EUROPEAN BANKING AUTHORITY

BANKING STAKEHOLDER GROUP

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BSG own-initiative paper on non-bank lending

In February 2021, the EU Commission issued a Call for Advice to the ESAs. As part of that Call for Advice, the EBA received an additional request for technical advice regarding non-bank lending.

According to the mandate, the EBA shall;

- report on the business models and legal structures employed,
- identify any regulatory and supervisory issues that may impede, on the one hand, effective risk management at both a micro and macro level, and on the other, scaling up of services cross-border and
- assess to what extent these activities are not (sufficiently) covered by other EU legislation, such as the CCD and the MCD.

The EBA should advise on any potential need to adjust the EU regulatory perimeter especially taking into account of the potential for the scaling up of these types of lending activities in light of the deployment of innovative technologies, the national rules in place to regulate these activities and to what extent is the approach homogenous across Member States, uncovered issues/risks not addressed, considering also the actual or potential carrying out of the activities cross-border. The EBA should develop and propose policy options to address any identified issues.

The Banking Stakeholder Group wishes to contribute to the request by the EU Commission to the EBA by this own initiative paper.

In this paper we consider three different aspects of the regulatory perimeter:

- entities which appear to be completely outside the regulatory perimeter;
- entities which appear not to be subject to the full set of regulatory requirements to which other entities are subject;
- forms of credit which appear to be unregulated or insufficiently regulated which may be provided by entities within or outside the regulatory perimeter.

We have also taken into account the fact that the underlying driver for some regulation of lending by banks is the fact that such lending is financed by deposit-taking, which will not be (or should not be) the case for non-bank lenders.

Lending by financial intermediaries outside the pan-EU financial services perimeter

Business models and legal structures

Corporate credits by financing companies

In several Member States, financing companies that engage in factoring as their main business activity can (and do) also provide credits to corporates. While these are considered as financial institutions, they are often not required to hold a license for these activities. Instead they have to register with the local financial supervisory authority, which means that are not required to hold a licence with the entailed regulatory requirements and supervisory actions as opposed to credit institutions. Consideration should be given to whether the financing companies are engaging in maturity transformation or taking on unmanaged credit risk in a way that could potentially give rise to systemic risk and warrant an enhanced prudential regime.

Short-term credits

Some financial institutions, typically card acquirers and factoring companies, are offering short term credits to corporates, sometimes based on invoice lending or invoice purchasing, typically at fairly high interest rates taking into account the short duration of the credit.

Regulatory and supervisory issues

As noted by the EU Commission and others, the entry of new market participants in the extension of credits (as well as for other financial services) opens up for increased competition, new channels for credit and consequently more choice for consumers and corporates. At the same time, it has the potential to raise risks both for consumer protection and financial stability as financial services become increasingly supplied by market participants that are less, or not, regulated and supervised. It is important to consider whether the business models and funding mechanisms give rise to potential systemic risk and also whether regulators have sufficient data about the activities of such providers to establish whether this is the case and ensure that they are not straying into areas of activity that could also raise consumer protection concerns. In the question for regulators and supervisors is where to draw the line for when a Fintech becomes sufficiently big to warrant a more intense regulatory and supervisory framework.

EU legislation coverage

Over the last decade, the adoption and implementation of several EU directives and regulations in the financial services area have led to a more harmonised regulatory situation across the EU. Moreover, the adoption of the e.g. the Mortgage Credit Directive and the Consumer Credit Directive have closed important gaps as these activities were not sufficiently regulated in Member States before their adoption.

However, the activities of Big techs and fin techs are less, or not, covered by regulation and supervisory attention[1], thereby creating risks for consumer protection and, as smaller Fintech firms grow, financial

[1] See e.g. https://www.bis.org/fsi/publ/insights27.pdf

stability. There are in principle two ways to achieve this aim. Firstly by ensuring that a certain financial activity is covered by the same legislative and regulatory requirements and supervisory attention irrespective of who the provider is. Alternatively, regulators and supervisors would have to find a tailored, entity-based regulation and supervision for each of these companies, as they differ in business model and legal structure. This latter approach has been suggested by the Financial Stability Institute.[2]

The BSG takes the view that irrespective of which avenue EU regulators choose, there is a need to review the current regulatory and supervisory perimeter in order to address the current gaps.

The need to adjust the EU regulatory perimeter

The potential for scaling up

As noted in many reports by the Financial Stability Board, the Bank for International Settlements and the Financial Stability Institute at the BIS[3], the extension of credits outside the banking sector is growing globally and in the EU. In particular the Big Tech companies have several advantages to move into financial services; technical expertise, financial strength, large customer bases as well as detailed information on customer behavior and purchase patterns. Also Fintech companies, albeit small in start, have the potential to grow and become significant and important from a consumer protection and financial stability point of view. As the digitalization of financial services continues and grows, the potential for on-line selling of financial services increases by new market participants.

National rules

While adopted EU legislation has contributed to a more harmonised legislative field in the financial services area, national differences in implementation continue to exist, both in the national transposition of EU legislation and the national supervisors interpretation of the rules, leading to significant differences between Member States. In particular credit institutions with activities in several Member States have to comply with the respective legislative requirements in each of the countries in which they operate. This naturally leads to an increased administrative burden in the form of e.g. supervisory requests and investigations, system requirements and reporting requirements. The development of new structures for certain types of lending in specific EU jurisdictions can also lead to supervisors regulating through soft powers, in order to fill the gaps between different regulatory areas that are covered by EU legislation, see below under mortgage credits. There are also different levels of enforcement of the EU legislation in the Member States, especially regarding consumer protection.

‘Buy now, pay later’

New business models have emerged for consumer credit which are outside the regulatory perimeter even when offered by banks or other authorised financial services providers because of existing exemptions under the Consumer Credit Directive.

[2] See e.g. https://www.bis.org/fsi/fsipapers17.pdf

[3] See e.g. https://www.fsb.org/2019/12/bigtech-in-finance-market-developments-and-potential-financial-stability-implications/, https://www.fsb.org/wp-content/uploads/P140219.pdf, https://www.fsb.org/2020/12/global-monitoring-report-on-non-bank-financial-intermediation-2020/, https://www.bis.org/publ/arpdf/ar2019e3.pdf

A good example is the 'buy now, pay later' business model which has become prevalent in several member states. Consumers are offered the chance to defer payment, interest free, with the merchant paying a fee to the credit provider. This model falls within a CCD exemption for interest-free loans. However, it brings significant risks of over-indebtedness to consumers and relies on behavioural biases which may mitigate against consumers making decisions in their own best interest.

Consumer organisations in several member states have highlighted concerns about the implications of 'buy now, pay later' credit and consumers' experience of using it. For example:

- AK, Consumentenbond and vzbv received many consumer complaints about Klarna and Afterpay on the payment process. Arbeiterkammer received many complaints from consumers using Klarna which asked them to pay even if they did not receive the good or service and used debt collection agencies if the consumer refuses to pay.
- In Portugal, where some big entrants have recently started offering 'buy now, pay later' (BNPL), DECO has pointed out that while BNPL may provide some flexibility in repayments it still means having to repay; and flagged the importance of budgeting to ensure that accumulation of repayments in a specific period does not lead to over-indebtedness and inability to repay.
- In Romania, Consumers United and Association of Romanian Financial Services Users (AURSF) has expressed concern about the potential for over-indebtedness and lack of regulation of these services. In Romania, the BNPL system is mostly provided by banks, through the so-called "free-interest instalments" of their credit cards.

Concerns have also been raised about these services outside the EU. In the UK, Which? and Citizens Advice did consumer surveys on BNPL schemes. Which? found in a survey that 24% BNPL users spend more money than initially planned, 26% used BNPL because it was offered as a default option (pre-ticked box). Citizens Advice did a similar survey and found 26% have regretted using a BNPL product, 39% used it without realising, 42% didn't fully understand at least one part of what they were signing up for and 41% have struggled with making a repayment. A review of the market by the UK authorities concluded that BNPL should be brought within the scope of regulation.[4]

The BSG considers that there is a strong case for regulating this form of consumer credit within the EU as well.

Pay day lending and other forms of quick loans

A particular attention should be given to pay day loans and other forms of quick loans, mostly because of the very high costs of such credits for consumers. Another important aspect of such credits is that the most frequent victims of them are vulnerable consumers, especially those with low levels of income.

Some loans are designed in such way that most of their users are trapped in a cycle of never-ending loan debt, with huge interest rates[5]. For instance, in Romania there are providers charging an APR of more than 30.000% for such short-term credits. An in-depth study of consumer credit markets in Spain, Romania and Ireland, prepared by Finance Watch and published in 2021 showed that selling of payday

[4] https://www.fca.org.uk/publication/corporate/woolard-review-report.pdf

[5] The EU should tackle exploitative consumer loans head on | Finance Watch (finance-watch.org)

loans and revolving credits bear a number of worrying risks for consumers, marked by unreasonably high costs (APR). The study concluded that pre-contractual information often proves inadequate and that mis-selling of consumer credit are more prevalent in the online credit market and in cases where loans are sold by non-bank entities.[6]

Uncovered issues and risks

The BSG considers the principle of "same activity, same risks, same rules" as stated by the EU Commission in the Digital Finance Strategy as crucial. In this respect, the safeguarding of consumer protection and financial stability is key. The Call for advice has considered the lending provided by financial intermediaries outside the EU regulatory perimeter. However, the BSG believes that the provision of a financial activity should be regulated and supervised in the same way, irrespective of who the provider is, in order to safeguard consumer interests.

In this respect, there are significant differences in the regulatory demands and supervisory attention also between different types of financial institutions. The BSG would like to encourage the EBA to review the current regulatory and supervisory landscape also between different financial institutions offering the same financial service. Some examples are given in the following sections.

Mortgage credits

While mortgages provided by banks are subject to both the rules in the EU mortgage credit directive 2014/17 (MCD) and to the capital requirements for credit institutions, stipulated in the EU's capital adequacy regulatory framework (CRR/CRD), mortgages offered by non-credit institutions, as defined in the MCD are often obliged to follow only the rules in the MCD. Below, a description of how this has created level playing field issues in some EU markets.

In e.g. Sweden and the Netherlands, non-credit institutions usually set up their funding structure involving one or more Alternative Investment Funds, which can be subject to some minimum capital requirements, but not for the purpose of covering exposures to mortgage clients as if they were credit institutions. These capital requirements are negligible in a mortgage exposure risk context. The AIFs connected to the non-credit institution that are offering mortgages normally issues some form of debt instruments, which are in turn offered as investments to insurance companies and other institutional investors, in some cases in a way so that the insurance company or investor becomes the direct owner of the asset (mortgage), creating an exposure for the insurance company. These exposures of the insurance companies are subject to the requirements in the Solvency Directive. However, in several cases, the debt instruments are structured in a way so that the exposure of the investing insurance company benefits from a so called "look through approach", which in practice leads to that the capital requirement according to the EU Solvency Directive become insignificant for this exposure. The non-credit institutions are not subject to risk retention rules, and the capital requirement for credit risk for insurance companies when investing in mortgages is, in cases where the above-mentioned setup is used, is zero.

The possibility to create a setup to offer mortgages without having to hold capital for the credit risk exposure, by combining several "non-bank licenses" creates level playing field issues between non-credit institutions as defined in the MCD and traditional credit institutions offering mortgages funded by deposits or traditional bank bonds (covered bonds or senior bonds). If a credit institution (traditional

[6] Consumer credit market malpractices uncovered | Finance Watch (finance-watch.org)

bank offering mortgages) subject to the capital requirements in CRR/CRD would create a similar setup using e.g. an AIF, the activity of the AIF and of other licensed entities related to the creation of an alternative structure for offering mortgages, would be defined as ancillary services, and would be subject to the rules on consolidation in CRR/CRD. This would in turn lead to that those activities would need to be covered with capital in the same manner as if the mortgage lending was offered directly from the credit institution.

It is the view of the BSG, that, while insurance companies have a demand for long-term assets as their liabilities are long-term indicating that the capital charge for liquidity risk could be lower than for institutions with a banking license, the credit risk and the associated capital requirement should be the same irrespective of the type of financial institution holding the exposure on the balance sheet. Quoting directly from the call for advice: "In terms of level playing field concerns, under current rules, specific entities belonging to a banking group may face different requirements than those operating outside such a group due to the particularly strong policy imperative of ensuring the safety and soundness of banking groups and the banking system. Technology companies can provide financial services and compete with banking groups without the additional requirements coming from the consolidation rules. It needs to be analysed if this gives rise to level playing field issues and, if so, how these could be addressed."[7]

Notwithstanding the level playing field issue between credit institutions and non-credit institutions as defined in the MCD, the non-credit institutions' setup using AIFs for financing the mortgages can also lead to financial stability concerns from the point of view of the supervisory authorities overseeing these non-credit institutions. E.g. in Sweden, the Swedish Financial Supervisory Authority has decided to require non-credit institution mortgage providers which fund their activities on the capital markets, to match the duration of the debt issuance with the duration of the mortgages granted, in order to protect the borrower from the risk of not having their mortgages refinanced.[8] Quoting from the policy of the SFSA:

- "Consumer protection rules apply regardless of which party is the creditor".
- Investors in mortgages should be professionals with the ability to both assess the risks in the investment, including the credit risk associated with the mortgages, and make long-term commitments.
- The starting point is that the financing in a mortgage structure must have a fixed maturity of at least ten years. There may not be any conditions that allow investors to redeem the instruments earlier than ten years.
- The maturity profile of the financing should show good distribution over time.
- Market participants must continuously monitor and manage the liquidity risks in the structures and should assess other tools and arrangements that limit refinancing risks in more difficult market conditions.
- If a bank establishes a mortgage structure outside its group (hereafter referred to as peribank structures) that is not fully consolidated, the bank needs to assess and manage any flowback risks itself, for example within the framework of the bank's stress tests of capital and liquidity.

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[7] Excerpt from the European Commission's document "REQUEST TO EBA, EIOPA AND ESMA FOR TECHNICAL ADVICE ON DIGITAL FINANCE AND RELATED ISSUES" published on the European Commission's website on the 2nd of February 2021.

[8] For a full description of the SFSA's policy memorandum regarding mortgage-based business activities, see https://fi.se/en/published/important-pms-and-decisions/2019/fis-view-on-preconditions-for-mortgage-based-business-activities/

> [….] the category other market participants who issue or acquire mortgages is not subject to capital and liquidity requirements and other regulations that apply to banks. The requirement on longevity and robustness must therefore be met in some other way. FI makes the assessment that market participants can do this by limiting their refinancing risks through compliance with the preconditions specified above. This applies regardless of whether a mortgage structure is owned by a newcomer or a bank."

Consumer credits

With the introduction of the consumer credit directive, regulatory requirements were placed on providers on such services. The BSG takes the view that this was an important step from a consumer protection point of view. However, there still exist significant differences in requirements depending on which type of institution provides the credit to the consumer. The growth of so called "quick loans" and "buy now, pay later" credits, as discussed above, give rise to risks to consumer protection and over-indebtedness.

Crowd-funding platforms

Crowd-funding platforms is a relatively new channel, also for lending to consumers and corporates. The current legislation does not sufficiently address consumer protection issues, particularly in the cases when non-professional investors invest in lending-based or equity-based crowd funding platforms.

In the view of BSG, regulation, regulatory requirements should be altered and supervisory attention assured to fully safeguard the best interest of consumers and small corporates.

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