individual has a consumer credit licence (zopa offers to assist any individual seeking such a licence). Zopa itself has a credit licence from the OFT. A stop on lending was imposed on boober.nl by the Dutch supervisor (AFM) until its practices were revised, specifically with regard to the maximum value and number of loans that someone could make through the site.[161]

Zopa assigns aspirant borrowers a credit score according to its own criteria (A*, A, B, C or Young), and are grouped on that basis. A lender defines the risk-rating, loan duration and price at which he or she is willing to lend. The borrowers can then select from whatever offers are available to them (the website operates as a form of financial marketplace cleared by an auction). There is risk-pooling, so that someone lending €585 (£500) or more would have their money spread across at least 50 borrowers.[162] (It is noted that Zopa does also provide the opportunity of direct one-to-one lending.)

Zopa monetises its business model by charging lenders a servicing fee equal to one per cent per annum of the amount lent. In the case of a default by the borrower, this fee is waived for the extent of that default. Borrowers pay a fixed fee of €110 (£94.25) per loan. In the event of a default, Zopa funds the services of a collection agency. However, other social lending platforms have adopted other remuneration models. For instance, at smava.de the borrower pays one per cent of the loan value (and a €10 administration fee when a borrower is late in making an interest payment). On the other hand, there are no charges on the lender.

Source: www.zopa.com and www.smava.de

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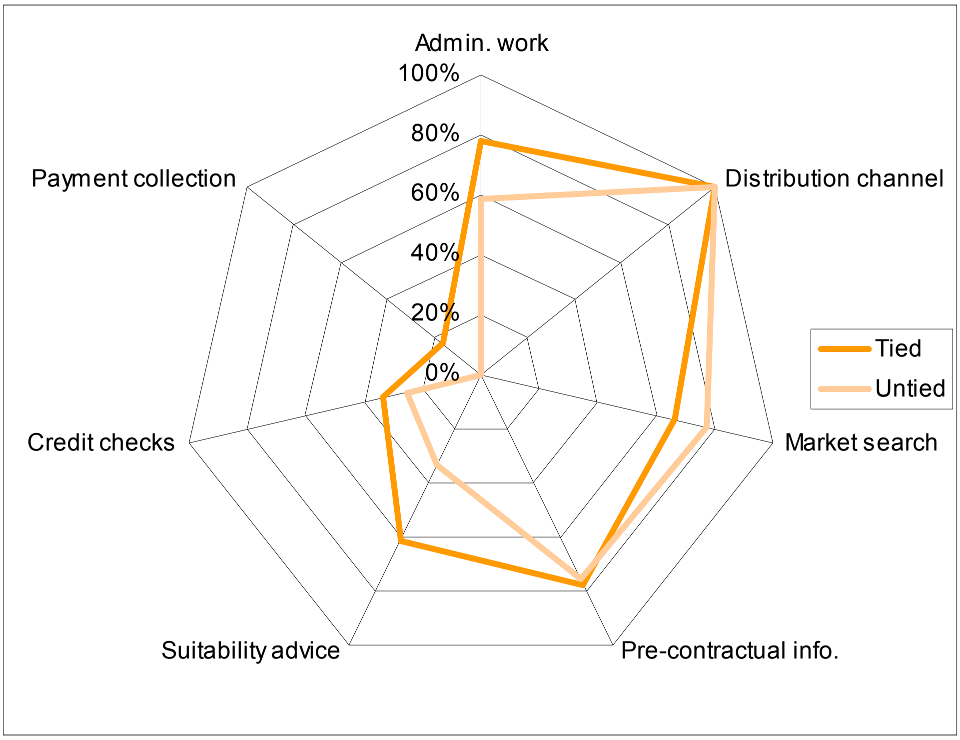
161 http://www.wiseclerk.com/group-news/category/countries/Netherlands.
162 http://uk.zopa.com/ZopaWeb/public/about-zopa/how-it-works.html

The Business Models of Intermediaries

Activities undertaken for consumers and lenders

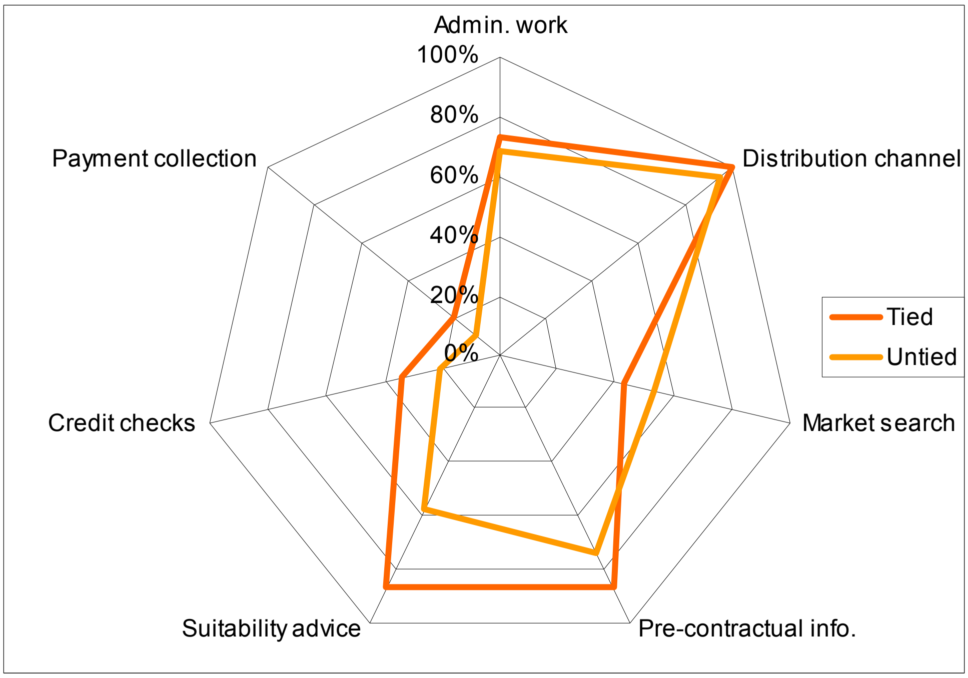
9.17 The following figures compare the activities undertaken by intermediaries in two core segments of the market — for intermediation of pre-approved credit and of unsecured loans.

Figure 9.6: Intermediation of pre-approved credit



Source: Surveys (based upon 45 stakeholder views)

Figure 9.7: Intermediation of unsecured lending



Source: Surveys (based upon 45 stakeholder views)

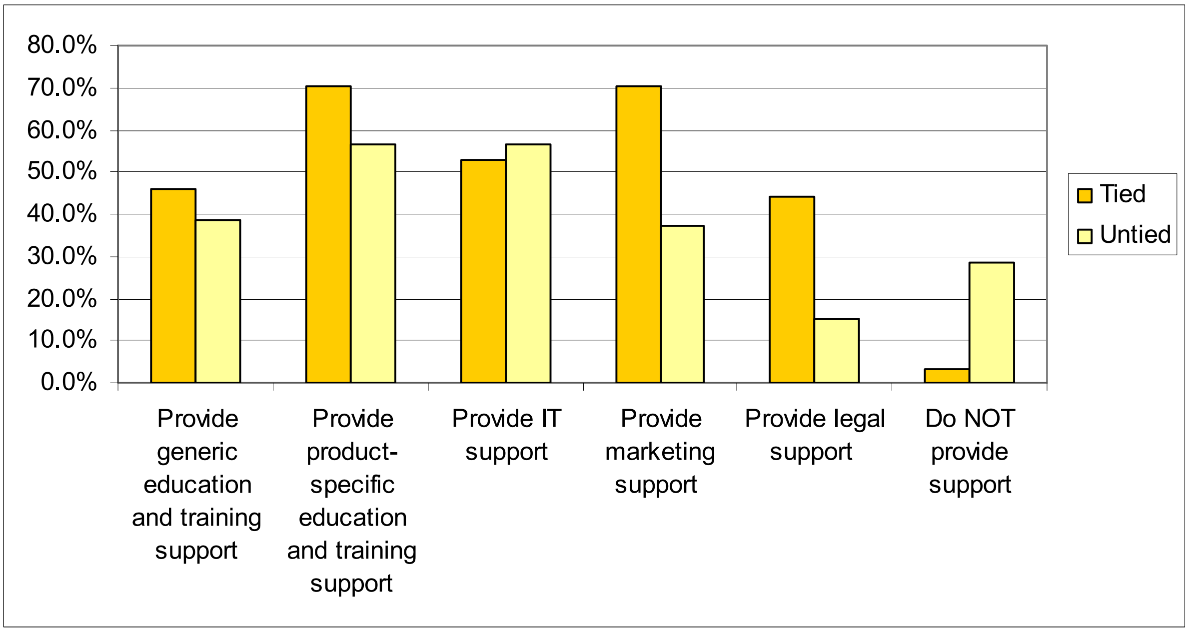
9.18 It is clear that the two-sided market search function is again prominent (i.e. the lender achieves access to a larger potential customer base at a reduced customer acquisition cost by comparison to advertising and marketing spend, and, for consumers also, there is a reduced cost). However, in contrast to residential mortgage intermediation, the emphasis is notably more on distribution on behalf of lenders rather than market search for consumers.

9.19 However, the alleviation of the consumers' asymmetric information problem (i.e. the relative importance of the recommendation of suitable products and the explanation of pre-contractual information) are perceived as being at least equally as important functions of the intermediary (although our survey does suggest that this is markedly less the case in, for instance, the UK). Those intermediaries lacking product ties to particular lenders are particularly focused on these activities.

Lender support

9.20 The support provided by lenders is significant, particularly where an intermediary is tied (either in an exclusive tie or in a multi-tied situation). On average, a tied agent will receive support in three of these categories, against just two for one without ties.

Figure 9.8: Lender support to consumer credit intermediaries



Source: Surveys (based upon 39 stakeholder views)

9.21 Although information is limited, we understand that most intermediaries in this segment work with lenders on a non-exclusive basis. For instance, in the UK, personal loan intermediaries will often work with a board of several lenders.

Table 9.3: Relationship exclusivity mix

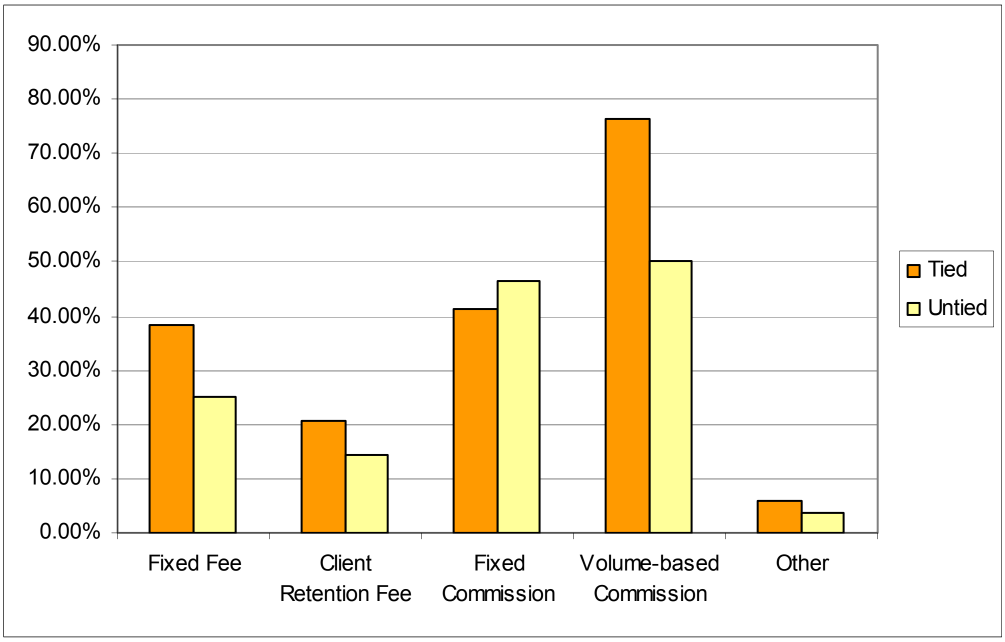
Majority (i.e. more than half) of relationships with lenders on non-exclusive basis	**Significant majority of relationships with lenders on non-exclusive basis (assessment made on a qualitative basis by stakeholders, i.e. "significant" can not be simply quantified)**
Austria Belgium UK	Czech Republic France Germany Italy Slovenia

Source: Surveys. Data not available on other Member States.

The remuneration of intermediaries

9.22 We set out below the upstream remuneration of intermediaries in this market segment.

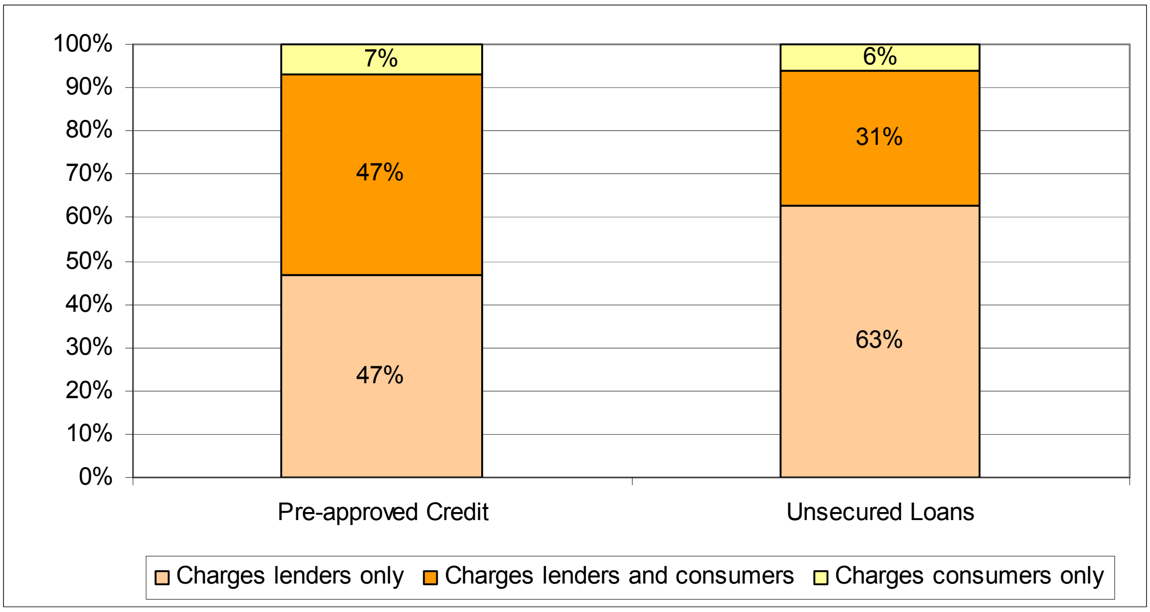
Figure 9.9: Upstream remuneration of consumer credit



Source: Surveys (based upon 42 stakeholder views)

9.23 Again, tied intermediaries appear to have a more complex pattern of remuneration. In contrast to the typical structures applicable in residential mortgage intermediation, there is a greater emphasis upon both fixed fees and client retention (i.e. risk-sharing fees). The chart below illustrates the situation with regard to downstream remuneration. It is not common practice to charge consumers *only* — most of the *direct* intermediation cost is borne by lenders.

Figure 9.10: Downstream remuneration of consumer credit intermediaries



Source: Surveys (based upon 42 stakeholder views)

Summary Financial Data

9.24 We set out below our estimates of the revenues generated by credit intermediaries in this market.

Table 9.4: Range of revenues from consumer credit intermediation, 2007

	€m		€m
Austria	14	-	16
Belgium	17	-	20
Bulgaria	4	-	5
Cyprus	1	-	1
Czech Republic	7	-	8
Denmark	8	-	9
Estonia	0	-	0
Finland	1	-	2
France	112	-	133
Germany	84	-	96
Greece	30	-	35
Hungary	13	-	15
Ireland	23	-	28
Italy	87	-	99
Latvia	1	-	1
Lithuania	0	-	0
Luxembourg	1	-	1
Malta	1	-	1
Netherlands	78	-	88
Poland	51	-	59
Portugal	20	-	22
Romania	21	-	24
Slovakia	2	-	2
Slovenia	3	-	3
Spain	107	-	126
Sweden	0	-	0
United Kingdom	252	-	292
	939		1,086

Source: Surveys

9.25 The revenues are based upon cost structures as follows: between 1.6–1.9 per cent of credit value (limit) for pre-approved credit and 2–2.25 per cent for fixed term lending. However, there is anecdotal evidence that commissions can be substantially in excess of this level, particularly with regard to the intermediation of sub-prime lending. For instance, an Austrian survey (conducted in 2005) found a number of local consumer credit intermediaries charging in excess of five per cent of the gross sum lent[163] (which, in any

[163] http://www.ak-sbg.at/bilder/d33/Kreditvermittler_im_Test.pdf

case, is the cap under Austrian law — see description of the Austrian regulatory framework in Appendix 2). Similarly, a survey respondent in Belgium indicated that higher-risk customers desiring credit might contact a consumer credit intermediary. The intermediary refers such cases to credit insurance companies, receiving a volume-based commission of up to 6–7 per cent of loan value.

9.26 In terms of the number of intermediaries and the associated employment, the limited supervision of the area has made robust data-gathering difficult. In addition, there is significant overlap with other categories: a sub-set of retailers offering finance at point-of-sale will also offer pre-approved credit. This is more common practice amongst larger retailers, with co-branded store cards.[164]

9.27 In addition, mortgage and other intermediaries will also potentially offer consumer credit broking services. For instance, the Netherlands regulator estimates that perhaps 10,000 (or more) intermediaries are operating in non-mortgage consumer credit intermediation. Similarly, the Bankenfachverband estimates there may be up to 5,000 such consumer credit intermediaries in Germany. Based upon the data we have on intermediary revenues, this strongly suggests that only a few of these firms are dedicated to consumer credit broking. Indeed, according to Central Statistical Office of Poland (2007) only 24 per cent of researched Polish firms involved in such credit intermediation were entirely dedicated to it.

9.28 Similarly, taking IPF as an example for the home credit sector, it has approximately 19,000 (part-time) intermediaries operating for it alone in EU27 (13,000 in Poland, 3,000 in the Czech Republic, 2,000 in Slovakia, and 1,000 in Romania).

Developments

9.29 We set out below the aggregated views of stakeholders in respect of the trends experienced over the past five years and the next. It should be noted that these results are based upon data gathered between April and July 2008. As such, they will self-evidently not reflect the recent credit market turbulence (particularly that ensuing from the collapse of Lehman Brothers in September 2008 to date) and the associated change in sentiment concerning the short- and medium-term prospects of the economic situation across the EU27.

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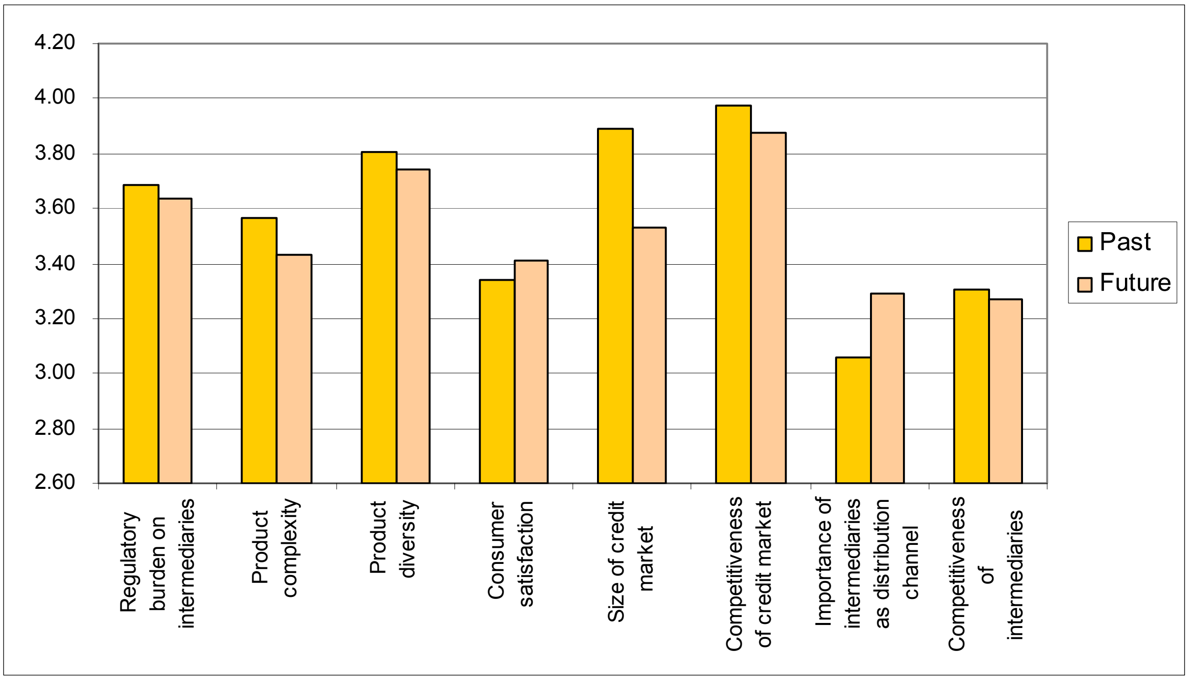
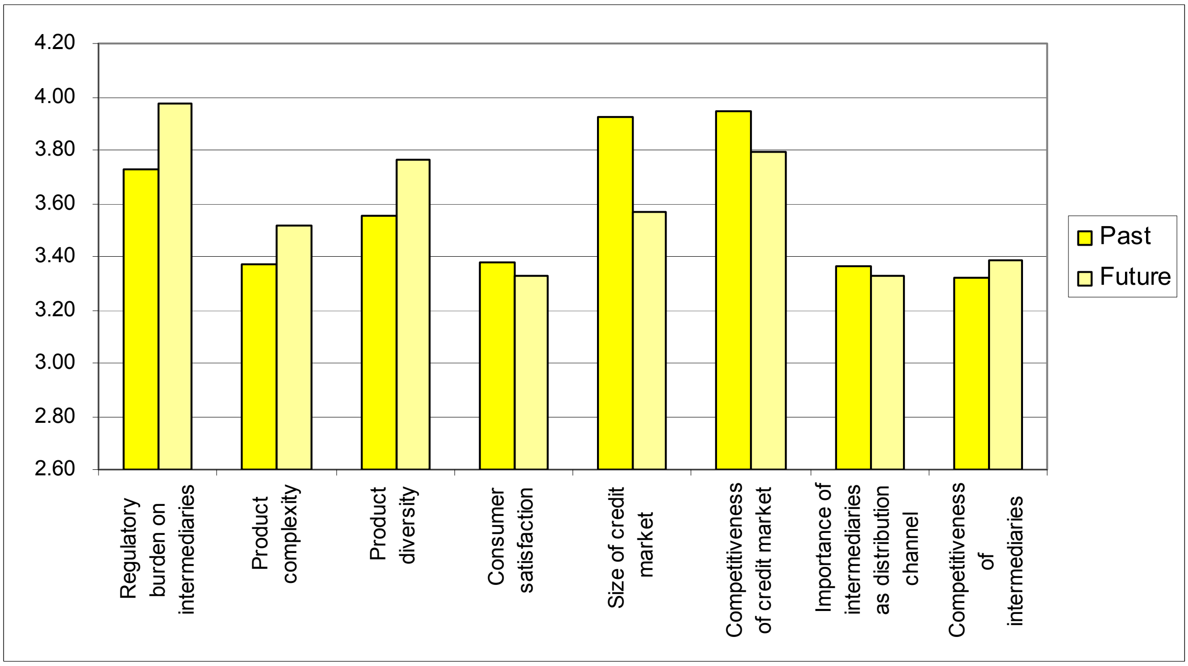
164 However, this is very much a developing market in some Member States. For instance, in France, co-branding has only been permissible since 2007.

Figure 9.11: Developments in the market for pre-approved credit



Source: Surveys

Figure 9.12: Developments in the market for unsecured loans



Source: Surveys

9.30 The importance of indirect distribution is seen as increasing somewhat over the next five years, in concert with the competitiveness of intermediaries. The impact of the credit crunch is apparent in the anticipated slowdown in the rate of expansion of consumer credit generally (i.e. regardless of distribution channel) by comparison to the recent past.

The Regulatory Framework across the EU27

9.31 Consumer credit (excluding point of sale) intermediaries arrange personal loans for consumers. In contrast to loans obtained at point of sale, a loan arranged by consumer credit intermediaries would not be contingent upon the purchase of a particular good and, indeed, may be used for purposes other than purchasing a good.

9.32 In Section 4, we discussed the approach we took to categorise the regulatory regime of different Member States. We do not repeat that discussion here.

9.33 We categorise Member States' regulation of consumer credit intermediaries below.

Table 9.5: Regulation of Other Consumer Credit Intermediaries

No or limited explicit statutory regulation of consumer credit intermediaries	Moderate level explicit statutory regulation of consumer credit intermediaries	Significant explicit statutory regulation of consumer credit intermediaries
Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia, Spain, Sweden	Austria, Bulgaria, Germany, Italy, Portugal, Slovenia	Hungary, Ireland, Malta, Netherlands, UK

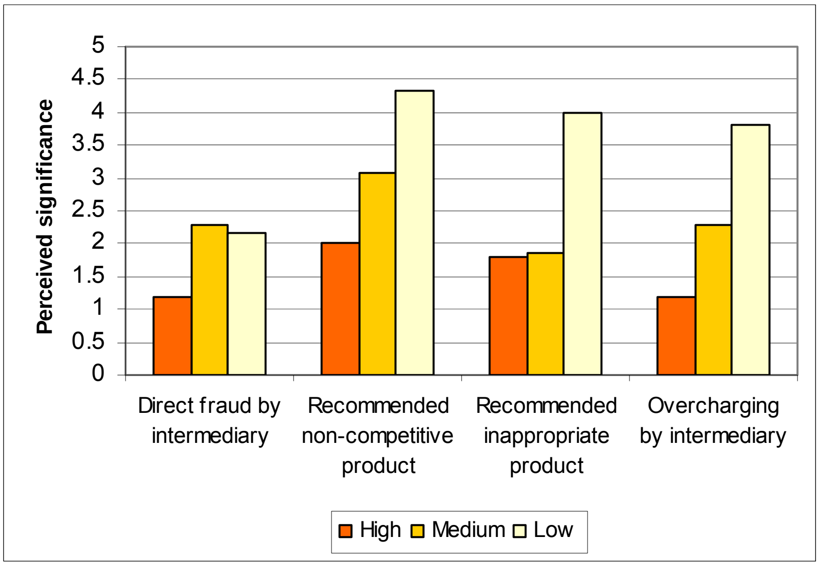
Source: Surveys, EE analysis

Consumer Detriment

9.34 This section should be read in conjunction with our analysis at the beginning of Section 4 (dealing with market failure and the scope for consumer detriment).

9.35 Responses from regulators and consumer associations regarding the perceived significance of various sources of consumer detriment were classed according to our broad categories of regulation. The graph shows that the lower level of regulation is associated with an increased perceived significance for the various types of consumer detriment, with the exception of direct fraud.

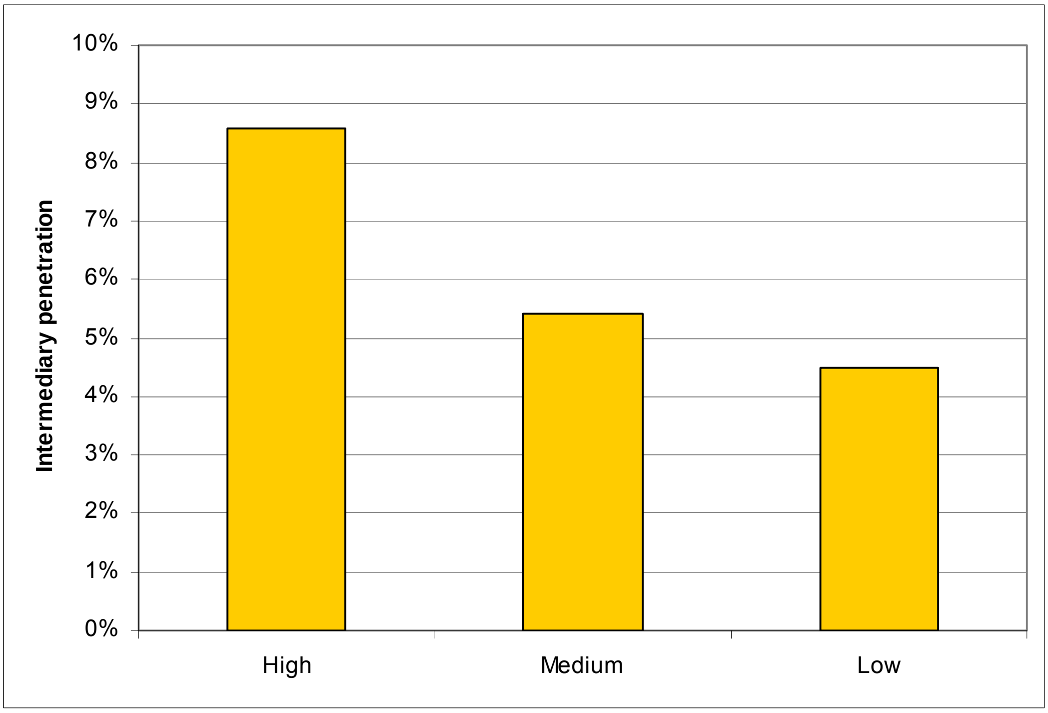
Figure 9.13: Perceived significance of types of consumer detriment according to level of regulation



Source: Surveys. 5 = high perceived significance; 1 = low perceived significance.

9.36 There is a weak positive correlation between the level of regulation and the intermediaries' penetration into the market. This is illustrated below. This implies that regulation has, perhaps, responded to market presence.

Figure 9.14: Variation in intermediary penetration according to level of regulation



Source: Surveys, EE analysis.

Direct fraud

9.37 VZBV has indicated to us that fraud, frequently targeted at vulnerable consumers, is not uncommon amongst German personal loan intermediaries, although specific examples were not provided. Specific issues related to upfront fees for arranging finance not being followed by either the provision of credit or the refund of the fees.

Inappropriate advice

9.38 Intermediaries may play a role in encouraging consumers to buy uncompetitive products (such as retail stores offering discounts on opening an account) — and may have pecuniary incentives to do so — but unless the price of the product experienced is set by the intermediary, it is hard to sustain the argument that the detriment is caused by the intermediary.

9.39 The rationale behind this form of detriment is the same that applies to residential mortgages — the typical compensation scheme is a volume-based commission which may hinder the credibility of the advice provided to customers. However, we expect this form of detriment to be less a cause for concern here compared to the case of residential mortgages because of the relatively lower intermediary engagement in the provision of expert advice (see Table 4.2).

Over-charging and other issues

9.40 Overcharging on the part of an intermediary for a financial product should not be confused with the product itself being relatively expensive. For example, the interest rate on store cards is often less favourable than straight forward credit cards. However, if a consumer is unable to get a credit card, or does not belong to a bank, this limits their alternatives and may increase their willingness to pay for the ‘overpriced’ product offered at the store. However, this reflects a lack of alternatives (perhaps caused by a lack of competition among lenders) and has little to do with the intermediary.

9.41 However, we have been informed of instances of over-charging by intermediaries in Germany and of inappropriate segregation of client funds in Portugal.

Examples

9.42 It is estimated by VZBV that personal loan intermediaries in Germany, who provide credit to circa 400,000 consumers each year, frequently make such loans conditional upon the person taking, say, credit-life, credit-disability, accidental death and dismemberment insurance and auto club memberships. There is also a lack of transparency on additional charges that may be levied, and these may be significant.

9.43 Several cases have been investigated by the Comissão do Mercado de Valores Mobiliários (CMVM) in Portugal. Information on these cases is rather limited but does give an indication of the ways in which consumers may have suffered detriment. Examples include:

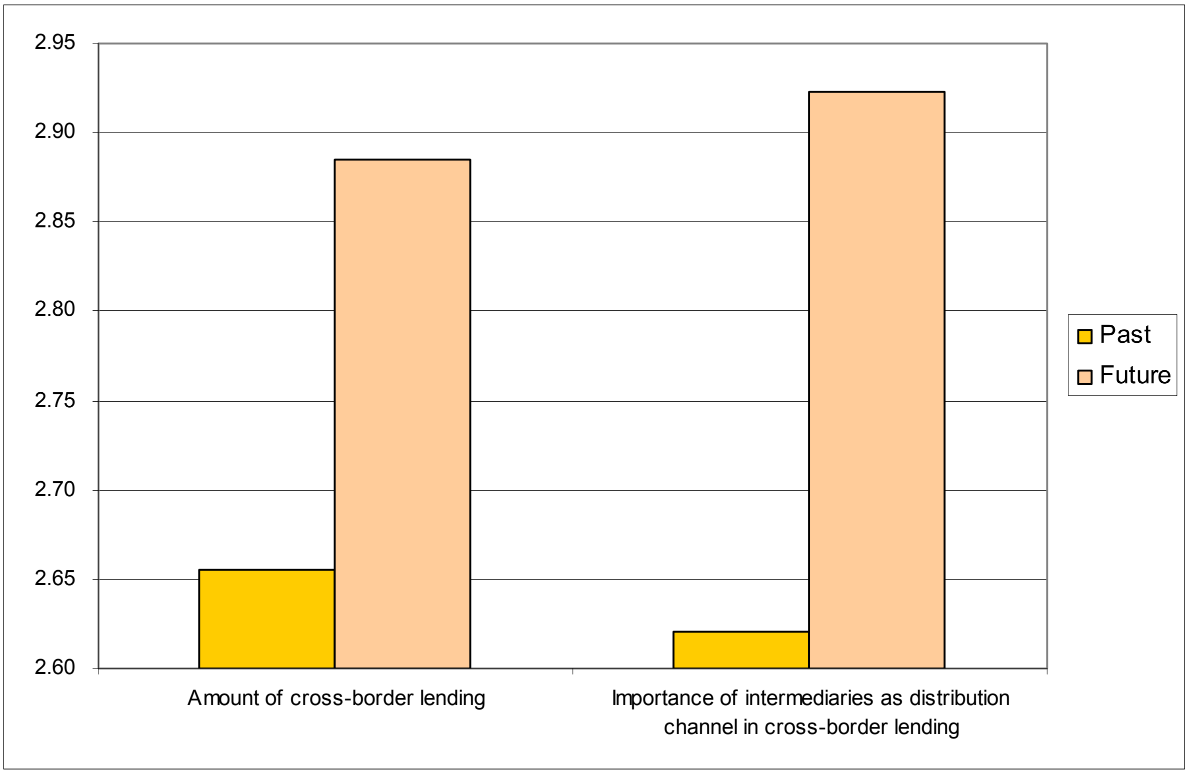
In 2006, Crédito Agrícola Dealer was accused of seven instances of not identifying clients' accounts and three instances of failing to ensure in all activities a clear distinction between its wealth and those of its clients. A fine of €100,000 was imposed, which Crédito Agrícola Dealer appealed against.

Finanser was accused of disposition of clients' accounting values without their consent, violating duty of good execution of orders and granting credit without registering with the CMVM during 2004 and 2005. The broker was fined €200,000, which it appealed against.

Cross-border Activity

9.44 The trend of the past five years and the next five are shown below. These results are based upon data gathered between April and July 2008. As such, they may be best interpreted as a guide to long-term trends rather than predictions applicable to the short-term.

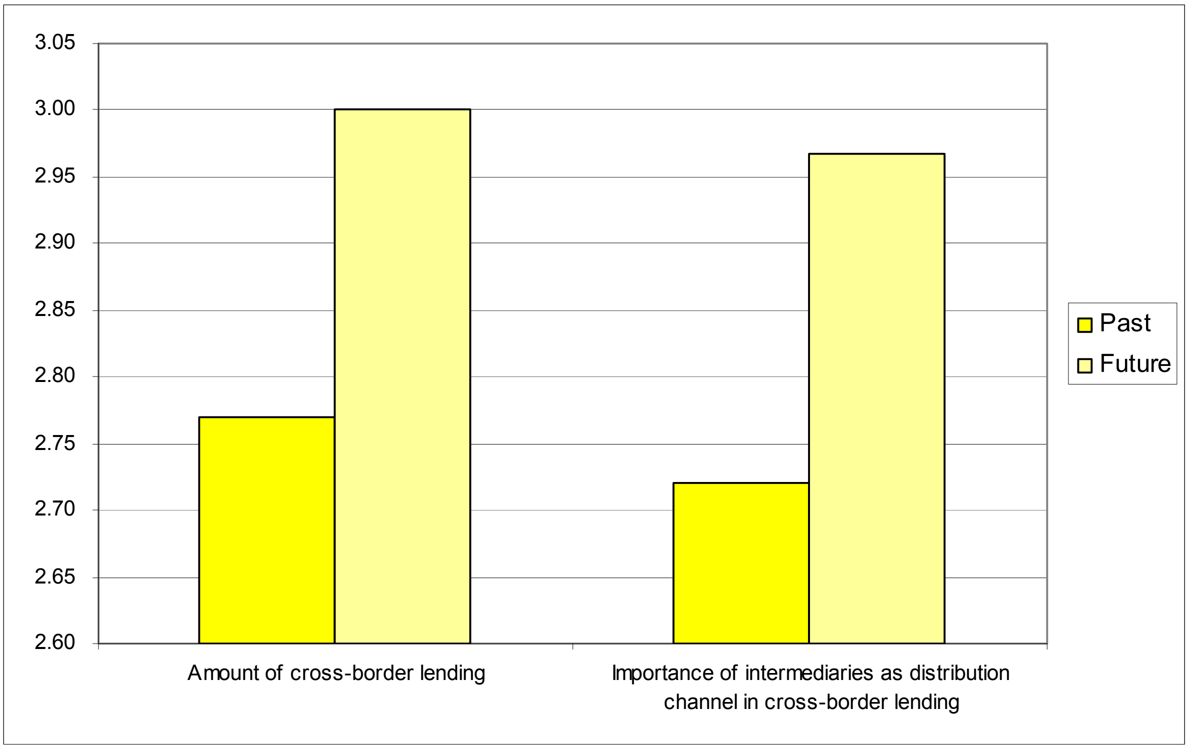
Figure 9.15: Developments in cross-border activity in pre-approved credit



Source: Surveys

9.45 In contrast to most areas of intermediary activity, cross-border activity (and the role of intermediaries) is seen as declining in importance over the recent past. This is expected to continue, or at best, to stabilise in the short to medium term.

Figure 9.16: Developments in cross-border activity in unsecured loans



Source: Surveys

9.46 Again, cross-border activity (and the role of intermediaries) has been seen as declining in importance over the recent past (from a low base). This position is expected to stabilise in the short to medium term.

9.47 As previously mentioned, this topic is covered in greater depth at Section 13.

10 CASE STUDIES RELATING TO OTHER CONSUMER CREDIT

Affinity Partnerships[165]

10.1 Affinity financial services is a way in which financial services businesses form strategic partnerships with external organisations in order to market and distribute their products; consumer credit companies offer their tools and knowledge to third parties who then provide credit to their members and/or employees. Essentially, a third party offers or endorses consumer credit that is administered and supplied by a separate creditor.

10.2 In this case study, we unpick the types of partnership formed and the nature of these relationships, in order to determine to what extent (if at all) affinity partnerships, as defined above, constitute credit intermediation.

Background

10.3 Our research suggests that affinity partnerships are quite idiosyncratic in their nature, however, it is broadly possible to split partner organisations into four main categories: not for profit organisations, financial institutions, other commercial entities and employers (known as worksite partnerships). For the purpose of this typology, we have taken a broad view of affinity partnerships to provide an overview of affinity partnerships in general which is then refined using the examples analysed.

Not for profit organisations

10.4 In the case of not for profit organisations (for example, charities, professional associations and trade unions), as one might expect, the business model is somewhat different from that briefly described above. For example, Groupe Caisse d'Epargne has an agreement with France's national federation of fireman, and associated entities, for the provision of financial services on preferential terms to the organisations' individual members and their families. In addition, commissions arising from sales of accident insurance are donated to a not for profit body supporting the orphans of parents who served in the fire fighting service.

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[165] Our research for this case study consisted of the following:
We conducted an interview with a representative from Cetelem (11 June 2008), a leading provider of consumer credit to help understand their approach to partnerships and the nature of the relationships formed.
Research into other lenders was also carried out, following on from their responses to the affinity partnerships section in the initial comprehensive survey,
Desk based research included:
(a) The report "Affinity and Partnership Marketing Strategies in Credit Cards and Banking in Europe" by Finaccord.
(b) The report "Consumer Credit in Europe: riding the wave" by Mercer Oliver Wyman.
(c) The report "What is the impact of the proposed Consumer Credit Directive" by OXERA.
(d) Affinity Finance International bulletins.
(e) Web-based research on affinity partnerships, including websites of certain banks.

Financial institutions

10.5 With regards to financial institutions partnering other financial institutions, European consumer credit markets offering higher than average growth potential have seen several joint ventures between local banks and specialised finance providers. For example, the partnerships formed between Banca Nazionale del Lavoro and BBVA in Italy, Banco Sabadell and GE Capital in Spain, Foreningssparbanken and Barclaycard in Scandinavia.

Commercial entities

10.6 When considering commercial partner organisations the variety of partnerships formed becomes more evident. Major retailers in Europe are expanding their activity in financial services as showcased by the link formed between Germany's Tchibo with Comfort Card to develop consumer lending propositions, and the launch of mortgages by the UK retailer Tesco in conjunction with First Active. However, Finaccord point out that the main trend among retailers revising their strategic approach in this field has been the tendency to sell all or parts of their financial services business, as exemplified by the deals between F Group and Crédit Agricole in Denmark, Otto Group and Société Générale in Germany, Quelle SAS and Cofinoga in France, and Marks & Spencer and HSBC in the UK.

10.7 As well as retailers, major partner categories for card issuers and banking institutions also include commercial non-financial organisations such as automotive associations, football clubs, media entities, telecoms companies, travel companies and utilities.

Worksite

10.8 Worksite marketing refers to any marketing relationship between an employer and a commercial organisation which includes the promotion and advertising of goods or services at the workplace to employees. It is generally regarded in the context of financial services as a subset of affinity and partnership marketing. According to the Finaccord report on affinity partnerships[166]

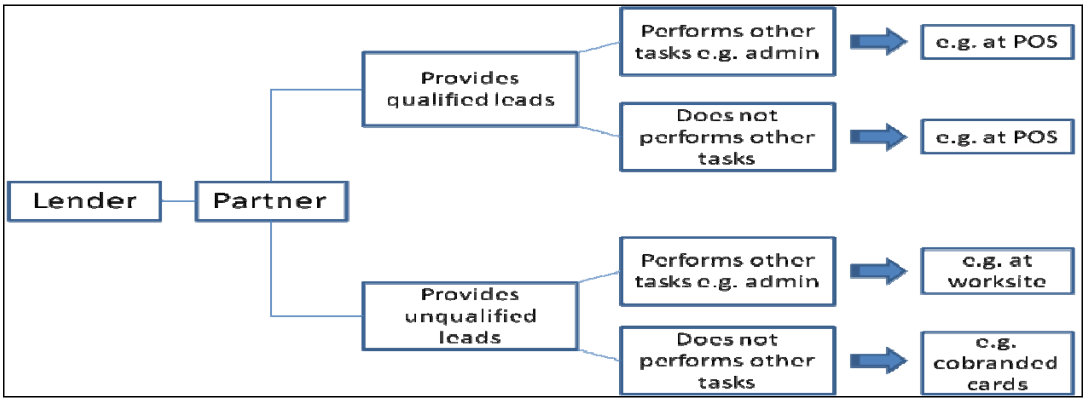
> "the development of worksite marketing in Europe is being stimulated primarily by factors such as the general move towards flexible and voluntary benefits and the twin drivers of pension and healthcare reform, rather than a specific desire to distribute credit cards or banking products."

166 "Affinity and Partnership Marketing Strategies in Credit Cards and Banking in Europe".

Are Affinity partnerships a form of credit intermediation?

Affinity partnership activity

10.9 Affinity partnership activity, in the context of credit intermediation, can be broadly categorised into two types: those that generate qualified leads for the lender; and those that generate unqualified leads for the lender (see the flow chart below).



Source: EE analysis

10.10 The link between the lender and the partner may result from a merger or an acquisition, or may be formed as a joint venture between two or more companies. In this case the affinity partner ceases to be a true third party intermediary. The joint venture (or the entity resulting from a merger or acquisition) would be subject to the same regulatory framework as the credit provider.

10.11 The examples in the flow diagram above are, of course, not mutually exclusive; there may be affinity partnerships at the worksite which do not perform any tasks other than generating leads for example.

Cetelem's partnerships

10.12 Cetelem, as a lender, has a relationship with a "dealer". The dealer proposes Cetelem's credit offering with the sale of its good; Cetelem then assesses the customer and deals with all pursuant lending activities. In most cases, the dealer is not linked exclusively with Cetelem.

10.13 Cetelem has formed partnerships with other companies, and as a result of these partnerships another brand is created; this brand however, is not a legal entity in itself. As with the first type of partnership, described above, an introductory fee is given to the dealer, however, there is an additional element in the form of distribution of profit. This is perhaps illustrated most clearly with the example of Suzuki Finance. Whilst the dealer receives an introduction fee, if the lead proves to be successful and credit is arranged, the profits from this transaction are split between Cetelem and Suzuki, the car manufacturer.

10.14 Cetelem has also formed partnerships by way of formal, incorporated joint ventures, in which a new company is set up as a result of the partnership between Cetelem and another firm. In this type of partnership, remuneration is provided to the shareholders. For instance, FACET is a captive finance company for a leading retailer, with its own consumer credit licence.

10.15 The main appeal to Cetelem of forming partnerships is that they provide access to new networks; members who they would not have necessarily been able to reach (or would have found it more difficult, and thus costly to reach) in the absence of a partnership. While potentially increasing revenue streams by increasing the volume of credit supplied, distribution costs may also decrease.

10.16 Given that forming a partnership provides the lender with access to potential customers that they might not otherwise have had access to, the effect of cannibalisation, i.e. the lender encroaching on their traditional business by lending through a third party, is minimal.

10.17 With regards to financial institutions partnering with one another, the main reason behind these partnerships is because different institutions specialise in different fields of finance – in the case of Cetelem, its "specialism" is consumer credit.

10.18 For the third party, i.e. the partner, the main advantage of forming a partnership with a lender is that they are in a position to sell greater volumes by offering credit with their product. In general, Cetelem provides product-specific education and assistance (and IT support and marketing support) to its partner; in the case of Cetelem forming a link with a "dealer", no legal support is provided, as there is no legal link between Cetelem and the dealer.

10.19 Consumers may benefit from credit that is more targeted towards them, given the richer access lenders may be granted to customer data.

10.20 As described above, the main form of remuneration for third parties is in the form of commissions. This is generally linked to the level of credit that Cetelem may be able to supply.[167] In a joint venture, remuneration would be in the form of profit share between the parties involved.

10.21 Research into other lenders confirms this: in a joint venture, remuneration will be an equal share of the profit or loss of that business; for affinity relationships not formed on the basis of a joint venture, remuneration will depend on the product – remuneration could be a flat fee per take up or a percentage linked to the value of the product.

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167 In France, it is forbidden to remunerate dealers as a function of the level of interest payments (see Appendix 2).

10.22 The commissions payable to dealers, by Cetelem, are not typically disclosed to borrowers. In some instances indirect payments may be disclosed to borrowers, for example, if the lender is linked to a charity, the borrower would be informed that they are making a donation to the charity.

10.23 Whilst Cetelem offers the same credit to all customers at the same rates, customers borrowing via a partnership may benefit from promotions offered by the dealer; the dealer must bear the cost of these offers. In some circumstances there may be incentives linked with the third party, for example, extra membership points for purchasing a certain good financed by credit from the partnership.

10.24 Therefore, one can conclude that there does not appear to be any direct price discrimination as a result of affinity partnerships; the lender offers credit directly and through partners at the same rate. However, consumers may benefit from discounts offered by the third party, thus allowing them to borrow at a reduced rate compared to the rate they would have to pay had they borrowed directly.

10.25 Given Cetelem's strong brand in the market for consumer credit, particularly in France, they are often approached by third parties about forming partnerships, as well as Cetelem seeking out potential partnering opportunities.

10.26 This suggests that there is not a dominant player in an affinity partnership. Lenders typically form partnerships with well-known brands, as this provides the greatest scope for new business, and similarly, third parties tend to form partnerships with established lenders. It is therefore unlikely that a lender could exert upstream pressure on a third party in order to squeeze margins, or vice versa, i.e. neither player has any significant pricing power.

10.27 Affinity partnerships may increase the barriers to switching by customers. This is likely to be because of the brand effects of the third party, a borrower takes out credit because of the partner rather than because of the lender (otherwise they would just borrow directly from the lender).

10.28 In France, there was previously a regulatory restriction which prevented non-bank partners from having their brands emblazoned on bank cards; this has been lifted since last October.[168] The removal of this restriction is likely to increase the incentive for lenders in France to forge affinity partnerships in order to produce co-branded credit cards.[169]

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168 This refers to the regulation of the "Groupement de Cartes Bancaires" which prevented banks from co-branding their cards. PLCs could always co-brand their cards in France, but not with VISA or Mastercard.

169 Cetelem has since made a joint venture with Orange to co-brand a VISA card.

Cross-border partnerships

10.29 With business becoming increasingly global in nature, cross-country partnerships are becoming more and more prevalent. Cetelem formed several new partnerships with other financial institutions after 2000, including partnerships in France with AXA , the Groupe des Banques Populaires and the Groupe des Caisses d'Epargne; and global partnerships with Bumiputra Commerce Bank (Malaysia), Dresdner Bank (Germany), and Thai Farmers Bank (Thailand).

10.30 Cetelem has also established relationships with numerous non-financial institutions. For example, since 1997, Cetelem has forged a partnership with Carrefour,[170] developing supermarket financial services in international markets.

10.31 Another partnership is with Dell for the provision of finance to its customers in southern Europe. This partnership is integrated into Dell's telephone and Internet platform for southern Europe.

10.32 The partnerships which Cetelem has formed outside of France are largely joint ventures. However, it is useful to note that on occasion these partnerships have been set up to overcome additional regulatory burden, for example, in Germany, all Cetelem's business is done under the Dresdner brand.

10.33 Our research suggests that affinity partnerships have not been used to a great extent to enter foreign markets, other than to extend a product range or distribution in markets where the lender already operates.

10.34 It would appear that where cross-border partnerships have been formed, they have largely been in the form of formal joint ventures. However, this is not to say that there is an absence of cross-border activity. Credit providers may enter foreign markets using partnerships (albeit in the form of a joint venture), thus it is not evident that consumer welfare is adversely affected in the internal market – particularly if partnerships are in the form of non-exclusive arrangements, as many of Cetelem's partnerships are.

10.35 If the third party, i.e. the partner, has a strong brand in a particular market (a product market or a foreign market), the lender may lever the partner's skills or regulatory credentials to enhance their own brand. Consumers may have confidence in the third party's brand, because they have more information about that firm's brand.[171] Conversely, consumers may have less information about the credit provider and the credit being provided.[172] The partner may help to alleviate asymmetric information problems by lending its brand to the credit provider. In particular, certain affinity partnerships may help

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170 Carrefour has a strong international presence, according to the Finaccord report it is present in eighteen countries worldwide and has issued around 10m credit cards.

171 Perhaps due to repeat purchases for example.

172 Perhaps due to infrequent purchase or lack of understanding of the financial product on offer.

to reduce the adverse selection problem of the lender; more reliable and trusted brands are likely to gain higher volumes than brands which are relatively less trustworthy.

10.36 On the other hand, this brand effect could have a negative effect too. Consumers may be more attracted to a brand that they have a personal association with (a particular brand that they always purchase, or a football club that they support for example), and are thus more likely to take out credit badged by this brand. As a result, credit may be distributed to a less competitive market, which could lead to higher rates of interest being paid by consumers in the medium to long term.

Summary of key findings

10.37 Credit providers are most likely to form partnerships with not-for-profit organisations, other financial institutions, commercial entities and with employers.

10.38 In the context of credit intermediation, partners can broadly be categorised into two types: those that generate qualified leads for lenders and those that generate unqualified leads for lenders.

10.39 Cetelem's partnerships are of one of three different types: point-of-sale partnerships; informal joint ventures and formal joint ventures.

10.40 Lenders benefit from partnerships by gaining access to new untapped networks, while the third party benefits by being able to offer credit to finance the purchase of their product (and from commission payments from the credit provider). Either side of the partnership may be in a position to take advantage of the others reputation.

10.41 Partnerships do not appear to be used to exploit price discrimination opportunities. Overall, consumers do not appear to be adversely affected by affinity partnerships.

10.42 Where affinity partnerships have been used to enter new markets, they have generally been in the form of joint ventures.

Home Credit in the New Member States[173]

10.43 Home credit lenders operate in a specific sector of the credit market. They specialise in small-sum loans, the delivery and the repayment of which is typically conducted in the borrower's home. The typical customer characterised by these types of lenders is that of someone with low income and/or without straightforward access to credit (e.g. without a credit record or access to a bank account).

[173] This case study was based on interviews with senior executives of International Personal Finance (3 July 2008) and web-based research.

10.44 Lending is unsecured and short term (six months up to two years) with, typically, a fixed repayment charge (the standard product does not incorporate default charges). The interface with the agents is very important for lenders in this market.

Overview of International Personal Finance (IPF)

10.45 IPF is a large player in the home credit market and was originally set up in 1997 by Provident Financial to develop home credit in overseas markets. Headquartered in the UK, IPF has six principal overseas subsidiaries, which run 179 branches across Central and Eastern Europe and Mexico. According to its latest figures, IPF has approximately 2 million customers, with some 5,000 direct employees, and also engages around 28,400 agents of whom 4,200 are employed.

10.46 In terms of the growth that has taken place in consumer credit between 2003 and 2006 however, the Czech Republic and Slovakia represent the fastest growing consumer credit markets of the European markets IPF operates in. We now turn to the performance of IPF itself (with data available for 2004–2007).

Table 10.1: Summary financial data

	Poland	Hungary	Czech Republic	Slovakia
Customers per agent	68.5	73.7	82.9	71.6
% Growth 2004-2007	*-18.9*	*13.8*	*5.0*	*1.0*
Credit per customer	311.0	407.5	412.2	314.5
% Growth 2004-2007	*21.4*	*17.3*	*22.5*	*17.9*
Impairment charge per customer	30.3	54.5	52.0	48.9
Impairment as % of revenue	17.7	20.0	20.3	23.3

Source: IPF

10.47 IPF operates using an agent network that, on average, provides one agent for every 70 customers. Further, the change in the customer/agent ratio has improved, with the international average of customers per agent having fallen by approximately 10 per cent between 2004 and 2007. However, within the Member States only Poland has experienced a decline in this average with Hungary, Slovakia and the Czech Republic all having risen slightly.

10.48 While the international average amount of credit extended per customer was approximately €320 per customer in 2007, the average for the Member Sates varied between €311 in Poland to €407.5 in Hungary. The growth in the average amount of credit per customer between 2004 and 2007 was in the region of 20 per cent for all the Member States supplied by IPF.

10.49 In 2007, the international average level of impairment charge was approximately €22 per customer. Among the Member States, this value varied from €28.2 in Poland to €54.5 per customer in Hungary. The impairment charge for Hungary for 2007 represents a 48.8 per cent increase since 2004. For Poland on the other hand, this 2007 figure is 54.9 per cent reduction from that in 2004. Impairment as a percentage of revenue shows a decreasing trend from over 35 per cent to less than 18 per cent in Poland and remaining at around 20 per cent in Hungary over the period.

Market segmentation

10.50 In the developing countries that IPF targets, the market segmentation methods are typically not as well defined as the segmentation methods used by other lenders in more developed economies. Data from credit bureaux for example, is limited and the market has yet to reach a point where well defined, risked-based segmentation can be applied. According to IPF however, it has managed to develop its own segmentation tools designed to identify higher risk consumer segments most likely to be underserved by banks, having analysed market data collected from detailed telephone interviews with sample groups of up to 25,000 people. These are likely to be those consumers that banks typically identify as high risk. These under-banked segments may be attracted to IPF's home-collected credit offer, which is intrinsically designed to manage and mitigate any risks through the use of agents and regular home visits Despite this segmentation, applications for credit come from a wide variety of potential borrowers and are not restricted to those within the 'high risk' category. Further, according to IPF, on average over 50 per cent of loan enquiries received are not converted to loans.

10.51 IPF also specified that with regards to the selection criteria used, this includes, inter alia, sufficient and regular income, being able to understand the contractual terms, and willingness to pay.

Overview of IPF's products

10.52 The key revenue driver of IPF is its core weekly home-collected product offerings and these are generally targeted at customers that require small-sum loans that are provided quickly. On average, new customers are allowed to borrow sums of between €100 to €250, and the period over which this is generally repayable ranges from 29, 39 or 52 weeks. According to IPF, new customers, as a general rule, are granted sums that are smaller and repayable over a shorter time period than for more established customers, who are, once having proved good payment performance, able to apply for larger loans repayable over a longer period (typically 52 weeks).

Role of the agent

10.53 In most territories agents are self-employed and tend to spend part of their time (two or three evenings a week) engaged in this role. On average, agents manage 70 to 100 customers while it is possible in some cases for agents to operate their agency business on a full-time basis and can build up a customer base of up to 200 to 250 consumers. At least once a week an agent will visit her local branch to meet the Development Manager, where they review the week's agency performance and discuss business activity for the coming week. Agents usually carry out a number of functions:

(a) *Risk management* — in addition to the above, agents also play an important role in assessing customers' ability and likelihood to repay their loan commitments. The first visit that the agent makes to the home of the customer, for example, allows the agent to gather information that would typically be unavailable to more remote lenders which constitutes part of the credit assessment. Further to this, the agent is also well placed to monitor and assess any changes that may occur in the customers' circumstances.

(b) *Generating new business* — in general, consumers will make contact with an IPF call centre in response to marketing after which the customer will be referred to an agent, who will then visit the consumer at their home and carry out the initial credit assessment. Any subsequent requests for lending from that customer are likely to be transmitted through that agent.

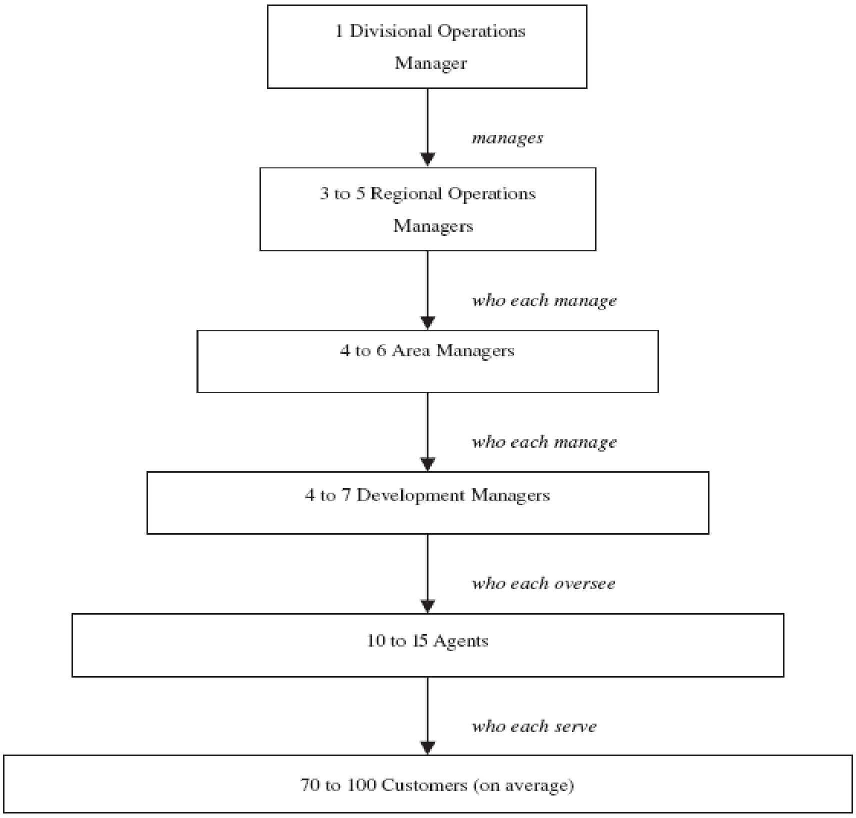
(c) *Developing relationships with customers* — the approach is predicated on the agent developing a good working knowledge of both the customer and his or her circumstances. It is believed that this provides an advantage of the agent in that the agent is typically in a good position to ensure that the amount of credit that is afforded to the customer is such that the customer will be able to afford the repayments given his or her circumstances. This also allows the agent to respond to the needs of the customer as a result of changing circumstances and, for example, offer flexibility when it comes to loan repayments without any penalty charges being incurred.

(d) *Collecting loan repayments* — agents typically collect repayments on a weekly basis which IPF stresses has the effect of reducing the level effort and cost (travel for example) that customers would typically have to incur otherwise. Further, IPF also highlights that allowing customers to make prepayments on a weekly basis is beneficial for customers in that it is consistent with customer preferences for weekly budgeting in clear cash terms.

Distribution network

10.54 Figure 10.1 below, sets out the standardised territory network that is typically deployed in each territory covered by IPF.

Figure 10.1: Standardised territory operating structure



Source: IPF

Agent renumeration

10.55 With the exception of Hungary (where agents are employees for regulatory reasons), agents are self-employed and paid by IPF on a commission only basis. The agent receives a small fixed payment for each new customer generated and a percentage of repayment amounts collected. Significantly, according to IPF's 2006 Prospectus, once a new market has settled down after the initial roll-out, agents tend to earn 80 to 90 per cent of their total commission through income through collections and 10 to 20 per cent through new customers.

Table 10.2: International average commission received per agent

International	2007	2006	2005	2004
Commission per agent (€)	3,062	2,222	2,573	2,337
Commission as % of revenue	13.8	11.6	11.5	11.5

Source: IPF Annual Report 2007. All translated at 2007 exchange rates.

10.56 Table 10.2 above illustrates the average commission that has been earned per agent between 2004 and 2007 as well as the total commission that IPF pays to it agents as a percentage of its overall revenue. While the international average amount of commission received per agent has increased by more than 30 per cent over the reported four year period, as a percentage of overall revenue, the increase has not been as significant, rising by only 1.5 per cent overall.

Monitoring of agents

10.57 According to IPF, their agents are closely monitored. They are for example, subject to mystery shopping and weekly meetings with managers. Reconciliations of cash in and out are performed on a weekly basis.

Development and retention of agents

10.58 Approximately 70 per cent of IPF's agents are female and most agents tend to live in the same communities as their customers. With respect to recruitment, it is mandatory that all agents enter into an agent's agreement with IPF. This agreement sets out provisions requiring agents to comply with relevant consumer credit and data protection regulations. Further to this, agents are also prohibited from soliciting IPF's customers and/or its agents for a certain period of time once an agreement has been terminated. An inquiry carried out by the UK Competition Commission (CC) in 2006 on the UK home credit market, identified the latter practice (typically formalised in a restrictive covenant issued by the home credit company to the agent) may act as a disincentive on agents to move companies. However, the CC did not cite this as one of the factors identified which serves to restrict, prevent or distort competition in the home credit market. Rather, it concluded that agents had numerous other reasons that are independent of the covenant which act as an incentive to remain with an existing lender such as:

- An established round which is likely to generate a more reliable and consistent income stream than one which an agent would have to build from scratch.

- The average size of a loan is likely to be higher on an established round and thus generate a higher average commission payment.

10.59 With regards to the development of agents, all of them undergo a 13 week development program and other various classes and seminars provided by Area managers with the aim of ensuring that all agents are fully aware of relevant consumer credit legislation and IPF then ensures that they comply with it.

IPF and Regulatory Framework

10.60 In the main, the agents operating as part of IPF's business in the EU27 are not formally regulated — although the Consumer Credit Directive will apply as and when it is implemented.

10.61 In most of the Member States where it operates — Czech Republic, Poland, Slovakia and Romania — registration of the agents is typically required. However, this is due to the self-employed status of the agents, not as a result of designated status as credit intermediaries. For instance, in Romania, agents must be licensed as self-employed persons in order that commissions can be paid.

10.62 In Hungary, the Banking Act has created two categories of intermediary — one with delegated authority from a lender (e.g. in respect of cash handling) and another which is in essence a facilitator. The agents used by IPF do not have delegated lending authority, but do handle cash on its behalf.

10.63 In order to comply with this and other local legislation, IPF has enacted significant changes to its business model in Hungary. There are two aspects to this:

(a) It has switched agents from a self-employed status to employed status. IPF considers the primary impacts of this compared with its traditional business model to be two-fold: first, of it having to bear an additional on cost in respect of each worker, and, second, that the dismissal of rogue or under-performing individuals will be made more complicated (although the company has policies and procedures in place to cater for any such circumstances). However, the remuneration of these employees is heavily geared towards commission.

(b) To qualify as a loan, the home credit products have been modified to incorporate default charges. However, these are nominal in value.

10.64 Poland has recently introduced rate cap legislation that means that the standard IPF product has also been re-engineered there. The product has been decomposed between an interest charge and an optional charge for home service. The alternative to the home collection service is payment through a bank account. It is not yet clear whether this will impact upon the use of agents (e.g. if there was a significant reduction in the demand for the home service product).

10.65 In addition, Slovakia is looking to enact new legislation concerning financial intermediaries, although the specific detail remains the subject of consultation and has yet to be confirmed.

10.66 Of the states where IPF operates, Financial Ombudsmen are set up in Hungary and Poland only.

Summary of key findings

10.67 Overall, IPF serves a market that would otherwise be excluded from credit provision who may, as a result, resort to the use of illegal money lenders working outside of the regulated market. According to IPF other benefits of the business model that IPF has adopted include:

(a) Moral hazard issues on the part of the borrower are mitigated by the home presence of the agent and personal collection payments.

(b) Borrowers are afforded a degree of flexibility (largely with regards to missed payments) as well as transparency about the price.

(c) Efficiency in increased by the risk-sharing remuneration scheme through commission that depends on the repayment rate.

10.68 On the other hand, there is potential for the trust relationship between the agent and the borrower to be exploited by decreasing consumer awareness and switching possibilities (this stems largely from the agents ability of offer further loans to existing customers).

10.69 While there have been some concerns raised by consumer protection organisations, for example in Poland, mainly about the high cost of loan charges, it would appear that there have been no major concerns expressed by national regulators themselves over the workings of the home credit market in any of the Member States in which IPF operates.

10.70 The Office of Competition and Consumer Protection in Poland for example, noted that they had no objections with regards to the organisation of the operations of the home credit companies in Poland. They did, however, say that in connection with works on the implementation of the EC Consumer Credit Directive in Poland, they are currently considering the possibility of introducing some supervision of home credit companies.

11 INTERMEDIATION IN THE BUSINESS FINANCE MARKET

Introduction

11.1 We set out below the evolution in non-residential lending over the period 2001–2007. The dramatic increase in Spain is particularly noteworthy. The limited coverage of the available data in terms of Member States is also highlighted.

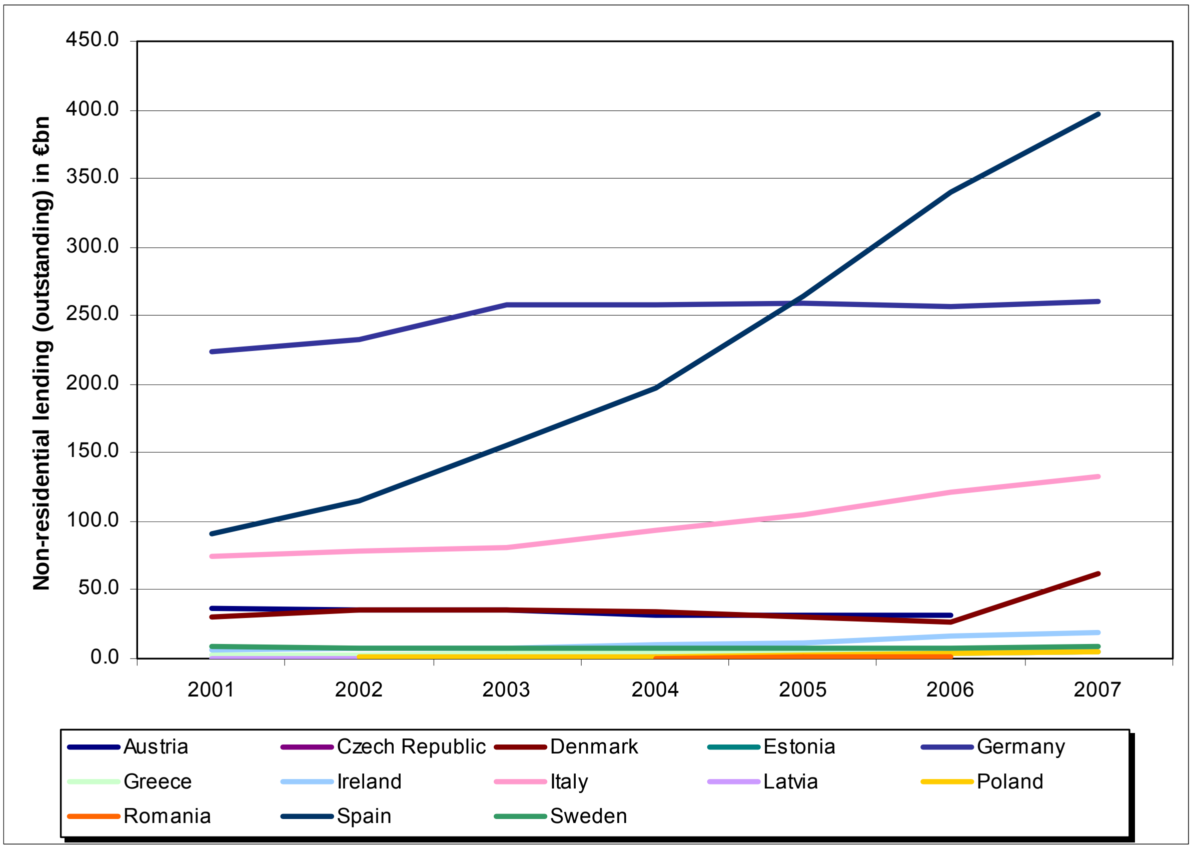
Table 11.1: Outstanding non-residential lending, 2007

	Total OUT-STANDING lending, €bn	OUT-STANDING debt/GDP, %
Denmark	61.5	27.0%
Estonia	5.5	36.0%
Germany	260.0	10.7%
Greece	4.8	2.1%
Ireland	18.5	9.7%
Italy	132.7	8.6%
Poland	5.5	1.8%
Spain	396.4	37.7%
Sweden	8.4	2.5%

Source: Hypostat 2008, eurostat (2007 data), EE calculations

11.2 The evolution of these balances from 2001 to 2007 is set out below.

Figure 11.1: Evolution of non-residential lending, outstanding, 2001–2007



Source: European Mortgage Federation (Hypostat 2008)

The Current Scale of Intermediation

11.3 In addition to the limited scope of the information available on the size of the markets (this is particularly the case with business mortgage lending), as is discussed below, the limited (or non-existent) supervisory role adopted by many Member States limits significantly what can be said about distribution channels. We set out below a table describing the situation where data is available (this does contain, at least partial, information about Germany, UK, Italy, France and Spain).

Table 11.2: Intermediary share in business finance, 2007

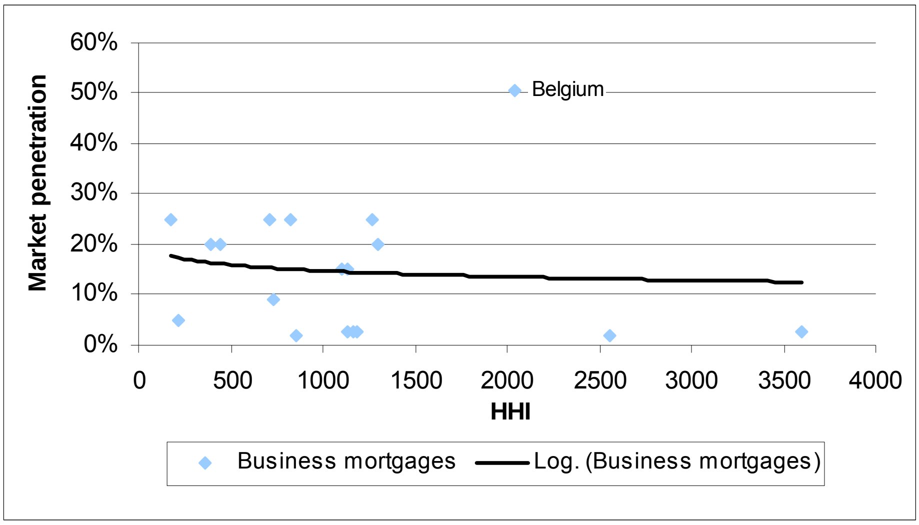
	Busines mortgages			Business leasing		
	Intermediary share (%)	***Direct share (%)***	**Value, FLOW €m**	**Intermediary share (%)**	***Direct share (%)***	**Value, FLOW €m**
Bulgaria	25.0%	*75.0%*	n/a	25.0%	*75.0%*	110
Czech Republic	15.0%	*85.0%*	135	57.5%	*42.5%*	105
Estonia	2.0%	*98.0%*	61	2.5%	*97.5%*	20
Finland	2.0%	*98.0%*	n/a	5.0%	*95.0%*	111
France	9.0%	*91.0%*	n/a	30.0%	*70.0%*	5,035
Germany	25.0%	*75.0%*	14,175	25.0%	*75.0%*	8,991
Hungary	25.0%	*75.0%*	n/a	25.0%	*75.0%*	984
Italy	5.0%	*95.0%*	2,125	80.0%	*20.0%*	19,584
Netherlands	n/a	*n/a*	n/a	50.0%	*50.0%*	7,468
Portugal	2.5%	*97.5%*	n/a	10.0%	*90.0%*	231
Romania	2.5%	*97.5%*	n/a	2.5%	*97.5%*	35
Slovakia	15.0%	*85.0%*	67	n/a	*n/a*	n/a
Slovenia	25.0%	*75.0%*	n/a	40.0%	*60.0%*	206
Spain	20.0%	*80.0%*	24,222	25.0%	*75.0%*	2,670
Sweden	2.0%	*98.0%*	43	30.0%	*70.0%*	1,764
United Kingdom	20.0%	*80.0%*	23,100	25.0%	*75.0%*	10,893
			63,928			58,207

Source: EMF (Hypostat 2008), leaseurope (2007), eurofinas (2007), surveys,[174] EE calculations

11.4 Even in this limited sample, there is significant variation in penetration, which we now turn to.

[174] Survey data used in this section is based upon up to 71 data points (see also Section 2). We have identified in this section where the number of responses was significantly less than this (typically where more detailed, and potentially more sensitive data — such as relating to remuneration structures, etc).

Figure 11.2: HHI and market penetration for business mortgages



Source: Surveys, ECB Banking Structures (2006 data)

11.5 The nature of intermediary effort is qualitatively different by comparison to the residential mortgage market: the focus is upon customisation rather than price (see the extract from the case study below). As a consequence, the lack of a clear relationship between concentration and intermediation in this case is unsurprising. A comparable lack of a relationship holds with regards to the perceived level of lender competition and branch density (not shown), with the same rationale.

Box 11.1: Business mortgage intermediation in the Czech Republic

The majority of stakeholders described the market for business mortgages as less competitive than that for residential mortgages. Partners for Life (in the Czech Republic) confirmed this by informing us that there were almost no other IFAs active in this area. They faced competition in the supply of business mortgages primarily from some specialised mortgage intermediaries and all the banks. For residential mortgages, they also faced competition by other intermediaries.

The main reason that one might expect the market for business mortgage intermediation to be less competitive than that for residential mortgages could be down to the product itself. According to Partners, whilst good software can be used to choose residential mortgages (e.g. eHyp, as described in an earlier case study), business mortgages require more individualisation and usually take at least twice as long to conclude. Banks take greater care in analysing the corporation to which the loan is made (a function of the larger loan values). Likewise, the corporation might desire a good working knowledge of the bank (this is a function of the more complex relationship that a business borrower typically has with its bank by comparison to a consumer). In at least some banks in the Czech Republic, business mortgages must be approved at a higher level of management than that required for residential mortgages.

While an intermediary tends to receive a percentage of the value of the mortgage for residential loans, commissions on business mortgages are usually capped and this may discourage intermediaries from supplying business mortgages. Many intermediaries claim the commission they receive does not cover the extra time and effort needed for business mortgages. Finally, banks tend to keep the best clients by offering special deals on other banking products, which also contributes to the low number of intermediaries in this market.

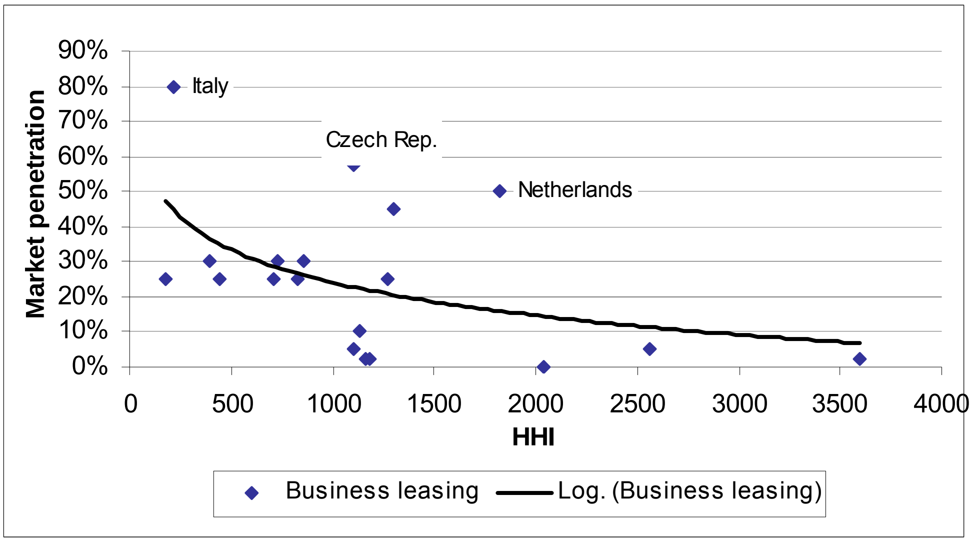
An offsetting factor, which theoretically should encourage competition in the market, is that dealing with corporate clients is easier in terms of better financial literacy and better understanding of adequate risk coverage. It is also not difficult for foreign corporations to own commercial property in the country and Partners themselves work with both Czech and foreign owners who seek financing in Czech crowns.

Most firms believe that while price competition was the dominant form of competition in residential mortgage markets, finding the right balance between price and range of products was more important for business mortgages. Again, this is likely down to the complexity of the product and characteristics of customers mentioned above. Several respondents did expect the state of competition between intermediaries to increase in the future.

Source: Case study, see next section

11.6 For business leasing, on the other hand, there is a relationship between concentration and penetration — the double-sided search function (i.e. acting as distributor for the credit provider, conduit to lenders for borrower) of the intermediary is again important.

Figure 11.3: HHI and market penetration for business leasing



Source: Surveys, ECB Banking Structures (2006 data)

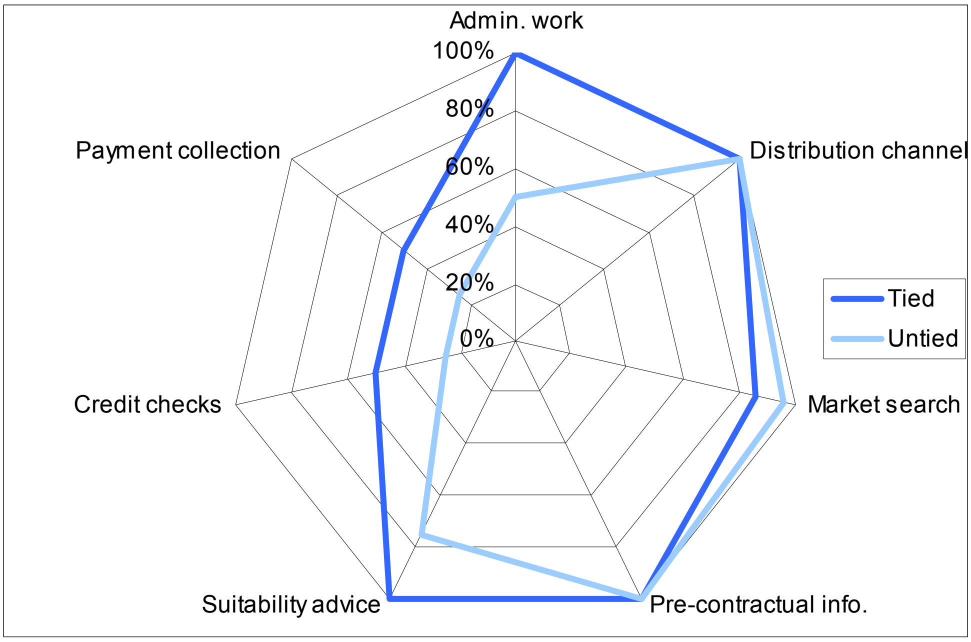
11.7 There is no clear relationship between lender competitiveness or branch density and penetration rates.

Business Models

Activities undertaken by intermediaries

11.8 The activities undertaken by business mortgage intermediaries are graphically represented below.

Figure 11.4: Business mortgage intermediation



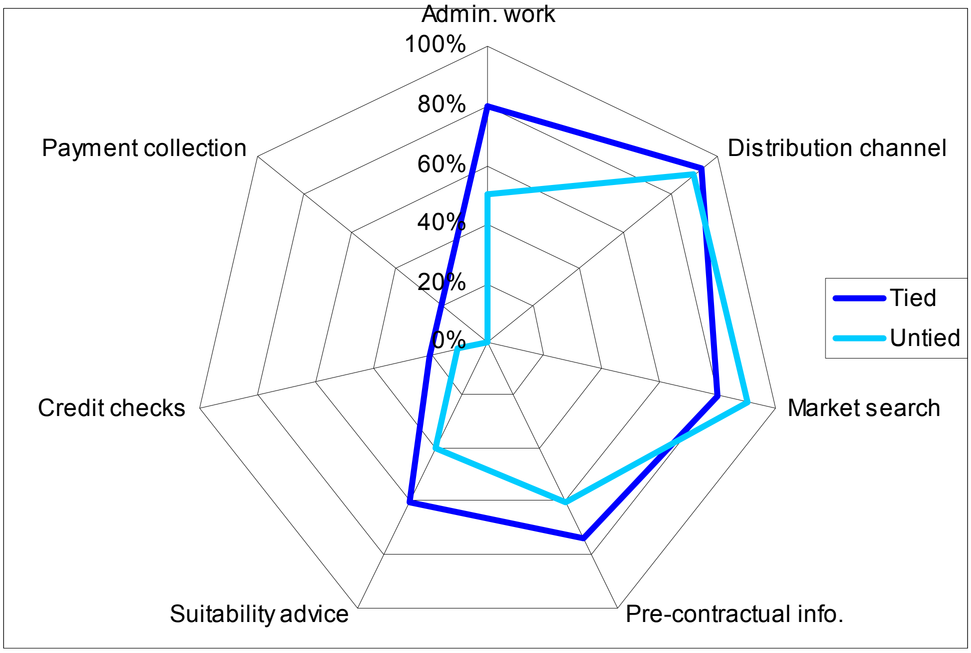
Source: Surveys

11.9 The dominant functions are the double-sided search, as previously described, and involvement in the paperwork around the transaction. These administrative tasks and the suitability advice appear to be a function of the customisation involved (e.g. rather than completing a standardised form, the intermediary may be involved in a more complex and negotiable legal document).

11.10 It is interesting to note that business mortgage intermediaries' involvement in assisting lenders in the assessment of the credit worthiness is far from negligible (especially among tied intermediaries). This is in contrast to residential mortgage intermediaries.

11.11 The activities undertaken by business leasing intermediaries are graphically represented below.

Figure 11.5: Business leasing intermediation



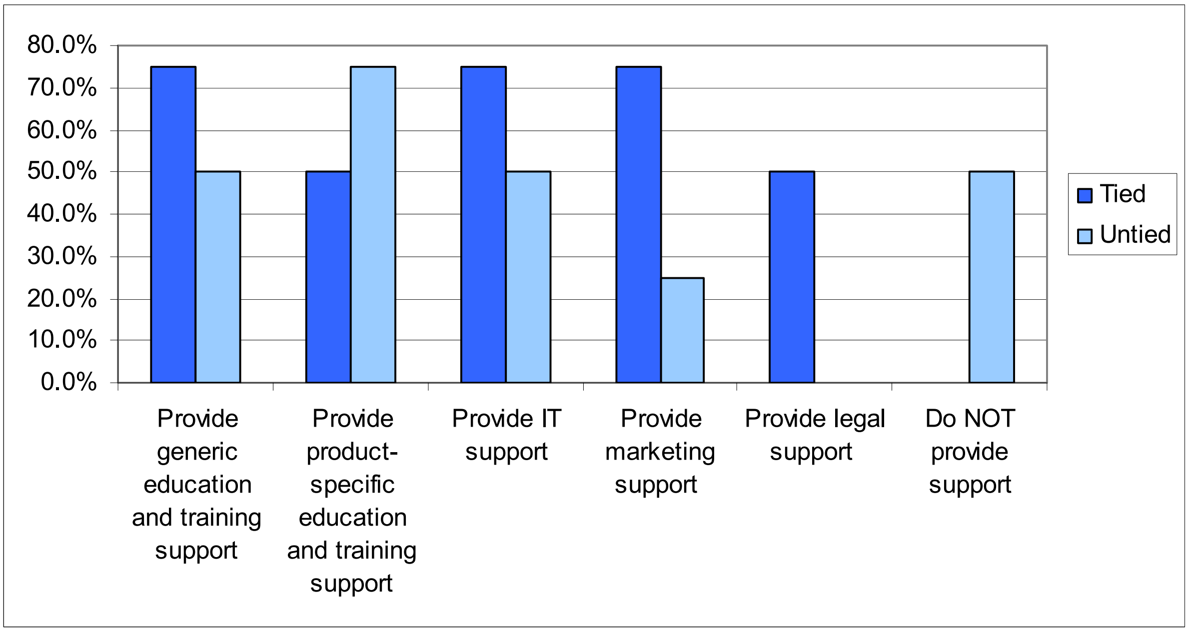
Source: Surveys (based upon 30 stakeholder views)

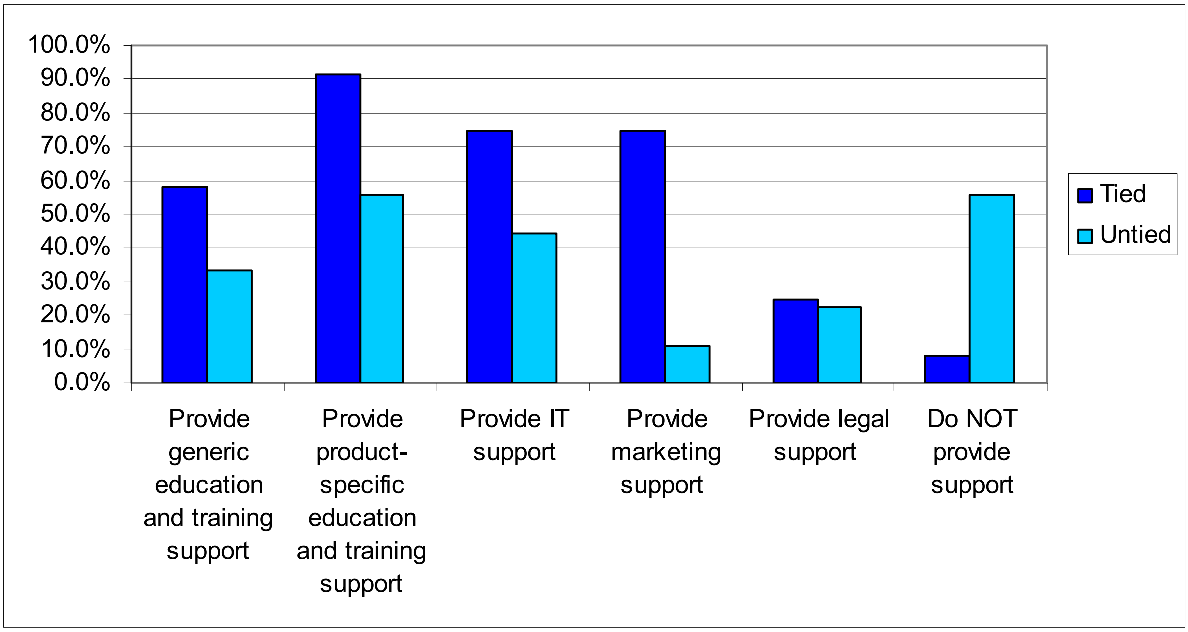
11.12 The search function dominates. The activities undertaken outside of the search function are much more prescribed than in the case of business mortgage intermediation.

Lender support

11.13 The nature of lender support offered to business finance intermediaries is reviewed below.

Figure 11.6: Lender support to business mortgage intermediaries (above) and business leasing intermediaries (below)





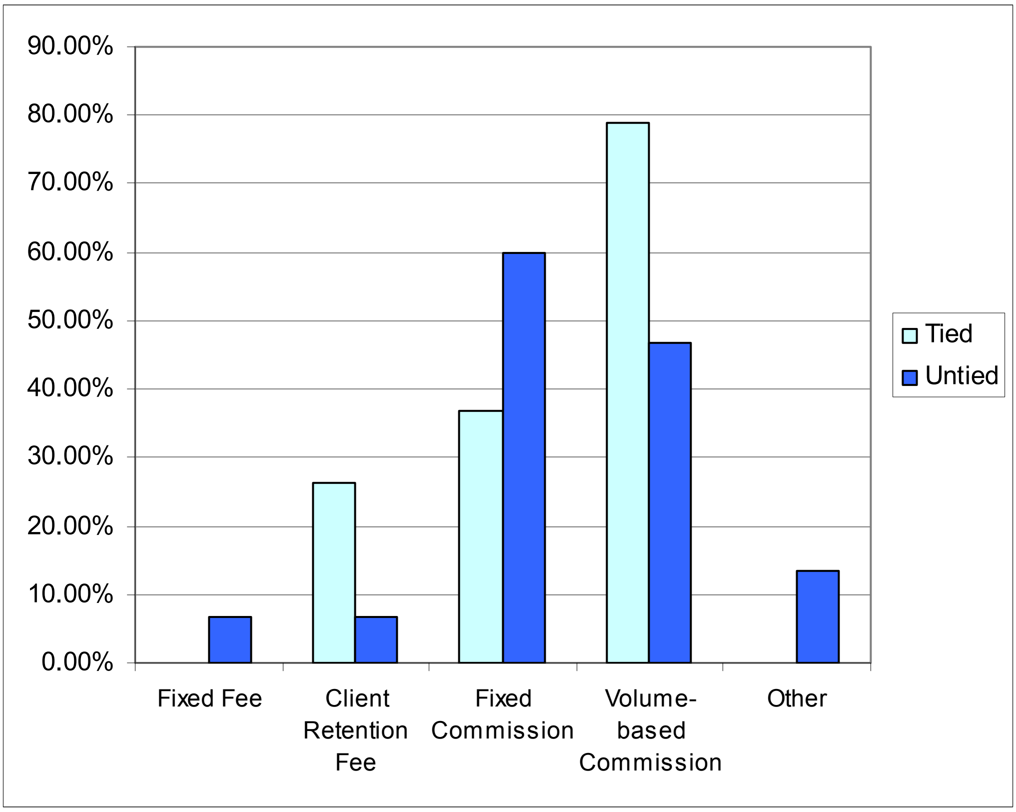
Source: Surveys (based upon 26 stakeholder views)

11.14 Based upon our survey results, where support is offered, it is in depth (particularly where a degree of exclusivity exists in the relationship with the lender). Somewhat contrarily, an absence of lender support is more common than in other product categories (exceptions include participating lenders based in France and Sweden).

The remuneration of intermediaries

11.15 Looking at both the intermediation of business mortgages and business leasing on a combined basis, we examine the upstream remuneration models below.

Figure 11.7: Upstream remuneration models in business finance intermediation



Source: Surveys (based upon 28 stakeholder views)

11.16 The remuneration schemes adopted are in line with the primary activity that intermediaries serve, with the focus being upon commissions linked to either the volume or value of transactions. Our evidence indicates that the use of volume-based commissions with tied agents, in particular, is the dominant model. Besides creating the right incentives for agents to perform efficiently, these schemes foster the development of long lasting relationships.

Summary Financial Data

11.17 The limited scope of available data reduces what we can say about this sector. We set out below estimates of the revenues accruing to intermediaries.

Table 11.3: Range of revenues from business finance intermediation, 2007

	€m			€m	
Bulgaria	1	+	-	2	+
Czech Republic	2		-	3	
Estonia	1		-	1	
Finland	1	+	-	2	+
France	50	+	-	76	+
Germany	203		-	277	
Hungary	10	+	-	15	+
Italy	213		-	315	
Netherlands	75	+	-	112	+
Portugal	2	+	-	3	+
Romania	0	+	-	1	+
Slovakia	1	+	-	1	+
Slovenia	3	+	-	4	+
Spain	220		-	282	
Sweden	22		-	27	
United Kingdom	217		-	296	
	1,022			1,415	

Source: Survey

11.18 In a number of instances, data is available upon mortgages or leasing only, so that even these estimates present a partial picture only (signified by "+").

Business mortgage intermediation

11.19 For business mortgage intermediation, the revenues received by intermediaries (expressed as a percentage of transaction value) are highly varied (without a clear Member State-specific pattern), which no doubt reflects the diversity of loan values being intermediated and that a cap on the fee is not uncommon. From the limited data available to us, the combined average of both downstream and upstream remuneration is around one per cent of the mortgage value (this is likely to be exceeded for smaller value loans, such as the buy-to-let market in the UK).

11.20 The customisation to the individual borrower calls for a different business model, with more limited scope for standardisation (see the extract from the case study at Box 11.1). Market participants are likely to overlap heavily with those providing residential mortgage intermediation services, i.e. with some proportion of those intermediaries also acting as business mortgage intermediaries, at least on an *ad hoc* basis.

11.21 Our sample includes Germany, Italy, UK and Spain: if one assumes that intermediary revenue achieved by each employee is at a comparable level to that holding in the residential mortgage intermediation, then this implies 4,900–6,700 FTEs working in this market segment in those Member States for which we have data. (It is noted that our case study relating to the Czech market implied that business mortgage intermediation may be less attractive than residential due to the requirements of greater customisation, and so on).

Business leasing intermediation

11.22 Again, the revenues received were highly varied between respondents (again, without a clear Member State-specific pattern). Average commission levels were reported to us as between 2–2.25 per cent of transaction value (this includes upstream and downstream remuneration). However, our stakeholder interview with the NACFB in the UK indicated markedly lower levels (up to 0.5 per cent). This may be a reflection of different business models (with the UK market being more volume-driven with the brokerage function performed remotely — i.e. by phone or through internet).

11.23 Our case study on the Italian business leasing sector suggests that, again, the majority of the intermediaries active here are non-specialist to business leasing intermediation activity *per se*.

11.24 The data available on the number of intermediaries or the scale of employment in this sector is extremely limited. However, we have been informed that there are about 20 such agents operating in Slovenia and approximately 1,200 in the Netherlands. If these data are correct, it implies average revenue per intermediary of between €110,000 and €200,000.[175] Two observations follow:

(a) If this can be used as a proxy for the situation across all of the markets where we have at least some data (i.e. ignoring *all* Member States-specific factors), then it suggests that the number of intermediaries active in the Member States indicated above (which includes Germany, Italy, France, UK and Spain) would be between 5,000 to 11,000.

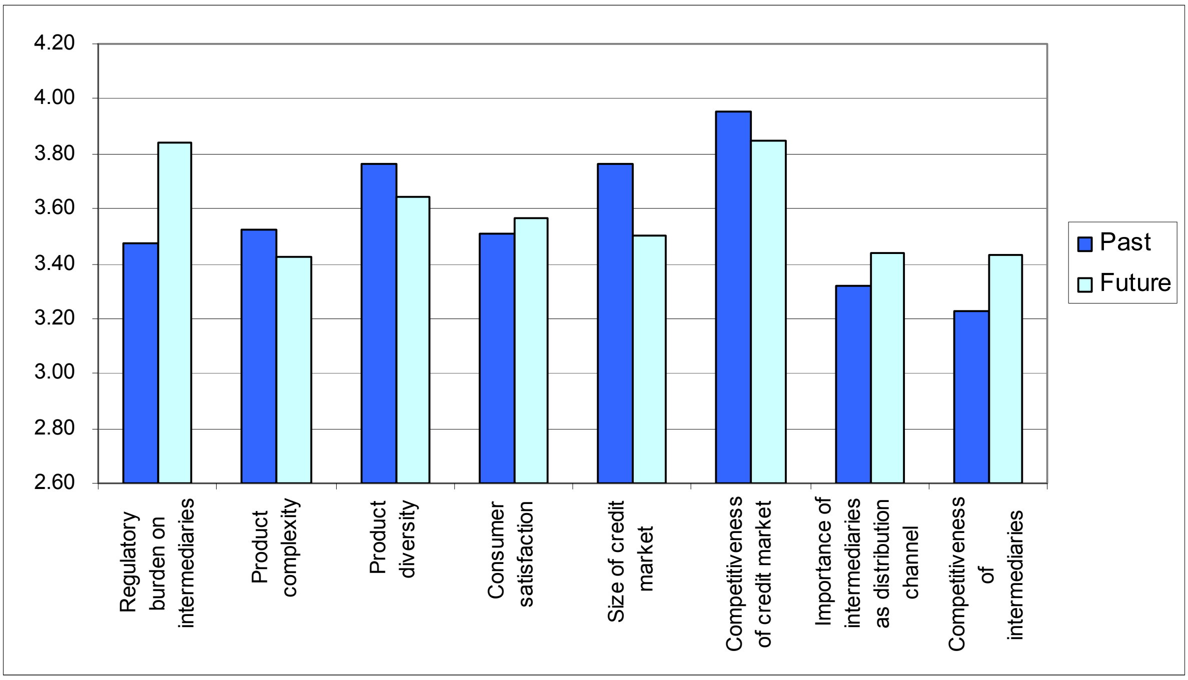
(b) It is strongly suggestive of the typical intermediary active here having a relatively small employment roster dedicated to such activity, perhaps in the range 2–4 FTEs, with aggregate FTEs in this sector of approximately 20,000–22,000.

[175] The larger figures relate to Slovenia — this implies that the sector may be more concentrated market in Slovenia or with greater involvement of specialist firms.

Developments

11.25 Figure 11.8 reviews the opinions of stakeholders on trends in business finance over the past five and next five years (in this instance, there is insufficient variation between the two categories to justify separate treatment). It should be noted that these results are based upon data gathered between April and July 2008. As such, they will self-evidently not reflect the recent credit market turbulence (particularly that ensuing from the collapse of Lehman Brothers in September 2008 to date) and the associated change in sentiment concerning the short- and medium-term prospects of the economic situation across the EU27.

Figure 11.8: Trends in business finance



Source: Surveys

11.26 This presents a somewhat familiar story of anticipated increases in the regulatory burden coupled to the credit crunch slowing down the growth in the size of the market (and correspondingly the development of product diversity/complexity).

11.27 Interestingly, the net effect of this upon intermediaries is expected to be an increase in the importance of their role as distribution channel.

The Regulatory Framework across EU27

11.28 Business finance intermediaries cover two main activities: business leasing and business mortgages. These intermediaries are subject to less regulation than credit intermediaries dealing primarily with consumers. In some Member States, intermediaries involved in arranging business mortgages are regulated more heavily than those involved in business leasing.

11.29 We categorise Member States' regulation of business finance intermediaries as shown in Table 11.4.

Table 11.4: Regulation of Business Finance Intermediaries

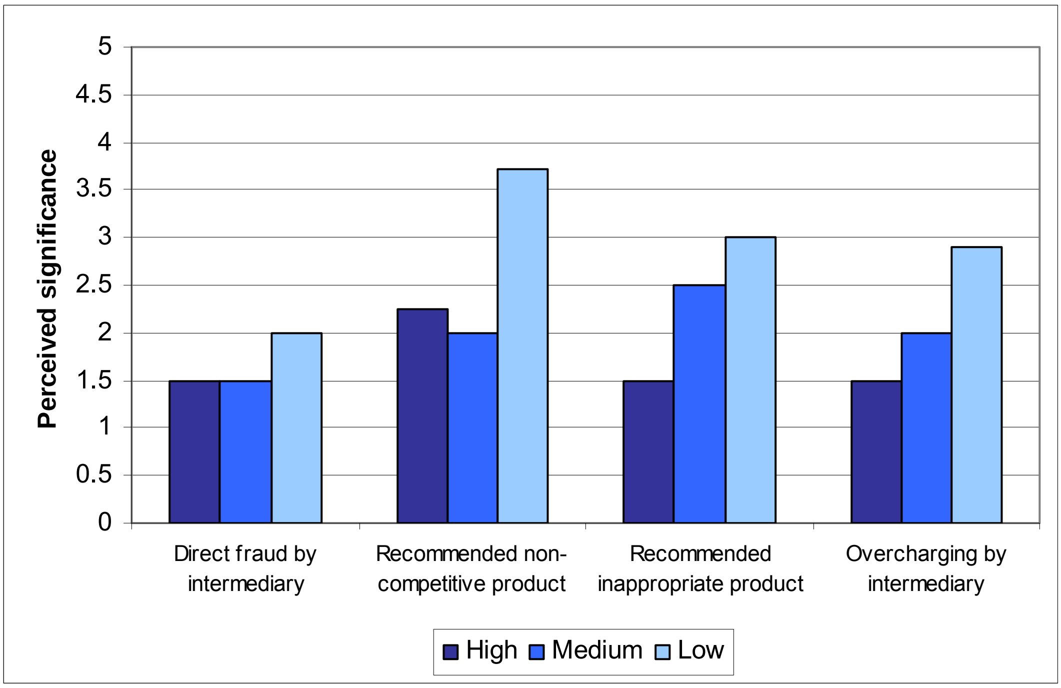
No or limited explicit statutory regulation of business finance intermediaries	Moderate level explicit statutory regulation of business finance intermediaries	Significant explicit statutory regulation of business finance intermediaries
Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Portugal, Romania, Slovakia, Spain, Sweden	Austria, Germany, Italy, Malta, Slovenia, UK	Hungary, Ireland

Source: Surveys, EE analysis

Detriment

11.30 This section should be read in conjunction with our analysis at Section 4. The graphic below identifies the perceived relative significance of various sources of detriment, according to our broad categorisation of the regulatory/supervisory level.

Figure 11.9: The potential for detriment according to the level of regulation



Source: Surveys, where 1 = not significant and 5 = highly significant.

11.31 As with the other categories, there is an association between the lower level of regulation and the perceived significance of the categories of consumer detriment relating to advice. In jurisdictions which we have characterised as having a low intensity of regulatory effort, the recommendation of a non-competitive or unsuitable credit product is perceived as being of average or above average significance. The other categorisations are not seen as being particularly significant sources of detriment (this may be partially due to the fact that, since the end consumers are business entities, their informational disadvantage towards intermediaries should be less marked).

11.32 The greater scope for the customisation of financing arrangements to particular circumstances (crudely because the values involved make this a plausible business model) means that the focus would be upon the skill and experience of the intermediary also.

11.33 There is no significant difference in penetration by intermediaries between our categories of regulation.

11.34 Three main sources of consumer detriment relating to the business finance market have been identified, namely high search costs, excessive charging and the provision of inaccurate information. (These are discussed here in general, and in more detail in the case study of Italian business leasing.):

(a) The possibility of consumers suffering high search costs may arise when the market structure is one where exclusive ties are commonplace.

(b) Excessive charging is possible only if two conditions are simultaneously met: that there is little competition among intermediaries and also between lenders. The possibilities for the customisation of business mortgages, in particular, result in the potential for excessive charges. On the other hand, that capped fee remuneration models appear to be more common in the business mortgage segment should militate against this.

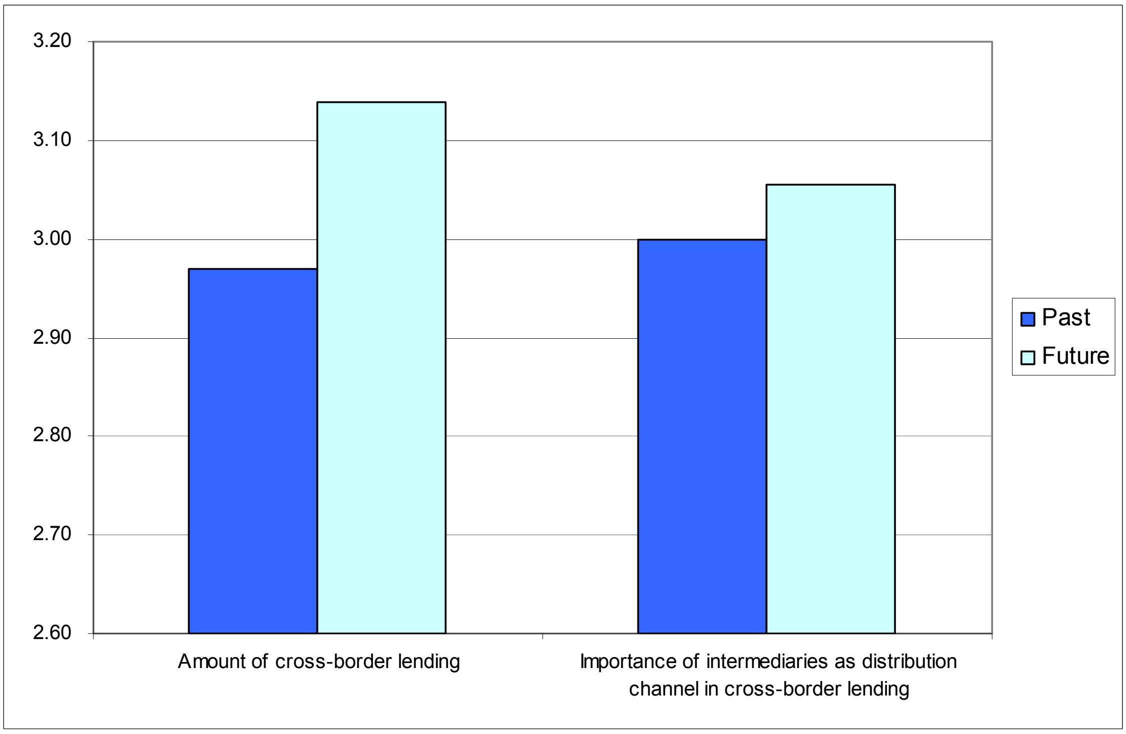
(c) A further possibility is the provision of inaccurate or misleading information. The (presumed) greater average financial sophistication of the business community should reduce the scope for this.

11.35 No specific examples of detriment involving a business finance intermediary have been provided to us.

Cross-border Activity

11.36 The figure below illustrates the views of stakeholders on past and future developments in cross-border activity. This topic is dealt with in more detail at Section 13. As previously, we note that these results are based upon data gathered between April and July 2008. As such, they may be best interpreted as a guide to long-term trends rather than predictions applicable to the short-term.

Figure 11.10: Trends in cross-border activity



Source: Surveys

12 CASE STUDIES AND INTERMEDIATION OF BUSINESS FINANCE

The Market for Intermediation in the Supply of Business Mortgages in the Czech Republic and Slovakia[176]

Introduction

12.1 This case focuses on a Czech credit intermediary, Partners for Life Planning (hereafter Partners), which provides business credit intermediation services as part of its overall business model.

12.2 Where the data is available, we have attempted to draw some parallels between the Czech market and the Slovak market. Since the break up of Czechoslovakia into the Czech Republic and the Slovak Republic in 1993, the individual countries have risen economically and politically.

Background

12.3 A recent study classified the Czech consumer credit market as dynamic, identifying it as a market with high levels of innovation, competition, liberal regulation and potential for growth.[177]

12.4 The Czech mortgage market as a whole (i.e. both commercial and residential mortgages) has been growing at a rapid pace over the last five years and performed strongly in 2006. By 2006, the outstanding value of non-residential mortgage loans reached €2.44 billion, while the value of new non-residential mortgage loans issued was €899 million.[178] Non-residential mortgages represented around 23 per cent of the total value of mortgages outstanding in the country and 18 per cent of new mortgages issued in 2006.

12.5 Partners were able to tell us there are about 50 independent financial advisory companies (IFAs) in the Czech Republic which employ over fifty individual financial advisors and an additional 12 which employ over a hundred advisors. The largest is German owned OVB Allfinanz and the second largest is Czech-owned ZFP Akademie. It should be noted that such companies are operating across a range of financial services (i.e. not just credit

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176 Since the relevant market is rather a niche one, an important source of information for this case study has been our own survey of stakeholders in the Czech republic and Slovakia with follow-up emails and interview with the vice-chairman of the Board of one Czech intermediary which supplies business mortgages.
Initial desk-based research consisted of the following documents and data sources, along with websites of Czech and Slovak market players:
(c) Consumer credit in Europe: riding the wave; Mercer Oliver Wyman, 2005
(d) Hypostat 2006; European Mortgage Federation, 2006
(e) European mortgage distribution: changing channel choices; Mercer Oliver Wyman

177 Consumer credit in Europe: riding the wave; Mercer Oliver Wyman, 2005

178 Hypostat 2006; European Mortgage Federation, 2006

intermediation, but also services such as investment advice). There are also other smaller intermediaries, with only a few advisors, and other specialists.

12.6 The mortgage market in Slovakia is smaller, but a similar environment of strong economic growth has driven up the supply of mortgage loans. Hypostat does not contain data on the value of non-residential mortgages in Slovakia but the total value of residential loans outstanding was €4.2 billion, roughly half the equivalent value in the Czech Republic. Thus, a sensible estimate of the value of non-residential loans outstanding would also be half the equivalent value in the Czech Republic, €1.2 billion.

Partners For Life Planning

12.7 Partners is one of the three largest Czech IFA companies, serving the whole country and providing financial advisory services, including the supply of credit.

12.8 Its current annual value of business mortgage lending is about €34 million, accounting for 12 per cent of its overall intermediated lending. Partners' market share in business mortgages is about two per cent and the aim is to increase this to five per cent by the end of 2008. The company is also in the market for residential mortgages (market share 3.5 per cent), pre-approved credit and credit for motor vehicles, as well as the wider market for the provision of insurance and investment. Overall, their credit intermediation business accounts for about 12 per cent of their total income.

The market for business mortgage intermediation

12.9 Mortgage lending specialists have been able to capture important market share in the Czech Republic.[179] According to Partners, there are 11 banks, five building savings banks and up to ten mortgage intermediaries with any significant volume in business mortgages. Since it is the only intermediary with any significant presence in business mortgages, we estimate that the market share of financial intermediaries (excluding specialised mortgage intermediaries) in the supply of business mortgages is less than five per cent. For residential mortgages, Partners estimate that the market share of IFAs is about 12 per cent, while mortgage intermediaries account for an additional 10 per cent share implying a 22 per cent market penetration rate for residential mortgage intermediaries as a whole.

12.10 The leading lender in the Czech Republic described the intermediation market for business mortgages as one in which intermediaries tend to establish long-term relationship with lenders rather than borrowers — an intermediary is affiliated with certain lenders and can only suggest their product. They work with 10 out of 11 banks in recommending mortgages (both commercial and residential) and also four out of five building savings banks for residential mortgages. This effectively means they can provide

[179] Consumer credit in Europe: riding the wave; Mercer Oliver Wyman, 2005

customers with access to almost all of the leading lenders, and therefore customer choice does not appear overly restricted as a result of these ties.

12.11 The other intermediaries we surveyed also reported they were affiliated with certain lenders. Partners confirmed our finding that almost all intermediaries in the Czech Republic are tied to certain lenders, telling us that “even specialised mortgage intermediaries usually work only with some of the banks. And even if they formally have contracts with all, production is usually focused on four to five key partners that might hold over 70 per cent of total production.”

12.12 The market share of the five largest intermediaries in the residential mortgage intermediation market in Slovakia is 93 per cent.[180] The representative from Partners told us that he would expect market conditions to be fairly similar in Slovakia, with possibly a lower market share of specialized mortgage intermediaries,

12.13 The Slovak Ministry of Finance believed that the size of the credit market and product complexity had increased significantly in the market for business mortgages over the last five years. Product diversity was also considered to have increased. Furthermore, they expected these factors to continue to increase over the next five years.

Competition

12.14 The majority of stakeholders described the market for business mortgages as less competitive than that for residential mortgages. Partners confirmed this by informing us that there were almost no other IFA active in this area. They faced competition in the supply of business mortgages primarily from some specialized mortgage intermediaries and all the banks. For residential mortgages, they also faced competition by other intermediaries.

12.15 The main reason that one might expect the market for business mortgage intermediation to be less competitive than that for residential mortgages could be down to the product itself. According to Partners, whilst good software can be used to choose residential mortgages (e.g. eHyp, as described in an earlier case study), business mortgages require more individualisation and usually take at least twice as long to conclude. Banks take greater care in analysing the corporation to which the loan is made (a function of the larger loan values). Likewise, the corporation might desire a good working knowledge of the bank. In at least some banks in the Czech Republic, business mortgages must be approved by higher management levels than that required for residential mortgages or through different channels.

180 Ministry of Finance of Slovakia

12.16 While an intermediary tends to receive a percentage of the value of the mortgage for residential loans, commissions on business mortgages are usually capped and this may discourage intermediaries from supplying business mortgages. Many intermediaries claim the commission they receive does not cover the extra time and effort needed for business mortgages. Finally, banks tend to keep the best clients by offering special deals on other banking products, which also contributes to the low number of intermediaries in this market.

12.17 An offsetting factor, which theoretically should encourage competition in the market, is that dealing with corporate clients is easier in terms of better financial literacy and better understanding of adequate risk coverage. It is also not difficult for foreign corporations to own commercial property in the country and Partners themselves work with both Czech and foreign owners who seek financing in Czech crowns.

12.18 Most firms believe that while price competition was the dominant form of competition in residential mortgage markets, finding the right balance between price and range of products was more important for business mortgages. Again, this is likely down to the complexity of the product and characteristics of customers mentioned above. Several respondents did expect the state of competition between intermediaries to increase in the future.

Regulatory framework

12.19 The basic regulatory framework in both countries is well established but there is no regulation which applies to specialised mortgage lending institutions (only licensing). The regulatory framework, as it stands, is described at Appendix 2. For independent financial advisories, such as Partners, while there are no licensing or reporting requirements for the supply of credit, there are often stringent requirements for selling investment and insurance products.

12.20 The Czech National Bank and the Ministry of Finance are the main bodies in charge of overall regulation, but there is no particular institution which supervises the activities of credit intermediaries. In general, they are supervised by Trade Licensing Authorities, because their activity is considered to be trade in the Czech Republic.[181]

12.21 Our survey of stakeholders in the Czech Republic found a somewhat recurring theme — one of concern at the limited level of regulation of intermediaries. This is of particular concern to the consumer association. According to the Ministry of Finance, there is, nowadays, a call for mortgage credit intermediary certification from inside the market and this is a view shared by Partners who believe that the regulatory environment does not sufficiently protect clients since it is product-based (for example, different disclosure rules apply to mutual funds and unit-linked insurance).

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[181] Ministry of Finance of the Czech Republic

12.22 Self-regulation is, however, present, with bodies such as the Association of Mortgage Brokers and Czech Banking Association adhering to their own Code of Conduct or Code of Ethics. According to Partners, the self-regulation works well in terms of communication with the supervisory authority but is weak in dealing with ethical issues and unfair business practices.

12.23 While there is no legal definition of credit intermediaries in the Czech Republic, in Slovakia, a credit intermediary is defined as an institution or individual that intermediates credit to another party from a credit provider.[182] As with the Czech Republic, credit intermediaries are not regulated or supervised so the regulator does not have precise information about this market. But the new Act on Financial Intermediaries and Financial Consultancy in the financial market is being drafted and should be in place from 2009. Regulation of credit intermediaries (with the introduction of license) and protection of consumers with regards to their dealings with intermediaries are part of the new Act.

Cross-border activity

12.24 Intermediaries can provide an accessible distribution network through which foreign lenders can penetrate other mortgage markets. At present, cross-border residential mortgage lending is virtually non-existent across Europe, except for specialists servicing expatriate communities and property investors.

12.25 According to the Czech Ministry of Finance, there are no additional requirements (aside from passporting) on non-domestic intermediaries entering the market. Further, they did not report any observed regulatory difficulties encountered by domestic lenders in entering a foreign market. But there is no regional regulatory coordination to ease or facilitate cross-border trade conducted through credit intermediaries either.

12.26 Partners are active only in the Czech Republic and, at present, have no plans to expand into another EU country within the next couple of years. In the future, the new EU members Bulgaria and Romania would be the first foreign markets to be considered for expansion into, with the Balkan countries being the second option. For the moment though, the Czech market is considered to be a growing one so there are many options for domestic expansion.

12.27 Partners also mentioned the difficulty in establishing distribution channels, brand and achieving economies of scale as barriers to cross-border supply. Another factor perceived to be a barrier is the fact that the Czech Republic was not part of the euro area.[183] Consumer resistance, lack of price transparency, difficulty in establishing a brand and concerns over the legal redress were also considered significant issues.

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182 National Bank of Slovakia

183 This view was expressed by the Czech consumer association.

12.28 Intermediaries do have some role in cross-border activity, in the form of enabling non-resident customers to take out mortgages through local lenders. For example, Hyposervis, another Czech intermediary, has a dedicated English speaking team specialising in providing mortgages to foreigners. The coordinator of the International Division of Hyposervis has been quoted as saying "mortgages for foreigners are very accessible and with the influx of foreign buyers on the Czech property market, most banks have become very compliable to the needs of non-Czech borrowers."[184] Somewhat encouragingly, many of the stakeholders surveyed said they did expect the amount of cross-border lending to increase over the next five years.

Summary of key findings

12.29 There are over 60 independent financial advisory companies (who, at least in part, act as credit intermediaries) in the Czech Republic. The market penetration of these firms, excluding specialised mortgage intermediaries, in the supply of business mortgages is about two per cent. Their market share in the supply of residential mortgages is higher, at about 12 per cent, while mortgages intermediaries account for an additional 10 per cent share.

12.30 The market for intermediation in business mortgages is less competitive than that for residential mortgages in the Czech Republic. The IFA we approached was practically the only such firm in the market for business mortgages. The factors which could be restricting competition are: greater product complexity leading to extra time and effort required in finding a suitable product and the dealing with the client; greater informational requirements about the corporation; caps on commissions and client retention by banks which discourage entry.

12.31 Almost all credit intermediaries operating in the Czech Republic are affiliated with certain lenders and can only suggest their products.

12.32 There is no direct regulation or entry requirements that apply to credit intermediaries and this is of some concern to the consumer association and market players, especially to those dealing with consumer protection issues.

12.33 An important factor inhibiting the supply of cross-border mortgages in the Czech Republic is the continued growth of the Czech mortgage market, which provides ample opportunities for domestic expansion, at least in the short-term.

12.34 Market conditions in Slovakia are broadly similar, although the mortgage market is roughly half the size. It is likely that mortgage intermediaries have a lower market share, while banks have a higher share. But we should be able to apply much of our finding about the market in the Czech Republic to Slovakia.

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184 http://www.czechpoint101.com/Newsletters/January-February2007_Newsletter.html

Intermediaries in the Italian Business Leasing Market[185]

12.35 Leasing represents a particular form of credit. While in a standard credit agreement the borrower is granted immediate access to a certain amount of cash which is then repaid through time, in a leasing contract the credit provider (lessor) conveys to the borrower (lessee) the right to use a property in return of periodic payments. Therefore a leasing agreement is, by definition, credit secured on a tangible product (e.g. a vehicle, machinery, plant, etc) for which the lessor acquires the right of use.

12.36 A particular aspect of leasing, common to both parties, is the interest in having the leased asset insured. The lessor has an interest as he is the legal owner of the asset, while the lessee's interest derives from his contractual obligation to reimburse the lessor for the damages that the good may suffer. Insurance is a financial product generally integral to the lease, and therefore, the role of insurance intermediaries is often performed in conjunction with the intermediation of the financing. Whilst our focus is upon the intermediary activity relating to financing, the involvement of insurance may mean that the Insurance Mediation Directive also applies to some intermediaries here, at least with regards to this aspect of their business.

12.37 Leasing is a form of financing particularly popular within the B2B sector. In Italy, leasing is a source of funds especially sought after by small and medium enterprises (including artisans and producer households).

The industry size and its structure

12.38 The leasing business in Italy has witnessed steady growth in the last decade and has reached a total business volume of €48 billion in 2006, making Italy the third largest leasing market in Europe at that date (after the UK and Germany). Abstracting from the inevitable negative impact that the credit crunch crisis is having on the market, the long-term outlook is positive an the Italian leasing market is expected to grow further by both enlarging the traditional customer's platform and expanding to new areas such as public administration and private individuals as opposed to businesses.

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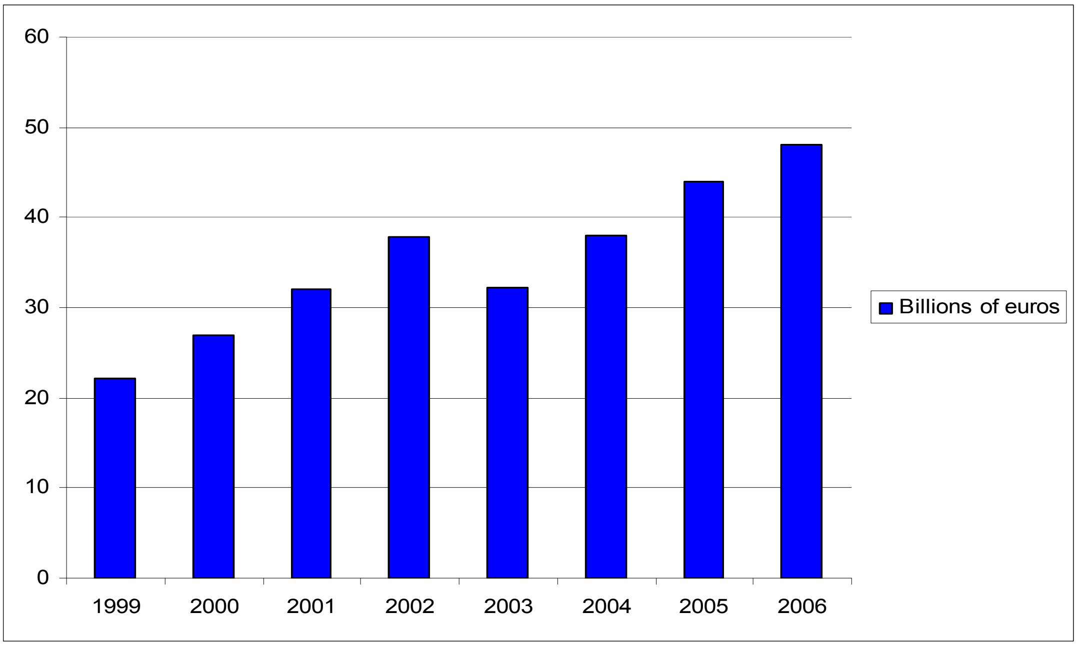
185 This case study was based upon web-based research, interviews with representatives of Assilea (10 April 2008 and subsequently by phone) and access to a survey conducted by Assilea amongst its membership.

Figure 12.1: New leased assets in Italy



Source: Assilea

The industry structure

12.39 The large size of the market is also accompanied by a high level of competition among the key players. In 2006 the top ten firms had almost 70 per cent of the total market, and the Herfindahl-Hirschman Index (HHI) of market concentration scored 726.8 indicating the high competitiveness of the market. It is however important to note that some consolidation of the sector is underway, which may lead to an increase in the market concentration over the next few years.

Table 12.1: Market shares of lessors

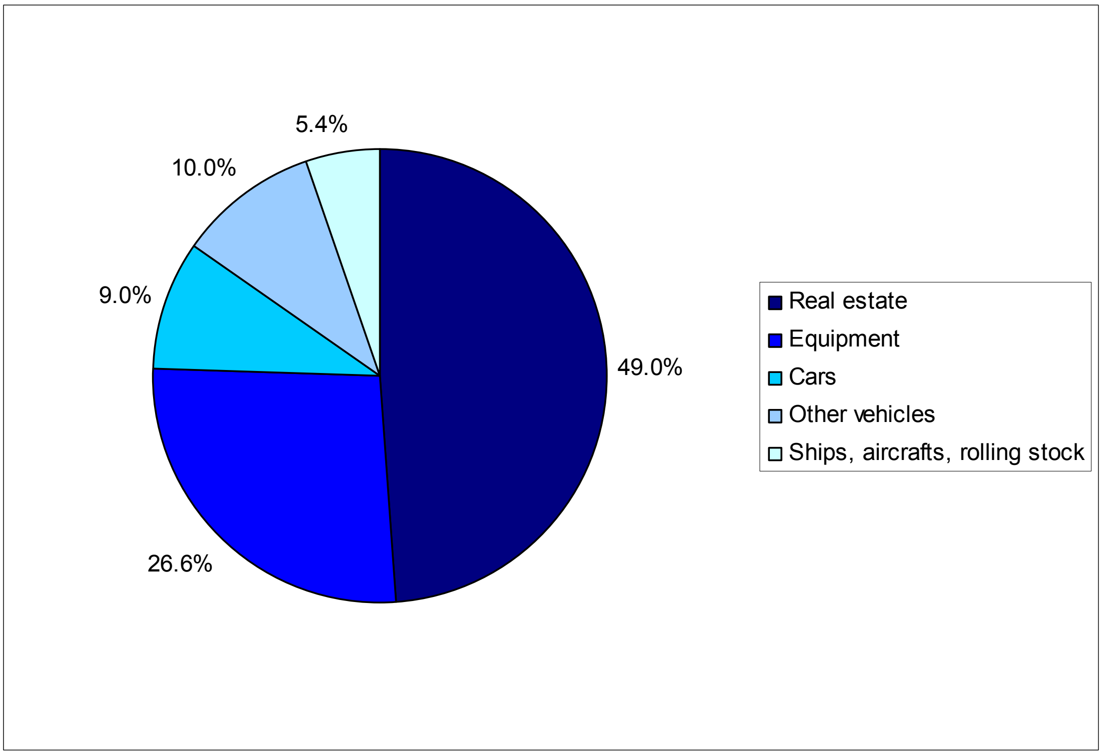
10 Top Leasing Companies in 2006	Market shares
Gruppo Bancario Banca Italease	19.3%
Locat SpA	12.7%
Intesa Leasing SpA	7.3%
Sanpaolo Leasint SpA	6.3%
Banca Agrileasing SpA	5.6%
BNP Paribas Lease Gropp - Locafit SpA	4.7%
Gruppo Capitalia (FINECO Leasing SpA and MCC SpA)	4.6%
Gruppo Salemabipiemme Leasing SpA	3.2%
SBS Leasing SpA	2.9%
Centro Leasing Banca SpA	2.6%
HHI	726.78

Source ASSILEA

The market sectors

12.40 In 2006, the leasing of real estate assets (e.g. laboratories, offices and shops) represented the largest share of the Italian market, followed by equipment leasing and automotive leasing (e.g. transport and commercial vehicles, cars, aircraft, watercraft), of which car leasing accounted for almost a 50 per cent share. In the European market as a whole (based upon EUROFINAS members), car leasing is the most important segment overall, accounting for more than 30 per cent of the total leased assets. The slightly lower figure in Italy is attributed in part to the more business-friendly tax regimes applicable to company cars in the rest of Europe compared to Italy. A sharp contrast is that real estate leasing is much more commonplace in Italy.

Figure 12.2: Leasing by segments

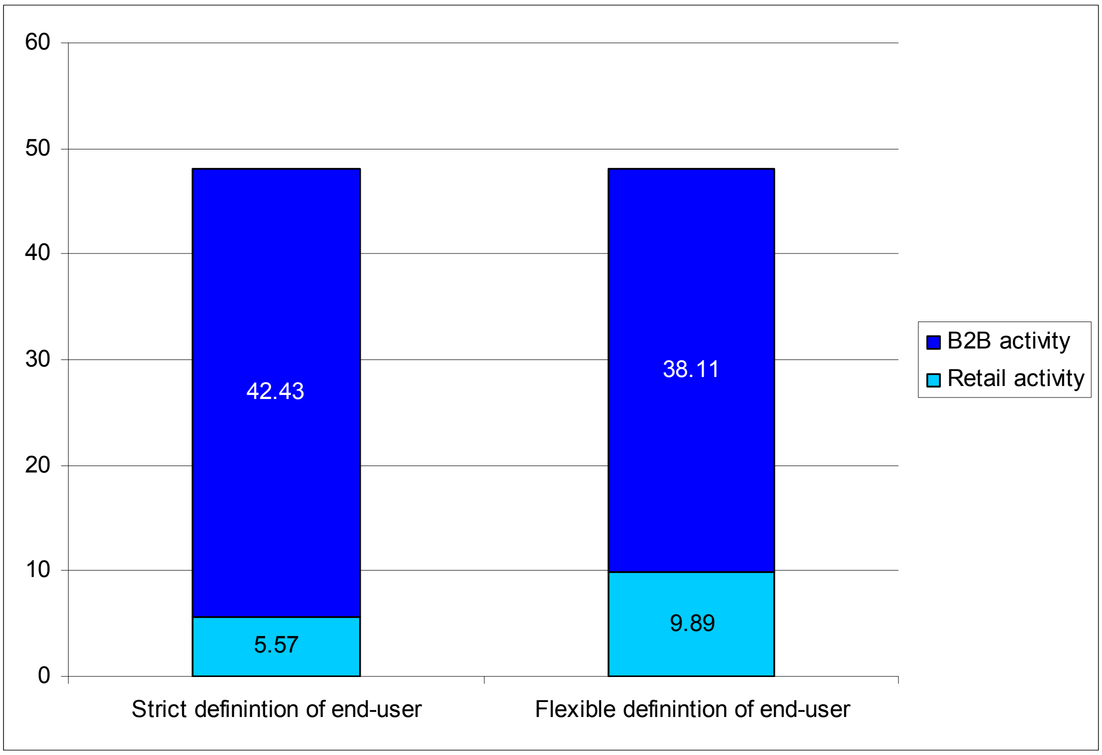


Source: Assilea

The value generated by leasing

12.41 We highlight below the value of leasing in Italy, allocated between business and non-business customers.

Figure 12.3: Value (billions of euros) of leasing



Source: Assilea and Europe Economics calculations

The role of intermediaries

12.42 The main activities carried out by intermediaries involved in the leasing process are:

(a) Establishing contacts with clients

(b) Undertaking activities prior to granting the lease: i.e. examining applications for lease, preparing a contract and undertaking other administrative tasks.

(c) After-sale management activities, i.e. monitoring the lessee's risk and ensuring the recovery of the asset at the end of the lease term.

12.43 Risk management activities are typically undertaken by leasing companies and are not delegated to intermediaries or agents. Such activities include both pre-contractual risk assessments of potential clients and post-contractual risk monitoring. Besides being vertically integrated, risk-management activities also display a certain degree of centralisation as the vast majority of leasing companies can access a centralized automated credit bureau[186] that contains data for more than 1.3 million leases.

12.44 Agents are therefore not entitled to take any decision concerning the approval decision of lease applications, but have an ancillary role in which they collect the relevant documents from potential clients, prepare contracts and undertake other administrative tasks.

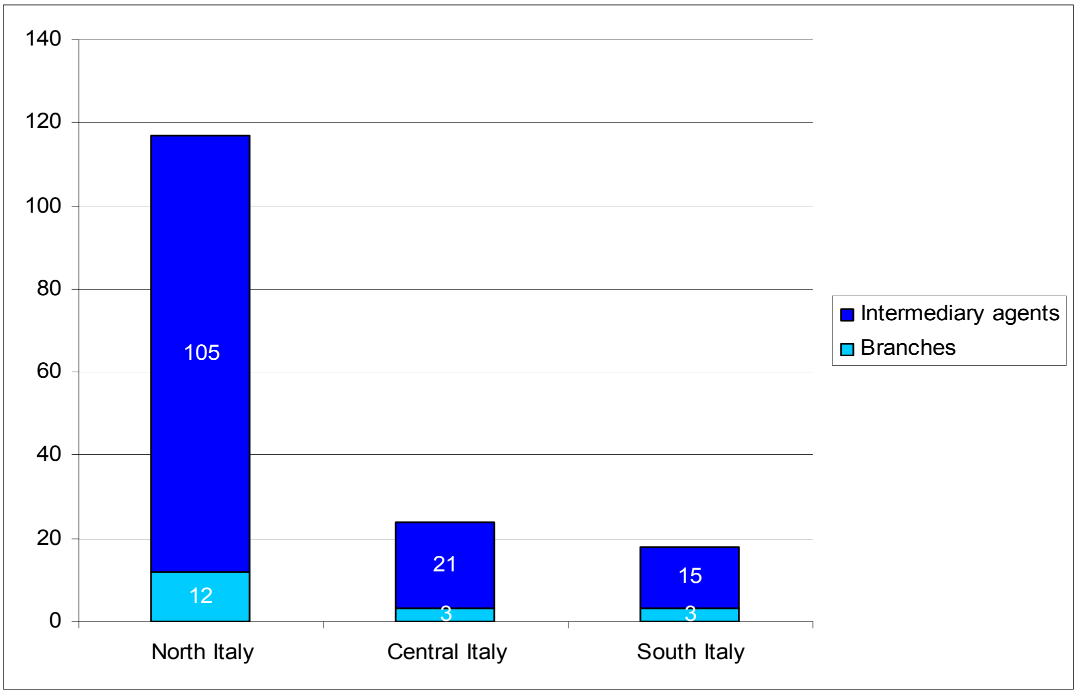
12.45 The most important activity agents undertake is establishing contact with potential clients. Agents represent the most popular distribution channel of leasing companies and allow them to have a strong and visible presence at a local level. For this reason agents contribute significantly to the leasing market by avoiding the need for a lessor to open branches and advertise their products, thus allowing lessors to invest the saved resources elsewhere. This means that for the clients, the intermediaries represent the main way in which introductions to a lessor can be effected.

12.46 It is estimated that up to 80 per cent of the leases are generated through the intermediary channel. A symptomatic example of the importance of agents as a distribution channel is provided by the business model adopted by one of the leading leasing companies in Italy, Locat Leasing. The number of agents used by Locat Leasing is seven times larger than the number of branches it has in Italy. Locat Leasing has a total of 18 branches in Italy: 12 in the North, three in Central Italy and two in the South. In contrast, the number of agents used is 141: 105 in the North, 21 in the Centre, and 15 in the South (see below).

12.47 The more significant penetration in northern Italy is explained by the larger volume of leasing activity present there. In 2006, more than 60 per cent of the total new leases were clustered in northern Italy.

186 The Automated Credit Bureau was established by the Italian Leasing Association established since 1989.

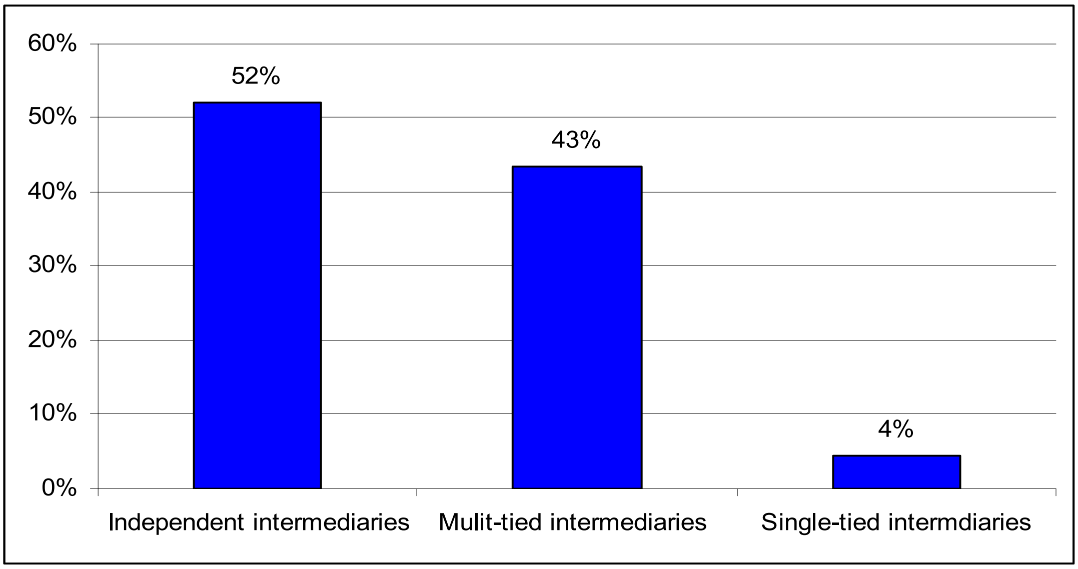
Figure 12.4. Distribution channel of Locat Leasing



Source: Locat leasing

12.48 Nearly all of the intermediaries used by lessors in Italy are not tied to a single lender for the intermediation of such products.

Figure 12.5. The relationship of intermediaries with lessors

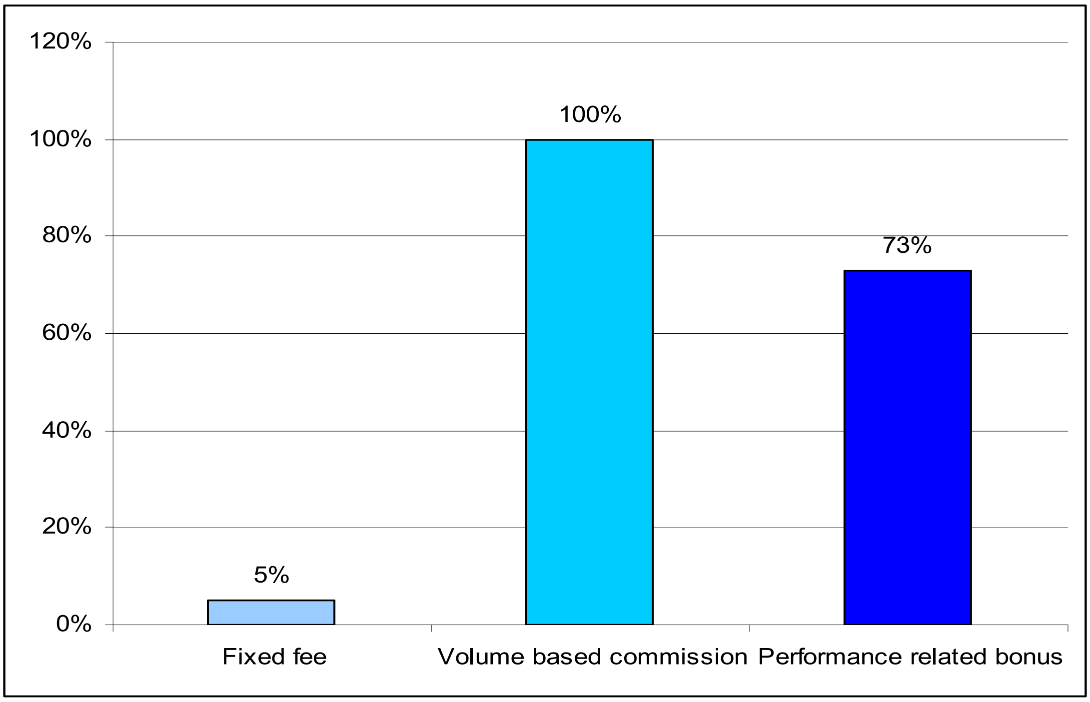


Source: Assilea

12.49 Agents do not typically specialise in the provision of leasing. It is estimated that 81 per cent of agents (both tied and independent) also operate in other product markets. The most common products intermediated by agents are residential mortgages (41 per cent), followed by consumer credit (35 per cent).

12.50 The remuneration schemes adopted in relation to the distribution of leasing products is in line with the primary retailing activity that intermediaries serve. All agents are compensated with volume-based commission and a substantial share of remuneration agreements also includes a bonus component linked to the performance of the agent, e.g. a pre-determined target sale volume being reached. Besides creating the right incentives for agents to perform as efficient retailers, bonus structured schemes facilitate the development of long lasting relationships, by giving lessors the possibility to rely on a stable distribution channel.

Figure 12.6. Agents' remuneration schemes



Source: Assilea

Possible sources of detriment

12.51 When looking for possible causes of detriment arising from the agents' activity, we consider potential damages suffered by both consumers and lessors

12.52 We have identified two potential causes of detriment for lessors:

(a) Inefficient distribution

(b) Market foreclosure

12.53 The first and most obvious possible cause of lessors' detriment is due to agents promoting and distributing products inefficiently. We have no evidence to believe that this is the case. First, the fact that a heavy usage of agents is common practice in the sector suggests that lessors are at least satisfied with the way agents operate and see any efficiency loss as being offset by the avoided cost of setting up a network of branches.

12.54 Moreover, lessors have at their disposal a set of incentive-compatible tools (commission schemes for remuneration, performance related bonuses, and tied relationships) that enables them to provide agents with the right economic incentives to advertise, promote and distribute leasing products efficiently.

12.55 The second detriment may arise as a consequence of key market players using exclusive agreements with agents as a way to foreclose the distribution channels to smaller firms. Our work suggests that this possibility should be negligible given the predominance of multi-tie agreements that enhance the possibility of market entry and competition among lessors. Moreover, the presence of serious barriers to entry is not confirmed by the market structures observed which, in contrast, suggests the existence of intensive and healthy competition.

12.56 Finally, it is important to stress that a lack of detriment on the supply side creates benefits on the demand side. If agents act as an efficient distribution channel consumers can benefit from lower prices and, possibly, have quicker access to relevant product information.

For consumers

12.57 On the demand side we have investigated three possible causes of detriment:

(a) High search costs

(b) Excessive charging by intermediaries

(c) Provision of inaccurate or misleading information

12.58 The possibility of consumers suffering high search costs may arise when a large number of agents are tied to a single lessor and are therefore unable to offer clients a sufficient range of products. As pointed out in the theoretical framework, this cause of detriment is relevant only if agents are highly dispersed, hence increasing consumers' cost of searching among intermediaries. We have found that the presence of intermediary agents on the ground is very intense, and therefore, there are no *prima facie* grounds to believe that high search costs are a serious concern.

12.59 Excessive charging for consumers is possible only if two conditions are simultaneously met: (i) there is little competition among intermediary agents, and (ii) little competition among lessors. The extent to which agents compete does not only depend on their number (which is already high) but also on their degree of differentiation. Given the agents' activity is primarily intended to facilitate the conclusion of leasing agreements, the intermediary services can be regarded as relatively homogenous, hence leaving little room for exploiting market power. Moreover, the high upstream competition among lessors, in turns, should translate into lower charges.

12.60 The last possibility for consumer detriment is represented by the agents providing customers with inaccurate or misleading information. First, our survey indicates that, in Italy, the characteristics of leasing products are well understood by the majority of consumers, hence giving little weight to the likelihood of purchases based on little or wrong information. Moreover the regulatory framework in Italy prescribes that lessors are ultimately responsible for the information provided by agents so, in the (we believe unlikely) instance of detriment, this should not be related to the agents' activity.

13 INTERMEDIARIES AND CROSS-BORDER TRADE

Introduction

13.1 This section is organised as follows:

- First, we discuss the integration of the internal market in credit products, define what we mean by cross-border trade, and present a high-level approach to modelling it.
- We then proceed to discuss the current role of credit intermediaries in facilitating what cross-border activity that there is and identify the potential social benefit that we estimate could accrue in the event of increased cross-border activity.

Integration of the Internal Market

13.2 In a fully integrated credit market, consumers should benefit from increased competition between lenders, which eventually translates into more product variety and lower prices. Such a market is likely to be characterised by cross-border trade, that is, a market where:

(a) Lenders sell domestic credit products to non-domestic consumers.

(b) Consumers purchase non-domestic products.

13.3 However, the proportion of customers that purchase cross-border financial services is at the moment, very limited. A detailed picture of the extent of cross-border activity is available for the mortgage market. Surveys indicate that cross-border mortgage purchases are next to none in most European countries. Even in countries where they are more prevalent, such as Netherlands and Belgium, only about one per cent of customers engage in cross-border mortgage purchases.[187]

13.4 The situation is somewhat different for the supply side of the market. Although most credit market transactions today are conducted locally, these products can be supplied by either a domestic or a non-domestic lender through the presence of a local branch.

13.5 The use of alternative distribution channels (such as the internet) to directly sell across borders or credit intermediaries (to sell indirectly) is also on the rise, with one study[188] reporting 11 per cent of mortgage lenders saying they make a ‘substantial’ number of loans in countries where they do not have either a branch (i.e. a local physical presence but without a local legal entity) or a subsidiary.

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[187] Public opinion in Europe on financial services; Special Eurobarometer 254, 2005

[188] *The Costs and Benefits of Integration of EU Mortgage Markets*, London Economics, August 2005, according to which “11% of mortgage lenders reported making a 'substantial' number of loans to borrowers in countries where they had neither a branch nor a subsidiary, with another 32% doing so rarely”.

13.6 These results suggest that the integration process is likely to be largely supply driven. Credit intermediaries have a role to play in this process. The obstacles to integration include the following:

Supply-side factors

(a) Legal differences (e.g. different regulatory frameworks);

(b) Difficulty in establishing distribution channel, say due to fragmented infrastructures;

(c) Difficulty for the lender in achieving economies of scale;

(d) Difficulty in obtaining regulatory approval/licence from regulatory authorities and the on-going regulatory/ administrative burden; and

(e) Difficulty for lender in establishing brand.

Demand-side factors

(a) Concerns over legal redress when dealing across borders;

(b) Low consumer confidence (e.g. due to cultural and linguistic differences) resulting in limited willingness to seek out opportunities across borders;

(c) Consumer resistance (e.g. due to product differences) and restricted borrower mobility (e.g. contract restrictions, high search costs); and

(d) Lack of price transparency (e.g. due to currency differences).[189]

13.7 Of course, some of the above obstacles may be more perceptual than actual. This does not in itself make them less important. An objective of the survey was to gather the data to analyse the relative importance of these, and other, factors. In addition, we have examined the scope for credit intermediaries to solve these problems, and to the extent that intermediaries are not currently providing solutions, attempt to identify why not.

Definition and Modelling of Cross-border Trade

Definition

13.8 By cross-border trade we mean a situation where a lender sells credit services in another Member State through the use of an intermediary. (We therefore exclude situations where credit in a non-domestic market is provided directly by subsidiaries or branches).

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[189] See also, for instance, the White Paper on the Integration of EU Mortgage Credit Markets.

Modelling

13.9 In order to model cross-border trade we use the competitive model of differentiated intermediaries discussed in Section 3 and Appendix 1. In terms of this model, an increase of cross-border trade corresponds to an increase in the number of intermediaries operating in the market and therefore an increase of the range of credit products being offered.

13.10 The key question is whether higher levels of cross-border trade lead to more business (and higher intermediaries' profits) or more competition (and higher consumer surplus).

Costs and Benefits

Benefits

13.11 An increase in the number of intermediaries implies a **higher variety** of credit products available in a certain domestic market. A higher product variety could impact consumers in two different ways:

(a) Some **consumers will switch to new products** as a result of the wider range of products now available due to increase of cross border trade.

In this situation the effect of higher levels of cross-border trade is an increase in product competition between intermediaries, which leads to:

- Lower intermediary profits
- Higher consumer surplus because the products available do better in meeting consumer needs.

(b) Some **consumers that were previously excluded from the credit market** (e.g. because of the existence of credit rationing) **will enter the market** because they are attracted by the new products now available.

In that case an increase in cross-border trade increases the size of the credit market and therefore leads to:

- Higher intermediaries' profits because of the increase in demand
- Higher consumer surplus due to the new segment of borrowers entering the market.

Costs

13.12 Since the credit market in each Member State is characterized by particular and unique characteristics (e.g. the level of per capita debt in the UK or Germany is substantially higher than that in any of the new Member States), as a result of cross-border trade consumers could witness the rise in their home market of new products highly differentiated from the domestic ones. This might ultimately lead to an increase in the degree of differentiation and thence to:

- Higher intermediary profits because of the higher market power they enjoy

- Lower consumer surplus

Dynamic assessment of the benefits and costs

13.13 A dynamic assessment of the costs and benefits is possible by distinguishing between two time horizons: short run and long run.

13.14 The benefits are likely to be present both in the short run and the long run period. The costs, in contrast, while being potentially significant in the short run are likely to disappear in the long run (since the very existence of cross-border trade implies the lack of national barriers to new entrants).

The Scale of Cross-border Trade

13.15 By cross-border trade, we refer to the situation where the two ultimate parties to a credit transaction (i.e. the borrower and the lender) are located in different Member States. The level of such trade at a consumer level is rather limited. For instance, for mortgages, between zero and one per cent of the population taking out residential mortgages have shopped away from their own Member State. This proportion is only at one per cent in Belgium, Netherlands and Luxembourg, where the level of cross-border trade in mortgages is the highest in Europe. In the case of credit cards, the proportion of the population that has acquired a credit-card from another Member State, has a range of between zero and eight per cent of the population, with Belgium and Luxembourg again at the top end of the scale, now joined by Latvia and Lithuania.[190] Indeed, our survey indicated that stakeholders believed that cross-border activity had been at best stable (mortgages), but had been of decreasing importance relative to business overall over the past five years. In the business finance sector, it is likely that the percentages are rather higher.

13.16 Credit intermediaries' role in facilitating cross-border trade is at present most noticeable in enabling expatriates and those acquiring second homes.[191] The customer benefits from the intermediary's knowledge of the language and legal idiosyncrasies of the foreign market, and the intermediary is able to provide the lender with valuable advice regarding credit assessment of the foreign client. However, there is still much evidence to suggest

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190 Special Eurobarometer, 230, 2005

191 For example, IMS is an intermediary based in Spain, but marketed directly at British citizens wishing to buy second homes in Spain.

that consumers currently do not have a large appetite to engage in cross-border mortgage purchase.[192]

13.17 In terms of the intermediaries, it would appear that the facilitation of such cross-border activity as there is calls for specialists. This is simply because the linguistic skills and depth of knowledge of more than one market (in terms of the regulatory framework and market participants) are not cheaply acquired. This is evident from the experience of IMS and Conti in the case study accompanying this chapter.

13.18 Our survey indicated that stakeholders believed that intermediaries would increase in importance as a distribution channel for such cross-border activity over the next five years, with the total level of cross-border trade also expected to weakly increase. The exception to this anticipated trend was in the area of consumer credit intermediation. Here, respondents from a number of Member States (including Belgium, Lithuania and Slovenia) expected sharp declines in cross-border activity generally and the importance of intermediaries in particular. In Lithuania and Slovenia, at least, this may be due to greater availability of consumer credit domestically. However, as we have indicated previously — given the timing of the data gathering — the immediate applicability of such beliefs may be limited.

Potential Economic Costs of Regulatory Divergence

13.19 The economic costs of the *differences* in regulatory regimes between Member States arise only in relation to cross-border trade as we have defined it. To put it simply, if lenders and borrowers were always located within the same country and lenders were always authorised and regulated by the national competent authority, differences in regulatory regimes would have no economic impact. This is not to say that the regulatory regime itself would not affect economic performance and the choice of regime could have a significant impact on the economy. However, this section is concerned with the economic impact of differences between regulatory regimes rather than the impact of the regime itself.

13.20 In the short-run, cross-border trade could lead to greater competition, increased product variety and lower prices for consumers. In the longer term, however, the impact of cross-border trade is less clear. On the one hand, product variety could fall as new Europe-wide products are developed (although there may still be greater variety than in the absence of cross-border trade) and mergers could occur amongst both lenders and intermediaries as firms seek to increase coverage and reduce unit costs so as to remain competitive. Each of these potential economic impacts of cross-border trade should be borne in mind throughout the following discussion of the relationship between regulatory divergence and cross-border trade.

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192 Eurobarameter; AMI; MOW

13.21 Differences between regulatory regimes can affect both the demand and supply sides of cross-border trade. On the demand side such differences restrict cross-border demand as consumers are not certain of their rights in other countries. Whilst this would be a concern for consumers if borrowing directly from a lender located in another Member State it could be amplified if obtaining credit through a non-domestic credit intermediary. This is because the consumer is likely to be uncertain of the responsibilities of two non-domestic organisations rather than one and because awareness of responsibilities of lenders is likely to be greater than that of intermediaries even within his home country.

13.22 Despite the proposed adverse demand-side impact of regulatory divergence, a Eurobarometer survey found that just 11 per cent of respondents believed legal protection would be poorer abroad.[193] Whilst this is not an insignificant proportion, it can be observed that regulatory divergence is only the sixth most important demand side barrier to cross-border trade. Indeed, 23 per cent of respondents believed a lack of information restricts cross-border activity in financial services and 20 per cent considered language difficulties to be a problem.

13.23 On the supply side, differences in regulatory regimes have a number of impacts, each of which act to restrict the likelihood of cross-border credit activity developing. If a lender wishes to begin operating in another country or an intermediary wishes to begin to compare both domestic and non-domestic products, it must invest time and resources to understand the local legislative and regulatory environment. This is a disincentive to cross-border trade as additional costs are created relative to purely domestic trade, which would be avoided if regulatory regimes were harmonised across the EU; the additional burden is clearly significant, as showcased by the current low level of cross-border trade — if the return was high enough, then lenders and intermediaries would engage in cross-border activity, despite this additional cost.

13.24 Differences in regulation may also necessitate the development of nation-specific products, dependent upon the type of differences between Member States. This further increases the costs to the firm of operating cross-border and is, in some sense, an unnecessary cost that would be avoided in the absence of regulatory regime divergence. In addition to this direct cost of developing nation-specific products, further costs arise because the divergence partially prevents the development of ‘standard’ products (as products from one Member State cannot be offered in another Member State).

193 Summary, Public Opinion in Europe on Financial Services, Special Eurobarometer 230, August 2005, p.11

Preferred Channels of Cross-border Activity

Supply-side

13.25 Lenders in the survey were asked to consider the relative attractiveness of the following means of conducting business away from their home market.

(a) Remote channel from domestic business (telephone, internet etc);

(b) Greenfield development in a new market (i.e. setting up an operation from scratch);

(c) Joint venture with an established non-domestic lender;

(d) Acquisition of a non-domestic lender;

(e) Using a domestic credit intermediary as a distribution channel; and

(f) Using a non-domestic credit intermediary as a distribution channel;

13.26 The table below shows the percentage of all of the lenders expressing an opinion that highlighted each approach to conducting cross-border business as the most important.

Table 13.1: The relative attractiveness of approaches to cross-border activity

Channel	Per cent
Remote channel from domestic business (telephone, internet etc)	31
Greenfield development in a new market (i.e. setting up an operation from scratch)	9
Joint venture with an established non-domestic lender	16
Acquisition of a non-domestic lender	19
Using a domestic credit intermediary as a distribution channel	16
Using a non-domestic credit intermediary as a distribution channel	9

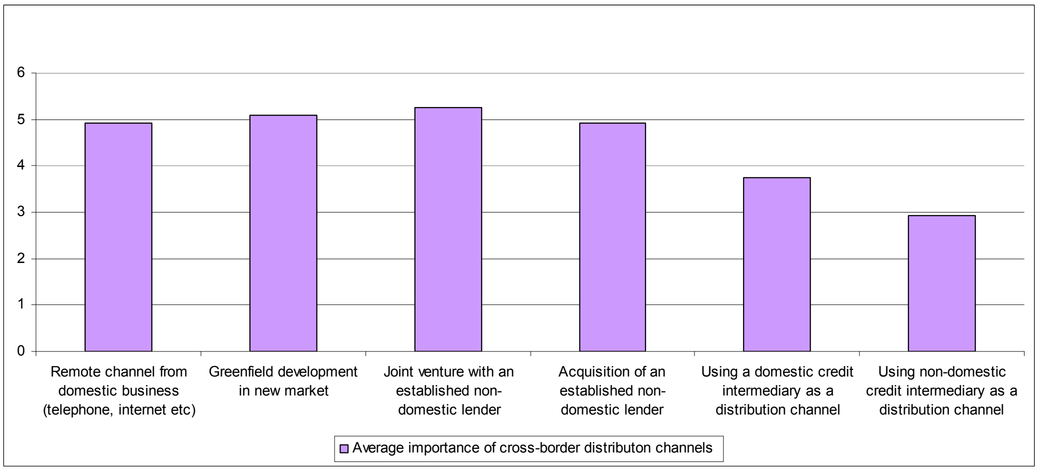
Source: EE analysis of survey responses

13.27 This indicates that direct involvement is preferred to indirect involvement, with a clear preference for remote channels (i.e. telephone and internet banking).

13.28 That said, there is some support for the use of credit intermediaries as a distribution channel. It is striking that, to the extent that lenders would rely upon credit intermediaries, there is a strong preference for domestic against non-domestic intermediaries. This is notwithstanding the fact that when a lender is considering the extension of lending outside its domestic arena, the non-domestic credit intermediaries would (presumably) offer better distribution. This is, perhaps, suggestive of the cultural issues around language and trust that are also played out by consumers.

13.29 These points are reinforced by the figure below that illustrates the *average* importance score of the respondents to our survey (7 stands for the highest importance, while 1 for the lowest importance — in other words, to reiterate, these options were considered on a complementary rather than an exclusive basis).

Figure 13.1: The relative importance of approaches to cross-border activity



Source: Surveys[194]

13.30 The preferred channels involve direct involvement in the non-domestic Member State. These results match those of previous studies in this area.

13.31 The views expressed by participants in our survey suggest that the importance of conducting remote business from the home Member State (via say the telephone or over the internet) is likely to grow in the future; driven by the lower cost of doing business via these platforms (without necessarily ceding direct control).

13.32 It is clear from Figure 13.1, and the data underlying it, that the lenders surveyed are typically often taking a multi-channel route, with the results suggesting that credit intermediaries have a role to play for many lenders in such a situation, albeit often a supplemental one to other channels (i.e. remote channel, Greenfield development, and so on).

194 These results are based on responses from 25 lenders from a range of Member States (France, Belgium, UK, Sweden, Germany, Italy, Czech Republic, Portugal, Spain and Hungary).

Barriers to Cross-border Trade

Supply side obstacles

13.33 In this section we first provide a discussion based on the responses we obtained from our survey. The following analysis explores what are considered to be the most important barriers to cross-border activity and how perceptions differ between lenders and intermediaries.

13.34 Based on our research,[195] we have considered the following types of barriers:

(a) **Legal constraints** such as the difficulty in obtaining regulatory approval (in the absence of pass-porting), the ongoing regulatory and administrative burden, tax-related issues and concerns over legal redress.

(b) **Limited access to relevant market information**, particularly with respect to access to the credit information registers of another Member State in order to adequately assess borrowers' creditworthiness.

(c) A **lack of consumer confidence**, due to linguistic factors, cultural preferences and the desire for geographical proximity to the retail market in question.

(d) Lenders' perceived difficulties in achieving economies of scale and consumers' concerns about a currency translation, i.e. a mix of **economic impediments** to the conduct of such business.

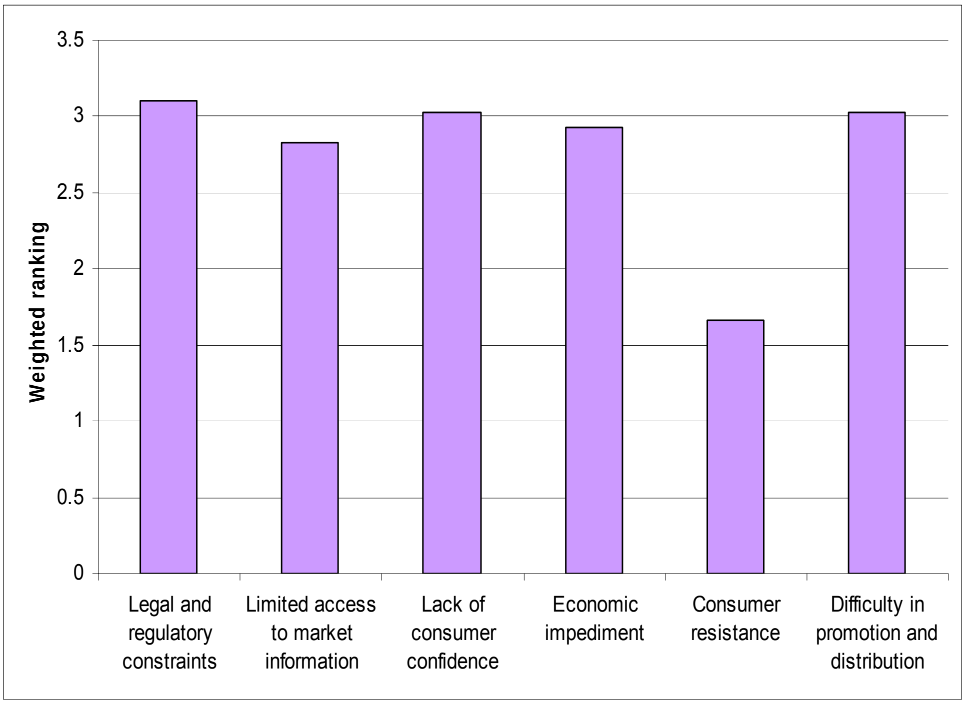
(e) **Consumer resistance,** due to product differences. For example, consumers may develop an inherent perception as to what a certain product should entail having only ever been exposed to the product within their domestic framework.

(f) **Difficulty in promoting and distributing products**, for instance due to a lack of a branch network.

[195] See for example, Deutsche Bank, April 7, 2006: EU retail banking – drivers for the emergence of cross-border business

13.35 The relative importance of these barriers is set out below.

Figure 13.2: Relative importance of barriers to cross-border trade



Source: Surveys (1 = insignificant, 5 = very significant)

Demand-side

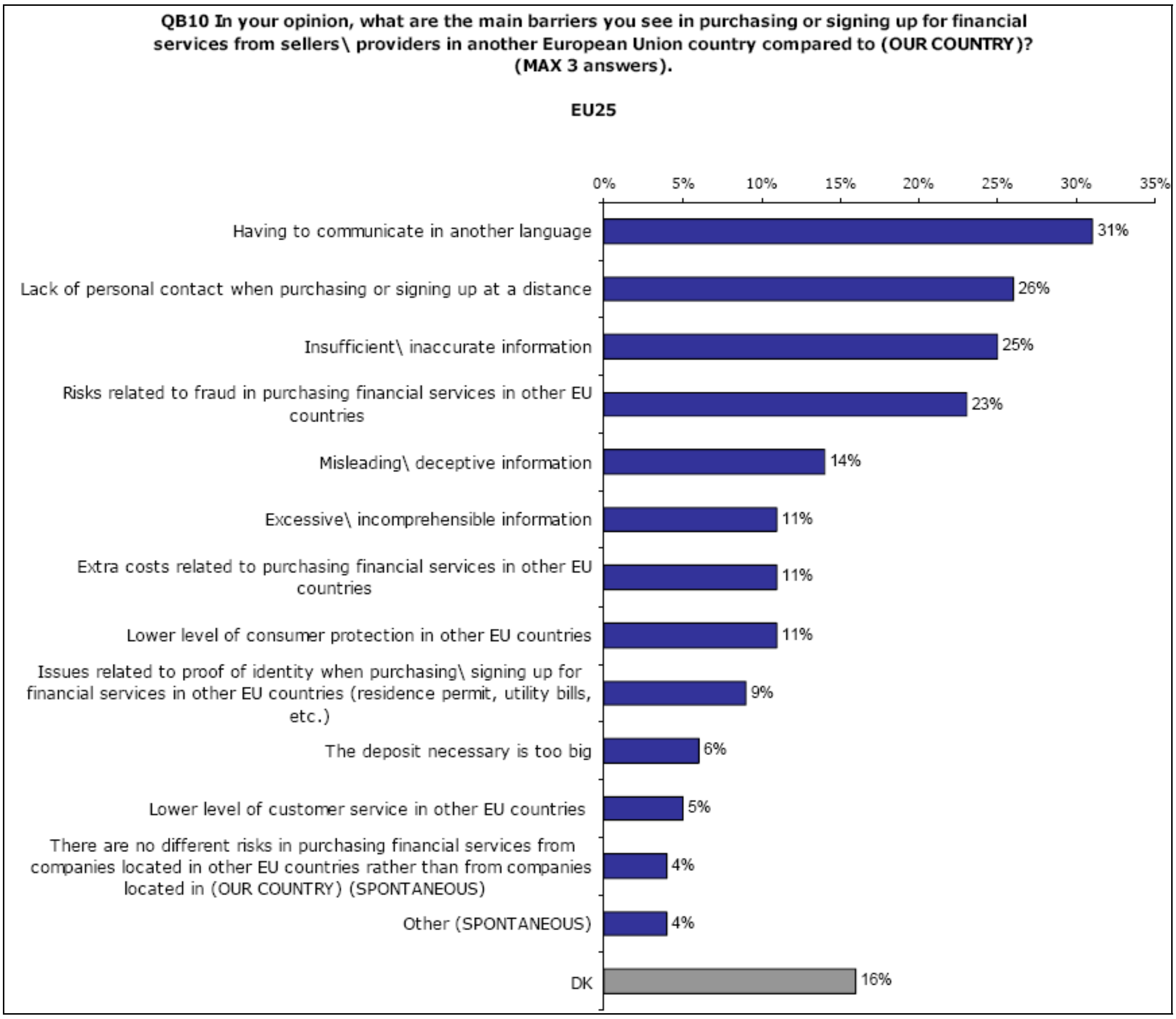
13.36 The most comprehensive information on consumers' cross-border engagement is from the Eurobarometer survey conducted in 2006.[196] In this survey, 94 per cent of responding EU citizens had not considered obtaining a mortgage or an insurance policy in another Member State (of course, some of these may not have considered such purchases at home either).

13.37 The survey also identified the main obstacles preventing consumers from purchasing cross-border to be: (a) language barriers, (b) lack of information about opportunities and (c) concerns about administrative formalities. Differences in the responses among countries were negligible. The only substantial difference was observable along a socio-demographic dimension as the willingness to purchase financial products abroad was higher for more highly educated and informed consumers.

196 http://ec.europa.eu/consumers/topics/eurobarometer_09-2006_en.pdf

13.38 Interestingly, the perceived risk of fraud also scored very highly. This is despite the fact that the same survey indicates that 54 percent of Europeans felt that they were adequately protected by the existing national consumer protections measures. The perceived risk of fraud deriving from cross-border purchase could therefore be interpreted not as a signal of an actual lack of consumer protection regulation but rather as a lack of knowledge about the extent of consumer protection available in other Member States.

Figure 13.3. Demand-side barriers to the cross-border purchase of financial services



Source: Eurobarometer 2006

The role of credit intermediaries

13.39 In this section we assess the potential role intermediaries can play in order to enhance the level of cross-border trade. Our definition of cross-border trade here only considers intermediation in the strict sense, i.e. credit intermediaries that facilitate an individual or firm obtaining access to credit from a third-party credit provider, where at least one of the parties is located in a different Member State from the others. In other words, we exclude the situation in which all the parties involved are in the same Member State, but for example, the lender is the *subsidiary* of a bank from another Member State, i.e. we do not deem, for example, a UK intermediary selling Abbey National mortgages to be cross-border trade for this purpose because Abbey National is owned by Santander which is a Spanish bank. The main roles of the intermediary would be as follows (this analysis is supported by the case study in the following section):

(a) Overcoming a lack of consumer confidence by assisting with cultural and linguistic factors, and explaining the key features of unfamiliar credit products.

(b) Providing credit providers with a distribution channel.

13.40 However, in terms of the other barriers that are in place, credit intermediaries may have only limited scope to make a substantial difference.

Access to relevant market information

13.41 A necessary condition for any lender wishing to operate in a foreign market is to have access to relevant market information, such as access to public and private credit risk databases. A key area looked at in order to achieve the objectives of the Integration of European Mortgage Credit Markets (White Paper) is access to credit information registers in order to foster responsible borrowing and lending.[197]

> "More responsibility should be placed on lenders to access credit information registers of all the other Member States in order to adequately assess borrowers' creditworthiness."

13.42 In some Member States the access to credit registers and other data sources is possible only to *lenders* that have a branch or even a subsidiary in that country. For instance, Greece has private registers which require past membership to get access to a credit history (please see also 4.144 to 4.145).

13.43 Another example, from within the leasing sector in Italy, is where the national leasing association established an automated credit bureau (in 1989) to which only the association's members have access. Moreover, for products like mortgages, assessing the quality of the collateral also represents a key function. Despite the fact that the methods used by property appraisers are fairly similar across the EU, databases of property valuations are not always publicly available and a physical visit is therefore required. Overall, inadeaquate access to relevant information (of all types) was identified (on average) as an issue of moderate significance (please see Figure 13.2 above).

13.44 In relation to this information problem, the role credit intermediaries can play is perhaps rather limited. The main reasons are that some information is available only to lenders (see the Greek example in the previous paragraph) and (as we have highlighted in the sub-sections reviewing intermediary business models) lenders tend to keep the management of the lending process wholly in-house. Therefore, even in the case in which non-domestic credit intermediaries were better positioned to obtain relevant credit history information, our work indicates that it is unlikely that lenders would decide to delegate credit-checking activities to those intermediaries (even if permitted to under local legislation).

Increasing consumer confidence

13.45 As highlighted previously in this chapter, "natural" barriers to the integration of credit markets, such as language and cultural differences may reduce consumers' confidence in credit products from another country. A specialist credit intermediary can help to alleviate the concerns of this nature that consumers may have. Indeed, this type of service is provided by the specialist intermediaries discussed in the following section.

13.46 Consumer confidence issues were seen as being of moderate significance (please see Figure 13.2 above).

Economic impediments

13.47 Following the European single passport, lenders operating in a foreign Member State must comply with rules in the host country, but are then supervised by the home country authority. If, for example, the home country has a more stringent capital requirement compared to the host country, the lender wishing to operate cross-border must take into account this difference; this may put the lender at a competitive disadvantage compared to lenders which only operate in the host country.

13.48 Our analysis of intermediaries' business models has highlighted that whilst credit intermediaries may act as expert advisors, remuneration structures are frequently geared to the effective distribution of the lenders' products. However, this problem of misaligned incentives is not necessarily made worse because of the intermediation being cross-border.

Assessment of Impact of Increased Cross-border Intermediation Activity

13.49 We identified at 13.8 to 13.14 some of the potential short-run and long-run impacts of increased cross-border activity. However, the fact that the European credit market remains highly fragmented implies that a higher level of cross-border activity would (for some products and specific geographical areas) result in higher profits margins for credit intermediaries in the short run; in the long run, one would expect entry into the market, increasing the intensity of competition, and therefore driving prices and profits down — this would ultimately translate into higher consumer welfare.

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[197] http://europa.eu/scadplus/leg/en/lvb/l24487.htm

The impact upon credit intermediaries

13.50 As shown in the case studies relating to cross-border trade (see Section 14), the credit intermediaries that do engage in cross-border activities appear to be somewhat specialised. Therefore, increased cross-border activity may, in the short-run, increase profits for those intermediaries that are already equipped with the necessary tools to carry out cross-border activities (language skills, knowledge of the local market, etc). However, as explained above, if cross-border trade persists in delivering better than normal profits, other intermediaries would also be incentivised to acquire the necessary skills and start providing competing cross-border services (provided, of course, that the additional cost of acquiring the necessary skills does not outweigh the expected benefit).

The impact upon consumer detriment

13.51 It is noted from Figure 13.3 that the risk of fraud was cited by 23 per cent of those surveyed as a factor in deterring them from engaging in cross-border search for financial products. Fourteen per cent cited misleading or incomplete information as a barrier. Indeed, only four per cent spontaneously expressed the view that there was no difference in risk between purchase at home and purchase across national borders. These concepts — and others, such as language barriers — are implicit in the categories of consumer resistance and low consumer confidence described above.

13.52 Of course, this does not mean that these concerns relate wholly or even mostly to the role of credit intermediaries. Indeed, credit intermediaries could have a part to play in helping to overcome these issues relating to low consumer confidence. On the other hand, increased consumer reliance upon credit intermediaries may result in its own difficulties — for instance, in our cross-border case study presented in the next section, IMS identified its concerns over rogue credit (specifically mortgage) intermediaries operating in Spain.

13.53 We have identified previously (e.g. in Section 4) some of the ways in which credit intermediation may give rise to consumer detriment. All else being equal, there is no reason to assume that these concerns would be reduced in a cross-border situation. Indeed, the opposite appears at least as plausible (e.g. with respect to fraudulent activity, as is illustrated again by the IMS case). In this case, it may be that increasing consumer confidence in credit intermediaries is a pre-condition of an increased level of cross-border trade in at least some of the credit products analysed as part of this study.

13.54 In the event of increased cross-border activity, driven at least in part by increased usage of credit intermediaries, one would expect these issues to diminish as reputation effects drive out firms engaging in malpractice (it is possible that this effect would take place over a shorter time-path in the case of cross-border intermediation *vis-à-vis* single-country intermediation, as firms are exposed to larger markets).

Long run economic impact

13.55 Looking at the long run, we would expect the impact of increased cross-border activity involving intermediaries to have a positive competitive effect upon credit intermediaries.

13.56 A simplistic model of the first round effect of increased cross-border activity is that there would be some degree of convergence between commission rates accruing to intermediaries. We have made two calculations to this effect:

(a) In the first example, intermediary remuneration would reduce to the average levels experienced (as expressed as the scale of remuneration as a percentage of the level of credit intermediated). This reduction would apply only to those instances where current levels are above average. The maximum benefit achieved due to this would be €0.4bn on an aggregate basis (i.e. this is the first round economic effect due to intermediary remuneration that is currently above the average level reducing to that average level. The volumes of credit intermediated are unchanged from the reference level).

(b) In the second, more optimistic case, intermediary remuneration converges to the lowest levels currently experienced (again, as expressed as the scale of remuneration as a percentage of the level of credit intermediated). This would then increase the maximum welfare gain across the EU27 to €1.6bn, on an aggregate basis.

13.57 If an elasticity of unity is assumed then the second round effects would be equivalent.

13.58 However, the economic impacts may be much more limited than this. As we have discussed above, to the extent that the credit intermediaries involved in cross-border activity are specialised, then the impact of increased competition may be restricted to their segment of the market. In this case, the spill-over effect would be heavily circumscribed. In other words, the potential economic impact provided here should be seen as an upper bound, or else it should be at least recognised that it is implicit in this that there is some normalisation of this activity.

14 CASE STUDY RELATING TO CROSS-BORDER TRADE

14.1 This case study explores the reasons for the presence of cross-border intermediaries, and gauges the extent to which they facilitate cross-border trade. We examine any barriers to cross-border trade, and possible areas of consumer detriment.

14.2 Intermediaries can either match domestic lenders with non-resident clients, or match foreign lenders with domestic clients. Most of the information we have received for our study in general has been from the point of view of foreign lenders using intermediaries to gain market access, and so this case study focuses on the former scenario.

IMS business model

14.3 International Mortgage Solutions (IMS)[198] is a UK-registered company with offices in the UK and Spain. They provide advice mainly to people wishing to buy in Spain, but also deal with the Canary Islands, Cape Verde and Morocco.

14.4 The main client base of IMS consists of UK citizens wishing to buy residential property in countries where they are not resident. IMS also offers its services to non-residents from other countries, as well as Spanish nationals.

14.5 The complex nature of buying a property in Spain and the financial risks[199] involved requires detailed knowledge of the Spanish market. There is thus high demand from non-residents for mortgage advisors who can provide this service. IMS feels that a successful aspect of their business model is their replication, wherever possible, of the UK FSA rules that currently apply in the UK. British clients therefore feel comfortable about taking out a mortgage in a foreign country, knowing the process is going to be similar to that in the UK.

14.6 IMS also provides a commercial packaging and processing service to other UK intermediaries, who often do not deal with Spanish bank mortgages and need occasional advice when faced with a client wishing to buy abroad. Around 70 per cent of IMS's business is made up in this way. It could be that if the demand for cross-border property purchasing increases, the number of specialised cross-border intermediaries will not significantly increase, but their business focus may expand more towards providing domestic advice.

14.7 IMS charges a flat fee of £650 (i.e. about €800) to their customers. This is a life-time fee and is not renewed if the customer wishes to arrange another mortgage. The fee is taken at completion only — due to the increasingly complex nature of matching lenders with customers IMS's ability to guarantee a loan is diminished. They provide the client with a written quote before any fee is paid, which includes risk warnings and information about

198 Interview with an IMS representative conducted on 26 June 2008.
199 For example, in Spain all deposits are non-refundable, so if a mortgage does not go through the client stands to lose a substantial amount of money.

aspects specific to the Spanish mortgage market (for example that re-mortgaging is a prohibitively expensive process).

14.8 IMS's market position is strong. In 2007 they were in the top three of non-resident intermediaries, and the top 20 overall, with €95m in lending.

14.9 From our research into cross-border intermediaries (many of whom focus on mortgages), it seems that many operate on a similar business model, i.e. providing advice to a particular nationality of non-resident clients. This is most likely because the clients value dealing with an advisor who is familiar both with the foreign mortgage market and with their own culture and expectations.

Conti Financial Services business model

14.10 Conti Financial Services is another UK-based specialised overseas mortgage advisor that arranges mortgage in 45 countries.[200] They deal mainly with English speaking clients wishing to buy property in countries where they are non-resident.

14.11 Conti's business model differs slightly from that of IMS in that in addition to matching non-resident clients with domestic lenders, they also assist foreign lenders operating in domestic markets by providing them with information concerning the domestic customers' credit situation and helping them overcome language and cultural barriers. For example, banks may not understand details of the domestic market (such as how to adequately assess the credit worthiness of a potential customer), or have trouble with the language and cultural idiosyncrasies.

14.12 Conti is not formally tied to any lenders, but maintains close relationships with only a few. When arranging cross-border mortgages with lenders without a physical presence, the quality of service (in terms of language accommodation and general efficiency) is very important.

14.13 Like IMS, Conti also offers advisory services to other (mainly UK-based) intermediaries who are not specialised in cross-border mortgage arrangements. Working with these can be difficult, as taking out a cross border mortgage is usually more complex than a domestic one, and the clients are often unwilling to undergo all the necessary extra administration.

The Spanish mortgage market

14.14 The Spanish mortgage market has a number of features that make it difficult for non-residents[201] to arrange a mortgage without putting themselves at risk. It is more expensive to set up a loan in Spain than in the UK; at an average cost of around 4 per

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[200] Interview conducted on 24 July 2008.
[201] In this case study most 'non-residents' are UK citizens.

cent of lending (partly driven by the mortgage deed tax which can be between 1.5 and 1.8 per cent of lending). IMS also expressed the concern that asymmetric information could result in the unnecessary bundling of products (for example, coupling the purchase of life insurance in order to get a mortgage) that in reality are available separately.

Intermediary market

14.15 Conti feels that competition among cross-border intermediaries in all the countries they deal with is increasing due to increasing market entry, attracted by the increase in cross-border property purchasing.

14.16 Some of these firms enter as specialised firms, whilst others combine mortgage advisory services with an estate or property development business. Conti feels that the latter business model is detrimental to consumers as it often results in conflicts of interest. The mortgage advisor may be encouraged to push an inappropriate mortgage through in order to make the sale of the house, or advise a client to take out a particular mortgage as an investment on a property when the investment is not sound.

14.17 IMS is also concerned about the number of “less-than-honourable” firms that operate in the Spanish intermediary market. These firms have been attracted by the increasing demand for mortgages from non-residents, as well as by the lack of regulation. They may offer incorrect or partial advice, or omit to tell clients about idiosyncrasies of the Spanish mortgage market or the individual lender.

The cross-border market

14.18 There has been a significant increase in the number of cross-border mortgage intermediaries operating in Spain in the past five years.

14.19 Historically, there has been very little competition in the Spanish mortgage market, with most property purchases being arranged by lawyers or estate agents, and the loans coming directly from the banks. In addition, the banks’ market positioning was relatively homogenised. Product differentiation was small, and consumers felt little need for the advice of intermediaries.

14.20 At present, increasing product differentiation and complexity have driven up the demand for intermediaries’ services. This is the result of the entrance of international lenders into the Spanish market — particularly from the UK and the US — with new products (such as interest only mortgages).

14.21 Whilst the entrance of foreign banks and the introduction of their more complex products have contributed to the rise of intermediaries, the converse is also true. Whilst no bank can lend money in Spain without a proper banking licence or a local subsidiary, their market penetration is helped by using intermediaries as a distribution channel. For example, IMS was responsible for over a third of a particular entrance bank’s total mortgage lending for the first three years that the bank was in operation in Spain.

14.22 Conti assists a number of foreign lenders supplying credit to domestic consumers through their knowledge of the local market and consumer base. Conti also assists domestic lenders dealing with foreign consumers. In both cases, the lack of local knowledge of many lenders with regards to the details of the customers' country's credit protocols raises the value of intermediaries like Conti who are able to inform lenders of how best to assess a client's credit situation, overcome language and cultural barriers, and make them more comfortable and willing about lending to a client from a different country. Intermediaries therefore greatly assist the trade in cross-border credit provision by helping both consumers and lenders.

14.23 In Spain, nationals are treated differently to non-residents in terms of the mortgage deals lenders offer them. This is partly due to the perceived risk factor; people buying in a foreign country, and often a second mortgage at that, are possibly less likely to keep up their mortgage payments, or to pay off the principal.

Trends in the EU

14.24 IMS considers Spain, with the exception of France which has a very established non-resident mortgage market, to be the leader in the non-resident mortgage market in the EU. They are of the opinion, however, that the demand for mortgages from non-residents is increasing in many other EU countries.

14.25 According to IMS, buying properties overseas has become much more affordable for many people and, where the presence of intermediaries is increasing, much easier. Some countries do have very particular lender regulations which prevent lenders offering mortgage to non-residents. This is a matter of law however, rather than preferences or market forces.

14.26 The trend of increasing cross-border property buying is almost certain to increase the prevalence of cross-border intermediaries, due both to the increase in the volume of mortgage transactions and the fact that a greater proportion of people are likely to go through an intermediary when buying foreign property than when buying domestic property.

14.27 Our survey responses show that lenders consider there to be many advantages of using intermediaries for cross-border lending. These intermediaries fulfil a different function to IMS, in that they match foreign lenders with domestic customers. Using intermediaries enables lenders swift access to markets without setting up and maintaining local offices. Penetration is made easier through the intermediaries' knowledge of the market and of the local consumers, and using intermediaries with an established image or reputation makes this penetration even more successful.

Obstacles to cross border trade

14.28 According to IMS, there are not many obstacles for consumers wishing to buy properties abroad. They do need to be aware of restrictions and idiosyncrasies in the foreign market, but unless the lenders have a specific policy against lending to a certain nationality, there is seldom a problem.

14.29 Lenders face more obstacles, which are in part eased by the presence of intermediaries. Currently, banks do not have very wide access to non-residents' credit ratings. Intermediaries have helped in this manner by informing banks which documents are best for assessing a client's creditworthiness.

14.30 Conti has not experienced many obstacles to their cross border trade. There are few instances of regulation being a burden, and where it is they are able to work around it. In Ireland, for example, Conti would need a particular license to operate, and therefore they work through an Irish mortgage intermediary in order to process their mortgage applications.

Regulation

14.31 There is currently no regulation or supervision of mortgage intermediaries in Spain. The lack of regulation, and subsequent attraction of low-grade intermediaries, seems to be a source of consumer detriment. Conti gave us examples of intermediaries acting fraudulently by filling in incorrect incomes in order to obtain a high-value mortgage.

14.32 The lack of regulation can pose a serious threat to consumers, but IMS feels this is less of an issue than lack of customer knowledge. They are of the opinion that cultural aspects play a role in putting non-resident customers at higher risk. For example, British customers often hold the belief that mortgage markets outside the UK are run in exactly the same manner as they are in the UK, particularly in terms of regulation and protection, and therefore are not cautious enough when dealing with unregulated advisors. In addition, clients may be more inclined to spend above their means in a foreign country as they know this will not be reflected in their home country credit records.

14.33 This behaviour of non-resident customers, combined with the presence of sub-standard intermediaries, may lead to poor quality advice. It may also affect the willingness of lenders to offer mortgages to non-residents, particularly post-credit crunch, given the possible risk of default or late payment.

14.34 IMS feels that more regulation would not necessarily solve this problem, and would create unnecessary burdens for reputable firms. Many of the cases of consumer detriment reported by IMS were less to do with the intermediary acting explicitly fraudulently, and more to do with the customer not taking into account the differences in regulatory standards when accepting advice. More important, therefore, would be the education of non-resident consumers to make them aware of the differences in taking out a mortgage in a foreign country and the potential dangers involved with incautiously trusting brokers.

14.35 According to the Spanish consumer association, consumers have an increasingly wide range of choice of mortgage products. However, they feel that consumers do not clearly understand the features of these products, and that it is their lack of financial sophistication which poses the most serious threat to them when dealing with both intermediaries and banks. It is interesting to note that while these comments are in reference to Spanish consumers, they are similar to what IMS feels to be the case with British consumers.

Summary of key findings

14.36 The demand for mortgage intermediaries specialising in cross-border trade is driven by consumers' need for help in circumventing language and cultural difficulties encountered when attempting to take out a mortgage in a foreign country, as well as in understanding the idiosyncrasies of the foreign mortgage market and avoiding being taken advantage of by local banks on the basis of their ignorance.

14.37 Intermediaries are also used by foreign lenders as a distribution channel in domestic clients. This seems to be a more common role.

14.38 Specialised cross-border intermediaries are used by domestic mortgage intermediaries needing advice on occasional cross-border loans they are asked to arrange, where the small scale of such requests does not warrant their becoming more familiar with the intricacies of the foreign market.

14.39 In Spain, cross-border mortgage intermediaries seem to mainly benefit non-resident consumers. While foreign banks' penetration is aided by intermediaries, this is not limited to cross-border intermediaries. Lack of regulation of intermediaries is a potential cause of consumer detriment. This is compounded by differences in regulation across Member States, as non-resident consumers from a well-regulated state may not be as cautious in taking advice from unregulated intermediaries as domestic consumers.

APPENDIX 1: TECHNICAL UNDERPINNING OF ANALYTICAL FRAMEWORK

Introduction

A1.1 We present in this Appendix the formal models associated with the development of the analytical framework presented at Section 3. For the sake of simplicity, we begin with a model that examines the potential for the interaction of credit intermediaries with borrowers and lenders to decrease the search costs of one or both sides.

A1.2 The basic model we propose proxies for the more complex remuneration arrangements that exist in practice. The proxy adopted is a bid-ask spread in the interest rate applicable to the credit product in question.

Decreasing Search Costs

A1.3 The model we propose here is intended to describe the contributions of credit intermediaries towards a reduction of search costs to both consumers and lenders. Consumers' search costs represent the effort, time, and possibly money, spent on getting information about price quotations. By lenders' search cost what we mean the marginal cost of reaching customers directly (e.g. marketing and advertising of the firms' products or opening a new branch in order to distribute to a new geographic area).

Assumptions

A1.4 The supply side of the market is represented by lenders that provide credit at a marginal cost, C. Consumers' willingness to pay for the credit product is V. We will always assume both parties benefit from trade, i.e.

$$V - C > 0$$

A1.5 It should be noted that this model, and the ones immediately following it, do not incorporate any uncertainty as to such outcomes. Therefore, they are not designed to analyse scenarios where, for instance, adverse selection plays a part.

Direct trade

A1.6 In absence of intermediaries trade between suppliers and consumers takes place at aggregate search costs, T. Total search costs T are the sum of consumers' search cost (T_C) and suppliers' search costs, (T_S), $T = T_S + T_C$. We assume that direct trading is mutually profitable, that is, $C + T_S < V - T_C$.

A1.7 With this setup suppliers and consumers will agree to trade at some price $C+T_s<p<V-T_C$, and the resulting consumers' utility and suppliers' profit are respectively:

$$U=V-p-T_C$$

$$\Pi=p-C-T_S$$

A1.8 The net trade gains resulting from of the direct exchange market (TGD) are:

$$TGD=V-C-T$$

Intermediated trade

A1.9 The economic contribution of intermediation lies in the assumption that an intermediary facilitates trade at total search costs (t) that are lower compared to those that arise in the direct market, i.e. $t<T$. The total search costs of an intermediated market can be expressed as the sum of consumers' and suppliers' search costs, $t=t_C+t_S$.

A1.10 If both supplier and consumers accept the intermediary offer (i.e., consumers accept to pay the ask price p_A and lenders accept to be paid the bid price p_B), the resulting consumers' utility, suppliers' profit, and intermediaries' margin are respectively:

$$U=V-p_A-t_C$$

$$\Pi=p_B-C-t_S$$

$$M=p_A-p_B$$

A1.11 With this setup the net trade gains of an intermediated market (TGI) are:

$$TGD=V-C-t$$

A1.12 and that the economic contribution of intermediation it represented by the additional trade gains due to lower transaction costs, which is:

$$TGD-TGI=T-t$$

Solution

A1.13 The solution of the model consists of finding the intermediary's optimal bid-ask spread and the pattern of intermediary relationships (with borrowers and lenders) that is consistent with the equilibrium bid-ask spread. These will generally depend on the specific market structure, i.e. the number of lenders and the number of intermediaries. We therefore consider four different scenarios: (1) monopolistic credit and intermediary market; (2) monopolistic credit and competitive intermediary market; (3) competitive credit and monopolistic intermediary market; (4) competitive credit and intermediary market.

Monopolistic credit and intermediary market

A1.14 The equilibrium price in a direct exchange market is $p = V - T_C$. At this price the monopoly credit supplier extract the whole consumer surplus, thus, the resulting consumer's utility and supplier's profits are respectively:

$$U = 0$$

$$\Pi = V - C - T$$

A1.15 A monopoly intermediary chooses ask and bid prices such that they leave consumers and suppliers indifferent between intermediated and direct trade. These prices are:

$p_A = V - t_C$ and

$$p_B = V - T + t_S$$

A1.16 and allow the intermediary to earn a margin which is equal to the reduction of the aggregate search costs:

$$M = p_A - p_B = T - t$$

A1.17 Of course, the borrower and the lender deal through the only available intermediary.

Monopolistic credit market and competitive intermediary market

A1.18 As in the previous case, the equilibrium price in an direct exchange market is $p = V - T_C$, However, price competition between intermediaries implies that the bid-ask spread must be equal to zero in equilibrium, that is, the ask-price and the bid-price must collapse to single price level. One can discern that any price level larger than $\underline{p} = V - T + t_S$ and smaller $\overline{p} = V - t_C$ is an equilibrium because at such a price: (1) both consumers and suppliers prefer to trade through intermediaries rather than directly, and (2) no intermediary has a profitable deviation. If we assume that the equilibrium price is the one that splits the intermediary margin evenly[202] between borrowers and lenders, which is

[202] That is, we assume that the equilibrium price is a Nash-Bargaining solution.

$$p_A = p_B = \frac{(V - T + t_S) + (V - t_C)}{2}$$

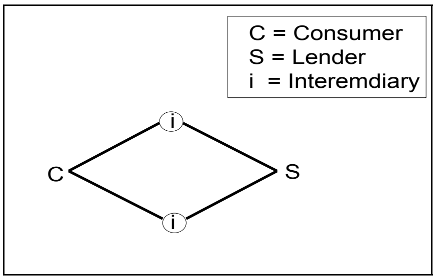
A1.19 then in equilibrium consumers' utility, suppliers' profit and intermediaries' margin are respectively:

$$U = (T - t)/2$$

$$\Pi = V - C - T + (T - t)/2$$

$$M = 0$$

A1.20 The tie structure for the case in which there are two intermediaries, is represented by the graphic below.



Competitive credit market and monopolistic intermediary market

A1.21 Price competition between credit suppliers implies that the equilibrium price in a direct exchange market is $p = C + T_S$. The resulting consumer's utility and supplier's profits are respectively:

$$U = V - C - T$$

$$\Pi = 0$$

A1.22 A monopoly intermediary chooses the following ask and bid prices:

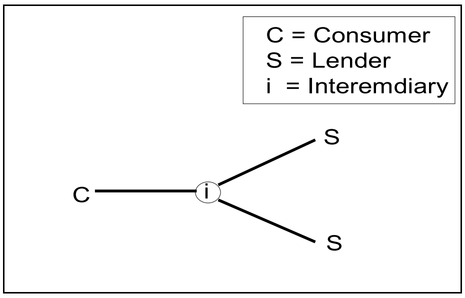
$p_A = C + T - t_C$ and

$$p_B = C + t_S$$

A1.23 Once again, the intermediary's margin equals the additional trade gains due to lower aggregate search costs:

$$M = p_A - p_B = T - t$$

A1.24 The market structure for the case of two competing lenders is depicted below.



Competitive credit and intermediary market

A1.25 The competitive price in case of direct exchange is again $p = C + T_S$, thus the consumer's utility and suppliers' profits are the same as in A1.21. Competition between intermediaries implies that, in equilibrium, the ask-price and the bid-price converge to a single price level. Any price level between $\underline{p} = C + t_S$ and $\overline{p} = C + T - t_C$ and is an equilibrium. For instance, at the equilibrium price

$$p_A = p_B = \frac{(C + t_S) + (C + T - t_S)}{2}$$

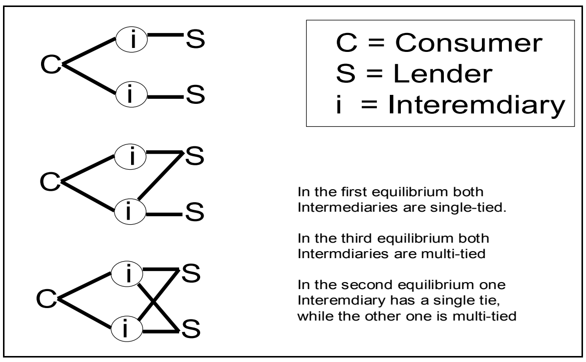
A1.26 the intermediary margin is split evenly between consumers and suppliers and, therefore, the consumers' utility, suppliers' profit and intermediaries' margin are respectively:

$$U = V - C - T + (T - t)/2$$

$$\Pi = (T - t)/2$$

$$M = 0$$

A1.27 As the figure below shows, there are multiple equilibrium link patterns: both single tied and multi-tied (or a combination of the two) intermediaries can coexist in equilibrium.



Decreasing Matching Costs

A1.28 Here we explicitly model transaction costs as the social costs that arise due to a mis-match of trading partners (e.g. where a consumer is sold a credit product unsuitable to his or her needs).

Assumptions

Demand and supply

A1.29 Suppliers are of two types and differ in the opportunity cost at which they can provide credit. One type of suppler can provide credit at a high marginal cost (C_H), and the other one at a low marginal cost (C_L). Similarly, consumers differ in their willingness to pay: one type of consumer has a high willingness to pay (V_H), while the other one has a low willingness to pay (V_L). The share of consumers with high willingness to pay is α, and the share of credit suppliers with high marginal cost is β. We denote the expected willingness to pay and the expected marginal cost respectively as:

$$E(V) = \alpha V_H + (1-\alpha)V_L$$

$$E(C) = \beta C_H + (1-\beta)C_L$$

A1.30 The existence of matching problems is ensured by assuming that consumers with low willingness to pay are willing to trade only with suppliers with a low marginal cost, and suppliers with high marginal cost are willing to trade only with high willingness to pay consumers. This situation is formally described by the following condition

$$V_H > C_H > V_L > C_L$$

A1.31 We assume that, once consumers and suppliers are matched, the distribution of the surplus is determined by a bargaining process. This simplifying assumption, despite precluding the modelling of lender competition (which has been already investigated in the previous models), allows us to clearly isolate the intermediaries' contribution towards solving matching problems.

Solution

Direct trade

A1.32 A direct exchange market is characterized by the random matching of the parties. From the previous condition it follows that the expected trade gains in a direct exchange market is

$$TGD = \alpha\beta(V_H - C_H) + \alpha(1-\beta)(V_H - C_L) + (1-\alpha)(1-\beta)(V_L - C_L)$$

A1.33 Assuming the outcome of the bargaining process corresponds to a Nash-Bargaining solution[203], the expected utility of the two types of consumers are

$$U_H = \beta\left(\frac{V_H - C_H}{2}\right) + (1-\beta)\left(\frac{V_H - C_L}{2}\right) = (1/2)(V_H - E(C))$$

$$U_L = (1-\beta)\left(\frac{V_L - C_L}{2}\right)$$

A1.34 and the expected profits of the two firms are

$$\Pi_H = \alpha\left(\frac{V_H - C_H}{2}\right)$$

$$\Pi_L = \alpha\left(\frac{V_H - C_L}{2}\right) + (1-\alpha)\left(\frac{V_L - C_L}{2}\right) = (1/2)(E(V) - C_L)$$

Intermediated trade

A1.35 We show here how the existence of a monopoly intermediary is sufficient to improve social welfare by eliminating the uncertainty responsible for the mis-matching of trading parties.

A1.36 One can easily see that the optimal pricing strategy for a monopoly intermediary is to charge an ask-price that attracts only the consumers with a high willingness to pay, and to offer a bid price that attracts only the supplier with low marginal cost. These prices, which leave the high-willingness-to-pay consumer and the low-marginal-cost supplier indifferent between direct and intermediated trade, are:

$$p_A = (1/2)(V_H + E(C))$$

$$p_B = (1/2)(E(V) + C_L)$$

A1.37 By setting the prices above the intermediary achieves the following margin:

$$M = p_A - p_B = (1/2)(V_H - E(V) + E(C) - C_L)$$

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203 In this setting the Nash-Bargaining Solution corresponds to an even split of the trade gain.

A1.38 Therefore, the intermediary creates a separating equilibrium that eliminates the matching uncertainty and yields the following trade gains

$$TGI = (1/2)(V_H - E(V) + E(C) - C_L) + (1/2)(V_H - E(C)) + (1/2)(E(V) - C_L) = (V_H - C_L)$$

A1.39 It is straightforward to see that the trade gains under intermediation (the equation after A1.38), are larger than those achievable by direct trade (the equation after A1.32).

Alleviating Adverse Selection

A1.40 In this section we present a model where a monopoly intermediary solves the market failure due to adverse selection.

Assumptions

Demand and supply

A1.41 There is one supplier who sells two types of credit products: a high quality and a low quality product. A high quality product is interpreted here as a credit product that bears a low default risk for consumers, whereas a low quality product is a credit product with a high default risk for consumers. The marginal cost of supplying the product is increasing in its quality so that the opportunity cost of providing a high quality product is C_H which is larger than the cost of providing a low quality product is C_L.

A1.42 A consumer's willingness to pay depends on the products' quality. The consumer is willing to pay V_H, for a high-quality product, and V_L for a low quality product, where obviously $V_H > V_L$.

A1.43 We assume that the supplier knows the quality of the product he is selling (i.e. he knows the exact financial risk associated with it) while the consumer (e.g. because of poor financial literacy or because of the credence good nature of the credit product) does not know the product's risk. Assuming that the probability of a high quality product being sold is α, then the expected willingness to pay of the consumer is

$$E(V) = \alpha V_H + (1-\alpha)V_L$$

A1.44 We assume that the market is prone to failure due to asymmetric information, i.e., the consumer willingness to pay based on expected quality is lower than the cost of providing the high-quality good:

$$\alpha V_H + (1-\alpha)V_L < C_H$$

Solution

Direct trade

A1.45 This condition implies that, in the case of direct trade, only low-quality goods are sold and therefore the (ex ante) expected trade gains are

$$TGD = (1-\alpha)(V_L - C_L)$$

A1.46 If we assume that the gains are equally divided between the two parties then the consumer's utility (U) and the supplier's profit (Π) are:

$$U = \Pi = \left(\frac{V_L - C_L}{2}\right)$$

Intermediated trade

A1.47 An intermediary can improve the aggregate trade gains by acting as a "quality guarantor" who observes and certifies the quality of the good. In the setting of this model this assumption corresponds to thinking of the intermediary as a financial expert that can credibly warn the consumer about the risks associated to a specific credit product.

A1.48 When this is the case, it is optimal for the intermediary to set ask and bid prices for a low-quality product in such a way that the consumer and the supplier are indifferent between trading directly or through the intermediary. These prices are:

$$p^L{}_A = V_L - \left(\frac{V_L - C_L}{2}\right)$$

$$p^L{}_B = C_L + \left(\frac{V_L - C_L}{2}\right)$$

A1.49 Since there in no direct market for high quality goods, the pair of prices that the intermediary sets for a high quality product is such that it extracts the whole surplus. These prices are:

$$p^H{}_A = V_H$$

$$p^L{}_B = C_L$$

A1.50 It can be seen that, with these two pair of prices, the intermediary earns a rent only by trading the certified high quality good, and its expected margin is:

$$M = (1-\alpha)\left(p^L{}_A - p_B{}^L\right) + \alpha\left(p^H{}_A - p_B{}^H\right) = \alpha(V_H - C_H)$$

A1.51 The aggregate expected trade gains are therefore:

$$TGI = \alpha(V_H - C_H) + (1-\alpha)(V_L - C_L)$$

A1.52 From a comparison of A1.45 and A1.51 it is clear that the trade gain due to intermediation are represented by the possibility of trading high quality goods.

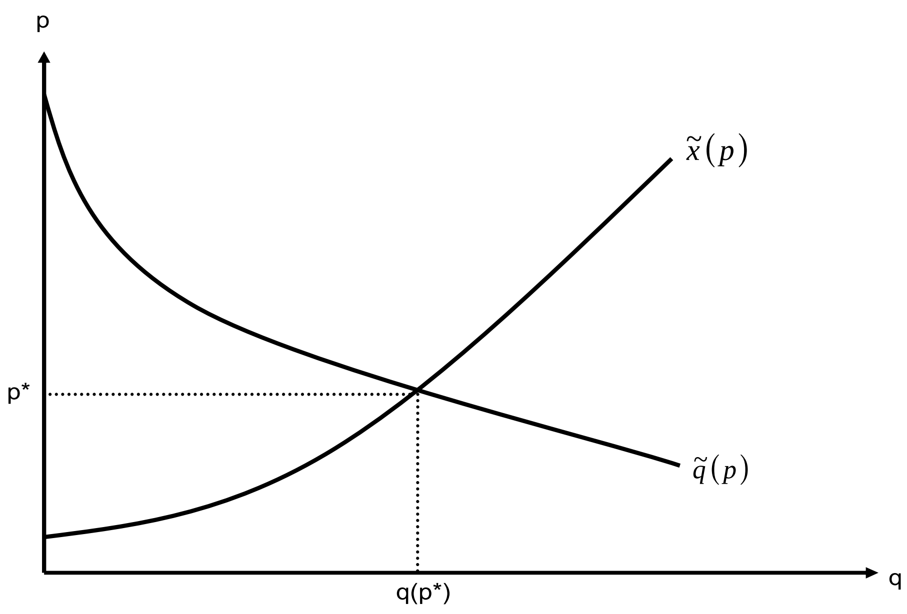
A1.53 In this section we explain in details the theoretical framework we have adopted for the study of credit intermediaries.

The Welfare Implications of Intermediation

Assumptions

Direct trade

A1.54 The direct-trade market is represented by lenders that whose supply function is $\tilde{x}(p)$ and consumers whose demand is $\tilde{q}(p)$. We assume that the direct market is perfectly competitive, as this does not affect the qualitative result of our analysis. The price (interest rate) at which credit is provided, $p*$, and the amount of credit provided, $q(p*)$, are therefore determined by the intersection of demand and supply (see figure below).



A1.55 The resulting consumer surplus and producer surplus are respectively:

$$CS(p^*) = \int_0^{q(p^*)} (\tilde{q}(p) - p^*)dq$$

$$PS(p^*) = \int_0^{q(p^*)} (p^* - \tilde{x}(p))dq$$

Intermediated trade

A1.56 Intermediated trade is possible because of the presence of an intermediary who allows trade to take place at lower transaction costs compared to the direct trade situation. The timing of events is as follows:

(a) The intermediary sets an ask-price (p_A) to be charged to consumes and a bid-price (p_B) for lenders. (In reality, a credit intermediary is perhaps unlikely to be in a position to set a bid-price as such. However, as described above, we are using this bid-ask spread approach to proxy for the greater complexity of the real world).

(b) After observing these prices, suppliers and consumers decide whether to trade directly or to accept the intermediary's offer.

(c) If both suppliers and consumers accept the intermediary offer, then trade takes place at the pair of prices announced by the intermediary.

A1.57 The advantage, to lenders and consumers, of dealing through the intermediary lies in the lower transaction costs they have to bear. Consequently, if intermediation takes place through the intermediary the supply function is $x(p) > \tilde{x}(p)$ for any p , and the demand function is $q(p) > \tilde{q}(p)$ for any p .

A1.58 When consumers and suppliers accept the intermediary offer the consumer surplus and the producer surplus are, respectively:

$$CS(p_A) = \int_0^{q(p_A)} (q(p_A) - p_A)dq$$

$$PS(p_B) = \int_0^{x(p_B)} (p_B - x(p_B))dx$$

A1.59 and the intermediary profit is

$$\mathrm{M}(p_A, p_B) = p_A q(p_A) - p_B x(p_B)$$

Solution

A1.60 The intermediary chooses the prices p_A and p_B that solve the following problem

$$\max_{p_A, p_B} \mathrm{M}(p_A, p_B) = p_A q(p_A) - p_B x(p_B)$$

A1.61 subject to the constraints

$$(i) \quad q(p_A) = x(p_B)$$

$$(ii) \quad \int_0^{q(p^*)} (q(p_A) - p^*) dq \geq \int_0^{q(p_A)} (q(p_A) - p_A) dq$$

$$(iii) \quad \int_0^{q(p^*)} (p^* - x(p_P)) dx \geq \int_0^{q(p_B)} (p_B - x(p_P)) dx$$

A1.62 We will assume that the constraints *(ii)* and *(iii)* are never binding. If they were, then the optimal pricing strategy would be determined by the solution the binding condition, which is the indifference condition already explained above (e.g., if *(i)* is binding, then p^*_A is that price that leaves the consumer indifferent between direct and intermediated trade, and p^*_B follows automatically from *(i).*

A1.63 Therefore, where only condition *(i)* is binding, the problem restated in terms of a Lagrangian function, is:

$$\max_{p_A, p_B, \lambda} \Lambda(p_A, p_B, \lambda) = p_A q(p_A) - p_B x(p_B) - \lambda(q(p_A) - x(p_B))$$

A1.64 The maximization of Λ is given by the solution of the system:

$$\begin{cases} \dfrac{\partial \Lambda(p_A, p_B, \lambda)}{\partial p_A} = q(p_A) + p_A q'(p_A) - \lambda q'(p_A) \equiv 0 \\ \dfrac{\partial \Lambda(p_A, p_B, \lambda)}{\partial p_B} = -x(p_P) - p_B x'(p_B) + \lambda x'(p_P) \equiv 0 \\ \dfrac{\partial \Lambda(p_A, p_B, \lambda)}{\partial \lambda} = q(p_A) - x(p_B) \equiv 0 \end{cases}$$

A1.65 and which can be simplified into the following system:

$$\begin{cases} p_A - p_B = \dfrac{p_A}{\varepsilon_D} + \dfrac{p_B}{\varepsilon_S} \\ q(p_A) = x(p_B) \end{cases}$$

A1.66 The first equation in A1.65 represent the First Order Condition where ε_D is the absolute value of the elasticity of demand and ε_S is the elasticity of supply

$$\varepsilon_D = -\frac{q'(p_A)p_A}{q(p_A)}; \quad \varepsilon_S = \frac{x'(p_B)p_B}{x(p_B)}$$

A1.67 The second equation in is the market clearing condition.

A1.68 The First Order Condition implies that lower demand and supply elasticities corresponds always to a higher intermediary's margin. The intuition is straightforward: the less sensitive consumers and suppliers are to price changes, the higher the market power enjoyed by the intermediary.

Competition with Differentiated Intermediaries

Assumptions

A1.69 There are *n* intermediaries. Each intermediary $i \in \{1,..,n\}$ chargers the ask-price $p^A{}_i$ in order to attract consumers, and offers the bid-price $p^B{}_i$ in order to attract lenders. We denote the set of prices set by all intermediaries but intermediary i by p_{-i}, and assume that the differentiated demand and differentiated supply of intermediary i are given, respectively, by the following functions:

$$q_i\left(p^A{}_i, p^A{}_{-i}\right) = \frac{1}{n}\left(1 - p^A{}_i(1+\delta) + \frac{\delta}{n}\sum_{j=1}^{n}\left(p^A{}_j\right)\right)$$

$$x_i\left(p^B{}_i, p^B{}_{-i}\right) = \frac{1}{n}\left(p^B{}_i(1+\sigma) - \frac{\sigma}{n}\sum_{j=1}^{n}\left(p^B{}_j\right)\right)$$

A1.70 $\delta \in [0,\infty)$ is the degree of similarity for the demand (i.e., it denotes how differentiated the intermediaries are in the eyes of consumers). $\sigma \in [0,\infty)$ is the degree of similarity for the supply (i.e., it denotes how differentiated the intermediaries are in the eyes of suppliers). If $\delta = 0$ ($\sigma = 0$) the intermediaries products are so differentiated that each intermediary is perceived as being a monopolist by consumers (suppliers). If, in contrast $\delta \to \infty$ ($\sigma \to \infty$), the products are perfectly substitute and therefore intermediaries are perceived as perfect competitors by consumers (suppliers).

A1.71 These specific functional forms in A1.69 are the so called Shubik-Levitan functions and are standard functions for modelling price competition with differentiated products. The reason why they are so popular is that they have two vital properties: the aggregate demand $Q = \sum_{i=1}^{n} q_i$ and the aggregated supply $X = \sum_{i=1}^{n} x_i$ do not depend on the number of intermediaries and on the degree of differentiation.[204] One can check that this also implies that aggregated demand and aggregated supply depend on the average the price. That is:

$$Q = 1 - \frac{1}{n}\sum_{j=1}^{n} p^{A}{}_{j} \text{ and } X = \frac{1}{n}\sum_{j=1}^{n} p^{B}{}_{j}$$

A1.72 The margin of intermediary i is:

$$M_i\left(p^A{}_i, p^A{}_{-i}, p^B{}_i, p^B{}_{-i}\right) = p^A{}_i q_i\left(p^A{}_i, p^A{}_{-i}\right) - p^B{}_i x_i\left(p^B{}_i, p^B{}_{-i}\right)$$

A1.73 and its problem is given by:

$$\begin{cases} \max\limits_{p^A{}_i, p^B{}_i} M_i\left(p^A{}_i, p^A{}_{-i}, p^B{}_i, p^B{}_{-i}\right) \\ s.t.: \quad q_i\left(p^A{}_i, p^A{}_{-i}\right) = x_i\left(p^B{}_i, p^B{}_{-i}\right) \end{cases}$$

Solution

A1.74 After applying the Lagrange method, and imposing the symmetry conditions $p^A{}_i = p^A{}_j$ and $p^B{}_i = p^B{}_j$ for any $j \neq i$, this yields to the F.O.C. below

$$\begin{cases} p^A - p^B = \dfrac{1-p^A}{1+\left(\dfrac{n-1}{n}\right)\delta} + \dfrac{p^B}{1+\left(\dfrac{n-1}{n}\right)\sigma} \\ p^A = 1 - p^B \end{cases}$$

A1.75 For notational simplicity let be $\Delta(n) = 1 + \left(\frac{n-1}{n}\right)\delta$ and $\Sigma(n) = 1 + \left(\frac{n-1}{n}\right)\sigma$. Then, solving the above system gives us: the equilibrium ask price $p*_A$, the equilibrium bid price $p*_B$, and the equilibrium margin of intermediation $M*$.

$$p*_A = \frac{\Delta(n) + \Sigma(n) + \Delta(n)\Sigma(n)}{\Delta(n) + \Sigma(n) + 2\Delta(n)\Sigma(n)}$$

$$p*_B = \frac{\Delta(n)\Sigma(n)}{\Delta(n) + \Sigma(n) + 2\Delta(n)\Sigma(n)}$$

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204 If for instance the demand was not a Shubik-Levitan one, we would have two paradoxical situations: (1) All else being equal, the consumer demand for the goods would increase with the number of intermediaries, and (2) The consumer demand for the goods would increase the more similar the intermediaries are. A similar paradox holds on the supply side.

$$M^* = (p^*_A - p^*_B) = \frac{\Delta(n) + \Sigma(n)}{\Delta(n) + \Sigma(n) + 2\Delta(n)\Sigma(n)}$$

A1.76 Substituting $\Delta(n)$ and $\Sigma(n)$ into this, we get a more explicit formula of the intermediation margin in equilibrium:

$$M^* = \frac{2n + (n-1)(\delta + \sigma)}{4n + 3(n-1)(\delta + \sigma) + 2\left(\frac{(n-1)^2}{n}\right)\delta\sigma}$$

A1.77 From a further analysis of the above we can draw the following conclusions:

A1.78 $\frac{\partial M^*}{\partial \delta} < 0$ and $\frac{\partial M^*}{\partial \sigma} < 0$ that is, a lower degree of differentiation between intermediaries implies a lower margin accruing to intermediation activity.

A1.79 $\lim_{\delta \to \infty} M^* = \frac{n}{3n + 2(n-1)\sigma}$ and $\lim_{\sigma \to \infty} M^* = \frac{n}{3n + 2(n-1)\delta}$ that is, if the intermediaries' services are perceived as perfect substitutes by consumers the intermediation margin is still positive because of the market power with respect to lenders. Similarly, if the intermediaries' services are perceived as perfect substitutes by lenders the intermediation margin is still positive because of the market power with respect to consumers. In order for the intermediation margin to be zero intermediaries must be perceived as perfectly homogenous by both consumers and lenders. This is the case because $\lim_{\substack{\sigma \to \infty \\ \delta \to \infty}} M^* = 0$.

A1.80 $\frac{\partial M^*}{\partial n} < 0$ and $\lim_{n \to \infty} M^* = \frac{2 + \delta + \sigma}{3 + 3(\delta + \sigma) + 2\delta\sigma} > 0$, meaning that, even though the intermediation margin decreases with the number of intermediaries, the margin is still positive due to the degrees of differentiation.

A1.81 The model also allows us to conduct a comprehensive welfare analysis. First, the aggregate demand and the aggregate supply given in A1.71 imply that, in equilibrium, aggregate demand and aggregate supply are

$Q = 1 - p^*_A$ and $X = p^*_B$

A1.82 Thus, in equilibrium, consumer surplus and producer surplus are respectively:

$CS = (1 - p^*_A)^2$ and $PS = (p^*_B)^2$

A1.83 Finally, since

$$\frac{\partial p^*_B}{\partial \delta} = \left(\frac{n-1}{n}\right)\frac{\Sigma(n)}{(\Delta(n)+\Sigma(n)+2\Delta(n)\Sigma(n))^2} > 0\;;$$

$$\frac{\partial p^*_B}{\partial \sigma} = \left(\frac{n-1}{n}\right)\frac{\Delta(n)}{(\Delta(n)+\Sigma(n)+2\Delta(n)\Sigma(n))^2} > 0\;;$$

$$\frac{\partial p^*_B}{\partial n} = \frac{\Delta'(n)\Sigma(n)^2+\Delta(n)^2\Sigma'(n)}{(\Delta(n)+\Sigma(n)+2\Delta(n)\Sigma(n))^2} > 0$$

A1.84 and keeping in mind that $p^*_A = 1 - p^*_B$, we can conclude that:

(d) An increase in downstream competition (i.e., a larger δ) leads to higher consumer and producer surpluses.

(e) An increase in upstream competition (i.e., a larger σ) leads to higher consumer and producer surpluses.

(f) An increase in the number of firms (i.e., a larger n) leads to higher consumer and producer surpluses.

APPENDIX 2: REGULATORY FRAMEWORK

Austria	
Information provided by:	Ministry for Social Affairs and Consumer Protection; Federal Ministry of Economic Affairs and Labour; internal research
Local definition	There are two types of credit intermediaries: personal credit intermediaries and mortgage brokers, which both fall under the same regulation. The Austrian Broker Act (§33) states a credit intermediary "is someone who commercially conveys credit - as defined by the Austrian Banking Act."
Relevant legislation[205]	Standes- und Ausübungsregeln für Personalkreditvermittler: BGBl.Nr. 505/1996 (professional rules for credit intermediaries, - link); Broker Act (link); Federal Law Gazette Nr. 262/1996 (link) especially §34, §37 and §39; Gewerbeordnung (Crafts, Trade, Service and Industry Act - link); Konsumentenschutzgesetz (KSchG - link - law for consumer protection); Wertpapieraufsichtsgesetz (law to regulate securities - link); Bankwesengesetz (Banking Act - link)
Description[206]	**General** § 117 of the Crafts, Trade, Service and Industry Act 1994 (Gewerbeordnung 1994) states that real estate brokers may also convey mortgages. § 136 of the above Act states that financial consultants (to which credit intermediaries belong) are allowed to intermediate credits and mortgage loans. In addition to permission granted to financial consultants according to § 136a Crafts, Trade, Service and Industry Act 1994, all other enterprises under this Act may intermediate credits if this takes place in a supplementary way connected to the main content of each trade. For example, no special training is required if a car dealer wishes to intermediate credit for the cars he sells. **Entry requirements** The activity of credit intermediation is part of the role of a "financial consultant", which requires a comprehensive qualification.

205 Throughout this Appendix we have inserted a web link to the relevant authorities or the laws discussed. In some cases no link is available; this occurs when our survey respondent cited a law which is not locatable via web search.

206 All information contained in the description sections relates directly to the reported legislation, unless we have otherwise indicated that the information came from our respondent or is extracted from codes of conduct/self-regulation.

	Ongoing requirements *Effectiveness of the credit intermediation contract* According to the Broker Act, a credit intermediation contract is only legally effective if it is written and explicitly concerns the mediation of credit. A translation of a document from another language, done by the credit intermediary, has to contain the full text. Further requirements to assure legal effectiveness are: - Precise estimation of desired amount of credit; this is the amount that the consumer will actually receive. - Stating of ceiling amount, as well as the statement of the maximum commission; the maximum total percentage rate, divided into the maximum possible debt and the maximum possible commission. - Stating of the latest possible date of acceptance of the credit offer, the minimum and maximum duration of the credit and all conditions for granting of the credit, which the credit intermediary is willing to accept, as well as an interest clause that has to apply to objective regulations; hypothecation of the salary, order of warrantors and agreement on consequences in case of delay in payment, with an indication of maximum interest rate on delay. *Obligation of information provision* The intermediary is obliged to state the name and address of the credit institution at the drawdown of the credit (at the latest). If the credit intermediary does not fulfil this duty: - The customer does not have to pay the commission or other charges. - The customer has to pay the credit institution only up to a maximum interest rate that does not exceed the double amount of the basic interest rate stated in the contract. If the credit intermediary is only active because of the customer's initiative, then the second sub-point above does not apply. The lawful relationship between credit institution and credit intermediary is unaffected by this. The *National Law*: *legislative provision for credit intermediaries,* from 8 December 2008, includes regulations regarding the professional behaviour of credit intermediaries. Credit intermediaries are obliged to refrain from unfavourable practices which cause damage to the reputation or the collective interests of the profession. Credit intermediaries are acting in an unfavourable way especially if they: - Do not meet agreed privacy commitments - Take money contrary to legislation given in the § 37, BGBl. Nr. 262/1996 - Retain entrusted documents

- Have unlawful titles and are not transparent about their business activities
- Work together with individuals or companies that operate without legal permission
- Offer the borrower a service other than credit mediation - this does not apply if it concerns a free of charge service

Advertisements must clearly state that they are on behalf of a credit intermediary.

Where a credit intermediary contributes to the completion of a mediation contract, the intermediary has to provide a copy immediately on demand of the borrower.

If the intermediary is aware that the consumer might not be able to pay the debt he or she has to refer him to a debtor help desk rather than assisting in finding new credit.

Intermediaries have to give their written business conditions to the 'Verein fuer Konsumenteninformation' (consumer-information office).

Commission disclosure

Credit intermediaries have to state the maximum possible commission rate clearly in the location where they interact with consumers.

The commission cannot exceed a maximum of 5 per cent of the gross credit sum.

Arbeitskammer Oberösterreich (employment office of the Austrian province of Oberösterreich - link) states that:

- Personal credit intermediaries are obliged by law to signal the commission charged within their business premises
- The commission cannot exceed a maximum of 5 per cent of the gross credit sum
- In case of a conversion of debts: the effective interest rate, including the commission of the intermediary, cannot exceed the interest rate of the previous credit.
- The credit mediation contract has to be written and has to contain details of the deal
- The credit mediation contract can only be made for a maximum of four weeks
- If a customer requests a copy of the mediation contract, the intermediary has to offer it without charge
- The credit intermediary is not allowed to raise additional handling fees or charges for copies
- A customer has to pay the commission only in case of a successful arrangement or in case the unsuccessful mediation was clearly the consumers fault

Restrictions

The credit mediation contract can only be made for a maximum of four weeks. This period starts the moment all of the

	requirements are in the hands of the credit intermediary. The credit intermediary is not allowed to charge extra charges for services, such as the translation of documents or handling fees, etc. The credit intermediary does not have the right to charge a commission if the name of credit institution is not stated on the documentation exchanged between the consumer and the credit institution. *Debt collection activity* Credit intermediaries are not allowed to actively collect money from consumers for the credit institution. They cannot 'chase' customers or act in the case of delayed payment. Credit intermediaries are also not allowed: - To profiteer - To offer a credit mediation service for credit offered by a credit institution that does not act lawfully - To offer lower rates than the credit institutions are actually offering - To offer credit without permission of the credit institution in question
Specific information	**Consumer credit intermediaries** *(All requirements here are from our survey respondents.)* Conduct Rules for personal credit intermediaries state that only 5 per cent of the gross credit capital may be claimed. Intermediaries have to indicate the APRC (§8) and must recommend a debt counsellor in case the consumer is in danger of over-indebtedness. Personal credit intermediaries must inform consumers of the full cost that the consumer will bear prior to signature of a credit agreement. *Entry Requirements* Minimum standards/qualifications needed to begin acting as an intermediary *Ongoing Requirements* Standardised presentation of key data to borrowers Requirement to explain risks and/or other key data to potential borrower Compliance with advertising and marketing standards **Mortgage intermediaries** *Entry Requirements*

	Minimum standards/qualifications needed to begin acting as an intermediary Defined level of professional indemnity insurance *Ongoing Requirements* Requirement to assess suitability of product to borrower Requirement to explain risks and/or other key data to potential borrower Ongoing minimum training requirements Compliance with advertising and marketing standards **POS** Compliance with advertising and marketing restrictions apply. **Business finance intermediaries** Survey source did not indicate any specific regulation.
Belgium	
Information provided by:	Commission Bancaire; Financière et des Assurances
Local definition	A credit intermediary is any person who aids in the conclusion or execution of a credit contract within the framework of his or her commercial or professional activities. This can range from a service provider who receives all or part of the amount of the credit and assists in the conclusion of the credit agreement, to someone who is just a salesman informing the customer of a particular lender (§ 1 and § 77)
Relevant legislation	Credit intermediaries are legally bound by the following law (in two documents): La Loi du 12 Juin 1991 (updated by the Loi du 24 mars 2003 - link) and L'Arrete Royal du 25 fevrier 1992, 4 aout 1992 (updated by the A.R. du 24 Septembre 2006 - link)
Description	**Entry requirements** Persons who exercise credit intermediary activities must register with the Ministry of Economic Affairs. **Ongoing requirements** *Obligation to source best product* The credit intermediary's first duty is to the client or the potential borrower. Intermediaries are bound to look for the best value for their client in the given situation. (§11 of La Loi du 12 Juin 1991)

	Upon refusal of credit, the intermediary is bound to tell the borrower the identity and address of the party responsible who he could consult. *Advertising and information disclosure* For consumer credit, the intermediary must indicate the APRC. For mortgage credits, the intermediary must mention the actual annual base rate. The credit intermediary must explain clearly to the consumer the consequences of the agreement. **Restrictions** Intermediaries do not perform credit checks themselves, but are legally bound to supply the lenders with certain information about the potential borrower in order to ensure the most complete credit check and responsible lending decision possible. A direct fee paid to the intermediary is prohibited under Belgian law. Credit intermediaries are not allowed to accept any money from the potential borrower. Intermediaries are not allowed to solicit at a consumer’s house, unless approached and asked to do so in writing by the consumer. **Self regulation/codes of conduct** The UPC is the professional association representing the private credit sector. Credit intermediaries belonging to the UPC abide by a Code of Conduct with the Belgian Banking association. The Code is overseen by the Union Professionel Reconnue. The code of conduct explicitly mentions credit splits, stating that the intermediary should not be party to the fractioning of credit, neither directly - by himself splitting the credit between two lenders, nor indirectly, by organising credit fractioning with other credit intermediaries. Further to that, the Code states that the credit intermediary should not paint a more positive picture of the situation than is the case. Specifically, he cannot hold back any information, manipulate information or add untrue information. Credit intermediaries cannot explicitly encourage the supply of credit to consumers who: - Will not be able to repay the debt - Are over-indebted - Have been refused elsewhere - Are in dispute - Are registered as ‘risky’

	- Have a weak credit profile The credit intermediary shall only put forward to the lender a case where he believes that there will be full reimbursement by the borrower. Intermediaries are prohibited by the code from giving the financial institution an inaccurate image of the situation and solvency of the consumer and/or leading the financial institution to accept an application for credit which it would not have accepted in all full knowledge of the facts. **Penalties** *By Law:* The financial institution reserves the right to claim compensation for any damage undergone resulting from the intermediary violating the code of law and reserves the right to suspend or terminate the collaboration with the credit intermediary. In addition, there will be an eight day jail term or €100 fine for a lender who offers or consents to a contract dealt by a credit intermediary who is not registered, or for an unregistered credit intermediary who completes the transaction. There is also the possibility of the suspension or termination of the intermediary's right to carry out operations. *Code of Conduct:* suspension or termination of collaboration with the UPC.
Additional specific information	**Mortgages** Specialist mortgage intermediaries are not currently subject to statute and do not have to fulfil any particular obligation to carry out this activity other than in respect to certain articles relating to advertising as in the law of 4 August 1992 relating to mortgage credit. An intermediary advising on mortgages for the purpose of buying or selling a home would only need to be registered and would be supervised according to product and marketing (i.e. advertising) rules. There exists to date a preliminary draft law aimed at putting mortgage intermediaries under statute. The new law, as and when introduced, would aim to introduce the same level of consumer protection to an intermediated sale as applicable in the case of a direct sale. In particular, the law as currently drafted would introduce: - Prudential criteria (e.g. ensuring that mortgage intermediaries are financially solid) - Know your client requirements - A formula for dispute resolution, including potential sanction from the CBFA. **Consumer and POS** Under the 1991 Consumer Credit Act there are some limited administrative requirements that are placed upon intermediaries in these fields. **Business mortgages**

	Mortgages for other purposes (e.g. business mortgages) are excluded from CBFA supervision.
	Bulgaria
Information provided by:	Bulgarian National Bank
Local definition	Credit intermediaries are not specifically defined. However, the business of credit intermediaries is considered to be part of "financial brokerage" activity. As such, it can be provided only by financial (non-credit) institutions; the term "credit intermediaries" excludes credit lending directly by banks, leasing companies, etc. The Law on Credit Institutions (LCI) defines "financial brokerage" as an intermediary activity in providing banking and other services, including credits (§1 (1), item 23, Additional Provisions of LCI). Financial brokerage is a business pursued by a financial institution (non–credit institution) according to the Bulgarian legislation (§3 (1) and §2 (2), item 10, LCI). The Law of Markets for Financial Instruments (§5 (1-7)) (LMFI) stipulates that financial intermediation includes, inter alia: - Contract intermediation for credit - Managing credit on behalf of the client - Providing credit consultations - Consulting firms regarding credit operations - General financial advice as relevant to credit intermediation
Relevant legislation	Law on Credit Institutions (link) Law of Consumer Credit (link) Law of Money Laundering (link) Law for Consumer Protection (link) Law of Markets for Financial Instruments (link)
Description	**Entry and ongoing requirements** The Law of Credit Institutions (LCI) does not explicitly regulate credit intermediaries, their market entry or ongoing activity. Since they are considered part of the financial brokerage system, but not lenders, they are not subject to licensing by the Bulgarian National Bank (BNB). *Set standard of management ("fit and proper" test)* As such they are not required to pass the Bulgarian equivalent of the "fit and proper" test. Instead, the intermediary must notify BNB about the scope of its intended activity within 14 days of market entry, unless it is governed by another law or

	license (§3 (2)). *Full disclosure of fee arrangement with lenders* All fees have to be disclosed upfront and, in the case of consumer credit involving the use of a credit card, the limit should be disclosed. The intermediary should fully notify the client of the terms of repaying the credit and the methods of terminating the contract. *Compliance with advertising and marketing standards* Advertisements for credit should include the APRC along with the advertised interest rate. All expenses relating to servicing the credit should be disclosed by the advertiser, whether it is the creditor or the credit intermediary. *Compliance with money-laundering legislation* The Law of Money Laundering (LML) requires the institutions of financial brokerage (to which credit intermediaries belong) to comply with the law by verifying client identification, identifying the owner of corporate clients, ongoing monitoring of transactions and sources of money when the transaction involves more than €15,300, and reporting suspicious information to BNB (§3 (1-5)). *Contract termination* The Law for Consumer Protection (LCP) requires credit intermediaries and providers to terminate the credit contract when the consumer requests. The consumer does not owe any penalties for terminating the contract either to the provider or to the intermediary. Any contract claiming otherwise is not valid (§56 (1-3)). **Restrictions** The Law of Consumer Credit (link) requires that credit intermediaries do not collect fees for intermediation; fees can be collected only on behalf of the creditor (§24 (1)). **Self-regulation***:* A new Association of Credit Consultants in Bulgaria (ACCB) was established in June 2008. Among its goals are to establish high standards of service and to create a self-regulation framework that would be applied to all members. However, by present date, the association has no website and has not made any formal statements on the issue. (link) **Other requirements highlighted by the Bulgarian National Bank:** Standardised presentation of key data to borrowers
Additional specific information	**Consumer Credit (excluding POS) intermediaries** *Entry requirements* (as highlighted by the Bulgarian National Bank): Minimum standards/qualifications needed to begin acting as an intermediary

	Minimum capital adequacy to act as an intermediary As far as it refers to access/ transferring data relating to bank's customer accounts, or to credit/debit cards, a banking license is a prerequisite. In addition, the rules of Law on Funds Transfers, Electronic Payment Instruments and Payment System must be considered. *Ongoing requirements* (as highlighted by the Bulgarian National Bank): Defined procedures for handling complaints and redress Compliance with money-laundering legislation (there is a lower level required in terms of intermediating unsecured fixed term loans). **POS intermediaries** *Ongoing requirements:* There are legal requirements in the Law on Consumer Credit on disclosure of fees collected by intermediaries under credit contracts. The Bulgarian National Bank also states that defined procedures for handling complaints and redress are required.
Cyprus	
Information provided by:	Ministry of Finance; internal research
Local definition	There is no legal definition of a credit intermediary.
Relevant legislation	No specific legislation at present but the Ministry of Finance is in the process of drafting new legislation on leasing. We also researched the following sources: Central Bank of Cyprus (link) Cyprus Securities and Exchange Commission (link) Cyprus Consumers Association (link) Consumers Union (link)
Czech Republic	
Information provided by:	Ministry of Industry and Trade (link); Ministry of Finance of the Czech Republic; internal research
Local definition	There is no legal definition of a credit intermediary in Czech legislation. Some legislation covers intermediation; however, this covers intermediation in trade and services in general, rather than

	specifically credit intermediation. For the purposes of legal practise, such credit intermediaries are understood to be a firm or an individual that does not provide credit itself, and is a representative of a credit provider. Association of Financial Intermediaries and Financial Advisers of the Czech Republic (AFZIZ) identifies two groups of intermediaries. (1) Entities operating on the market that combine consulting with an offer of financial products for which remuneration is paid in the form of brokerage fee (commission) for intermediated products. These intermediaries are non-exclusive, or untied. In this case the client makes no direct payment to the intermediary. (2) There are also exclusive (tied) representatives who are either subsidiaries of a financial institution or a direct sales network with direct contractual links to a financial institution.
Relevant legislation	Commercial Code (link); Trades Licensing Act (link); Consumer Protection Act (link); Consumer Credit Act The new EU Consumer Credit Directive creates new duties for intermediaries in consumer protection. Competency standards for credit intermediaries are expected to be introduced in the next five years.
Description	**General** There is no particular institution which supervises activities of credit intermediaries. In general, credit intermediaries are supervised by the Trade Licensing Authorities, because their activity is considered to be a "reportable independent trade" (according to Act No. 455/1991 Coll., The Trade Licensing Act, as amended) in the Czech Republic. The Commercial Code (Act No. 513/1991 Coll., §642–651) regulates the agreement between the intermediary and the consumer. **Entry requirements** According to the Trade Licensing Act (Act No. 455/1991) "Intermediation in trade and services" falls into the category of unqualified trade (listed in Appendix 4). As an independent trade, intermediation of trade and services does not require proof of any professional or other qualification (§25). General conditions for acquiring an intermediation licence apply. These are: - the individual applying for the licence must be 18 years old and above; - has the capacity for carrying out legal acts; and - has no criminal convictions (CRB check required). **Ongoing requirements** An intermediary is obliged to work towards conclusion of a contract between the consumer and a third party. S/he is obliged to notify the consumer about all important details that may influence the consumer's decision to conclude a contract with the third party.

	As highlighted by the Ministry of Finance, credit intermediaries must comply with advertising and marketing standards, have defined procedures for handling complaints and redress and comply with money-laundering legislation. Credit intermediaries must inform the consumer of the full cost that the consumer will bear prior to signature of a credit agreement. If the intermediaries do not inform customers about the final costs of credit in advance, they may be penalised under the Consumer Credit Act. Credit intermediaries have an obligation to include the APRC in the contract and the APRC has to be mentioned in any advertisement. For other types of credit there is no obligation regarding information on costs (Act No. 321/2001, the Consumer Credit Act) There is no specific out-of-court redress mechanism. **Self-regulation** The Association of Financial Intermediaries and Financial Advisers of the Czech Republic (AFIZ - link) adheres to an Ethical Code (link). The Code requires intermediaries to: - act honestly and in accordance with the principles of fair competition - use only true information in advertising their services - disclose all the material information - not offer benefits they cannot guarantee - provide clear and comprehensible, accurate, honest and timely information to their clients, to make it easily understandable and to communicate the key facts and issues - give their clients enough time to process and evaluate the received information and to make a decision without duress - be polite and open to all clients, following the principle of equal and fair treatment Any breaches of this code are a subject to a disciplinary action. Sanctions may range between: - a written warning - a penalty - a suspension of membership - exclusion from the Association - a public release of information about the disciplinary measure. The Association of Mortgage Brokers (link) has a Code of Conduct, which includes requirements for intermediaries to find

	optimal solutions for their clients and provide them with objective information. The Czech Leasing and Financial Association (link) follows the Code of Ethics of the Financial Market and the Code of Conduct, which requires adherence to the law and commitment to direct and honest activities. The Czech Banking Association has the Code of Conduct in Relations between Banks and Clients and the Code of Ethics of the Financial Markets; however, they only deal with general bank services. Only the Code of Conduct on Home Loans (link) specifically mentions credit intermediaries. This code requires that information provided to the client by the lender should include, where applicable, the identification and address of the intermediary and any related intermediary costs.
Denmark	
Information provided by:	Danish FSA (FSA link); Danish Consumer Council; Internal research
Local definition	According to the Danish National Bank (link), a credit intermediary is a company or a person who offers to arrange for a consumer the provision of credit or the letting of goods in return for a commission from the provider of the credit.
Relevant legislation	Marketing Practices Act 2005 (link); Sale of Goods Act; the Consumer Contracts Act; the Act on Consumer Complaints (link); the Credit Agreements Act (link); and the Act on Legal Counselling (link)
Description	**General** The main aim of these Acts is the protection of consumers. These Acts apply to credit providers and to credit intermediaries, and form an extensive consumer protection scheme, which consists of mandatory legislation in favour of the consumer. A Consumer Ombudsman was introduced to supervise compliance with the Marketing Practices Act. **Ongoing requirements** When products are offered to be purchased on credit, credit intermediaries are required to inform the consumer of the exact credit amount and all the costs involved: the total and the repayments, the interest (annual percentage rate) and any other incurring costs. When the consumer is choosing the credit option for purchase, s/he needs to be informed about the difference between the credit costs and the cash price. If there is a possibility that the amount of credit interest, repayments, repayment schedule or other terms and conditions should change during the period of credit agreement, this information should be disclosed to the consumer before s/he enters the agreement, and it should be made clear beforehand under which conditions the terms of the agreement would be altered. A fee may be payable for a specific service linked to the purchase of a product or service; no fees are payable directly to the intermediary for an independent service. If the consumer is entitled to end the agreement this must be clearly expressed, including the conditions for the termination

<table>
<tr><td></td><td>of the agreement.

Penalties

The consumer is entitled to complain to the Danish Consumer Complaints board about an intermediary's actions. If a decision (not legally binding) is not complied with by a business, the case may be brought before the civil courts and the consumer may receive legal aid. In special circumstances a decision may also be brought to court by the Danish Consumer Council.

"Firmatjek" (link) is a web-based listing of businesses that have not complied with Consumer Complaints Board decisions (after the final judgement if the case is brought to court).</td></tr>
<tr><td colspan="2">Estonia</td></tr>
<tr><td>Local definition</td><td>There is no explicit definition of a "credit intermediary" in Estonian legislation.

However, the general description of credit intermediary is stated in paragraph 403(1) of the Law of Obligations Act. According to this paragraph the credit broker is a person who undertakes to arrange, for a charge, for credit to be granted to consumers in the course of the economic or professional activities of the credit broker, or to indicate the possibility to enter into a credit contract (a credit brokerage contract).</td></tr>
<tr><td>Relevant legislation</td><td>Law of Obligations Act (link)</td></tr>
<tr><td>Description</td><td>Credit intermediaries do not require permission or a licence to operate and are not supervised by the Estonian FSA. The task is divided between the Ministry of Justice, Ministry of Economics and Communications and the Ministry of Finance.

Requirements

Every credit intermediary, when granting consumer credit or mortgage credit (i.e. not applicable to business finance intermediation), must in principle follow the relevant provisions on credit contracts stated in paragraphs 402 to 421 of the Law of Obligations Act:

Disclosure of information and all costs

A declaration of intent signed by a consumer shall set out the following:

- the credit to be paid (net amount of credit) or the upper credit limit;

- the gross amount of all payments to be made by the consumer in order to repay the credit and to pay interest and other costs (gross amount of credit) and, in the case of a credit contract with variable terms and conditions, the gross amount of all payments calculated on the basis of the initial terms and conditions upon entry into the contract;

- the conditions for repayment of the credit, particularly the number of instalments the consumer must pay, interest and costs, the size of the instalments and the terms or due dates of the payments;</td></tr>
</table>

- the annual interest rate;
- other expenses relating to the credit contract, including credit brokerage charges which are to be borne by the consumer and, if the amount of these charges is not known, the basis for calculation of these charges;
- the annual percentage rate;
- the payments and costs arising from an insurance contract to be entered into in connection with the credit contract;
- in the case of early repayment of the credit, the right of the consumer not to pay the interest for the period during which the credit is not used and not to bear other expenses relating to the credit for that period;
- the conditions for termination of the credit contract, including the right of the consumer to withdraw and the procedure and term for the exercise of such right;
- the security required from the consumer.

A consumer credit contract is void upon failure to comply with the requirements

In addition to ensuring the credit contract meets all the above requirements, credit brokers must meet the following requirements for their credit brokerage contract:

- A credit brokerage contract shall be entered into in writing.
- The commission of a credit broker as a percentage of the net amount or net price of the credit shall be set out in the contract.
- If the credit broker also agrees on commission with a creditor, this shall be indicated in the contract.
- A credit brokerage contract and a credit application shall not be contained in one document.
- A credit broker shall issue a copy of a contract to the consumer.

Commission payable to credit brokers

A consumer shall pay commission to a credit broker only if the consumer is granted credit as a result of the activities of the broker and the consumer can no longer withdraw from the credit contract.

If credit is taken for the early payment of other credit with the knowledge of the credit broker, the credit broker has the right to receive commission only if the annual percentage rate or the initial annual percentage rate does not increase. Upon calculation of the annual percentage rate or the initial annual percentage rate for repayable credit, the possible brokerage costs for the repayable credit shall not be taken into account.

With respect to services related to the arrangement of credit for a consumer or the provision of information, a credit broker shall not claim anything other than the commission specified above and, and with the agreement of the

	consumer, reimbursement of the necessary expenses incurred by the credit broker.
Finland	
Information provided by:	Bank of Finland; Internal research
Local definition	Credit intermediaries are not explicitly mentioned in any law or regulation concerning credit institutions. The Finnish Financial Supervision Authority acknowledges their existence but no formal definition of their place in the Finnish financial system can be found.
Relevant legislation	There is no specific regulation of credit intermediaries but certain rules (including money laundering regulations and know-your-customer requirements) recognise the role of the third party. Information (not law) found on Finnish FSA website (link)
Description	**General supervision** (provided by the FSA) A credit institution can offer some services though an agent (intermediary), who will not need a license. A public register of these intermediaries has to be kept. The FSA has noticed that an increasing number of organizations under its surveillance use agents or representatives to market their services. These agents will be considered as part of the organization itself and will be subjected to same set of regulations. The organization is responsible for any information given to customers by the agent, and it will be held liable for any claims for damage compensation. **Restrictions** Such an intermediary can be tied to only one credit institution at a time. An agent is only allowed to present its services and make offers, but can not make contracts in the name of its principal. **Requirements** The Credit Institution Law, supervised by the FSA, states that the customer must be informed of all relevant information relating to credit deals from the marketing of credit institutions. The FSA recommends that it be stated clearly in the marketing material who is offering the service. The intermediary also has to be clear about whom he represents. **Self-regulation** Beyond the supervision of the FSA, the Finnish Consumer Agency (link) and the Federation of Finnish Financial Services have gathered a checklist for issuers of consumer credit within the retail sector (POS intermediaries). - The customer should be free to make an independent choice about the payment method. - The characteristics of all available credits types should be presented clearly, without hurry. - The cost of the credit should be clearly explained.

	- The contract should be read and understood by the customer. - The ability of the customer to repay the loan should be confirmed with him/her. - The customer should be told who the actual credit provider is and who to contact if any problem arises.
France	
Information provided by:	Association Française des Sociétés Financières
Local definition	The equivalent in French law of credit intermediaries are intermediaries in banking operations (Intermédiaires en operations bancaires) which are defined as any person who, on the basis of their usual profession, acts as an intermediary between parties that are interested in concluding a banking operation without any *del credere* guarantee. An intermediary in banking operations or IOB is a natural person or legal entity mandated by banks or credit agencies. IOBs complete daily documentation to be submitted to authorised banks for restructuring or credit acquisition. They report on any outstanding debt the customer may have. (link)
Relevant legislation	Relevant regulations are contained under Intermediaries in Banking Operations: Articles L. 519-1 et seq. of the Monetary and Financial Code (link) and Articles L. 313-11, L. 321-1, L. 322-1 et seq. of the Consumer Code (link)
Description	**Entry requirements** The intermediary must hold a mandate issued by the lender. This mandate mentions the nature of the operations the intermediary is authorised to carry out, and the conditions attached thereto. **Ongoing requirements** Any intermediary in banking operations who, even on an occasional basis, has funds entrusted to him in his capacity as authorised agent of the parties, is obliged at any time to provide proof of a financial guarantee specifically earmarked for the reimbursement of these funds. This guarantee can only result from a commitment to security made by an authorised credit institution, an insurance company or a capitalisation governed by the Insurance Code. An IOB may make offers for its services by letter or prospectus, providing that the name and address of the credit institution which has issued a warrant are included on these documents. *Remuneration* The intermediary is not allowed to be remunerated as a function of the credit rate granted. *Advertising and information disclosure* Some information must appear in the advertisements disseminated on behalf of the intermediaries. In particular, mention

	must be made of the fact that it is forbidden to receive remuneration from the borrower before a loan is obtained, and the name of the lenders on behalf of whom the intermediary is acting must be indicated. **Restrictions** Intermediaries cannot receive remuneration from the borrower before the loan is finalised. It is exclusively up to the lender to accept or decline a loan. It is unlawful for any person or entity that provides assistance in any capacity or in any manner whatsoever, directly or indirectly, to obtain or provide a loan, collect provisions, commissions, costs of research or files before the payment of lent funds and before the registration of the transaction (through written notice), a copy of which must be delivered to the borrower. An IOB is also prohibited, before handing over the funds and a copy of the notice, to present acceptance of the borrower's bills of exchange, or to write receipts in order to recover intermediary costs or commission. Furthermore, it is unlawful for any person: - to engage in solicitation; - to collect deposits of public funds; - to advise on the subscription in shares of real estate companies.
Germany	
Information provided by:	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)
Local definition	Credit intermediaries do not conduct lending business within the meaning of the German Banking Act (*Kreditwesengesetz* – KWG). They do not grant credits themselves, but enter into contracts on behalf of third parties. Credit intermediation does not constitute banking or financial services business within the meaning of the Banking Act. The KWG (KreditWesenGesetz) addresses 'Finanzdienstleistungsinstitute' . These are institutions or businesses that provide financial services for others by means of profit-generation or commercial operations but are not credit institutions themselves. (Link) 'Finanzdienstleistungsinstitute' offer the following services, among others, that could be connected to the services credit intermediaries offer: - Providing personal recommendations concerning commercial operations with certain finance instruments, to consumers or their representatives (only if recommendation is based on examination of personal circumstances of the consumer). - Management of finance instruments for third parties.

Relevant legislation	German Banking Act (*Kreditwesengesetz* – KWG) (link) Law on credit mediation according to the BGB (BuergerGesetzBuch) (link) There are no other specific plans to include credit intermediaries in banking supervision.
Description	Credit intermediaries are not subject to supervision by BaFin **Entry requirements** Intermediaries require: - licence obligation (§ 32 KWG) - "EU-Pass" (§ 24a KWG) - Start-up capital of €125,000 (§ 33.1.1 KWG) - minimum of two general managers - strict regulations on annual financial statements **Ongoing requirements** Ongoing requirements all come under the BGB (BuergerGesetzBuch) law. *Credit mediation contract* The 'credit mediation contract' has to appear in a written form. The mediating institution has to indicate the commission, as a percentage charged of the provided credit, in the contract. Where the intermediary has an agreed commission with the credit institution, this commission has to be stated on the contract in the form of a percentage as well. If the above regulations are not followed, the contract is not valid. *Commission* The end-user is only obliged to pay the commission charged by the intermediary if the credit agreement, mediated by the intermediary, is provided to him. If the 'consumer-credit contract' serves the purpose of conversion of debts the mediating institution can charge consumers only if the annual percentage rate does not increase. This does not include possible charges of mediation services of finding a new loan. *Charges outside the commission*

	The credit intermediary cannot agree upon charges for services, such as the mediation of credits or related subjects, other than the commissions described above. However they are allowed to charge the customer for separate expenses.
Additional specific information	The Law on mediation of contracts on a commercial scale as a form of business states that anyone who wants to contract on a commercial scale on mortgages, properties, premises or credit loans is obliged to obtain a legal permission from the responsible (local) authorities (§ 34 c GewerbeOrdnung (GewO) - link). Permission will be denied in the case of: - A criminal conviction of the applicant in the last five years - The applicant has debts - If the authority has doubts about credibility or imminent risk for public security.
Greece	
Information provided by:	Bank of Greece and internal research
Local definition	There is no formal definition of credit intermediaries in Greece.
Relevant legislation	Bank of Greece website information (link); Governor's Act (link); Laws 2076/1992 and 3606/2007 (which permit the appointment of brokers by banks and Investment Services Providing Companies); Banking Code of Conduct 2600/2007
Description	**General regulation** The Bank of Greece regulates the credit institutions (and companies providing credit) in Greece and determines rules for the sufficient provision of information to borrowers regarding the terms of the provided banking products and services (Governor's Act Number 2501/31.10.2002 - ΠΔ/ΤΕ 2501/2002). Credit institutions and companies providing credit are responsible for the compliance of credit intermediaries and connected representatives with the following provisions/rules – this is done through cooperation contracts between the credit intermediaries/companies providing credit and credit intermediaries/connected representatives. Bank of Greece can be considered as the supervising body of credit intermediaries only indirectly. **Permissible tasks for intermediaries** According to the Banking Code of Conduct 2600/2007, credit intermediaries in Greece can: - inform the public about the products of credit institutions and/or companies providing credit - inform/warn debtors for the repayment of their liabilities towards credit institutions and companies providing credit - it is permitted in certain circumstances, depending on the nature of the transaction, for the broker to also receive a

	fee from the Client. Credit intermediaries cannot: - accept deposits; - provide loans or credit directly; - assume any obligation, sign any document and receive or accept any means of payment on behalf of a credit institution or company providing credit; - conduct credit-worthiness checks on clients; - the broker is not permitted to sign any document or undertake any obligation on behalf of the Principal or to accept payment from the Client on the Principal's behalf. **Entry and ongoing requirements** A broker must be registered with the Register of Finance Representatives maintained with the Bank of Greece and comply with the Banking Code of Conduct. This Code states that: - the broker must have a registered office and telephone land line connection - the broker must be registered for tax purposes and issue invoices and receipts for agreed fees - a written agency contract must be entered into between the broker and the Principal (bank or other investment service provider) - the broker may act as a liaison between the Principal and the Client by communication or forwarding the Client's instructions to the Principal - the broker may advertise the investment opportunities and services offered by the Principal to potential clients. Specifically regarding those credit intermediaries who inform/warn debtors about the repayment of their liabilities towards credit institutions, they are not allowed to receive money on behalf of credit institutions unless they have special permission from the Bank of Greece to do so. In such a case, they have to inform the borrower, in a manner that does not disturb the trust between the credit providers and credit receivers. In addition, they should comply with the provisions for the protection from illegal processing of private data, the adherence of banking confidentiality as well as the banking transactions obligations (e.g. provision of sufficient and correct information, seemly conduct, avoidance of repeated calls with disturbing and improper tone at inappropriate time, etc). There is no requirement for a special qualification to become credit intermediary. The way a person or a company can become a credit intermediary is dependent on the credit institution/company providing credit. For example, if a bank thinks

	that an applicant satisfies the profile of a credit intermediary then that is a good enough reason for assigning the applicant a credit intermediary status. After entering into a contract with the credit intermediary, the credit institution/company supplying credit simply has to inform the Bank of Greece so that the latter includes the details of the credit intermediary in the registry of credit intermediaries (link). Once an intermediary's name is published on that list it effectively has formally been recognised as a credit intermediary.
Additional specific information	Greek legislation distinguishes credit intermediaries from "connected representatives". Connected representatives need to be listed on the Bank of Greece's registry. According to Governor's Act number 2600/28.11.2007, and contrary to credit intermediaries, listing connected representatives on the Bank of Greece's registry requires that these representatives have relevant qualifications as determined by Article §14 of Law 3606/2007. According to the abovementioned law, connected representatives can: - Advertise investment services which can be offered by credit institutions - Receive and convey customer investment instructions - Mediate for the placement of financial assets - Advise customers in relation to the services supplied by the credit institution Connected representatives are not allowed to possess money or financial assets on behalf of a credit institution.
Hungary	
Information provided by:	Internal research
Local definition	Pursuant to Act No. CXII of 1996 on Credit Institutions and Financial Enterprises ("CIFE Act"): 12, b) 'Intermediation of financial services' refers to activities pursued in order to facilitate a financial institution's financial services without any involvement in handling the customer's money or assets, and in the course of which no commitments are made on the financial institution's behalf. According to the Hungarian FSA (Pénzügyi Szervezetek Állami Felügyelete or PSZAF - link), there are two kinds of intermediary: - Type "a" who works on behalf of a financial institution, meaning that the responsibility and risks remain with the financial institution. This intermediary type is also authorised to make a contract with the borrower as it is described in his commission contract with the financial institution. Type "a" agent activity can be practised by non-financial organisations that are legal entities e.g. a limited company. - Type "b" who only helps the credit business to be realised, and cannot handle money. This intermediary cannot take risk or offer guarantees independently on behalf of the financial institution. Type "b" agent activity can be practised

	by other non-financial business forms such as a self employed person.
Relevant legislation	Credit Institutions and Financial Enterprises Act (English link); (Hungarian link) The cross-sectoral harmonisation of the rules applying to financial agents is under consideration.
Description	**General** The PSZAF authorises the creditor to use intermediaries on the condition that the financial institution ensures the intermediary abides by the laws and regulations that apply to financial services activities. In this respect the creditor is responsible for monitoring their intermediary's activities, and is liable for the latter's activities, regardless of whether they are a type "a" or type "b" intermediary. When dealing with complaints, the PSZAF will apply measures against the financial institution. **Entry requirements** (link) For type "a" intermediary activity both the agent and the financial institution needs to be licensed by PSZAF. Licence applications must include the following: - Proof of business form, not older than 30 days - Receipt of €110 service fee (12/2002. (II. 20.) PM) - Proof of compliance with anti-laundering regulation as described by PSZAF - Proof that the personal and material conditions are met. The credit company needs to submit the contract that has been made between the institution and the intermediary to the PSZAF The contract needs to contain the condition that the PSZAF can check the agents' activities and financial documents without restrictions. Type “b” intermediaries do not need a licence, but need to be registered by their financial institution with the PSZAF, within two days of the contract being signed between the agent and the institution. (Paragraph 9, Section 3 of the CIFE Act). **Ongoing Requirements highlighted by our respondent** Intermediaries are required to fully disclose to potential borrowers their ties to lenders, including any fee arrangements they may have with the lenders. They are also required to explain the risks and/or other key data to potential borrowers, and present key data in a standardised form. Intermediaries are also obliged to assess the suitability of a product to the borrower. *Compliance with advertising and marketing standards* Since the modification of the law regarding credit institutions (Hitelintezeti torveny 01/07/2005), the advertising agent needs to state the financial institution's name and products that he is agent of. Otherwise he commits an infringement.

	Compliance with money-laundering legislation Type "b" agents do not need have proof of compliance with PSZAF authorised anti-laundering regulation. The financial institution can check on their agents without restriction since it is the institution that is liable and takes the risks. **Restrictions** Type "b" intermediaries cannot take independent responsibility for the financial institution's risk, or offer guarantees independently on behalf of the financial institution. They also cannot handle money. Neither type of intermediary can employ or otherwise use a contractor.
Ireland	
Information provided by:	Irish Financial Services Regulatory Authority (link); National Consumer Agency (link)
Local Definition	"Credit intermediary" means a person, other than a credit institution or a mortgage lender, who in the course of his business arranges or offers to arrange for a consumer the provision of credit or the letting of goods in return for a commission, payment or consideration of any kind from the provider of the credit or the owner. "Mortgage intermediary" means a person (other than a mortgage lender or credit institution) who, in return for commission or some other form of consideration (a) arranges, or offers to arrange, for a mortgage lender to provide a consumer with a housing loan, or (b) introduces a consumer to an intermediary who arranges, or offers to arrange, for a mortgage lender to provide the consumer with such a loan. This definition is designed to capture both mortgage intermediaries and mortgage introducers.
Relevant legislation	Consumer Credit Act 1995 (link); Consumer Protection Act 2007 (link); Central Bank and Financial Services Authority of Ireland Act 2003 (link)
Description	**General** Intermediaries are regulated by the Financial regulator by: - site visits - monitoring their advertisements - complaints from consumers or their competitors and - through an agreement that is in place between the Financial Regulator and the Finance Houses that commission is not paid to any intermediary that is not properly authorised.

	Entry requirements A person shall not engage in the business of being a credit intermediary unless he is the holder of an authorisation granted for that purpose by the Financial Regulator, and holds a letter of appointment in writing from each undertaking for which he is an intermediary. An application to become authorised must include the following: - the true name of the applicant, - the name under which the applicant trades, - the name of any undertaking for which the applicant acts or intends to act as a credit intermediary, - the address of any business premises of the applicant to which the application relates, and - such other information that the Director may require. An authorisation is valid for 12 months from the date specified on the authorisation. A holder of an authorisation shall only engage in the business of being a credit intermediary in the name specified in the holder's authorisation. *Other requirements highlighted by IFSA* - Minimum standards/qualifications needed to begin acting as an intermediary (not specified in legislation) **Refusal of authorisation** The Financial Regulator may refuse an authorisation of an applicant on a number of grounds, mainly for failure to supply the appropriate documentation, or if they hold certain licences (money lending, gaming, publican or pawn broking). Other grounds include the failure of the applicant to provide a current Revenue tax clearance certificate in respect of himself or his business; or in the opinion of the Financial Regulator they are not fit and proper to hold an authorisation. **Ongoing requirements** *Requirement to explain risks and/or other key data to potential borrower* Before any agreement relating to the provision of credit is entered into by the customer, the intermediary must make clear - the nature of the financial accommodation - who has the property rights of the goods during the agreement. *Full disclosure of fee arrangement with lenders* The intermediary must make clear to the customer if they receive a commission, payment or consideration of any kind from

	an undertaking (lender) for arranging any such financial accommodation between the consumer and the lender. *Disclosure to potential borrowers of ties to lenders* Before the conclusion of any agreement the intermediary must make clear to the customer the name of any lender for which the seller acts as a credit intermediary. *Standardised presentation of key data to borrowers* Credit intermediaries are obliged to inform consumers of the full cost that the consumer will bear prior to signature of a credit agreement. This includes the amount, number and frequency of payments and, where applicable, the APRC (Section 148 Consumer Credit Act). The IFSA also stated that intermediaries are required to assess the suitability of products to the borrower. They must also comply with money-laundering legislation and advertising and marketing standards, and define procedures for handling complaints and redress. **Restrictions** It is not permissible to pay a credit intermediary a direct fee or commission. Any commission must come from the lender. **Self regulation** The Society of the Motor Industry have a limited code of conduct.
Additional specific information	A separate, although similar, authorisation is required for **mortgage intermediaries**. This application to become authorised must also include: - Tax Clearance Certificate - Letters of Appointment - Certificate of Incorporation or business name (where appropriate) A separate definition for a tied mortgage intermediary is given in the Consumer Credit Act 1995, along with certain requirements and restrictions: An agent who enters into a written agreement with a mortgage lender (a “contracting mortgage lender”) under which: (a) the agent undertakes that in the course of his business he - will not arrange or offer to arrange or be involved in the provision of a housing loan by a mortgage lender other than the contracting mortgage lender - will not permit any premises which he uses in the course of arranging or offering to arrange the provision of housing loans to be so used for the purposes of arranging or offering to arrange the provision of a housing loan by a

	mortgage lender other than the contracting mortgage lender - will state on his letter headings and business forms which are used for the purposes of arranging or offering to arrange the provision of a housing loan by the contracting mortgage lender that he acts solely on behalf of the contracting mortgage lender - will not deal with any housing loans that are referred to him by a mortgage intermediary (b) the contracting mortgage lender is responsible for any act or omission of the agent in respect of any matter pertaining to a housing loan offered or made by the contracting mortgage lender, as if the agent was an employee of the contracting mortgage lender (c) the name of the contracting mortgage lender is conspicuously displayed (both externally and internally) on any premises used by the agent for the purposes of arranging or offering to arrange the provision of a housing loan by the contracting mortgage lender. *Inspections* On-site inspections only apply to mortgage intermediaries (see the Protocol for Inspections link). These typically take 3 days, depending on the size of the firm and the issues arising. During the inspection the regulator will review all relevant documents, as well as client files.
Italy	
Information provided by:	Ministry of the Economy and Finance; internal research
Local definition	The Italian legislation makes a distinction between two professional figures: (a) Credit brokers, ("mediatori creditizi"), who are independent and do not act in the interest of either party (b) Financial agents ("agenti in attivita' finanziaria") that operate in the interest of one or more credit providers.
Relevant legislation	Various consumer credit and financial services laws, found on the Bank of Italy site (link). These include: Comunicato della Banca d'Italia published on GU n.211, 9/9/2002 Comunicato della Banca d'Italia published on GU n.11 del 14/1/2006 D.P.R. 28/7/2000, n. 287 Comunicato della Banca d'Italia published on GU n.211, 9/9/2002 Comunicato della Banca d'Italia published on GU n.11, 14/1/2006 Decreto 13/12/2001, n. 485

Description	Different legal requirements exist for both types of intermediary. Both categories of credit intermediaries are entered into a register held by Banca d'Italia. Both categories of credit intermediaries must comply with minimum education and integrity requirements. Neither category of intermediary can access credit registers or undertake credit checks on behalf of the lender. ***Credit brokers*** The general activity of credit brokerage ("mediazione creditizia") is regulated by several legislations. A direct link to all relevant laws can be found on the Bank of Italy site (link). The activities of credit brokers used to be under the regulatory control of the "Ufficio Italiano Cambi" (UIC), whose functions have been taken over by the Bank of Italy since 1st January 2008. **Entry and ongoing requirements** In order to operate brokers must be registered into the register of credit brokers (Albo dei mediatori creditizi) which used to be kept by the Ufficio Italiano Cambi (UIC), now belonging to the Bank of Italy. Minimum requirements are needed to begin acting as a credit broker, i.e. for individual persons it is sufficient to: - Be an Italian or EU citizen, or an extra-communitarian citizen if there exist a bilateral agreement between Italy and the country of origin; - Meet standard integrity ("onorabilità") requirements; - Be in possession of a high school diploma; - Have a domicile in Italy For legal entities the requirements are the following: - To have legal address in Italy, or (for entities with legal address abroad) to operate in Italy on a stable basis; - The shareholders should meet standard integrity ("onorabilità") requirements; - The corporate objective of the entity should include the (though not exclusively) undertaking of credit brokerage. **Penalties** The Bank of Italy may order deletion or suspension from the register if requirements are no longer met or if there have been serious violations of applicable rules. **Restrictions**

	The activity of credit broker is subject to a set of restrictions. (a) Credit brokers cannot act in the interest of either party, as their activity must be independent. (b) The legal definition of credit brokerage explicitly allows the provision of expert advice with the purpose of assisting clients in the purchase of products. (c) They cannot conclude a credit agreement, as the direct assessment of credit worthiness is under the complete control of lenders. However this does not preclude credit brokers from carrying out activities that facilitate lenders in assessing credit risk, such as collecting documents and assisting borrowers in filling credit applications. (d) They are not entitled to undertake any money handling activity, such as providing clients with the access to credit, or collecting borrowers' payment on behalf of the lender. **Transparency requirements** Credit brokers must comply with the legislation specifically designed to ensure transparency of the contract conditions, and to avoid the communication of misleading information. More specifically, and in relation to the activity of credit brokers, the following apply: (a) Brokers are allowed to undertake advertising activities, e.g. by communicating the main characteristics of a typical credit agreement that they intermediate. However, since credit brokers must be independent, any marketing activity must be intended as one initiated independently by the broker with the only purpose to attract consumers. (b) Any characteristic of the credit product advertised that implies a cost for the consumer must be clearly stated. These include for instance: - The interest rate and repayment plan; - Legal fees that are automatically implied by the purchase of some credit products (e.g. notaries fees in the case of residential mortgages); - The cost of additional products (e.g. credit insurance) that are necessarily tied to the product advertised; - Intermediation charges. (c) Advertising messages should not include words such as "Bank", "Credit Institution", or other terms that might induce consumers to believe that the broker is entitled to provide credit on its own. (D.Lgs. No. 385/1993) (d) Any contract proposed must allow clients to clearly identify the lender providing credit. The same transparency requirements apply to lenders and, moreover, in order to avoid a shift of regulatory burden from lenders to intermediaries', lenders have also the responsibility to ensure the brokers' compliance with the requirements.

	Financial Agents The general activity of financial agency ("agenzia in attivita' finanziaria") is regulated by several laws. A direct link to all relevant laws can be found on the Bank of Italy site (link). **Entry requirements** The minimum requirements needed to act as a financial agent are essentially the same as those that apply to credit brokers. The only significant difference is that, for legal entities, the corporate objective should be that of undertaking *exclusively* financial agency activities. **Restrictions** As opposed to credit brokers, financial agents are not independent as they act mainly in the interest of lenders. As a consequence of this: - They can have specific agreements with lenders with the purpose of promoting specific products; - They can operate through exclusive relationship with a single lender (i.e. they can be single-tied). However the following restrictions apply: - They can operate only though agency contracts that are set by the lenders and are not modifiable - The intermediation activity of the agent is limited to a set of standardised products (which is explicitly stated in the terms of the agency contract) - They cannot conclude any credit agreement, as the direct assessment of credit worthiness is under the complete control of lenders. Again, this does not preclude credit brokers from carrying out activities that facilitate lenders in assessing credit risk, such as collecting documents and assisting borrowers in filling credit applications. The activity of financial agency includes also the possibility of intermediation at point-of-sale. Indeed the regulation allows the possibility for lenders to use agents that are typically involved in commercial (i.e. non-financial) activities like shops, and retailers. However the point-of-sale intermediation must be limited to debit cards and pre-paid cards. **Transparency requirements** In terms of transparency advertising requirements, financial agents are subject to regulations similar to those that apply to credit brokers, i.e. (a) Any characteristic of the credit product advertised that imply a cost for the consumer must be clearly stated. These include, for instance: - The interest, and repayment plan; - Legal fees that are automatically implied by the purchase of some credit products (e.g. notary fees in the

	case of residential mortgages); - The cost of additional products (e.g. credit insurance) that are necessarily tied to the product advertised; - Intermediation charges. (b) Any contract proposed must allow clients to clearly identify the lender providing credit. However, as opposed to credit brokers, and as result of the tied nature of their activity, agents can carry out explicit promotional activities. As for the case of credit brokers, lenders also have a responsibility to ensure the agents' compliance with the requirements. **Penalties applying to both types** The Minister of Economy and Finance, acting on a prior proposal of the Bank of Italy, may order deletion or suspension from the register if requirements are not met or if there have been serious violations of applicable rules.
Latvia	
Information provided by:	The Financial and Capital Market Commission; internal research
Local definition	The Law of Commerce refers to the term broker, which is defined as a business institution that performs an intermediary agency transaction for third parties, without being involved in contractual commitment with any of these parties. However this definition applies to any intermediary activity and it does not specifically relate to credit provision.
Relevant legislation	The activities of credit institutions in Latvia, including foundation, maintenance, reorganization and dissolution of an institution, are regulated by the Law of Credit Institutions, the Law of Financial Instruments Market (link) and the Law of Commerce. However, none of these laws refer explicitly to credit intermediaries.
Description	After the implementation of the Consumer Credit Directive, the activities of credit intermediaries will be more clearly regulated. The changes in the legislation of Latvia according to the Consumer Credit Directive should be implemented by the 1st of January 2010.
Lithuania	
Information provided by	Ministry of Finance; internal research
Local definition	There are no legal acts regulating the activities of credit intermediaries.
Relevant legislation	At present there are no legal acts regulating intermediaries' actions. It is stated that after the implementation of the Consumer Credit directive intermediaries' activities will be regulated more effectively. Particular attention will be paid to requirements about information provision to consumers.
Description	In February 2006 new contributions to the law were made to create regulations for intermediaries. Contribution Number 19

	"Creditors and intermediaries activities regulation" and contribution Number 20 "Intermediaries obligations" state that intermediaries should be controlled by the two parties using them, but do not explain how this should be done; this is left for the lender and customer to decide. (link)
Additional specific information	In February 2008 the Lithuanian Real Estate Association together with colleagues from the European Union CEREAN organisation (Central European Real Estate Associations Network) decided that free intermediaries' activities will have to be regulated legally. It is stated that Lithuania's real estate intermediaries are still not working under regulations, and there is no system to measure the performance of organisations. Currently any firm/individual is able to become a mortgage or consumer credit broker. Actions should be taken to regulate the educational background of intermediaries and restrict the opening of new broker agencies around the country without specific permission. (link)
Luxembourg	
Information provided by:	Commission De Surveillance Du Secteur Financier (link)
Definitions and regulation	There is no regulation of credit intermediaries by the CSSF.
Malta	
Information provided by:	Malta Financial Services Authority (link); internal research
Local definition	The term "Credit Intermediary" is included in Maltese legislation. It is usually understood to refer to persons who intermediate and offer their services to customers wishing to access credit facilities (usually with a credit institution). The intermediary would not be itself a supplier of credit. Credit intermediaries are a subset of Money Brokers, for which there are specific regulations. Money broking covers the activity of introducing counterparties utilising wholesale and retail financial products. This is an intermediary/agency/introducer function through which an institution undertaking such activities brings together principals who wish to deal at mutually agreed terms for the same financial products.
Relevant legislation	Financial Institutions Act (Cap 376); Financial Institutions Directives 1 and 2; Policy Document on the Regulatory Provisions for the undertaking of money broking activities (link)
Description	**General** Credit intermediation is encompassed in the Money Broking Policy Document FI/PD/09 - on the regulatory provision for the undertaking of money broking activities by an institution authorised under the Financial Institutions Act (Cap 376). This policy document sets out what constitutes money broking activities; what the appropriate prerequisites are for undertaking this; and specifies the standards and controls that licensed institutions should adopt.

Following from this there are two local directives (link 1); (link 2) which are applicable to such institutions for regulatory and supervisory purposes. Accordingly these Financial Institutions Directives cover issues such as licensing and on-going regulatory/prudential requirements.

Entry and Ongoing requirements

Licensed intermediaries are required to inform their customers about all of the costs involved prior to signing a credit agreement. This requirement is one of the conditions set out as part of their licence.

Credit intermediaries are subject to a monthly reporting requirement as well as periodic on-site supervision exercises as may be required.

Minimum standards/qualifications needed to begin acting as an intermediary

Institutions carrying out money broking activities must be specialised in their knowledge of relevant financial products and are expected to be fully conversant and aware of the sources of supply and demand, and terms and conditions related to such products, and relevant market information.

Set standard of management ("fit and proper" test)

The persons employed with licensed institutions that deal in money broking activities must be fit and proper to conduct this activity. In general terms, the fit and proper test includes the following criteria: integrity, competence, experience, qualifications and the requirement to be financially sound. All criteria must be met. Such persons must have the requisite experience and competence and must also be conversant with the various financial products involved.

Minimum capital adequacy to act as an intermediary

The Competent Authority will only authorise an institution to carry out money broking activities if, besides other licensing criteria, the institution has a sufficient capital base. An adequate capital base would allow the institution to meet its running expenses and also to continue operating for a reasonable time in the event that business volume drops significantly.

Any deposits accepted on a fiduciary or matched principal basis by a licensed institution acting as a money broker are to be placed with an appropriately licensed institution under the Banking Act 1994.

The Competent Authority expects that all licensed institutions should maintain full and updated records of segregated accounts.

The Competent Authority expects a licensed institution carrying out money broking to ensure that:

- employees who commit the institution to a transaction have the necessary authority to do so, and, moreover, they must ensure that at no time should they mislead counterparties about the institution's limited role;
- employees are adequately trained in the practices of the markets in which they transact, and are aware of their own and the institution's responsibilities;

	- employees understand the products in which they are appointed to deal; material facts to transactions are disclosed to interested parties prior to a deal being effected, except where such disclosure would constitute confidential information about the activities of another form or counterparty; - employees comply with any other regulatory requirements that may be applicable or relevant to the institution's activities. *Other requirements highlighted by the MFSA* - Credit intermediaries are required to fully disclose any fee arrangements with lenders. They must explain risks and/or other key data to potential borrowers, and present key data in a standardised manner. They must also assess the suitability of a product to the borrower. Intermediaries are required to comply with advertising and marketing standards and money-laundering legislation, and to define procedures for handling complaints and redress. **Restrictions** A licensed institution carrying out money broking transactions is entitled to receive brokerage or commission fees (except where a prior explicit agreement between the interested parties to a deal provides otherwise). A broker cannot act as a principal. In particular, this refers to the assessing of the creditworthiness of customers or counterparties; only principals (lenders) can do this. Brokers cannot pass on confidential information about the market activities of individual customers. **Tied brokers** In most cases, money brokers are seen as independent, arranging transactions. All the information above applies to these. There is a specific reference, however, to 'tied' brokers, identified as: "a licensed institution acting as an agent for connected or other undertakings, and not dealing in the capacity of a money broker on a stand alone basis." The Competent Authority expects these brokers to: - always make it absolutely clear to all concerned the capacity in which the they are acting; - declare at an early stage of negotiations the party for whom they are acting (it may be considered desirable to set out this relationship formally in writing for future reference); - ensure that all confirmations show clearly that a deal has been done on an agency basis; and - make it clear at the outset to potential counterparties that it is acting as an agent of an unregulated principal if it is the case, and must include a qualification as such in its confirmation. **POS and business leasing intermediaries**

	The MFSA's regulatory regime does not apply to these categories of intermediary.
Netherlands	
Information provided by:	Autoriteit Financiële Markten (AFM) (link)
Local definition	The Financial Services Act provides relevant definitions in § 1:1. An intermediary is the party providing mediation services. The definition of providing mediation services with regard to credit is "all activities carried out in the course of a profession or business focused on concluding, as a middleman, a contract regarding credit between a consumer and a lender or on assisting in the administration and performance of such a contract".
Relevant legislation	Financial Services Act (link)
Description	The task of the AFM is supervision of conduct. The DNB (De Nederlandsche Bank - link) maintain a database about all registered, licensed banks, insurers, financial businesses, pension funds, transaction and trust offices legally operating in the Netherlands. **Entry requirements** It is illegal to mediate a financial service without having a legal license provided by the AFM - An exception can be made for intermediaries who have been given a license from the Nederlandsche Bank (DNB) - An exception is made for an intermediary who mediates financial products without charging a commission, or for intermediaries that operate as a department of a credit institution and these are registered as such at the AFM **Ongoing requirements** The Financial Services Act states that any agreement between a lender and an intermediary must be in writing. There are a number of requirements applicable to financial services in general, including intermediaries: - The practice of a business offering a financial service of any kind must be led by an individual who is competent to do so. The financial service-provider is responsible for the professional expertise of his employees. - The management of a financial service provider must object any violation of the law to prevent any damages to the reputation of his field of expertise. - A business providing a financial service but which is not a financial institution, a credit institution or a insurance company, is obliged to operate a moderate management structure. This includes orderly and transparent financial market processes, decent relationships with other market participants, and correct treatment of clients and consumers, which means: ▪ Providing correct information to clients and consumers

	▪ Correct completion of business with clients and consumers ▪ An adviser has to give advice based on objective analysis. *Disclosure of fee arrangement with lenders* Intermediaries are not obliged to disclose the level of commission they receive from the lender. The ministry is planning to change the Financial Services Act on this point. According to statements by the Minister of Finance, commissions are to be made transparent and be limited to certain situations (comparable to MIFID). Commissions to intermediaries can only be paid in monthly instalments over the duration of the loan. In other words it is forbidden for a lender to pay one-off commission to an intermediary. The AFM also stated that standardised presentation of key data to borrowers is required. *Disclosure of contracts with lenders* An advisor or intermediary has to give information to customers about possible contracts with credit institutions. They also have to provide information about whether they are independent or not. **Restrictions** A business providing financial services cannot be connected to other individuals by means of a management structure that is non-transparent to such an extent that it interferes with business practice. A business providing financial services cannot be connected to other individuals by means of a management structure if this individual is from a non EU-member state whose rules might interfere with regulations in the Netherlands. Commissions to intermediaries can only be paid in monthly instalments over the duration of the loan. In other words, it is forbidden for a lender to pay one-off commission to an intermediary. **Self-regulation** There is a code of conduct for both consumer credit and mortgage credit. This code is meant primarily for lenders, but intermediaries are aware of the code and compliance is reasonable, according to the AFM.
Additional specific information	**POS intermediation** Intermediaries that provide credit to finance the purchase of goods are exempt from most of the Financial Services Act regulation, provided that the duration of the loan is shorter or the same as the life-expectancy of the goods financed. That means that intermediaries responsible for car sales are not always exempt (e.g. if the loan outlives the car). **For personal mortgages and pre-approved credit** *Entry Requirements*

	Entry requirements stated by AFM include minimum standards needed to begin acting as an intermediary, and a set standard of management ("fit and proper" test). Intermediaries also require a defined level of professional indemnity insurance *Ongoing Requirements* (as highlighted by AFM) Mortgage and pre-approved intermediaries are required to assess the suitability of products to borrowers, as well as to explain risks and/or other key data to potential borrowers. They must comply both with money-laundering legislation and advertising and marketing standards. They are required to have defined procedures for handling complaints and redress, and a defined level of professional indemnity insurance. (Intermediaries are only required to asses suitability if they also provide advice. Intermediaries are not required to provide information on risk, but other data has to be included in a prospectus).
Poland	
Information provided by:	Financial Services Authority; internal research
Local definition	Polish law does not have a local definition of a credit intermediary. However, the most commonly used definition in Polish business or financial literature is the one used by the European Court of Justice. The ruling of ECJ from 21st June 2007 in Case C – 453/05 Volker Ludwig v Finanzamt Luckenwalde is a point of reference for Polish intermediaries and helped to define them as firms or individuals whose activities are focused on arranging credit between a lender and a customer. They do not provide the credit themselves and are independent. (link)
Relevant legislation	There is no specific legislation concerning intermediaries.
Description	**Requirements:** According to general Polish law the only requirements for those who want to provide credit intermediary services are: being an adult and registering the company in Town Council. (link) **Restrictions:** As there is no specific law, there are also no restrictions. Intermediaries do not need a licence or registration with any of the financial authorities. There is also no controlling or supervising authority. **Self regulation** On the 19th June 2008 *Zwiazek Firm Doradztwa Finansowego* (Association of Financial Consulting Firms) was officially registered (link). It incorporates the eleven largest financial consulting and intermediation companies in the Polish market. Its priority is to create better legislation of financial services and establish common working standards. At the moment it is trying to introduce obligatory registration and licensing for all types of financial advisors (including credit intermediaries) in order to increase the quality of these services in Polish market (link).

	Code of Conduct The association has recently signed *Kanon Dobrych Praktyk Rynku Finansowego* (Code of Conduct in Financial Market - link), created as a result of cooperation between the Polish Financial Supervision Authority, associations of companies that offer financial services, associations of consumers and various experts. The main purpose of the Code is promoting and clearly stating basic values and ideals that should be respected by all financial consultants. At the same time it allows them to shape and apply these ethical standards in accordance to the market sectors they operate in. *Penalties* All companies that joined ZFDF, as well as those who agreed to sign the Code of Conduct, are required to respect it. However, as of today there are no written penalties for those who break these rules.
Portugal	
Information provided by:	Banco de Portugal; internal research
Local definition	In Portugal only the Promotores are regulated. The Promotores are individuals (not firms) tied to one unique credit institution (or group) that facilitate the access to the activities reserved to that credit institution or financial company.
Relevant legislation	There exists a law for all credit institutions and financial associations named: “Regime Geral das Instituições de Crédito e Sociedades Financeiras” Under §73 to 77 of this law, the Bank of Portugal published a Manual of Instructions (Manual de Instruções do Banco de Portugal Instrução nº 11/2001) referring to ‘promoters’ in particular. (link)
Description	**General** The Manual was published concerning the need for uniform procedures regarding contracts between credit institutions and clients, through third persons (does not apply to investment firms). **Entry requirements** None. **Ongoing requirements** All relations between agents and clients must be regulated by a written contract, where the agents must be named as ‘promoters’ and not ‘financers’ nor any other name that may cause confusion regarding the service provided. Information regarding services and limitations of these services provided to the public must be transparent: - If there is no establishment (office) open to the public, the promoter’s business card must name him/her as a promoter, indicate the institution he/she promotes, that he/she is not authorized to realize any financial operations/transactions and that he/she follows a code of conduct. - When there exists an establishment open to the public, it must be clear that the establishment is of the promoter and

	not the institution he/she promotes. The word 'promotor' must be displayed on a sign in the exterior of the establishment, with reference to the institution which he/she promotes, as well as a statement that he/she is not authorized to realize any financial operations/transactions. In the interior, a display of the following must be visible: ▪ Photograph of the promoter and respective identification ▪ Indication of activities he/she is allowed to conduct ▪ Information regarding activities he/she is prohibited to conduct, especially that of receiving/delivering payments, credits and others ▪ Indications that all operations will be conducted directly with the represented institutions, in person, via telephone or online ▪ Information that his/her activity as a promoter is regulated by a code of conduct, which must be available for consultation by the client. The contracts must state that: - the promoter cannot delegate or subcontract his/her activities - the promoter must provide the institution with all necessary information - the institution is responsible for all activities with the public, clients or potential clients, where the institution can deny the promoter - the promoter must follow all of the institution's regulations. The institution must deny the contract if the promoter has not respected established norms, which must be made public, if justified, to guarantee correct information to the public. **Restrictions** Promoters promote for a particular institution and cannot promote for other institutions, unless these are affiliated. Contracts can only be made to promote business, and no financial transactions/operations can be performed, nor can the promoter receive or deliver any payments. **Code of conduct** Institutions must create a 'code of conduct for promoters' that must be sent for approval to the Bank of Portugal. The code of conduct, once approved, must be made available for all clients, independent of the existence or not of an establishment open to the public. Institutions must communicate with the Bank of Portugal, within 30 days of signing the contract, the identification of its promoters, the area under which he/she operators and the existence or not of an establishment open to the public. Institutions that already have a network of promoters or agents must adapt to this instruction within 90 days of its

	validation. This instruction is valid on the day of publication. **POS intermediaries** These restrictions do not apply.
Romania	
Information provided by:	National Bank of Romania; National Authority for Consumers Protection
Local definition	In Romanian legislation, “credit intermediary” is defined only in relation to consumer lending. This definition and regulation is in Article 2 of Law no. 289/2004. The Law states that a credit intermediary is any natural or legal person that, in exchange of a fee, acts as an intermediary by presenting or offering credit agreements, or by performing other works in preparation of such agreements.
Relevant legislation	Law no. 289/2004 on the legal regime for credit contracts for individual consumers Law 148/2000 related to publicity Law no. 363/2007 (transposing Directive 2005/29/EC) on the protection of consumer economic interests from unfair business-to-consumer commercial practices (link).
Description	**General** Credit intermediaries are expressly regulated only in relation to their business activity on consumer credit. Other types of credit intermediaries are not subject to any similar legal requirements. §3 (1) Law no 289/2004 presents an exhaustive list of the types of credit for which this legislation does not apply. This list does not include personal (residential) mortgages, and therefore the Law applies to all personal consumer credit, including mortgages. **Entry requirements** Law 289/2004 establishes that, in order to operate, a credit intermediary must be licensed. However, steps have yet to be taken to implement this. Therefore, while credit institutions and non-banking financial institutions are authorised and supervised by the National Bank of Romania, credit intermediaries are not currently authorised by any authority. **Ongoing requirements** *Information disclosure* In any advertisement or offer of consumer credit which is displayed in a public place and includes interest rate or any other figures regarding the cost of the loan, must clearly state the APRC and observe the provisions of Law no. 363/2007 (which transposed Directive 2005/29/EC) that protects consumer economic interests from unfair business practices. Credit intermediaries are required to inform the consumer regarding any other cost related to the conclusion of credit

	contract, additional to the APRC. Prior to the conclusion of any distance contract for financial services, the supplier has to provide the consumer with correct, comprehensive information about its identity (i.e. the identity of the intermediary, its main business, all contact data, its registration number in trade register etc.). The consumer has the right to withdraw from the contract without penalty. *Information requests* Intermediaries must inform the consumer about the documentation necessary to the approval of credit. This must include: - current financial situation of consumer and any guarantor, - a description of the general method of guarantees for the payment of the total debt - a description of the conditions of credit, the value of credit, the APRC, the interest rate, the payment scheme and the scope for which the credit is sought. **Anti-money laundering compliance** Government Decision No.594/2008 was issued to approve the regulation for the enforcement of the provisions of Law No. 656/2002 (link) on preventing and sanctioning money laundering, as well as on measures to prevent and combat terrorism. The legislation requires intermediaries to apply the standard measure of knowing the client and to report suspicious transactions to The National Plenary Office of Prevention and Combat of Money Laundering (Plenul Oficiului National de Prevenire si Combatere a Spalarii Banilor).
Slovakia	
Information provided by:	National Bank of Slovakia; Ministry of Finance; Internal research
Relevant legislation	Proposed Act on Financial Intermediaries and Financial Consultancy (link). Currently there is no regulatory framework for credit intermediaries in Slovakia. All information here relates to this proposed law.
Description	**Proposed Act** At present there is no legislation regulating the business of credit intermediaries. However, a new law (the Act on Financial Intermediaries and Financial Consultancy) has been prepared by the Ministry of Finance (MoF) in cooperation with the National Bank of Slovakia (NBS), which will cover the regulation of credit intermediaries. This law was submitted by the MoF to the Government at the end of November 2008 for approval, and is supposed to be passed by the Parliament by the end of the year. It should be in place in 2009, although there are adjustment periods allowed for full compliance. **Definition** According to the proposed law, a credit intermediary falls under the category of financial intermediary. A financial *intermediary* (agent) provides services to an extent depending on his/her qualifications, and has a contract with one or more

	financial institutions. A financial *consultant* provides services based on a contract with a client. A financial intermediary will not be able to be a financial consultant at the same time. **Entry and ongoing requirements** The new Act will require financial intermediaries and consultants to register with the NBS. The Act will also specify necessary qualifications: there will be four levels of professional competence defined, with corresponding qualifications in terms of education and years of experience prescribed**.** **Self-regulation** The Association of Financial intermediaries and Financial consultants (AFISP) is formed of firms and individuals providing financial intermediation and consultancy services. Its members are subject to a Code of Conduct (link), which is to ensure: - high quality of service - observance of ethical standards - protection of clients in financial intermediation. *Penalties* AFISP established an ethical committee as a body responsible for the supervision of the compliance with the Code of Conduct. In case of an infringement of the Code by a member, the ethical committee may require improvement by the member, or may propose to AFISP's board the member's expulsion. Practices not in accordance with the Code may also be made public for client protection (link)
	Slovenia
Information provided by:	Banka Slovenije, Ministry of Finance; Internal Research
Local definition	The Consumer Credit Act (§2) identifies two kinds of intermediaries 'tied' and 'untied'. *Tied*: An intermediary working for a bank, defined as a natural or legal person, who within the framework of their activities, business or profession mediates in the conclusion of credit contracts for a bank/savings bank which has permission to provide consumer credits. *Untied*: An intermediary, defined as a natural or legal person, who within the framework of their activities, business or profession mediates in the conclusion of credit contracts within the framework of the activities of the creditor; an intermediary cannot do so in the name of the creditor, or if he is employed with the creditor.
Relevant legislation	Consumer Credit Act - 70/2000, 41/2004, 77/2004, 111/2007 (link); Regulation on the Conditions to be met by Credit Intermediaries (Official Gazette 28/2007) (link)

Description	Supervision
	The organisations that regulate credit intermediaries are the Bank of Slovenia, Ministry of the Economy and Consumer Protection Office. The supervision of intermediaries is the responsibility of the Market Inspectorate of Republic of Slovenia, who can demand access to existing contracts regarding credit (§25). **General requirements** Intermediaries have to act in accordance with the conditions set out by either the Bank of Slovenia (intermediaries working with banks/building societies) or the regulations of the Minister for Consumer Protection (§20). *Standardised presentation of key data to borrowers* Prior to the conclusion of the credit contract, the customer has to be informed about all conditions of the credit contract. *Compliance with advertising and marketing standards* A credit intermediary advertising or offering to obtain credit for a customer has to clearly outline the total costs, i.e. the APRC, and provide an easily understandable example of how the total cost of the credit can be calculated. *Compliance with money-laundering legislation* Intermediaries have to comply with the Money-laundering Act **Entry Requirements (tied)** A credit intermediary may perform intermediation services solely on the basis of the authorisation set out in a written agreement concluded with a bank. **Entry requirements (untied)** An intermediary requires an authorization within a written agreement concluded with the creditor. Also required is a written declaration by the creditor of the intermediary's status as such, to be issued when the agreement is concluded. **Ongoing Requirements (tied)** Every bank has to inform the Bank of Slovenia about the activities of its intermediaries. Any kind of loss suffered by the consumer due to an intermediary's actions is the shared responsibility of the bank and the intermediary. The intermediary must keep records of all the consumer credit orders carried out. *Disclosure to potential borrowers of ties to lenders*

	Before any act of intermediation on a consumer credit the intermediary must identify himself as being such with the written authorization of the bank, and the authorization must remain visible at the work place of such an intermediary. **Ongoing requirements (untied)** Before any act of intermediation on consumer credit the intermediary must identify himself as being such with the written declaration made by the creditor, and the authorization issued by the creditor must remain visible at the work place of such intermediary. The creditor must keep records of the transactions made by their intermediary. The creditor must also send a list of all the intermediaries they have worked with during the year to the Council for Consumer Protection of the Republic of Slovenia. **Restrictions** The Consumer Credit Act states that the consumer is not obliged to pay the intermediary for any kind of services or expenses. All payments to the intermediary are included in the total cost of the credit (§19). *Penalties:* If the consumer faces demands for such payments, the intermediary faces a fine of between €12,500 and €125,000 (Article 10 111/2007).
Spain	
Information provided by:	Banco de España; ADICAE; Instituto Nacional del Consumo
Local definition	In Spanish regulation only the concept of an agent of credit institutions is legally defined. An agent of credit institutions is a third party to which the institution has granted powers of attorney so that they may act on its behalf, vis-à-vis its customers, in the negotiation or conclusion of operations that are typical of the business of credit institutions. An agent may only represent one credit institution or one consolidated group of credit institutions. An agent can not represent or act on behalf the consumer. Agents of credit institutions may act in all kind of operations (except the execution of bank guarantees or other off-balance sheet exposure). Credit institutions are responsible for compliance with regulatory and disciplinary provisions in the acts performed by their agents.
Relevant legislation	Credit intermediaries are not supervised by the Bank of Spain at present. Credit intermediaries are subject to the legal and regulatory framework on consumer protection rather than the regulations that apply to financial institutions. The consumer laws that apply are *Real Decreto Legislativo* 1/2007 (reforming the text of the *Ley General para la Defensa de los Consumidores y Usuarios* – General Law for the Defence of Consumers and Users); and the Law 7/1995 referring to

	Consumer Credit. **New law** There is a new initiative presented in the Proyecto de Ley of 24 November 2008 that in due course is expected to be converted in a fully-fledged law. This law will relate directly to credit intermediaries. (link)
Description	This description relates to the new law that will be passed. **General** The new law would result in: - Wider protection to consumers in contracting with non-financial entities, in mortgage credit and in the consolidation of debt. - New obligations of transparency and informational requirements that companies engaging in this kind of activity will have to comply with. - Information to the consumer will have to include about all of the commissions, charges, and expenses arising from each contract. - Obligations for the companies to subscribe for, before the start of this activity, insurance for civil responsibility (compensation for damages) and to enrol in a register. - This will apply to firms engaging in credit intermediation that are currently not under the supervision of the Bank of Spain nor subject to the existing regulation for financial activities. **Definition** §1.1 specifies that the law will affect those firms which, on a professional basis, carry out intermediation activities aimed at the subscription of a loan or credit contract, by presenting, proposing or performing preparatory works and possibly the submission to the consumers of those contracts available for subscription. **Entry and ongoing requirements** The law establishes that intermediaries will be obliged to register in the public registry of the autonomous community they reside in, or in the State registry (that also collects all the information from autonomous communities) if they reside abroad. Those registries will be publicly and freely accessible (§3). It also establishes that intermediaries will have to subscribe with an authorized entity a “seguro de responsabilidad civil” (public liability insurance) or a bank guarantee covering the liabilities that may arise from consumer detriment deriving from intermediation activity; the specific amounts will be determined by royal decree (§7).

	Advertising standards The condition of being independent or tied is part of the information that must be communicated to consumers in intermediaries' commercial communications and advertisement (§19). *Obligation to source best product* Independent intermediaries will be obliged to select among products available in the market the most suitable with respect to the characteristics mentioned by the consumers, and to present at least three binding offers by credit institutions, while advising the consumer with regards to their legal and economic conditions. **Restrictions** Intermediaries working exclusively for one credit institution or other firm shall not receive any compensation from clients (§22).
Additional specific information	**Point of sale intermediaries** §1.1 of the new law specifies that providers of goods and services that act as intermediaries of credit related to their products are only subject to the obligations established under §22.5 of the law. This merely states that they shall give consumers the information required for the specific loan or credit contract proposed to the consumer. They would not be subject to the other obligations mentioned above (e.g. registering into public registries).
Sweden	
Information provided by:	Ministry of Justice and Ministry of Finance; Swedish Consumer Agency
Local definition	There is no specific definition of the term "credit intermediary" or "credit broker".
Relevant legislation	There is at present no specific legislation regarding credit intermediaries. The most applicable legislation in the consumer credit area regulates credit provision (and within this also credit intermediaries to a certain extent) in "Konsumentkreditlagen" — Consumer Credit Act (1992:830) (link) Also relevant is Act (1996:1006) on the obligation to register certain financial operations (link)
Description	**Entry Requirements** If the intermediary's main activity is credit intermediation the provisions above in the Act 1996:1006, obliging registration of certain financial operations concerning management and qualified holders, apply. According to the Ministry of Finance, a set standard of management ("fit and proper" test) is also required. **Ongoing Requirements**

	The Ministry of Finance states that a set standard of management ("fit and proper" test) is required. *Disclosure of information* Section 7 of the Consumer Credit Act (1992:830) states that before a credit agreement is concluded, the firm that provides or arranges the credit shall provide the consumer with information in the respect of and to the extent stated in Section 6. The information shall, according to the same Section, be provided in writing. *Compliance with advertising and marketing standards and disclosure of information* Section 6 of the Consumer Credit Act states that when advertising, displaying and with similar marketing in relation to credit, a business shall provide information concerning the effective interest for the credit. In a case of credit for the acquisition of particular goods, the provision of a service or other utility, Section 6 means that the credit cost and the cash price shall be stated as well. Information under Section 6 need not be provided if the credit relates to a sum of not more than SEK 1,500 (i.e. about €160), or if the credit must be repaid within three months. There are no other specific rules on marketing and advertising, but general rules in for the Marketing Act and the Consumer Credit Act (1992:830) apply. *Compliance with anti-money laundering legislation* The provisions aimed at preventing money laundering Act (1996:1006) create an obligation to register certain financial operations, and is also applicable to credit intermediaries if intermediation is the main business. **Self-regulation/code of conduct** The Finance Companies Association states its view of what "good practice" in finance is – this "good practice" differs across the types of financial services. So far, the Association has published ethical guidelines (FF 1), and statements of good practice on financial leasing terms (FF 2); in accounting for leases (FF 3 and FF4), and Consumer lease / lease private (FF 5). The statements are available on the association's homepage. (link)
Additional specific information	According to Section 2 of the Consumer Credit Act, "Cash price" means the price which the goods, service or other utility is normally offered to consumers for cash payment, "Credit cost" means the total sum of interest, additional costs and other charges which the consumer must pay for the credit and, finally, "Effective interest" means the credit cost expressed as annual interest calculated on the credit amount, having regard to any instalment payments to be made during the term of the credit period.
United Kingdom	
Information provided by:	Office of Fair Trading; Financial Services Authority

Local definition	The relevant legislation (the Consumer Credit Act 1974) does not define 'credit intermediary'. However, the Act specifies a number of activities that require a consumer credit licence if a firm or individual is to carry them out. The activities of relevance are described in section 145 of the Act under credit brokerage. Accordingly, credit brokerage is the effecting of introductions: - of individuals desiring to obtain credit, or - in the case of an individual desiring to obtain credit to finance the acquisition or provision of a dwelling occupied or to be occupied by himself or his relative, to any person carrying on a business in the course of which he provides credit secured on land, or - of individuals desiring to obtain goods on hire to persons carrying on businesses to which this paragraph applies, or - of individuals desiring to obtain credit, or to obtain goods on hire, to other credit-brokers. For mortgage intermediaries, legislation specifies particular activities for which a firm needs to be regulated. These are "advising on" or "arranging" a regulated mortgage, as defined in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).
Relevant legislation	Consumer Credit Act 1974 (link); Financial Services and Markets Act 2000 (Regulated Activities) (link) The FSA has committed to undertaking a broad review of the mortgage conduct of business regime, including the scope for moving towards a greater reliance on principles and other high-level rules.
Description	**General** The Consumer Credit Act states that such brokers as described in the definition require the same licence as other credit firms. The majority of regulation for credit intermediaries comes from the OFT (link). **Entry requirements** The OFT only issues a licence if satisfied that the applicant is a 'fit person' to hold one. It can take into account anything it considers relevant to a person's fitness, including past conduct and competence in relation to the nature of the credit activities applied for and the circumstances of the trader. Some credit activities are seen as more high risk than others - for example secured sub-prime broking and broking in the home - and applications for these are subject to greater scrutiny. **Ongoing requirements** Once licensed, the licensee must maintain the required standard of fitness. The OFT fitness guidance and NSLG (non-status lending guidelines) make clear that failure to disclose fees or commissions, or ties with lenders, or to take into account the suitability of the product to the borrower, may constitute unfair business practices and so may reflect on fitness to hold a

	credit licence. The general principles in paragraph 6 of NSLG apply to all lending and broking, not just secured non-status lending. These guidelines are based on the Consumer Credit Act, and outline the practices that brokers should adhere to if they do not want their licences brought into question. There are a number of general principles underlying these guidelines which translate into ongoing requirements. *General guidelines* There should be no high-pressure selling, and adequate time should be allowed for the borrower to reflect on the terms and conditions of the loan and to obtain independent advice before signing. Lenders should take all reasonable steps to ensure that brokers and other intermediaries regularly marketing their products do not engage in unfair business practices, or act unlawfully, and that they serve the best interests of the borrower. Contract terms and conditions should be fair, and should be written in plain English to ensure as far as possible that borrowers understand the nature of the loan agreement and their rights and responsibilities under it. There should be responsible lending, with all underwriting decisions subject to a proper assessment of the borrower’s ability to repay and taking full account of all relevant circumstances. *Disclosure of fee information and contract terms* There should be transparency in all dealings with potential and actual borrowers, with full and early disclosure and explanation of all contract terms and conditions and all fees and charges payable. Any ancillary charges (for example, on default or early settlement) should be brought to the attention of the borrower before the agreement is entered into and should reflect as closely as possible the costs reasonably incurred by the lender and not already recovered at the time when the charges are made. *Compliance with advertising standards* Advertising and other promotional material should not mislead, and there should be no cold-calling or canvassing off trade premises without the borrower’s prior consent. Section 151 of the CCA refers to regulations regarding the advertisement of business on the part of credit brokers: information must be clearly brought to the attention of the person to which the advert is directed, and must not contain any false information. *Disclosure of ties and commission* Brokers should disclose at the outset their status with regard to the borrower and the lender, and the extent of the service offered to the borrower. Brokers should disclose, both orally and in writing at the outset, the existence of any brokerage or other fees payable by the

	borrower. Brokers should disclose, both orally and in writing at an early stage, the existence and nature of any commission or other payment payable by the lender, and of any other reward available from the lender. **Exclusions** The obligation to provide pre-contract information, including on costs, rests with the creditor and not the credit broker. The creditor must ensure that the APRC takes into account any brokerage fee, where known or ascertainable, but there is no specific obligation on the broker to notify this to the consumer. The requirement to assess the suitability of the product for the borrower is only relevant where advice is given. The requirement to explain risks and/or other key data is a disclosure/information obligation rather than a duty to explain. There are rules on credit advertising, canvassing and circulars to minors, plus the Consumer Protection from Unfair Trading Regulations 2008 when they come in to force to replace s46 CCA. **Self regulation** The Association of Mortgage Intermediaries recommends the benchmark qualification for all financial advisors (including mortgage brokers and other credit intermediaries) as the Certificate in Financial Planning or equivalent. However, to show evidence of professional commitment, higher level exams are recommended. There are currently 38 advanced qualifications offered by eight examination awarding bodies. At the top is a Chartered Financial Planner, which may take up to four years to achieve. The National Association of Commercial Finance Brokers (NACFB) has a Code of Practice that require its members, among other things, to: - Give competent advice to clients, having first considered appropriate comparable products on their behalf - Not propose to a potential client terms and conditions for the provision of services which are anything other than fair and reasonable - Use all due diligence, and take such action as is necessary and appropriate, in protecting their clients' interests - Charge fees, commissions or other payments that are compatible with the prevailing terms of business normally applied in the industry. Client fees should not generally exceed 1 per cent of the gross advance (specified for buy-to-let mortgages) - Disclose in writing to the client on their request the lender's commission paid - Disclose in writing any existing conflict of interest or any circumstances that might give rise to conflict of interest - Disclose to his client all information material to the clients' loan agreement

	- Maintain a separately designated Client Account if he holds client monies - Conduct advertising in accordance with principles specified by prevailing legislation or nationally recognised advertising Codes - Maintain proper record for five years of all business undertaken on behalf of the client - Establish a complaints procedure that at least provides for a complaint to be made to the Association. *Penalties* This Code is voluntary. However, if a Member violates any of the regulations then formal disciplinary proceedings will take place. The Member may be cautioned, reprimanded, suspended or expelled from the Association.
Additional specific information	**Mortgages** The Financial Services Authority (UK FSA) has responsibility for residential mortgage regulation. Regulation does not apply if: - The intermediation is not done "by way of business", i.e. happens only very occasionally; or - The activity is limited to introducing the consumer to a regulated mortgage firm. In such cases, the introducer must disclose any business links or benefit obtained. *Entry Requirements* Mortgage-specific qualifications are not required in order to become a mortgage advisor. The available qualifications (such as CII Certificate in Mortgage Advice or the IFS Level 3 Certificate in Mortgage Advice and Practice) start from Level 3 (i.e. not entry level). Source: Financial Services Skills Council (link) According to the FSA, entry requirements also include a minimum capital adequacy requirement and a set standard of management (“fit and proper” test). *Ongoing Requirements* Additional information provided by the FSA indicates that in addition to ongoing requirements required of all credit intermediaries, mortgage brokers are requires to have defined procedures for handling complaints and redress, as well as a defined level of professional indemnity insurance. They are also required to comply with money-laundering legislation. The FSA also recommends the adoption of ‘Controlled Functions’ - allocation of key responsibilities for named individuals. **Business mortgages** Entry and ongoing requirements are similar to those for residential mortgage brokers. However, it must be noted that in relation to business mortgages, credit provided to incorporated bodies of persons, such as limited companies, is unregulated by the Consumer Credit Act. Only partnerships or other unincorporated bodies of persons, not those consisting entirely of

	bodies corporate, are covered, but borrowing or hire by partnerships of more than three members is not regulated. **Business finance** Credit provided to incorporated bodies of persons, such as limited companies, is unregulated by the Act. Only partnerships or other unincorporated bodies of persons, not those consisting entirely of bodies corporate, are covered, but borrowing or hire by partnerships of more than 3 members is not regulated.

APPENDIX 3: GLOSSARY OF ABBREVIATIONS AND TECHNICAL DEFINITIONS

Adverse selection	A market process in which only products of inferior quality are selected or traded (or no products are selected/trade at all) due to information asymmetries, i.e. the consumer has access to different information to the provider of the product
Affinity partnership	Formation of a strategic relationship with an external organisations in order to market and distribute a product
Agent	Frequently used as a synonym for (typically tied) credit intermediaries
AMI	Association of Mortgage Intermediaries
APRC	Annual Percentage Rate Change
Broker	Frequently used as a synonym for (typically independent) credit intermediaries
Bundling	Several products are offered for sale as one combined product
Business leasing	The process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of periodic contractual payments
Business mortgages	This is where a business or enterprise acts as the borrower for its own premises
Cannibalisation	A reduction in sales of one product as a result of the introduction of a new product by the same producer
CBFA	Commission Bancaire Financière et des Assurances
CC	UK Competition Commission
CCPA	Consumer Credit Protection Act
Consumer surplus	The amount that a consumer benefits by purchasing a product at a price that is less than the price they would be willing to pay.
Credit crunch	The sudden reduction in the general availability of credit
Double marginalisation	The exercise of market power at successive vertical layers in a supply chain
Economies of scale	Economies of scale are the cost advantages that a firm obtains due to increasing output.
FOS	Financial Ombudsman Scheme
FSA	Financial Services Authority
FTE	Full Time Equivalent. This concept translates part-time workers and those employees working only part-time on certain activities into their full-time equivalents
HHI	Herfindahl-Hirschman Index of concentration - the sum of squares of market shares, defined as percentages
Home Credit	Home credit lenders specialise in small-sum loans, the delivery and the repayment of which is typically conducted in the borrower’s home
IFA	Independent Financial Adviser
ILO	International Labour Organisation
IMLA	Intermediary Mortgage Lenders Association
LSE	London School of Economics
Market failure	The inefficient allocation of goods and services by a free market
Matching cost	The cost associated with potential trading partners “finding” each other

MCCB	Mortgage Code Compliance Board
Marginal cost	The change in total cost that arises from producing an additional unit
Moral hazard	Moral hazard arises when a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk.
Multi-tied intermediary	An intermediary that is contractually linked to more than one lender
NACFB	National Association of Commercial Finance Brokers
Nash-bargaining solution	A Nash equilibrium occurs when each player is pursuing their best possible strategy in the full knowledge of the strategies of all other players
Opportunity cost	The value of a product forgone to produce or obtain another product
POS	Point-of-sale
Personal lending	See unsecured fixed term loans
Pre-approved credit	A pre-approved limit to the amount of credit available to the borrower is set, for example credit cards
Price elasticity of demand	Measures the sensitivity of quantity demanded to changes in price; it is the ratio of percentage changes between quantity demanded of a good and changes in its price
Price elasticity of supply	As above, except it measures the responsiveness of the quantity supplied of product to a change in price of that product
Producer surplus	The amount that a producer benefits by selling a product at a market price that is higher than they would be willing to sell for.
Single-tied intermediary	An intermediary that is contractually linked to just one lender
SIOB	Syndicat des Intermédiaires en Opérations de Banque
Sunk cost	A fixed cost which cannot be recovered once it has been incurred
Tied intermediary	An intermediary that is contractually linked to (at least) one lender (see also single-tied and multi-tied intermediaries in this glossary)
UCCC	Uniform Consumer Credit Code
Unsecured fixed term loans	A loan which lasts for a certain period of time, in which the lender is not offered any security, guarantee or collateral
Vertical merger	A merger between firms operating at different levels of the value chain is defined as vertical merger